percent higher than the amount outstanding in 1929; and we found that the amount outstanding at the end of 1939 was only 4.5 percent higher than the amount outstanding at the end of 1929—10 years earlier. Thus, the net effect of the 186 changes recorded by Mr. Bunker was not very substantial, averaging an annual increase of about one-half of 1 percent.

So much for the actual importance of these 186 changes and 16,740 transactions. In terms of total trading, our index would require very much less turn-over than is typical of management investment companies. Still, we are forced to admit that this increase, small as it is, does require adding funds to the original portfolio if the fund is to be maintained without effecting transactions in all 90 stocks. Mr. Bunker told you that there were no idle funds and that the company would be forced to liquidate a small fraction of each stock in order to make these adjustments. This is true, he said, because "dividends paid do not enter the construction of the index." Now, Mr. Bunker says in another place that he has "examined with care these studies of performance." Despite this, he did not notice that we did include in our performance figures the dividends paid by investment companies and the dividends paid by the 90 stocks making up the Standard Statistics index. Thus, we do have a fund available for making the relatively small adjustments required by these capital changes, while avoiding the transactions totaled by Mr. Bunker. The dividends accruing to this fund averaged 4 percent or more annually. Now, 4 percent is at least equal to one-half of 1 percent, on the average at least, and therefore reinvested dividends would be ample to take care of all capital changes. Thus, we are spared the 16,740 transactions of Mr. Bunker, and a fund can actually be invested in the index.

However, we can settle this controversy in a very simple fashion, if the foregoing facts do not sufficiently dispose of Mr. Bunker's contentions. If we are correct in our belief that the capital changes during this period were entirely unimportant to the actual performance of the index, that the "management" of the index over the period was completely negligible, then it should be true that the performance of a fixed fund would be practically identical with the performance of the index. Mr. Bunker told this committee that we probably had this erroneous idea in mind. We did have; and we tested it. We invested a fund in these 90 stocks in proportion to the market value of each of the 90 stocks on December 31, 1929. In order that there could be no claim that retroactive judgment was exercised in the substitution of securities, we eliminated four stocks which were replaced by other stocks some time during this period. We were left with a portfolio of 86 common stocks as of the end of 1929. At the end of 1935 we evaluated exactly this portfolio, and obtained the performance record of a fixed fund, without a single change of any kind during a 6-year period. We even ignored the few instances of valuable rights, with the result that the performance of this fund must necessarily be worse than the true performance of the actual unmanaged fund. Even so, the value of this portfolio at the end of 1935 was 62.8 percent of the 1929 value, whereas the 90 stock index which was used in our study and which was attacked by Mr. Bunker as being impossible to achieve, wound up the same period with a figure of 62.5 percent, nearly 1 percent less than the completely unmanaged fund.

This same unmanaged fund at the end of 1939, a 10-year period without management of any kind and without obtaining the benefit of valuable rights, stood at 58.3 percent, as compared to the value of 59.2 percent recorded by our 90 stock index. The difference of less than 1 point in favor of the actual index is certainly little more than the value of the rights which were ignored in our comparison. Therefore, we are perfectly willing to substitute this index over the 10-year period for the 90 stock index; and it goes without saying that any conclusion which we drew from the 90 stock index may with equal propriety be drawn from this fund, which even Mr. Bunker must admit is completely unmanaged.

Time did not permit us to extend this study over the whole of the 1927–39 period. We did, however, analyze the fate of a fixed fund invested in the Standard Statistics 90 stocks over the 1927–29 period, during which relatively large capital changes took place. The performance of this fixed fund was 155.7 percent as compared to the figure of 159 percent which we used in our study. Thus, the difference is but 2 percent, hardly enough to invalidate the S. E. C.'s study of performance, in view of the fact that we ignored valuable rights in constructing the completely unmanaged fund.

So much for Mr. Bunker's second point—that it would be impossible to achieve the Standard Statistics results without incurring heavy expenses. The studies just presented should suggest that there is little merit in this line of attack. So we come to Mr. Bunker's third criticism of the index—that there are only two ways of approximating the performance of the index, both of which result in far greater losses than we showed over this period.

Now, how could Mr. Bunker obtain these losses, in view of the fact that we have just shown that capital changes were of no real importance, and that you could do just as well as the index by ignoring all capital changes?

The point is highly technical. If you look at Mr. Bunker's table I, you will note that he gives performance figures for the 3 industrial components of the 90-stock index—one figure for the 50 industrial stocks, 1 for the 20 utility stocks, and 1 for the 20 railroad stocks—all included in the index. These values are averaged in a certain way to obtain the figure Standard Statistics gives for the 90-stock average. In combining these 3 groups, the industrial stocks are from 4 to 5 times as important in the final result as either the rail or the utility stocks. This is because they are weighted on the basis of the number of shares outstanding in the 3 industries, and there are many more shares outstanding for industrial concerns than there are for railroads or utilities. By combining these 3 indexes in the proportions given by the Standard Statistics Co., you can obtain the values given by Mr. Bunker for the 90-stock index which we utilized.

