Speeches & Appearances
Pres. Funston

Institutional Investors

HOW IS THEIR GROWTH AFFECTING THE STOCK MARKET?

Remarks by G. Keith Funston

President, New York Stock Exchange, before the 50th ANNUAL MEETING,
AMERICAN LIFE CONVENTION, Chicago, Illinois, October 14, 1955

BETWEEN 9 o'clock this morning and 5 o'clock this afternoon the great and small financial institutions of this country can be expected to purchase an additional 6 million dollars in the ownership of American business. They invested approximately this much additional money yesterday, and, on the average, they can be expected to do so again on Monday, and on every business day of the year.

I would like to speak with you about this astonishing figure—and what it implies for the country, the stock market and the institutions themselves. In the space of a relatively few years institutional investors have emerged as one of the most powerful influences in our economy. They are likely to play an even larger role in the future, and perhaps a decisive one in shaping future U. S. economic patterns.

I have been asked recently if institutions are not in fact, becoming the most important single element in the stock market. I don't believe for a moment institutions can, ever will, or indeed should assume such an extensive role. The stock market is, after all, a living instrument that exists to serve the public, industry, and members of the securities business as well as institutions. And the question of relative market importance is something like the question asked of Andrew Carnegie as to whether he considered labor, capital or brains the most important factor in industry. Mr. Carnegie rendered the problem academic by replying, "Which is the most important leg of a three-legged stool?"

With considerable safety I can reply in the same vein. Certainly the market needs and must serve equally well its many types of investors. It is clear, though, from the Fulbright hearings earlier this year and from growing notices in the press, that people want to know a good deal more about institutional investors. And I am delighted at this opportunity to present some of the Exchange's views on this subject.

Funds Pouring Into Institutions as Balance of Economic Power Shifted . . . A Look at the Last Decade

All of us here have, I believe, an enormous responsibility, of which we are well aware, for influencing the country's economic well-being. In the particular case of institutional managers, however, this responsibility is somewhat unique – and it is one I well appreciate in view of my own present association with the Metropolitan Life Insurance Company and former connection with the Connecticut General Life Insurance Company. You are, first of all, trustees of other peoples' money – in this case the funds of millions of middle-income and working people who have come to hold the real balance of economic power in the U. S. And second, as savings have been institutionalized, your rapid growth has given you an incredible though perhaps unanticipated and even unwelcome amount of economic authority and muscle. Institutions today represent millions of people from every walk of life and every economic strata who, by virtue of institutional stock investments, have become indirect owners of American business.

Implicit in the rise of financial institutions is the fact that a prosperous people are not only enjoying the best possible life today, but concurrently they are also planning for the good life tomorrow. They have discovered that in our arsenal of investment techniques the average man can put *today's* dollar to work whether his goal *tomorrow* is safety, income, or long-term appreciation. And they have, as a result, been pouring an impressive quantity of dollars into insurance companies, pension funds, savings banks, investment companies and other institutions, as well as into direct stock ownership. This literal flood of dollars has brought our institutions face to face with an old problem that has a new urgency and intensity: how are these funds to be put to work, productively and with reasonable safety, day after day, without let-up? The money should not be allowed to lie idle. It must be invested – whether in real estate, government securities, corporate bonds, or common or preferred stock. As a result of this pressure to find investment outlets, institutions have purchased common stocks heavily in recent years and thereby the American people, by the tens of millions, have become indirect owners of American business.

New NYSE Study Shows Position of Institutions Today

The sharp growth of our institutions in the last decade, as this growth affects the securities markets, can best be seen in a New York Stock Exchange study, now nearing completion. This new study brings up to date — as of the beginning of this year — our knowledge of institutional investors. I would like to report some of the preliminary results to you and then mention what is perhaps more important: the insight the study provides as to what the future holds.

Ten years ago, the assets of our financial institutions — life, fire and casualty insurance companies, pension funds, charitable and educational groups, savings banks, and investment companies amounted to $85 billion. Now, these assets amount to $175 billion, and they are growing at the rate of $10 billion a year.

