Investment Bonds

An Address by

JAMES J. HILL

Delivered at the

Convention of Investment Bankers Association of America

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Less than a year's subsistence stands between man and starvation. That is the measure of his accumulations. Six and a half bushels of wheat per capita is a low estimate for consumption and seed. The 97,000,000 people living, according to the census estimate, in the United States in 1913 would require 630,500,000 bushels to keep their stomachs and fields in condition for a year. That is a little less than the crop of 1911 and a little more than the crop of 1912. Subtract our total exports of domestic wheat and flour for the last three years from our total wheat production, and the average surplus retained for home consumption is less than 600,000,000 bushels per annum.

What is true of our bread supply is more than true of most other necessaries that we consume and produce. We could live for a few months only on our savings. Immense as seems the total of accumulated wealth, most of it is not available for consumption. Even the income from it must be transformed into things to eat and drink and wear, and tools to work with; into capital for future production, without which not only the machinery of industry but the human machine itself would presently cease to operate, and a dead world remain the monument of defeat in that economic battle which man has waged with nature from the beginning.

The principal asset of the world, aside from the land, is its plant; in the form of buildings, machinery, transportation agencies, apparatus of all kinds in which capital has been fixed to enable the work of production to go on in increased volume and with added economy. To this every man who earns more than he spends contributes. Into this tremendous reservoir the surplus efforts of the ages have poured contributions from the hundreds of millions of men who, by planning, directing and working, add to the margin of profitable production all over the world. Credit enables them to do this. They acquire a participating interest in a host of enterprises through loans represented by shares of stock, bonds, notes or other instruments of credit. This relation of operating efficiency on the one side and credit support by capital on the other, in its extent, artfulness and practical working success, is the principal advantage of modern over ancient civilization. There is less difference between the forked tree drawn by cattle and the improved steam plow than there is between labor in the isolation of distrust and labor in th universal co-operation which credit facilitates and encourages. No wonder that credit has been called the most wonderful invention and the greatest wealth-producer devised by man.

With the greater security of modern industry from war and other destructive forces, with increased efficiency in the worker and a multiplication of machines each multiplying again the total product, the aggregate of usable surplus capital grows. It forms the general investment fund; and the demand of this fund for safe and remunerative employment is as real and urgent as the demand of production of every sort for capital to support and continue it. In the year 1912, which was far from being lively in investment circles, there were issued and sold through Wall Street, according to the New York Times analyst, either to investors or dealers—in the latter case merely for transfer to investors later on—more than $2,000,000,000 of new securities. This excludes municipal and refunding issues. It is at the rate of nearly $7,000,000 for each business day. And yet, to provide the money for this amazing purchase, it required only that each one of a hundred million people should put by for investment the sum of seven cents per day.

The workers of France own billions of dollars in such investments. So do those of Germany, of Great Britain and of the United States, in smaller measure. The London Statist estimates the savings in this country last year at $5,000,000,000. The extent, the growth, the opportunities of this country make it potentially the greatest producer of investment capital in the world. When the inevitable stress of competition with the rest of the world shall have made our workers as frugal and as thrifty as theirs, the accumulations of its people will reach amounts that sound fabulous to-day.

In order that capital may thus be saved and invested freely, a credit system must be highly developed. Credit has a body and a mind. The body asks whether the borrower will be able to pay according to promise. It concerns itself with the security. The mind asks whether the borrower will be willing to pay. It concerns itself with the character of the debtor. On these two premises are founded the most intricate processes of the investment world, and to them the study of it and its laws and movements will always return in the last analysis. Credit is an intelligent thing. It discriminates between individuals as well as between circumstances and opportunities. However apt the public is to lose sight of this in a complicated industrial world, where loans are made to corporations and represented by bits of engraved paper, instead of being made to individuals in exchange for notes of hand, it is none the less the all-decisive fact. So long as credit exists, the only indispensable questions must always be, "Will he be able to pay?" and "Will he be willing to pay?"

