Learning from one another's mistakes: closed end mutual funds 1868 - 1940

Janette Rutterford

Author attending conference and presenting

Professor of Financial Management
Open University
Michael Young Building
Walton Hall
Milton Keynes
MK7 6AA
Tel: +441908 655812
Fax: +441908 655898
Email: :j.rutterford@open.ac.uk

EFM classification code 370 & 530
Portfolio Management and Asset Allocation
All Other Institutions – Management

Discussant

Abstract

This article explores the development of the closed end investment trust, in the context of the investment management strategies adopted and whether they provided value-added services for investors. Comparison with the United States is made, showing how the US investment trusts of the 1920s boom years were heavily influenced by their earlier UK counterparts. However, US investment trusts differed from British investment trusts in a number of key ways, in particular how they were managed, which led to their relatively much worse performance in the stock market crash of the late 1920s and early 1930s. This poor US trust performance led directly to the creation of the US open-ended 'fixed trust', marketed as an antidote to the generally poor management of conventional closed-end investment trusts. As confidence in mutual funds slowly returned in the United States, open-ended funds were gradually given more flexibility, but investment trust companies, with share prices at a steep discount to liquidation value, and partly blamed for the Crash, were encouraged to convert to mutual fund status by the 1936 Revenue Act. By 1944, open-end funds had overtaken investment trusts in terms of asset size, a phenomenon which did not occur in Britain for another thirty years.

Learning from one another's mistakes: closed end mutual funds 1868 - 1940

What's in a name? that which we call a rose
By any other name would smell as sweet;

W. Shakespeare, Romeo and Juliet (II, ii)

Introduction

In the past few years, a number of scandals have hit the investment management industry, on both sides of the Atlantic. In Britain, the heavy marketing of zero dividend preference shares in split capital investment trusts backfired on the investment trust industry in 2000, as high-leverage, cross-holdings of illiquid trust stocks, and falling stock markets left investors with heavy losses. There are currently a number of investigations into the so-called 'magic circle' of split capital investment trusts, whose managers stand accused of price manipulation and mis-selling. Poor corporate governance practices, in particular, multiple directorships, have been cited as a causal factor. Many of the same accusations were levelled at the US investment trust industry more than seventy years ago. Plus ça change...

This article explores the development of the closed end investment trust, in the context of the investment management strategies adopted and whether they provided value-added services for investors. Comparison with the United States is made, showing how the US investment trust industry of the 1920s was heavily influenced by their earlier UK counterparts. However, US investment trusts differed from British investment trusts in a number of key ways, which led to their relatively much worse performance in the stock market crash of the late 1920s and early 1930s. This poor US trust performance led directly to the creation of the US open-ended 'fixed trust', marketed as an antidote to the generally poor management of conventional closed-end investment trusts. These fixed trusts invested in a list of pre-selected, disclosed equities and, once established, allowed no manager input at all. In Britain, in the 1930s, unit trusts introduced the American concept of a diversified portfolio in domestic equities to British investors. Although initially modelled on the US fixed trusts, British unit trusts soon adopted a flexible structure, with British investors believing that their fund managers would add, and not destroy value, and British investment trusts still offering an international alternative. As confidence slowly returned in the United States, open-ended mutual funds were gradually given more flexibility, but investment trust companies, with share prices at a steep discount to liquidation value, and partly blamed for the Crash, were encouraged to convert to mutual fund status by the 1936 Revenue Act. As late as 2004, the Yahoo web site, advising retail investors, stated: 'Investing in closed end funds can be very confusing for the novice investor and we don't recommend it … you're better off sticking to open-end funds.'[1]

The First British investment trusts

There is some disagreement as to the origins of investment trusts. Authors such as Cassis point to the Société Générale des Pays-Bas pour favoriser l'Industrie Nationale, founded in 1822 by King William I of the Netherlands.[2] Others point to earlier antecedents in the *Eedndragt Maakt Magt* 'negotiatie' founded, in 1774, by an Amsterdam broker named van Ketwich.[3] However, there is general agreement that the Foreign and Colonial Government Trust, founded in 1868, was the first British investment trust, designed to provide investors with the opportunity to invest in a carefully selected variety of investments.[4] Promoted by Philip Rose, a partner in a law firm, familiar with the legal structure of trusts, and chaired by Lord Westbury, who, as Attorney-General had carried through the Fraudulent Trustees Bill in 1857 and the Bankruptcy and Insolvency Bill in 1861, the trust form was preferred to that of the limited liability company to avoid 'the now unpopular name of the company'[5]. The aim of the trust, as outlined in the prospectus, was to: 'give the investor of moderate means the same advantages as the large Capitalists, in diminishing the risk of investing in Foreign and Colonial Government Stocks, by spreading the investment over a number of different Stocks'.[6] The authors of the prospectus used a historical example to press home their point.

> A Capitalist who, twenty or thirty years ago had invested, say, £1,000,000 in ten or twelve such stocks, prudently selected, would on the above plan, not only have received a high rate of interest but by this time have had nearly the whole of his original capital returned by the action of Drawings and the Sinking Fund, and still have held the greater part of his Stocks for nothing[7].

The objective was clear: to allow ordinary investors to earn the higher yields that were available on overseas government bonds, compared with domestic Consols, but to reduce the risk of possible loss through default on coupon or final payments by investing in a range of different securities. As the Times commented:

> The scheme in its principle supplies a want that has long been felt, since it not only gives to that large number of persons who are always disposed to encounter the risk of foreign investments the means of restricting that risk to the smallest amount, but will also to a great extent provide an insurance against it by limiting the yearly dividends to a sum which, with the gains from sinking funds, will admit of an accumulation to meet any untoward contingencies[8].

There were also practical reasons for employing others to manage overseas investments – lack of knowledge of overseas concerns, the difficulties inherent in holding bearer bonds in a secure place and in collecting coupons in dollars, francs, and other foreign coin, and, finally, the risk of a large spread between buying and selling price for infrequently traded securities[9].

In the case of Foreign and Colonial, the diversification was spread across eighteen different government and colonial bonds, whose coupons ranged from 3% to 8% and whose yields ranged from 5.1% for New South Wales stock to 13.7% for Turkish 5 per cents. The list of stocks provided in the prospectus is given in Table 1. These were not all risk-free investments; The Economist referred to Austria as a 'dishevelled' state and Italy as 'inchoate'.[10] In 1868, the Turkish 5 per cents were priced at 36 1/8. They rose to 53 in 1873, a rise of 31.8%, only to fall back to 39 ½ a year later.[11] Trustees and investors expected defaults; as early as 1871, the Foreign and Colonial was reporting non-payment of interest on Turkish 6 per Cents of 1865, although the Chairman was confident of payment as 'he had always found the Turks very honourable in their commercial dealings'.[12]

Table 1 about here

Foreign and Colonial Government Trust Schedule of Investments, 1868

In the Foreign and Colonial prospectus, a minimum amount of diversification was guaranteed by requiring that the percentage holdings in any one stock was a maximum of ten per cent, with the individual holdings chosen so as to give an exact overall yield of 8%. The trustees promised investors in trust certificates a yield of 6% on a price of £85 per cent, equivalent to a yield of 7% on the amount invested. The 1% difference between the yield received and the yield paid out was retained as a reserve against unforeseen events and to pay off the capital using annual drawings. The life of the trust was fixed at 24 years. On that date, any certificates not redeemed would be repaid at par, and all certificate holders, whenever repaid, were given rights to a share in any surplus. An actuary was cited in the prospectus as estimating that all certificates would 'in all probability' be paid off in 24 years and there would still remain stock to the value of just over £900,000 compared with an estimated £1,000,000 original flotation[13].

The issue was a success. Although the flotation only raised just over half the estimated £1 million, there were four further issues by the same trustees in the next five years so that, by 1873, £3.5 million had been raised. Since each issue was closed to new money, excess demand required the creation of new trusts. Costs were kept to a fixed amount for each issue, which used the same trustees and the same management process. Only the securities changed. These issues had a number of key characteristics behind their success. The funds were invested in fixed interest high-yielding overseas government bonds, making it easy to cover promised dividend payments on the trust certificates. A safety cushion was created by not paying all the income receipts out as dividends, and from early repayments on the government bonds themselves. This was to be used in the event of default or delay in the payment of coupons. There was transparency for investors in that they could see the initial portfolio. There was no intimation by the trustees that bonds would be bought and sold, although they had the freedom to do so if they wished. It was expected that the majority of the original bonds would be until maturity. There was to be no change of management – trustees were appointed for life unless they chose to retire. There was no leverage – investors bought certificates backed by government bonds. Their risk was the average risk of the underlying portfolio. The fees were explicit, being a total of £2,500 per trust,[14] equivalent to approximately ½% of the underlying assets invested.[15] Another key factor was the reputation of the five trustees and of the bank through which dividends would be paid, Glyn Mills Currie & Co[16]. Given that overseas bonds were bearer bonds, investors had to trust the holders not to abscond with the certificates.