Ten years ago, institutions held approximately $11 billion in common and preferred stock. As of early this year, their equity holdings were worth $32 billion. Institutional holdings represent about 12% of the total marketable shares of American business. These figures, and others I shall refer to, do not include personal trusts administered by banks, which at the end of 1954 held stocks worth $37 billion.

When we look behind institutional holdings, we find that about 75% of their common and preferred stocks represent shares listed on our Exchange, and, in fact, amount to some 14% of the value of all our shares.

Since rising markets have been responsible for much of the increased value of institutional holdings, I would like to burden you with just one more set of statistics. It is, by all odds, the most dramatic set of figures that can be shed on the dimensions of institutional activity.

Ten years ago, institutions were making annual net purchases of stocks at a rate of about $250 million a year. Now, these net purchases are running at an annual rate of $1.5 billion or six times as much.

It is difficult for most people to grasp what this last figure means to our economy and to the men like yourselves who are charged with making daily investment decisions. We have become so used to talking in millions and billions that the figures themselves have an air of unreality about them. But in this case, we are talking about dollars — single dollars, if you will, invested by millions of people. And as these dollars are funneled into our institutions day after day, and as you translate them into shareownership, they swell to a total big enough to stagger anyone but an astronomer. The number is so great we have broken it down to arrive at the figure I mentioned at the start of my talk: *during the average business day,* and on the basis of 1954 figures, U. S. institutions make net purchases of common and preferred stock of about \$6 million. I am intrigued by the thought that this is equivalent to \$750,000 *every working hour.* During our 3-hour meeting this morning, institutions across the country have wrestled with problems involving the collective purchase of an additional \$2.2 million in equities of the country's industrial enterprises. And these figures concern only *net* purchases. In addition to investing new money, institutions are constantly readjusting their portfolios as conditions warrant, switching in and out of common and preferred stocks. There may, of course, be many days when institutions will be sellers of equities on balance.

In Upward Economy, Value of Institutional Stockholdings Will Almost Double in Next 10 Years

Measured against such present activity, what does the future hold?

When we study the next decade, of course, our projections assume that there will be an increase in population, production, the number of shares and shareholders. But, in order to develop our estimates conservatively, we have not assumed any change in stock prices beyond the levels of 1954. We learned long ago that there is no profit to a Stock Exchange president attempting to be a prophet as to the future course of the market. We recognize, of course, that historically stock values do appreciate as the economy expands. Since 1929, according to Department of Commerce figures, the real growth of the economy has averaged 3% a year.

Let's, however, assume constant stock prices at the 1954 year-end level and look for a moment at just two types of institutional investors. We estimate that by 1965, pension funds, which have exhibited the most dynamic recent growth, will own about \$17 billion in equities compared to \$3.5 billion today. They will be influenced in large part by the necessity of furnishing a man who retires with a certain purchasing power, regardless of how many dollars it takes to provide it. And we believe life insurance companies, who by size alone hold a crucial key to the future role of institutions in the market, will own $6 billion in stocks, as against $3.3 billion now. Life insurance companies have a gargantuan investment appetite, yet few such companies have taken full advantage of their legal opportunities to own equities. Our future estimates must reflect, in part, the experience of insurance companies during the past quarter century: in the Depression, real estate mortgages frequently entailed greater risks than sound equities; in post-World War II, inflation cut deeply into purchasing power and fixed income investments were unable to meet the rise in the cost of living. There is today, as a result, a growing realization that at times great risks can frequently be *avoided,* instead of assumed, through the institutional ownership of sound common stocks.

When we look at the broad picture as it may appear in 1965, we estimate total institutional stockholdings will reach approximately $60 billion – almost double present holdings. These securities will include an estimated $50 billion of New York Stock Exchange issues then outstanding, equal to about 24% of the estimated value of all our shares at that time, based on 1954 price levels.

