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INVESTMENT TRUSTS AND INVESTMENT COMPANIES

LETTER

FROM THE

CHAIRMAN OF THE SECURITIES AND EXCHANGE COMMISSION

TRANSMITTING, PURSUANT TO LAW, A REPORT ON

INVESTMENT TRUSTS IN GREAT BRITAIN

June 28, 1939.—Referred to the Committee on Interstate and Foreign Commerce and ordered to be printed

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LETTER OF TRANSMITTAL

SECURITIES AND EXCHANGE COMMISSION,
Washington, D. C., June 26, 1939.

SIR: I have the honor to transmit herewith a Report on Investment Trusts in Great Britain which supplements the Commission's over-all report on its study of investment trusts and investment companies made pursuant to Section 30 of the Public Utility Holding Company Act of 1935. This report was prepared in London, England, for the Commission by two economists, Dr. Thomas Balogh and Dr. Ernest Doblin; and the material and opinions contained therein are solely those of the authors. The Commission transmits this report, as prepared by the authors except for typographical and other changes of a minor nature, as a document which is relevant to its over-all report on investment trusts and investment companies in this country, and as one of a series of supplemental reports to be transmitted to the Congress by the Commission on special phases of its study.

Part One, Part Two, and Chapter I and all but one section of Chapter II of Part Three of the over-all report have heretofore been transmitted by the Commission to the Congress. Part One, which was transmitted by the Commission to the Seventy-fifth Congress on June 10, 1938, consists of a discussion of the nature, classification, and origins of investment trusts and investment companies, and has been printed as House Document No. 707, Seventy-fifth Congress. Part Two, the transmission of which to the Seventy-sixth Congress was completed on March 10, 1939, consists of a statistical survey of investment trusts and investment companies, and has been ordered printed as House Document No. 70, Seventy-sixth Congress. Part Three, of which the most recent section was transmitted to the Seventy-sixth Congress on June 14, 1939, deals with the abuses and deficiences in the organization and operation of investment trusts and investment companies, and has been ordered printed as House Document No. 279, Seventy-sixth Congress.

By direction of the Commission.

JEROME N. FRANK, *Chairman.*

The PRESIDENT OF THE SENATE.
The SPEAKER OF THE HOUSE OF REPRESENTATIVES.

INVESTMENT TRUSTS IN GREAT BRITAIN

PREFACE

This report on investment trusts in Great Britain was prepared in London for the Commission by Dr. Thomas Balogh and Dr. Ernest Doblin. It covers (1) management investment trusts, which broadly correspond to the Commission's category of management investment companies proper, and (2) so-called unit trusts, which resemble in many ways the fixed and semifixed trusts and, in certain respects, the open-end investment companies in the United States. The report does not include the British finance companies, which have some of the aspects of certain types of investment-holding companies in this country. In general, the material in the report does not relate to the period after the autumn of 1936, although in certain instances the authors have referred to later developments.

The Commission submits this report as prepared by the authors except for typographical and other changes of a minor nature; and any facts cited or any opinions expressed in the report are therefore solely those of the authors.

Thomas Balogh, Ph. D. (Econ.) is honorary lecturer at University College, London, and engaged in economic research in London, and was for a number of years economist with one of the larger investment banking and brokerage houses in that city.

Ernest Doblin, Ph. D. (Econ.) is the author of various books and articles on the problems of monopoly, international finance, and British economic problems. He was formerly assistant at the Institute for Research in Monetary Economics (Berlin), and research assistant at the London School of Economics.

TABLE OF CONTENTS

LIST OF TABLES

CHAPTER I

THE DEVELOPMENT OF MANAGEMENT INVESTMENT COMPANIES IN GREAT BRITAIN [1]

1. SUMMARY

It is not quite certain when the first British investment trust was created. The year 1863 is often mentioned as the starting point of the movement because the International Finance Society was organized in that year with the financial assistance of the Credit Mobilier of Paris. While the International Finance Society became an investment trust only in the later stages of its development, the Foreign and Colonial Government Trust, organized in 1868, adopted from the beginning the policy of spreading investment risks over a great number of securities and to that extent may be regarded as the first investment trust in Great Britain. There is no doubt, however, that the institution of investment trusts gained a solid footing in the 70's, when about 50 companies were organized for the purpose of diversified investment in securities. Quite a number of reasons have been given for the sudden growth of this new form of investing capital at just this moment: increasing distribution of wealth; the tendency of the average British capitalist not to invest his whole property in his business, but to keep a certain portion in reserve; the legal system and the institution of the "limited" company; an active Stock Exchange, and, in consequence of the low yield on British Governmental and other domestic gilt-edged securities, a special interest for foreign investments. It was especially this last point which made the investment trust, expert in the markets for foreign securities from the beginning of its existence, an important factor in the British capital market.

The organization of new investment trusts has been confined to a considerable degree to three rather short periods. Although it is true that from the beginning of the 80's scarcely a year elapsed without a new investment trust being created, nearly 70 percent of the total of all management investment trusts now in existence were founded either in 1887–90, or in 1909–14, or in 1927–29. All these were years either of the later phases of business recovery or of boom. (Practically all fixed trusts have been organized since 1932, i. e., during the current recovery.)

The close relation between the organization of new investment trusts and the course of the business cycle in Great Britain is graphically brought out in Table 1. (An index of the volume of production of capital goods has been used to represent cyclical fluctuations in business.) It will be seen that during the 50 years covered by the table there has been a marked parallelism between the course of the business cycle and the intensity of the formation of new investment

[1] This report is based primarily on the original balance sheets of British investment trusts and information collected in London. The investment trust supplements of *The Economist* and Dr. Hanns Linhardt's book, Die Britischen Investment Trusts, Berlin (1935), furnished valuable material for the study.

trusts. Years with a large number of investment trust organizations are almost always years in which the index of business is at or near a peak. Every period of prosperity in business has been accompanied by a wave of new investment trusts.

The first period, 1887–90, constituted an upward break in the long depression which prevailed during the last third of the nineteenth century. At that time an added incentive was furnished to the development of investment trusts by the Goschen conversion of the 3 percent Consols into 2¾ percent in 1888–89 which seemed to make a switch to investments with higher yields advisable to some groups of capitalists. Since investment trust debentures and preference shares then offered a yield of about 4 percent, they assumed increasing importance, although largely unknown before, and in 1889–90 accounted for one-seventh of total issues on the London market. In 1890, however, the difficulties of the private banking firm of Baring Brothers marked the beginning of a prolonged economic depression in Great Britain, which was accompanied by a shrinkage of the demand for investment trust shares and debentures. Table 2 indicates that a total of about £75,000,000 ($365,000,000)—then a very considerable sum—was raised by investment trusts during this first period of active and extensive distribution:

TABLE 1.—*Investment trust share prices, formation of new investment trusts, industrial share prices, and production*

Year	A. Index of investment trust ordinary shares	B. Index of British industrial ordinary shares	C. Production index (capital goods)	D. Registration of investment trusts in existence, 1935
1887	91.8	85.2	52.0	5
1888	100.0	87.9	57.2	9
1889	100.1	99.8	62.0	14
1890	100.0	100.0	60.9	4
1891	77.5	97.9	59.4	1
1892	70.0	96.7	57.3	1
1893	56.8	97.7	55.0	2
1894	45.5	101.0	59.9	----------
1895	51.5	111.5	60.7	1
1896	48.0	134.5	65.8	1
1897	47.3	148.9	67.5	3
1898	50.7	148.1	68.7	2
1899	55.0	152.0	72.6	2
1900	52.0	150.1	73.3	1
1901	55.5	142.3	71.3	1
1902	59.9	139.7	73.4	3
1903	61.0	136.4	74.6	1
1904	59.7	128.6	74.6	1
1905	70.1	136.4	80.1	1
1906	80.2	138.4	84.3	1
1907	78.1	135.9	84.4	3
1908	79.5	127.7	77.1	2
1909	84.1	127.2	80.1	5
1910	90.0	138.1	84.7	7
1911	99.0	144.6	87.4	3
1912	100.2	144.4	85.8	4
1913	111.0	142.5	100.0	4
1914	109.0	140.4	91.9	4
1915	67.9	143	87.3	----------
1916	77.6	152	89.3	----------
1917	70.5	171	89.6	----------
1918	79.9	205	87.0	----------

TABLE 1.—*Investment trust share prices, formation of new investment trusts, industrial share prices, and production*—Continued

Year	A. Index of investment trust ordinary shares	B. Index of British industrial ordinary shares	C. Production index (capital goods)	D. Registration of investment trusts in existence, 1935
1919	86.1	241	85.2	
1920	87.4	242	90.6	
1921	82.1	165	57.2	
1922	88.4	188	72.5	2
1923	114.8	231	88.8	2
1924	124.0	228	94.4	11
1925	147.9	252	89.0	7
1926	165.7	266	66.4	11
1927	181.0	288	106.1	15
1928	213.2	329	98.0	24
1929	191	323	113.4	15
1930	161	201	103.8	3
1931	133	203	86.4	2
1932	118	191	98.5	
1933	108	240	103.0	
1934	115	280	118.0	
1935	127	313	125.5	2

Sources for the various columns are as follows:
A. 1887–1928, own index; 1929-35, actuaries index.
B. London & Cambridge Index (London and Cambridge Economic Service Special Memorandum No. 47.—An index number of securities).
C. 27 industries, Weltwirtschaftliches Archiv, 1934.
D. The Economist.

TABLE 2.—*New capital issues in London* [a], *1887–92*

[In millions of pounds]

Year	Total issues	Investment trusts
1887	111.2	3.5
1888	160.3	9.3
1889	207.0	30.0
1890	142.6	21.0
1891	104.6	9.0
1892	81.1	2.3

[a] The Economist Supplement, Commercial History and Review of 1893, Feb. 17, 1894, p. 6.

The second period of active investment trust promotion likewise took place during the ascending part of a business cycle. After the adjustments following the collapse of extensive copper speculation in 1907, and widespread strikes and lock-outs in 1908, revival started in 1909 and ushered in a period of rising stock exchange values and general prosperity. One of the chief activities of the British investment trusts at that time was the purchase of North American stocks, especially railway securities. This period was brought to an end by the Great War.

The last promotion of management investment trusts began shortly after the war. Between 1922 and 1931 no less than 95 investment trusts were created—54 in the years 1927–29—partly by way of "second" and "third" companies formed to supplement old-established trusts and partly in the form of new organizations, often with the participation of the private banks, which had previously shown little interest in this field. The capital raised from 1923 to 1931 can be estimated at about £120 million.[2] Since the capital of all investment trusts at the beginning of that period totaled from £150 to £160 million, the capital invested in investment trust securities increased by about 75 to 80 percent during this period.

Improving business activity since 1933 has not witnessed a fresh tendency toward the creation of management investment trusts for depreciation in the market value of the existing trusts' portfolio and the loss of income have greatly delayed the recovery of investment trust dividends and share prices. Only two investment trusts, properly so-called, have been formed in the recent period of market activity. In July 1935, the Cables Investment Trust was organized in order to acquire investments in Cable and Wireless (Holding), Ltd., for £7,000,000, the proceeds being used to repay a part of the preference stocks of that company. Some £3,000,000 redeemable debenture stock and £2,000,000 preference shares were issued to the public, while £2,000,000 common shares were subscribed by the parent company. There were, therefore, special circumstances in the formation of this trust. The other new management trust, the Green Friars Investment Co. (registered December 1935) was a subsidiary of the Witan Investment Co., and had a capitalization of £750,000 in common shares only.

The interest of the investing public and of promoters has been centered almost exclusively on the fixed and flexible unit trusts, which had a forgotten predecessor in London 60 years ago. The fixed trust was first introduced in 1931, in imitation of American practice. Neither in the total number nor in the extent of its controlled resources has the fixed trust movement attained the dimensions of the investment trust companies. As of July 1936 there were more than 70 unit trusts in existence whose sales have been estimated at about one-fifth of the total investments of the management trusts.

The movement up to now has gone through only one period of general recovery and more or less uninterrupted rise of stock exchange values. It is, therefore, at the present time impossible to pass judgment on the behavior of the English unit trusts in the course of a full cycle. The first fixed trust was launched in 1931 about one year after the subunits of some American trusts were placed in London. It was not before the middle of 1933 that the strong psychological resistance against this new type of securities was overcome. The number of registrations of unit trusts rose from 1 in 1931 to 2 and 5 in 1932 and 1933 and then jumped to 24 in 1934, decreased to 21 in 1935 and to 17 in 1936. Of the 72 unit trusts in existence at the middle of 1937, 39 are rigidly fixed, 12 are fixed with flexible provisions, and 21 are practically management trusts very similar to the American open-end management companies.

The amount of unit trust sales can only be estimated, for sales data are generally regarded as secret, although the National Group, apparently the largest concern which has sponsored almost a dozen unit trusts, claimed, at the end of 1935, sales of over £16,000,000 and 55,000 unit holders on its books. An estimate of The Economist,

[2] £85,000,000 for 1923–28 according to statistics of The Economist for January 5, 1929, p. 25, and about £35,000,000 for 1922 and 1929–31.

based on information from all but one group, suggested a figure of net sales of £45,800,000 at the end of 1935 compared with £20,750,000 a year earlier. An estimate of £50,000,000 for the spring of 1936 was confirmed by the Board of Trade Committee's Report and in February 1937 the total sales were estimated by The Economist at £71 millions.

The most remarkable change in the structure of the unit trusts since their introduction in 1931 has been the growing tendency to "flexibility." The first trusts (whose pattern was borrowed from the United States) were "fixed" in the full sense of the word and represented a reaction against the experience of unfortunate or mismanaged investment trusts of the management type. As the movement developed the emphasis on the advantages of rigid portfolios became smaller. Now the movement has made a full circle. Almost all trusts formed since 1935 are of the fully flexible type.

Very roughly, five steps can be distinguished in this development to more or less complete flexibility. The first was rigid fixity, moderated only by the possibility of eliminating individual securities in cases of emergency. The second step consisted in giving power to the managers to reinvest the proceeds of these eliminations in other securities. This was followed in the third step by the managed trust of the unit type, where managers were free to choose the investments from a predetermined permitted list. Later trusts, as a fourth step, allowed the managers to add a certain percentage of new companies per annum to the original permitted list. Finally, almost complete liberty from restrictions was provided making the permitted list very broad and, in addition, giving the power to invest, under certain conditions, in securities not on the list.

In 1937 the unit trust movement entered a new phase which, if continued would be the final one. Beginning in June 1937 a few unit trusts—five until the end of October [3]—offered to their subunit holders the opportunity to convert their certificates into shares of newly formed management investment trusts of the ordinary limited liability types.[4] It appears that, roughly speaking, about one-half of the subunit holders have exercised the option of conversion offered to them.

The fixed trust management groups retain an interest in the fortunes of the managed companies, since they provide secretarial services and carry out transactions in securities on the instructions of the new investment trust boards. They make indirectly available the proportion of the original loading charge applicable to the subunits which have been converted towards the management expenses of the new trust companies. The personnel of the new trust companies is to some extent drawn from existing figures in the investment trust movement. Although this new feature in the unit trust movement has not as yet reached more than an experimental stage, the impression is growing that more of the unit trusts of the old fixed type may take an opportunity in the future to offer similar conversion opportunities to their subunit holders.

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[3] The series of unit trust certificates for which such offers of conversion have been made are: British Empire Fixed Trust, Series A, Series B, Cumulative Series and Comprehensive Series; National Trust, Series A.

[4] A similar tendency—conversion of fixed trust certificates into shares of open-end management investment companies—has been observed in the United States since about 1932.

2. THE EARLY HISTORY OF BRITISH INVESTMENT TRUSTS

The first period of the investment trust movement—the late eighties—was, on the whole, unsuccessful in showing the wisdom of creating investment institutions with the purpose of earning a relatively high return on capital while spreading risks through geographical and individual diversification on a wide range of securities. Nearly all the mistakes which could have been made were, in fact, exemplified during that period.

Portfolios were purchased at high prices. Of the £65,000,000 of stocks and debentures issued by investment trusts between 1887 and 1890, more than £50,000,000 were offered in 1889–90, when stock exchange quotations were near their peak.[5] New issues found a very favorable market, and the rapid advance in prices, even before the collapse, made it impossible to obtain a yield of over 3½ percent. Some newly created trusts found it difficult in 1888–89 to find suitable investments at all. On the whole, the list of eligible securities was so small that speculative over-valuation was further exaggerated by the purchase for account of investment trusts. The limitation of the choice of securities, however, was due less to an actual lack of opportunities than to personal factors. The same persons reappeared on the boards of a large number of new trusts, and tended to direct their investments into much the same channels in every case. The low level of prevailing yields tempted the managements to acquire a certain percentage of decidedly risky securities, not quoted on an exchange and without a market in time of danger. Most of the trusts further endeavored to offset a decline in earnings from dividends and interest by participating in outside banking and underwriting operations.

The dangers were aggravated by the limitations of the investments of certain trusts to small issues of securities in one or a few industries which did not allow them to distribute the risk sufficiently. Even before the general crash, heavy losses were revealed in some trusts specializing in railway investments.

The institution of "founders' shares"—a practice not restricted to investment trusts—tended to direct directors' policy in directions often not compatible with the interest of the majority of share holders. "Founders' shares" usually had a claim on a high percentage of the earnings after deduction of a certain minimum dividend on the paid-in capital. The directors, being mostly identical with the founders, therefore, had every inducement to leave a large part of the regular shares only partly paid since such policy often increased the profit accruing to the founders' shares. A contemporary list of sixteen prominent companies shows that of an ordinary issued capital of £13,800,000 only £4,000,000 was paid up. The trust managers also tried to obtain excessive earnings in a single year, even at the risk of disproportionately small profits in the next year, since such surplus in the "good" year went to the founders, while the subsequent deficit and loss had to be borne by the remaining shareholders. An example of the results of the tremendous leverage inherent in founders' shares is provided by the Debenture Corporation where at one time £200 of founders' shares had a market value of £300,000.

[5] An unweighted price index of 7 important securities shows the following values for the years 1887–93 (1886=100): 98, 101, 107, 101, 96, 91, 81. Securities included: Bank of England common; Great Western Railway common; Central Pacific; Canadian Pacific bonds; Portuguese 3's; Argentine 5's; Chile 4½'s.

Activities in fields other than long-term investment proved costly. The increasing business activity of the late 1880's was accompanied by large profits from new flotations. Some investment trusts were, as was said in those days, "practically promoting and underwriting agencies in disguise." No income accounts were published, from which the distribution of receipts from different sources can be deduced, but it was known that promoting and underwriting were much the most profitable activities of many trusts.[6] It may be added that underwriting was a more or less irregular business without firm legal sanction up to the end of the century, and the rate of profit was correspondingly high. After the Baring crash, these profits ceased, but the companies were burdened with the nonmarketable securities they had to take up in ventures which did not appeal to security buyers.

3. FROM THE BARING CRASH TO THE WORLD WAR

It is largely due to the lessons learned from the losses of the nineties that, right up to the outbreak of war, no similar collapse occurred. The crisis of 1907–8 cannot be compared in the intensity of its effects on investment trusts with the Baring crisis. One of the chief reasons for the relative stability of investment trusts is that in the meantime a fairly clear separation had occurred between investment trusts, on the one hand, and financial companies which develop new industries or firms by taking over their issues and nursing them pending their absorption by the market. Further, the financial situation of the foreign countries in which British investment trusts had heavy investments—the United States, the British Dominions, and South America—had made great progress since the eighties. The crisis of 1907 therefore produced no serious difficulties for the trusts and the war alone interrupted their progress. Even during the war they suffered far less than in the eighties, though in its first year most companies reduced their dividends. The most interesting wartime feature was the change which occurred in the distribution of investments. In order to support the sterling exchange, the British Treasury mobilized large amounts of American and other foreign securities, of which the investment trusts were large holders. In part, these securities were lent on special terms, which increased the income of the investment trusts; a more substantial portion was purchased outright by the Government. The trusts were consequently in a position to reinvest in a time of relatively low prices for domestic securities and to switch from American stocks, which included a number of nondividend payers, to investments giving a higher yield.

4. THE POST-WAR PERIOD

The post-war period in Great Britain was, in general, one of prolonged stagnation (Table 3) with a limited amount of recovery in 1927–29 and a stronger upward movement from 1933. In addition to the promotion of new investment trusts on a considerable scale during the twenties, the issued capital of the existing companies in-

[6] See The Economist, August 9, 1890, p. 1,016.

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creased rapidly. As a result of this development the total capital placed in investment trusts moved sharply upward, most of the increase taking the form of common shares. There was also an appreciation in the book value of investments in all trusts—an increase of more than 60 percent between 1923 and 1928. This increase was accompanied by a change in the regional distribution of investment, which became directed to the European continent. Both the expansion of capitalization during this period and the direction which it took have been shown by subsequent events to have been unfortunate.

TABLE 3.—*Investment trust issues in London, 1923–28*

[In thousands of pounds]

	1923	1924	1925	1926	1927	1928
Common shares	3, 651	8, 294	7, 808	14, 237	12, 142	23, 276
Preference shares	17	20	1, 669	771	1, 014	2, 284
Debentures	962	—	1, 322	302	1, 793	5, 890
Total	4, 630	8, 314	10, 799	15, 310	14, 949	31, 450

Data compiled from The Economist, Jan. 5, 1929, p. 25. For the total amount in investment trust issues from 1922 to 1931, see note [a] to Table 2.

