THE ARMY INDUSTRIAL COLLEGE
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ECONOMIC JUSTIFICATION

OF

ENTERPRISE

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Economic Aspects of Stocks and Bonds

by

Capt. Jas. H. Beals Bogman, Sig C.,

Instructor.

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The subject, Stocks and Bonds, is an ambitious one. Lifetime studies have been concentrated on special phases of it and truly wise men have lost prestige and reputation by bold interpretations. Recently the favorable prognostication of a nationally known economist was followed by the October break some twenty-four hours later. Therefore, when we talk about stocks and bonds, we should realize that we may jeopardize our reputations. However, having everything to gain and nothing to lose, we are in an enviable position.

This discussion will shape itself about a natural setting. We will assume that an individual goes into a business which expands into a partnership and later is incorporated and grows into a great corporation, taking on the characteristics of American big business. We will follow this undertaking through the vicissitudes of business as a means of trying to ascertain the function of financial management in business and agree upon a few sound concepts pertinent to the subject.

Let us think of the small entrepreneur, an individual with a certain sum of money, who wishes to go into business for himself. Having been an Army officer, he has great ability, so he desires to make use of whatever theory he can. He reviews his notes of the business course given at the Army Industrial College, finds the outline given in Chart I, and recalls that Economics teaches that

a. There is a scarcity of economic goods which is reflected by an insistent demand.

b. The demand is generally capable of unlimited expansion even though for a particular commodity at any one time, and in a given market the demand is not susceptible of stimulation beyond a certain point.

c. The selling price of a given commodity in the long run approaches the price of production and is set by the costs of the marginal producer.

d. It is necessary to enjoy a favorable differential in order to survive the competitive struggle. A favorable differential may be enjoyed as a result of an unusual production of monopolistic characteristics, protected by patents or secret processes, or the like, or, as a result of lower costs of production.

It is obvious that all factors relating in any way to the business may contribute to low costs but, in the final analysis the entrepreneur's ability is the dominant factor.

CHART I.

ORIENTATION

CONSIDERATIONS BEFORE LAUNCHING A CERTAIN ENTEPPRISE

1. ECONOMIC CONCEPTS

   a. A SCARCITY OF ECONOMIC GOODS

   b. THE DEMAND FACTOR IS

      1 IN GENERAL CAPABLE OF UNLIMITED EXPANSION BUT
      2. THE DEMAND FOR A PARTICULAR COMMODITY AT ANY ONE TIME AND IN A GIVEN MARKET IS NOT SUSCEPTIBLE OF STIMULATION BEYOND A CERTAIN POINT

   c. THE SELLING PRICE OF A GIVEN COMMODITY IN THE LONG RUN APPROACHES THE PRICE OF PRODUCTION AND IS SET BY THE COSTS OF THE MARGINAL PRODUCER

   d IN ORDER TO SURVIVE THE COMPETITIVE STRUGGLE A FAVORABLE HANDICAP MUST BE ENJOYED.

      1. AN UNUSUAL PRODUCT PROTECTED BY PATENTED OR SECRET PROCESSES.
      2 A FAVORABLE DIFFERENTIAL IN THE COSTS OF PRODUCTION.

   e. FACTORS CONTRIBUTING TO LOW COST OF PRODUCTION

      1. ALL FACTORS OF PRODUCTION
      2 ENTREPRENEUR'S ABILITY THE DOMINANT FACTOR

2. EVALUATION OF FACTORS

   a. PAR FACTORS

      1. COMMONPLACE PRODUCT
      2 ORDINARY PRODUCTION PROCESSES
      3. LOCATION, RAW MATERIAL, LABOR, TRANSPORTATION COSTS AND THE LIKE AT THE AVERAGE

   b. PREMIUM FACTORS

      1 KEEN ENTREPRENEUR ABILITY WITH APPRECIATION THAT FACTORS MUST BE AT THE OPTIUM AND THAT ONLY FAVORABLE FACTOR CAN RESULT FROM

      2. FINANCIAL MANAGEMENT PROVIDING

         a. LOW COST OF CAPITAL
         b. GREATEST UTILIZATION OF CAPITAL INVESTMENT

A review of these economic concepts leads our individual to an application of them to his particular problem He believes that before launching this proposed enterprise, he should evaluate certain factors and as he sees them, they divide themselves into factors that are at par and those that are at a premium. The par factors result from the fact that production is more or less commonplace and that ordinary production processes apply, further, that the location of the proposed plan, the raw materials used, the labor involved, and the transportation necessary, are all about normal, but that the factors above par result from the fact that the individual has keen entrepreneur ability with full appreciation that all the different elements involved must be at the optimum, and that the only factors which can contribute to a favorable differential result from proper financial management which will provide capital at the lowest possible cost and will utilize the capital investment to the fullest.

In order to accomplish this, he decides to concentrate on finance

One might logically ask, "What is the definition of finance and what is its purpose in business?"