The success of the Foreign and Colonial Government Trust issues led to a rash of imitations of what became known as 'average investment trusts'.[17] For example, The Share Investment Trust, floated in 1872, drew directly on the success of the Foreign and Colonial:

> The principle of distribution of risk by embodying in a Trust a number of undertakings, yielding high rates of interest, introduced by the F&C Trust, has been fully recognised to be of great advantage to investors… The present scheme proposes to embrace a number of well-selected industrial undertakings yielding high rates of interest. The greater variety in the investments will have the effect of extending the average and further distributing the risk, thus making one class of investment insure the other.

For this trust, there was less transparency, the authors of the prospectus limiting themselves to saying that they would buy 'fully paid-up shares, stock and debentures' in 'submarine cables, tramway companies, iron and engineering companies, telegraph and construction companies, and other industrial undertakings yielding high rates of dividend'. Within a few years of issue, the annual reports show an unbalanced portfolio, with takeovers and mergers leading to large holdings in a few companies such as the Anglo American Telegraph Company Limited. There were, however, limited purchases and sales, with a committee of certificate holders making recommendations to the Trustees, who met monthly. The minutes reveal that their recommendations were mostly ignored, but that two or three purchases and sales were typical of the monthly meeting. However, another risk factor soon became apparent – embezzlement by the Trust's secretary.[18]

By 1875, 18 trusts were listed on the London Stock Exchange, specialising in a range of types of security, both British and overseas, from British gasworks and waterworks debentures to American securities and, by the end of the 1870s, 70 investment trusts had been launched.[19] The first Scottish trust, based in Dundee and specialising in

American securities, was launched by Robert Fleming in 1873 and followed by two more in 1879.[20] Some were of the trust status initiated by the Foreign and Colonial; others adopted a corporate form, such as the Railway Debenture Trust Company (Limited) and the Railway Share Trust Company, Limited, both in 1873. One rationale for the investment trust company structure was that 'the latter is generally the best form for the management, as there are dangers to trustees lurking behind their legal status, which might hereafter prove serious, should any neglect or mistake in carrying out its provisions be found to have occurred'.[21] By 1878, structural problems with the trust structure had arisen, partly due to the role of trustees (who were liable to be taken to court for breaches of trust[22]), and partly to the fact that the annual drawings at par or above, were causing inequities between those whose certificates were drawn and those whose certificates were not. As interest rates fell, and as the government bonds in the portfolios were redeemed and replaced with lower yielding securities, so it was becoming harder to pay the promised annual dividend to the remaining certificate holders. 'The early recipient gains, however, more than the money value of his full Bonus for he also escapes the uncertainty of the future'.[23] Foreign and Colonial and the Share Investment Trust began legal proceedings to have their trust deeds altered so that capital realised from the sale of securities would not be available for dividend payments. This attempt to restructure trusts was overtaken by a challenge to the legal status of investment trusts in the case of the Government and Guaranteed Securities Trust. Threatened with a similar legal challenge, Foreign and Colonial moved quickly to adopt a corporate status. The Share Investment Trust did not follow its lead: it went into liquidation in the same year. Although the investment trust structure was declared legal in an 1880 appeal by The Submarine Cables Trust, all but this investment trust converted to company status. The limited liability company became the norm for investment trusts, with the Submarine Cables Trust finally succumbing to a change of status in 1926.[24] Although still called investment trusts, they were now investment trust companies. The first confusion of nomenclature had been successfully resolved.

The structure of investment trust companies

The potentially more complex capital structure of the investment trust company allowed investment trusts to have more than one type of investment medium and appeal to more than one type of investor. Senior fixed interest securities, such as debentures and preference shares, could be sold to the more risk-averse investor seeking a regular and reliable income. Ordinary shares could be sold to the less risk-averse investor, aiming for high yield or even capital gain but aware that both yields, and prices, could go down as well as up. The difference between fixed interest and variable dividend securities had been less clear-cut in the original trusts. For example, the Foreign and Colonial 1868 Prospectus had promised investors 'Annual Interest of 7 per cent' rather than a more uncertain 'dividend'.[25]. Entrepreneurial promoters were quick to see that the more they raised in fixed interest securities, the higher the dividend they could offer to ordinary shareholders and the more profits for the founder shareholders. The Chairman of the Railway Debenture Trust commented at the 1875 Annual General Meeting that: 'Every increase of £500,000 in the borrowed money at 5 per cent interest and ½ per cent for Sinking fund, would add 1 ½ per cent dividend to the share capital, so that with a borrowed capital of £2,000,000 they would be able to pay a steady dividend of 10 per cent … and the shares would be worth a considerable premium.'[26] In some cases, ordinary shares were left partly paid to increase the profit potential. Founders' shares were even more profitable, typically entitled to ten per cent of the net profits in any year in which the ordinary shareholders received a minimum dividend, say 6% or 7%.[27] However, this entitlement was given to a very small number of founders' shares, 200 of £1 each in the case of The Gas and Water Debenture Trust, compared with 100,000 ordinary shares of £20 each.[28] These advantages led to high values for founders' shares; at one time, £200 of founders' shares in The Debenture Corporation had a market value of £300,000.[29] There was pressure from the ordinary shareholders to buy them out. For example, a shareholder in The Railway Share Trust moved a resolution at the 1875 annual general meeting: 'that the directors be requested to endeavour, and are hereby authorized to commute the founders' Shares which exist in this Company on the best terms they can, not exceeding payment of £250 in this Company's 'B' 6 per cent Preference Shares for each one [£1] founders' Share'.[30]

Investment trust companies quickly established a capital structure norm, many choosing to issue equal amounts of preference shares and ordinary shares. For example, the Railway Share Trust Company, Limited issued £1,000,000 of ordinary shares, of which £500,000 was paid up, followed up by £500,000 in 6% Preferred Shares.[31] The liability capital structure of English investment trusts pre-1890 averaged approximately 30% ordinary shares, 30% preference shares and 40% long-term debentures. Scottish investment trusts had similar percentages for preference shares and long-term debentures, although the percentage of ordinary shares was lower at around 25%, the remaining capital being provided by short-term debentures, not popular south of the border[32]. On the asset side, investment trust portfolios consisted mostly of fixed interest securities, representing a higher percentage of assets than did the fixed interest securities of long-term liabilities. This was for prudence' sake. For example, at the first meeting of shareholders of the Railway Share Trust Company Limited, the Chairman declared: 'In order to form a solid basis for the Company's Preferred Shares, which will shortly be issued, a large proportion of these investments has been made in Debentures and Preferred Stocks, giving a high rate of interest, with good security, and prospect of improvement'.[33]

The switch to a corporate structure had another impact on the investment trust industry – it removed the fixed life expectancy of the trusts. They could now continue in existence as long as the shareholders wished. This meant a change in emphasis from the three-fold means of reward embedded in the trust system - the income yield, the prospect of capital gain through an early drawing at par or above, and further potential capital gain when the trust was wound up on maturity. Under the corporate system, the potential benefits were split by type of security. Debenture holders and preference shareholders were offered the regular yield, but they were not offered additional benefits. These were reserved for ordinary and founders shares, in the form of enhanced dividends which were then reflected in higher share prices. Indefinite life had another impact on the new investment trust companies. The directors, formerly trustees, had to manage the investment portfolios. As yields fell in the late nineteenth and early twentieth centuries, and as the original bonds matured, replacement investments had to be found, the cash no longer being returned to investors. The 'average' strategy adopted became 'extension of securities', that is, the addition of individual securities to the portfolio, each assessed as to capital safety and yield, with little consideration of the impact of the new security on the portfolio's existing characteristics[34]. This extension policy is evident in the case of the Foreign and Colonial which, in 1879, consolidated five individual trusts with less than 20 securities each into one investment company with a portfolio of around £2.5 million invested in less than 90 securities[35]; by 1905, Foreign and Colonial had more than tripled the number of securities to 280, comprising a portfolio worth, in book value terms, only 20% more at £2.99 million.[36] Investment trust directors perceived their role to be one of yield enhancement and risk spreading. The more securities held, the merrier: ’the bigger the company, the more the investments can be spread and the more can any particular risk be minimised’.[37] Investment trust directors were not required to engage in market timing or stock selection to add value, although ‘judicious selling’ was deemed appropriate. The ‘first object’ of an investment trust company was seen to be ‘the distribution of risks and the maintenance of a steady income’.[38]