The management investment trusts passed through this latest crisis in their history with heavy capital losses and extensive reduction in dividends. In only a few cases, however, was reorganization, and in not a single case was liquidation, found necessary or advisable. The Midland Caledonian Investment Trust was compelled to reduce its capital to write off a loss of £400,000 on realization account. The Clyde and Mersey Trust, under the pressure of unusually high bank debts, underwent a reorganization in 1934, after having ceased preference dividend payments in 1931. Several other companies suffered heavy losses on the sales of securities; the Independent Investment, e. g., which set out to take advantage of changes in monetary and investment conditions over the world, and to benefit from rising American security prices, was seriously affected by the Wall Street collapse in 1929 and the devaluation of the dollar in 1933.

An idea of the extent to which individual trusts were affected by the difficulties of this period may be obtained by considering the extent to which common dividends were passed in 1933, the worst year (Table 4). In that year only seven pre-war trusts, holding not more than 3 percent of the value of the total investments in the group, had to pass the dividend on their common shares. Among the post-war companies, however, the proportion of companies without dividends was well over one-third, representing about 40 percent of their total resources. Those companies which had been organized at the end of the boom suffered most; 17 of the 25 firms registered in 1928 and 9 of the 15 registered in 1929 did not earn enough to pay common dividends in 1933. The weakness of the younger trusts was due mainly to the high prices at which their investments had been purchased.

5. THE PERFORMANCE OF BRITISH MANAGEMENT INVESTMENT TRUSTS

The claim of the investment trusts to have administered the national savings in better and more secure fashion than the average investor over a long period does not seem to be fully justified by the facts. Neither the course of profits, nor the movement of capital values, affords conclusive evidence in favor of the investment trusts.

(*a*) *Earnings.*—Table 5 compares the trend of earnings of British industrial and mercantile corporations during the period from 1913 to 1935 with that of British investment trusts based on the annual net profits of all companies' balance sheets published in the first quarter of each year as recorded in the statistics of The Economist.

TABLE 4.—*Nondividend-paying investment trusts, 1933* [a]

	Number	Total number of companies in group	Book value	Total book value of companies in group
			(Millions of pounds)	*(Millions of pounds)*
Pre-war English trusts	4	58	3.6	127.0
Pre-war Scottish trusts	3	36	2.7	81.5
Post-war English trusts	26	65	24.8	76.5
Post-war Scottish trusts	24	38	27.5	47.3

[a] Data compiled from The Economist Investment Trust Supplement, Dec. 1, 1934, pp. 18–23.

Investment trust earnings are for obvious reasons affected by the up and downward movement of the business cycle, although a time lag of one year or more of investment trust earnings behind industrial earnings is usual. In the rather short crisis of 1921, however, trusts and industrial concerns showed decreasing profits during the same year. The losses of industrial and mercantile companies were far larger than the reduction in the earnings of investment trusts but were compensated by the following year's recovery. Investment trusts were unaffected by the fall in profits in industrials in 1926, the year of the general strike. In the whole predepression period (1922–29) the trend of profits was more favorable for investment trusts than for British industrial or mercantile corporations. During the depression period from 1930 to 1933, however, the relationship was reversed. From 1931 onward the percentage decline in investment trust earnings exceeded the corresponding percentage for general industrial concerns in the preceding year, i. e., after making rough allowances for the time lag. The trusts have participated only slowly in the improvement in earnings since 1933.

Divided into four stages, the comparative development of earnings shows the following features: From the outbreak of the war up to 1925 the profits rose for the industrial concerns 168 percent; for the trusts only 51 percent. The next period (1925–29) brought some compensation for the trusts with an increase in the earnings of 55 percent against 14 percent in the industrial group. From the peak of the boom to the bottom of the crisis (1932) the trusts' profits fell 33 percent; industrial profits 26 percent. In the recovery (1932–35) the industrial concerns regained 39 percent, the trusts, however, only 7 percent.

TABLE 5.—*British corporation profits, 1914–35*

[Amounts in millions of pounds]

Year	Industrial and mercantile companies			Investment trusts [a]			Chain index of profits 1913=100 [b]	
	Number of companies [c]	Profits	Profits previous year	Number of investment trust companies [b]	Profits	Profits previous year	Industrial and mercantile companies	Investment trust companies
1914	254	18.8	18.2	39	2.35	2.22	103	106
1915	245	21.5	17.8	41	2.01	2.27	132	95
1916	227	21.7	19.2	36	1.89	1.92	150	94
1917	320	26.1	26.3	27	1.25	1.25	149	94
1918	407	33.8	30.1	29	1.52	1.51	167	95
1919	469	42.4	34.1	31	1.58	1.49	207	100
1920	378	41.6	40.3	34	1.75	1.57	214	112
1921	408	25.3	45.7	34	1.49	1.62	148	103
1922	374	38.7	72.0	31	1.55	1.47	212	108
1923	386	38.4	35.3	33	2.13	1.86	230	124
1924	391	42.9	39.4	34	2.41	2.19	250	136
1925	424	49.1	45.7	36	2.60	2.34	268	161
1926	483	49.3	51.8	37	2.98	2.66	256	168
1927	463	58.2	50.5	41	3.52	3.10	294	190
1928	386	34.1	33.2	26	1.99	1.81	302	209
1929	456	55.1	56.5	60	4.95	4.42	306	234
1930	526	62.4	70.6	70	5.32	5.21	274	238
1931	486	49.9	58.2	62	4.39	5.17	244	207
1932	500	48.4	52.6	62	3.67	4.51	226	176
1933	478	52.5	49.1	69	3.28	3.78	241	155
1934	522	64.1	55.8	70	3.00	2.79	277	166
1935	569	75.7	66.8	72	3.47	3.07	314	188

[a] Including some financial trusts.
[b] As the number of companies varies from year to year, each profit figure is compared with the profit of the same companies in the preceding year; the chained percentages of the annual increase and decrease in the profits of identical companies give a fair picture of the development of profits during the last quarter of a century.
[c] Companies reporting in first quarter of following year. Data compiled from material given in The Economist in the first quarter of each year during the period 1914–35.

Secondly, the claim of steadier income, so far as it was justified, was also offset by smaller earnings. An original investment in the average of industrial companies producing £100 in 1913 would have earned almost 50 percent more during the period than an investment producing originally the same sum from investment trust securities.

(*b*) *Stock prices.*—It is difficult owing to the lack of material on investment trust stock prices to compare the course of prices of investment trust shares over long periods with that of the published indexes of general security prices. Moreover, any comparison with an index of industrial shares (such as that published by the London and Cambridge Economic Service) must take into account the differences between the composition of that index and the nature of investment trust portfolios with their considerable proportions of fixed interest and foreign securities. Up to the war home industrials did not figure largely in British investment trust portfolios, and even today the total proportion represented by British, as opposed to overseas investments, is, on the average, less than 50 percent of the whole.

The index of common (ordinary or deferred) stocks of investment trusts given in Table 1 is based on a varying number of stocks [7] (beginning with 7 in 1887, and including 22 stocks since 1905), the quotations of which are combined as arithmetical averages. This very simple index is intended to serve as a rough guide only.

The movement of the investment trust common stocks differs somewhat from that of the industrial common stocks. The course of the general business cycle in Great Britain shows, after a period of moderate prosperity, a panic in 1890 followed by five years of depression, and a revival beginning in 1896, and ending in a new depression in 1902. The next prosperity period, after 1904, was interrupted by the repercussion of the American crisis of 1907 on the English economic situation. Business activity, however, increased steadily, with the exception of a recession late in 1913 and 1914, from 1909 until after the end of the war. The post-war period was characterized by a continued dullness after the break-down in 1920–21 and a certain revival in the second half of the 1920's. The crash in 1929 led, soon after the departure from the gold standard, to a new period of growing prosperity.

On this background the industrial shares went through four great cycles, the maxima being in 1890, 1899, 1920, 1928, with minor peaks in 1906 and 1912—on the whole corresponding to the line of development of the general business. The prices of investment trust common stocks behaved somewhat differently. They did not follow the upward movement of the industrials in the nineties owing to the abovementioned distrust of the public toward the trusts. From the end of the century until the outbreak of the war they showed an appreciation. They suffered in the war more heavily than the industrials, but on the other hand they were scarcely affected by the first post-war crisis. Again they lost more after the 1929 break-down and gained less in the following revival than the industrials. The maxima of these three great cycles in the period reviewed are in 1889, 1913, and 1928. In comparing the two indexes it should be borne in mind, however, that the investment trust index is based on the shares of pre-war companies with rather high leverage, which tends to exaggerate the difference

[7] List of British investment companies whose stocks are included in the index of investment trust security prices:

INVESTMENT TRUST (COMMON STOCK)	*In the index since—*
American Trust Co	1887
Foreign, American and General Investment Trust Co	1887
Foreign and Colonial Investment Trust Co	1887
Globe Telegraph & Trust Co	1887
Government Stock and Other Securities Investment Co	1887
Mercantile Investment and General Trust Co	1887
Railway Debentures and General Trust Co	1887
United States and South American Investment Trust Co	1888
Army and Navy Investment Trust Co	1889
Investment Trust Corporation	1889
River Plate and General Investment Trust Co	1890
British Steamship Investment Trust	1891
Bankers Investment Trust	1891
British Investment Trust	1891
Edinburgh Investment Trust	1891
Industrial and General Trust	1891
London Trust Co	1891
Merchants Trust	1891
International Investment	1894
Guardian Investment Trust Co	1900
Dominion Investment Co	1900
Metropolitan Trust Co	1905

between the movement of industrial share quotations in general compared with that of a group of investment trust common shares. It is impossible to say which investment—a theoretical "fixed trust" consisting of investment trust shares or another of industrial shares—would have been more profitable for investors. Much depends upon the period of comparison and the selection of the underlying shares made. The narrow base on which the investment trust index is calculated—necessitated by the length of the period covered—indicates that the comparison attempted here should not be pressed too far. It affords prima facie evidence, however, in support of the view that the claim of the British investment trusts to provide a steady appreciation for their shareholders is not unchallengeable and that the appreciation, when it occurred, has often been smaller than that experienced by the holder of British industrial shares.

CHAPTER II

LEGAL AND VOLUNTARY REGULATIONS

1. THE COMPANY LAW

No special legislation on investment trusts and no legal regulation of investment trust practices exist. Investment trusts, however, have to follow the general rules of the company law.

The public limited company, which is compelled to publish an annual report is the common legal form for investment trusts, although a few financial trusts have the form of private companies. A small group of cooperative investment trusts is registered under the Industrial Provident Societies Acts.

The operations of each investment trust are defined by the Memorandum and Articles of Association adopted under the Companies Act. The Memorandum is the legal basis of the company in its relations to the outside world. It deals with the name of the company, the registration, the capital, the limitation of the liability, and the objects of the company. The description of the activities is of importance since in English law transactions of a type not covered by the Memorandum are null and void. The statement affirmatively determines what shall be the power of the company and limits and restricts the action of the company to the powers thus conferred (except insofar as other powers are given by statute). In order to avoid future complicated changes, the objects clause in the Memorandum of investment trusts usually covers a rather wide range of activities.

The Articles of Association contain regulations for the management of the affairs of the company. They are controlled by and are subordinate to the Memorandum. They deal with the allotment of shares by the directors, transfer of shares, increase in the reduction of capital, general meetings of the directors, dividends and reserve funds, accounts and audits, notices, winding up provisions, and so forth.

The Articles of Association of the British investment trusts are usually very voluminous documents sometimes containing about 150 printed pages. The differences from trust to trust as to their material content, however, are remarkably small. Most of the articles, in particular those of the younger companies, include provisions concerning the split ratio of new issued share capital (see infra). The long-term borrowing power is generally limited to the amount of the share capital; the maximum amount of short-term indebtedness is also occasionally fixed by the articles. The powers of the board of directors usually are considerable, whereas the influence of the shareholders is restricted to the decisions on questions of vital importance to the company (such as the balance sheet and income accounts, payment of dividends, the election of directors, and changes in capitalization). As a general rule the directors are allowed to transfer some of their rights to the managing directors.

British company law regulates to a considerable extent the methods used in the issue of new capital. It requires on such occasions a very detailed statement of the financial situation of the company, the provisions on this point having been made more stringent with each revision of the company law. According to the law as it stands since 1929, the prospectus required for every public offering of securities must state among other things the content of the Memorandum and must contain particulars of the capital structure and voting rights, and of the directors (names, remuneration, number of shares for qualification, etc.), minimum subscription, addresses of vendors and amount payable to each, underwriting commission, estimate of preliminary expenses, amounts paid to promoters, all material contracts not made in the ordinary course of the business during the last two years, the interest of directors and promoters in promotion and auditor's report on the profits and dividends of the last three years.

2. REGULATIONS OF THE LONDON STOCK EXCHANGE

Independent of these requirements of the Companies Act, the London Stock Exchange authorities set their own conditions before granting permission to deal in an issue. Again no special provision seems to exist with reference to investment trust securities. The general rules were not very definite until 1931, but have been made rather strict since then. They provide for a copy of the prospectus and of all contracts mentioned in the prospectus, a description of the shares and the method by which they have been or are to be issued (for cash, to vendors, in pursuance of an option), a statement of the number of shares for which permission to deal is now applied for, underwriting commissions, trustee for debentures, and a list of allottees or present holders. Regulation of investment trust practices, apart from the correct issue of new capital, is beyond the power of the stock exchange authorities.

3. TAXATION

Investment trusts, in general, are subject to the same taxation obligations as all corporations. They, therefore, pay a tax of 25 percent on all income, except dividends received from another corporation subject to British income tax. Capital gains are not subject to the tax if allotted to a capital reserve which may not be used later for the payment of dividends but is restricted to the purpose of offsetting past or future capital losses; if retained as general reserve, capital gains are taxed exactly as if they were distributed, i. e., at the present time (1937) at the rate of 25 percent. Investors receiving dividends from investment trusts may deduct the 25 percent paid by the trust from their personal income-tax liability.

4. INVESTMENT TRUST ASSOCIATIONS

Voluntary associations of investment trusts do not seem to be of importance. The Association of Investment Trusts is not a cartel in the continental sense, but a protective organization on the lines of the Corporation of Foreign Bondholders.

CHAPTER III

SIZE AND GROUPING OF INVESTMENT TRUSTS

1. NUMBER, SIZE, AND AGE OF BRITISH MANAGEMENT INVESTMENT TRUSTS

The number of public investment trusts, broadly so-called, is now about 210 against about 70 at the beginning of the century and about 110 in 1920. This total includes, however, certain finance trusts and specialized trusts operating in a narrow group of securities. If these finance and specialized trusts are eliminated for proper comparative purposes, the total is reduced slightly, to 199. Almost one-half—94 trusts—are of pre-war origin, and account for 58 percent of the paid-up capital of all the trusts. The remaining 105 trusts were formed in the post-war period, including a dozen trusts which were incorporated before 1919, but whose original activities were in a specialized field of finance, such, e. g., as the mortgage business.

This change from a specialized finance to a general investment business has been noticeable particularly in some Scottish trusts. On the whole, the origins of the Scottish and English investment trusts are somewhat different. In London, from the beginning the movement was associated to some extent with the banking and stock exchange community, although certain accounting firms played an important part in its development. In Scotland the promoters of investment trusts were frequently smaller merchants and, at a later stage, accountants and lawyers. The shareholders of Scottish trusts are still fairly localized, and the personal ties between the trust management and the shareholders are often strongly pronounced. For 25 years from the Baring crisis to the beginning of the Great War, the number of investment trust registrations in Scotland was larger than in England. After the War, expansion in London made far greater progress, so that today its predominance is attested by the existence of 125 trusts out of the total of 199, and by the command over about 62 percent of the total capital raised by all management investment trusts.

The usual size of an investment trust, measured by the balance sheet total, lies between £500,000 and £3,000,000 but nearly one-third of all trusts have total assets between £1,000,000 and £1,500,000 (Table 6).

The older companies are naturally equipped with larger funds than the average, owing to successive capital increases. The £4,000,000 line is crossed only by pre-war trusts, except for Cables Investment Trust, which was formed in 1935. The trusts registered in 1929–35 are almost completely concentrated in the two columns below £1.5 million, whereas the post-war generation (1919–28) on the whole is fairly widespread over all size groups except the largest class of over £4,000,000 total amounts.

TABLE 6.—*Age and size of 199 British management investment trusts,*[a] *1935*

Registered in—	Balance sheet totals (in millions of pounds)							
	Less than 0.5	0.5 to 1.0	1.0 to 1.5	1.5 to 2	2 to 3	3 to 4	Over 4	Total
1863–78			1		3		1	5
1879–88	1	1	7	3	6	7	5	30
1889–98	1	3	10	2	3	2	8	29
1899–1908	1	4	3	5	5			18
1909–18	5	6	7	3	3	3		27
1919–28	6	14	19	16	10	3		68
1929–35	2	7	11		1		1	22
Total	16	35	58	29	31	15	15	199

[a] Data compiled from balance sheets.

2. INVESTMENT TRUST GROUPS

A considerable number of investment trusts are associated in groups. This, however, does not involve dependency upon the same banking house as sponsor or underwriter but usually takes the form of a common or partly common management. Such groups are managed by the same leading personalities, although their offices may vary in different trusts; thus, the manager of one trust may be the secretary of an associated trust. Joint management is to a certain extent evident from the more or less similar composition of the boards of directors in a number of all the companies. There were 452 individuals on the boards of directors of 199 investment trusts examined, seven of them occupying ten or more seats and 171 more occupying two to nine seats, leaving but 275 individuals with one seat only (Table 7).

TABLE 7.—*Distribution of directorates in British investment trusts, 1935*

Number of directorates per person	1	2	3	4	5	6	7	8	9	10	11	12	13	14
Persons	275	75	40	21	14	6	4	6	5	1	1	1	2	2
Total number of directorates	275	150	120	84	70	36	28	48	45	10	11	12	26	28

If the presence, on a board, of a director who holds a similar position with another investment trust, were regarded as an indication of group membership, hardly a trust could be called "independent." If, however, the term "group" is understood to comprise only a number of trusts with a substantially similar board, nine larger groups can be distinguished. A tenth group may be added, under the management of the accountant firm of Graham's, Rintoul, Hay & Bell, of Glasgow, where the boards of directors are composed of different individuals. Again, another "group" under R. Fleming & Co. is controlled, not by directorships, but through the firm acting as secretary to the constituent trusts. Altogether these 11 groups include 100 trusts with a share and debenture capital of £180,000,000 or about 60 percent of the whole capital invested in investment trusts. The capital controlled by a group appears to vary from about £9,000,000 to £25,000,000 (Table 8).

TABLE 8.—*British investment trust groups and their capital, 1935*

[In millions of pounds]

Group	Capital
"VISCOUNT ST. DAVIDS" GROUP	
City and Foreign Investment Trust, Ltd	0.4
Consolidated Trust, Ltd	1.4
Foreign Railways Investment Trust, Ltd	3.0
Government & General Investment Co., Ltd	.3
Government Stock and other Securities Investment Co., Ltd	2.1
International Financial Society, Ltd	1.0
London and Overseas Investment Co., Ltd	.5
National Dominion & General	.3
New York & General Trust, Ltd	1.2
Municipal Trust Co., Ltd	.8
Omnium Investment Co., Ltd	2.5
Premier Investment Co., Ltd	3.0
Second Consolidated Trust, Ltd	2.0
Union Commercial Investment Co., Ltd	1.1
Colonial Securities Trust Co., Ltd	.5
London Maritime Investment Co., Ltd	1.0
Total	21.1
Viscount St. Davids, director of South American railway companies.	
"GRAHAM'S, RINTOUL, HAY, BELL" GROUP	
Glasgow Stockholders Trust, Ltd	1.4
Scottish National Trust Co., Ltd	2.0
Second Scottish National Trust Co., Ltd	1.5
Third Scottish National Trust, Co., Ltd	1.5
Anglo Scottish Investment Trust, Ltd	1.0
London and Lomond Investment Trust, Ltd	1.2
London & Strathclyde Trust, Ltd	.9
Total	9.5
"INDUSTRIAL & GENERAL" GROUP	
Cedar Investment Trust, Ltd	1.0
City National	.2
Continental Union Trust Co., Ltd	1.2
Industrial & General Trust, Ltd	6.0
Second Industrial Trust, Ltd	1.7
Sphere Investment Trust, Ltd	1.5
Trust Union, Ltd	1.3
Trustees' Corporation, Ltd	2.8
Debenture Corporation, Ltd	3.2
Total	18.9
A. Touche & Co., London, chartered accountants.	
"ROBERT BENSON" GROUP	
English and New York Trust Co., Ltd	1.4
Merchants Trust, Ltd	3.3
"ROBERT BENSON" GROUP—continued	
Traction and General Investment Trust, Ltd	2.0
Charter Trust & Agency, Ltd	1.3
Investment Trust Corporation, Ltd	7.1
Metropolitan Trust Co., Ltd	2.5
United States and General Trust Corporation, Ltd	2.7
Total	20.3
Robert Benson & Co., merchant bankers and investment trust managers.	
"LAYTON-BENNETT" GROUP	
Coldstream Investment Trust, Ltd	0.5
Pentland Investment Trust, Ltd	.9
London Scottish Investment Trust, Ltd	.9
English & Caledonian	.9
Scottish Investment Trust Co., Ltd	3.0
Second Scottish Investment Trust Co., Ltd	4.4
United States Trust Co. of Scotland, Ltd	1.0
Total	11.6
Layton-Bennett, Chiene & Tait, Edinburgh, chartered accountants.	
"BAILLIE & GIFFORD" GROUP	
Scottish Mortgage and Trust Co., Ltd	3.3
Second Scottish Mortgage and Trust Co., Ltd	1.3
Edinburgh and Dundee Investment Co., Ltd	2.4
Second Edinburgh & Dundee Investment Co., Ltd	1.3
Scottish Capital Investment Co., Ltd	2.0
Scottish Central Investment Trust, Ltd	2.0
Abbotts Investment Trust, Ltd	.9
Friars Investment Trust, Ltd	1.5
Monks Investment Trust, Ltd	1.0
Total	15.7
Baillie & Gifford, Edinburgh.	
"STOCKHOLDERS" GROUP	
Lake View Investment Trust, Ltd	1.8
Southern Stockholders Investment Trust, Ltd	1.5
London Stockholders Investment Trust, Ltd	.7
Scottish Stockholders Investment Trust, Ltd	.9
Stockholders Investment Trust, Ltd	1.4
London Border & General Trust, Ltd	2.4

TABLE 8.—*British investment trust groups and their capital, 1935*—Continued

[In millions of pounds]

Group	Capital
"STOCKHOLDERS" GROUP—continued	
Alliance Investment Co., Ltd	1.3
American Investment and General Trust Co., Ltd	3.5
Foreign American and General Investments Trust Co., Ltd	3.5
Foreign and Colonial Investment Trust Co., Ltd	3.0
Total	20.0
"SIR MILES MATTINSON" GROUP	
London and Colonial Investment Corporation, Ltd	.3
London and New York Investment Corporation, Ltd	1.0
New Investment Co., Ltd	.3
Mercantile Investment & General Trust Co., Ltd	6.5
Second Mercantile Trust, Ltd	1.6
Imperial Colonial Finance & Agency Corporation, Ltd	.3
United States and South American Investment Trust Co., Ltd	1.9
Brewery and Commercial Investment Trust Co., Ltd	.4
London General Investment Trust, Ltd	1.1
Total	13.4
Sir Miles Mattinson, K. G.	
"MOODY STEWART & ROBINSON" GROUP	
First Scottish American Trust Co., Ltd	1.1
Second Scottish American Trust Co., Ltd	1.3
Third Scottish American Trust Co., Ltd	1.3
Northern American Trust Co., Ltd	3.3
Cemperdown	1.5
British Canadian Trust, Ltd	.6
Total	9.1
Moody Stewart & Robinson Dundee, connected with Robert Fleming.	

