

This brown section [indicating on chart] includes nearly \$500,000,000 of merchandising expense.

If we had included the years 1936 through 1939, the left-hand side of this bar [indicating] would only be slightly higher, as sales of investment-company securities during those 4 years are estimated at not much over \$400,000,000.

The left half of the bar shows the total amount of money taken in from investors by investment companies and trusts to the end of 1935. The right-hand side shows what became of the money taken in. At the bottom you see, in green, the market value of the assets at December 31, 1935, and that is slightly less than 3½ billion dollars. We have estimated that the comparable figure for the end of 1939 would be about ¾ billion dollars, a quarter of a billion less.

Senator WAGNER. You mean, the assets of gains?

Mr. GOLDSMITH. No; the assets are smaller. That is due to various factors—management, decline in security prices, redemptions, and so on.

Then we have in blue the sums which investment trusts and companies paid out in the process of repurchasing their own securities.

Senator WAGNER. How much is that?

Mr. GOLDSMITH. That is about \$1,500,000,000 up to the end of 1935, and probably up to \$1,800,000,000 if we carried it through 1939.

If investment companies and trusts had managed to preserve intact the funds they had at the beginning of 1927 and those received from investors during the period from 1927 through 1935, or 1939, and if they had paid out their net current earnings as interest and dividends, then the two bars of course would be equal.

But you see from the chart that that is not the case, and that there remains a distance to go on the right-hand side before we come to the end of the left half of the bar. The difference of approximately \$3,000,000,000, shown appropriately in red, represents the amount by which the assets retained for or returned to investors fall short of the money received from them. That is what we have called investors' capital loss or shrinkage. You can call it whatever you want to. It is the difference between the money paid in and returned by repurchases or retained. We give the companies, of course, credit not only for the assets which they still have in 1935, but for those which they returned to investors through repurchase of their own securities.

Senator WAGNER. Do you have the prices of the repurchases?

Mr. GOLDSMITH. The repurchases are taken at the price which was paid by the investment companies to the investors who redeemed the shares. Therefore the losses on redemptions form part of this. We did not have enough material to calculate it separately. Mr. Schenker cited one example, and we figured it for a number of companies, but we did not feel we could make any over-all estimate.

Senator WAGNER. According to your chart the investors lost about \$3,000,000,000?

Mr. GOLDSMITH. Yes, sir. I have tried to make clear how this figure is calculated and just what the 3 billion is.

There is a dotted line here [indicating on chart] because there is a similar break in the charts when published in the report. The total red section represents capital losses. You can try to split it up in two parts to see what happens. How did that money go out? This part here [indicating] would be equivalent to the dividends and interest paid out.

I will show briefly why that is included in capital loss and is not deducted from capital loss. I think that is not so difficult. To take the payments of dividends and interest into account in the calculation of investors' capital loss would be to commingle and confuse capital, which is not good accounting. It would imply that the security holder was not entitled to receive any return on his money, and if he only preserved what he ever had that was all he could expect.

The interest and dividend payments, according to our estimates, have averaged not much more than 2 percent on the amount paid by the public for the securities issued by investment companies, namely, approximately \$7,000,000,000.

Senator WAGNER. Did those dividends represent payments out of capital?

Mr. GOLDSMITH. There has been a long discussion about that.

Senator WAGNER. I did not want to get you into a long discussion.

Mr. GOLDSMITH. I am not an accountant nor a lawyer, and I do not want to get into a discussion of that.

Senator WAGNER. You did not calculate that, then?

Mr. GOLDSMITH. No. We only took from the records what was the total of dividends and interest paid out; whether it was earned or unearned we do not know. That is an extremely difficult problem in each individual case.

Senator WAGNER. You attribute it to capital loss to the investors?

Mr. GOLDSMITH. That is correct.

Senator WAGNER. If a dividend is paid out there is not any capital loss to the investor, is there?