Investment trust booms

The late 1880s saw a boom in new issues of investment trust shares, with 70 new companies floated between 1887 and 1890 raising £45 million new nominal capital on the London Stock Exchange. The newer investment trust companies deviated from the simple averaging strategy of the early trust companies. Formed in a stock market boom, they found it difficult to acquire investments with a high enough yield, and diversified into earning fees from company promotion and underwriting commission, as well as investing in illiquid stocks. Others limited themselves to a particular market segment without the benefit of diversification[39]. Some borrowed from banks, to meet losses from sales of depreciated securities, whilst others invested in the fixed interest securities of other investment trusts, in the face of a shortage of suitable high yield investments[40]. Founders’ shares, held by directors, were an added incentive to take such short- term profits. ‘To satisfy the founders, promoting and underwriting business had to be engaged in and, in addition, … some of the Trusts which were early in the field adopted the curious policy of assisting in the estabishment of apparently rival undertakings’.[41]

Investors were not always able to tell the difference between the original ‘average’ investment trusts and the newer ‘financial’ trusts, as investment trust companies did not disclose their portfolios as the Foreign and Colonial Government Trust had done. ‘They call themselves investment trust companies, but surely never has the assumption of so faith-inspiring a name proved to be less justified’.[42] The Baring crisis brought the relative risks of these two types of investment trust to the fore. The newer companies suffered relatively more after the Baring crisis of 1890, with those formed after 1880 falling 29.2% in price in 1893, compared with a fall of 14.5% for the pre-1880 trusts[43]. Overall, *The Economist* reported the average investment trust share price fall in the years after the Barings crisis to be 35%, including the total loss of some of the 'more speculative' investment trusts. However, by 1896, *The Economist* believed that investment trust promoters had learned from their mistakes, and from the fact that the very name of Trust had come to be a bye-word and a reproach' so that 'company-mongering business' was 'now being eschewed' and that there was a 'disposition among those who conduct those undertakings, even of the less assured character, to "forswear sack and live cleanly"'[44].

As markets stabilised and began to rise again, at the turn of the century, investors regained confidence in the more respectable type of investment trust and a third wave of investment trust new issues took place between 1905 and 1914, with 44 new issues during that period[45]. The terminology issue was not yet fully resolved, with the Stock Exchange Official Intelligence and the Stock Exchange Year Book continuing to include both 'average' investment trusts and investment trusts run as finance companies in the same category, together with land and mortgage companies. Of 854 companies listed as financial trusts by the Stock Exchange Daily Official Intelligence in 1914, perhaps only 80 to 100 could be described as Foreign and Colonial-style investment trusts. [46] However, in practical terms, by the pre-World War I investment trust new issue wave, British investors had learned to tell the difference[47].

The 1920s saw the largest new issue boom in British investment trusts to date, with 103 new investment trusts floated between 1924 and 1929[48]. One such trust, The Independent Investment Company, was floated in 1924, and included John Maynard Keynes as a director. It aimed at 'obtaining a higher return on the capital employed than is open with safety to the individual investors'. Its investment strategy did not limit itself to stock selection – that is buying a spread of stocks in a particular sector, and holding them until repayment. Unusually for a trust, the expertise of Keynes and the other directors was to be used to carry out market timing strategies: 'periodic changes also take place in the relative values of money on the one hand and real property on the other, which are reflected in the relative values of bonds and shares, … , so that here also the same principle of changing from one class to another at appropriate times can be applied'. The emphasis was also to be on US securities.

This was also in contrast to the norm. British investment trusts maintained an international outlook post-World War I, but the average US percentage was relatively low, from many trusts having sold US securities in exchange for British government securities to aid the war effort during World War I. This meant relatively high percentages in domestic and Empire securities.

Table 2 about here

Geographical split of British investment trust assets in percentage terms 1890 and 1929

The capital structures of the 1920s trusts were similar to those of the pre-Baring crisis trusts. The average English investment trust post-World War I had 26.0% long-term debentures, 38.1% preference shares and 35.6% ordinary shares.   Scottish trusts had higher gearing, with 40.8% in long-term and short-term debentures, 34.0% in preference shares and 25.2% in ordinary shares.[49] However, the average British investment trust retained the relatively cautious attitude to risk of their pre-Baring crisis forebears: they still invested less in equities than they had ordinary shares in their capital structures.

US investment trusts

In the United States, the investment trust industry did not fully develop until the mid-to-late 1920s. Chamberlain and Hay attributed the development of British as opposed to American investment trusts in the nineteenth century to the existence of the British landed gentry, who was 'not conversant with business ways and securities in particular'. Balogh and Doblin argued that it was the fact that British entrepreneurs liked to invest partly outside their own companies, unlike their American counterparts, which had led to the development of the British investment trusts. [50] Dowrie and Fuller believed that American real estate and mortgage bonds offered high enough yields and low enough risk to obviate the need for the averaging of risk through investment trusts.[51]

Early examples of American investment trusts included the Boston Personal Property Trust, organised in 1893 and the Alexander Fund, established in Philadelphia in 1907.[52] The main rush of issues occurred in the early 1920s, with the International

Securities Trust of America in 1921 followed by the State Street Fund, The Bond Investment Trust, the Massachussetts Investment Trust, the American Trust Share Corporation, United Bankers' Oil Company, United American Chain Stores Incorporated, United American Railroads Incorporated, and United American Electric Companies, all formed in 1923 or 1924. According to Fowler's Investment Trusts, only 18 trusts had been formed by 1924.[53]

These trusts were modelled on their English and Scottish predecessors. Some adopted a trust structure, others, as their names imply, were companies. Those adopting the trust structure were run as the early Foreign and Colonial Government trusts had been, with a fixed portfolio, and no debt. Instead of certificates, investors were issued with Bankers' shares, which were backed by the collateral of the securities in which the trust invested. Most, as their names implied, invested in the securities of a particular industry, and most concentrated, unlike their British counterparts, on common stock rather than fixed interest securities. As with Foreign and Colonial, the names of the securities were published in advance and it was not envisaged that they would be switched, although trustees were given full powers to alter the investments should they so wish. However, investors in these American trusts also had more power than those in the ill-fated Share Investment Trust; instead of advising the trustees on investment strategy and running the risk of their advice being ignored they could, in the Alexander Fund, if 'dissatisfied with a security purchased may go to a Board of Overseers elected by the shareholders from among themselves and, if they agree with him, can force the manager to sell the security'. Such an approach reflected the fact that the Alexander fund was originally set up by a small circle of friends and eventually expanded to include the general public. A handful of trusts such as the Alexander fund had an open-ended structure unknown in Britain: they offered investors not a potential repayment on drawing and a fixed maturity, but the option to 'withdraw on demand and receive the value of the unit on withdrawal'[54]. However, the majority of American investment trusts were of the classic corporate structure.

The late 1920s boom in investment trusts in the United States can be attributed to a number of factors: the increasing wealth of Americans and the rise in stock market values post World War I; aggressive marketing tactics by banks and broking firms based on the mass-marketing of Liberty bonds during World War I; and the support given to investment trusts of a number of influential authors, most notably Edgar Laurence Smith, Leland Robinson, P. W. Garrett, Irving Fisher and Marshall Williams. Smith, President of The Investment Managers' Company, wrote an influential book, published in 1924, entitled 'Common Stocks as Long-term Investments', in which he showed that, provided a portfolio of common stocks or shares had been held for a period of ten years, in both inflationary and deflationary environments, common stocks outperformed bonds[55]. He went on, in his concluding chapter, to recommend investment via an investment manager. 'Sound investment management, while always subject to error, cannot fail to improve average investment results if the principle of diversification is strictly adhered to'[56].