Group	Capital
"SHEPHERD" GROUP	
Anglo-American Debenture Corporation, Ltd	2.0
Railway Debenture and General Trust Co., Ltd	2.6
Railway Share Trust and Agency Co., Ltd	2.1
American Trust Co., Ltd	1.6
Second American Trust Co., Ltd	1.4
Investors Mortgage Security Co., Ltd	3.3
Second Investors Mortgage Security Co., Ltd	2.9
Scottish Cities Investment Trust, Ltd	.7
Total	16.6
Shepherd & Wedderbrun, Edinburgh.	
"FLEMING" GROUP	
Clydesdale Investment Co., Ltd	2.0
Second Clydesdale Investment Co., Ltd	.9
Caledonian Trust Co., Ltd	2.2
Second Caledonian Trust Co., Ltd	1.0
Third Caledonian Trust Co., Ltd	1.0
Scottish Western Investment Co., Ltd	2.1
Second Scottish Western Investment Co., Ltd	2.0
Third Scottish Western Investment Co., Ltd	1.4
London and Hollyrood Trust, Ltd	2.5
London and Provincial Trust, Ltd	1.4
London & Clydesdale Trust, Ltd	1.2
Capital and National Trust, Ltd	1.0
Railway & General Investment Trust, Ltd	1.0
British Steamship Investment Trust, Ltd	4.2
Second British Steamship Trust, Ltd	.9
Total	24.8
Brown, Fleming & Murray, chartered accountants; R. Fleming & Co., merchant bankers.	

Sources: Company reports—London Stock Exchange Yearbook 1935 and Linhardt, Hanns, *Die Britischen Investment Trusts* (1935), pp. 77–118.

Interconnections go still further. First certain connections are found whereby some directors appear in more than one group. The important influence of Robert Fleming & Co., in particular, is exerted in this way, through directorates in the St. Davids and Poole-Touche groups.[1] Secondly, some group directors are on the board of companies outside the group. According to Linhardt, 18 individual directors in 1928 were connected by directorates and influence on groups with at least 90 trusts, with a total capital of almost £150,000,-

[1] According to Linhardt (Die Britischen Investment Trusts (1935), p. 118) R. Fleming & Co. is estimated to exert an influence in some form or another on companies with more than £110,000,000 total assets.

000. Thirdly, only the big groups have been covered in this analysis. In addition, small groups were formed by the organization of "second" and "third" trusts. For example, the British Assets Trust created the Second British Assets Trusts, etc. From this point of view about two-thirds of the total investment trusts' capital seems to be organized in a relatively small number—about two dozen—of groups. The point must not be over-emphasized, for the degree of control within a group is often very small.

These investment trust groups were formed by organic growth, not by the purchase of control of existing trusts. It has proved easier to use the same amount of money which would be necessary to purchase a controlling interest in an investment trust in promoting a new trust, the portfolio of which can be arranged according to the ideas of the founders. The normal way by which a group is formed, therefore, is successive promotion by the same founders. Often the name of the firm indicates this process, e. g., Guardian Investment Trust, Second Guardian, Third Guardian; 1st, 2d, 3d, Scottish American Trust. To some extent, this process may be regarded as an increase of capital in disguise. The Great Northern Trust (organized 1924) established the Home & Foreign Investment Trust (1926) which two years later started the London & Strathclyde Trust Co. and the Anglo-Scottish Investment Trust.

Certain advantages attach to the creation of new trusts, instead of an increase in the capital of existing trusts. For instance, the capacity of the market for issues of an existing trust is in practice often limited. Securities of new associated companies have a special appeal to the investor. The regulations in the articles of association can be varied in a new trust according to new requirements. Investment policy can also be varied to suit the general lines of the trust group's policy. The special interests and ideas of individual directors, which are overlooked in one big trust, can be adopted by individual firms in a group. At the same time larger amounts of securities than an isolated firm would usually care to take over can be held by the constituents of a group. Finally, the question of directors' fees is of some importance, for their remuneration increases automatically with every new directorship and, therefore, contributes to some extent toward the formation of new companies.

The nucleus of the groups may be accountants or a legal firm, specializing in the supervision of investment trusts,[2] or in the business of acting as secretaries to investment trusts.

The participation of investment banking houses in the formation of investment trust groups is small and that of brokerage houses nonexistent. J. Henry Schroeder & Co. is interested in one or two trusts, M. Samuel & Co. in two other trusts, Helbert Wagg & Co. in several trusts, which do not form groups in the sense defined above.[3] Among the big groups, R. Fleming & Co. and R. Benson only are directly connected with banking. The firm of R. Fleming began the work as issuing house before the War specializing in American railways. In the later stages, this part of the activities was neglected in favor of investment trust management, although some security issues are still made.

[2] Some well-known accounting firms which appear as auditors for a number of investment trusts (e. g. Price, Waterhouse & Co., Deloitte Plender Griffiths & Co., etc.) are, of course, not associated with the management of the trusts concerned.

[3] The general outline of the relation of bankers to investment trusts is discussed in the following chapter.

CHAPTER IV

INVESTMENT TRUSTS AND BANKS

The associations between investment trusts and banks, and bankers, may range from the use of bank credits to the complete control of a trust by a banker.

The amount of bank credit used by the investment trusts is usually relatively small; the average is about 2 percent of the investments. However, since 1931 some investment trusts have made rather greater use of bank credit. This method of financing is not without objection, but apart from its limited use, the recovery in security prices during recent years would have prevented any difficulties arising from the use of bank credit.

Some trusts, when the depression came, were burdened with bank loans representing more than 20 percent of the balance sheet total, e. g., British & German Trust, East of Scotland Trust, Edinburgh Investment Trust, Scottish Eastern Investment Trust, Second Caledonian Trust, Third Scottish Western Trust. The Clyde & Mersey Investment Trust, registered in 1929 even has a bank debt of four-fifths of the share capital. Several companies which were reorganized after the crisis showed a very high proportion of bank advances. Midland Caledonian Investment Trust sold securities over a considerable period in order to reduce a bank overdraft, no part of the balance being funded until 1934. The Second Great Northern Investment Trust also had to sell large blocks of securities in 1933 at heavy losses in order to decrease its indebtedness to the bank.

Usually investment trusts have only one bank connection and scarcely ever more than three. Their bank credits are of short-term character, at least normally. As new issues can be made only at certain intervals, short credit may be used to take advantage of attractive investment opportunities which would be missed if surplus funds had already been placed in long-term investments. The bank loans can be repaid from the proceeds of sales of other securities by the investment trusts or from the proceeds of a new issue of its own securities. (The bank, of course, does not take any of the securities which are issued in repayment of the loan.) Some trusts, for instance the British Assets Trust, adopt this method of purchasing new securities before issuing new capital as a regular policy. A difference exists, however, between the older and younger trusts, since the latter, though prepared to use more loans, have a less favorable credit status than the older trusts. For about one-half of the trusts, the articles of association contain no clause limiting the raising of short-term credits. The maximum borrowing power permitted is usually based on a percentage of the share capital, 10 percent and 20 percent being the favorite ratios. In less frequent cases, the upper limit is determined by share capital, plus reserves (10 to 25 percent) or plus debentures (10 percent) or by the total amount of the reserves, or by a fixed sum as £50,000 or £100,000. The older companies do not, as a rule, impose a limit on bank loans.

In addition to normal short-term borrowings more intimate connections sometimes exist between the investment trusts and other financial institutions.

It is usual to contrast the British, on the one hand, and the American, and particularly the continental system, on the other by emphasizing the strict specialization in London, where most financial institutions confine themselves to a limited field. The functions of the private banker are usually two-fold, financing foreign trade and issuing securities, mainly consisting of foreign loans. Indeed, the complete mixture of all kinds of banking transactions, characteristic of the Continent, is absent in Great Britain. The traditional view, however, is too simple to be true. In reality, some merchant bankers, in extending their interests beyond their normal domain, effectively control certain investment trusts.

The original business of the merchant bankers suffered by the fall in world trade and restrictions on the issue of foreign loans. Their general influence, however, always went much further than the size of their capital figures would indicate, partly because of their privileged eligibility as directors of the Bank of England and partly by their interest in certain investing institutions. Many merchant-banking houses are interested in a more or less affiliated trust, which may be willing to take over a somewhat larger proportion of any issues which the connected banking house sponsors than might be the case if such issues were made independently.

To get a true idea of such mutual connections it must be remembered that the number of trusts of all types in London is somewhat larger than the 200 concerns which have diversified portfolios. This total does not include trusts with specialized financial activities, like issuing securities or dealing in stocks and shares, mortgage business, etc. The relations between private banks and such specialized financial trusts, however, seem to be closer than for the investment trusts proper. They do, nevertheless, exist between the banks and certain British investment trusts, although the majority of the Scottish trusts are independent.

The first method of elucidating such connections is by examining the published address of the trust's bankers. In most cases, one or possibly two joint-stock banks are employed by the trusts. About a dozen firms, however, have private bankers in addition, as will be seen from the second column of the table below. A private banking connection of this kind is not necessarily proof of control by the bank but it does give some prima facie indication that an affiliation may exist. The second test is the appearance of partners of a private banking firm on the board of an investment trust. The third column of the table below indicates the banking firms whose partners or directors appear on the boards of any of the 200 investment trusts. The table thus shows the trusts with banking and directorate affiliations and also those trusts with directorate affiliations only. It will be noticed that representatives of more than one banking concern are on the board of the same investment trust company in several instances.

Connections between bankers and investment trusts in Great Britain [a]

Investment trusts	Current bank connections	Representation on board
Ailsa Investment Trust	Morgan Grenfell & Co	
British & German Trust	Helbert Wagg & Co	Helbert Wagg & Co. (twice).
City & International Trust	Erlangers, Ltd	Erlangers, Ltd.
Compass Investment Trust	S. Japhet & Co	S. Japhet & Co. (3 times).
Continental & Industrial	J. Henry Schroeder & Co	J. Henry Schroeder & Co. Guinness, Mahon & Co.
English & International	do	J. Henry Schroeder & Co. Dawnay Day & Co. Ed. de Stein.
General Consolidated	Erlangers Ltd	Guinness, Mahon & Co.
Grange Trust	Morgan Grenfell & Co	
Mid-European Trust	Hambros Bank	Ed. de Stein. Dawnay Day & Co.
1928 Investment Trust	M. Samuel & Co	M. Samuel & Co.
1929 Investment Trust	do	Do. Helbert Wagg & Co.
Trans-Oceanic Trust	Helbert Wagg & Co	Do.
Winterbottom Trust		
Anglo-Celtic Trust	Morgan Grenfell & Co	Goschen & Cunliffe. Higginson & Co.
Second Anglo-Celtic Trust		Goschen & Cunliffe. Higginson & Co.
Hambros Trust		Hambros Bank.
Charter Trust & Agency		S. Japhet & Co. Robert Benson & Co.
U. S. & General		S. Japhet & Co.
Mercantile Investment & General		Lazard Bros. & Co.
Second Mercantile Investment & General.		Do.
Hellenic & General		Helbert Wagg & Co. Erlangers, Ltd.
Independent		Helbert Wagg & Co. O. T. Falk.
London & Lomond		Helbert Wagg & Co.
British Combined Investors		Do.
Investment Trust Corporation		Higginson & Co. (twice). Robert Benson & Co.
General & Commercial		Higginson & Co.
London & Provincial		Do.
St. Andrew Trust		Do.
London & Holyrood		M. Samuel & Co.
Sterling Trust		Erlangers, Ltd.
City & International		Erlangers, Ltd. (3 times).
London Scottish American		Brown, Shipley & Co.
Second London Scottish American		Do.
Merchant Trust		Robert Benson & Co.
Great Northern Investment Trust		Do

[a] Information secured from annual reports.

There appear to be about 35 trusts with banking connections, usually evidenced by directors. The special position of the banking firm of R. Fleming & Co., which is associated with a further dozen companies by secretaryship, was discussed in Chapter III. In about 50 instances (the Fleming concerns included), some 16 investment-banking houses appear to be associated, among them several leading London issuing houses. The 50 trusts have about one-quarter of the total book assets of the 200 trusts examined. Excluding the Fleming trusts the proportion of trusts with investment banking relationships amounts to about 20 percent of the number and about 20 percent of the assets of all investment trusts. Further connections may exist, for the list is representative; rather selective than inclusive. Such connections, however, are not ascertainable by this method.

No statistics are available concerning those trusts which have a specialized financial business. The frontiers here are very vague. Their connections with bankers are probably more intimate, and the companies themselves are sometimes little more than issuing and underwriting institutions working on behalf of the banker.

The next table, in the first part, shows the links between banking houses listed in "Bankers Almanac" and, in the second part, of other banking and financial concerns and the boards of investment and financial trusts. It includes all the cases shown in the previous table. Mere representation on the board of directors must not be regarded as a proof of control of the trusts. It must be assumed, however, that banking interest, if not actual control, exists over a fairly large field in the trust movement. Hardly any private bank lacks some connection with an investment trust. In the aggregate about 20 banking firms have representatives on the board of more than 60 investment trusts (excluding R. Fleming & Co., about 50 trusts). In about a dozen instances banking firms are represented by two directors in the same trust, two instances by three, and in one by four directors.

Bankers	Investment trusts
Goschens & Cunliffe	Anglo-Celtic Trust (chairman); Second Anglo-Celtic Trust (chairman).
Grace Bros. & Co	Cumbre Trust, Ltd.
Guinness, Mahon & Co	Continental & Industrial; British & Foreign-Electro Trust, Ltd. (twice); London United Trust, Ltd.
Hambros Bank	Hambros Trust.
S. Japhet & Co	Compass Investment Trust (3 times); Chartered Trust & Agency-London Foreign Colonial; U. S. & General.
Kleinwort Sons & Co	Drake Trust (4 times).
Lazard Bros. & Co	Mercantile Investment & General Trust; Second Mercantile; Whitehall Trust (4 times).
Baring Bros	Bankers Industrial Development Co.; British & German Trust; Hellenic & General; 1929 Investment Trust; Independent Investment Trust; London & Lomond Investment Trust; Traction & General; Trans-Oceanic (twice); Westpool Investment Trust (twice); British Combined Investment Trust.
Higginson & Co	Investors' Trust Corporation (twice); Anglo-Celtic Trust; Second Anglo-Celtic Trust; General & Commercial; London & Provincial; St. Andrew Trust.
Samuel & Co	1928 (twice); 1929 (twice); French & Foreign Investors Corporation; London & Holyrood Trust; English & Dutch Investment Trust.
J. Henry Schroeder & Co	Bankers Industrial Development Co.; Continental Industrial Grange Trust (through Schroeder Banking Co. (N. Y.).
Seligman Bros	London & South American.
Erlangers, Ltd	Sterling Trust; City & International (3 times); Latin American Investment Trust; Hellenic & General Trust.
Brown Shipley & Co	London & Scottish American; Second London & Scottish American.

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Bankers	Issuing houses and trusts
Robert Benson & Co	Merchant Trust; Industrial Selective Trust; Traction & General Trust; Brunner Investment Trust (twice); Chartered Trust & Agency; Investment Trust Corporation; London, Foreign & Colonial Securities; Telephone & General Trust; Great Northern.
O. T. Falk & Co	Independent Investment Trust; Industrial Selective Trust; Constructive Finance & Investment Co.; Mid-European Trust; Romney Trust.
P. H. Hill and partners	Quadrant Trust; Wallbrook Trust.
Nicholson and partners	Yorks. & Lancs. Corporation.
W. A. Phillips and partners	Yorks. & Lancs. Corporation (twice).
Dawnay Day & Co	English & International Investment Trust; Mid-European Corporation.
R. Fleming & Co	Cf. list on Groups and their Capital.

Information secured from Directory of Directors, London, 1936.

This table covers a larger part—but not all—of the complexity of banking and financial connections with the trust movement. Representatives of several overseas banking houses are on the board of British investment trusts; the governor of the National Bank of Greece is on the board of Hellenic & General Trust, the Deutsche Bank and the Berliner Handelsgesellschaft (Germany) are represented in the British & German Trust.

The Canadian & Foreign Trust, Investors' Trust Association, Mid-European Corporation, Ailsa Trust, Bankers' Investment Trust, Alliance Trust, London Trust, Colonial Securities Trust and some other companies have stock brokers on their boards.

Points of contact with the joint-stock and clearing banks are not so numerous, owing perhaps to the fact that issuing business is outside their proper activities. Nevertheless, some joint-stock bank directors have seats on the boards of investment trusts. Mr. R. McKenna, chairman of the Midland Bank is a director of Tobacco Securities Trust Co.; Mr. Bromley-Martin (Martin's Bank) is a director of London Trust; Coutts & Co. are represented in the United States Debenture Corporation; and Glynn Mills in Witan Trust.

The insurance companies are also interested in investment trusts. A director of the largest British company, the Prudential Assurance, is represented on the British & German Trust, and two of their secretaries are represented on City & International Trust and Mid-European Corporation. Pearl Assurance is connected with Trans-Oceanic Trust. The Scottish Consolidated Trust (1927) was promoted and is managed by two insurance company directors, while other insurance interests are represented on the boards of the two Anglo-Celtic Trusts, Glasgow Stockholders, and the three Scottish National Trusts.

Attempts to show the influence of banking control on the investment policy of an associated trust are faced with the difficulty that these trusts frequently do not publish a list of their holdings. Some light, however, is occassionally thrown on the matter by the figures of the regional distribution of investments. The specialization of Helbert Wagg & Co. in the issue of German securities is known, so that even without thorough research, the assumption may be well founded that a certain part of the portfolio of the British & German Trust—in which German securities are represented in the book total to the extent of over 30 percent—consists of issues sponsored by Helbert Wagg &

Co. The list published for 1935 by the Trans-Oceanic Trust—another company connected with Helbert Wagg—does not show a large participation in those issues. But of the 38 issues made by Helbert Wagg since 1926 (counting duplicated issues for the same borrower as one and excluding the Trans-Oceanic Trust issues) as many as 20 are still included in investments of the Trans-Oceanic Trust, having an average value of about £3,000 (compared with total book value of the investments of about £1,000,000). The relation between the Mercantile Investment & General Trust and Lazard Bros. is reflected by the fact that 12 of the 25 issues made by this house since 1926–27 were, in 1935, included among the holdings of the trust, in amounts of about £10,000 to £20,000 each (total book value of investments £7.8 million). It must be remembered that the sums mentioned may not show the original amount of the securities taken over from the bank since some part of the original allotment may have been resold. In 1930, for example, the Anglo-Celtic Trust had 12 items in its list out of 22 issues sponsored by Higginson & Co. with an average of £5,000; in 1936 only four items, of small amounts, remained in the portfolio.

Even the independent trusts are not absolutely free in their sub-underwriting business. In practice, it is usually found on the London market that a firm on the list of an issuing house, as current sub-underwriter, has to accept some second-class business with the good. Where trusts are associated with banking business, the refusal of speculative underwriting is likely to be at least as difficult as for the "independent trust." The clause found in almost all articles of association, which forbids a director to vote in a matter connected with his other interests, may not limit his influence over the board's policy regarding underwriting business.

CHAPTER V

CAPITALIZATION OF INVESTMENT TRUSTS

1. SUMMARY

The total capital of the British investment trusts at the end of 1935 was about £300,000,000 or $1,500,000,000. It is distributed over debentures, preference stocks and common stocks roughly in the proportion of 4:3:3 (Table 9).