Such are the tests to be applied to the manifold forms of credit that invite and accommodate investment to-day. The superior efficiency of wealth united under corporate management over money employed in small sums by individuals has concentrated investment in corporations. Investment securities are mostly stocks and bonds. The former entitle the holder to a proportionate voice in the management of the concern, and to a share in the profits or a responsibility for the losses. The place of the share of stock has changed little. The bond has been subject to alteration and dilution. With a great increase in total volume has come a depreciation of many of them in both reputation and quality.

A corporate bond is a lien on the property that it covers. The bondholder being a contingent owner, and taking precedence of the stockholder, the bond had a special value of its own. The very name became a synonym for security. "His word is as good as his bond" is a proverbial way of expressing supreme reliability. And until comparatively recently nothing had happened to impair this confidence, just shown to be so essential an element in credit. Even though the borrower might not be willing or able to pay, the property would and could be made to pay. A bond could become a losing investment only in the case of so large an issue or so serious a depreciation in the property that its total proceeds would not equal the total of outstanding bonds. Formerly this was a possibility too remote to be taken into consideration in the case of legitimate business concerns.

It happened, perhaps inevitably, because of the increase of capital for investment, the increase of vision and of daring among borrowers, and the assured reputation of the bond, that its standing was slowly sapped. The repudiation of debts by some American states gave public credit a heavy blow. Panics and reorganizations compelled a closer scrutiny of corporate securities. But the main cause of such deterioration as the bond has suffered is the putting out under that name of a great volume of paper promises which are not entitled to it. And this is partly the effect of the excessive borrowing and spending of our day, and partly that of an expansion of industrial effort and an inflation of the capital of industrial enterprises which have often raised the total of bond issues, heretofore representing the value of the property under the hammer, to approximately the figure that would once have covered stock and bonds combined. In fact, the stock of more than one pretentious concern would have nothing behind it if the bondholders had to be paid off. Nor could the latter themselves hope to receive dollar for dollar on a forced sale. The dangerous proportions of this abuse of credit are shown in a recent address by Mr. Joseph T. Talbert, Vice-President of the National City Bank. He said: "If we take the ten years from January, 1904, to January, 1913, inclusive, and tabulate the controller's reports for national banks, the first call of the year, we find that loans increased from $3,511,000,000 to $6,147,000,000—a net increase of $2,636,000,000, or 75 per cent. During the same period the deposits of these banks increased from $4,789,000,000 to $8,361,000,000—a net increase of $3,572,000,000, or 74.6 per cent. During the same period the investments in railroad, municipal, public service, industrial and miscellaneous bonds increased from $555,000,000 to $1,057,000,000, or 90.4 per cent. These figures are dazzling and they are so large as to become confusing. Taking a shorter period and beginning with the year before the panic of 1907, we find that the net increase in the loans of national banks is slightly over $2,000,000,000, or nearly 50 per cent. During the same period the deposits increased $2,613,000,000, or about 45 per cent. Investments increased $383,000,000, or about 60 per cent."

Criticism, or even a proper understanding of the situation calls for discrimination between the classes into which bonds are divided. First are those of public bodies; the government, states, counties, cities and sometimes villages. Here a frightful inflation is going on. An old-fashioned public aversion to debt still holds the nation and, to some extent, the states in check; though many of the latter evade it by marketing certificates of indebtedness which differ from bonds only in the shorter time they have to run and the inferior weight of the sanction behind them. The total national debts of Europe rose from about eight billion dollars in the period 1845-48 to nearly thirty billion dollars in 1905-07. With the exception of a slight rise in 1899, made good the following year, the total debt of the United States, less cash in treasury, was greater on the first of last May than it had been for twenty-five years. In a study of credit made some time ago, I showed that the net ordinary expenses of the United States government had increased 1.4 per cent between 1870 and 1890, and 121.4 per cent between 1890 and 1908; while between 1890 and 1909 the expenditures of the thirty states from which reliable reports could be obtained had increased 201.6 per cent.

