Journal of Accountancy

Volume 47 | Issue 3 Article 1

3-1929

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The JOURNAL *of* ACCOUNTANCY

Official Organ of the AMERICAN INSTITUTE OF ACCOUNTANTS

Vol. 47 MARCH, 1929 No. 3

The Accounts of an Investment Trust

BY HERMAN E. SCHREIBER

The choice of the subject of this paper, the accounts of an investment trust, was prompted by the fact that as far as I know no book nor magazine article has yet been published, in this country, on this particular phase of the investment-trust problem. Each of several authoritative publications on the investment trust contains a few short paragraphs on accounting problems peculiar to such companies, but none gives the necessary details—nor even an outline—for the installation of a scientific accounting system.

Today the rapidly growing number of investment trusts and the increasing size of those organizations make it imperative that adequate accounting systems be installed to take care of the large volume of business that is and will be done by them. While there were only a few small investment trusts record keeping by them was a simple matter and presented no problem. As evidence of the increasing number and size of investment trusts in this country the following figures have been compiled by an authority on investment trusts:

End of year	Number of trusts in existence	Estimated invested capital
1923	15	$15,000,000
1924	27	75,000,000
1925	48	150,000,000
1926	69	300,000,000
1927	150	700,000,000
1928 (June 30th)	199	1,200,000,000

It has been prophesied that "The day of the individual trust controlling a billion dollars of resources is near at hand."

A study of accounting practices and constructive suggestions for the solution of investment-trust accounting problems are further needed to bring about greater uniformity in accounting procedures. The lack of uniformity and the result of such lack of uniform practice will be fully shown in the section of this paper dealing with accounting problems peculiar to an investment trust.

It is the purpose of this paper not only to treat of the general principles and peculiarities of investment trusts and their accounting problems but to give to the student, the investment-trust organizer and manager, the systematizer and the auditor the details involved in the preparation of accounting forms, in the systematic recording of the business transactions, and in the auditing of the accounts during or at the close of the fiscal period.

In order to arrive at a solution of the problem of organizing a practicable system of accounting, the writer has used such information as is now available on the general subject of the investment trust. So that the reader will fully appreciate the use of the system that will be presented, a résumé of investment-trust principles, organization, management and business operations is given in the first part of this paper. In the last part the writer presents a constructive plan for investment-trust accounting based upon approved principles of accounting and auditing.

DEFINITION OF AN INVESTMENT TRUST

An investment trust is an organization of investors who have combined their funds for the purpose of purchasing a wide variety of securities, scientifically selected by skilled management; to insure safety of principal through diversification; to assure a dependable income, and to profit by capital appreciation, but without assuming a controlling interest in the companies whose securities are purchased.

The purchase of new issues and the financing of new companies is not the true function of an investment trust. That is the work of the financing company or of the investment banker.

Leland Rex Robinson gives the following definition in the *Trust Companies Magazine*, October, 1925: "An investment trust is an organization by means of which the funds of many investors, whether in large or small amounts, are jointly invested in a wide variety of securities." He has given a definition in his book, *Investment Trust Organization and Management*, in which he adds " . . . safety of principal is attained in diversification, while no control, or directive responsibilities, result from investment."

The British investment trusts conform to these definitions as well as do the true investment trusts in the United States. It must be remembered, however, that frequently, in magazine articles, in newspapers, and in various reports, holding companies and financing companies are classed as investment trusts: a clear-cut distinction is seldom made.

INVESTMENT TRUSTS DISTINGUISHED FROM OTHER BUSINESSES WHICH HANDLE INVESTMENTS

The term "investment trust" has unfortunately been used to include a great variety of organizations, both in Europe and in the United States, which are not truly investment trusts but merely perform, incidentally, some of the functions of such trusts while carrying on a banking, insurance or financing business. Some companies are frequently termed investment trusts when they are nothing more nor less than holding companies organized to control certain industrial or public-utility corporations.