TABLE 9.—*Capitalization of British investment trusts at the end of 1935* [a]

Group	Debentures	Preference stock	Common stock	Total	Investments
	Capitalization (in thousands of pounds)				
Pre-war English trusts	46, 243	33, 417	31, 530	111, 190	126, 082
Post-war English trusts	27, 190	29, 413	28, 316	84, 919	88, 485
Pre-war Scottish trusts	33, 036	22, 303	16, 868	72, 207	88, 289
Post-war Scottish trusts	19, 496	15, 341	11, 353	46, 190	49, 523
Total	125, 965	100, 474	88, 067	314, 506	352, 379
	Percent of total of each category				
Pre-war English trusts	37	34	35	35	36
Post-war English trusts	22	29	33	27	25
Pre-war Scottish trusts	26	22	19	23	25
Post-war Scottish trusts	15	15	13	15	14
Total	100	100	100	100	100
	Percent of each group				
Pre-war English trusts	41	30	29	100	
Post-war English trusts	32	35	33	100	
Pre-war Scottish trusts	46	30	24	100	
Post-war Scottish trusts	42	33	25	100	
Average	40	32	28	100	

[a] Data collected from balance sheets.

A more detailed analysis shows the following features:

2. AVERAGE CAPITALIZATION

The average total capital is nearly £1½ million per trust. Canadian and Foreign, General Securities, City and Foreign, West London, and Provincial are among the smallest trusts according to capital, with about £200,000 to £400,000 each. The largest single company

English trust is the Investment Trust Corporation (£7.1 million) and among Scottish trusts the British Assets Trust (£5.2 million).

On the whole the percentage of total capital represented by debentures is somewhat higher than the proportion contributed by common shares, which amounts to less than one-third of the total capital. Of the paid-up capital the debentures represent some 40 percent, about 4 percent of which are short-term debentures. Common stocks form 28 percent of the capital, so that a 1-percent increase in total assets or total earnings is reflected in a 3½-percent increase in the unit value or the earnings of the ordinary shares.

3. INFLUENCE OF AGE AND SIZE OF COMPANY

However, the averages differ according to the age and size of the company, as will be seen from Table 10 showing the capital structure of 147 companies in 1928, according to six age groups:

TABLE 10.—*Capital structure of British investment trusts by different age groups* [a]

Date of organization	Value (in millions of pounds)			Percentage distribution		
	Common	Preferred	Debentures	Common	Preferred	Debentures
1. 1919-28	11.8	11.5	8.3	37	36	26
2. 1909-18	7.8	8.5	6.2	35	38	28
3. 1899-08	4.6	5.1	5.7	30	33	37
4. 1889-98	12.1	17.3	19.7	25	35	40
5. 1879-88	16.5	17.6	27.2	27	29	45
6. 1869-78	2.9	3.9	4.2	26	36	38
Total	55.7	63.9	71.3	29	34	37

[a] Data compiled from Linhardt, Hanns, Die Britischen Investment Trusts (1935), p. 138.

The composition of the capital changes with the age of the company. A trust normally begins with an issue of common shares and in the course of its expansion usually finances additional capital requirements by fixed interest issues. Policy is in part directed to improve the value of the ordinary shares, regarded generally as some indication of the reputation of the company. The percentage of the fixed interest capital, therefore, shows a clear tendency to increase until trusts of more than 30 years' age are reached. For the oldest group of trusts with substantial reserves, this factor is not of the same importance and their equity capital percentages remain more or less stable. The impetus to complete the capital structure by debentures and preference shares rather than by common shares is extremely strong even in the first years of the life of a new company. Of course, the method of financing also depends upon the general situation of the capital market, and the contemporary relative valuation of investment trust common and fixed interest securities.

The relation between preference shares and debentures does not follow this same uniform trend, although broadly the younger trusts have a larger proportion of preference share capital than the older trusts. The preference shares are, with but few exemptions, nonconvertible and irredeemable.

4. DIFFERENCES BETWEEN ENGLISH AND SCOTTISH TRUSTS

As between English and Scottish trusts, practice varies considerably, and the factors mentioned here regarding age, size, and capital apply to a fuller extent to the English than to the Scottish companies, which show certain exceptions to the general rules. Though the English trusts have a larger proportion of their issued capital in ordinary shares than the Scottish firms, the post-war Scottish trusts have a greater proportion of equity capital than the pre-war trusts registered after the Baring crisis. This latter factor may be attributed to the popularity of short-term redeemable debentures which were issued by many trusts formed during that period.

5. DEBENTURES

The total amount of long-term debentures issued by 153 out of the 199 trusts examined is £126 million, i. e., an average of £600,000 per company. The interest rate varies between 3½ and 5½ percent (with 5 percent as the most frequent figure); the general average is slightly over 4½ percent. The old trusts pay less than that rate, as a rule about 4 percent, and the trusts paying only 3½ percent were all registered before 1889.

The debentures are usually of approximately 30 years' life, and are sometimes repayable at a premium. The younger companies, however, definitely prefer to repay at par. Bonds carrying conversion rights to common stock are rarely met. Where different categories of bonds are issued by one trust they usually rank pari passu; the Sterling Trust, however, has issued cumulative bonds and noncumulative income debentures.

Debenture interest rates (1935)

Percent	3¼	4	4¼	4½	5	5¼	5½	Total
Number of issues	5	49	6	29	77	1	1	168

(All debenture issues of any one company at the same rate of interest are carried as one issue.)

Redempton price of debentures

Percent	100	102–103	105	Over 105	Total
Number of issues	98	19	24	2	143

Source: Linhardt, Hanns, Die Britischen Investment Trusts (1935), pp. 196–197; figures brought up to date.

Irredeemable debentures are rather unimportant, amounting to little more than 10 percent of the total long-term debenture capital, although the proportion is higher for the Scottish trusts. The average period which must elapse before the remaining 90 percent of the debenture issues can be redeemed is, at present, almost 30 years. Analysis shows that the average for 76 companies of all classes is nearly 29 years and 28½ years for 36 trusts registered since 1928.

Short-term debentures have been adopted by most of the Scottish trusts. About 47 trusts out of a total of 74 in the Scottish group have in issue bonds with a running period of less than 12 years representing an average of £210,000 per trust. The total of £11 million short-term debentures, however, compares with the total long-term indebtedness of all trusts taken together of £115 millions.

Certain companies are prevented by the Articles of Association from issuing debentures. As a rule, the borrowing power of the directors is limited in proportion to the subscribed or issued capital. Occasionally, further restrictions apply. For example, the bond issues of Lake View Investment Trust are limited to the amount of the issued capital, but in addition a debenture issue of more than £250,000 must be preceded by a written statement of an auditor confirming that the value of the assets is twice as high as the total bond debt. Mostly, however, the formal precaution of maintaining a given relation between bond issues and issued share capital is regarded as sufficient.

Limitations on borrowing power for debentures:

	Companies
Capital plus reserves	28
Nominal capital	11
Subscribed capital	57
Issued capital	38
Part of capital plus reserves	7
Other	28
Total	169

Source: Linhardt, Hanns, Die Britischen Investment Trusts (1935), pp. 204–207.

There is a certain discrepancy between limitations upon borrowing policy and the relative importance of borrowing to the companies affected. As a matter of fact, the limitations are more stringent for the younger, small trusts, whereas the amount of their bonds outstanding is smaller, both absolutely and relatively, than that of the older trusts.

The legal protection for bond issues, which is usually provided by the Trust Deed, is considerably more rigid in the case of issues by the younger trusts. Some 18 pre-war companies provide neither a Trust Deed nor any other covenant securing the bonds. The legal form of the investment trust debenture deed differs significantly from that usually adopted for securing an industrial debenture issue. The latter would normally be secured by a specific charge upon certain physical assets; investment trust debentures, however, are usually secured by a "floating" charge on the assets. The use of the "personal bond"—a document written by the directors to the trustees confirming their duties against the bondholders, without other security and without pledging securities—is not in general use yet, but it has been increasingly adopted during the past decade.

6. ORDINARY SHARES

Where only ordinary shares have been issued originally, the shares are frequently split later into common and preference. Sometimes, the Articles of Association contain a clause for this purpose, or the shareholders meeting may adopt a corresponding resolution. The residual proportion of common shares, after the splitting, normally varies between 40 and 60 percent. Normally, after the splitting, the quotation of the existing ordinary shares goes up, whereas the existing preference shares tend to fall to a lower level.

During 1935, investment trust issues, almost without exception, were debentures. Examination of the share-issuing policy of a pre-crisis year, therefore, gives a fuller indication of the regular issuing technique. Of the 147 companies covered by the records of Messrs. Anketell Fletcher and Company for 1927–28, as many as 65 had made share issues in various forms. In 33 instances the shares were split up after full payment. The details are complicated. In 29 out of the 33 instances ordinary shares only were originally issued; in 4 other cases a unit of ordinary and preference shares was marketed, the ordinary being split off afterwards. In 20 other instances a combined issue of ordinary and preference shares was made, splitting not being called for in these cases. In addition, 7 issues of ordinary and 5 of preference shares were made independently of each other and without a subsequent split. In 21 of the above 33 cases, the original shares were split into 60 percent ordinary and 40 percent preference, while in 7 other instances a 50–50 basis was adopted.[1]

Existing shareholders usually receive rights to subscribe for new issues. Some 44 instances are on record for the 147 companies of the Anketell-Fletcher compilation. In some cases the need of new capital is the sole reason for the issue of subscription rights. But instances are on record in which new issues on "rights terms" are adopted for the dual reason of increasing the capital to a moderate extent, and at the same time of allowing existing shareholders the opportunity to "cash in" on the Company's reserves without making a scrip distribution of bonus shares.

Rights to subscribe for new issues are usually reserved for the common shareholder. Occasionally—there are 9 instances among the 147 companies mentioned above—the preference shareholders also receive rights. This procedure offers some addition to fixed dividends and a certain participation in the expansion of the earnings of the company for the preference shareholder, and increases the number of investors willing to undertake ordinary share risks. The contrary right for ordinary shareholders to subscribe for new preference shares is far more general.

The method of the issue (with or without rights) and the age of the firm have their influence on the price of issue. The influence of the age factor upon the issuing price of ordinary shares is shown in the table below. The average premium for issues of trusts organized during 1919–28 was only 11 percent; for the oldest trusts, however, the average premium was as high as 74 percent.

TABLE 11.—*Issuing price of ordinary shares (percent of par value), 1927–28* [a]

	Year of organization of trust				
	1919–28	1909–18	1899–1908	1889–98	1879–88
Number of issues	23	7	6	15	10
Average issuing price	111	127	129	165	174
Split issues	110	112	141	115	153
Other issues	116	175	119	206	189

[a] Based on figures in Linhardt, Hanns, Die Britischen Investment Trusts (1935), p. 179.

[1] Linhardt, Hanns, Die Britischen Investment Trusts (1935), pp. 169–170.

The actual premiums in the case of pre-war trusts are much greater absolutely than for the post-war trusts. Prices were lower for share issues to be split up after full payment, with the exception of the 1899–1908 group where only one split case exists, the special circumstances of which change the usual relationship.

The issue prices were as a rule lower than market quotations. This applies rather to the older companies than for the younger ones. The older companies, thus, in effect, made available part of their reserves in realizable rights.

7. PREFERENCE SHARES

Preference shares account for 32 percent of the total issued capital of all investment trusts. The percentage is slightly higher for the post-war trusts than for the older companies. Only nine companies, mostly younger concerns, have no preference share issue at all; one of these, however, has followed the older custom of issuing "founder's" shares. As a rule, the trusts have made only one preference share issue. In six instances two issues, and in another case, three different issues have been made by the same company. The usual dividend rates are 5 percent (119 instances) and 4½ percent (27 instances). For the rest (44 instances) the rates vary between 4 percent and 7 percent. Except in six cases, the preference stocks are all cumulative.

Generally, the preference shares of British companies are entitled to vote only if their dividend is in arrears for a certain time, or on questions affecting their rights. In a sample of 181 investment trusts (taken from the Stock Exchange Official Year Book, 1936) this applies, however, only to 14 instances. For about one-third (71 trusts) the voting rights for the preference are the same as for the ordinary. For the other companies, voting power of an ordinary share varies between that of two and five preference shares (83 instances). Occasionally the ratio goes as far as 100 to 1.

8. PROBLEMS OF GEARING (LEVERAGE)

The capital structure of investment trusts consists, on the average, of 28 percent common shares, 32 percent preference shares, and 40 percent debentures. The relation varies from trust to trust, but most trusts have issued certain amounts of each type of securities. Only 26 trusts, mostly younger firms, have not issued debentures, while five have no preference shares and four have neither debentures nor preference shares. Since in all fixed interest capital contributes nearly three-quarters of the trust resources, the first impact of oscillations in the earnings and unit values of the trusts is borne by only one-quarter of the total capital.

By far the greatest part of the fixed interest burden of the trusts is also fixed in a temporal sense. Short-term debentures have been adopted by most of the Scottish trusts. The total of £11 million short-term debentures, however, compares with the total long-term indebtedness of all trusts taken together of £115 millions. The trusts will, therefore, be unable to take advantage of a lowering in the level of long-term interest rates for a considerable period ahead. As a matter of fact, the list of conversions of investment trust debentures in the cheap money period since 1932 was very small, and only about £4 millions of debentures were converted with a reduction in the interest burden of only £28,100 (Table 12).

TABLE 12.—*Conversions of debentures of British investment trusts* [a]

[In thousands of pounds]

Year	Trust	Loans	Amount at issuing price	Interest rate of issue redeemed
1933	Sterling Trust	4-percent debentures	693	5-percent debentures.
1935	Railway Share Trust & Agency	3½-percent debentures.	507	4½-percent debentures.
1935	Metropolitan Trust	3½-percent debentures.	1,375	4-percent debentures.
1935	General Investors & Trustees	3½-percent debentures.	606	4-percent debentures.
1935	Standard Trust	3¾-percent debentures.	850	4½-percent debentures.

[a] Data compiled from The Economist, London, Dec. 23, 1933, p. 1237, and Mar. 2, 1935, p. 483.

To get an idea of the concrete amount of the annual interest burden, a sample of 51 companies was examined which shows a total debenture capital of £43,850,000, with annual gross interest of £1,995,000, an average rate of 4.55 percent. A more detailed inquiry into a larger sample of companies (cf. The Economist, Investment Trust Supplement, p. 15) shows that the post-war companies pay, on the average, a higher rate than the pre-war companies and the Scottish trusts more than the English firms.

For the same group of 51 trusts, the dividend requirements on £37,430,000 preference shares were £1,827,000, an average of 4.88 percent.

Examination of the larger sample referred to above shows similar differences in rates on pre-war and post-war trust preference shares. The post-war companies pay somewhat over 5 percent, but the pre-war trusts' average rate is below 5 percent. The English trusts, however, pay, on the average, a higher preference dividend rate than the Scottish firms.

A very considerable part of the total income is, therefore, earmarked in advance for the fixed interest and dividend payments. Table 13 completes the picture by showing the effects of this leverage (called "gearing" in Great Britain) on the common shares. The sample slightly overemphasizes the effect of leverage, since the proportion of common stock capital for the 51 companies is no higher than 24 percent compared with a general average of 28 percent. The right-hand column in the table shows the estimated percentages applicable to all 199 trusts, by assuming that the weighted average of 4.7 percent for the service of the debentures and preference stocks of 51 companies is representative of the whole. The final percentages indicate the "magnification" of a given increase in total earnings or assets, when translated into assets or earnings for the ordinary stock.

For all trusts an increase of earnings equivalent to 1 percent on the total capital corresponds to about 3½ percent on the ordinary shares. The figure for the pre-war British trusts and for the Scottish trusts is higher, and that for post-war British trusts lower than the average.

It is obvious that the different composition of the capital must be reflected in wider movements in the quotations of common shares for the higher "geared" trusts in the course of the business cycle. For this purpose two unweighted price indexes (for five companies each)[2] were constructed, one comprising companies with a common stock capital greatly exceeding the average, and the other including companies of relatively small common stock capitalization. Table 14 presents three index figures for both groups, viz: Net earnings after payment of debenture and preference distribution; common dividends paid; and common share prices. The comparison of the movements in the three indexes shows striking differences. The movement of common share quotations for the low-geared trusts is moderate compared with the high-geared group.

TABLE 13.—*Effects of "gearing" in British investment trusts, 1935*

	51 companies	199 companies
Total debentures and share capital (£ millions)	107.0	314.5
Of which—		
Percent debentures	41	40
Percent preferred stock	35	32
Percent common stock	24	28
Service of fixed charges as percent of total capital	3.6	3.4
1 percent earned on total capital (£ millions)	1.07	3.15
1 percent ordinary capital (£ millions)	25.7	88.0
Additional 1 percent earned on total corresponding to percent on common	4.2	3.6

TABLE 14.—*Earnings, profits, and stock prices* [a] *of two groups of British investment trusts* [b]

[1927=100]

	1928	1929	1930	1931	1932	1933	1934	1935
5 LOW-GEARED COMPANIES								
Earned for common	111	113	107	96	81	75	69	73
Common dividends paid	107	104	100	87	76	71	61	65
Prices	105	101	90	81	67	88	98	108
5 HIGH-GEARED COMPANIES								
Earned for common	113	132	143	126	88	47	28	29
Common dividends paid	107	113	122	104	73	37	24	26
Prices	104	111	101	85	64	43	51	52

[a] Earnings and profits: Financial year. Prices: Average of high and low prices.
[b] Original figures taken from Moody's British Companies Service.

Changes in the trend of the low-geared index in either direction precede similar movements in the more speculative high-geared shares by a considerable time interval. The average level of their quotations for 1935 showed an appreciation of 8 percent compared with the level of 1927, against a loss of 48 percent for the high-geared trusts. High-geared trust equities fell by more than three-fifths between 1929 and 1933, while the low-geared shares fell by about only one-third between

[2] Low-geared trusts: Debenture Securities Investment, London & Colonial Investment Corporation, London Maritime Investment, British Investment, and Canadian & Foreign Investment. High-geared trusts: British Assets Trust, Army & Navy Investment, American Investment & General, Scottish Investment Trust, and Scottish American Mortgage.

1928 and 1932. For the high-geared group earnings for common shares during 1934 and 1935 were only one-fifth of the level of the best year (1930), whereas, in the case of the low-geared companies, the 1934 level was about three-fifths of the highest level (1929).

9. CORRESPONDENCE BETWEEN STRUCTURE OF ASSETS AND CAPITALIZATION

The question of the correspondence between the capital structure of an investment trust (debentures, preference and common shares) on the one hand and the structure of its investments on the other hand has been much discussed. It is obvious that the parallel, if it exist, cannot be absolute; the composition of the capital of the investment trusts is rather rigid, whereas investments, at least in theory, can follow changes in market conditions and be shifted without difficulty from one category of securities to another.

About 150 investment trusts now publish an analysis of their investments separated into debentures, preference and ordinary stocks. For a first approach to the comparison, all trusts revealing common share investments exceeding 60 percent of their total investments were grouped together; this ratio was then compared with the proportion of their issued capital (including short-term debentures), represented by common shares. The same procedure was adopted for companies whose holding of common stocks was lower than 25 percent (Table 15).

TABLE 15.—*Asset structure and capital structure in British investment trusts* [a]

INVESTMENT IN COMMON STOCKS (PERCENT) [b]

	60 percent and more	25 percent and less
Number of companies	17	14
Unweighted average common investments to total investments (percent)	69	22
Unweighted average of common stock in capital to total capital (percent)	39	26
CLASSIFICATION OF COMPANIES ANALYZED		
Pre-war English trusts	----------	4
Pre-war Scottish trusts	5	4
Post-war English trusts	5	4
Post-war Scottish trusts	7	2

[a] Data compiled from annual reports.
[b] Absolute amount of the two items on the opposite sides of the balance sheet not the same; investments partly based on book values, sometimes on market values; capital of the trusts at nominal amount, investments at cost after deducting reserves and other write-off.

Small as the sample is, some conclusions may be drawn from the comparison. For trusts with a smaller interest in common shares, a close relation between common share investments and issued common capital is preserved. For the trusts with investments predominantly in common shares, the common capital percentage is much smaller than the ratio of common shares to total portfolio. In other words, common dividends received by these companies are employed to a relatively large extent in meeting fixed interest charges. Naturally, the younger trusts have participated to a greater extent in common share investments, not only because they began their career with an issue of common stock, but also because they commenced operations in a period of rising common share prices. In the group of trusts showing high common share investment percentages, there are in fact only two instances of companies having a higher common share capital than common stock investment ratio—both of which are new firms with only common shares issued. At the other extreme one old-established Scottish firm holds as much as 68.5 percent in common stocks in its portfolio against a ratio of 13 percent between the common and total capital. On the other hand, 7 out of 14 companies having no more than 25 percent of their portfolio in common share investments have an even lower proportion of common share capital to the total issued. An example of extreme conservatism is provided by the London and Colonial Trust, which has no debentures, but more than 50 percent common share capital and not more than 12.7 percent common shares in its portfolio.

The trusts may also be grouped in order of the percentage of investments held in common stocks, within brackets of 10 percent for each group. The results for the first 10 trusts in each group according to alphabetical order (the group of trusts with over 71 percent of ordinary share investments includes only 6 companies) are compared below with the ratio of common stocks in their capital ratios. Table 16 shows no clear trend and differences between the highest and lowest figures in each average are considerable. The correlation between the percentage of common stock investment and the percentage of common stock capital is only small (Table 17).[3]

TABLE 16.—*Common stocks issued and held* [a]

	Proportion of common shareholdings to total investments (percent)					
	21–30	31–40	41–50	51–60	61–70	70 or more
Proportion common stock to total capitalization:						
Average (10 companies) [b]	21	27	37	34	29	47
Highest rate in group	25	50	60	62	50	100
Lowest rate in group	17	20	16	20	9	22

[a] Data compiled from balance sheets.
[b] There are 6 companies in the 70-percent and more group.