Most of our cities are mad spenders; intent only on securing an increased margin for bond issues by raising the assessed valuation. Not a few of them are meeting part of their current expenditures by issuing bonds; while refunding, instead of levying taxes to pay at maturity, has become the almost invariable rule. Several large cities whose credit has always stood high have offered bonds within the last few months without finding takers, even at an increased interest rate. This collapse of the market is due not only to a relative scarcity of investment capital at the time, but also to an underlying consciousness on the part of the public that the danger line has been reached. A state, county or city has no income or resources aside from taxation. Public buildings, public improvements, school houses and the apparatus of fire departments could not be sold without dissolving the community itself. They are only imaginary assets. The issue of bonds in excessive volume has, therefore, compelled the buyer to consider a possible inability of the people to pay. That point will presently be reached unless we sharply correct the prevailing policy.

In the five years between 1907 and 1912 the sales of municipal bonds in the United States nearly doubled. According to a summary made this year by the Commercial and Financial Chronicle, the average sales for the period immediately preceding 1904 were about $150,000,000 a year. In 1911 they were $396,859,000; and in the dull year 1912 they were $386,551,000. This is an enormous increase for the market to digest. But it is far from telling the whole story. This amount represents only our own actual municipal bond sales within the territorial limits of the United States. New York has now become a financial center to which outside customers resort for purchasers. Adding to the domestic municipal bond sales the temporary loans and sales on account of Canada, Hawaii, Porto Rico and other borrowers in our market, the grand total for the year amounts to nearly $781,000,000. The figure speaks for itself.

It is fairly certain that our market cannot absorb such a flood without a perceptible increase in the interest rate and some financial derangement in the conduct of ordinary business. Thus the unchecked rage for borrowing affects not only those who issue and those who sell securities, making it more difficult to place bonds, but also general business operations, by lessening the supply of available free capital and increasing the price at which it can be had. If the true story of all municipal indebtedness, now concealed behind various temporary makeshifts, so as to maintain an ostensible credit and help push out the annual crop of new or refunding bonds, could be told, it would shock the country and give pause even to the advocates of unlimited expenditure for public purposes.

The situation with regard to bonds generally spoken of as "industrials" is worse. The field is so large and so diverse as to defy statistical tabulation. Hundreds of millions of bonds have been issued to promote consolidations, these securities being part of the purchase price of the smaller concerns to be united in one big corporation. Other hundreds of millions have been issued against property still to be developed, such as mines, timber lands, irrigated lands and even ordinary real estate, where many separate holdings are combined in the hands of an active selling or developing concern. These are of varying degrees of soundness; from the bond with property behind it that would fetch face value at a forced sale at any time, to mere speculative pledges of a future realization or increment that is little better than a guess. Finally, there is the enormous mass, recorded only locally and beyond any reliable estimate in amount, of bonds that are not, in view of the flimsy or insufficient security behind them, entitled to be called bonds at all.

In days of soberer financing, an industrial concern was capitalized at somewhere near the amount of cash actually put into the business. With the advent of the large corporation, capital stocks began to grow by multiples of five, ten, one hundred. A company could scarcely respect itself if it had less than a million dollars of capital stock; while from five to a hundred millions became not uncommon. Now the market for stock shares is always limited. The supply increased so fast, the underlying values became so attenuated or doubtful, that some additional assurance was needed to bring in the ready money. Here began the deterioration in the significance of the word, "bond." Finding that bonds would sell where stocks would not, the promoter substituted the latter for the former. A concern that might reasonably have carried a total capitalization of $500,000 bonded itself for that amount, and issued half a million or a million dollars of stock in addition. Little local manufacturing or commercial corporations bonded themselves for the limit; the bond in these cases, of course, being nothing but a share of stock, and having no sounder value behind it. The old definition of a bond no longer fits.