There are many examples of companies which carry on an investment business but are to be distinguished from investment trusts. Holding companies, such as the Massachusetts Utilities Investment Trust, which controls a group of gas and electric companies through stock ownership, are not investment trusts because they control other companies and at the same time do not intentionally diversify their holdings. The National Public Service Corporation, The Associated Gas and Electric Corporation, and The United Light and Power Company are other examples of this type of organization. Financing companies which partake somewhat of the nature of investment trusts are those which have been sometimes called "financing investment trusts," "promoting investment trusts" and "Continental investment trusts." They can be readily distinguished from true investment trusts in that they more or less intimately control the enterprises in which they invest. It is their chief purpose to bring about the success of their subsidiary operating companies.

Insurance companies, trust companies and banks use a large portion of their funds in investing in securities of other companies, but their functions are varied. They do not restrict their operations to the business of investing for the benefit of the stockholders.

One other type of company which requires mention at this point is the "stock conversion", "trustee certificate" or "bankers share" company. Dr. Robinson formerly treated this type as not belonging to the investment-trust group, because it is not an active organization. (In his article in the *Proceedings of the*

American Institute of Banking, June, 1928, he classifies this type as a "unit series type of investment trust.") The portfolio, in this type of trust, can not be changed by the organizers nor by the trustees. Such a company resembles an investment trust in that the holdings may be diversified, in that the holdings do not represent a controlling interest in any company whose securities it owns and in that the chief purpose of the business is to invest for the benefit of the shareholders. The chief difference lies in the inability of the management to realize capital profits by taking advantage of market trends, which a skilled investor or a general management investment trust would do.

Diversified Trustee Shares is an example of the conversion trust, while the International Securities Corporation of America and the Second International Securities Corporation are examples of Dr. Robinson's general management investment trusts.

Both these types of trusts, as well as certain financing and holding companies, are classified in financial and daily newspapers under the one heading—investment trusts. This plan is usually followed by *The Annalist*, *Commerce and Finance*, *Bank and Quotation Record*, *New York Herald-Tribune* and *The Wall Street Journal*. The *New York Times* lists the holding and financing companies in the investment-trust column but under a special subheading. *The Journal of Commerce* and the *New York Evening Post* use four divisions under the general heading of investment trusts—general management, specialized management, fixed or limited management, and holding and financial companies. It is not the purpose of this paper to decide just where the line of demarcation between investment trusts and other companies closely resembling investment trusts shall be drawn. It seems that it would be quite proper to include under the name "investment trusts" all organizations conforming to the definition given at the beginning of this paper, which does not describe specifically the method to be employed in managing the portfolio.

THE PRINCIPLE OF DIVERSIFICATION

The greater the number of securities owned, if they have been chosen with reasonable care, the greater is the chance of avoiding loss on the whole, and at the same time the greater is the chance of averaging a liberal income from both dividends and market appreciation. The investor who buys 50 different securities, wisely chosen, has 50 chances to make a profit while the one who invests in only one security has only one chance. Statistics show that a certain number of securities considered good at a given time eventually depreciate in value, cease paying dividends, and even become worthless, while the average of a large number of securities would show a substantial profit to the investor owning an equal number of each of these securities. Diversification of investments is one method of applying the law of averages. With scientific selection of securities which seem certain to pay substantial dividends and to show, over a period of time, considerable market appreciation the law of averages operates by making certain a resulting substantial profit on the whole.

The investment trust, through the accumulation of funds from a large number of investors, may diversify to a much greater extent than is possible for the average investor with a limited amount of capital, a limited amount of time to study securities and a limited amount of scientific knowledge of investment conditions. The investor in investment-trust shares is thus enabled to "place his eggs in more than one basket even though he has only one egg."

European investment trusts generally invest in from 100 to 1,000 different securities originating in different industries in many different countries. They place no restrictions upon the management except as to the proportion of the capital which may be placed in the securities of an enterprise or a geographical subdivision.