The Encyclopedia Britannica says that finance is the art of providing means of payment The immediate aim assigned to finance in any business is simply that of maintaining at all times an adequate cash balance in money or bank credit, but the means employed include all the multifarious methods of borrowing money and exchanging one sort of pecuniary right against another. This leads to the thought of capital and naturally the sources of capital.

The economist considers capital as tangible instruments of production, while the business man goes one step further and considers the capital investment as being represented by physical property and valuable intangible assets. Consequently there are different types of capital.

Chart II shows the different kinds of corporate capital somewhat in the order of its bonding value. These different types of corporate capital are roughly divided into fixed capital, which is tied up in a fixed or permanent form, such as land, building, and equipment, and working capital This last type of capital deserves much thought and consideration for it is safe to say that the majority of failures is probably due to the lack of this sort of capital. Let us consider what is meant by working capital.

In the "Wealth of the Nations" published in 1776, Adam Smith, the father of economic thought, said

KINDS OF CORPORATE CAPITAL

1

1. LAND

2. BUILDINGS

3. EQUIPMENT

**4 RAW MATERIAL AND SUPPLIES

**5. WORK IN PROCESS

**6 FINISHED PRODUCT

**7 LLS AND ACCOUNTS RECEIVABLE

**8 CASH

**9 SECURITIES

10. GOOD WILL, INCLUDING SECRET PROCESSES, PATENTS, COPYRIGHTS, AND TRADE NAMES.

"When the stock which a man possesses is no more than sufficient to maintain him for a few days or a few weeks, he seldom thinks of deriving any revenue from it. He consumes it as sparingly as he can, and endeavours by his labour to acquire something which may supply its place before it be consumed altogether. His revenue is, in this case, derived from his labour only This is the state of the greater part of the labouring poor in all countries.

But when he possesses stock sufficient to maintain him for months or years, he naturally endeavours to derive a revenue from the greater part of it, reserving only so much for his immeadiate consumption as may maintain him till this revenue begins to come in. His whole stock, therefore, is distingished into two parts That part which, he expects, is to afford him this revenue, is called his capital. The other is that which supplies his immeadiate consumption, *****

There are two different ways in which a capital may be employed so as to yield a revenue or profit to its employer.

First, it may be employed in raising, manufacturing, or purchasing goods, and selling them again with a profit. The capital employed in this manner yields no revenue or profit to its employer, while it either remains in his possession, or continues in the same shape. The goods of the merchant yield him no revenue or profit till he sells them for money, and the money yields him as little till it is again exchanged for goods. His capital is continually going from his in one shape, and returning to him in another, and it is only by means of such circulation or successive exchanges, that it can yield him any profit. Such capitals, therefore, may very properly be called circulating capitals.

Secondly, it may be employed in the improvement of land, i the purchase of useful machines, and instruments of trade, or in such-like things as yield revenue or profit without changing masters, or circulating any further. Such capitals, therefore, may very properly be called fixed capitals "

The business man of today would say that the time-honored definition of working capital is the existence of current assets over current liabilities. Current assets are those which, in the ordinary course of business, can be or will be turned into cash within a brief period (not exceeding a year normally) without diminution of value and without disrupting the organization. Current liabilities, on the other hand, are those intended at their inception to be paid in the ordinary course of business within a reasonably short time (normally within a year) out of the income of the business.

Now let us return again to this working capital, this circulating capital. We see from Chart III, which is a simple chart showing the main paths of circulating capital, that cash leaves the cash fund by two paths, by the one it buys service in the form of operating expenses, by the other it purchases materials in the form of inventories. These, combined with operation, result in the production of finished goods which are sold and transferred in the form of cash or credit receivables, and as they receivables are collected, the cash fund is again built up.

If we return again to Chart II, we see that those items with the asterisks represent circulating capital and those without, particularly items 1, 2, and 3 represent fixed capital.

Again, we recognize other forms of capital besides fixed and working capital. In addition to fixed and working capital, there are seasonal and exceptional capital. The seasonal requirements may be attributable to influences of weather, custom, or the like. For example, there is a decided seasonal requirement in the financing of department stores caused by the fact that their peak sales come in December.

Let us take a homely example to bring out this relationship. If the business under consideration were such that the peak demand lasted only one month and involved a working capital of ten thousand dollars, whereas the normal working capital was only five thousand dollars, it would be wise to borrow the working capital for the season rather than cutting down in production. In other words, it is sound to borrow to take care of seasonal requirements. The nature of this exceptional capital previously referred to is indicated by its title. It is of a non-recurring nature and each case must be handled on its individual merits. However, expediency usually governs.

Regarding the sources from which capital funds can be secured, Chart IV shows the methods of raising capital and the sources of supply. Our individual concludes from the chart and his knowledge of general business conditions that the time is not propitious to seek permanent capital in any form from the outside, that the capital must be furnished by himself. His funds are adequate to provide for the business needs, while the seasonal requirements will be provided by commercial bank borrowing.