Even to a people conditioned to statistics running into the billions, these figures admittedly seem enormous. But we must, I think, orient our planning to what we see ahead. The America of 1965, with entire new industries built into the economy, may bear only a superficial resemblance to what we are familiar with now. We foresee, for example, a need by corporations for some $80 billion in new equities simply to reach industrial levels projected for 1965, and in order to keep corporate equity and debt financing in sound balance.

The additional equity money which institutions are likely to furnish in the next 10 years – about $30 billion – will meet only 38% of the country's anticipated needs. The point to be noted is that while net equity purchases by institutions will rise 200%, the nation's over-all equity needs should leap ahead by 350%. Obviously, it is urgent that we look to individual investors, even more than institutions, to provide tomorrow's growth money.

Focus on the Present:
Institutions Have Helped Solve Some Market Problems

While the *future* is exciting to consider, it is apparent that at *present* the rapid growth of institutions has given the economy and the securities business a formidable new factor to consider. The financial power of institutions must be harnessed not only to meet their own particular needs, but also to meet those of the economy. This is a job that will take great skill and considerable ingenuity. No great change in history has ever been accomplished without certain growing pains, and the sudden rise of institutions is no exception. As is usually the case, the growing pains have received more notice than the growth itself. I would like to discuss in a moment some of the problems that have arisen, and what can be done about them. But I want first to point out some of the actual benefits to both the economy and the securities business that have stemmed from institutional growth. They have received scant attention.

To the economy as a whole, which was and still is badly undernourished for equity capital, institutions have made an important contribution. Through their net purchases of stocks during 1945-1954, institutions supplied $10 billion to the equity market – an amount equivalent to 60% of the money raised through new equity issues. In furnishing this money, and in meeting their own needs, institutions have prevented a further widening of the already serious gap between debt and equity financing. In their emphasis on blue-chip equities, they have released funds for reinvestment by others in new, growing and more risky enterprises. They have also given us a reminder that U. S. economic vigor is not an accident of history or geography, but is tied to our willingness to risk money on the future.

Moreover, institutions have helped extend to millions of people an indirect stake in the ownership of business. Among investment trusts, mutual funds and investment clubs, we find thousands who are only half-a-step removed from direct ownership. For many of these people, we hope that indirect ownership is only a first – and important – move towards direct participation. We are convinced that individuals as well as institutions must share directly in the rewards and risks of shareownership. We have consistently believed, and our research has borne out, that there are millions of financially able Americans with steady incomes, cash savings and insurance protection, who can best realize their economic goals by the sound purchase of stocks. As they become shareowners, that very act will pump new blood into our economic lifeline.

Where the Stock Exchange itself is concerned, we have seen institutional share volume rise steadily over the last three years, regardless of general market activity or price levels. This day-in and day-out activity has contributed to the market's vitality.

Important, too, is the fact that institutions have lent a strong investment tone to the market. Their objectives are long-term. They buy for cash and they are not harried by short-term price fluctuations. They have thus proven to be a steadying influence – and this is a particularly important element in the expansion we are witnessing. Institutions are, in short, "professionals" – and by their knowledge, skill and research they have added to the market's stature.

The Problems Created By Institutional Investors

There is an ancient bit of wisdom that declares progress is largely a matter of discarding old worries and taking on new ones. If institutions have helped solve some of the nation's financial problems, their growth has unquestionably created others – not only for the economy and the securities business – but also for the institutions themselves.

The men who manage our insurance firms, pension funds and investment companies, the men Peter Drucker calls "The New Tycoons," have fallen heir to extraordinary power and responsibility. Once their funds are invested, for example, how are they to wield the power represented by their shareownership? There are some who feel that institutions ought not exercise their corporate vote on the grounds that their extensive ownership will give them too much control over public companies.

