

11-1925

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### Recommended Citation

Thornton, F. W. (1925) "Investments," *Journal of Accountancy*. Vol. 40 : Iss. 5 , Article 2.

Available at: <https://egrove.olemiss.edu/jofa/vol40/iss5/2>

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## Investments

BY F. W. THORNTON

Some recent writers have pointed out misapprehensions as to the relative position of bonds and stocks as investments. They have done much to clear the public mind, although much remains to be said. It is intended to show here something of the variation among differing classes of common stocks, and for that purpose a short review of the whole situation, covering bonds as well as stocks, seems needed.

Perhaps accountants are about as well fitted as anyone to point out popular gross accounting errors in matters of investment. Should the question be asked: What are the safest forms of long-term investment? the answer would almost surely be: life insurance, good bonds and mortgages, savings bank deposits, good preferred stocks, good common stocks—and about in that order. Accountants are not a little responsible for this general classification of investments. Figures for the last twenty years show that the order should be reversed.

Consider first the position of the bonds. If a person in 1913 had bought a gilt-edged bond, say, U. S. Steel sinking fund 5%, he would have received in interest \$600, which, with return of the capital, would amount to \$1,600. How much better off is a man with \$1,600 in 1925 than he would have been with \$1,000 in 1913? What was the real income available to buy things to eat and wear?

Fortunately, there are available figures to show this. So-called "index figures" showing the cost of all commodities and of the cost of living as compared with 1913 are published by Harvard university, Fisher, Bradstreet, bureau of labor statistics, and others. All concur in a figure for 1925 indicating the costs as compared with 1913 to be about 155 per cent. This means that \$1,550 would buy of general commodities as much as \$1,000 would have bought in 1913. Our bondholder has received in twelve years \$50 of income in excess of that needed to preserve the value in necessaries of his original \$1,000.

Suppose the money had been put in the savings bank at 4% interest. Compounding the interest his present deposit would be almost exactly \$1,600. Again the real return is \$50 in twelve years:

Our investor might well have wrapped his talent in a napkin—bought steel rails, washing soda, window glass, anything—and stored it in his cellar till now; he would be about as well off.

In time of severe stress, such as Europe has been passing through since 1918, the case is worse. An instance cited to me was that of an Hungarian family with an income from industrial bonds—I think it was 5,000 kröner—sufficient to enable them to get enough to eat and wear and to maintain a certain gentility albeit a little shabby. Since the war their coupons are sufficient to buy a small sandwich once a year.

True, they would have lost had their investment been in the stock of the company whose bonds they held; but not nearly so severely, for the stock represented some assets which remain and are not the sport of debased currency nor subject to the steady loss of value that all currencies have suffered in all countries at all times ever since the laborer got one penny, his full union rate of hire for a day's work in the vineyard. Who can point to a case of increased purchasing power of a monetary unit over a period of 100 years? I have sought it in vain.

He who buys a bond or mortgage, life insurance, non-participating preferred stock, or acquires in any way a future right to a specified amount of money is gambling on the chance that a money unit, gold or other, will retain its purchasing power—a losing bet for a thousand years.

But, suppose our investor had put his money into good common stock—to continue the parallel let it be U. S. Steel common, although any good stock would do. First, his immediate return would have increased from \$5 to \$7 a share annually; not enough, truly, to compensate for the increased cost of living, but an increase. Next, his stock is still represented by assets (aside from profits retained in the business) that would be worth as much, measured in the world's goods, as those that represented it in 1913. And, finally, it is probably represented by two additions, one being the undistributed profits and the other the amount represented by the loss in real value of the bonds and preferred stock arising from the fact that they with their interest and dividends are repayable in a less valuable monetary unit.

If a steel furnace costing \$200,000 in 1913 were then bonded for \$100,000, the bondholders would own half of it and the stockholders would own the other half. If it were now replaced, as such furnaces often are, and were constructed no worse and no

better than before its cost would be perhaps \$400,000. Now our bondholder owns one quarter of it, the stockholder three quarters.

It is true that common stocks fluctuate in price much more than bonds, but it is equally true that over any long period the net effect of all the fluctuations of common stocks is a rise in money value more than equal to the rise in the index figure for general commodities.

It is also true that common stocks sometimes become worthless. The remedy is to spread an investment over many stocks. Upon the whole the gain on those that do not fail is more than enough to compensate for loss on those that do, provided that the stocks are chosen with a moderate amount of judgment.

Bonds are not altogether free from losses. Whenever such losses occur in the case of trustees' investments there is no compensating gain on other bonds, such as has been spoken of in the case of common stocks; the principal of the trust is irremediably depleted, even on the dollar basis. At the present time we have some bonds that either are or have been considered gilt-edged, to which attention might be directed—What price Chicago, Milwaukee & St. Paul 4%, Erie 4%, New York Railways 6%, Chicago & Northwestern 3½%?

