

Senator TAFT. I was thinking that it would be hard to say, at that time, with demoralized prices, whether people thought highly of Lehman Bros. or not.

Mr. SCHENKER. That is why I say they may have been performing a useful function in supplying a market to distressed sellers, who probably got a better price. But I just want to show the significance, and we think it is one of the important problems, when you deal with repurchases of their own stock. That is why we deal with that problem in the bill, Senator—when you take the one-class stock trusts repurchases present such difficult problems, you can imagine what it does when you have senior securities in the capital structure. If Lehman Bros. had senior securities, Senator, every time they bought back stock, the question would have been presented as to the fairness to the preferred-stock holder, to the debenture holder, or to the common-stock holder?

Senator TAFT. I think the whole policy is a doubtful one. I do not question that.

Mr. SCHENKER. You have the same problem when you take the open-end company with senior securities.

Senator TAFT. It is more doubtful where you have various securities than where you have just one.

Senator WAGNER. Is your testimony in criticism of the practice of buying securities, or is it that you wanted to account for the difference in the—

Mr. SCHENKER. I just wanted to do this, if posterity should happen to read the transcript of this testimony—I did not want to appear to have overlooked the effect of the repurchases on the performance of Lehman Corporation.

I wanted to give some of the facts in connection with this \$134, and just to show how difficult a job it is to manage other people's money. That is why we say that unless you regulate this industry as a whole it might not serve a useful function. If all trust companies were like Lehman Corporation we would not be here. There is no question about that.

I sat here for a couple of weeks, Senators, and I heard in connection with those prepared statements, "I am not a lawyer"; and then the reader would lift a legal left hook from the floor—a hook evidently coached by some lawyer.

Now, I am not a statistician, Senators, but at the same time we undertook to study the performance of investment trusts. We wanted to be fair about it, and we picked the 49 largest companies in the country to see how they managed other people's money. We took those companies and we tried to devise a concept to see how well they were able to handle this fund. Our statisticians will describe the technique we used. Then, in order to get some basis of comparison, we said, "Let us see if they can do better than the Standard Statistics 90-stock average or worse." There has been some criticism of the use of the 90-stock average. Our statisticians will explain that. But I just want to make this observation, that before we completed our study various periodicals tried to appraise the value of the management on the basis of the performance of investment companies. When our study appeared I got this letter from Barron's National Financial Weekly, and I would like to read one paragraph from that

letter. They acknowledged receipt of the report, and the writer says [reading]:

My main interest in it is due to the fact that I have been working for some time trying to set up a performance gage for the closed-end trusts, similar to the one sheet we are already publishing at the end of each quarter, for about 20 open-end companies. Publication of your report has, I hope, solved the difficulty in choosing the best formula to follow. I shall simply use yours—

And so forth.

After our report on performance of investment companies came out Barron's said they adopted the Commission's method of measuring performance.

Here [indicating] is Barron's published by the Wall Street Journal. When they tried to appraise the performance of investment companies they did not use Standard Statistics 90-stock index; they used the Dow Jones index. The Wall Street Journal publishes Dow Jones; so they used their own index. So, if you have difficulty with the 90-stock index as a yardstick, you must have difficulty with Dow Jones yardstick.

Barron's use our method of comparison to appraise management. Mr. Winston, who supplies the entire industry with data or material on performance, uses the 90-stock index. The fact of the matter is that in their sales literature, when they sell investment companies' securities, many companies stated, "You see we have been able to do better than the 90-stock average."