We tried to derive Mr. Bunker's 90 stock values from the 3 indexes he himself presented to the committee. We were unable to do so. Then we put a mathematician on the job and told him to find out for us the basis which Mr. Bunker must have used to obtain figures so contrary to our study. His answer is very interesting.

Apparently, Mr. Bunker did not follow the correct procedure in making the approximations to the index which were presented to this committee. He apparently decided to make the railroad and utility stocks nearly as important in his fund as the industrial stocks.

Now, it just happens that utility and railroad stocks fared very poorly over this particular period, as compared to the industrial stocks, as can be seen from the figures presented by Mr. Bunker. Any index which exaggerates the influence of railroad and utility stocks will tend to do poorly as compared to the Standard Statistics index, and this apparently is the reason why Mr. Bunker's approximations show such very poor results from the attempt to invest a fund in the 90 stocks.

Actually, if you treat Mr. Bunker's indexes for the three different groups in the same manner as Standard Statistics Co. treats their indexes, and as we treated our index, you will find that the index we used lost more money than either of Mr. Bunker's indexes, over the period from 1929 to 1935, to 1937, or 1939—exactly opposite from Mr. Bunker's contention! Thus, there can be no question that we were being very fair when we used the Standard Statistics index and avoided all the trouble which Mr. Bunker must have experienced in constructing these indexes which actually did better than either our index or investment companies.

So much for the attack upon our way of doing things, as found in Mr. Bunker's statement. In addition to criticism of our study, Mr. Bunker presented to the committee certain constructive comparisons which, he felt, "view this entire business in some realistic setting." In the first place, it seemed to Mr. Bunker "to be particularly fitting to make a study of all issues other than investment companies which were offered and sold in the year 1929 and trace through their behavior in comparison with the behavior of the portfolios of investment companies."

Presumably, this study avoids the incomparabilities and distortions which are alleged to be found in the S. E. C.'s approach, and constitutes a thoroughly fair comparison. We agree with Mr. Bunker that the results of this study are extremely interesting. We also feel that the method employed in making this study is extremely interesting. What was done?

He included the selling load in the loss for noninvestment companies but omitted this loss in calculating investment company performance; he measured the loss in investment companies, not from all companies, but from the experience of 49 hand-picked companies which performed far better than the general run of investment companies; and he used market values in figuring the noninvestment company loss in 1935, and asset values for investment companies. The biggest bias was in using the 49 company figures; but when I tell you that the common stock of the Lehman Corporation, admittedly one of the companies with the best performance record, was selling at a discount from asset value of about 31 percent at the end of 1939, you can see how much difference it would make to Mr. Bunker's comparison if he used market values instead of asset values for investment companies.

In view of these incomparabilities and distortions, we feel that no significance can be attached to Mr. Bunker's results. Instead, we propose to submit a comparison which we deem to be correct, now that Mr. Bunker has pointed out the usefulness and validity of comparing all investment companies organized in 1929 with all other issues brought out in 1929.

In contrast to Mr. Bunker's figures, which show that the investment companies lost a mere 44 percent over this 6-year period while all common stocks of other types of companies brought out in 1929 lost 67 percent of their original cost to investors, we can inform this committee that the investors in the investment companies organized in 1929 had lost 64.3 percent of the fund they invested by the end of 1935, without taking into account the factor of discount from asset value. If we adjust for the discount from asset value, then this loss would exceed 67 percent, leading to the conclusion that investment companies organized in 1929 were certainly no better and quite possibly were worse than all other common stocks issued in that year.

The second comparison made by Mr. Bunker was to a list of 50 stocks recommended on September 30, 1939, by one of the best-known investment rating services, whose recommendations he regarded as representative of sound and experienced judgment at that time. Mr. Bunker informed this committee that the fund invested in the 50 stocks recommended by this agency suffered a loss of more than 50 percent between the end of 1929 and the end of 1935, while the average of investment trust portfolio valuations at the end of 1935 was 69 percent. He went on to tell this committee that investment company portfolios preserved 44 percent more of their assets than if they had been composed entirely of these recommended and leading stocks.

I believe that the evidence which I have presented to this committee indicates that this comparison may be prejudiced somewhat in favor of investment companies. You will note that Mr. Bunker again uses the performance of 49 leading closed-end companies as representative of all investment companies. If all such companies were included, the loss would certainly have been greater than 50 percent. Furthermore, an examination of the list of 50 stocks used in this comparison gives us a very good clue as to the source of the relatively large loss experienced by this list of securities. Included within the 50 were 5 bank stocks, 12 utility stocks, and 15 railroad stocks; that is, nearly two-thirds of the issues belong to industries which performed very poorly over this particular period. Railroad stocks, for example, constitute 30 percent of the number of issues, an importance never approached in the portfolio of investment companies.