In fixing capital stock, a corporation may, to some extent, capitalize its good will. It is not always illegitimate or at all uncommon for a business concern to capitalize its actual profits for a year or a period of years past, sometimes even to capitalize future profits based on percentages of actual past growth, and issue stock to correspond. Except where a community is young, growing rapidly and has a future assured by its possession of great natural resources, this is dangerous financing. But if this capitalization consists of stocks only, and the process is without misrepresentation of facts, the effect is not so bad. The investor knows what he is getting, and takes his chance of a loss for his chance of a profit. The investment market is seldom demoralized in this way. Any disappointment in outcome is part of the necessary percentage of failures on which all business growth is built. But when exactly the same representations are made and the same security is offered for a so-called "bond" issue, the circumstances are materially altered. The old meaning of the word is destroyed. The market for legitimate bonds is impaired. Credit is affected by this tampering with one of its main supports, and the results are disastrous to the community as well as to the investor.

Formerly, and always in any properly financed undertaking, the limit of a bond issue is the total cash value of tangible property in possession; not its value for the uses to which it is being or is to be put, but its value as an asset for immediate conversion by forced sale at any time into cash. Under this rule the investor might rest secure. The worst that could happen to him would be to have to take over this property, in case of a receivership, wind up the business and get back his money. About all that he could lose would be the interest on his investment for the unrealized term of the life of his bond. Now it is altogether different. Not only wild-cat concerns, which are outside the range of this discussion, but companies of real merit and solvency, conducted by men who would scorn to do an act commonly recognized as dishonorable, do not hesitate to bond their businesses for very much more than could be obtained from either a forced sale or a careful liquidation. Plant is set down at its cost or its estimated value in use, and not its selling price as real estate and second-hand machinery if affairs had to be wound up. And in addition, present or prospective profits or both, and sometimes mere good-will, are capitalized. The security behind the bond has deteriorated. Its value is diminished. Capital takes alarm. Loans must be made at a higher rate and are harder to place. Instead of a man's word being as good as his bond, his bond has become no better than his word. Securities of that name which actually deserve it, by being worthy of their lineage and true to the traditions of their past, must jostle their way to market through a mob of tatterdemalions with scarcely a rag of respectability to cover their poverty and deceit.

Without undue preference for the interest to which most of my active life has been given, I think I may say that the railroad bonds of this country as a rule have remained faithful to their trust. For one thing, it is practically impossible to place an over-issue of railway bonds. If a manufacturing or commercial concern liquidates, its property has only current real estate value unless some successor wishes to carry on the same or a similar business. If an industrial enterprise is wrecked by competition that it cannot meet, by a shift in the market for raw materials, by a cessation of demand owing to changed conditions or new inventions, its bonds may fall to a few cents on the dollar; because the intangible values behind them are reduced to nothing, and the tangible can no longer be turned to profitable use. A railroad is differently situated. Its business cannot be discontinued. While it may and does suffer from unjust legislative and other assaults that add to its expenses and subtract from its revenues, it enjoys as a compensation security through the courts against actual confiscation. The road and its belongings will always remain there. They can always be operated. They must be operated by somebody. Therefore the security cannot altogether vanish; and experience has shown that it will eventually bring, under wise management, some return in the most desperate cases.

So far as the old, established properties, with an unbroken record for payment of interest and dividends, are concerned, there is no security that can compare with them for safety of the principal and certainty of the interest payment. The United States government itself has been compelled to suspend specie payments; but the best railway systems of the country went through the stress that drove it to the wall without disappointing investors in them of one dollar when it was due or expected. There never was a bond issued through the centuries since the word first came into use which better deserved to bear the title than the first-class railway bonds that are the favorite investment to-day of the great life, fire and accident insurance companies, of savings banks, of all who make it their first condition that a security shall have full value behind it, pay at maturity, and be readily convertible into cash with the least shrinkage, even in time of public panic and financial demoralization.

Limitations by law on increase of capitalization are of recent origin. The managements of our railways have, for the most part, financed them voluntarily, so far as bond issues at least are concerned, moderately and wisely. The amount of railway capital outstanding in 1911 was, by official report, a little over $19,000,000,000. Of this, $10,738,000,000 was funded debt, $7,825,000,000 of that amount being bonds. There is no present means of estimating the total money value of railroad property. We do know that it represents the greatest property interest in the country next to the land on which we live and its improvements. It is so far in excess of capitalization that the margin of safety is plainly in view. It is so much farther from the total of the railway bonded debt that the most careful administrator of a trust never guarded it more completely against possible depreciation.