[3] An attempt has been made by Dr. Linhardt (op. cit. supra, note 1, pp. 243–44) to adjust the capital and investment figures in order to avoid the difficulties mentioned in note b to table 15. The book values of the investments of 40 trusts in 1928 were reduced by 20 percent, corresponding to the fact that the share and debenture capital of the companies represent on the average only 80 percent of the investments. Secondly, the common shares were valued by capitalizing the average dividend over the previous 10 years on a 5-percent basis. If this complicated method—which is itself not free from objection—is adopted, it becomes possible to compare the estimated valuation of the common shares with the value of the corresponding common share investment holdings. The result is that although the total issued capital is smaller than the investments held, the amount issued in common shares is much larger than the amount invested in common shares. Three-fifths of the common stock capital issued is invested in debenture and preference stocks. Little direct influence attributable to difference of size and age is apparent in these statistics.

TABLE 17.—*Proportion of common stocks in capitalization and assets by age group and size of trust* [a]

	Number of companies	Adjusted share capital [b]	Common stock investment [c]
All companies	40	55	21
Year of formation:			
1919–28	14	51	23
1909–18	5	48	15
1899–08	7	51	24
1889–98	7	49	19
1879–88	7	54	19
Size (in millions of pounds):			
Less than 0.5	3	70	11
0.5–1	7	53	30
1–1.5	12	58	20
1.5–2	3	52	24
2–3	9	45	17
3–4	3	49	14
Over 4	3	55	22

[a] Data compiled from Linhardt, Hanns, Die Britischen Investment Trusts (1935), pp. 243–244.
[b] Percent of adjusted total capitalization.
[c] Percent of total investments.

10. RESERVES

Three types of reserves created by investment trusts may be distinguished: general reserves, capital reserves, and "inner" reserves resulting from undervaluation of investments.

The two types of open reserves are strictly separated from each other by origin as well as by purpose. The sources of the capital reserve are the profits from the sale of securities and the premiums received from its own issues of capital. This type of reserve is not used for payment of dividends. Its main purpose is to cover capital deficits corresponding to the special profits which are responsible for its growth, i. e., losses from the sales of investments under cost, and discounts on the company's own (debenture) issues. If these limitations are definitely stated in the Articles of Association, allocations to capital reserve are exempted from the normal income tax which now amounts to a flat 25 percent. A company seeking acknowledgement as an investment trust by the tax authorities always lays down such limitations in the use of capital reserves in its Articles of Association, and is consequently prohibited from increasing its dividends in a period of reduced earnings out of the profits on investments sold.

The use of the general reserve is not restricted in this way. Like the normal reserve of any company it consists of current earnings which the directors deem it advisable to be retained. It can therefore be applied to writing off capital depreciation as well as to supplement current earnings for dividend payments. Since the general reserve is freely usable, allocations to it are subject to the normal income tax.

The disclosed general and capital reserves of the English and Scottish investment trusts amount to more than £30,000,000, equivalent to some 9 percent of total shares and debentures outstanding, and to an average of £150,000 per company. These figures exclude the free balances carried forward in the companies' profit and loss accounts. Compared with the share capital alone the disclosed reserves are equivalent to one-sixth of the total, a ratio somewhat smaller than that for British commercial banks which runs to fully 20 percent.

These open reserves, however, do not give a fair picture of the situation since they fail to take account of the existence of hidden reserves. It is usual for trusts almost without exception to value their holdings at cost price or less, without heeding market appreciation. In years of large oscillations in market values, changes in hidden reserves, although undisclosed, are far larger than the amounts put to open reserves. The market value of the investments, however, is published for a number of companies. An analysis of 27 pre-war and post-war companies, which between themselves represent about one-fifth of the total assets of all management investment trusts, furnished the results expressed in Table 18.

TABLE 18.—*Open and hidden reserves of British investment trusts* [a]

[Amounts in thousands of pounds]

Year	Book value of investments	Market value	Difference in market and book value	Difference in percent of book value	Open reserve	Open and hidden reserve	
						Amount	Percent of book value
1928	58,300	71,357	+13,057	+22	7,894	+20,951	+36
1933	68,800	55,140	−13,660	−20	9,547	−4,113	−6
1935	75,500	73,480	−2,020	−3	9,965	+7,945	+13

[a] 1928 and 1933 data compiled from Linhardt, Hanns, Die Britischen Investment Trusts (1935), pp. 269 and 402; brought up to date.

In 1928 the "hidden" reserves were nearly double the open reserves, and both taken together amounted to more than a third of total investments. Total reserves were equivalent to 45 percent of the total share and debenture capital of these trusts. For some companies the market value was more than double the book value and reserves were larger than total book capitalization. As a result of the depression the "hidden" reserves had not only completely disappeared in 1933, but a deficit of the same amount as the surplus of 5 years ago had developed. The deficit was large enough to cancel out all open reserves, although they had been increased in the meantime by 20 percent. Recovery has since decreased the excess of book over market values and at the end of 1935 both values were very nearly equal. Some 160 investment trusts which published figures at the end of 1935 reported a total deficit of £44,500,000 after deducting appreciation revealed in 16 cases. Nearly all companies with a deficit usually give exact figures, whereas concerns with an excess over book values, often confine themselves to more general remarks (such as, "a valuation of the investments at the closing date shows a surplus over the amount at which they appear in the balance sheet"), so that statistics which are limited to companies giving exact figures are bound to exaggerate the actual amount of the depreciation of assets against cost. Thus 144 out of the existing 200 trusts had not yet recovered the book values of their investments. The remaining 16 published figures showed a surplus while some 40 companies contented themselves with general remarks regarding the existence of an appreciation on their portfolios.

The reported deficit amounted to 15 percent of the book value of the investments of the 144 companies in question, while the extent of the appreciation in the remaining 50-odd trusts is not known.

It is obvious that, more than anywhere else, the age of the investment trust is an important factor in determining the reserve situation. A certain time elapses before retained profits of all kinds have reached the usual size. Not only does the amount of reserve per company grow in each successive age group, but also the percentage of disclosed reserves to capital shows a distinct tendency to increase, from 2 percent in the youngest trusts to about 18 percent for the companies registered between 1890 and 1900. Only the very oldest group shows an exception to this trend, owing, apparently, to previous capitalization of reserves in the form of bonus issues. Compared with total capital including debentures, disclosed reserves in 1929 showed the following values:

Reserves by age groups

	Year of organization				
	1919-28	1909-18	1899-1908	1889-98	1879-88
Reserves as percent of capital including debentures	2.1	9.0	16.1	17.7	15.9

Source: Linhardt, Hanns, Die Britischen Investment Trusts (1935), p. 156.

CHAPTER VI

INVESTMENT TRUST CAPITAL ISSUES

1. METHODS OF ISSUE

Three chief methods of issuance of securities are used in Great Britain: public subscription, offer for sale, and stock exchange introduction. In the first two an issuing house makes a public offer of the issue at a fixed price, either on direct behalf of the issuer or on its own account after having purchased the issue outright. In the case of a stock exchange introduction the issue is placed with a stock exchange firm without a preceding offer to the general public, and is available for purchase in the ordinary way. As a rule a public subscription is underwritten as insurance against the risk of an insufficient subscription.

The raising of capital of the investment trusts differs from that employed for the average issuer in the British market chiefly in that investment trusts do not have their own issues of new capital underwritten. A list of investment trust issues for 1934 and 1935 containing 56 items reveals only 3 exceptions. The London & Yorkshire Trust twice acted as issuing agent for the reorganized Clyde & Mersey Investment Trust, and the issue of the newly formed Cable Investment Trust was underwritten by the brokerage firm of Cohen, Laming, Hoare & Co. (£3,000,000 debentures, commission 1¼ percent and ¼ percent overriding, and £2,000,000 preference shares, commission 1¼ percent and ¼ percent overriding.) As a general rule, however, the investment trusts arrange the issue of their own securities for themselves, thus saving the usual underwriting commission. This is an unusual feature for any other type of issue. In 1929, the peak year in new issue activity, 138 prospectuses of nongovernment issues were published in The Times, only 16 of these were not underwritten, and 9 of the latter were issues of investment trust securities.

Otherwise, the technique of issuing investment trust securities follows the normal way. A prospectus is published containing the very numerous legal requirements, description of the issuer, terms of the new issue, minimum subscription, etc., and with the help of the brokers connected with the trust and through advertising is brought to the attention of the public. Application forms are filled up and sent with a cheque of the amount of the first installment to the bank handling this issue. The securities are allotted and the Stock Exchange Committee is officially approached for grant of "permission to deal" or an official quotation. The new issue department of one of the joint-stock banks usually does the clerical and routine work.

The offer-for-sale method—purchase of the securities by a banker and distribution on his own account—is not often adopted for investment trusts securities. The trusts have normally a good financial reputation and sufficient financial experience to be able to avoid this intermediate state.

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It most frequently happens, indeed, that public subscription is avoided altogether, and the simple "stock exchange introduction" method is chosen. Here again the procedure does not differ from the normal form used for all other stock exchange introductions; application to the stock exchange authorities and publication of a statement, similar to a prospectus, "for information only." The acting broker then distributes the securities by sale in the Stock Exchange.

Only 20 of the 55 issues were offered by prospectuses, 35 being brought to the public in the form of a "stock exchange introduction." For the smaller issues the latter method is definitely preferred on grounds of economy and convenience not only by investment trusts but also by general companies. The average size of "introductions" was as low as £100,000, whereas the average prospectus offer amounted to £480,000. The increase in stock exchange introductions compared with offers by prospectus is a new feature developed in recent years which has met some criticism from the public and the stock exchange authorities.

Investment trusts in the past few years have followed a rather one-sided issuing policy. Of a total of £13,000,000 raised by 55 investment trusts during 1934 and 1935 only £3,500,000 represented ordinary stock issues, whereas the remainder consisted of debentures (excluding the £7,000,000 flotation of the Cable Investment Trust). The size of these issues varied between the wide limits of £60,000 and £1,300,000 and averaged about £240,000, the total being £2,800,000 in 1934 and £10,300,000 in 1935.

Analysis of new issue activity in 1934 and 1935 shows that it did not correspond closely to the existing total capital of the two pre-war and post-war trust groups. Judged by the number of trusts making new issues, and, to a lesser degree, by the existing total capital of the groups, the post-war companies' share in the new issues of these 2 years greatly exceeded their share of the total assets of all trusts. By number, some two-thirds of all new issues were made by post-war companies and the post-war English investment trusts in particular took a disproportionate share of the new capital raised. Calculations of the size of individual issues, however, show that English pre-war companies made issues of new capital which, on the average, were twice as large as those of other groups (Table 19).

TABLE 19.—*Issues of British investment trust securities in 1934 and 1935* [a]

	Number	Per-cent	Amount of issues (in thousands of pounds)	Per-cent	Average amount (in thousands of pounds)
Pre-war English trusts	8	15	3,975	30	494
Post-war English trusts	22	40	4,141	32	189
Pre-war Scottish trusts	13	23	2,214	17	170
Post-war Scottish trusts	12	22	2,710	21	226
Total	55	100	13,040	100	236

[a] Data compiled from Issuing House Year-book 1935.

This position is in fact similar to that obtaining during the pre-depression period. In 1927–28 the younger companies participated to a relatively greater extent in new issues than the older trusts. During

1927–28 the over-all increase in share capital of all trusts was about 29.5 percent, while the increase was no less than 46.5 percent in the youngest age group (organization after 1919), compared with only 17.5 percent for the oldest group (organization from 1869 to 1878).

2. DISTRIBUTION OF OWNERSHIP

Investment trust shares are fairly widespread among the public. Table 20 gives the distribution of the shares of the British Assets Trust, one of the largest pre-war Scottish trusts with a book value for investments of nearly £7,000,000. More than 2,600 single shareholdings were in existence in March 1933. These have been grouped according to size. The average number of 5-shilling stock units held by the common stock holders was almost exactly 700 units with a market price of about £420. About four-fifths of all holdings, however, (2,078 out of 2,616 holdings) comprised 700 units, while 60 percent of the holdings ranged between 1 and 300 stock units. The smallest holding was 1 unit, the largest 86,500 units (5 percent of total). The managing director of the company himself held a considerable interest at this date. As a matter of fact the holdings are even smaller and distributed among a still larger circle of persons than the figures of the table suggest since the majority of the holdings in the group of 5,000 and more are registered in the names of bank nominees, and consequently most likely cover a number of individual beneficial owners. The number of shareholders of this trust in earlier years was far smaller, but a rapid increase occurred after the splitting of the £1 share in 5/-s stock units which brought the shares within the range of the smaller investors.

TABLE 20.—*Size distribution of 5 shilling common stock units of British Assets Trust, Limited* [a]

Holdings	Number of shareholders		Number of 5-shilling units held	
	Total	Percent	Total	Percent
1 to 99	585	21.2	28,238	1.5
100 to 199	599	23.0	77,703	4.2
200 to 299	377	14.4	89,287	4.8
300 to 399	187	7.1	63,685	3.4
400 to 499	139	5.5	59,836	3.2
500 to 799	299	11.5	183,240	9.8
800 to 999	93	3.6	82,028	4.4
1,000 to 1,499	124	4.7	147,539	7.9
1,500 to 1,999	59	2.3	104,729	5.5
2,000 to 4,999	136	5.2	399,518	21.4
5,000 and over	48	1.8	603,589	35.9
Total	2,616	100.0	1,872,392	100.00

[a] Data compiled from the list of stockholders.

The turnover of the holdings is rather small. The predominant part of the transactions was attributable to the large holders. In the smaller groups the changes were much less important. It may serve as a proof of stability of ownership that a number of small- and medium-sized holdings reappear for identical amounts, evidently for two or more members of the same family. This fact may reflect holdings obtained through inheritances, which evidently have an especially low velocity of turnover.

All this helps to explain the narrowness of the market for investment trust shares. No turn over figures are published on the London Stock Exchange either for total transactions or transactions in investment trust securities. The number of transactions marked is shown by the annual report of the Stock Exchange Committee, but this figure only applies to officially quoted securities. Moreover, there is no obligation to "mark" the dealing price of any transaction in the London market, and even when transactions are "marked" no particulars of its size are recorded.

An indirect approach seems possible from the annual accounts of the companies. The sales and purchases of securities (with legal transmission on the death of a holder) are registered by the companies for a special fee, which does not vary very much from firm to firm—2/6d per transfer being the usual amount. The income account for the majority of trusts shows the item "transfer fees" separated from other sources of income and from other fees received. The total figure of the transfer fees received by 139 investment trusts with about three-fifths of the capital of the trusts in 1935 amounted to £4,463, representing on the basis of 2/6 d per transfer somewhat more than 35,000 transactions. Assuming that the same relations hold for all trusts, only 50,000 transfers per year or about 250 per company, would result from this very rough calculation. The true figure may be higher because of bank nominees. These figures, however, relate only to transactions, and the amount of capital transferred cannot be ascertained.

CHAPTER VII

INVESTMENT POLICY

1. FUNDAMENTALS

Questions regarding the investment policy of the trusts can be answered in two ways, either by reference to the financial results of investment policy or to the leading ideas which the trusts employ when investing.

To begin with the second point, the working rules are not very strict and leave much free scope. The names of the trusts often suggest a certain specialization in particular types of securities, but, as a general rule, the investments are not wholly limited to those suggested by the name. The British and German Trust for example, was organized for investments in German securities, but under the changing conditions of the world security markets it has been forced to enter into other fields. Many trusts formed before the war to hold South American rail stocks are now completely general in character. Certain limitations, however, are usually adopted by the companies in their Articles of Association. Generally, the Articles prohibit investment in securities with unlimited liabilities, while the Companies' Act forbids the purchase of their own shares. About one-half of the trusts restrict investments in one security to a certain percentage of their capital. The restrictions differ considerably in detail, but usually 5 to 10 percent of the share plus debenture capital is adopted as a maximum, although sometimes a smaller percentage, say, of 2½ to 3 percent of the share capital alone is laid down. These restrictions usually do not apply to British Government securities. For the older trusts the permitted maximum percentages are usually lower than for the younger trusts. Occasionally, capital plus reserve is employed as the basis, so that the size of individual holdings may automatically widen from year to year by the growth of the reserves without any increase of capital. In practice, the maximum percentages are usually smaller than the Articles of Association permit. Thus the Scottish International Investment Trusts take 1 percent instead of the permitted 5 percent as a "working arrangement." An absolute figure is seldom prescribed as the upper limit for investment in any one security, although the River Plate & General Trust has adopted a maximum of £10,000.

So much for the written regulations. In reality, the restrictions of the investment policy go further because the managers usually concentrate on particular branches of investment, the scope in the market being so large that it is difficult to keep in close touch at all points. The personal predilections of the directors and the investment conceptions in the minds of those who have to direct the flow of investment trust funds, therefore, should not be underestimated as factors determining the trusts' investment policies. The association of Viscount St. David, for example, with all branches of investment in South America may explain the high percentage of South American investments in the "St. David's" group of trusts. Sometimes an investment "fashion" may lead to a general reorientation of investment policy such, for instance, as occurred in the middle twenties, when Central Europe was rediscovered and several new trusts participated in the new stream of investment flowing to those countries. Occasionally, theoretical considerations are the basis for an attempt in a new direction. The Independent Investment Trust, for example, was built up on Mr. J. M. Keynes' conception of the higher long-term yield of equities. In this case, however, a start very late in the last boom, and heavy losses from the depreciation of the American currency have affected the trust's activities for a number of years.

On the whole, the role of scientific research in guiding investment policy should not be overestimated. Individual investments, of course, are analyzed, and the movement of their quotations is closely watched. Balance sheets and special information are studied and the management is in touch with brokers, who are anxious to supply information about companies, and with specialists' advice. But not all companies have their own statistical department, and many are satisfied with a subscription to one of the usual statistical services, except in the event of a very big change in investment policy. The personal judgment of the manager again is different for each company, and often more decisive than systematic research.

Four underlying ideas can be ascertained in this connection, except for those trusts which are under direct control of bankers and therefore have only a limited independence in their investment policy. First, the investment trust prefers to do its operations in given securities at a time when they are a little in the background of public interest. It leaves the favorites of the day to the general public and tries to choose among temporarily neglected securities with a yield over the average. The speculative angle of short-term appreciation does not affect their operations, which are based on the realization of the fact that a well-chosen long-term investment, even with sacrifices in the beginning, will improve the long-run yield of the fund.

Secondly, this attitude often results in a special interest on the part of the trusts in new issues which require nursing for a certain time before the company is fully established. This explains the activities of the British investment trusts as subunderwriters in the capital market. The aim is not primarily to earn commissions, but rather to get the securities at net issue prices, reduced to the extent of the commission.

Thirdly, the trusts take steps to insure a special kind of liquidity, in the sense that changes from one investment to another should as far as possible encounter the minimum of friction. The investment trusts therefore now concentrate their holdings largely on securities with a London market, whereas in former times a much wider circle of securities was held. The published percentage of investments officially quoted is often as high as 95 percent.

Finally, the trusts try to hold their commitments in individual securities down to amounts which can easily be liquidated.

2. DIVERSIFICATION

The number of individual investments of the trusts, which published a complete list in 1935, ranged between 174 and 930, with an average of over 500. From Tables 21 to 23 it can be seen that as the total resources of an investment trust grow the portfolio not only contains more issues, but represents a larger absolute investment in each issue. An optimum both in total size and diversification, nevertheless, appears to exist, for beyond a certain limit control and supervision of the portfolio become difficult.