Authors such as Robinson, Garrett, Fisher and Williams specifically urged US investors to adopt investment trusts, with Robinson citing the longevity of many British investment trusts as support for his advocacy of the British investment trust system being introduced to America. Robinson argued that the critics of the British type of investment trust overlooked one of the chief tenets of wise investment – periodical inspection, with the purpose of eliminating any issue which it is undesirable to hold longer'.[57] Garrett, in an article entitled 'Blue chips, unless recounted often, tend to turn pink' also pointed out the dangers of purely passive investment, and recommended 'co-operative' investment as a solution.[58] Fisher was assertive in his advocacy of investment trusts as the best way of investing in common stocks. 'In truth investment trusts are just the opposite of dangerous. They represent not only expert knowledge, such as that to which the older investment houses can lay claim, but two other safeguards – diversification and incessantly vigilant management'.[59] Early commentators, therefore, perceived investment trust managers as having rudimentary stock selection – and de-selection – skills. As the bull market progressed, managers were also credited with market timing prescience. As Williams commented in 1928, 'skilful managers of investment trusts develop a feeling, or an art, in turning over the portfolio to advantage'.[60]

However, all was not rosy. The absence of federal laws regulating investment trusts, created a number of problems. There were misunderstandings as to terminology. Investors were unclear as to the difference between corporate investment trusts and 'fixed' trusts backed by Bankers shares and redeemable by investors. More worryingly, the investing public was misled by the term ‘investment trust’, just as British investors had been before. An investigation by the Investment Trusts Committee of Investment Banks into investment trusts recommended anti-fraud legislation by states and reported:

> The committee is of the opinion that there has been a good deal of general misunderstanding which is no doubt due to a large extent to the title “Investment Trust”, really a misnomer. These companies are …actually investment companies, and as such should be compared by investors and speculators alike to other companies, whether industrial, railroad, public, etc.[61].

The Governors of the New York Stock Exchange, as early as 1924, were cautious vis-à-vis the new-fangled entities and commented that brokerage houses might be tempted to use investment trusts as a dumping ground for unwanted securities[62]. The New York Stock Exchange adopted a resolution:

> The participation by a member of the Exchange or Stock Exchange firm in the formation or management of investment trust corporations or similar organizations which in the opinion of the Governing Committee involve features which do not properly protect the interests of the investors therein may be held to be an act detrimental to the interest or welfare of the Exchange.[63]

In the boom years of the late 1920s, and highly recommended by influential commentators, investment trusts appeared to investors to offer a simple way to acquire a portfolio of ever-rising equities. Bankers and brokers competed to promote new investment trust companies, using techniques developed for the sale of Liberty Bonds during World War I, to an eager public. More than 7,000 securities dealers and 30,000 banks bid against each other for new issue. Investment trust shares offered an infinite supply of such new issues.[64] As the supply of industrial and commercial common stock began to dry up, new investment trust companies were floated to invest in the common stock of other investment trust companies, creating pyramid structures. Bonus stocks and shares went to promoters, capital structures became ever more complex, cross-holdings increased, and management expenses ballooned. One oft-cited example is that of Goldman Sachs Trading Corporation, floated in December

1928, with $100,000 paid into treasury from the sale of 900,000 shares at $104 each. A further 125,000 shares were issued, followed by a merger with first Financial and Industrial Securities Corporation and then Central States Electrical Corporation. At one point, the entire edifice was capitalised at $326 million.[65] Given high demand, American investment trust shares were sold at a premium to par value – as high as 200% in some extreme cases - with the par value itself the market value of the underlying securities, which might, in turn, be investment trust shares included at a premium to their own par value; and so on.[66] Not all commentators approved of such activities. The Times, in 1925, reported the Chairman of the Rock Investment Company criticising his fellow American investment trust directors for 'this financially incestuous buying of one another's junior stocks'.[67] Withers, commenting on this in his 1926 text *Hints about Investments,* recommended that careful investors should discriminate between those investment trusts which 'made a practice of it' and those which did not.[68]

By mid-1928, the US investment trust sector had overtaken that of the UK, with an aggregate capital of $1.2 billion compared with an equivalent $1 billion in capital for British investment trusts[69]. The pace quickened as the investment trust market rose to a peak in 1929, with half the total amount of new investment trust capital raised in that year alone.[70] By the end of the boom, more than $7 billion was invested in 675 investment companies of all types, of which 193 were investment 'management' companies, with assets of $2.7 billion, including 19 open-ended funds, accounting for a mere $140 million.[71] This meteoric rise was followed by a crash which was nothing if not spectacular. *The Economist* reported that the Standard Statistics index of the common stocks of 30 leading American investment trusts showed a fall of no less than 75% from their peak whereas the Institute of Actuaries index of the common stocks of the 15 leading British investment trusts showed a fall between their peak (March 1928) and March 1931 of only 17%.[72]. By 1934, nearly 200 American investment management companies had disappeared, including the notorious Goldman Sachs Trading Corporation. By comparison, British investment trusts suffered extensive capital losses and reduced dividends, but there were only a few reorganisations and no reconstructions. In 1933, the worst year, only 7 pre-World War I, and one-third of post-War, British investment trusts, passed their dividends.[73]

Comparing British and American investment trust management

There are a number of reasons why the investment trust crash in the United States was greater than that of the Baring crisis in the 1890s and greater than the late 1920s fall in value of British investment trusts. One difference was lack of experience of bear markets, not an issue for their longer-lived British counterparts. But most of the differences were due to institutional and structural differences between UK and US investment trusts, such as size, regulation, capital structure, accounting practices, and management.

The typical American investment trust was larger than that of its British counterpart, but held, on average, fewer securities. The relative size was £1.7 million for British investment trusts in 1936, compared with over $20 million for American investment trusts in 1929.[74] The typical British investment trust held over 500 stocks by 1936, compared with 81 for their American counterparts.[75] The tradition of small British investment trusts derived from the Foreign and Colonial, which had responded to additional demand by creating a series of new trusts.   Balogh and Doblin put forward the reasons for this approach as British investor preference for new issues, the ability to take advantage of director specialist expertise via a new trust, and the ability to charge more fees, the greater the number of trusts created.[76] Another reason was the size of the individual security issues. British investment trusts were invested in relatively small capitalisation issues compared to their American counterparts, which were invested in large capitalisation companies created by merger into great monopolies.[77]

The average capital structure of US investment trusts was less aggressive than that of their British counterparts: 40% common stock and 60% 'senior' securities, of the latter the great majority preferred stock. 'Americans do not like short-term debt, nor do they like perpetual'.[78] The British favoured one-third equity and two-thirds senior securities. 'It should be remembered that the debentures, and to a lesser extent the preferred stock, are what the British public buys'.[79] However, the investment strategy of American investment trusts was more aggressive than that of the British. It has already been observed that the typical American investment trust invested in domestic equities, rather than the British preference for an international portfolio of fixed interest securities. Between 1929 and 1935, the average American investment trust held between 55% and 75% in equities compared to less than 40% in their own capital structures.[80] Prior to the crash, American investment trusts had in the more extreme cases invested in the leveraged common stocks of other investment trust companies. Such investment trust company shares created an additional layer of leverage or gearing for common stock holders.   The imbalance between the capital structure of the American investment trusts and their asset allocation strategy was unfavourably compared with that of their longer-lived British counterparts which 'over a period of nearly fifty years, tended to hold bonds, preferred stock and common stock in portfolios in approximately the same ratios as these securities in their capital structures', so safeguarding their dividends, whereas many American investment trusts were forced to suspend their preferred stock dividends, or worse, in the years 1930 to 1933.[81]   Those American trusts which had chosen not to leverage, fared much better. By the end of 1937, an average dollar invested in July 1929 in an index of leveraged investment trust common stocks was worth 5 cents, compared with 48 cents for the common stock of an index of non-leveraged investment trusts.[82]

The preference for common stock as an investment over fixed interest securities can be attributed to a number of factors[83], but had the effect of increasing the risk of American versus British investment trusts, particularly in the 1920s. As the dividend yield from common stocks fell, so American investment trusts became unable to pay the higher yield promised on their senior securities. This was the opposite situation from British investment trusts, which typically had a safety cushion between the yield on investments and that promised to their senior security holders. After World War I, they were helped by generous yields available on UK government securities.[84] As a result, American investment trust directors turned to capital gains to plug the income gap. In Britain, capital gains, provided they were not paid out as dividends, were exempt from income tax. In the United States, by contrast, realised capital gains were required to be reported as income and taxed accordingly. The temptation to pay out realised capital gains as dividends was hard to resist. ''Trusts abroad do not include capital gains as income – in this country, however, such earnings must be reported under the head of income, and taxes paid thereon. Whether it would or no, the

American trust must include, besides interest and dividends received, all profits derived from the sale of securities from its portfolio'.[85] As markets rose in the late 1920s, dividend yields fell, and American investment trust directors in some cases went so far as to pay the fixed dividends on preferred stock from unrealised as well as realised capital gains, marking stocks to market as they rose in price.