I showed six years ago that the actual growth of the transportation business called for an immediate investment of at least one billion dollars a year for five years, to catch up with traffic demands. The event proved that forecast under instead of above the mark. The need grows continually with the increase in population and the development of the country. The money obtained by the sale of securities is put into construction and equipment. So we need not be surprised to learn, according to an estimate made by the New York Times, that while, in the year ending October 1, 1912, the railways issued stocks and bonds to a total of $23,821,000 less than the year preceding, the industrial concerns issued $362,000,000 more. The remaining class of bonds, those of public utilities, requires no separate discussion. Water bonds in most cases stand on the same footing as those of the municipality; gas and electric light bonds are simply a special form of industrials; while street railway bonds resemble those of the steam railways, except that generally a mere franchise instead of an ownership of property is the main guarantee behind them. The creation of public utilities commissions in various states tends to consolidate or standardize all these, so far as their sanction and security are concerned, into a special class of state-approved but not state-guaranteed security.

This survey and analysis should explain whatever may seem mysterious or discouraging in the recent course of the bond market. In spite of the care with which men who under-stand and respect the limitations of credit attempt to guard and restrict bond issues, the grand total mounts so fast and the security is so progressively impaired that the investor hesitates. Those who are desperate for capital bid higher. The rate of interest rises. So does the risk. And these results, unhappy for the borrower, unhappy for the lender, discouraging and dangerous for the community, will continue until the country reconsiders and amends its ways. The two noticeable features of the general bond situation are the extraordinary conservatism in the increase of the railway bonded debt and the extraordinary recklessness of public authorities and the managements of industrial enterprises, taken as a whole, in forcing out every dollar of bonds that anybody will take, until they must finally be advertised as summer sales and peddled out over the bargain counter. Less spending for purposes that can wait; less borrowing on any terms; and a clear distinction between the different classes of security and instruments of credit, so that each shall make its own appeal and cherish its own value, are the only conditions upon which improvement can be hoped. The investment market cannot know a prosperous activity, except by feverish starts to be followed by still more pronounced reactions, until the immutable laws of credit have been generally recognized and respected.

I need scarcely sum up for you, whose business it is to know them well, the present conditions of the investment world. There is plenty of capital in the country. The extent and productivity of our soil, the enterprise of our business men, the sagacity of capital and the industry of labor are continuing that marvelous accumulation of resources which constitutes the aggregate of the nation's wealth. The rate of interest is low for call loans, except in temporary crises. The man with money is content with a small return if he is sure of getting it back the instant a cloud rises in the sky. The reserves of the New York banks show an ample store. But long-time loans are hard to place at rates from one-third to one-half higher than they were even three or four years ago. "The simple truth," says a recent financial criticism, "is, the country to-day is suffering as perhaps never before except in times of actual panic, from a loss of confidence. The money market is abundantly supplied with funds, but there is timidity and fear, so that no one is willing to let his funds go out of reach." There could be no completer illustration of the essentials of credit as I stated them at the outset. The investor is not sure to-day of either the ability or the intention of the soliciting borrower to pay at maturity. The country is waterlogged with bonds. Confidence cannot be restored until the name "bond" has won back something of its old standard. And that cannot happen until issues are limited by moderation, conformed to the value of the security and confined to the margin of safety and the form of credit for which the bond was originally designed.

A new situation confronts the country, as well as the dealers in investment securities and the men who must find new capital wherewith to satisfy legitimate business needs. Formerly 3½ per cent in some cases, and at most 4, was regarded a satisfactory return on a gilt-edged bond. To-day the best issues are much higher. Some first-class properties have paid 6 per cent for short-time loans. This rise, computed on the face of the outstanding securities of the country, represents a tremendous annual tax. It is reflected, of course, not only in the higher cost of living but in a decline of bond prices. This ranges, for high-grade paper, from 4 to 15 points, and in particular cases more. Many financial experts look for a remedy only "through a decline of prices until the interest yield on the money invested in the old issues approximates the increase from the newer bonds, which pay a higher rate of interest." This, of course, is the natural way of working off a debauch, by the operation of natural laws. But it entails great hardship on millions of worthy investors, on savings banks, on those least deserving to suffer. And since, in the main, the situation was not created by observing economic law, but by its violation, it would seem not unreasonable to seek relief by curbing those qualities which have impaired credit, retarded investment and demoralized legitimate business by an over-issue of under-secured bonds, both corporate and public.