TABLE 21.—*Frequency distribution of the number of investments of British investment trusts, 1935*

Number of investments	English trusts		Scottish trusts		Combined English and Scottish trusts		Combined pre-war and post-war trusts		All trusts combined
	Pre-war	Post-war	Pre-war	Post-war	Pre-war	Post-war	English	Scottish	
0 to 99	-	-	-	-	-	-	-	-	-
100 to 199	2	2	-	1	2	3	4	1	5
200 to 299	-	6	1	6	1	12	6	7	13
300 to 399	1	10	2	4	3	14	11	6	17
400 to 499	5	9	1	6	6	15	14	7	21
500 to 599	4	2	7	2	11	4	6	9	15
600 to 699	2	-	2	3	4	3	2	5	7
700 to 799	3	1	-	-	3	1	4	-	4
800 to 899	1	-	5	-	6	-	1	5	6
900 to 999	1	-	1	-	2	-	1	1	2
1,000 and over	-	-	-	-	-	-	-	-	-
Total	19	30	19	22	38	52	49	41	90

TABLE 22.—*Frequency distribution of the book value of investments of British investment trusts—1935*

[Amounts in thousands of pounds]

Book value of investments (£000)	English trusts				Scottish trusts				Combined English and Scottish trusts				Combined pre-war and post-war trusts				All trusts combined	
	Pre-war trusts		Post-war trusts		Pre-war trusts		Post-war trusts		Pre-war trusts		Post-war trusts		English trusts		Scottish trusts			
	Number	Amount	Number	Amount	Number	Amount	Number	Amount	Number	Amount	Number	Amount	Number	Amount	Number	Amount	Number	Amount
0 to 99	-	-	1	98	-	-	-	-	-	-	1	98	1	98	-	-	1	98
100 to 499	9	3,363	8	2,804	2	560	3	1,145	11	3,923	11	3,949	17	6,167	5	1,705	22	7,872
500 to 999	6	4,441	16	12,812	3	2,255	11	9,332	9	6,696	27	22,144	22	17,253	14	11,587	36	28,840
1,000 to 1,999	18	23,549	32	43,828	16	24,266	18	24,956	34	47,815	50	68,784	50	67,377	34	49,222	84	116,599
2,000 to 2,999	9	21,675	5	11,433	6	15,205	5	11,164	15	36,880	10	22,597	14	33,108	11	26,369	25	59,477
3,000 to 3,999	10	33,570	3	10,123	5	17,942	1	3,079	15	51,512	4	13,202	13	43,693	6	21,021	19	64,714
4,000 to 4,999	3	14,642	-	-	2	8,603	-	-	5	23,245	-	-	3	14,642	2	8,603	5	23,245
5,000 to 5,999	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
6,000 to 6,999	-	-	-	-	2	13,514	-	-	2	13,514	-	-	-	-	2	13,514	2	13,514
7,000 to 7,999	2	15,558	-	-	-	-	-	-	2	15,558	-	-	2	15,558	-	-	2	15,558
8,000 to 8,999	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
9,000 to 9,999	1	9,166	-	-	-	-	-	-	1	9,166	-	-	1	9,166	-	-	1	9,166
10,000 and over	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Total	58	125,964	65	81,098	36	82,345	38	49,676	94	208,309	103	130,774	123	207,062	74	132,021	197	339,083

TABLE 23.—*Correlation table of book value of investments and number of investments of 90 British investment trusts, 1935*

Book value of investments (£000)	Number of investments											
	0-99	100-199	200-299	300-399	400-499	500-599	600-699	700-799	800-899	900-999	1,000 and over	Total
0 to 999		4	9	4	4							21
1,000 to 1,999		1	4	11	13	8	1	1	4			43
2,000 to 2,999				1	3	5	4	1				14
3,000 to 3,999				1	1	1		1		1		5
4,000 to 4,999						1	1		2			4
5,000 to 5,999												
6,000 to 6,999							1					1
7,000 to 7,999										1		1
8,000 to 8,999												
9,000 to 9,999								1				1
10,000 and over												
Total		5	13	17	21	15	7	4	6	2		90

Development of portfolio diversification between 1928 and 1935 is characterized by two features. First, the average holding has become considerably smaller and, second, the number of holdings has become larger. Of the total sample of 32 companies for which the comparison was possible, over that period, the second statement holds without any exception, and the first in 25 cases. These companies had an average number of investments of 382 in 1928, but of 559 in 1935; the average amount invested per issue was £4,800 in 1928, but only £4,200 in 1935. This development implies a break with the previous policy of increasing the size of the individual investment more quickly than its number. The average size of new investments purchased in the past few years seems to have been particularly small. One reason may be the increased caution after the shock of the depression. Another reason may be the growing preference for home industrials, for which the average size per issue is smaller than for the international securities which were favored before the depression.

3. VOLUME OF TRADING

No figures are published with reference to the activities of the investment trusts on the Stock Exchange. An examination of the list of the investments, however, enables a rough analysis of the amount of the purchases and sales to be made.

The following sample analysis of the changes in investments of the London Trust Co. illustrates the method of calculation, but it would be possible to adopt the method for only about half of the total number of trusts, owing to lack of information regarding the remaining portfolios. The London Trust Co. is one of the larger pre-war firms, registered in 1889. No changes in capitalization were effected during 1935–36, so that all changes in the portfolio must result from a change in the use of existing funds (including realized profits). It can be assumed that the company should be as active in its investment policy as any average trust.

In 1936 the company had invested its funds in 940 different securities. A comparison of the lists of investments for March 1935 and

March 1936 showed that in the course of 1935, 101 items disappeared from the list, whereas 11 others came in; at the same time the size of 83 existing items was increased and that of 53 other items diminished. This calculation compares the state of the portfolio on 2 days. Purchases and resales between these days cannot be taken into account. Assuming that all holdings were each of identical value (an assumption which may be made in view of the number of holdings involved), about 11 percent of the total portfolio would have been replaced during the year. Supposing further that the reduction in the size of existing holdings could be regarded as affecting half of the value of the 53 items in question, a further 3 percent of the investments would have been moved. Altogether, therefore, about 13 percent of the investments at the beginning of the year were replaced and the turn-over of the investments (sales+purchases) can be roughly estimated at one-fourth of the average value of the investment for this trust during 1935–36.[1]

4. GEOGRAPHICAL DISTRIBUTION OF INVESTMENTS

The geographical distribution of the trusts' investments reflects the former importance of foreign lending on the London market. The investment trusts played an important role in the development of the railway system of the United States and the British financial expansion in South America before the war. They were also interested in the post-war reconstruction of central Europe. But they now show, after the financial crises in many foreign countries, an increased interest in home investments.

An investigation of geographical distribution for a long period faces the difficulty that the range of companies publishing their distribution lists becomes smaller and smaller the further the investigation goes back. The fact that sometimes book values of the investments are used and in other cases market values are taken introduces an additional difficulty.

It is at least safe to say that between 1913 and 1931 the importance of investments in the United States declined in favor of central Europe (Table 24).

TABLE 24.—*Geographical distribution of the portfolios of 25 British investment trusts, 1923–28* [a]

	1923	1928
	(Percent)	*(Percent)*
Great Britain	34.5	34.4
British Empire	10.5	10.7
United States of America	17.7	10.5
Argentine	12.4	10.1
Other parts of South America	11.2	10.9
Mexico and Central America	5.1	3.4
Europe	4.5	15.8
Asia and Africa	4.1	4.2
Total	100.0	100.0

[a] Data compiled from the Economist, Jan. 12, 1929, p. 52.

[1] If proportion of issues acquired is taken as basis, turn-over would amount to only about 10 percent. The average of both measures would be slightly below 20 percent.

The reasons are well known; the purchase of American stocks by the Government during the war, the changed position of the United States to that of a creditor country, and the general interest of the British investor in the reorganization of Central Europe. Before the depression, about two-thirds of the trusts' investments were outside the United Kingdom and considerably more than half outside the Empire. The risks seemed to be reasonably spread according to "normal" standards, but during the depression the distribution proved to be detrimental.

It should be explained that statistics of the geographical distribution of investments at that time, calculated on different bases and including different trusts, vary considerably from each other. Even within an investment trust group no strict uniformity in geographical distribution of investments is visible. In the case of the Fleming-Murray group, the chief field of investment for the older companies was Great Britain and the Empire, whereas the younger companies placed a growing percentage in Europe—except the Scottish International Trust (registered 1927) which invested in the first year of its existence 75 percent of its funds in home industrials. The St. David's group, on the other hand, shows a uniform emphasis on South America.

In the crisis of 1929, the capital losses on British securities were smaller than on overseas issues. Two-thirds of the total investments, however, were subjected to the additional risk of exchange restrictions and the more serious deterioration of world conditions. The results of these changes on the portfolios of the investment trusts are shown as a first approximation by a comparison of the book values from 1929 to 1933. The statistics shown above suggest that the composition showed scarcely any change, the pre-crisis distribution being maintained with remarkably small variations. There is little trace of "policy" in the geographical aspect of attempting to escape from threatened areas and to find greater security elsewhere. Accordingly, changes in the percentage distribution based on market value show, to a certain degree, the consequences of "mal-investment." Latin American and Central European investments, for example, each constituted 20 percent of the market value of the portfolio in 1929, but accounted for less than 15 percent 5 years later (Table 25).

Regional distribution usually varies according to the age of the investment trust concerned. The post-war companies have concentrated a large part of their funds in Central Europe, while pre-war companies prefer to maintain greater investments in South America than the younger firms. But in each case the high ratio of foreign investments made "switching" difficult, owing partly to restrictions upon international capital movements and partly, perhaps, to the unwillingness of certain companies to show the large losses involved in their balance sheets. In these circumstances a change in the regional distribution could only be slow.

TABLE 25.—*Geographical distribution of investments of British investment trusts, 1929 and 1933* [a]

	Number of companies	Amount, in thousands of pounds	Percentages					
			United Kingdom	Empire	United States	Latin America	Europe	Rest of the world
Market values:								
1929 pre-war trusts	5	21,489	36.4	6.9	12.9	22.0	17.9	3.9
1929 post-war trusts	9	9,422	27.2	10.0	14.2	18.5	25.2	4.9
Total	14	30,911	33.6	7.8	13.3	21.0	20.1	4.2
1933 pre-war trusts	5	16,596	45.9	8.8	11.9	14.9	14.3	4.2
1933 post-war trusts	9	7,654	36.0	13.2	15.9	13.9	15.4	5.6
Total	14	24,250	42.8	10.2	13.1	14.6	14.6	4.7
Book values:								
1929 pre-war trusts	8	24,637	48.3	10.6	5.1	18.4	10.7	6.9
1929 post-war trusts	12	16,279	31.3	15.4	10.7	13.7	23.5	5.4
Total	20	40,916	41.5	12.6	7.3	16.5	15.8	6.3
1933 pre-war trusts	8	26,014	45.4	15.1	6.1	16.9	9.4	7.1
1933 post-war trusts	12	16,196	35.6	16.3	9.9	12.9	19.6	5.7
Total	20	42,210	41.7	15.6	7.6	15.3	13.3	6.5

[a] Data compiled from The Economist, Investment Trust Supplement Dec. 1, 1934, p. 8.

5. INDUSTRIAL DISTRIBUTION OF INVESTMENTS

The distribution of investments, by categories, shows that industrial investments now constitute as much as two-thirds of the whole, Government securities about one-eighth, railways rank at a similar percentage, while public utilities account for only 8 percent of the book value. Another sample of companies,[2] basing their percentages on market value, shows railways and public utilities with a somewhat higher figure. Industrials, however, are still shown to comprise more than 60 percent of the whole (Table 26).

Concentration on industrial issues is more strongly pronounced in the younger trusts than in the pre-war companies. Railways could not be regarded as a propitious investment in the whole post-war period. But railways had formed the backbone of the portfolio of the early investment trusts. Four trusts formed before the Baring crisis have names suggesting their original specialization on railways, and American railways were in pre-war times leading favorities on the British capital market. The situation was changed by the repatriation of United States investments during the war, which protected the trusts against heavy losses in the next two decades. On the other hand, a greater participation in public utilities would have helped the trusts in the last depression, and the relatively small participation in gilt-edged securities has limited the advantages derived from the big rise in British Government issues during recent years.

[2] The Economist, Investment Trust Supplement Dec. 1, 1934, p. 10.

TABLE 26.—*Industrial distribution of investments of British investment trusts, 1929 and 1933* [a]

	Number of companies	Amount, in thousands of pounds	Government and corporations	Railways	Public utilities	Industrial and miscellaneous
Market values:						
1929 pre-war trusts	4	21, 582	13. 7	28. 7	12. 3	45. 3
1929 post-war trusts	4	2, 696	15. 1	14. 4	11. 5	59. 0
Total	8	24, 278	18. 9	27. 1	12. 2	46. 8
1933 pre-war trusts	4	16, 635	18. 4	20. 6	15. 6	50. 4
1933 post-war trusts	4	2, 226	10. 4	9. 9	9. 9	69. 8
Total	8	18, 861	13. 0	19. 4	14. 9	52. 7
Book values:						
1929 pre-war trusts	10	25, 220	13. 4	16. 1	3. 8	66. 7
1929 post-war trusts	13	20, 000	15. 1	10. 3	9. 7	64. 9
Total	23	45, 220	14. 2	13. 6	6. 4	65. 8
1933 pre-war trusts	10	24, 859	13. 8	14. 5	5. 9	65. 8
1933 post-war trusts	13	19, 665	14. 5	10. 1	8. 1	67. 3
Total	23	44, 524	14. 2	12. 5	6. 8	66. 5

[a] Data compiled from The Economist, Investment Trust Supplement, Dec. 1, 1934, p. 11.

Changes in the industrial distribution between 1929 and 1933, as measured by the book values, are conspicuously small, and it would appear that switching was quite limited. If market values are used, the figures suggest a disproportionately heavy depreciation in railway holdings, which tends to exaggerate the increase in the industrial percentage. Naturally this change is more noticeable in the case of the pre-war trusts with their larger railway interests.

6. DISTRIBUTION BY TYPE OF SECURITIES

Calculated on book values, debentures, and common stocks in 1933 each represented approximately 40 percent of the total portfolio, while preference shares accounted for less than one-quarter (Table 27). On the basis of market values which are available only for part of the trusts, the share of common stocks was smaller, owing to the disproportionately heavy fall in the price of equities, with a corresponding higher proportion of bonds plus preference stock.

The older trusts invested their funds to a higher extent in debentures than the post-war trusts. They have reduced the scale of their debenture investments in the last decade, but up to the depression preference shares rather than common stocks were substituted for debentures in the portfolios. Up to 1929 these changes were due less to switches in the existing portfolio than to a modified policy of investing money obtained from new issues. On the whole, however, the resulting changes were rather slight.

TABLE 27.—*Type distribution of investments of British investment trusts, 1929 and 1933* [a]

	Number of companies	Total, in thousands of pounds	Percentages		
			Debentures	Preferred	Common
Market values:					
1929 pre-war trusts	9	35,257	50.7	25.5	23.8
1929 post-war trusts	8	7,203	42.3	23.6	34.1
Total	17	42,460	49.2	25.2	25.6
1933 pre-war trusts	9	27,146	49.3	28.0	22.7
1933 post-war trusts	8	5,852	38.3	27.8	33.9
Total	17	32,998	47.4	28.0	24.6
Book values:					
1929 pre-war trusts	13	36,870	48.1	20.8	31.1
1929 post-war trusts	16	23,402	44.1	19.1	36.8
Total	29	60,272	46.6	20.1	33.3
1933 pre-war trusts	13	37,783	45.1	20.5	34.4
1933 post-war trusts	16	22,853	38.0	20.5	41.5
Total	29	60,636	42.5	20.5	37.0

[a] Data compiled from The Economist, Investment Trust Supplements.

Nevertheless there are some signs which suggest that the process of switching has made further progress since 1933. The table below is an attempt, in rough form, to ascertain the changes (by an unweighted average) in the published percentages of 140 companies; book values and market values are lumped together in both years without discrimination.

Type of investments (percent of total amount)

[Data compiled from annual reports]

	Debentures	*Preference*	*Ordinary*	*Total*
1933	36.4	27.4	36.2	100
1935	31.8	26.2	42.0	100

The direction of the change, rather than the precise distribution itself, may be inferred from these statistics. So far as market values are contained in the original figures, the increase in the percentage of equities may be partly the result of their higher stock exchange quotations in recovery. But as the majority of companies use book values as a basis, it is reasonable to assume that the higher percentage of common stocks in 1935 is a result of switching operations during 1934 and 1935 from debentures to common stocks.

This movement has coincided with a change in capital structure in the opposite direction. Normally, the English and Scottish investment trusts hold a greater proportion of common shares in their portfolios than is represented by the ratio of their own issues of common shares to their total capital [3] This tendency, in the last few years, has been reversed to a certain degree, in both respects. The importance of common stocks in portfolios has increased and a far larger proportion of recent new issues has been in debentures.

[3] Cf. Ch. V: Capitalization of Investment Trusts.

CHAPTER VIII

THE PARTICIPATION OF INVESTMENT TRUSTS IN UNDERWRITING

Underwriting business in London goes through two stages. An issue is underwritten by a main underwriter, who usually reinsures a substantial part of the issue by subdividing his guaranty liabilities among a series of subunderwriters.

In the main underwriting, the investment trusts, in the narrower sense of the word, play little part. In the same way as short-term speculation is not associated with regular investment trust business, underwriting for the purpose of obtaining the overriding commission does not usually belong to the ordinary activities of these trusts. Their participation in subunderwriting is intended to obtain securities at a discount compared with the issuing price. The trusts sometimes make use of the opportunity to subscribe a certain percentage "firm" and then have a further chance to receive the rest of their applications at a price reduced to the extent of the underwriting commission.

It is difficult to obtain concrete figures on the participation of the investment trusts in subunderwriting. It is common knowledge that they play a significant part in this field, but, in contrast to the main underwriter, their participation is not mentioned in the prospectus.

In the annual income accounts, the item "underwriting commission" is usually merged in commissions of all kinds. Only few companies show it separately. It can be seen from Table 28 that commissions form widely differing proportions of individual trusts' total earnings.

TABLE 28.—*Underwriting commissions, earnings, and investments of British investment trusts, 1935* [a]

[Amounts in thousands of pounds]

Trust	Commissions	Total earnings	Investments	Commissions as percent of earnings
American Trust Co	0.52	83.0	1,929	0.6
Colonial & General	0.33	12.5	324	2.6
General Securities	0.45	6.8	187	6.6
Hellenic & General	2.32	81.9	1,054	2.8
Indian & General	1.58	41.0	1,008	3.8
International	2.73	87.3	2,130	3.1
Kelvin	0.13	3.2	98	4.1
London Border & General	1.22	98.6	2,546	1.2
Rio Claro	0.33	153.7	3,464	0.2
Second American	0.69	63.8	1,465	1.1

[a] Data compiled from balance sheets and income accounts.

The differences may be explained partly by different methods of accounting, partly as a result of differences in the volume of business, partly by the different meaning of the item "total earnings," which may or may not include the income tax on the dividends and interest received, and partly by the fact that when a trust has raised new money it may have temporary free funds which permit an increase in underwriting business for the company. The above sample is too small to allow an estimate of the amount earned by all investment trusts in subunderwriting. The year 1935, it may be noted, was not a period of peak activity in the new issue market.

The financial trusts frequently act as main underwriters. Those trusts which are controlled by bankers enjoy corresponding facilities for their issuing business. In addition to their functions as underwriters, these trusts may be employed by the banks concerned as a "tap" to the market (see supra). Table 29 shows the issues which were known to be subunderwritten by 33 of these financial trusts in 1934–35.[1] It will be seen that trusts participated in underwriting of 150 issues having a total value of £50,000,000. Since an issue is as a rule underwritten by only one trust, the question of duplication in the statistics does not rise. The amount of issues in the underwriting of which investment trusts participated is almost 20 percent of the total amount of private issues in that period.

TABLE 29.—*New issues in London, 1934–35, underwritten by financial trusts* [a]

Trust	Number of issues	Amount in thousands of pounds
African & European	3	600
Anglo-French Consolidated	3	1,750
Anglo-Oriental and General	2	200
Aynsley Trust	1	375
Bankers Industrial Develop	1	2,000
Beaver Trust	1	195
British Shareholders	11	11,200
British Trust Association	5	2,500
Cheviot Trust	10	800
Commercial & General Finance	1	84
Commercial Mining & Finance	1	350
Consolidated Mines & Industrial	1	300
Dominions & Overseas Trust	1	155
Electric & General Industrial Trust	3	1,150
Federated Trust & Finance Corporation	12	2,370
F. P. H. Finance Trust	4	650
Gresham Trust	1	125
Guildhall Trust	2	200
Hollybush Trust	4	880
Investment Registry, Ltd	17	3,150
London & Yorks. Trust	14	5,660
London Financial Trust	5	1,270
London Industrial Finance	8	910
Lonsdale Trust	1	1,200
Mercers Trust	9	240
Primary Investment Trust	1	180
Quadrant Trust	6	5,400
Seton Trust	5	1,250
Shirland Investment Trust	2	125
Standard Industrial Trust	14	2,400
Telephone & General	4	970
Tobacco Securities	2	4,610
Yorks. & Lancs. Corporation	3	400

[a] Data compiled from Issuing House Year-book, 1936 (Institute for Commercial Research).

[1] See supra. Ch. IV, for banking connection of these trusts.

The next table supplies some information of the same kind from a different angle. For this purpose all prospectuses of corporate issue published in The London Times were examined as to their size and the issuing house. The table arranges the issues in five groups according to the value of the issues at the offered prices. The size of each issue, and the trust responsible therefor, is shown (in thousands of pounds) in the second column. A comparison is then afforded in the last two columns between the total of issues sponsored by the financial trusts and the total value of issues sponsored by other concerns:

Issues sponsored by financial trusts, 1935 [a]

Size of issue	Trust responsible and size of individual issue (in thousands of pounds)	Total (in thousands of pounds)	
		Group	Other issuing houses
100-300	London & International Finance, 300—Standard Industrial Trust, 270—London & Yorks Trust, 200—Yorks. & Lancs. Corporation, 285—Electric & General Trust, 170.	940	3,410
300-600	London Industrial Finance Trust, 450—Cheviot Trust, 524—Mercers Trust, 450—Telephone & General Trust, 400—Consolidated Mines & Industrial Trust, 400—British Trust & Securities Corporation, 430—Australian & General Exploration, 375.	3,029	2,295
600-1,000	British Trust Assn., 600—British Shareholders Trust, 660—Federated Trust & Finance Corporation, 638.	1,898	----------
1,000-2,000	Seton Trust, 1,197—Quadrant Trust, 1,500—Investment Registry, 1,115.	3,812	6,855
Over 2,000	----------	----------	36,060

[a] Data compiled from prospectuses published in The London Times, 1935.

The table suggests that the importance of the trusts is largely restricted to medium-size issues, while the large issues are usually reserved for banking and larger broking concerns. From what external evidence is available regarding the 1928–29 new issue boom, it would appear that the specialized finance trusts have lost some of their importance. In earlier years, it was not uncommon for "mushroom" finance trusts to be formed as issuing houses, responsible for a large proportion of speculative issues.

The participation of investment trusts in pools is not widespread. One or two instances are known, the most famous of them being the repatriation of a controlling participation of Boot's Pure Drug. In that case the Tobacco Securities Trust was, together with certain banking concerns, engaged in purchasing the shares and redistributing them at a later stage on the market. Transactions of investment trusts in commodities are unusual.

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CHAPTER IX

EARNINGS AND DISTRIBUTIONS

The total profits of the English and Scottish investment trusts (before debenture interest, but after income tax) amounted in 1935 to roughly £11 to £12 million. They were divided between debenture interest, preference dividends, common dividends, and reserves in the relation of about 6 : 4 : 4 : 1. A more detailed analysis shows the following features:

1. Between 1924 and 1930 the profit of 92 pre-war trusts (out of 94 in existence) rose without interruption by a total of 67 percent. Profits declined in the following 3 years by about 35 percent and recovered only moderately until 1935, when they reached only some 80 percent of the peak year (Table 30).