The Investment Trust Corporation, Limited, according to the directors' report for the year ended May 1, 1928, has 632 investments distributed as follows:

	Percentage of valuation
British government securities	4.4%
Railways, including street railways	29.3%
Telephone, gas, electric lighting and other public works	15.4%
Commercial and industrial	27.5%
Trust companies, etc.	8.6%
Foreign government and municipal loans	9.6%
Steel, coal and iron	5.2%
	100.0%

An ideal distribution of investments is maintained by the International Securities Corporation as shown by its report of November, 1927.

According to territorial distribution the portfolio showed:

United States and possessions	29.789%
British Empire	1.873%
Central and South America	7.629%
Continental Europe	57.412%
Asia	3.297%
Total	100.000%

According to type of securities the portfolio showed the following classification:

Bonds	
Governmental	37.519%
Transportation	3.310%
Public utility	8.791%
Industrial	13.578%
Agricultural bank	7.755%
Commercial bank	3.522%
Land association	2.326%
Extractive industries	1.716%
Total bonds	78.517%
Preferred stocks	
Transportation	0.376%
Public utilities	0.528%
Industrials	2.104%
Banks and trust companies	0.002%
Investment organizations	0.197%
Extractive industries	0.046%
Total preferred stocks	3.253%
Common stocks	
Transportation	0.335%
Public utilities	0.101%
Industrials	1.009%
Banks and trust companies	1.370%
Insurance companies	0.003%
Extractive industries	0.296%
Total common stocks	3.114%
Other funds	
Bankers' acceptances	0.031%
Treasury notes	3.860%
Cash	11.225%
Total other funds	15.116%
Grand total	100.000%

CLASSIFICATION OF INVESTMENT TRUSTS

In Great Britain we find two general classes of investment organizations listed as investment trusts:

1. Those which act as financing, holding and promoting companies, and
2. Those which restrict their activities to investment of funds in seasoned securities.

They have been classified by American writers in various ways, four of which are outlined below:

- I. Classified as to groups—
    1. Groups of professional investment-trust managers, whose interests entirely center in this field.
    2. Firms of investment consultants, who operate investment trusts in addition to their investment advisory work.
    3. Issuing and investment banking houses which have gone into the investment-trust business.
    4. Banks and trust companies and their associated security companies.
- II. Classified as to capital set-up—
    1. "Fixed" or "limited management" investment trusts, which raise capital by issuing certificates.
    2. Management investment trusts which issue only shares.
    3. Management investment trusts which issue more than one class of security.

  Or,
    1. Statutory trust, which owns the portfolio of the trust.
    2. Contractual trust, whose portfolio is owned by the certificate holders.
        - (a) Fund trust, whose portfolio is owned in common by the certificate holders.
        - (b) Unit share trust, where the portfolio consists of identical units.
- III. Classified as to legal forms—
    1. Corporate form of trust, which operates under general state incorporation acts.
    2. Trust indenture form, which appoints a trustee who issues trust certificates for the securities deposited with him.
    3. Massachusetts Trust form, which operates as a common-law trust.
- IV. Classified as to nature of portfolio—
    1. Bonds.
    2. Stocks.
    3. Stocks and bonds.
    4. Limited diversification
        - (a) As to territory.
        - (b) As to industry.