Now, if you wanted to select in 1939 a list of stocks which would perform very poorly between 1929 and 1935, it is quite clear that you would avoid as much as possible industrial stocks and would pick a list of stocks which would include a high proportion of railroad, utility, and bank stocks. It would be virtually impossible to pick a diversified list of these stocks which would perform as well as the better investment companies, which invest from two-thirds to three-fourths of their fund in industrial securities. We feel that these particular figures prepared by Mr. Bunker do not throw much light upon the performance of investment companies since, on the one hand, the figure used by Mr. Bunker does not truly reflect investment company experience and, on the other hand, there is considerable doubt as to the unprejudiced nature of the list of 50 stocks he used. We are convinced that the comparison to the Standard Statistics 90 stock index is completely fair and realistic and that there are adequate grounds for preferring its use to either of the comparisons prepared by Mr. Bunker.

So far we have devoted this discussion to the points presented to you by Mr. Bunker. Now, there were quite a few points about our study which Mr. Bunker did not mention; and I should like to call to this committee's attention a few of the more positive, constructive results obtained from this study.

Among the companies included in our study, the best record was an appreciation of 323 percent, experienced by an open-end company, which was included for the entire period from 1927 to 1937. The next best company, with an appreciation of about 184 percent, was included only for the 1933-37 period—a relatively short time. Two other companies had an appreciation of almost 100 percent, one of which was formed in 1927 and the other in 1933. At the other extreme, we find 7 of the 38 closed-end companies experiencing net depreciation of 40 percent or more, by the end of 1937.

Of the 38 closed-end companies we analyzed through 1937, 25 showed a net loss up to 1937, while only 13 showed a gain over the period of their life. As would be expected, the record of the younger open-end companies is better, only 10 showing depreciation through 1937 and 25 showing gains.

The fact that approximately half of the companies had intact their investible fund at the end of 1937 is not as favorable a picture as might at first sight appear. Contributing to this result are all the distributions—interest and dividends—received by the security holders of these companies. This means that the performance record of no net loss over the period reflects portfolio losses about equal in amount to the return actually paid to investors. If we set as a standard an annual return of 4 percent for the period of the company's existence, we find that only one of the 38 closed-end companies performed sufficiently well to retain its capital without loss and yield a 4 percent return to its security holders, while 15 of the 35 open-end companies did sufficiently well to yield 4 percent or more. Fifty-seven of the seventy-three companies included in the study were unable to return as much as 4 percent per annum to investors through 1937.

The evidence indicates that investment companies are unable to make money on their investments year after year. In years of rising common stock prices, they do make money; but in years of declining stock prices, they lose about as much as they make in good years. Over the period we studied, the management investment companies whose performance we included just about broke even on their investments, when the return on these investments is taken into account. Furthermore, we found that individual managements were quite unable to maintain a consistently good record over several years.

Since actual performance depends so much upon the major swings in security prices, the mere statement that investment companies made or lost money over a particular period does not throw much light upon the "expertness" or skill of the management of these companies. The great majority of these companies was organized to invest in common stocks, and the investors who purchased these securities were generally aware that their money was going into common stocks; and thus we may assume that most of them realized that they were exposing themselves to the risk of capital appreciation or loss. If these investors were interested as much or more in capital gains as in steady income, the actual record must be evaluated with this in mind.

One such comparison is obtained through the use of an index of leading common stocks. Mr. Bunker dissenting, the performance of such an index reflects an unmanaged fund, invested in a diversified list of widely held common stocks of the sort which actually bulk large in the portfolios of the investment companies in question. The changes in the stocks making up the index occur but infrequently, and new stocks are selected not for their investment appeal, but simply upon their status as leading stocks. There are one or two things about this index which Mr. Bunker did not discuss.

In the first place, the index always remains 100 percent invested in common stocks, whereas the investment company is free to keep its fund in cash, in bonds, preferred stocks—any way it pleases. Thus, the investment company can perform better than such an index, that is, exhibit its expertness, by shifting its funds into common stocks, when they are a good investment, and getting out of common stocks prior to a major decline in stock prices. A trust that remained 50 percent in cash throughout the post-1929 depression would, of course, perform much better than the index, unless the remaining investments were extremely bad.