Just one other observation—and I know Mr. Bunker will not become angry with me. There was a comparison made by Mr. Bunker between a list of securities which was published by a leading statistical organization, and he showed what would have happened if you had invested in that list and what would happen if you invested in the 49 handpicked investment companies. One of our statisticians will attempt to show the fallacies of Mr. Bunker's reasoning; but I just want to make this observation. In some respects I do not think he was very complimentary to our investigatory ability. There were only one or two companies in the world which could have issued that list and we located that statistical agency. That list was contained in a weekly letter and that is changed practically every week. I do not think that Mr. Bunker even remotely contends that the investment adviser service said, "You buy these stocks and put them away and forget them for 10 years." That was not the nature of their recommendation at all. And as I understand it—I would not be sure—the statistical organization had not a little difficulty with the use of the list for the comparison made by Mr. Bunker. I may be wrong about that. However, as I say, I am not a statistician, and therefore I have to rely on the New York Times sometimes. Evidently Mr. Bunker's comparison had a hole in it so big that it was visible 250 miles away, because within 24 hours the financial editor of the New York Times wrote [reading]:

STATISTICS

Somebody connected with the closed-end investment trusts went to a great deal of trouble in gathering statistics to show that the average trust performed a great deal better between 1929 and 1935 than did the average new security issue floated in 1929. The first group, it appears, lost 51 percent of its initial value in that period; the latter, only 44 percent. It should be obvious that a company which raises money and buys material and equipment at the peak of a price movement has less chance of succeeding than one which buys at any other time. In

fact, it is hard to think of any considerable group of securities which might have fared worse than the issues of 1929. If the investment trusts can think of no better proof of the average advantages of their management, perhaps they had better stick to the trusts which have managed to do better than the standard average.

I just want to indicate that Mr. Bunker found difficulty with our analysis, and evidently other people find difficulty with his analysis.

(The article on investment company performance referred to and submitted by the witness is as follows:)

[From Barrons, February 6, 1939]

INVESTMENT COMPANY PERFORMANCE ANALYZED BY SECURITIES AND EXCHANGE COMMISSION—RESULTS FOR 1927-1937 PERIOD FOUND SIMILAR TO COURSE OF GENERAL MARKET

For the entire period 1927-37 investment-company management as a whole obtained results which were neither significantly better nor significantly worse than the results which could have been obtained from an "unmanaged" fund placed in a common-stock index. This is the conclusion reached by the Securities and Exchange Commission after an exhaustive study of the management performance of 85 large companies of both closed-end and open-end type.

In sending to Congress last week this chapter of its report on the study of investment trusts and investment companies, the Securities and Exchange Commission emphasized that the full significance and implications of the analysis cannot be completely evaluated until studies of such other investment institutions as insurance companies, trust companies, investment counsel organizations, educational and charitable foundations become available. The Securities and Exchange Commission also pointed out that they were not setting up a stock index as a standard of performance and suggested that what the investors in these companies would have done had they not bought investment company securities should be considered.

The present analysis does not discuss the actual experience of investors who bought investment company securities. The concept of performance employed is described as the "extent to which * * * the fund or assets which management controls is enhanced or diminished over a particular period as a result of the investment policies, activities or decisions of the management." A future report will deal with the actual experience of investors in investment companies.

The average large closed end investment company—"closed end" companies are those with relatively fixed capital structures— was found to have performed a little worse than the general trend of common stock prices in each of the years 1927, 1928, 1933 and 1935, and a little better in 1929, 1930, 1931, 1932 and 1934. In other words, investment companies as a group have generally failed to do as well as the market in years of rising prices and have succeeded in doing a little better in years of declining prices.

This tendency the Securities and Exchange Commission attributes primarily to the fact that the companies characteristically keep a small though varying proportion of their assets in cash and other liquid items which are not substantially affected by stock price movements, and in preferred stocks and bonds which fluctuate less violently than common stocks.

VARIATION IN INDIVIDUAL RESULTS

The Securities and Exchange Commission found, of course, considerable variation when it came to study the management performance of the individual companies. No single company was able to do better than the general market in all of the 6 years from 1930 to 1935, but three companies were found which achieved this in 5 of the 6 years. Little evidence of consistency in yearly performance ranking among the various companies as compared with each other was found, although some companies displayed a tendency to perform consistently during years of rising security prices and to perform consistently during years of declining security prices.