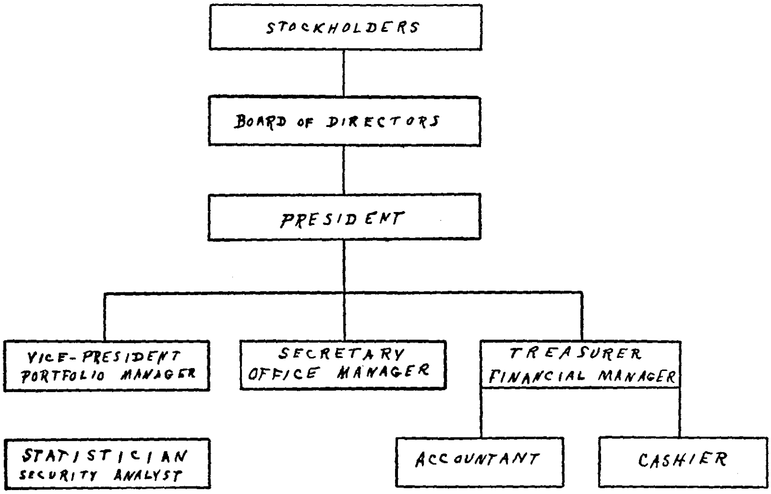
ORGANIZATION

The suitability of a plan of organization depends upon the specific type of investment trust and upon the extent of its operations.

An ideal organization is outlined in a booklet of the International Securities Trust of America, "Five years of growth and progress." This plan of organization would be suitable for an investment trust which is international in scope and is doing an enormous volume of business. On pages 169 and 170 are reproductions of charts outlining the general organization and the detail of the administrative departments.

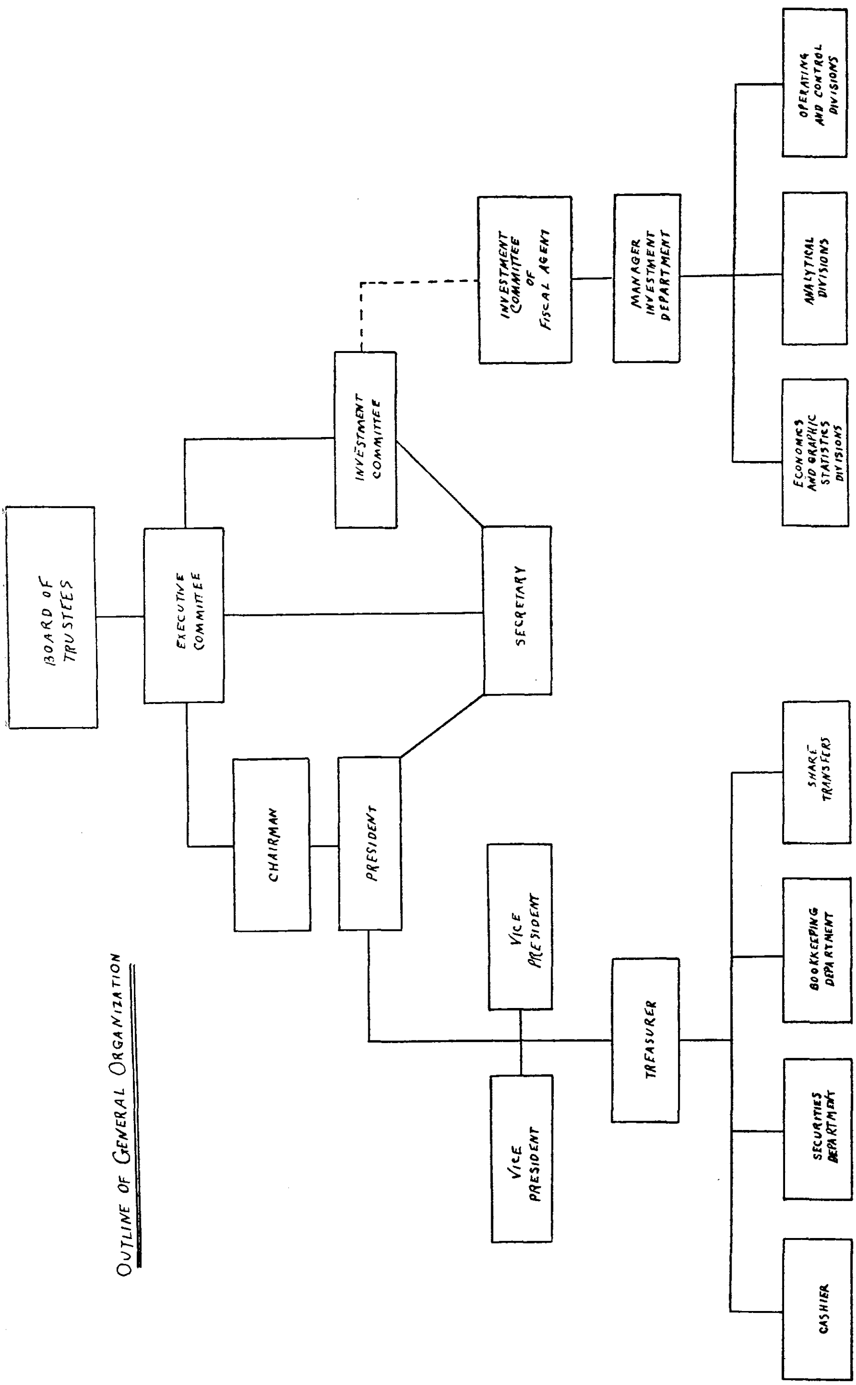
Investment trusts which depend entirely upon outside investment services need not maintain statistical organizations. The organization chart of the International Securities Trust of America provides for a complete organization, but shows that the statistical department is maintained by the fiscal agent.