In the second place, "expert" management implies the selection of better performing stocks for the portfolio than the investor would be likely to select. In contrast to the index, which contains but 90 stocks, the combined portfolios of these investment companies contained between 1,000 and 2,000 different common stocks. Presumably, management decided upon the selection of this great variety of stocks because these were, in their judgment, better investments. If they were not better investments than a handful of most widely held stocks, it is indicated that the judgment of management is no judgment at all, or that the many abuses of unregulated management more than offset their native good judgment. In either event, it seems reasonable to say that no management can claim to be "expert" or deserving of much compensation if its performance is much worse than the performance of an unmanaged index. We may allow a percent or so in favor of management, since the index is not charged with management's expenses, and still justify the comparison.

Analysis of the annual record shows that investment companies managed to lose less money in bad years than the index lost, but failed to make as much as the index stocks in good years. Specifically, the companies performed better than the index in 1929, 1930, 1931, 1932, 1934, and 1937, all years of declining prices; and they performed worse than the index in 1927, 1928, 1933, 1935, 1936, and 1938—years of rising prices. Over the 1930–35 period, closed-end companies performed exactly the same as the index, and 12 open-end companies performed slightly better than the index. These figures relate only to our hand-picked group of companies, and not to all companies. Over the 1927–37 period, 33 companies out of 85 managed to perform better than the index over their period of existence, and 52 companies, or 61 percent, performed worse than the index.

The general conclusion is that these management companies are unable consistently to "beat the averages." The fact that they do better in years of declining prices and worse in years of rising prices suggests that the decision to make investments other than common stocks is an important factor making their performance as good as it is. In the post-1929 depression, for example, a number of companies had only 50 or 60 percent of their fund in common stocks, and consequently performed much better than the index.

If we compare investment-company performance to the performance of a combined index of common stocks, preferred stocks, bonds, and cash, represented by indexes, and blended in the proportions characteristic of the actual portfolios of these companies each year, we can eliminate this aspect of the investment policy and find out whether skill was exercised in the selection of individual securities. If management does no better than such a combined index, it means that there is either no extraordinary skill in the selection of investments or that the money gained through clever investments is somehow dissipated.

We found that performance of this combined index over the 1930–35 period was some 30 percent better than the performance of the investment companies we treated. While actual figures are not available for the period subsequent to 1935, it is quite certain that the average company performed considerably worse than the securities in these indexes over the 1927–39 period.

Given these facts, we were led at the time of making our study, to the following conclusion: "Using the 90 common-stock index as a basis of comparison, the management of the typical investment company made no substantial performance contributions in the typical year to the investors in these companies." We see no reason to change this conclusion.

Thank you.

Senator WAGNER (chairman of the subcommittee). Thank you very much.

We adjourn now until tomorrow morning because the full committee has a very important meeting this afternoon, which will probably take a good part of the afternoon.

Will you gentlemen be prepared tomorrow morning at 10:30?

Mr. SCHENKER. Thank you, Senator.

(Thereupon, at 1:15 p. m., an adjournment was taken until tomorrow, Thursday, April 25, 1940, at 10:30 a. m.)

INVESTMENT TRUSTS AND INVESTMENT COMPANIES

THURSDAY, APRIL 25, 1940

United States Senate,
Subcommittee on Securities and Exchange,
of the Banking and Currency Committee,
Washington, D. C.

The subcommittee met, pursuant to adjournment on yesterday, at 10:30 a. m., in room 301, Senate Office Building, Senator Robert F. Wagner presiding.

Present: Senators Wagner (chairman of the subcommittee), Herring, Townsend, and Frazier.

Senator Wagner. The subcommittee will come to order. Mr. Bane.

ADDITIONAL STATEMENT OF BALDWIN B. BANE, DIRECTOR OF THE REGISTRATION DIVISION, SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, D. C.

Mr. Bane. Mr. Chairman and Senator Frazier: First, I would like to make two or three corrections in the testimony I gave the last time I appeared before you. I did not have an opportunity to go over it carefully enough before it had to be returned for printing. There are two or three errors in it.

First, on page 137, next to the last paragraph on that page, the transcript reads:

> This one man who had a share at $55 now finds two shares in at $55.

The first $55 there should be $59.

On page 140, about midway of the page, I said, or the transcript shows that I said:

> Now, granted, which we do—

Mr. Chairman, you will see it in the paragraph beginning "On September 11, 1939."

Senator Wagner. Yes. You may go ahead.

Mr. Bane. Now, the very next sentence, about the middle of the page:

> Now, granted, which we do, that September 5 was an unusual day, no one can contend that the market fluctuations on September 11 and September 19 were in any way abnormal. As a matter of fact, over the past 9 years the Dow-Jones industrial averages change more once each 3 weeks than the changes in the market of September 11 and September 19.

I was in error, or at least I think that gives an erroneous impression. First, it whould be 6 years instead of 9 years; and, secondly, that should read:

> Once each 3 weeks on the average.