Taking the period 1930-35 as a whole, and assuming the reinvestment of all distributions to security holders, the Securities and Exchange Commission found that the typical large closed-end management investment company would have been about 12 percent better off if it had retained its funds in cash, rather than investing them. This comparison, the Securities and Exchange Commission

warned, is applicable only to the particular period and does not give any indication of the comparative experience in other periods.

During the same period, the performance of individual companies ranged from an increase, including distributions, of 60 percent to a shrinkage, also including distributions, of 80 percent. Among 38 companies for which 1936 and 1937 figures were obtained, the range for the period 1930-37 was from an increase of 35 percent to a decrease of 85 percent. The average for the group was a 23.3 percent decrease, compared with a 24.2 percent decrease in a common-stock index.

Substantially the same results were shown for the 36 open-end companies studied. The open-end companies, sometimes called mutual funds, are those which buy back their shares at liquidating value. Most such companies continuously sell new shares directly to the public at the underlying asset value plus a commission. Average performance of this group for the entire period 1929-37 was just about the same as for the closed-end group and virtually identical with the common-stock index.

Individual companies in the open-end group showed less variation in overall results than did the closed-end group, the range for the period 1930-37 being from an increase of 29 percent to a decrease of 39 percent. The average decrease of 17.8 percent compared with an average decrease in the common-stock index of 24.2 percent. This 8-year comparison is based on the performance of only 11 companies.

OTHER HIGHLIGHTS IN SECURITIES EXCHANGE COMMISSION REPORT

Other observations and conclusions of the Securities Exchange Commission, based on the analysis of investment company performance, included:

1. Performance over the period suggests the historical superiority, among closed-end companies, of the diversified nonleverage companies formed in 1928-29.
2. A definite relationship between the incurring of bank debt by investment companies and poor performance over the period 1930-35 as indicated. Investment companies with large bank debt had an average shrinkage in their funds of 69 percent, as compared with a 39 percent shrinkage in funds of companies with moderate bank debt, and an approximately 8 percent shrinkage in funds of companies with no sizable bank debt.
3. The typical performance of fixed trusts was inferior to that of the management investment companies analyzed, although not significantly so.
4. Companies of the closed type which traded extensively in their portfolio securities did not perform much differently from companies which traded moderately or inconsiderably. Among the open-end companies, the Securities Exchange Commission reported some indication that extensive trading in portfolio securities was associated with relatively poor performance for the years 1933-35.
5. For the period 1930-35, as a whole, the companies with diversified portfolios did not experience the extreme variations in performance that companies specializing in utility stocks and other specialized companies did.

STATEMENT OF RAYMOND W. GOLDSMITH, SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, D. C.

Mr. GOLDSMITH. My name is Raymond W. Goldsmith. I am one of the assistant directors of the Trading and Exchange Division of the Commission and in charge of its Research and Statistics Section, and I would like to explain, if the committee will bear with me for about half an hour, how we calculated what we call (and what has been referred to here several times as) investors' experience.

It is true that we have set forth in as much detail as we thought fit in chapter VII of part 2 of the Commission's report, what we meant by that term and how we calculated it. However, notwithstanding our best efforts, I take it from the testimony of some representatives of investment companies that that concept and the method of calculation have been misunderstood by at least part of the industry. The criticism which you have heard, though it was sporadic, may have left some members of the committee with the impression that something

is wrong with our calculations. We therefore appreciate this opportunity of letting the members of the committee see for themselves how valid our results are and how much or how little merit there is to the strictures against them which have been made. We are also glad to have an opportunity of extending to the end of 1939 some of the calculations of the report which covered the period through 1935.

We measure investors' experience by subtracting from the amount of money originally paid by investors for the investment companies' securities the sum of two items, namely, (a) the amount of money repaid to investors by investment companies in connection with the repurchase of their own outstanding securities, and (b) the amount of funds preserved for investors in the form of the net assets of the investment companies at the date with which the calculation ends; either the end of 1935 or the end of 1939, or at the date of liquidation of the company, if that was different from either of these closing dates.