A simple plan of organization is shown below. As it is possible of infinite expansion it is ideal for a growing organization. It may be adapted to either a small or a large concern.

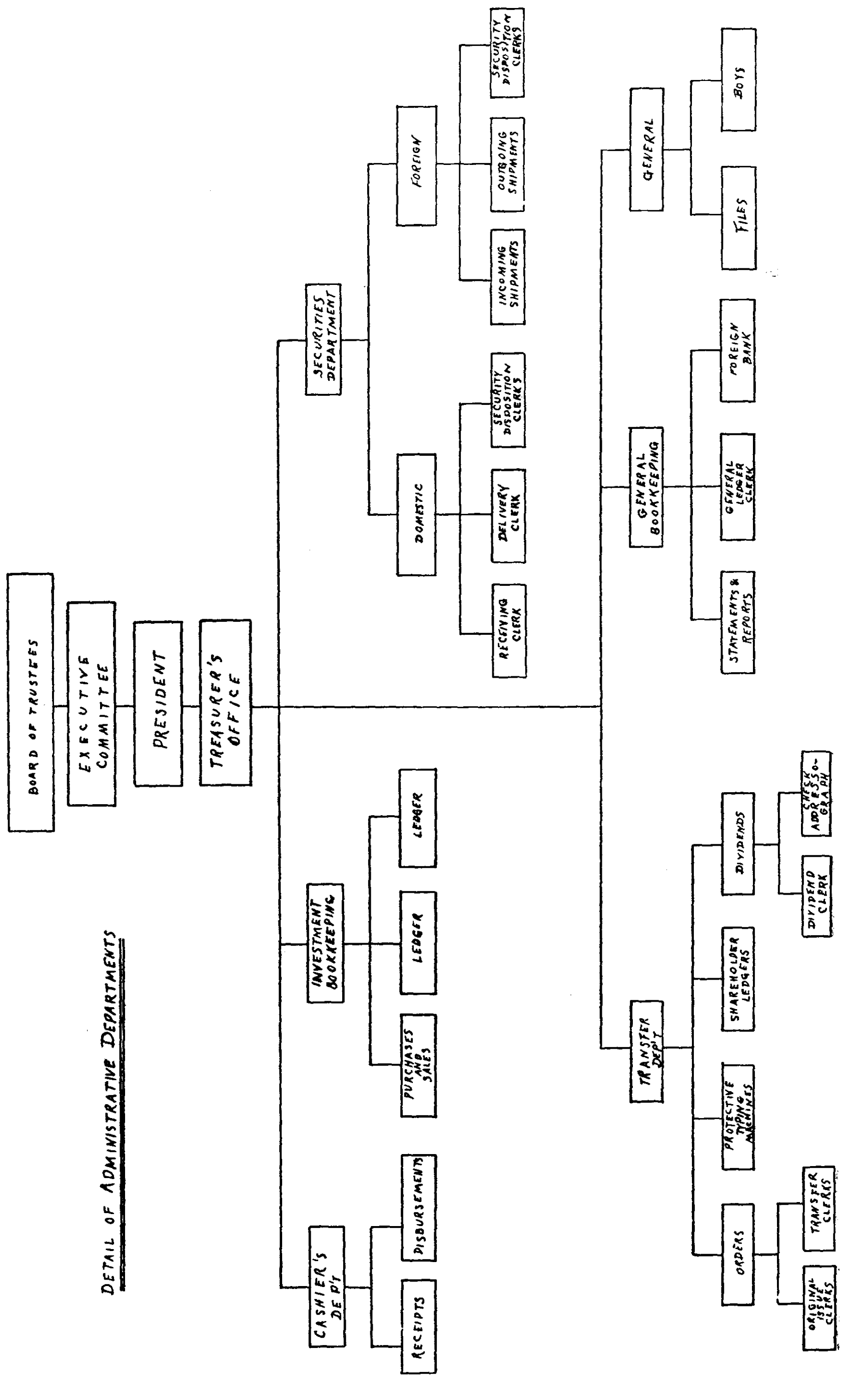


MANAGEMENT

British experience has taught that the secret of successful management lies in the judicious adjustment of the portfolio in accordance with market conditions. Therefore, within certain



OUTLINE OF GENERAL ORGANIZATION


DETAIL OF ADMINISTRATIVE DEPARTMENTS
BOARD OF TRUSTEES
EXECUTIVE COMMITTEE
PRESIDENT
TREASURER'S OFFICE
SECURITIES DEPARTMENT
FOREIGN
INCOMING SHIPMENTS
OUTGOING SHIPMENTS
SECURITY DISPOSITION CLERKS
DOMESTIC
RECEIVING CLERK
DELIVERY CLERK
SECURITY DISPOSITION CLERKS
GENERAL
FILES
BOYS
GENERAL BOOKKEEPING
STATEMENTS & REPORTS
GENERAL LEDGER CLERK
FOREIGN BANK
TRANSFER DEP'T
ORDERS
ORIGINAL ISSUE CLERKS
TRANSFER CLERKS
PROTECTIVE TYPING MACHINES
SHAREHOLDER LEDGERS
DIVIDENDS
DIVIDEND CLERK
CHECK ADDRESSOGRAPH
INVESTMENT BOOKKEEPING
PURCHASES AND SALES
LEDGER
LEDGER
CASHIER'S DEP'T
RECEIPTS
DISBURSEMENTS

limitations, the directors are allowed to manage the portfolio according to their own judgment by buying and selling at such times as they believe such action is advisable for the best interests of the trust. The earlier trusts were so conservatively managed that they were able to pass through periods of depression without passing dividends. They built up large reserves—mainly secret reserves—so that the securities held were able to stand a great amount of market depreciation without resulting in the impairment of capital. Management has been independent of banking and financing institutions so that the directors and managers of the portfolio have not been influenced by interests other than the success of the trust with which they are charged. Accountants and lawyers have usually been chosen to manage the trusts.

We find in the United States a variety of management organizations and management policies. In the trust form of organization the trustees are charged with the management, while in the corporation form the burden of management is placed upon the directors. Bankers, brokers, accountants and financial advisors are usually appointed to manage our investment trusts.

The duties, rights, restrictions and limitations of the managers of the portfolio are usually specifically set forth in the instrument which establishes the trust.

The management of trust funds should accomplish three purposes: (1) safeguard the principal against loss, (2) make income certain and regular, and (3) increase the income or principal or both.

The weakness or the strength of the trust depends upon the management upon whose shoulders falls the burden of properly selecting and changing securities for the portfolio.