After all has been said, the main explanation of prevailing conditions in the bond market runs back to the old law of demand and supply. There has been too much spending and borrowing. The individual, the corporation, the municipality is no longer willing to pay as it goes. The future is mortgaged until the interest charge alone absorbs more current revenue than can be spared. This is the standing danger, the crowning abuse of credit, from which no age has been free. It has been the cause of every act of currency inflation, always aggravating the evil. Inflation by bond issues in excess is just as dangerous in practice, produces the same effects and leads to the same end. Correct this, and the troubles of the market will be relieved; since credit always adjusts itself automatically to the public need when freed from artificial stimulation or compulsion. Let the present abuse of credit continue, and an abyss of possible suffering and financial distress opens before us. This need not happen. It will not happen if the wiser counsel and the conservative view reassert themselves.

It is your duty and your good fortune to help bring this about; to perform this service to the people at the same time that you promote most surely the highest interest of the business in which you are engaged. Investment, like other things, has been specialized. The investment banker has come into the field. He disposes of a large portion of new issues. He is the intermediary between the big underwriters and the buying public. He is the agent of those who wish to buy, sell or exchange securities already purchased. Since the public estimate of the value of these is seldom accurate and frequently distorted, his aid is invaluable, his assistance sought and his advice listened to. Without him it would not be an easy task to-day to dispose of a current flotation to the investor, as distinguished from the speculative buyer. And it is into the hands of the former that every well-regulated concern wishes to see its securities pass.

It is within your power, then, at least to aid in checking the unfortunate tendencies of the time. The men here are not those to whom a commission from a sale ought to or could weigh against the violation of a trust. You handle more frequently the patient and painful savings of the worker, the widow and the helpless than you do the fortune of the millionaire. You cannot venerate your calling too truly or set its standards too high. Your association should voice its opinion and set its face against any trading in bonds that are not proof against all assault. You might even consider whether you should not ask for it the recognition and the safeguards of the law. There would be little need for blue-sky laws if all who engage in your business were bound by a code both moral and legal to stamp out not only the obviously wild-cat security, but every other that has a surplus of prospectus and a deficit of live assets behind it. There is no reason why your occupation, any more than that of the national banker or the physician, should be disgraced by the adventurer, the charlatan or the quack.

The times demand of you a new loyalty and a more searching discrimination. You need no proofs to tell you that if the deterioration of bonds by excessive additions to their volume and by relaxed rules for security is to continue, it will be as disastrous to the reputation of your office and the growth of your business as it can be to the investing public. The man who has been disappointed in his hope of a safe and paying investment, for whom either principal or interest fails, who in time of need is obliged to sell out at a loss, has a long memory, an easy tongue and a bitter heart. That is human nature. So that for you as for all of us, if we were but wise enough to see it, the path of duty and that of self-interest do not merely run side by side, but converge and melt into each other. You are not merely business men, not merely agents of large bankers or capitalists, not merely traders in paper floating about the street, you are representatives of millions of hard earned savings; and you are, to a large extent, the custodians of the future welfare of the country. Your work is not only to buy and sell, but to study the foundations, the impairments and the safeguards of credit; to insist upon its proper limitation; to keep its flying instruments true to their promises and always equal to or better than their face. Remembering the place that the slow accumulation of wealth has had in the advance of civilization, the growth of intelligence and morals, the amelioration and enlargement of the common lot, your function and your opportunity are not lower or less sacred than those of patriots and statesmen. What are the coming years to show as the reward of your labors—which need be none the less helpful because they need not be wholly unselfish—for the common good?