Thus, although based on British investment trusts, American investment trusts became very different in nature, emphasising capital gain rather than income, speculation rather than investment, market timing rather than simple diversification of risk.

> It is made plain that these investment companies are a transplantation from England and Europe, where, indeed their trusteeship is *implied* at least. Investors there become members of the corporation with the understanding that they entrust their funds for the purpose of investment under *fixed* conditions. Thus a company becomes an agent for investment in certain securities that cannot be shifted at will. But so great has become the speculative desire of the American people that companies of this class and kind, that shift their securities at will and often, or occasionally pass from investment to dealers, eliminate even that implied trust relation … Having eliminated the element of trusteeship and considering these companies as purely investment companies, in what way are they more serviceable than our investment bankers? It rests wholly on management.[86]

The management style of investment trusts differed significantly between American and British investment trusts. British investment trusts relied on their Boards of directors, and before that, on trustees to enhance their reputation using 'men of standing and ability'.[87] English and Scottish trusts turned to MPs, aristocrats, lawyers, merchants turned bankers, such as Robert Fleming, and accountants. British trusts were international in scope, requiring directors who were international in outlook and, if possible, well-travelled. There was no such requirement for the domestically focussed American investment trusts.

The reputation for cautious and the 'moral responsibility' of British investment trust managers derived from a practice begun with Foreign and Colonial: the putting aside of reserves against a rainy day. The American Kilborne argued that dividend policy was the best test of management, citing in 1927 the Chairman of the Edinburgh Investment Trust as saying that one of the secrets of trust management was to allow a portion of the net revenue to accumulate at compound interest, in effecting setting up a reserve to take care of future losses.[88] This began early on with the concept, put forward in the 1870s, that the key was income and that capital gain should be held for a rainy day. With the demise of the drawing system, where capital proceeds were used to buy back certificates at a premium to the issue price, directors of investment trust companies chose to set aside realised capital gains against future losses. Realised capital gains were not paid out as dividends. Foreign and Colonial, as early at 1878, had attempted to put this into the trust deed.[89] In this way, the share price could be kept close to par value whilst the dividend was maintained. Regular yield was deemed preferable to occasional windfalls.   Investors were in for the long term.[90] Unrealised capital gains were even less touchable. 'At the same time, he thought that they should not treat profit resulting from the enhanced price quite as if it was cash realised'[91].

By the late 1920s, British investment trusts had two types of reserves: declared general and capital reserves and undeclared 'inner' or 'secret' reserves. General reserves were taxable, and could be used, if desired, to supplement dividend payments. Capital reserves derived from the sale of securities and premiums from the sale of the trust's own securities, were not taxable, and could not be used for the payment of dividends.   Hidden reserves were the difference between market value and book (cost or written down value) value. Investments were kept in the books at cost, and sometimes depreciated further when there was a surplus available to do so. 'One trust wrote down their holding of 5,000 Shell Transport costing $5 per share to 60 cents, compared with a market price of $10 in depressed conditions'.[92] This stood them in good stead for the Wall Street Crash. For those British investment trusts which did publish their holdings, allowing the market value of their portfolios to be calculated, it was estimated that, in 1928, 1933 and 1935 respectively, the premium of market value to book value (equal to the 'hidden' reserve) was +22%, -20% and –3% respectively.[93]

The world of British investment trust management was small. It was common for the same coterie of directors to sit on the boards of several investment trusts, with 'stables' of investment trusts being managed by a common management structure. Common management groups oversaw a number of different trusts – for example, by 1939 11 investment 'groups' included 100 investment trusts with share and debenture capital accounting for 60% of the total in issue, and by 1929, Robert Fleming was linked to 66 different trusts invested in a total of £114.8million.[94] Each individual British investment trust had only a handful of directors: The Independent Investment Company, floated in 1924, numbered only four directors other than John Maynard Keynes. By contrast, the American investment trusts had 'a board of 50 directors stretching from coast to coast'.[95]

A key difference between the British and American management structure was the role of those investment trust directors. In the US, investment trusts had managers as well as directors, with managers providing investment expertise. In the UK, directors, as well as providing respectability and conservatism, had a key management role. In Britain, it was traditional for the small number of directors to meet weekly or fortnightly[96] and to take investment decisions themselves, rather than allowing the managers to do so[97]. This policy was widespread in the investment industry in Britain with few managers and actuaries on the Boards of companies until well into the 1930s.[98] Indeed, Keynes, in his capacity of Chairman of a major insurance company, had considerable difficulty in persuading the directors to delegate investment decisions to a sub-committee of the Board, including the Chief Actuary. In reply to a suggestion in 1929 from Keynes that a finance sub-committee be allowed to take investment decisions, rather than the full Board, a board director, Mr Curzon, replied:

> In my opinion, the present system works well enough – after all, when the actuary or any director brings forward an investment on a Wednesday, it is almost certain that at least 2 or 3 members of the Board, constituted as ours is, have some special knowledge of it, and when they have not, the investment can always be turned down, or a decision deferred until further information is obtained.[99]

Keynes tried to argue for an informed and managerial approach to investment:

> There is already sufficient knowledge in the office to prevent any undue reliance on mere 'tips' and it would be foolish not to recognise that there do exist really authoritative sources of information in regard to almost all securities which it would be advantageous to know and to cultivate. In this connection, many members of the Board might be of great assistance if they felt sufficient confidence in the management to give the general manager or the actuary introductions to their friends.[100]

American authors Chamberlain and Hay commented admiringly that ordinary shareholders in British investment trusts elected their directors who 'assume a much greater moral responsibility and are called on for more realistic services than here'.[101] Investment decisions in British investment trusts relied on 'the personal judgements of the managers and directors, who … depend to a considerable extent on personal contacts and the advice of brokers … The operation of the law of averages is relied on to minimize the effect of mistaken judgments'.[102] American investment trusts were, in contrast, 'expertly staffed organizations, often of considerable size, to analyse and select securities for investment'.[103] 'That the British have not required comparable research staffs has been due in part to the more administrative part played by British directors, their more intimate knowledge of foreign conditions acquired by travel and commercial ties of long standing and to the small part played by common stocks in their investment portfolios'.[104] Instead of investing in a small number of common stocks of large corporations, the British invested in a large number of fixed interest securities around the globe. American investment trust managers were credited both with stock selection and with market timing skills. The British concept of just buying a large number of stocks as they were issued and holding them to maturity was considered 'plodding'. The Americans argued that 'superior management was a desirable substitute for diversification' with Leibson recommending 'a field staff of experts throughout the world'.[105] American investment managers were expected to buy and sell rather than just buy and hold: 'the investment trust manager who devotes his time to whether oils or motors are the more attractive group … is certainly performing one of the essential functions of management'.[106] However, in practice, in the face of the bull market of the late 1920s, the professional approach to investment and the search for undervalued securities took second place to the purchase of blue chips. As Graham and Dodd commented, after the Wall Street crash:

> Most paradoxical was the early abandonment of research and analysis in guiding investment trust policies. Investment had now become so beautifully simple that research was unnecessary and statistical analysis a mere encumbrance. Hence the sound policy was to buy what everyone else was buying … The man in the street, having been urged to entrust his funds to the superior skill of investment experts – for substantial compensation – was soon reassuringly told that the trusts would be careful to buy nothing except what the man in the street was buying himself.[107]