TABLE 30.—*British investment trust profits, 1924–35* [a]

[In millions of pounds]

	1924	1925	1926	1927	1928	1929	1930	1931	1932	1933	1934	1935
92 pre-war trusts	6.04	6.73	7.50	8.18	9.05	9.84	10.12	9.18	7.67	6.63	7.10	8.00
83 post-war trusts	------	------	------	------	------	4.00	4.55	4.04	3.26	2.89	2.90	3.30
175 trusts	------	------	------	------	------	13.84	14.67	13.22	10.93	9.52	10.00	11.30

[a] Data compiled from The Economist, Dec. 1, 1934, Investment Trust Supplement, pp. 2 and 5. Figures for the years 1934 and 1935 are rough estimates.

The trend in profits is the result of changing dividend and interest income and changing capitalization of the trusts. An idea of the participation of the first factor separately can be derived from the estimate that £100 of the investment gave a total income of £4.95 in 1924, £4.45 in 1929, and £3.25 in 1933.

2. The results of the post-war trusts—with an average age of 2–3 years at the beginning of the crisis—were considerably worse: they earned only £3.9 per £100 of investments in 1929 and £2,790,000 in 1933. The decrease in profits from 1930 to 1933, amounting to about 36 percent, was of about the same order as that of the older trusts.

3. The influence of the age factor on trust profits is visible from Table 31. The ratio between income and book value of portfolio is least favorable in the youngest age class, and highest in the group of trusts organized in the last decade of the nineteenth century. With certain exceptions yield improves with the growing age of the trust, in consequence mainly of the conservative valuation of the portfolio of the older trusts.

TABLE 31.—*Earnings and dividends of British investment trusts, by age groups* [a]

[126 companies]

Year of organization	1918–28	1909–18	1899–1908	1889–98	1878–88	1869–78	All trusts
Gross income as percent of balance sheet totals (1928)	4.65	5.44	5.78	6.03	5.87	5.61	5.48
Average dividend on common shares (1919–28)	6.30	6.93	12.14	12.52	13.81	16.24	10.69
Average distributions [b] 1919–28 as percent of total capital	5.48	5.68	7.14	6.88	7.38	7.22	6.65

[a] Data compiled from Linhardt, Hanns, Die Britischen Investment Trusts (1935), p. 141.
[b] Average dividend on common shares plus 5 percent on preferred stocks and bonds.

Relations between dividends paid and value of assets is of a similar nature; the older the trust, as a rule, the higher the dividend rate. However, a partial explanation of the better showing of the older trusts is provided by their capital structure, which contains a higher percentage of preferred stocks and bonds.

4. In the average of the years 1922–35, out of £100 total income (before debenture payment) roughly £30 were paid for debenture interests, £20 on preferred stock, and £40 on common stocks; £10 were put to reserve. The dividend on common stocks averaged 7 percent but oscillated in that period between 4 and 10 percent (Table 32).

TABLE 32.—*Distribution of profits* [a] *of British investment trusts* [b]

[Amounts in thousands of pounds]

Year	Net profits (after debentures)	As percent of net profits			Average rate of return (percent)		
		Common dividends	Preference dividends	Reserves	Debenture capital	Preference capital	Common capital
1935	8,976	43.2	44.1	12.7	4.4	4.0	4.4
1934	7,995	44.3	48.8	6.9	4.5	3.8	3.9
1933	7,640	45.8	50.0	4.2	4.6	3.9	3.9
1932	8,227	46.7	43.0	10.3	4.5	3.8	4.7
1931	12,075	53.9	34.0	12.1	4.5	4.0	6.2
1930	14,201	55.2	28.3	16.5	4.5	4.2	7.6
1929	12,794	55.4	28.9	15.7	4.5	4.4	9.2
1928	11,015	56.3	24.2	19.5	4.5	4.1	8.4
1927	8,995	58.9	22.1	19.0	4.4	4.5	10.2
1926	7,082	59.7	22.2	18.1	4.4	4.4	10.0
1925	6,161	54.5	24.3	21.2	4.2	4.3	9.1
1924	5,707	56.9	25.0	18.1	4.2	4.1	7.2
1923	4,784	57.4	26.9	15.7	4.2	4.2	7.2
1922	1,553	54.9	33.8	11.3	4.3	4.0	6.3
Average 1922–35		53.1	32.5	14.4	4.4	4.1	7.0
1914	386	50.1	29.2	20.7	4.0	4.4	7.6
1913	430	46.9	25.5	27.6	3.5	4.3	7.9

[a] Data compiled from annual statistics of company profits in The Economist.
[b] Number of trusts (including some financial trusts) changing from year to year. Only percentages comparable.

They absorbed on the average more than one-half of the net profits (after debenture), the percentage varying between 43 and 60 percent.

Open reserves in 1934 absorbed 4.2 percent of net profits; they reached their maximum participation of over 20 percent in 1925 and showed an average of 14 percent over the period 1922–35. The share of reserves in profits had been considerably larger in the years immediately preceding the war, and it amounted to about 24 percent in 1913–14.

The trusts have tried to stabilize their common dividends, to a certain degree, by their reserve policy. Although it is unusual to draw on reserves to pay common dividends, the reserve allowance in times of falling profits is permitted to fall to a smaller proportion in the total income. The ratio of reserves to equity earnings which averaged about 20 percent over the whole period 1922–35 decreased to 8 percent of the much smaller total amount available for distribution in 1933 (Table 33).

TABLE 33.—*Allocation to open reserves of British investment trusts, in percent of equity earnings* [a]

1935	23	1929	22	1923	21
1934	13	1928	26	1922	17
1933	8	1927	24		
1932	18	1926	23	Average	21
1931	18	1925	23		
1930	23	1924	24		

[a] Data compiled from Table 32.

5. An attempt was made to examine the influence of the size of the investment trusts on the earnings. Three groups each comprising 10 trusts were chosen: Larger companies with a book value of more than £3.5 million each, medium-sized trusts with a portfolio value of £1.5 to £2.5 million, and small firms with less than £0.5 million investments. The ratio of income to book value of investments in 1929 is shown in Table 34. Although the medium-sized trusts have the most favorable ratio of total income to book value the dispersion of the ratios of the individual trusts in all groups from the average is so wide that no definite conclusions can be drawn from these statistics in this respect.

TABLE 34.—*Income of British investment trusts by size groups* [a] *(pre-war trusts)*

[In thousands of pounds]

I. LARGE TRUSTS

	Total income before debenture	Book value [b]	Income as percent of investments
American Investment & General	185.5	3,642	5.1
British Steamship	260.4	4,818	5.4
Debenture Corporation	198.3	3,876	5.1
Foreign & Colonial	171.5	3,532	4.9
Industrial & General	454.6	7,705	5.9
Investment Trust Corporation	348.8	8,088	4.3
Mercantile Investment & General	432.6	7,645	5.7
U. S. Debenture Corporation	218.7	4,348	5.0
British Assets Trust	288.5	6,736	4.3
Second Scottish Investment Trust	174.4	4,202	4.1
Total	2,803.1	54,592	5.1

[a] Data compiled from The Economist, Investment Trust Supplements, Dec. 1, 1934.
[b] In 1929 book values generally were below market values.

TABLE 34.—*Income of British investment trusts by size groups (pre-war trusts)*—Continued

[In thousands of pounds]

II. SMALL TRUSTS

	Total income before debenture	Book value	Income as percent of investments
Brewery & Commercial	31.7	482	6.6
Government & General	27.8	445	6.4
Canadian & Foreign	16.9	425	4.0
City National Investment	14.6	268	5.4
General Securities	6.3	169	3.7
Imperial Colonial Finance & Agency	15.4	319	4.8
London & Colonial	21.5	380	5.7
New Investment	24.2	319	4.3
General Scottish	5.0	131	2.3
Northern Securities Trust	19.4	446	4.3
Total	182.8	3,384	5.4

III. MEDIUM SIZED TRUSTS

	Total income before debenture	Book value	Income as percent of investments
Anglo American Debentures	142.4	2,232	6.4
General Investment & Trustees	97.8	1,527	6.4
Government Stocks and other Securities	123.7	2,206	5.6
Guardian	103.9	1,834	5.7
International Investment Trusts	104.8	2,081	5.0
Nelson	101.4	1,551	6.5
Railway Share Trust & Agency	120.5	2,106	5.7
Trust Union	82.0	1,510	5.5
Clydesdale Investment	116.7	2,265	5.1
Edinburgh Investment Trust	100.5	1,867	5.2
Total	1,093.7	19,179	5.7

6. In consequence of the usually high leverage ratio of British investment trusts, the amount available for dividends on common stocks is subject to considerably larger oscillations than total profits (Table 35). Whereas total profits for a sample of pre-war trusts decreased by about one-third in the crisis between 1929 and 1933, the amount of earnings available for common dividends fell as much as 60 percent. In the whole period the payments on senior securities remained practically unchanged.

TABLE 35.—*Effects of leverage on profits of 92 Pre-war British investment trusts* [a]

[1929=100]

	1924	1930	1931	1932	1933
Total profits	61	103	93	78	67
Earned on common stocks	63	104	87	61	42
Earned on common stocks of 56 English investment trusts	66	101	85	60	43
Earned on common stocks of 36 Scottish investment trusts	58	109	91	64	41
Senior charges	59	100	99	97	98

[a] Data compiled from The Economist, Investment Trust Supplements, Dec. 1, 1934, pp. 2–4.

The yield of the common stocks of investment trusts since the last decade of the nineteenth century has oscillated between 5 and 6 percent. Figures calculated by the late Mr. Joseph Kitchin of the net yield of six equity stocks show an irregular fall from 5¾ percent in 1890 to under 5¼ percent in 1899. Except for a short-lived rise to 5½ percent in 1908 (crisis of 1907) only small deviations occur from the level of 5¼ percent. The war took the curve, at first, to over 6 percent and later below the 5 percent level. Again a sudden increase occurred in 1920 to 6 percent when quotations dropped, and dividends increased at the same time by about 10 percent compared with the preceding year. From that year the yield figures begin their continuous decline, despite increased dividends, due to a compensating upward movement of stock exchange quotations for investment trust common stocks. In 1922 the yield, for the first time, fell below the 5 percent level, in 1925 to 4.35 percent, and 1927 to 4 percent.

Table 36, the figures of which are not comparable with the Kitchin statistics, shows the trend since 1928. It shows that dividend yields rose sharply to 1932, and then declined to below the predepression level, not because of the improvement in investment trust stock prices, which was rather slow, but as a result of the low average dividends paid.

TABLE 36.—*Yield on ordinary stocks of British investment trusts and individual companies* [a]

INVESTMENT TRUST SHARES

	1928	1929	1930	1931	1932	1933	1934	1935
Yields on dividends	4.31	5.07	5.41	6.82	6.92	4.79	3.55	3.45
Yields on earnings	5.63	6.63	7.70	8.55	9.09	6.07	3.50	3.57

INDUSTRIAL SHARES

	1928	1929	1930	1931	1932	1933	1934	1935
Yields on dividends	5.14	6.81	7.21	7.16	6.94	3.47	3.67	3.68
Yields on earnings	6.81	8.05	9.87	6.03	3.04	0.66	0.12	3.28

[a] Data compiled from Actuaries' Investment Index.

CHAPTER X

THE COST OF MANAGEMENT

The management costs of the English and Scottish investment trusts are relatively low, for they amounted on the average to 0.38 percent of the value of the investments per annum in 1935, and have averaged about 8 percent of earnings during the last 5 years.

The general level of the management expenses in relation to the investments seems to be fairly constant. The average for 17 companies for 1913 is nearly the same figure—0.31 percent—while for individual companies the figure ranged at that time from 0.22 to 0.47 percent.

The income accounts of the companies are not very revealing on the distribution of these expenses. The directors' fees must be disclosed, but other expenses are usually given in a total sum. Occasionally auditors' and trustees' fees are disclosed. In the following remarks, the directors' remuneration is included as a "management expense." Table 37 analyzes the management expenses of 197 trusts and compares these expenses with their issued capital.

TABLE 37.—*Management expenses of 197 British investment trusts* [a]

	Capital, including debentures, in millions of pounds	Expenses, in thousands of pounds	Percent of capital
Pre-war English trusts	111.2	485.6	0.44
Post-war English trusts	77.2	269.4	0.35
Pre-war Scottish trusts	72.2	247.9	0.34
Post-war Scottish trusts	46.2	145.7	0.31
Total	306.8	1,148.6	0.38

[a] Data compiled from Moody's British Companies Service.

The costs of the pre-war companies are higher than those of the post-war trusts, and the expenses are higher in England than in Scotland.

The advantage in favor of the younger trusts may be partly explained by their connections with older trusts, which bear more than a proportionate share of the group's expenses. Apart from that, very much depends upon the regulation of the directors' remuneration which is for many of the older trusts based on the company's profits. Although in the original state the fees were moderate, they increased with the growth of the firm. The relation of directors' remuneration (which normally excludes managing directors' fees) to management expenses is shown in Table 38.

TABLE 38.—*Directors' remuneration in 157 British investment trusts* [a]

[In thousands of pounds]

	Directors' fees	Total management expenses	Percent
Pre-war English trusts	172.6	433.7	39.8
Post-war English trusts	99.3	225.3	44.1
Pre-war Scottish trusts	89.0	223.6	43.0
Post-war Scottish trusts	50.6	140.4	36.0
Total	411.5	1,023.0	40.2

[a] Data compiled from Moody's British Companies Service.

The total directors' remuneration lies somewhere between £1,000 and £3,000 for the whole board and averages between £250 and £750 per board member.[2] Sometimes they are higher; thus for the Cable Investment Trust, the total remuneration is £5,000 after deducting income tax, with a possibility of extra remuneration for services outside the scope of the ordinary duties of the director. Occasionally fees are based upon the profits of the company, 3 to 5 percent for the big trusts and up to 15 percent for the smaller ones. Since the Company Law makes it necessary to publish all directors' remunerations in the accounts, the number of managing directors to whom the regulations do not apply has probably increased. Extraordinarily high fees or supervisory remunerations, however, are not characteristic of the British trusts. In spite of that, however, the accumulation of fees from a series of directorships held by one person may make his total income from investment trusts very high. "Founders'" shares do not exist except in one case (Imperial Colonial Finance and Agency Corporation).

Since managing directors' fees are not disclosed, these figures underestimate the total cost of management. The directors' fees however, are a decisive item in the total management expenses, amounting to two-fifths of the whole and to £2,700 per trust. In individual cases they rise to about two-thirds of the total expenses. The post-war English trusts show the highest average. The other cost items are not usually important. The trusts are able to work with a small equipment and staff. The bookkeeping department, even of a group, need not consist of more than 5 to 20 persons, while auditors' and trustees' expenses in larger firms amount from £500 to £1,000 per annum.

The influence of size of company on management costs is indeterminate. An examination of six very large trusts and of another group of very small trusts (up to £300,000 capital) shows a percentage of costs to capital of 0.27 percent for the first and of 0.34 percent for the second group both under the average; the first group with only small deviations from their mean value, the other, however, with a mixture of very high and especially low percentages. The relation between the management expenses of different groups is of interest. In the Touche group, for example, each trust shows a percentage above the normal level, with 0.52 percent as the average.

[2] The average number of members on the board (excluding the managing director) is about 4.

It is true that this ratio is not reached by the other groups and may be explained by somewhat larger boards of directors in this group. In spite of that, the "saving" theory of the group formation does not always seem convincing: predepression statistics of management expenses expressed as percentages of the balance sheet totals reveal a ratio of 0.48 percent for six big groups against 0.45 percent as average for all companies. Perhaps the boards in these large groups are remunerated on a higher basis than smaller trusts.

Table 39 is based on a sample of 25 companies, and compares management expenses with income after income tax. The contraction of costs between 1929 and 1935 was rather slow and amounted to only 15 percent. As a consequence of the rapid decrease in income, therefore, the ratio of expenses to earnings showed a tendency to increase. The division in groups of different sizes shows clearly the more favorable position for the larger trusts in relation to earnings. The very small trusts, with a high percentage of expenses, however, have reached the precrisis level again, whereas the larger companies are not yet back to the old standard.

TABLE 39.—*Management expenses and earnings in 25 British investment trusts, 1929–35* [a]

[In thousands of pounds]

	1929	1930	1931	1932	1933	1934	1935
Earnings	[b] 3,503	3,577	3,245	2,688	2,346	2,314	2,454
Management expenses	226	233	230	220	209	203	198
Percent	6.5	6.5	7.1	8.2	8.9	8.8	8.1
8 LARGE COMPANIES							
Percent	5.6	5.5	5.9	6.8	7.6	7.4	6.6
12 MEDIUM-SIZED COMPANIES							
Percent	7.8	8.1	9.0	10.4	11.2	11.4	11.1
5 SMALL COMPANIES							
Percent	[c] 12.7	12.4	12.7	15.8	15.2	15.2	12.7

[a] Data compiled from annual accounts.
[b] 23 companies.
[c] 3 companies.

CHAPTER XI

FIXED TRUSTS [1]

The legal position of the fixed trusts (or "unit trusts," as they are now to be officially designated) is entirely different from that of the investment trusts.[2] The companies which manage the fixed trusts are mostly private concerns, and the relations between them and the banks or insurance companies which act as custodian trustees are embodied in a trust deed, or in supplementary correspondence. The trustees, additionally, usually have, under the deed, certain supervisory powers over the exercise of management and, in some cases, a veto in such matters as "switches" from one security to another. In other instances, the trustee may, under given conditions, replace the managers by new managers. The trust deed provides, further, for the limitation and life of the trust, for its early termination under certain circumstances (such as unfavorable legislation, etc.), the distribution or reinvestment of the proceeds of dividends, capital rights, or eliminated securities, the maximum size of the trust, etc. If the Board of Trade Departmental Committee's Report on Fixed Trusts is implemented, the matters to be dealt with in the trust deed will be most closely specified, in the interests of maximum publicity.

Neither in total numbers nor in the extent of its controlled resources has the fixed trust movement attained the dimensions of the investment trust companies. There are something over 200 investment trusts extant in the narrowest sense of the term, excluding financial trusts and specialized branch trusts, and their total investments amount to £300,000,000. As of July 1936, there were nearly 70 fixed trusts in existence, whose sales of units have been estimated in several quarters at approximately £50,000,000.[3]

The majority of managing companies control more than one unit trust, and when duplication of directors is taken into account the scope of the management is even more closely concentrated, several of them having the same board of directors. The whole business is in the hands of 11 groups: Municipal and General Securities Co.; United Fixed Trusts, Ltd., with connecting companies; Fixed Trust Investments, Ltd.; Investors' Specialized Fixed Trusts, Ltd., with associated companies; Allied Investors' Fixed Trusts, Ltd.; Trust of Insurance Shares, Ltd.; First Provincial Fixed Trust, Ltd.; British Keystone Securities Trust, Ltd. (with several associated companies); British General Fixed Trust, Ltd.; F. T. M. Ltd.; Selective Fixed Investments, Ltd.; Trust of Transport Share Ltd., and Protected Fixed Trusts, Ltd. Full particulars of capitalization and personnel of the majority of these groups are given in The Economist's Fixed

[1] At many points, the following discussion of unit trusts is affected by the recommendations of the Board of Trade Committee on Fixed Trusts, and this section should be read in conjunction with that report.
[2] See the Commission's Supplemental Report: Fixed and Semifixed Investment Trusts.
[3] See Report of the Departmental Committee appointed by the Board of Trade, 1936, Fixed Trusts, London, 1936, p. 7.

and Flexible Trust Supplement of March 7, 1936, page 12. Among them, only Selective Fixed Investments and First Provincial Trust manage only one trust each. On the average, 5 trusts were then controlled by each company, British Industrial Corporation and United Fixed Trust leading with 11 controlled trusts each. Municipal and General then operated 5 trusts (since increased to 7). One group has split in the course of the last year: Allied Investors and Trust of Insurance Shares, formerly with the same board of directors, are now separately operated.

The existing managing companies are all private companies and are, therefore, not under the obligation of publishing annual balance sheets. British Industrial Corporation and Municipal and General, originally public companies, changed their constitutions after entering the fixed trust field.

The capital of management companies is in most cases small, ranging from £10,000 to £25,000, usually in ordinary shares. Apart from Municipal and General and British Industrial Corporation, which were already in existence, all the managing companies were founded ad hoc.

Control of the managing companies, so far as a list of directors and shareholders offers information, seems to lie mainly in the hands of private persons who were not, in many cases, already familiar in the City of London. Some solicitors are represented on the boards, though possibly as nominees. It is now less usual to find stockbrokers acting as directors, since the interim report of the Stock Exchange Sub-Committee on Fixed Trusts suggested their exclusion from fixed trust management. The financial writer, Hartley Withers, is on the Allied Investors' board, while the management of the Trust of Insurance Shares consists of insurance company directors. In two instances financial interests are represented by Municipal and General, which is controlled by White, Drummond & Co., while the "Investors" groups is completely controlled by the banking firm of Dawnay Day & Co.