Mr. GOLDSMITH. There would be two possibilities of treating dividend and interest payments. We could take into consideration not only the money paid out but also allow the investor the normal interest. You can make it 3 percent or 4 percent or whatever it is. We lean over backward in not debiting them with what the money should have earned and in crediting them with what they actually paid out in dividends. They paid out on an average only somewhat over 2 percent a year, and that is, whichever way you look at it, less than the going rate for the hire of money. Government bonds yielded about 3 percent for the period as a whole. Even time deposits probably have brought somewhat over 2 percent.

Senator HERRING. Is it not a fact that the only one who would be penalized by that is the one who has paid out of capital rather than out of earnings?

Mr. GOLDSMITH. It is true that there are companies that have paid out more than 2 percent. But if we take the industry as a whole, there are others who paid less than 2 percent. I do not want to say that there are not companies who did not pay considerably more than that.

Senator WAGNER. I want to ask you another question. This [indicating on chart] represents capital loss, and you told us a moment ago that from this black line down that loss represents dividends paid out.

Mr. GOLDSMITH. That is to indicate that they paid out dividends to that extent. I just wanted to explain why we are rather leaning over backward, rather than the reverse, because if I had tried to make a statement on both capital and income experience, then I would have had to debit them, obviously, with the hire of money at rate, for

instance the rate Government bonds draw, and that would have been much more than this, so that the loss would be larger than I have shown it here.

Senator WAGNER. Whenever dividend payment results in capital loss, it must mean that the dividends came out of capital, does it not? Otherwise it would not be a loss of capital.

Mr. GOLDSMITH. During the time of capital impairment all their payments were out of capital. If these were all one company, then you could say that. But this is a total for numerous companies, some of whom paid out of capital and others did not. Thus I do not make any such claim. If all of them were (statistically) lumped together, all the dividends could be said to have been paid out of capital—

Senator WAGNER. Not all the dividends. You mean the dividends which resulted in a loss of capital?

Mr. GOLDSMITH. Yes; because in 1927 and 1928 there were earnings and capital gains. After 1929, for the industry as a whole, there was a capital impairment.

Senator WAGNER. What about earnings?

Senator HERRING. If they are paid out of earnings they are not penalized.

Mr. GOLDSMITH. This [indicating on chart] is the total dividend and interest they paid.

Senator WAGNER. You mean, out of earnings too?

Mr. GOLDSMITH. All dividends which they paid. Of those dividends which they paid you cannot know which ones came out of earned income or capital gains or capital surplus. All these payments made up somewhat over 2 percent a year on original investment.

Senator WAGNER. I do not want to pursue this question too far, because it may be that I am on the wrong track; but if that represents all the dividends, then there were no dividends that were actually earned on capital?

Mr. GOLDSMITH. It would have been simpler if I had not put this in, but since we discussed it in the report I did not want to lay ourselves open to having it said, "The guy went back on his own statement and didn't explain it fully." I have given considerable consideration to not burdening the record with this discussion but I did not want to give the impression that I was suppressing anything which we had in the report.

Senator WAGNER. If dividends are paid as a result of earnings by capital, then those dividends do not reduce the capital, do they?

Mr. GOLDSMITH. No.

Senator WAGNER. So when you speak of dividends that result in capital loss, they cannot be earned dividends?

Mr. GOLDSMITH. The dividends do not result in loss, of course—

Senator WAGNER. Unless they are paid out of capital?

Mr. GOLDSMITH. Even if they are paid out of capital they are not lost. But in a certain sense they are a return of capital.

I am sorry that I took so much time on this.

Senator WAGNER. I am responsible for that.

Mr. GOLDSMITH. I do not need to explain much about the other bars. They are just for the five main groups of investment companies. But we have also made some calculations and have charts for a number of important subgroups within the two largest groups, namely, the

management investment companies proper and the management investment holding companies. Those are exactly the charts which we have printed.

There is one thing, however, that I think I should say, and that is that there is one group in which investors did not make a capital loss, but made a capital gain. It would have been shown in white on the wall chart if there had been any opportunity for it.