A comment here is appropriate. At the Exchange we believe very strongly that the corporate ballot is tied to our economic freedom as the November ballot is tied to our political freedom. We believe that casting a corporate vote is not only a right, but also a duty –

because ownership cannot be divorced from responsibility. Much of our recent educational effort and much of our work with listed companies pivot on this point. If we want a free economy, we must extend freedom wherever we can, not limit it. And the specter of sizable institutional holdings need not haunt us. Existing regulations frequently limit the total amount of stock any institution may hold and also limit the amount of stock that may be held in one company or one industry. Undoubtedly, these safeguards will be improved and strengthened in the future where they do not now exist. Moreover, it is a curious piece of illogic that holds that hundreds of individual institutions, with their diverse needs and responsibilities, vote as a bloc at any given time.

To us at the Exchange and in the financial community, however, there is a real problem created by institutional growth. It is in meeting the unique and sizable needs of institutions — in a free, orderly and open market — without in any way impairing service to millions of private investors.

New Techniques Developed by NYSE To Meet Needs of Institutions

Our approach has been that while institutions differ from individuals as to the size of their transactions, both require a broad, liquid market. To any holder of securities much more is involved in the concept of "liquidity" than is readily apparent. For a liquid market is one that brings buyers and sellers together quickly and holds price changes to a minimum. Liquidity, by its nature, enhances the marketability of every listed security held by an institution. To the portfolio manager, this problem is particularly pressing. He is in the market daily. He wants to get the best possible purchase or selling price for *today's transactions* — and he must be concerned with *tomorrow's transactions* as well. He thus shares increasing responsibility for seeing that the market remains liquid, and with each succeeding market transaction he is, in effect, making his own job that much easier.

Because institutional activity frequently involves large blocks of stocks which must be speedily marketable, the Exchange has in the last several years taken a number of steps to achieve this objective.

Through *Exchange Distributions* we have developed a method by which a member-broker in certain circumstances can help sell large blocks of securities by soliciting purchase orders.

Through *Specialist Block Purchases* our specialists are permitted to buy blocks of stock outside the auction market.

Through *Special Offerings* large blocks may be traded on the floor during regular hours without competing with sales in the regular auction market.

Through *Secondary Distributions* large blocks may be offered to the public through both members and non-members in a process that resembles the sale of new issues, but which takes place after the close of trading.

These and other new techniques which we are working to develop have played a big part in meeting the institutions' problems. In addition, we have made a concerted effort to broaden the scope and understanding of the market, on the grounds that the broader the ownership base, the healthier the market will be. We have, for example, strengthened the specialist system, and it was our specialists, incidentally, who did such a wonderful job on September 26th in helping to absorb the flood of selling which followed announcement of the President's illness. We have approved permissive incorporation for our members as part of a program to attract qualified non-member broker-dealers to the Exchange. We have held periodic meetings with institutional investors to explore areas of mutual interest, and we have prepared special materials for them about our facilities. Finally, we have urged qualified corporations to seek listing on the Exchange and to gain for their shareholders the great advantages of listing. In the past five years some 102 newcomers to the Exchange list have added a total of 244 million shares with us. I am puzzled, incidentally, why many of the fine stock companies represented here today have not sought the listing of their securities on the Exchange in order to achieve a better market and broader ownership. I just happen to have here in my pocket copies of our listing agreements. I would be delighted to discuss them with you. As we adjourn for lunch I hope the line will form here on my right.

I have mentioned these Exchange methods and programs in some detail because they are still relatively new, and because they hold great promise for meeting your long-range needs and strengthening the fabric of the economy. At the Stock Exchange we are pledged to maintaining a market place that is fair, orderly, and open. This is our primary, but by no means our exclusive responsibility. It is a job that must be shared with us by the companies whose securities are listed, and by individual and institutional investors alike who have the greatest stake in the sound and continued use of our facilities. The progress we have made together in recent years indicates that the market place can, in fact, be made continually responsive to the country's new needs.

More Equity Financing . . . Wider Ownership . . . Sound Tax Program Needed to Offset Long-Range Institutional Purchases

There is one more distinctive feature to institutional growth that needs mentioning. It concerns the supply of available stock. One often hears the questions: Are institutions, with their heavy net purchases, drying up the supply? What are the facts?