If the amount of money paid by investors for the securities of investment companies and trusts over the period is larger than the sum of the amount repaid to them during the period and the amount preserved for them at the end of the period, we may speak of a capital loss to investors.

If, on the other hand, the amount originally paid is less than the sum of the amounts repaid and preserved, investors may be said to have made a capital gain as a result of their purchases of the securities of investment companies and trusts. Both investors' gain or loss, as here calculated, are, of course, partly unrealized at the closing date of the calculation. Definitive determination of the realized loss or gain would have to wait for liquidation of all companies covered.

Investors' experience seems to us to be a fairly simple concept. It is essentially a statement (in accounting form) of certain items of outgo and receipts of those investors who participated in the companies which we have under investigation. There is not much that is hypothetical about the whole calculation except, of course, that a value must be put on such assets as investment companies and trusts still hold at the end of the period which is studied; that is, December 31, 1935, for the calculations in the Commission's report, or December 31, 1939, for some of the figures which I am going to cite. We have accepted the market values, as shown in the companies' reports, as a measure of the realizable value of assets. It is only because we do not have exact data for all of the 1,300 investment companies and trusts which have existed at some time during the last 10 years, that we were forced to resort to a number of estimates in making these calculations. The margin of error in these estimates, however, is small enough to make us feel confident that the true figures cannot be significantly different from those which we have presented in the Commission's report and which I am citing here. That complete accuracy cannot be obtained in calculations of this type—meaning accuracy to the last dollar or cent—every expert knows.

The actual amount of investors' capital gain or loss given by our measure of investors' experience has no ulterior implications. What the experience of investors would have been had they not invested in the securities of investment companies, or had they bought and redeemed those securities at different times, are matters of conjecture, of course matters of importance for several aspects of the bill under consideration. But our measure of investors' experience per se

is not concerned with such hypothetical situations. It is simply a figure in dollars and cents, or, rather, I should say, in millions of dollars, representing the loss incurred by investors in investment companies under the assumption that the companies were liquidated at the end of the period covered by the calculation, and that the value of the securities still outstanding at the end of the period is represented by the market value of the underlying assets.

It is important to realize, particularly in view of the apparent failure of several of the representatives of the industry to do so, that investors' experience is not the same thing as performance. There are certain differences in calculation and there are differences in the point of view from which you apply the two concepts.

Investors' experience views the problem strictly from the investors' angle and reflects the net effect of a multitude of forces at work over the entire period covered by the analysis. The calculation does not try to ascribe investors' capital loss or gain to specific causes. In particular, it does not tell to what extent a company's management was responsible for the capital gains or losses of the investors participating in that company.

If there is interest in further discussion of the difference, I think it can be conducted by Mr. Vass, who has made a study of performance.

Now, I want to clear up briefly at this point two points as to which, by their testimony before this committee, some representatives of the industry have misunderstood our procedure. Those are two very simple points which can easily be dealt with. I will clear up a few other points, a little bit more complicated, as I come to the relevant sections of the calculation.

Mr. Bunker, in a section of his testimony labeled "Erroneous impression of losses," imagined—he was not quite sure that he was right—that we failed in our calculations to give credit to the investment companies for the money returned to security holders in connection with repurchases. Of course his assumption is erroneous—a look at chapter VII would have settled that matter right away—and you will see, when you consider the actual figures, that the much discussed capital loss or shrinkage of \$3,000,000,000 is arrived at after crediting the investment companies with nearly \$1,600,000,000 for repurchases of their own securities. So, notwithstanding Mr. Bunker's impression—the loss or shrinkage is \$3,000,000,000.