The second stage in the business is approached when the individual business has prospered and future prospects warrant an increase in production. Yet, since general business

CHART III.

MAIN PATHS OF CIRCULATING CAPITAL

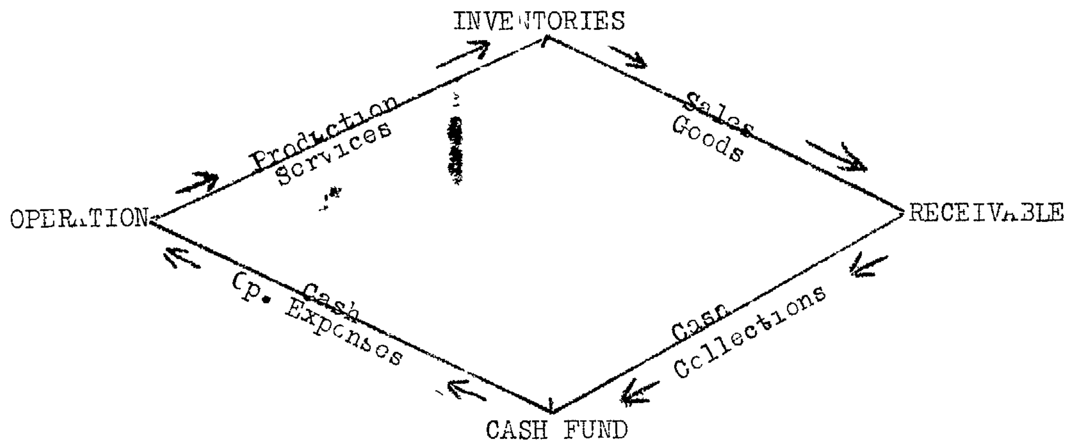

CHART IV

METHODS OF RAISING CAPITAL AND SOURCES OF SUPPLY

METHODS

1 Profits

2. Trade Credit

3 Short Term Loans

4 Assessments

5. Sale of Securities
   - Bonds
   - Long Term Notes
   - Preferred Stock
   - Common Stock

SOURCES OF SUPPLY

1 The Business

2 Parties supplying Materials, Supplies or Services.

3. Commercial Banks

4. Discount Companies and Individua Discounters

5 Warehouse Companies and Commerci Credit Companies

6 Present Owners

7 Affiliated or Controlling Interests

8 Investing Public, Including Savings Banks and Other Institutions.

9. Speculative Public.

conditions and the money market are such that the time is not propitious to finance through floating a stock issue, this individual is faced with the problem of securing additional funds in order to take care of an expansion in his business, which is economically justified.

It is obvious that help can come only in the form of a partnership. In other words, he must seek an individual who has sufficient funds and is willing to associate himself with the enterprise The financial policy is similar to that of the individual partnership The partners must furnish that fixed and working capital while the banks can be looked to for capital to take care of seasonal and exceptional requirements.

The third stage of our business is reached when the partnership has prospered, the business grown, and the partners wish to diversify their risks. One of the partners has grown old and wishes to prepare for his gradual retirement and the shifting of risks that is incident to a partnership. The partnership has a proved record of earnings which will furnish a basis for capitalization The general business and market conditions are favorable for the financing of sound business enterprise. In a word, business is sound, the partners wish to provide for gradual retirement and the public is in a receptive mood. Consequently, thought is given to the method of financing that satisfy the different interests. The older partner did not understand all the terms that were being used during conferences held by the bankers and the partners for the purpose of deciding upon the financial structure of the proposed corporation.

The term "Instruments of Finance" was explained to include generally, two classes

1 Stocks which represent the owners intrest in the business, and

2 Funded debt, which includes bonds and notes and represents the creditor's claims upon the corporation.

The term "Capital" is fairly well understood from a previous discussion.

"Capital Stock" is explained as the amount of stock authorized for issue.

The word "Capitalization" causes some misunderstanding. One partner says that it is the sum of the outstanding stock and funded obligation of the concern, which in some cases, includes the earned surplus, while the young banker, who is attempting to arrange the financing, contends that capitalization is simply the method of distributing control risk and income among security holders. In an effort to clarify this contention, he developed Chart V showing that the owner of capital is compensated for (1) the use of his capital and (2) the risk of losing it, and that capitalization should provide the proper distribution of control, risk, management, and income and at the same time that form of capitalization should be selected which takes advantage of existing conditions considering (1) general business conditions, (2) money market, and (3) fads.