A danger to which investors in common stocks are subject is the temptation to sell when a profit appears, in short, to speculate. It is pretty well resisted by the owners of large fortunes. Every accountant knows that the really wealthy choose their common stocks carefully and keep them long; that they are not affected by the daily fluctuations in price but hold their stocks with a view to development over many years. That is the difference between investment and speculation.

Looking broadly at the investment situation as it affects trustees, the prescribed investments under the laws governing trusts are such as to insure with all but absolute certainty the eventual realization by the beneficiary of a sum not greater in dollars and less in purchasing power than the sum originally deposited in the trust.

Let it be admitted that the instances cited are extreme—they are. War conditions have hurried forward the rising tide of prices, and for a few years we may look for a period of relatively slow loss of purchasing power of monetary units. None the less these instances, while exaggerated, are highly characteristic of the whole financial history.

Not everyone is fooled. Our financiers know better than to bury their money in bonds. They know that falling money values favor the debtors of the nation and so they become the debtors. At the same time the professional friends of the poor, from Jack Cade to Bryan, with the childlike idea that the poor are the debtor class, have urged the cheapening of the currency. The relatively poor put their money in savings banks, which in turn buy bonds issued by corporations; small investors buy bonds themselves; they buy life insurance, their premiums being invested in bonds; and they do not borrow, partly because nobody will lend them anything. So, when the value of the dollar decreases, as it always does, they lose, and those who borrow their savings win.

To induce the small investor to buy bonds, graphs are made up to show the relative steadiness of the prices of bonds as compared with stocks, and the return on bonds if held to maturity is given with great accuracy, always on the assumption that a dollar is a dollar and forever worth the same. The decrease of dollar value which has averaged five per cent a year for twelve years is not thought worth mentioning.

We also have professors, with their Sprague's tables and logarithmic formulæ, who tell us to the hundredth of one per cent what return a fifty-year bond bought at 101 15/16 will give us; and what part of the interest must be set aside on a basis of scientific amortization to maintain the principal unimpaired. Will they tell us what that principal will buy when the bonds mature? If one were measuring the cubic content of the pyramids these professors would come running up with half a brick saying, "See, you have left this out," with eyes unseeing that the rule had shrunk by half and was shrinking.

They have measured the national wealth and income with their lessening measure and after a time measured it again; and they cry: "How great the growth, how rich we are," and government, willingly enough, taxes the increase.

Life insurance has been referred to, but it is only as an investment that the remarks have been intended to apply. There are those who have taken upon themselves such responsibilities that it is imperative on them to make provision against possible early death. For them the premiums they pay have two components: one a portion paid for protection, the other a portion paid as an investment. For the company there is but one component; the

number of their policy-holders is so great as to establish a statistical average upon which they can rely. A man is 61; so far as the company is concerned it may say with certainty that for their purposes he has  $13\frac{1}{2}$  years to live; so that for an insurance of \$1,000 he must pay annually a sum that will amount in  $13\frac{1}{2}$  years, at some previously fixed rate of interest, to \$1,000. Examination of life-insurance rates with an annuity table will show the rate of interest allowed. It is always less than bonds would pay, as indeed it must be since the premiums are invested largely in bonds and out of the interest must be taken commissions, operating expenses, profits and those monumental buildings that adorn our cities.

As a protection, then, life insurance is a necessity to some; they pay for it. As an investment it is an absurdity, largely so because life-insurance companies must invest their funds in precisely those securities that are the poorest investment for others. The excuse is, of course, a mythical safety attached, in the minds of our lawmakers, to evidences of indebtedness as compared with the part ownership of material things.

The matter is perhaps now more clear. If we buy bonds we invest in futures of a commodity—money—that has been falling in purchasing power since the memory of man runneth not back to the contrary. If we buy common stocks we invest in actual existing things that may be expected to rise in price—not in real value—just as fast as the cost of living rises, with further gain, if the stocks are preceded by preferred stock and bonds, of the amount lost by them in the rise of prices.

Which is the conservative investment? Is it conservatism to assume that some loss is necessary and choose the least of the losses, while another course is open without loss but with gain?

Altogether one is reminded of Teufelsdröckh:

“Toward anything like a Statistics of Imposture, indeed, little as yet has been done; with a strange indifference our Economists, nigh buried under Tables for minor Branches of Industry, have altogether overlooked the grand all-overtopping Hypocrisy branch; as if our whole arts of Puffery, of Quackery, Priestcraft, Kingcraft, and the innumerable other crafts and mysteries of that genus had not ranked in Productive Industry at all.”

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So far common stocks have been spoken of as a class. There are, however, different classes of common stocks in which form of organization, legal and commission controls and character of assets bring about in a period of rising prices results departing widely from the general average.

There is, first, a class including railways, gas and water companies, and some other public utilities for which a limited or specific return is prescribed. This return may be computed as a fixed percentage on cost, on present replacement value, or on "actual investment." If the percentage or other limit of income prescribed is to be applied to the first cost of the properties, and if in the future no increase is to be allowed, the common stocks have the same losses as bonds when prices rise.