This was a group made up of three large investing holding companies, investing in chemical securities. It is, however, a fact that the American investing public has had but a very small participation in the profit of these three successful companies, because the overwhelming bulk of their equity securities is owned by a few large shareholders, domestic shareholders in one of the three companies and foreign shareholders in two of the companies. Therefore, if we wanted to get a little bit nearer to the experience of the general investing public, we have to eliminate these three companies, in which case the investors' loss would go up about a quarter of a billion. It would be $3\frac{1}{4}$ billion rather than 3 billion dollars.

I also have another chart that shows the situation at the end of 1939. The changes are small. It is generally, of course, the same picture, since there were only small sales and small repurchases. The investors' loss, as we calculate it, as of the end of 1939, would be slightly larger, say, $3\frac{1}{4}$ billions instead of 3 billions to the end of 1935.

Senator WAGNER. This chart makes it very clear to me.

Mr. GOLDSMITH. I had some further remarks with reference to a comparison of investors' experience with the experience in other forms of investment, but I can skip that. That has been covered partly by Mr. Schenker; and Mr. Vass, when he discusses performance, will tell you more about it. So, unless you specifically desire to hear about that, I will skip it.

Senator WAGNER. I think these charts should be put into the record. (The charts referred to appear XXXXXXXXXX in part 3.)

Mr. SCHENKER. I will get reduced copies of the large ones and introduce them also.

Will the committee hear from Mr. Vass now? That will finish all our statistics. He will not take more than 15 minutes.

Senator WAGNER. All right.

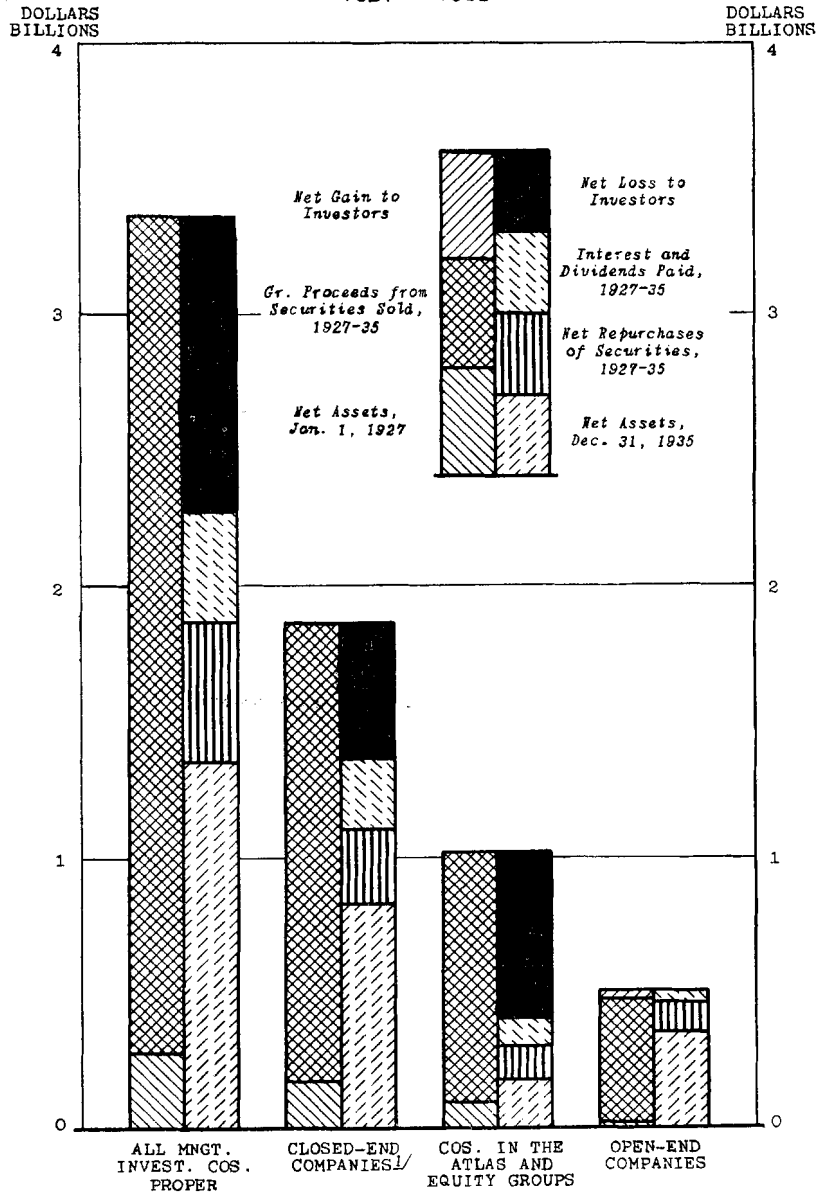
STATEMENT OF LAURENCE C. VASS, STATISTICIAN, SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, D. C.