From a study of Chart 5, it is appreciated that the owner of the capital that is to be supplied must be considered. His wants are dominant. Securities must be provided that will meet his requirements, otherwise capital will not be forthcoming. In other words, he must be properly rewarded for the use of his capital in proporation to the risk involved from loaning it. After considering the desires of those who will provide the capital, that form of capitalization should be selected which will

1. Invest in the proper interests the amount of control over the business that is required.

2. Distribute the risk properly

3. Invest in the owners or those selected the management of the enterprise, and

4. Distribute the income proportionately.

A consideration of these four factors just mentioned is approached principally from the management's point of view. It must be insured of sufficient control over the business without accepting undue risk and without distributing more income than is necessary. At the same time the management should approach the problem from the opportunist's point of view. That is to say, the capitalization decided upon should take advantage of existing conditions of a general business nature together with those in the money market and existing fads.

Apropos of fads, it is interesting to note the influence of style on securities. Its diction is felt here as well as in other lines. For example, there are styles in securities as well as there are styles in cars and dresses. Years ago common stocks were not in favor while in the year 1929 up to B. C. (B. C. and A. D. are herein referred to as before the crash and after the drop), bonds were a drug on the market. Everyone wanted equities. What will happen A. D. remains to be seen. The pendulum may swing back to where bonds are in favor, or some happy middle ground may be reached. Thus it is seen that while common stocks were not in favor years

OWNER OF CAPITAL COMPENSATED FOR

1. Use of His Capital
2. Risk of Losing It

CAPITALIZATION SHOULD PROVIDE PROPER DISTRIBUTION

OF

1 Control
2. Risk
3 Management
4. Income

CAPITALIZATION SHOULD TAKE ADVANTAGE OF EXISTING

CONDITIONS

1. General Business Conditions
2. Money Market
3. Fads

ago, when Mr Carnegie sold his steel holdings, he took bonds in payment In this connection, while Mr J. Pierpont Morgan claimed that Mr. Carnegie out-traded him, it is evident that Mr. Carnegie's conservatism in dictating acceptance of bonds cost him the tremendous appreciation of the common stock that resulted from sound operations over period of years. At the present time, it would appear that investment trusts are in ill repute Yet they had increased in favor to last year when the financing was in the following proportion 45% was in common stock issues, 35% in bonds, and 17% in preferred stock issues. In other words, about 65% of the 1929 financing was done through stock issues and this compares to about 40% of the year previous *

The conference between the partners and the bankers brought out the fact that the coporation's financing for the purpose of securing fixed and circulating capital for the needs of the business rests normally upon the issuance of stocks or bonds and that stocks fall into two general categories

1. Common which either has par value or no par value.

2. Preferred stocks which may have culmulative non--cumulative, callable, and different protective provisions

On the other hand, bonds are of many types and kinds The young banker, in order to clarify certain issues, draws up Chart VI which shows the principle forms of securities with respect to transfering control, income and risks. The partners, after being completly advised by the young banker, decide to attempt the simplest sort of financial structure consisting of one type of bond, one type of preferred stock, and one type of common stock. The bonds represent property owned by the corporation That is today, in the event of a foreclosurer the bond holders would look primarily to the real estate owned by the corporation for protection. The preferred stock was protected by plant and working capital, while the common stock represented a fair capitalization of probable future earnings based upon a proved record of past earnings. This method of capitalization of earnings is shown in Exhibit A appended hereto.

In short, the partners attempt the simplest capital structure consisting of bonds, preferred stock, and common stock, in proportion to give the required control, keeping the risk at a minimum and distributing the profits equitably. The investment banker's function here was to underwrite the securities to enable the partners to gradually retire and to furnish investors with good securities.

The next stage of our business is characteristically

*STANDARD TRADE AND SECURITY STATISTICS.

CAPITALIZATION OF EARNINGS.

"If the tangible assests amount to $100,000 and the net earnings of a company amount to $25,000 a year, and we consider that five per cent is a fair rate at which to capitalize the earnings, the capitalized earnings will be $500,000 and the excess capitalized earnings will be $500,000 less the amount of tangible assets ($100,000) or $400,000. This company, then, would have $100,000 of preferred stock and $400,000 of common stock."

V. C GERSTENBERG,
"Financial Organization and Management".

merican. The small corporation went through a period of successful management under the old partners but gradually passed into younger more aggressive hands Inventories had piled up and general business conditions were bad. Current obligations were pressing. A reorganization was necessary.

Let us get this picture clearly. Here is a company that has been successful but has gotten over extended. It is sound over the long run point of view, bit is insolvent at the time. The company must have money and its condition is comparable to an individual who finds it necessary to seek accommodations from a loan shark. Do not think of the investment bank as a loan shark. The investment banker preforms an economic function. He is sought out by the corporation who needs the money and he must fufill his functions or he will lose out in the competitive struggle Consider this problem from the banker's point of view. He must have something to sell, a type of security that will stay sold and that will not come back on him. This involves feeling the temper of the market. He realizes that restrictive provisions include debentures and agreements serve certain purposes but that they are not always what they purport to be. The investment banker's problem might be thought of as a give and take between what the people who are buying securities demand and what the company seeking capital has to offer It should be fully appreciated that when a company gets into such a predic ment, it must have money, and temporary governs. The banker approaches the problem from the philosopical point of view and this approach is represented in Chart VI where the principle forms of securities are listed with respect to varaying control, the income, and the risk. In other words, the general financial structure must take some definite shape after this philosophizing Later the frills can be filled in. The frills usually result from a desire to substitute form for substance. Obviously, where a company is sound and prosperous, the financial structure would be simple and without frills.