Our figures for the last 10 years show that while institutions increased their net holdings of listed stock by 220 million shares, the Exchange's list actually expanded by 1.6 billion through new and additional listings, including stock splits and stock dividends. There are two meanings to this bit of history. We can see that institutional acquisitions absorbed almost 15% of the new supply. But even so, the general public found many more shares available to meet its needs.

In the next 10 years our estimates show that new issues and additional listings will add approximately one billion shares to the Exchange's list. This does not include additions that may be expected through stock splits and stock dividends. Of the increase, institutions are expected to absorb about 375 million shares, or 38% of the new supply.

Thus, the pattern of the future, while it provides for a large supply of stocks for the public, will see a somewhat stronger emphasis on institutional growth. In this prospect, there is an inescapable problem we must consider. It is one of "balance." There is an urgent need as our economy expands for maintaining a reasonable balance between individual and institutional holdings. Greater ownership by institutions must be accompanied by greater and wider ownership among individuals.

In stressing the individual's role, I don't want to understate the importance of institutions. Their past growth is a matter of record and their future growth is clearly indicated. But they should not be expected to put up a greater proportion of new equity money in the next decade than they now seem likely to invest.

We are convinced of this because we are going to require more equity capital than we have ever attempted to raise, and we are going to have to look to the individual investor to supply most of it. If we are to count on the individual we must at all times and at all costs make certain that he can take full advantage of his investment opportunities. We must make sure that the auction market is a place where he can express his needs instantly, that the supply of stocks is ample to meet his needs, and that he has adequate incentives for investment. I think we must look to the average investor not only to put up the greatest amount of equity money, but also to make the most venturesome investments.

If we fail to attract enough individuals in the face of steady institutional growth, the character of the free auction market would change. It would prove difficult for the small investor, whom we number in the millions, and for the large institutions, to express their needs . . . it would pose the real danger that institutions will eventually own a preponderant share of our stocks.

Should that happen, the ready marketability of a great number of shares would be materially impaired. Such a situation would greatly inhibit the liquidity of the auction market, and would prove as enervating to institutions themselves as to the economy. Finally, the failure of private investors to meet the country's equity needs would damage the concept that our people, as individuals, ought to be our primary source of venture money – ought themselves to be the voting owners of American business.

The key to maintaining a healthy balance between individual and institutional holdings lies, of course, in maintaining a healthy market with a constantly increasing supply of stocks. It lies in encouraging industry to raise $80 billion in new capital through the equity route so that 1965's industrial goals can be achieved. It lies equally in educating people to the advantages and risks of ownership, and in providing them with the necessary financial incentives so that they will stake some of their funds on our economic future.

To help broaden ownership the Exchange is pursuing a realistic educational program that in the last 3 years has helped increase the number of shareholders in public corporations from 6½ to 7½ million people. We have urged management to rely on equity financing wherever practicable, and we have urged that existing high-priced shares be made more marketable and attractive through stock splits.

Not the least of what must still be done lies in the field of legislation. We are still faced with two massive barriers to broader public participation in the market. The first is the capital gains tax which forces the individual to levy what amounts to a self-imposed penalty should he desire to shift his investment, and which locks in venture capital that the economy needs. The second is the double tax on dividends which, though now partially relieved, still discourages both equity investment and equity financing. We believe that the double tax on dividends should be lifted to the extent that individual investors receive at least a 10% tax credit on their dividends as against the present 4%.

If these barriers are removed, and as our economy expands, we will see an investment climate develop that will be noteworthy for three reasons:

First, the role of our institutions will be seen in the proper perspective. They *are* big and getting bigger, but so is everything else in our economy.

Second, we shall raise sufficient equity capital to realize the country's remarkable future goals. In relying largely on individual investors, we shall be preserving our essential character as a nation of individuals – individuals who are able to vision, and are willing to venture.

And finally, the supply of stocks will be entirely adequate to place within the reach of every individual the opportunity to own a share of our productive might. When we have accomplished this, we shall have spelled out for the rest of the world what we mean by a man-in-the-streets kind of capitalism.