Costs were higher for American investment trusts than their British counterparts, both as a percentage of assets managed and of income.[108] This can be explained by the large staffs of 'experts' and the large Boards of Directors, as well as the heavy marketing costs involved in the mass marketing of investment trust shares. The initial flotation costs for a British investment trust were less than 5 per cent, compared with 8 to 9 per cent for their American counterparts. [109] Auditing fees and legal fees were 'absurdly cheap' in Britain, with the only people who were paid more than their American counterparts being the British directors.[110] Both British and American directors had shares in their trusts, but British directors typically had to pay for them 'at the going rate' and were as a consequence interested in 'steady growth' whereas American directors acquired them cheaply through bonus issues or stock options, encouraging a short-term approach. This labour-intensive and 'scientific' approach to investment analysis did not save the American investment trusts from losing heavily in the Crash, partly due to leverage, partly to the pyramid structure created by cross-holdings and valuing shares in the accounts at market value, and partly because analysis was rapidly abandoned in favour of following shares on their upward spiral, an early example of momentum investing.[111] 'Far from having learned the lesson of the Baring Crisis, it must be admitted that most American investment trust managers repeated all the mistakes of the British pioneers and even invented some new ones'.[112] As *The Economist* remarked, Leland Robinson, in promoting investment trusts as a diversification tool, had perhaps forgotten 'other features, like generous reserve accumulation, which British practice has shown to be of at least equal importance'.[113]

The rise of the unit trust

The direct result of the Wall Street crash was a collapse in the American investment trust market. So important had the sector become, and so great was the fall in value of investment trust shares, affecting millions of investors, that investment trusts were directly implicated as causing rather than being the victims of the Crash. A number of investigations into the workings of the investment trust industry were set up.[114] However, the need for diversified portfolios for small investors did not disappear. Promoters were more than happy to fill the gap. But they filled it with a new type of pooled investment vehicle, known as the 'fixed trust'. This was similar in structure to the Alexander Fund, although it had the specific characteristic of allowing management no investment discretion whatsoever. Fixed trusts were designed to restore faith in stock market investment for the small investor and were viewed as a major criticism of American investment trust managers:

> Provided we are allowed the premise that the American public is not absolutely financially illiterate, it is indisputable that the success in the sale of fixed trusts must stand as one of the bitterest indictments ever launched upon Wall Street. It audibly reverberates the unsavoury accusation "we will trust them only if their hands are tied".[115]

Fixed trusts were given a number of reassuring characteristics missing from conventional investment trusts, which were, in the early 1930s, in liquidation or trading at substantial discounts to net asset value. The portfolios of fixed trusts were fully disclosed to potential investors, exactly as the overseas government bonds had been in the case of Foreign and Colonial. There was to be no management of the portfolio, with managers expressly forbidden from buying any other shares, and only allowed place on cash deposit funds derived from the sale of bonus issues, "rights" or stock splits. Fixed trusts offered diversification, the original rationale behind the first investment trusts, but expressly no active management and no market timing or stock selection skills. There was no leverage, as in the early British investment trusts, with investors holding units invested in a diversified portfolio of stocks. Fixed trusts also had a pre-determined life as, long ago, had the Foreign and Colonial; for example, the North American Trust was to be dissolved at the end of 1953.[116] This was to allow for the fact that companies in which the trusts invested were not expected to have infinite lives, but rather to grow or die according to economic and industrial circumstances dictated. Importantly, the fixed trusts were open-ended mutual funds. Investors could buy and sell units as and when they wished, confident that they could trade at close to market value of the underlying portfolio, with no possibility of the massive discount to net asset or liquidating value of American investment trust shares post 1929, these discounts being seen as ‘evidence that investors feel that operating results after expenses have not been as satisfactory as returns from direct investment in common stocks’.[117] Demand for the fixed trusts was reflected in the number of units and the size of the trust, rather than in the discount or premium to net asset value.

Fixed trusts were highly successful with the American public - 150 American fixed trusts worth a total of $400 million were launched in the two years to March 1931, with the largest at $145 million.[118] A typical example was that of the North American Trust, which invested in four ordinary shares each of 28 large American corporations, from, in alphabetical order, American Telephone and Telegraph Company to The Texas Corporation. Such fixed trusts were marketed as giving access to the ‘pick’ of the contemporary market, with the companies chosen, by that stage, having an impressive pedigree in terms of longevity and dividend payments. Not surprisingly, only a limited number of common stocks satisfied the selection criteria, leading to a common core of equities in the fixed trusts. Since fixed trusts required that, if a company - as many did in 1932 and 1933 - passed its dividend, the shares would have to be sold, implying a forced sale in a bear market in company with all the other fixed trusts holding the same shares.

The Economist was critical of the new fixed American fixed trusts, arguing that, in Britain at least, with investment trusts having a good reputation, investors were happy for managers to actively manage portfolios and did not see any point in a pure passive investment strategy with high commissions.[119] It estimated costs for the investors in American fixed trusts to be an average of 9 per cent, exclusive of brokerage. *The Economist* also adopted the traditional British wariness as to the likely longevity of equity investments, arguing that the average British investor preferred to spread his risks across fixed interest securities as well as shares (as investment trusts had done), and that fixed trusts did not offer the same level of protection in the form of reserves.

It forecast that fixed trusts would not take off in Britain where ‘the Management Trust has had so successful a career’.[120]

Despite *The Economist’*s predictions, the first British fixed trust was set up in 1931, appropriately called The First British Fixed Trust. This adopted the American open-ended format and also chose a portfolio of purely British equities, an innovation compared to the relatively conservative investment strategy of investment trusts. It offered a yield of 6.79% on a portfolio of shares in 24 British companies compared with 4.34% then available on 2 ½% Consols. It too introduced rules as to how to deal with any changes in capital of the companies in which it invested, but allowed more flexibility than the American fixed trusts. For example, a share had to be sold if the net average earnings or the dividend fell below the previous five-year average. However, the high commissions were copied from the American fixed trust model, rather than the British investment trust model, with *The Economist* estimating total costs at around 9.4%.[121] The British retail investor responded positively to the fixed trust model, with the largest, The British Assets Trust, raising £7 million from 2600 shareholders in March 1933.[122]

Within a few years, the disadvantages of the fixed trust model became apparent on both sides of the Atlantic. With a high amount of corporate finance activity, such as bonus and rights issues, many fixed trusts accumulated large cash balances which they were not allowed to invest. Mergers and takeovers also created imbalances in the portfolios and the forced sale of certain companies, combined with the inability to sell shares which were likely to fall in value in the future, led to poor investment performance of the units. In 1934, the first British flexible unit trust was launched, and, from 1936, at which point the stock market had recovered to its 1929 high, only flexible unit trusts were created. [123] These flexible unit trusts introduced the idea of an ‘investment list’ of suitable equity investments, broader than the original investment portfolio, which investment managers or directors could buy or sell as they wished. Spare funds, whether reinvestments from existing investments or new monies, could be used to buy shares from this list. The success of flexible unit trusts in Britain can partly be explained by the recovery of the equity market in Britain quite soon after the Wall Street crash in 1929. By 1936, the stock market in Britain had recovered to its 1929 high; in the US, the market did not reach its 1929 high until

1953.[124] British investors seeking equity investment turned to flexible unit trusts. Investment trusts, eager to take advantage of the higher yields on offer for ordinary shares compared with fixed interest securities, also partly switched to equities. By 1935, a sample of 31 British investment trusts had 31.7% in equities, of which 22.9% were industrials.[125] Investment trusts offered the advantages of a long history, a wide spread of international investments, and a cautious approach to reserves. Unit trusts offered the advantages of a concentration on equities, transparency and no discount to net asset value.[126] Both investment trusts and unit trusts offered complementary forms of pooled investment to British investors.

The switch from fixed to flexible unit trust also took place in the US, with directors typically limited to a list of eligible companies as constituted from time to time by vote of the shareholders.[127] However, the reputation of investment trusts, which had also invested in domestic equities, and had had flexible portfolio strategies, was in ruins. American investment trusts tried a number of ways to reform, including a change of accounting policy: the exclusion of capital gains - and losses - from the income statement.[128] Developments, as far as investment trusts were concerned, were affected by the regulators who, after a number of investigations into the behaviour of investment trusts during the Wall Street boom and crash, passed the Revenue Act in 1936. This encouraged investment trusts to mutualise; if they did so, they were rewarded by exemption from federal taxes.[129] This Act was followed by the Investment Company Act of 1940 which strictly limited fund leverage, cross-holdings and imposed the Foreign and Colonial rule of a maximum of 10% in any one investment for all types of investment management company, whether open-end or investment trust – closed-end.[130] Although the American investment trust industry still exists today, it was effectively taken over by the open-ended mutual fund industry in the 1930s, a fate which did not befall the more conservatively run British investment trusts.