If present value is used as a basis, then for those who originally invested in the stock a proper allowance is made for any depreciation of the dollar in the past but with no hope for the future. If future rates are to be based upon values to be fixed from time to time the stock is in the class of investments protected against fluctuation in value of the money unit.

It might be said that public utilities have earned profits far in excess of those necessary to pay a reasonable return and to keep pace with the falling value of money. Some have done so; some have barely paid expenses; some have gone to the wall. The policy of governments, federal, state or municipal, has fluctuated in the past between wide extremes. The tendency today is towards a more stabilized condition in which public authority recognizes that it is not wise, even if it is practicable, by restriction to limit profits of utilities to inadequate returns; and the utilities are recognizing that reasonableness on their part will produce more satisfactory results than will excessive exactions from the public. Exceptions are to be found—the transportation situation in the city of New York being a striking one—but these are relatively infrequent and usually attributable to some special influence or condition. Variations from average conditions are found when the assets of a company are either predominantly capital or predominantly current. Where prices rise the benefit of the apparent increase in value of fixed assets does not at once appear. They remain on the books at original cost for many years, and in the current profits appear only those gains arising from current operations, plus an additional gain due to the use of plant obtained at a lower price than would have to be paid for replacement—the depreciation provision, for instance, being less. On realization of the whole business the increased price of fixed assets partly compensates for the decreased value of money, but not wholly, because some part of the apparent gain has appeared in current earnings. Indeed, over a period sufficiently long,

earnings would absorb almost all the gain in money value of fixed assets, since these must be replaced at current costs from time to time. Few, indeed, of our enterprises have such a long history as to produce such a condition.

Where the assets are principally current assets, however, there is little accumulation of increased price to compensate for decreased purchasing power of money. The current earnings are inflated by the constant absorption of the price changes. For example, a corporation had a capital in 1900 of \$200,000; it has been engaged in wholesale high-grade dress material merchandising; all its "profits" have been paid out in dividends. At this time its capital enables it to own a little less than half as much merchandise as it could own in 1900. The other half has been distributed as profits. All merchant companies, film companies, amusement enterprises, proprietary-medicine manufacturers, and other companies with little fixed plant pay out as dividends, or at least show as profits, part of the purchasing power of the original capital, and in that respect their common stocks approach the status of bonds.

Companies of this kind should show current earnings on a scale materially higher than those of enterprises with large fixed assets, and the stockholder should, in his own mind, classify part of the dividend and accumulated surplus, if any, as representing depreciation of the money unit, rather than an increase in the real wealth of the businesses.

There are companies with much capital in fixed assets, with no capital liability but common stock, and no bonds. These companies approach nearest to the condition where apparent earnings are true earnings, and the loss of purchasing power of money is compensated by the increasing price of the fixed assets. If such fixed assets exactly equalled the common stock, the adjustment would, at first, be perfect; but as the fixed assets were replaced or their depreciation provided for on the basis of book value, not current replacement costs, the equilibrium would be gradually disturbed and there would be some inflation of current income with a loss of real value of fixed investment.

Finally there are companies with large fixed assets, bonded debt, preferred stock and common stock. As all the increment of price arising from the falling dollar value goes to the common stock these companies should in theory accumulate for that stock not only the increment of price in respect of the



fixed assets it represents, but also the increment in respect of such assets purchased with proceeds of bonds and preferred stock.

How large may be the practical advantage depends on the competitive situation. In a trade which is close to the saturation point and in which most of the competing plants were constructed before the decline of the money unit, little practical gain can be expected. The steel industry today, for instance, has no expectation of earning a fair return on the replacement cost of the property employed in it.

On the other hand, public utilities that before the decline of the money unit were enabled by law to earn a fair return on the present replacement value of their property might reap a large proportion of the theoretical gain. So too (assuming equal efficiency) would an older plant competing for business with plants newly constructed.

Perhaps the most interesting thing that appears on a comparison of these classes of stock is that in no case can current earnings fail to include some fictitious gain when prices rise. Such gain is greatest when the assets are principally current assets, liquidated within a year, and lowest where the assets are principally fixed, in fact almost disappearing in such cases to reappear on final realization of the fixed assets.

The factor of increased money prices as a compensation for decreased purchasing power of money units would seem to apply in theory to the several classes of investments about as shown below, the greatest compensation to the first named:

<i>Security</i>	<i>Conditions</i>	
Common stock	Much fixed assets, bonded debt, preferred stock	
Common stock	Ditto	none          none
Common stock	Little fixed assets	
Common stock	Income limited by regulation, based on cost or a fixed valuation of assets	
Preferred stock	Participating	} None of these has any compensation for falling dollar value
Ditto	Non-participating	
Bonds		
Mortgages		
Savings banks		
Life insurance		

It may be an excess of caution to point out that the considerations herein advanced do not form and are not intended to form a complete basis for an investment policy. It is believed, however, that they are entitled to greater weight than has been commonly accorded them in the past.