RAISING OF CAPITAL

The British investment trusts raise capital by selling ordinary and preferred shares and debentures. There may be several kinds of each of these. At the present time about one third of the capital is raised by the ordinary shares while the remainder is raised by preferred shares and debentures. The increasing cost of money tends to reduce the amount of borrowed capital. The par value of the stock is kept low to attract the small investors. The preferred stock is usually cumulative, non-participating and preferred in other respects over ordinary shares, and pays dividends from 4 to 5½ per cent.

The articles of association always limit the amount of capital to be raised by the issue of debenture stock. Other forms of borrowing are seldom used. The debenture stock has an advantage over collateral trust bonds in that the former permits the issuing company to change its investments—the lien on the investment securities being a floating one.

Increments to capital are generally obtained in flotations in lump sums at stated times.

A few British investments trusts are listed below to show their capital structure. (Taken from *Handbook for Investors*, F. C. Mathieson & Sons, 1928):

Company	Outstanding stock (1928) Deferred or common	Preferred	Debenture
Alliance Investment	$200,000	$600,000	$302,695
American Investment and General	750,000	750,000	750,000
Army and Navy Investment	200,000	360,000	*400,000
Bankers' Investment	900,000	900,000	*900,000
British Investment	900,000	1,350,000	1,633,550
British Steamship Investment	1,800,000	300,000	*200,000
Foreign and Colonial Investment	1,550,000	....	1,250,000
Guardian Investment	500,000	500,000	*500,000
Investment Trust Corporation	1,250,000	1,875,000	2,000,000
Rubber Plantations Investment	2,250,000	....	....
United States Debenture Corporation	525,000	1,050,000	1,207,500

*Perpetual debenture stock.

Two methods of raising capital are in use: making occasional flotations, as is practised by the British trusts, or "feeding" out securities to the public as the demand will assimilate them. The latter method is quite often used in the United States because the investors are just beginning to learn the advantages of investment trusts. After the financial standing of the trust is established and becomes familiar to the public, occasional flotations will be less costly and can be resorted to successfully.

There is little uniformity in the matter of capital structure. This is largely dependent upon the character of the trust. Fixed trusts raise all capital by issuing trust shares, while the management types of trusts issue bonds, preferred stock and common stock, or only common stock.

NATURE OF THE ACCOUNTS OF AN INVESTMENT TRUST

Business transactions. The business transactions of a typical investment trust are few in number compared with those of other financial and investment businesses. The raising of capital is undoubtedly the most important of its transactions, but when this part of its business is turned over to its fiscal agent very little bookkeeping is required—the entire issue of stock is disposed of by one transaction. This now leaves the buying and the selling of investment securities and the collection of dividends on such securities as the main source of bookkeeping records to be kept by the trust. Consequently, cash is received and paid. Securities are bought and sold. About the only other class of transactions which will require the attention of the accountant in the installation of an accounting system is the incurring of expenses—the cost of operations.

Sources of income. The income is derived from five sources:

1. Interest on bonds held.
2. Dividends on stocks held.
3. Profits made in changing investments.
4. Interest on loans and bank balances.
5. Sale of stock dividends and stock rights.

These are the only sources of income of the investment trust when carrying on business only as such. Most of the British and some of the American companies carry on other lines of business in addition to the purely investment business. They may act as fiscal agents for other trusts; they may act as trustees for private estates; or they may even act as promoters for other corporations. In case such other lines of business are carried on by the trust additional sources of income will begin to appear.

Expenses. Cost of management in England in some instances may consist of a lump-sum payment for "directors' fees," or it may consist of a payment of an amount calculated as a per cent. of the capital, or the trust agreement may provide that a percentage be appropriated to defray expenses and that the remaining balance shall accrue to the credit of the directors.

The usual expenses incurred in operations are fees to trust company or directors' or trustees' fees, legal costs, auditors' fees, management expenses (management fee or officers' salaries), rent, stationery and other office expenses, office salaries, commissions and brokerage fees, taxes (income, state franchise, property, transfer), interest on loans and brokerage accounts, cost of exercising rights and miscellaneous expenses.

(*To be continued*)