Mr. Griswold, in presenting calculations purporting to be made in accordance with our method, started with the net proceeds to the companies of their issues of securities instead of beginning, as is done in our calculations, with the amount paid for these securities by investors. Thus to disregard the cost of selling investment-company securities seems erroneous if we want to measure investors' experience. What the investor is interested in is what happened to all the money which he paid for the securities of investment companies, and he does not care, whether he paid 90 cents on the dollar for the underlying assets and 10 cents for the service which was supposedly done him in selling the securities. So I cannot see how that argument has any validity against the calculation of investors' experience or investors' capital losses by our method. This item of load, as you have heard, is by no means of negligible proportions. It amounts to about \$500,000,000.

We have interspersed in our report a lot of limitations, hedges, and so forth, and I am only going to refer to one or two, because they are sometimes overlooked.

It is important to keep in mind that the figures for the capital gain or loss to investors in any company reflect the experience of all investors participating in that company at any time during the period covered, not solely the experience of investors holding securities at the end of 1935 or 1939, as the case may be.

Moreover, the figures which we have shown in the report show in one aggregate the experience of bondholders, preferred stockholders and common stockholders. They do not differentiate, because we did not have in all cases sufficient data, between the experience of the general investing public or of the insiders. Therefore this total loss which we show is not the loss of the general investing public and it does not take into account that in issuing the securities there was in a number of cases a certain amount that passed from the pockets of the general public directly into the pockets of the insiders. I have told you that we start with the offering price of the securities. In many cases, particularly before 1930, the company originally issued the securities to a group of insiders, say, at \$10. They then turned around and with the help of a little market manipulation put the price up to \$20, and that was the price at which the public bought. There are numerous cases of that.

Senator WAGNER. Do the insiders as a rule sell their stock?

Mr. GOLDSMITH. We have a number of cases where they did that. In other cases they have held on to all or part of their holdings. In some cases where the insiders organized the company with the intent of running it and controlling it and having a stake in it, they stuck with it. In other cases this set-up was chosen to give the insiders an intermediary profit. There are a number of cases of that type discussed in detail in the Commission's report, in part III. But the point I want to make is that we take the securities at their original offering price.

Finally, we have shown separate figures for investment company gain or loss only for certain broad groups of investment companies; and I want to repeat that there are many investment companies for which investors' experience is much better, and others for which it is much worse, than the aggregate figures which we have calculated.

I now come to a problem which apparently has given at least some representatives of the industry some trouble, and that is the losses on repurchases. This is simpler than the discussion on repurchases at below asset value and market value, which you have just heard.

We feel that since what we have measured is simply what happened to the money contributed by investors, it is perfectly proper to include among capital losses the loss suffered by those investors who redeemed their shares at the low prices of the depression, or whenever it may have been. Such losses are not offset, if the price later rises, by the gain of any other participating investor, as is the case when one investor sells a security to another investor on the stock exchange.

Mr. Griswold thought he had us beaten when he cited the example of 1,000,000 shares of U. S. Steel originally offered—I suppose he meant originally offered in 1929—at \$250 and then sold on the stock exchange in 1932 at \$25 by one investor to another.

That is 100 percent beside the point, because while the shares remain outstanding and just one investor sells to the other, if the price afterwards goes up to \$100, the first investor may regret his folly and the other has the advantage, but for all investors of the United States Steel Co. it washes out. This by no means is the case when an investor redeems, because there is no other investor who profits when the price later rises. It is not necessary to calculate losses in redemptions in any different way in open-end or closed-end companies, as Mr. Griswold intimated. If there is a net redemption—and I will come to that in a moment—it has the same effect whether it is an open-end company or a closed-end company. The share is canceled, and the loss of the redeeming investor is final.

I hope I have shown that there is no theoretical basis to Mr. Griswold's objection. Now I am going one step further and discuss the practical importance, and I will make that very brief. Obviously it is practically important only if there is net redemption, because if the same amount of shares is redeemed and then sold—and that is, of course, what the general practice would be in an open-end company—it washes out.