In an effort to illustrate what might be termed "frills" let us examine some of these high-sounding titles that usually accompany gilt-edge, engraved certificates such as real estate first mortgage gold bonds.

Should we look in most any one of the more of less select current periodicals of several years ago, we would find that G. L Miller Company, at one time of Atlanta, Georgia, and later of New York City, advertised that "No One Ever Lost A Cent in Miller Bonds", we might select a particular issue known as the Richmond Hotel. A superficial analysis of this issue would show that the hotel, located in Augusta, Georgia, was well placed, that there was an economic demand for the service, and even a closer examination would disclose that as time went on the hotel gave all promise of being profitable. However, a fact that did not appear untill later when the

PRINCIPLE FORMS OF SECURITIES

WITH RESPECT TO VARYING CONTROL, INCOME

AND RISK

1. Securities arranged in order as they restrict the right of control.

    1. Non-voting stocks.
    2. Bonds (their holders have the ultimate control of foreclosure).
    3. Preferred stock and income bonds that are to vote if holders do not receive income.
    4. Bonds convertible into stock.
    5. Vetoing stocks.
    6. Voting stocks.

2. Securities arranged in the order of potential claims to increasing amount of income.

    1. Non-participating preferred stock.
    2. Income bonds.
    3. Ordinary bonds.
    4. Bonds convertible into stock.
    5. Profit sharing or particapating bonds.
    6. Common stock.
    7. Participating preferred stock.

3. Securities arranged in the order of safety of principle.

    1. Stocks, not preferred as to assets.
    2. Stocks preferred as to assets.
    3. Sinking fund, redeemable stocks.
    4. Debenture bonds.
    5. Debentures to be protected by future mortgages if and when executed.
    6. Adjustment of bonds.
    7. Junior mortgages.
    8. General refunding mortgages to take up prior liens.
    9. Senior mortgages.

G. L. Miller Company went into bankruptcy and the bond holders protective committee attempted to salvage the small equity behind these bonds, was that the bonds rested upon the lease-hold and that the lease-hold covered land that was used jointly by this hotel and a department store. Though the hotel was profitable, the department store was a failure and it became necessary to use a great part of the profits of the hotel to protect the lease-hold. This condition resulted in a final statement whereby the holders of these real estate first mortgage gold bonds secured thirty-three and one third cents on the dollar.

The same issue of the reputable monthly included an advertisement of the Adair Company, likewise of Atlanta, Georgia, and their advertisement cited the fact that "NO ADAIR INVESTOR HAS LOST A CENT IN 57 YEARS", but as time went on, the Adair Company went into the hands of the receivers and many of their loans were found to rest upon inflated land values particularly when these issues represented operations in Florida. So much for past history.

Today the F. H. Smith Company, a local concern, is being investigated by the Department of Justice, and their books are being requested by the Courts of different states. It will be interesting to learn the details in such underwritings as resulted in the Hamilton Hotel affair. It is believed that matters of interest will be brought out in connection with their ingenious use of gold bonds.

Lest it be thought that real estate mortgage bonds monopolized these abuses, we will look at railroad bonds and the recent classic example ~~xxxx~~ of such an issue is the Chicago, Milwaukee, and St. Paul Railroad receivership. In this case a bond which cost 84 some months before the reorganization was quoted around 50 at the time of the reorganization.

In general, while a mortgage provides for foreclosure and sale, it should be appreciated that such procedure is expensive and not at all certain. The notice of a foreclosure sale does not insure a purchaser, and, of course, a purchaser is necessary if sale is to be consumated. Then too, foreclosure has often been resorted to in order to write down fixed charges.

Preferred stock represents the effort on the part of the management to avoid the risk of foreclosure implied by the mortgage and creditor interest and at the same time to keep as much of the operating income as possible. In other words, preferred stock is a hybrid. In summarizing, it might be said the preferred means something sometime. Yet, it may be inferred from Professor Arthur Stone Dewing's book that preferred more normally means restriction that hampers management without any real additional security to the stockholder. While essentially it does not represent a creditor's interest, neither does it provide equity participation It often includes restrictive provisions that hamper management as might be illustrated in the case of the Allis Chalmers Company which will be described in the following

In early 1927 the financial structure of the Allis Chalmers Company reflected the emergency financing incident to the reorganization of 1912 when each $1,000 bond was transferred for $1,000 of preferred stock with a bonus of $350 of common. At the same time the preferred stock was assessed $20.00 per share and the common stock $10.00 per share. This method of reducing fixed charges and increasing working capital necessitated a preferred stock that would be attractive to the old bond holders. As a result, this preferred stock carried a 7% cumulative dividend, the power to elect the majority of directors and prohibitive restrictions against prior liens Now it can readily seen that if this preferred stock were in the hands of people who were reluctant to face the ordinary business risks, then these prohibitive restrictions included in the preferred might be in opposition to the best interests of the company so that any re-financing which would decrease the cost of capital, eliminate the onerous provisions of this preferred stock and re-invest control in the common, would be beneficial to the company. This is precisely what the company did and the cost of this refinancing together with its probable savings is shown in Exhibit "B".