Conclusion

The different management styles of British and American investment trust managers reflected a different attitude to investment. By the 1920s, Americans were happy to invest in equities and were happy for fund managers to seek to achieve capital gain through leverage, market timing and 'expert' stock selection. In the UK, retail investors preferred the security of fixed interest securities and were content with a relatively low return in the form of income yield in return for safety through a conservative approach to reserves and an emphasis on a relatively passive investment strategy. British investment trust fund managers also learned useful lessons from the Baring crisis of 1890. This caution helped British investment trusts weather the Great Crash better than their American counterparts and, when open-ended trusts became popular in the 1930s, quickly preferred flexible to fixed trusts, having faith in their fund managers' diversfication skills with respect to equities as they had earlier in their diversification skills for fixed interest securities. British investment trusts continued to dominate British unit trusts by asset size for a further 30 years after the Crash - as late as 1962, 302 British investment trusts had funds valued at £2,360 million, compared with 54 unit trusts with assets of £257 million. By comparison, US investment trusts were overtaken by open-end funds in 1944. By 1960, the relative asset sizes were $17,026 million for open-end funds and $1,776 million for investment trusts.

Table 1

Foreign and Colonial Government Trust 1868 Schedule

	Description of Stock	**Amount of stock £**	**Two-hundredths**	**Mkt Price of Stock as % par**	**Price Paid as % par**	**Amount of purchase money £**		***Actual yield %***
1	Austrian 6 per cents	52,900	8	73.00	75.50	39939.50	4.0	*7.95%*
2	Austrian 5 per cents	88,200	12	65.50	68.00	59976.00	6.0	*7.35%*
3	Brazilian 5 per cents, 1865	46,800	7	72.25	74.75	34983.00	3.5	*6.69%*
4	Chilian 6 per cents	54,600	10	89.00	91.50	49959.00	5.0	*6.56%*
5	Chilian 7 per cents	50,200	10	97.00	99.50	49949.00	5.0	*7.04%*
6	Danubian 8 per cents	83,200	12	69.50	72.00	59904.00	6.0	*11.11%*
7	Egyptian 7 per cents	55,400	10	87.75	90.25	49998.50	5.0	*7.76%*
8	Egyptian Railway Loan, 7 per cent	53,300	10	91.25	93.75	49968.75	5.0	*7.47%*
9	Italian 5 per cents, 1861	201,000	20	47.25	49.75	99997.50	10.0	*10.05%*
10	New South Wales, 5 per cent	15,100	3	96.50	99.00	14949.00	1.5	*5.05%*
11	Nova Scotia 6 per cents	34,700	7	99.75	102.25	35480.75	3.5	*5.87%*
12	Peruvian 5 per cents	124,200	20	78.00	80.50	99981.00	10.0	*6.21%*
13	Portuguese 3 per cents	119,700	10	39.25	41.75	49974.75	5.0	*7.19%*
14	Russian Anglo Dutch Bonds, Fl. 1,070,000	90,682	16	85.75	88.25	80026.87	8.0	*5.67%*
15	Spanish new 3 per cents	259,590	20	36.00	38.50	99942.15	10.0	*7.79%*
16	Turkish 5 per cents	166,000	12	33.63	36.13	59967.50	6.0	*13.84%*
17	Turkish 6 per cents	69,200	8	55.25	57.75	39963.00	4.0	*10.39%*
18	United States 10/40 Bonds	36,225	5	66.38	68.88	24949.97	2.5	*7.26%*
						999910.2338		*Weighted*
							Weighte d Average	*Avge Yld 8.03%*

Table 2
Geographical split of British investment trust assets in percentage terms

	UK	**Empire**	**US**	**Latin America**	**Europe**	**Rest of World**	**Total**
1890	12.8	5.7	36.1	23.1	0	22.3	100
1929	41.5	12.6	7.3	16.5	15.8	6.3	100

Sample of 10 companies in 1890, 20 companies in 1929, book values of funds

Source: The Economist, 20 December, 1937, p. 365

[1] See the web page http://biz.yahoo.co/edu/mf/sm_mf9.sm.html

[2] The London Financial Association and the International Financial Society, both founded in London in 1863, were also aimed at financing industry and modelled on the Crédit Foncier of France. See, for

example, Y. Cassis, The emergence of a new financial institution: investment trusts in Britain, 1870-1939' in J. J. Van Helten and Y. Cassis, (eds.), *Capitalism in a Mature Economy: Financial Institutions, Capital Exports and British Industry 1870-1939*, (Aldershot, 1990), pp. 139-58.

[3] See

[4] See A. Scratchley, On Average Investment Trusts (London, 1875), p. 3.

[5] N. McKendrick and J. Newlands, F&C: *A History of Foreign & Colonial* (London, 1999), p. 26. The failure of the newly floated Overend, Gurney Bank in 1866 had led to a loss of confidence in the public company.

[6] Guildhall Library, MS 18000, File 1223.

[7] Ibid..

[8] The Times, 20 March, 1868, p.10.

[9] Scratchley, *On Average Investment* Trusts, pp. 52-3.

[10] *The Economist*, cited in McKendrick and Newlands, p. 37.

[11] Scratchley, *On Average Investment* Trusts,p. 16.

[12] McKendrick and Newlands, *Foreign and Colonial*, p. 42.

[13] Prospectus, Guildhall Library, MS18000, File 1223.

[14] Scratchley, *On Average Investment* Trusts, p. 16.

[15] Scratchley, *On Average Investment* Trusts,p. 4.

[16] Scratchley, *On Average Investment* Trusts,p. 6.

[17] Scratchley, *On Average Investment* Trusts,Title page.

[18] Prospectus, Guildhall Library, MS 14235, Share Investment Trust Minute Book, 6th annual meeting of Trustees.

[19] T. Balogh and E. Doblin, *Report on Investment Trusts in Great Britain*, Letter from the chairman of the SEC, 1939. British Library.

[20] Y. Cassis, 'Investment trusts in Britain, 1870-1939', p. 141.

[21] Scratchley, *On Average Investment* Trusts,p. 21.

[22] McKendrick and Newlands, *Foreign and Colonial* ,p. 50.

[23] McKendrick and Newlands, *Foreign and Colonial*, p. 42.

[24] McKendrick and Newlands, *Foreign and Colonial* , pp. 47-55.

[25] Prospectus, Guildhall Library, MS18000, File 1223.

[26] Scratchley, *On Average Investment* Trusts,p. 38.

[27]Scratchley, *On Average Investment* Trusts,. p. 30.

[28] Ibid.

[29] T. Balogh and E. Doblin, *Report on Investment Trusts in Great Britain*, Letter from the chairman of the SEC, 1939. US House Document, 76th Congress, 1st Session, No. 380.

[30] Scratchley, *On Average Investment* Trusts,p. 36.

[31] Ibid.

[32] *The Economist*, Investment Trust Supplement, 1937, p.2.

[33] Ibid.

[34] G. May, 'The Investment of Life Assurance Funds, *Journal of the Institute of Actuaries*, Vol. XLVI, 1912, p. 136.

[35] Guildhall Library, MS18000, File 202.

[36] McKendrick and Newlands, *Foreign and Colonial* , pp. 200-1.

[37] *The Investor's Monthly Manual*, March 1928, p. 127.

[38] *The Investor's Monthly Manual*, April 1925, p. 172.

[39] Balogh and Doblin, *Report on Investment Trusts in Great Britain*, p..

[40] Cassis, La City de Londres 1870-1914, Alencon, Belin, 1987, p. 110.

[41] *The Economist*, February 4 1893, p. 131.

[42] Cited in MkKendrick and Newlands, p. 65.

[43] Bankers Magazine, cited in Cassis, 'Investment trusts in Britain', p. 141.

[44] *The Economist*, May 23 1896, p. 653.

[45] *The Economist*, Investment Trust Supplement, 1937, p. 1. There is some disagreement as to the number of British investment trust companies in existence in the late nineteenth and early twentieth centuries. Balogh and Doblin, *Report on Investment Trusts in Great Britain*, cite 70 in 1900, 110 in 1920 and 210 in 1939.

[46] Cassis, 'Investment trusts in Britain', p. 143.

[47] Balogh and Doblin, *Report on Investment Trusts in Great Britain*, p. *.

[48] *The Economist*, Investment Trust Supplement, 1937, p. 2.

[49] Ibid.