Senator WAGNER (chairman of the subcommittee). All right, Mr. Vass. Will you give your full name, please?

Mr. VASS. My name is Laurence C. Vass and I am one of the statisticians who worked on the S. E. C.'s study of investment companies. My particular job was to prepare the study of performance, about which Mr. Bunker told this committee a few things, not all of which were highly flattering to the study. Among his less subtle criticisms was the blunt statement: "The whole thing was invalid."

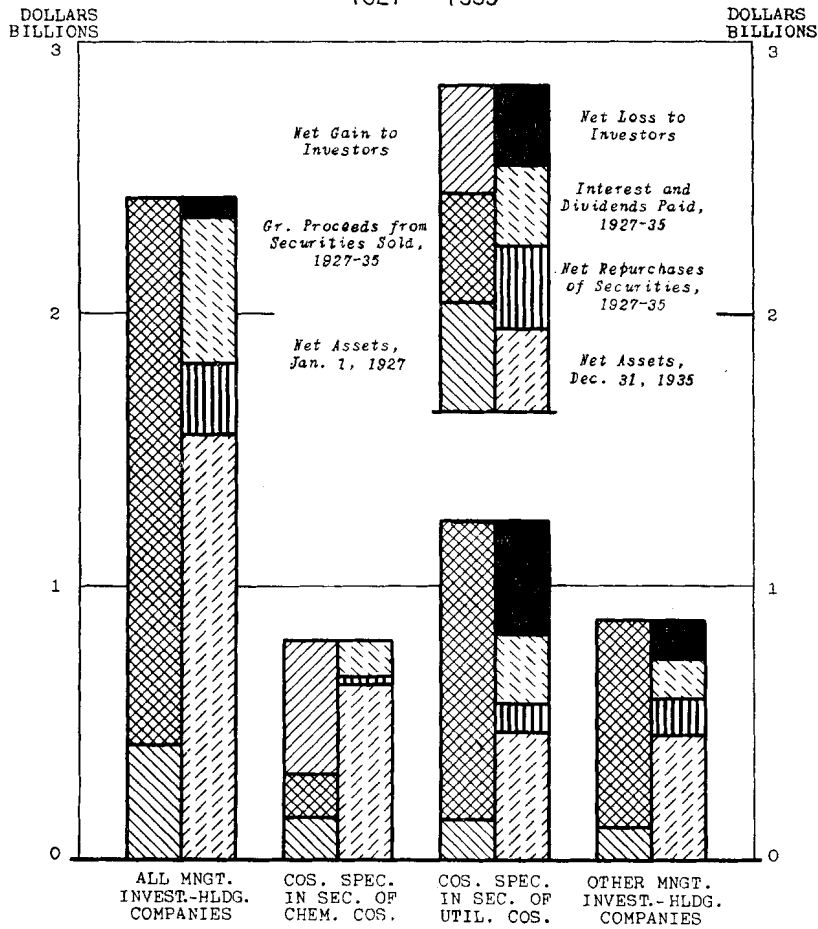
That is a very serious challenge, and I have been very busy during the past 10 days examining the basis for his claim. The facts we have uncovered show that it would be very unfortunate if this committee were left with that impression; since the facts, as we see them, do not verify this assertion.

INVESTORS' EXPERIENCE IN MANAGEMENT
 INVESTMENT COMPANIES PROPER
 1927 - 1935



^{1/} Other than those in the Atlas and Equity groups.