The amount of unit trust sales can only be estimated, for sales are generally regarded as secret, although the National Group, apparently the largest concern of all, claimed, at the end of 1935, sales of over £16,000,000 and 55,000 unit holders on its books. An estimate of The Economist, based on information from all but one group, suggested a figure of net sales of £45.8 millions at the end of 1935 compared with £20.75 millions a year earlier. The computers suggested that sales had reached £50,000,000 in the spring of 1936, an estimate subsequently confirmed by the Board of Trade Committee's Report. In the 5 years of its existence, the funds invested in unit trusts have amounted to one-sixth of the nominal value of the investment trusts' capital. The total of £50,000,000 is small, compared with the debt of the existing savings institutions (Post-Office Savings Bank, £390,-000,000; National Savings Certificates, $390,000,000; and Building Societies, £526,000,000). Nevertheless, the growth of the unit trust movement in 1935 alone was as great as the net growth of Post Office and Trustee Savings Bank deposits.

The following table gives particulars of the organization of the fixed trusts. For fuller details, see the Fixed and Flexible Trust Supplement published with The Economist of March 7, 1936, pages 26–29.

TABLE 40.—*Various data on unit trusts, March 1936*

All	Fixed	Flexible	Managed	Open	Closed	General	Specialized	Cumulative	Distributive	Mixed
NUMBER										
56	40	10	6	50	6	41	15	13	24	14

NUMBER OF SECURITIES IN PANEL

	1 to 20	21 to 30	31 to 100	100 to 150	150 to 200
Number of trusts	17	19	17	2	1

NUMBER OF DIVISIONS OF SUBUNITS

	1,500	2,000	4,000	4,800	5,000	6,000	7,500	8,000	10,000	12,000	15,000
Number of trusts	1	9	13	8	8	3	1	8	3	1	1

TRUSTEES

Number of trusts with banks as trustees	47
Number of trusts with insurance companies as trustees	9
Lloyd's Bank	10
Midland Bank Exec. & Trustee	29
National Provincial Bank	3
Williams Deacon's Bank	2
Martin's Bank	2
Clydesdale Bank	1
Royal Exchange Assurance	6
General Accident Fire & Life	2
Equity & Law Life Assurance Society	1

The most remarkable change in the structure of the unit trusts is the growing tendency to "flexibility." The first trusts (whose inspiration was borrowed from the United States) were "fixed" in the full sense of the word and represented a reaction to the experience of unfortunate or mismanaged investment trusts of the limited-liability type. As the movement developed the emphasis on the advantages of rigid portfolios became smaller. Now the movement has come the full circle. All trusts formed in 1936 are flexible. At the first stages of the unit trust movement, the managers were primarily concerned with sales problems, but in the future the question of successful management of flexible portfolios will attain growing importance.

Very roughly, five steps can be distinguished in the development to more or less complete flexibility. The first was rigid fixity, moderated only by the possibility of eliminating individual securities in cases of emergency (First British Fixed Trust). The second gave power to the managers to reinvest the proceeds of these eliminations in other securities (Investors Gas & Electric). This was succeeded by the managed trust of the unit type, where managers were free to choose the investments from a permitted list (Limited Investment Fund). Later trusts allowed the managers to deviate from the permitted list and to introduce, apart from the securities comprised in it, a certain percentage of new companies per annum (Midland and Southern

Counties, Ind.). Finally, almost complete liberty from restrictions is provided by a large panel of companies within which the managers may invest the trust funds, while retaining powers, under certain conditions, to invest in other securities (Aviation & Universal Investment Trust).

The marketing of investment trust securities does not differ from that of other securities except that they are rarely underwritten. The sale of units of fixed and flexible trusts, however, presents new problems of issue. There are, at present, no legal restrictions controlling the sale of units, and all the methods of modern publicity have been used to put the subunits before the public.

Public advertisement of shares and debentures in management investment trusts is non-existent. The prospectuses of any new issues must be published in accordance with Company Law and the stock exchange regulations, but there is no continuous publicity regarding their investment merits. Fixed trust units, on the other hand, are advertised continuously and in all places, in the press, particularly in the Sunday papers, underground trains and railway stations, in special periodicals published by the trusts, in booklets, in postage-stamp books, in lectures, and elsewhere. Such continuous publicity is not accorded to other securities and is adopted to a much smaller degree by building societies. For 1935 the advertisement costs of the unit trust in newspapers only were estimated at about £200,000, and the total costs were considerably higher. This expensive publicity is not free from several doubtful elements. The emphasis upon the name of a bank (which appears in bold type on the first page of a prospectus) has its parallel in the unit-trust advertisements, where the trustee's name (usually a bank) is printed in a similar way. This may convey the impression to a potential buyer that the security is in some sense "guaranteed" by the bank, which in fact acts only as custodian trustee. It seems, however, that the trustees have begun to exercise some influence against such possible misconceptions. Sometimes the advertisements contain impressive figures which are of no special significance, such as, for instance, the total value of capital and reserves of the 150 companies of the underlying panel.

The necessity of speaking a language understandable to the small investor has influenced the choice of the underlying securities. For this reason, investments had to be chosen, in the first place, from well-known leading shares, familiar to the public and giving an air of stability to the portfolio. This practice is not without the danger of overduplication of particular shares, though it offers certain guaranties in a wide market and excludes highly speculative investments.

But, in this respect, an advantage which works in favor of the investment trusts is necessarily lost for the unit trust. The latter cannot purchase the shares of smaller companies which, despite their good prospects, are beyond the view of the general public. The unit trusts in fact, purchase market leaders, for the most part, at relatively high prices and are, therefore, likely through their buying policy further to inflate the price of this type of security.

Secondly, the range of securities eligible for these purposes is remarkably small. The panels of the different unit trusts frequently show a conspicuous similarity. Many leading securities are "duplicated." It is difficult to estimate the total market importance of this tendency, for not all of the unit trusts have reached the point of maximum expansion. If the trusts with fixed portfolios sold up to their maximum number of units, they would hold at least 10 percent of the capital of some 40 companies, while for some cases the percentage would amount to 30 or 40 percent.

The third objection lies in the possible weakness of any investment movement which bases its appeal on contemporary popularity of given sections of the market. Thus, armament shares have, for some time, received more attention than future earnings of these companies seem to justify in some cases. Aviation shares have similarly received widespread speculative support in recent months. Some trusts have been formed in response to this public interest, which is, of course, primarily supported by reasonable foundations. But the fate of these specialized unit trusts when the scope of the earning power of popular speculative counters is defined, when their quotations are adjusted to that level, and speculative interest subsides, is rarely considered.

The selection of high-priced securities chosen from the "popularity" point of view results in a modest yield, and since it is considered necessary to attract the purchaser by a higher return, some adjustment becomes necessary in the portfolio. With few exceptions, the unit trusts improve the yield from the basic industrial securities by including gold mines and similar "wasting" securities in their investments. Since current dividends include a capital element, which should be set aside for future amortization, the apparent yield is accordingly much higher than on industrial shares. According to The Economist's statistics, Government Gold-Mining Areas (Modd.), is held in the portfolio of 11 fixed trusts, Crown Mines by 7 trusts, Spring Mines by 8 trusts, Johannesburg Consolidated by 10 trusts, etc. These figures illustrate the extent to which yield figures are "sweetened." The published yield figures are naturally based on former dividends, but the advertisement usually contains a suggestion (or leaves it to be inferred) that future yield expectations are good. The calculation of yield figures in advertisements is rarely clearly defined and is never authoritatively checked. In the case of the flexible trusts, high figures can only be achieved by including an undue proportion of the speculative shares in the list.

The channels of sale of fixed and flexible trust units are far more numerous than for investment trust shares. Stockbrokers, although participating, have no monopoly. Most groups include a sales staff which is in contact with solicitors, local bank managers, and so on. The publicity booklets contain a number of application forms, and the transaction is usually executed directly between trust and customer. Transactions arranged solely through stockbrokers (as required by the Municipal and General Group) are the exception.

It is generally usual to pass a proportion of orders for the purchase of underlying securities to the broker who sells the subunits, a feature known as "reciprocal business." By this means the most important selling institution of the market has an interest in recommending trust units to their clients.

1. LOADING CHARGES

Subsection (f) of the report of the Stock Exchange Committee dealing with the form of Trust Deeds demanded the inclusion of clear provisions as to the remuneration to be received by trustee and managers, and the reservation of a part of the initial loading charge for the future.

The loading percentages for the trusts of the "fixed" type are compiled in the following table:

Loading charge (percent)	8	7.5	7	6.5	6	5	10 [a]	5 [a]
Number of trusts	2	2	10	3	8	15	4	6

[a] Added to costs.

Two methods of calculating the loading charge are employed. The fixed trusts adopt a once-for-all loading charge. The flexible trusts, however, usually adopt a combination of a fairly large initial charge, together with an additional percentage annual contribution.

The total income to the managers, however, is somewhat larger than the published load percentages. The main sources of additional gains are from adjustment of dealing prices and quotation differences. The subunit dealing prices are quoted to the nearest upper multiple of 1½d or 3d, so that fractional gains accrue to the managers. The prices of the underlying securities employed in calculating the subunit quotations are usually the "offered" prices on the London Stock Exchange on the same day. The "offered" prices, however, are normally higher than the actual price at which business is done. A further increase in the real loading may result if the nominal percentage is based on the final price and not on the costs.

By these sundry adjustments a figure of about 7½ percent as loading charge for the average "fixed" trust of 20-year life seems to be normal. Although trusts do not publish any information for a detailed analysis of costs, the following estimate of The Economist is probably a sufficient guide:

Loading charge 7.5 percent

	Percent
Broker's commission	1. 50
Advertising	1. 25
Management over 20 years, office rent and initial charges	1. 15
Trustee's fees	1. 15
Preparation of dividend warrants, permanent staff, etc	1. 00
Managers' margin	1. 45
Total	7. 50

From this analysis there is no evidence that the managers make undue profits from direct loading charges. Where several trusts are managed by one group, and profitable jobbing opportunities occur in the underlying securities, profits will doubtless be higher. But the mechanism of competition operates on the published loading figures. Net sales of about a quarter million pounds would probably be necessary to cover the cost, and half a million pounds as minimum for a normal profit. The figure of net sales of £50,000,000 for less than 60 trusts, suggests that at least the more successful companies have reached the level which leaves them a satisfactory profit.

Whether sufficient reserves are formed from that income to cover the future expenses for anything up to 20 years, after closing the trust, is rather doubtful. Most of the trusts think their prospective holders satisfied with a superficial remark on "escrow" funds, stating that such arrangements exist sometimes (British Empire group) under control of the trustee, sometimes (National Group) agreed by trustee and auditors, sometimes without information regarding control. The fixed trusts of the Municipal-General group stated their escrow and figure for April last year at £160,000. The Dawnay-Day group reserves one-third of the service charges for trustees' and managers' expenses for the remaining life of the trust, the share of the manager being placed in "escrow" from which half-yearly distributions are made. The usual ratio of the provision for the special fund is about one-third of the loading charge.

For the flexible trusts which have current management expenses, the provisions are somewhat different involving the separation of an annual charge from the original loading charge (cf. The Economist Fixed Trust Supplement, Mar. 7, 1936, p. 34). The annual charge is usually based on the average value of the trust property and thus depends upon the course of security values on the stock exchange, which is, of course, not directly connected with the trust's expenses. Such fluctuations may alter the receipts from total annual charges which are usually about three-fourths of 1 percent except for the trusts of the insurance groups (three-eighths of 1 percent).

A price calculation of a sub-unit of the Security First Fixed Trust is reprinted in The Economist Fixed Trust Supplement of March 7, 1936, page 20. The total price of the securities is increased apart from the service charge by brokerage and stamp fees (the latter include "appropriate" stock exchange charges at the current date for the Keystone Certificates and stamp duties including those payable on the creation of the units or subunits or on the certificates for the Hundred Securities Trust). Furthermore, a sum is included to cover accrued dividend rights, etc., to be distributed at the end of the six-month period.

For the cost of Keystone Certificates units (December 19, 1935) the following figures were given in a recent (March 1936) issue of The Stockbroker:

Cost of shares or stock	£5, 756.	19.	0
Broker's commission	70.	13.	1
Stamp duty	74.	5.	0
Transfer fee and stamps	9.	1.	0
Total costs	£5, 910.	18.	1
Management charge 8 percent	552.	17.	5
Dividend equalization	107.	3.	4
Total	£7, 570.	18.	10

One-thirtieth thereof=250 subunits £252. 7. 3.

Cost of one subunit 20/2¼d.

Selling price 20/3d.

Earned per 250 subunits by rounding off 15/7½d.

A calculation of the theoretical costs of 250 subunits bought singly, at the dealing prices on the same day comes to £253. 13. 0½; so the loading charge of the trust in that special case—which does not take into account the actual difficulty of obtaining unusually small quantities on the Stock Exchange—seems to be earned mainly by savings in commissions of all kinds owing to high level of minimum brokerage rates: the theoretical broker's commission for the purchase of 30 'parcels" of 250 subunits is £397. 10. 0. and stamp duty £103. 10. 0. compared with £70. 13. 1. and £74. 5. 0. for the full unit. For larger amounts, of course, this factor works in favor of direct investment.

The repurchase price is based on the total stock exchange "selling price" current at the date in question, less brokerage stamp duty and transfer fees with downward price adjustment to the nearest 3d. This is the minimum price which the managers are prepared or guarantee to pay. As long as the trust is open, a certain part of the loading charge may be repaid in order to keep the margin between dealing prices conveniently narrow.

Calculation of dealing prices falls to the manager or dealer and there is no authoritative control against mistakes and miscalculations from other reasons.

2. LEGAL REGULATIONS

No special legal regulations apply, for the time being, to the fixed trusts. The recommendation of the Fixed Trust Committee of the Board of Trade may, however, be adopted by the Government as a basis for legislation. Important recommendations which would control the movement by exacting the fullest possible publicity rather than by imposing rules for detailed control of management are made in the Report, which should be carefully consulted. The regulation of the fixed trust complex is therefore left to possible legislation.

In the meantime, the majority of managing companies (although there are a few important independent groups still outside) have formed a Association of Fixed and Flexible Trust Managers acting on the lines of the Stock Exchange report on fixed trusts, to impose control from within. So far, however, the effects of the Association on the conduct of unit trust business have not introduced radical changes.

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CHAPTER XII

PUBLICITY AND ACCOUNTING

The balance sheet and income accounts of investment trusts are difficult to analyze. No strict rules determining the content of the accounts (apart from the general requirements of the Companies Act) are in force. The same item may be stated in two different balance sheets on a quite different basis.

By far the most important item under the assets is "investments," valued "at cost or under." Sometimes these include "secured loans," which are normally very small sums originating from mortgage business, etc., which are usefully separated by some trusts. Even when strictly separated from all extraneous items the amount shown for investments, i. e., the "book value," may give insufficient information on the original market value of the securities invested since it may be shown after internal provision for depreciation. The figures are consequently not directly comparable from trust to trust. The reason lies in different methods of treating reserves in the balance sheet. A direct undervaluation is quite frequent. "Investments at cost, less amounts written off" is a familiar entry. On the other hand, special investment reserves may be formed and separately disclosed on the liabilities side of the balance sheet. In some cases both methods may be combined. Again, the capital reserve fund may not necessarily be disclosed in the balance sheet. Very often, only the net value of investments "at or under cost, less capital reserve fund" is stated. The following methods of treating investment valuations are common: (1) "investments at cost or under"; (2) "investments at or under cost, after deduction of depreciation reserve"; (3) "investments at or under cost, less capital reserve and depreciation reserve"; (4) "investments at or under cost, less reserves"; (5) "investments at cost price, less amounts written off certain securities."

The question of "market value versus cost value" for investment valuation in the balance sheet has long ago been decided in favor of the latter. Cost values, after any provision for writing down, are exclusively employed. One trust only (Midland Caledonian Investment Trust) uses a mixed system by stating (December 31, 1935) the value according to the valuation of July 23, 1934, with additions since at cost. A considerable surplus of market over book value of investments is shown, however, by this trust. The cost method conforms with the usual method of valuing assets in the balance sheet of every company. Sales over costs are regarded as capital profit, but unrealized appreciation is not taken into account. For the investment trusts two further leading principles are constantly used. The "profit" from investment sales is not available for distribution in dividends, because the trusts are institutions to preserve and increase capital values from which the revenue alone is distributed. On the other hand, "losses" by depreciation in the value of investments do not necessitate specific provision, until they are realized by the sale of the securities.

The practice of giving in a note the market value of the investments has been more widely adopted during recent years. Originally it was deemed sufficient for the auditors to qualify their report, by stating, for example, that a "heavy depreciation" exists on the book value of investments and occasionally even today this formula is to be found. Generally, however, the depreciation is now disclosed in plain figures in one form or another by a percentage of the book value, by quoting the difference or by stating the market value itself. If not in the report, the figure is often to be found in the Chairman's address. If, on the other hand, the market value exceeds book values, the fact is usually recorded without detailed figures being given.

Shares of subsidiary companies are separately revealed at cost price.

The other items under the assets are considerably smaller. "Securities sold for future settlement" (and the corresponding item "bought" on the other side of the balance sheet) represent securities traded during the current account for settlement after the balance sheet date. Cash at the back and cash in hand is clear and usually small, and sundry debtors are small. Occasionally, small amounts of "secured loans" appear in the balance sheet. Few items remain, apart from occasional entries for debenture discount and issue expenses not yet written off. But another "assets" item, which in some instances is substantial, is the "Realization Account," to which losses from the sale of investments, in excess of previous investment reserves, are transferred.

On the liabilities side, the first entries relate to share capital, subdivided into preference and common shares of different classes, where necessary. Next come debentures, classified according as they are terminable or otherwise, and set out in various groups according to the rate of interest payable on them. Next in order are the reserves, which are subdivided into capital and general reserve. Occasionally reserves for special purposes, e. g., taxation, are shown separately. The only remaining significant items on the liabilities side are the amount of the bank overdraft, if any, and the balance of profit and loss account. Any residual items are usually small, and may include securities bought for subsequent settlement, unpaid dividends and debenture interest and outstanding accounts. In some cases deposits with the trusts, shown separately in the balance sheet, may be of fair importance.

Although not part of the balance sheet accountancy, the amount of contingent liabilities in respect of partly paid shares (and occasionally in respect of guarantees for subsidiary companies, underwriting contracts, foreign exchange, etc.) must be separately stated. This, too, is not always done very clearly, for a number of trusts confine themselves to the statement that "there are liabilities in respect of partly paid shares."

The difficulty of interpreting the trend of balance sheet figures is accentuated by the practice of some trusts in crowding together in a single total several items which are generally separate. One may find bonds and deposits in a single account, or short-term credits and accrued dividends. Again, deposits may be included with bank debts, while certain reserves are taken out of the liabilities side altogether and deducted from the investments, only a net figure being given. Sometimes, a "contingent fund" appears. This should probably be regarded not as a part of the reserve fund, but as an internal account used for writing off losses on investments.

The income account normally should be shown in two sections, the profit and loss account and the appropriation of net revenue account. The profit and loss account specifies management expenses, directors' fees, legal and trustee charges, auditors' fees, and debenture interest on the one side. On the other are set out dividends received, other interest, underwriting commission, and transfer fees. The appropriation of net revenue account sets out the position as regards the distribution of profits among the different groups of shareholders. The amounts already paid in interim dividend are separated from those proposed to be paid by the directors in final dividend. That, at least, is an ideal form of accounts.

In practice, actual disclosure frequently falls short of it. Disclosure of underwriting commission has become rather the exception than the rule. Dividends and commission are often placed in the same portmanteau, and transfer fees are shown together with other fees, e. g., from trusteeship. Of all the sins of concentration, however, the method of dealing with taxation is the worst. Some companies show incoming dividends gross (before taxes), and other companies net (after taxes). Dividends paid to shareholders may be set out after and sometimes before deduction of income tax. It is not uncommon to find dividends received by the company shown gross and dividends distributed by the company to its shareholders shown net. For this reason great care is necessary in showing comparable figures before attempting to add together the earnings of different investment trusts.

Such is the present state of investment trust accounting. There is no trace of uniformity, and there appears little hope of improvement in the near future. Even individual groups may have no homogeneous system. In the Mattinson group, for example, the income of the United States and South American Investment Trust is shown before taxation, while the New Investment Trust, the Mercantile and 2nd Mercantile Trusts report net income after taxation. In the St. Davids group, Metropolitan Trust Co. shows gross earnings, while Governmental and General Investment Co. gives net earnings. During the past decade there has been little progress towards standardization of balance sheets and income accounts. Comparison of a number of pre-war reports with those of 1935 gives the impression of continuing conservatism, with minor changes in the information given. Even in typography the pre-war and post-war accounts are often undistinguishable. The practice of carrying investments at cost (or written-down) value, however, now is generally accepted. This practice was adopted soon after the investment-trust movement began, despite some fears that excessive dividend payments might be made when Stock Exchange values declined.

Apart from the annual balance sheet and income accounts, the director's report or the chairman's speech usually offers some additional information on the portfolio. Undoubtedly, these two media have in recent years provided much useful information, and today the majority of the trusts give some details regarding their investments.

For example, a list of investments is published by 70 companies, while 75 other trusts state at least the number of their different holdings. An increasing number of trusts disclose the distribution of their investments, geographically, industrially, or by type of security, in percentages. Before the war the investments were rarely subdivided into their component groups (government securities, railways, etc.). Today, the distribution analyses, expressed as percentages, are usually supplied in the text of the report or in the chairman's speech. Some 66 trusts now publish percentage figures of geographical, industrial, and security type distribution; the geographical and security type distribution is given in 64 other instances. A smaller number of trusts give information regarding one or other of these headings. It is, however, sometimes difficult to decide whether these percentages are based on the book or the market value of investments.

The chairman's speeches usually refer to the business situation as a whole, and for the rest, largely repeat and occasionally interpret the figures of the report. The elucidations offered by the speech are not usually far reaching, and there seems to be no considerable change in the substance compared with former times, apart from the more frequent inclusion of figures on the constitution of the portfolio. No interim reports are published.