The cost of this refinancing can be segregated into the original expenditure and the annual cost. The original expenditure involves all expenses incident to the refinancing and amounts to $2,250,000. The resulting actual saving was figured to be $304,350 and the saving during the life of the debenture should be $2,350,000. Thus the annual saving represents a return in excess of 13% on the original expenditure, and this does not give full weight to the fact that the costs incident to the elimination of thempreferred stock can be prorated over a longer period. Likewise, future financing will not be burdened with a 10% premium if it is decided to take advantage of favorable markets to furth reduce the cost or to eliminate the fixed charge It should be appreciated that in early 1927 when this financing was contemplated business conditions promised to continue on a fairly even level, and that the business of the Allis Chalmers Manufacturing Company was known to correlate closely with and follow general business, and hence, the time was propitious for such a financing.

While the control of the company was reinvested in the common stockholders as a result of this refinancing, still a fixed debt was created. It is true that these debentures were not a lien and were not therefore entitled to foreclosure but they were an obligation and as such would culminate in a

THE ALLIS CHALMERS MANUFACTURING COMPANY

Refinancing

Expenditure Involved - Annual Savings - Cumulative Saving

I. Original Expenditure

Premium on Preferred		
10% $16,500,000		$1,650,000
Spread on Debentures		
1% Discount	$150,000	
3% Commission	$450,000	600,000
Total		$2,250,000

II. Annual Cost

5% Interest	$15,000,000	Debentures	$ 750,000
4% "	$ 3,750,000	Marketable Sec *	150,000
Amortization	$ 600,000	Deferred Charge**	60,000
Total			$ 960,000

III. Annual Saving

a) Dividends on old preferred		
7% $16,500,000		$1,155,000
Annual cost under Refinancing		
Previous Section		960,000
Savings		$ 195,000
b) Income Tax Reductions***		
1) 13½% $750,000	$101,250	
2) 13½% 60,000	8,100	109,350
Total Annual Savings		$ 304,350

IV. Cumulative Saving

Savings of $304,350 over the life of the Debentures ****	$4,000,000
Original Expenditure (Sec.I)*****	1,650,000
Total Cumulative Saving	$2,350,000

*Represents a reduction in other income of the company. Financial statements show that these securities were returning 4%.

**To be written off during life of Debentures.

***The interest on the Debentures and the annual reduction of the deferred charges are charges that are deducted in computing the taxable income according to the Income Tax Provisions.

****Table of Annuities 10 years @ 6% compounded Annually.

*****The deferred charge will have been completely written off See Sec. II.

receivership if neglected. It would seem then, that the very existence of the business might be threatened by the creation of this fixed charge but there is no danger so long as the obligation is met. This obligation is $750,000 annually The source of meeting this obligation is the profit derived from the business, and a study of the company's earnings since 1922, shows in general that there has been ample margin of safety and in particular, that the poorest monthly earnings during this period were more than sufficient to cover the respective fixed charges.

Therefore, it might be concluded that the Allis Chalmers Company through debentures created a fixed charge, but the amount of the fixed charge was small relatively and the almost certain future earnings were large. Consequently, additional risk was negligable in comparison with the savings gained.

Continuity of present management was insured, the onerous provisions of the old preferred were eliminated together with any possible hinderances that might be put in the way of the application of the policies of an aggressive successful management by an active hostile minority and the dollar and cents savings resulting from this re-financing promised to be some two and a half million dollars. EXHIBIT "B".

The case of The Allis Chalmers Company is included in this discussion and in such detail in an effort to show that the theories and principles included in this paper are actually put into practice by far-sighted big business men.

In conformity with the custom of this school, we will discuss trends that seem to have taken shape, together with the probable future tendencies One of the most significant changes has to do with ownership. The most superficial study convinces one that this ownership has become more diversified. Whereas in the more distant past corporations were owned by a few shareholders, today some of the large corporations number their shareholders in the hundreds of thousands. Another significant fact is the larger proportion of ownership that is represented by common stocks. Apropos of this, it will be recalled that Mr. Carnegie in accepting payment for his steel properties, insisted upon bonds In contrast to this Mr. Asa Candler, when relinquishing control of the Coca Cola Company, accepted payment in the form of preferred stock in the new Coca Cola Company. The Candler heirs would have benefited more materially had Mr. Candler accepted common stock.