INVESTORS' EXPERIENCE IN MANAGEMENT
 INVESTMENT-HOLDING COMPANIES
 1927 - 1935



DS-1123

It is important to note that Mr. Bunker did not attack our method of measuring the performance of investment companies, nor did he attack the actual results obtained for the companies included in the study. He did not challenge our figures which show that 49 large closed-end companies which survived through 1935 actually lost about 30 percent of their fund over the 1930-35 period and about 45 percent of their fund during the period from 1930 to 1937. He did not challenge our statement that the entire body of investment companies undoubtedly performed worse than this sample of the best companies, picked because they had at least \$5,000,000 or more left at the end of 1935. He did not deny that these companies performed no better than the Standard Statistics index. The sole point of attack was the conclusion we drew from this last comparison.

Thus, Mr. Bunker apparently agrees with us that even this hand-picked sample of good companies lost a substantial proportion of their funds during this period; but he does not exactly agree with our evaluation of this loss. We found that this loss was as great as the loss experienced by a certain type of unmanaged fund—a common-stock index—and, therefore, concluded, to quote Mr. Bunker, that—

the results the managements of investment companies had achieved is exactly nothing, that one would have done just as well had he bought a package of securities as represented in well-known indexes and carried them throughout this trying period.

Mr. Bunker, however, cognizant of these same facts, informed this committee that "the record of these companies over the depression period has been little short of remarkable." Furthermore, Mr. Bunker found our conclusion unrealistic, giving no true picture whatever of the actual comparative performance achieved. What in brief were his objections, as presented to this committee?

In the first place, he claimed that this particular index cannot be considered an unmanaged fund. In the second place, he said that it would be impossible to set up a fund to follow this index without incurring tremendous costs through constant shifts in the portfolio. In the third place, he claimed that there are only two other ways of approximating the performance of the index, both of which would involve extremely large losses, with the result that the investor in this fund would fall far behind both the alleged performance of the Standard Statistics 90 Stock Index and the average performance of the investment companies included in the study. In short, he cannot accept our conclusion because he feels that it is unfair to investment companies to use the index in this manner. Let us examine his criticisms.

First, we have his contention that the index represents a managed fund. Let us suppose, for the sake of argument, that there actually were 333 rights offerings during this period, and that it actually would have required 29,970 market operations to keep up with the index. Would this make it a "managed" fund, in any real sense?

Our answer is that investment trust managers do little managing if that's all the managing they do. There is not the slightest element of judgment involved in making the portfolio adjustments necessitated by changes in the index. Suppose, for example, a company retired half of its common stock. It doesn't require an expert mathematician, a highly paid market forecaster, a research department, a statistical department, or mahogany furniture to figure out how much of this particular security to sell and how much of other securities to buy.

The Standard Statistics Co.—makers of the index—will gladly furnish without cost the simple mathematical formula whereby the necessary changes are determined. A course in high school algebra and a high degree of honesty are the only requirements for managing the index fund. We cannot find management where there is no judgment or discretion. If this be management, then the trustees of fixed trusts are entitled to as much remuneration as the managers of management trusts. If Mr. Bunker is willing to agree that in actual operation no more than this has been involved in the management of the companies which we compared to the index, then we would admit, not that both were managed but, rather, that both were unmanaged, the one with relatively low cost, the other with extremely high cost, given the degree of management.

So much for the argument that the index would constitute a managed fund. What of the claim that there were so many capital changes during this period that the cost of following the index would be prohibitive? According to Mr. Bunker, the Commission overlooked the fact that the entire portfolio might have to be turned over every time there was a capital change in one of the 90 companies. We were aware of this fact. Mr. Bunker laid particular stress upon rights offerings, which require new money, or a turn-over of the portfolio. We were aware of this fact. Mr. Bunker informed this committee that—

there were 333 occasions during the period between 1927 and 1939 on which it was necessary to take up rights to purchase stock as offered.

We most certainly were not aware of that fact.