Mr. Griswold, by his emphasis on redemptions at low prices, may have given the committee the impression, though unintentionally, I am sure, that there were heavy net redemptions in open-end companies during those terrible years when the bottom dropped out of everything. But that is unfortunately, or fortunately, not the case. In table 81 of chapter III of part II of the Commission's report we have shown this for 40 open-end companies, practically all companies that were then actively selling. These companies took in more money from the sale of their own shares than they paid out in redemptions in every year between 1927 and 1936. In both 1930 and 1931, for instance, proceeds from new sales were about twice as large as cost of repurchases; and in 1932 sales exceeded repurchases by over 200 percent.

Even on a quarterly basis there were only two instances, namely, the fourth quarter of 1930 and the third quarter of 1931, in which net redemptions took place and in both cases net redemptions were very small, namely, under half a million dollars per quarter.

Mr. Griswold, using an expression coined in a different connection, has called this simple and, I think, self-evident calculation "a statistical monstrosity." I leave it to the committee's judgment whether such strong words are in order. I beg to submit that calling this a "statistical monstrosity" is due either to an inherent horror of simple arithmetic, or to a failure to understand the difference between investors' experience and performance.

I want to say now a word about the coverage of our calculations, just to show the committee how we did it. We made detailed calculations—

Senator WAGNER. Before you get to that: Did you ever go into the question of dilution at all?

Mr. GOLDSMITH. No, sir.

Senator WAGNER. You discussed the question of redemption.

Mr. GOLDSMITH. We credited the companies with the money they paid out and we debited them with the money which investors paid. So that would not come in there. One fellow's gain is the other fellow's loss, and that washes out. We took the experience of all the

investors together. We cannot segregate a certain group of investors and say what they made or lost. That is why I emphasize that we cannot segregate the insiders, for instance.

Senator WAGNER. The stockholder, before the dilution took place, was just deprived of a certain amount. I was wondering whether you had gone into that.

Mr. GOLDSMITH. No, sir. The companies covered by these calculations include practically every trust or company having assets at any time in excess of \$10,000,000, and there were about 200 of them, and they accounted together for 75 percent, approximately, of the total funds invested in all investment trusts and companies.

These figures were taken from the balance sheets furnished us by the investment companies and trusts, or derived from their books and documents by the Commission's accountants, or, in a few cases, from financial manuals. Then they were supplemented by estimates for the remaining numerous but smaller investment companies and trusts for which similar detailed calculations could not be made. Those estimates, which of course can be in error to a certain extent, cover only about 25 percent.

What we have here therefore to speak again in mining engineer's language, is neither a specimen nor a sample, but it is a whole body of ore in the mine.

These calculations were made in an earlier phase of the Commission's study, and they covered the period from the beginning of 1927 when investment companies and trusts first began to be of importance, through the end of 1935. We have recently made some attempts to extend them to 1939. They are considerably less reliable, necessarily, than the figures for the earlier period.

If the committee will still bear with me, I will use a wall chart to make clear what we added and subtracted, and then to show what some of the arithmetical results are.

These are essentially charts which have appeared in the Commission's reports. There is nothing new about this chart, but I would like to show what we did and whether we accomplished a "monstrosity" or not.

This chart has six double bars, and it covers all investment companies or trusts with the exception of two small groups. We have omitted installment investment plans and common trust funds, because the aggregates involved are too small to show distinctly on the chart.

The left-hand side of each bar is made up of two items. At the bottom we have, in orange, the net assets of the companies at January 1, 1927; and that means total assets minus all liabilities which are not evidenced by securities, such as bank debts, unpaid dividends, and current accounts payable.

The second section of the left-hand side of the bar, the one in brown [indicating on chart]; shows the amount of money which investors paid from January 1, 1927, through December 31, 1935, for the securities issued by the investment companies and trusts.

For all companies and trusts included in our calculations the net assets at the beginning of 1927 are slightly below \$900,000,000. The gross proceeds from securities sold from 1927 through 1935 are slightly above \$7,000,000,000.