Carrying this contrast still further, many of us, surely, are able to recall the underwriting characteristics of 1929 when common stocks were at a premium, preferred without any participating features, and bonds had no market. The high water mark of this sort of financing probably was reached when the Goldman-Sachs Trading Corporation put forth the Shenandoah Corporation and its child the Blue Ridge. Since this financing is fresh in our memory, let it suffice to say that the treasury of the Goldman-Sachs Trading Corporation benefited materially at the time of the Shenandoah undertaking since the Goldman-Sachs Trading Corporation owned the stock which was theoretically issued at the price of 17, but which immediately opened on the New York Curb Market considerably higher and reached a high of better than 39. If it is assumed that the Goldman-Sachs Trading Corporation fed this stock to the market and realized an average of say, better than 30, the theoretical unearned increment accruing to the corporation's surplus is apparent.

It is of no particular significance so far as this discussion is concerned that the current price of this same stock is 9, but it should illustrate the influence of fads and it should be obvious that while it was not only possible but profitable for the Goldman-Sachs and many other similar organizations to float such issues some six months ago, such financing is utterly impossible now since many investment trust securities are selling at prices below their liquidation value.

Another outstanding characteristic of the past year has been the tendency for banks to split their shares This was started by the gigantic National City Bank Company reducing the par value of their common stock from 100 per share to 20 per share and split the stock five for one The advantages claimed for this sort of thing is the diversification of ownership and the theory that a larger number of stockholders will tend to bring the bank more business. A less recognized motive might be the belief that greater diversification of ownership provides easier control That is, control is made possible by the control of the smaller proportion of the stockholders since the majority of stockholders are indifferent and inactive whereas a larger proportion of small stockholders have a tendency to become more interested in the affairs of the company. A complement to this split-up in bank shares and the reduction of the par value was the issuance of rights. this is a very interesting development and worthy of a specific case.

Take the case of the Bank of Manhattan. This Bank split its stock five for one thereby reducing the par from 100 to 20 dollars on the new stock. Then the bank allowed each holder of six shares of the new stock to suscribe to one additional share of the new stock at $120 Of this $120, twenty dollars represented the par value of the new stock and one hundred represented a sum that the company could apportion as they saw fit. For all practical purposes, this one hundred dollars went into the surplus or undivided profits of the bank. Now we know what these items mean to a bank. the capital means that at some time someone has put in that amount of money to make possible the operations of the bank, and as the bank's operations become profitable, the profits can be distributed either as dividends or go to make up the item of undivided profits which later are added to the surplus at the discretions of the directors. Thus it is seen that the undivided profits and surplus result normally from the long time profitable operations of the business. Yet by this device of allowing the stockholders to pay the one hundred and twenty dollars for common stock that has a par value of twenty dollars, one hundred dollars can be added to the undivided profits or surplus. That is to say, that for every one dollar added to the capital, five dollars is added tothe undivided profits of surplus-truly, an easier and more certain way of building up surplus than loan operations.

Lest one should get the idea that such an arragement was not agreeable to the stockholders, we will see how this affected the stockholder. When this announcement was made and before the severe drop in security prices materialized, the stock sold at the high of $272. In other words, a subscriber could theoretically pay in $120 and immeadiately sell his share at 272. Naturally the stockholders were enthusiastic It would seem then, that this financing procedure by taking advantage of the general business and credit situation and catering to the then existing fads in the security market was able to add this tremendous sum to the surplus and at the same time to reward the stockholders, thereby increasing the strength and prestige of the organization.

Returning to our philosophical discussion, we find that the bank was able to secure a great amount of capital without losing any degree of control and without incurring any appreciable risk.

In discussing trends, the ethical side should not be omitted.

In this connection, it is interesting to observe the changes that have been executed in the policy of the Standard oil corporation. The early practices of this corporation are history, to which Thomas Lawson and others have contributed vivid accounts. Last year a most interesting fight for control through the use of proxies occured in the case of the Standard Oil Company of Indianna In a few words, Mr John D Rockefeller, Junior, became dissatisfied with certain practices of Mr Stewart the chairman of the Board of the Standard Oil Company of Indianna, and as it became impossible to reconcile these differences, Mr Rockefeller secured sufficient proxies to oust Mr. Stewart. In this case a higher evaluation was placed upon business integrity than upon profit accumulation.