It is no exaggeration to say that we were dumfounded to learn from Mr. Bunker that there were exactly 186 offerings by means of rights between 1930 and 1935, the period upon which we primarily based our conclusions, and during which we were reasonably certain that there were few important capital changes. This is an average of two offerings per stock—a very high figure. If there were 186 rights offerings, just imagine how many capital changes of all types there must have been, and how profound an effect capital change must have had upon the index which we used so naively.

However, I will be frank and admit that we were immediately skeptical of this figure of 186. So we looked into the matter. A hasty perusal of the financial manuals disclosed that there were only 9 or 10 rights offerings recorded during the 1930-35 period. Surely, this could not be correct, since the difference between 10 and 186 is all of 176. So we asked the Standard Statistics Co. to estimate for us the number of rights offerings affecting the index during this period. Now, it is true that our own figure was not verified by the Standard Statistics Co., since they informed us that there were but 4 such offerings; but we are still a long way from verifying Mr. Bunker's figure of 186.

However, we immediately concluded that Mr. Bunker was perhaps speaking loosely and he really meant capital changes of any kind when he spoke of 186 offerings by means of rights. So we asked the Standard Statistics Co. for their estimate of the number of capital changes of any kind during this period which could have had some effect upon the index. They told us that there were 6 substitutions (which we had recorded), that there were 4 rights offerings, that there were 19 cases of capital acquisitions requiring the issuance of additional stock,

and that there were 21 changes of 1 percent or more resulting from the retirement of treasury stock. Thus, there were 44 changes in all which might have had some slight effect upon the index.

By now we had begun to suspect that the 186 rights offerings and the 16,740 market operations recorded by Mr. Bunker may have had little net effect upon the index, after all. As a matter of fact, when we originally decided to use the Standard Statistics index we gave some thought to this problem. We noticed that there were few actual substitutions. We looked over the 90 companies, and we concluded that capital changes would not be of material importance. We were encouraged in the decision to use the index by the knowledge that we were setting no precedent in so doing, since several financial publications utilize stock indexes in just this way. We submitted the study to Prof. E. B. Wilson, of Harvard University, who wrote that it was a "sound and thorough job." Furthermore, Mr. Alexander Sachs, vice president of the investment company of which Mr. Bunker is the executive head, was kind enough to permit us to examine a study prepared in 1937 by Lehman Corporation in which the performance of investment companies was compared to the Standard Statistics 90 Stock Index—the same index we are using. Since nothing was said in that study about the impropriety of such a comparison, or its unreality, we felt even more that it was safe to go ahead.

Therefore, the sweeping attack by Mr. Bunker on this index was quite unexpected. Apparently, we were entirely wrong in our belief that capital changes were not of much importance, and a great deal of money would be needed to follow the index.

There was a very simple way to find out whether we or Mr. Bunker had been misled.

We looked at the manuals and found that about 27 percent of the stocks, exclusive of four stocks involved in substitutions, had the same amount outstanding in 1929 and 1935. Forty-one percent of the issues increased the amount of outstanding shares over the period and 32 percent of the issues decreased the amount outstanding. Thus, new money could be required for only 41 percent of the issues. It is perhaps understandable that Mr. Bunker stressed rights offerings and acquisitions of property when he pointed out to this committee that it required an "inexhaustible supply of money" to follow the index. To emphasize the fact that money was made available every time the number of outstanding shares was decreased would not strengthen his case against our index. Furthermore, it appears that Mr. Bunker, in describing to you the number of capital changes and the necessary market operations, did not mention the possibility of capital changes offsetting one another. If his 186 changes were all increases, the amount of new money necessary to follow the index might be a very large figure; if these changes offset one another, it may just be that a supply of liquid funds somewhat less than "inexhaustible" might do the trick. This also can be determined very simply.

For this, we figured out just how many shares were outstanding for the index stocks at the end of 1929, and then we figured out how many shares these companies had outstanding at the end of 1935 and also at the end of 1939. We left out the companies involved in substitutions, because they would distort the picture. We found that the amount outstanding in 1935, after adjusting for rights, was a mere 3.5