Another aspect of the ethical influence can be apprecited by a study of the changes in sentiment expressed toward the non-voting common stock. Non-voting common stock was used in many cases to secure control with little expenditure. The Goodyear Tire and Rubber financing and the Dodge Motor Company are examples. More will be said later of the Dodge case. Professor Ripley at Harvard criticised the corporations for cutting down the stockholder's rights, particularly by the device of non-voting common stock. The New York Stock Exchange adopted a hostile attitude toward non-voting stock. The final development in the Dodge Motor deal then came along. In this Dodge Motor Company deal it appears that the Dillon-Read Company pain $146,000,000 cash for the Dodge Motor Company and proceeded to sell stock securities of the company to the extent of $160,000,000, at the same time retaining control. This gave Dillon-Read the voting stock and the legal right to sell to Mr Chrysler. Dillon-Read, however, decided that they would rather have the consent of preferred and common, and therefore amended the charter giving the preferred and common stockholders the right to vote, and in so deciding, made it necessary to go into the market and buy in order to insure a consummation of this deal

Needless to say, there are other factors that have not been mentioned. Very recent developments along these lines is the National City Bank-Corn Exchange proposed merger The preliminary arrangements of this merger provided that each holder of five shares of Corn Exchange Bank would receive in exchange four shares of National City Bank and a provision was included that stockholders of the Corn Exchange Bank should have the option of receiving $360 cash for each share of Corn Exchange stock. When these preliminary arrangements were agreed upon, the stock of these two banks was sold in the proportion of five to four, and Corn Exchange Bank was considerably higher than $360. In fact, before the break it sold as high as $448 a share Before the final arrangements were made, the speculative enthusiasm had spent itself in the market and the severest depression of all times had resulted. Corn Exchange Bank was quoted around 140 and National City around 190 Consequently, Corn Exchange Stockholders would benefit materially by this preliminary agreement if they should excercise their option and receive $360 cash for their shares. Such a proposition did not now appeal to the National City management and in order to prevent such a severe strain upon the National City cash resources, the stockholders of the National City Bank failed to ratify this preliminary agreement. Much has been written and said in favor of and against such an action Time alone can tell just how the public will evaluate such procedure.

In concluding this discussion of the ethical side, it is fitting to touch upon changing ideals. Much has been said about absentee ownership. The thought has been expressed that the American Telegraph and Telephone Company management might be thought of as being farther removed from the owners than from the customers. The indifference of stockholders has been a source of annoyance to many managements. It has been said "that the relation of directors and officers to stockholders generally has been drifting into 'inocuous desuetude'."* The apathetic stockholder is illustrated in the Chicago, Milwaukee and St Paul reorganization. Six thous nd shares of preferred and fifteen million shares of common had not been deposited although there was an equity as payment of assessments of about $49 00 for each share of preferred and $33.00 for each share of common according to market quotations

All of this disgression into the ethical aspect would seem to lead us to the conclusion that while this might be a possibility, yet our political and business leaders recognize this and do not fear the consequences. Our President, Mr. Hoover, has said, "I think we are in the pres nce of new era in the organization of industry and commerce pregnant with infinite possibility of moral progress", and Mr Owen D Young, our great industrial leader sees business management as a sort of trusteeship with three groups of beneficiaries

1. The stockholder
2. The workers
3. The customers and the general publi

He conceives its duties to be (a) th the cap tal which is put into the concern is s fe, honestly [illegible] used, and pays a fair rate of return, (b) th [illegible] who put their labor and lives into the business get [illegible]s, continuity of employment and the right of adv [illegible] (c) that the customers get a product which is as repres n [illegible] t price consistent with the obligation to the people [illegible] t their capital and labor in, and lastly, (d), that th [illegible] s a right to cepect that a concern will function [illegible] public interest and prefoim its duties s a great and good citizen should, in short, that the management no longer feels any obligation to take from labor for the benefit of capital nor to take from the public for the benefit of both [illegible] ther to adminster wisely and fairly in the interest of [illegible]

A discussion of this kind can be concl ded in no better way than by attempting to arrive at cer [illegible] financial concepts that may be useful to remember (See Chart VII).

(1) the capitalization should provide the necessary control with minimum risk, and the minimum cost (2) the capital structure should be simple and flexible, (3) the best security should be kept to the last, and (4) balance should be struck between some sound policy and expediency.

The individual can approach an investment problem only if he fully appreciates factors that influence his own case, his age , his responsibilties, his station in life, his

*JOHN H. SEARS.

CHART VII.

FINANCIAL CONCEPTS

1. The Corporation

    1 Capitalization should provide

        a. Necessary control

        b. Minimum risk

        c. Minimum cost

    2 Capital structure

        a Simple

        b. Flexible

    3. Best security should be kept until the last.

    4. Balance struck between sound policy and expeniency.

2 The Individual

    1. The investor should decide upon satisfactory distribution of

        a. Control

        b Risk

        c. Income

    2. Investment should provide

        a. Such a satisfactory distribution

        b. An additional premium in payment for a wise selection.

aspirations, and many intangible factors that are difficult of evaluation. After the individual has evaluated these factors and decided how much risk he can afford to take, how much control over his security is essential, and how much income is imperative, he is in a position to approach his investment problem just as the business manager approaches the financial problems of his company In short, the investor should decide upon a satisfactory distribution of (1) control (2) risk and (3) income. The he should seek out that investment which provides the distribution decided upon and in addition gives the investor an additional premium in payment for a wise selection This is sound investment.