[50] L. Chamberlain and W.W. Hay, *Investment and Speculation* (New York, 1931), p. 94 and Balogh and Doblin, *Investment trusts in Great Britain*, p. *.
[51] G.W. Dowrie and D.R.Fuller, *Investments*, Second Edition, 1950 (New York: John Wiley & Sons) , Chapter 16.
[52] H. Bullock, *The Story of Investment Companies*, (New York: Columbia University Press), 1959.
[53] Chamberlain and Hay, p. 107.
[54] M. Rottersman, The Early History of Mutual Funds, www.fundexpenses.com/root/data/Book/Early_History_of_Mutual_Funds.htm
[55] E.L. Smith, Common Stocks as Long-Term Investments (New York, 1924)
[56] Smith, Common Stocks as Long-Term Investments, p. 117.
[57] Leland R. Robinson, Wall Street Journal, 14 December, 1925.
[58] Cited in Rottersman, *The Early History of Mutual Funds*. Blue chips, as defined by B. Graham and D. Dodd, *Security Analysis*, 1934, p. 311, were 'a select list of highly popular and exceedingly expensive issues'. The term became commonly used in the Wall Street stock market boom of the late 1920s when such stocks were trading on high price-earnings multiples.
[59] I. Fisher, in North American Review, 1929, cited in H. Withers, The Quicksands of the City (London, 1930), p. 216.
[60] M.Williams, *Investment Trusts in America*, (New York: Macmillan) 1928, p. 6.
[61] Financial Chronicle, July 27 1928.
[62] Rottersman, p. 6.
[63] R. D. Kilborne, 'American Investment Trusts', *Harvard Business Review*, Vol. 3, No. 2, 1925, p. 167.
[64] J. Moody in the Preface to J. F. Fowler, *American Investment Trusts*, New York: Harper & Bros, 1928.
[65] Ibid.
[66] See McKendrick and Newlands, *Foreign and Colonial*, p. 87. The Edge Act was blamed for allowing the multiple leverage common to American investment trust structures of the 1920s. See T. Grayson, *Investment Trusts, their Origin, Development and Operation*, (New York: John Wiley & Sons), 1928.
[67] *The Times*, 3 September 1925, cited in H. Withers, *Hints about Investments*, 2nd edition, Eveleigh, Nash and Grayson, London, 1926, p. 239.
[68] Ibid.
[69] See, for example, Grayson, *Investment Trusts.*
[70] Chamberlain and Hay, *Investment and Speculation*, p. 107.
[71] Balogh and Doblin, *Report on Investment Trusts in Great Britain*, Part II, Chapter IV, p. 276..
[72] The Economist, 30 June 1931.
[73] Balogh and Doblin, *Report on Investment Trusts in Great Britain*, p. *.
[74] E. D. Allen, Study of a Group of American Management-Investment Companies, 1930-36, *The Journal of Business of the University of Chicago*, Vol. 11, No. 3 (July, 1938), pp. 235 and 245.
[75] Balogh and Doblin, *Report on Investment Trusts in Great Britain*, p. *.
[76] Balogh and Doblin, *Report on Investment Trusts in Great Britain*, p. *.
[77] For further discussion of this point, see C. R. Geisst, *Wall Street: A History*, New York, Oxford University Press, 1997, Chapters 4 and 5.
[78]
[79] Chamberlain and Hay, *Investment and Speculation*, p. 96.
[80] Allen, 'Study of American Management-Investment Companies', p. 244.
[81] Allen, 'Study of American Management-Investment Companies', p. 245.
[82] *A report on the origin, scope and conduct of the study, nature and classification of investment trusts and investment companies, and the origin of the investment trust and investment company movement in the United States:* Securities and Exchange Commission, US House document, 75th Congress, 3rd Session, No. 707, Report Part II, Chapter IV, p. 276.
[83] For a fuller discussion of this point, see J. Rutterford, From Dividend Yield to Discounted Cash Flow: a History of UK and US Equity Valuation Techniques, *Accounting, Business & Financial History*, Vol. 14, No. 2, July 2004, pp. 115-149.
[84] *The Investor's Monthly Manual*, May 1919, p. 235.
[85] Williams, *Investment Trusts in America*, p. 43.
[86] *Financial Chronicle*, 15 December 1928, p. 3301.
[87] Scratchley, *On Average Investment Trusts*,p. 6.
[88] R. Kilborne, 'American Investment Trusts', *Harvard Business Review*, Vol. 3, No. 2, 1925, p. 170.
[89] McKendrick and Newlands, *Foreign and Colonial*, p. 47.

[90] For a comparison of attitudes of American and British investors to income and capital gain in the nineteenth and twentieth centuries, see Rutterford, 'A History of Valuation 1790-1970'.
[91] Scratchley, *On Average Investment* Trusts,p. 37.
[92] Chamberlain and Hay, *Investment and Speculation,* , p. 122.
[93] Balogh and Doblin, *Report on Investment Trusts in Great Britain*, p. *.
[94] Balogh and Doblin, *Report on Investment Trusts in Great Britain,, p. ** and Cassis, 'Investment Trusts in Britain', p. 141.
[95] Bullock, *The Story of Investment Companies.*
[96] For example, The Share Investment Trust trustees in the 1870s, met monthly (Guildhall Library, MS 14235, Minute Book) and the Board of the National Mutual Assurance Company, which invested in bonds and in investment trusts, met weekly (Guildhall, Library, MS 34570).
[97] It was not until the 1930s that managers and actuaries were allowed onto the Boards of British investment trusts companies in any significant numbers. See Chamberlain and Hay, *Investment and Speculation,* Chapter XI,
[98] Cassis, 'Investment Trusts in Britain, p. 152.
[99] Guildhall Library, MS 34570, Board papers of National Mutual Assurance Company, Letter from Mr Curzon, 27 October, 1929.
[100] Guildhall Library, MS 34570, Board Papers of National Mutual Assurance Company, Memorandum from J. M. Keynes, 1930.
[101] Chamberlain and Hay, *Investment and Speculation,* 1, p. 98.
[102] Dowrie and Fuller, *Investments,* p. 244.
[103] Dowrie and Fuller, *Investments*, p. 246.
[104] Dowrie and Fuller, *Investments*, pp. 128-9.
[105] I. B. Leibson, *Investment Trusts – How and Why,* Boston: Financial Publishing Company, 1930.
[106] P.W. Garrett, Barron's Weekly, 31 August 1931.
[107] Graham and Dodd, *Security Analysis,* p. 311.
[108] Allen, 'Study of American Management-Investment Companies', pp. 242-3.
[109] Chamberlain and Hay, *Investment and Speculation,* 1931, p. 100.
[110] Ibid..
[111] Chamberlain and Hay, *Investment and Speculation*, p. 246.
[112] Chamberlain and Hay, *Investment and Speculation*, p. 126.
[113] *The Economist,* 21 March, 1931, p. 620.
[114] A substantial number of Reports were produced by the Securities and Exchange Commission as a result of these investigations, including Balogh and Doblin, *Report on Investment Trusts in Great Britain,* but also, *A report on the origin, scope and conduct of the study, nature and classification of investment trusts and investment companies, and the origin of the investment trust and investment company movement in the United States:* Securities and Exchange Commission, US House document, 75th Congress, 3rd Session, No. 707, and *Investment Trusts and Investment companies. Letter from the Chairman of the Securities and Exchange Commission transmitting a report on commingled or common trust funds administered by banks and trust companies*. US House document, 76th Congress, 2nd Session, no. 476.
[115] Standard Statistics, cited in Chamberlain and Hay, *Investment and Speculation,* p. 126.
[116] *The Economist*, 21 March, 1931, p. 620.
[117] Allen, 'Study of American Management-Investment Companies', p. 242.
[118] Ibid.
[119] *The Economist,* 21 March, 1931, p. 621.
[120] Ibid.
[121] *The Economist*, 2 May 1931, p. 950.
[122] Balogh and Doblin, p. 41.
[123] Although, by the outbreak of World War II, fixed trusts outnumbered flexible trusts in Britain. See H. Burton and D.C. Corner, *Investment and Unit Trusts in Britain and America* , London: Elek Books, 1970, pp. 254-5.
[124] See Rutterford, *A History of Valuation Techniques*, p. 135.
[125] Balogh and Doblin, *Report on Investment Trusts in Great Britain,* p. *.
[126] Unit trusts were required to disclose their portfolios unlike investment trusts. See Burton and Corner, *Investment and Unit Trusts..* It was not until the Companies Act 1948 that investment trusts were required to disclose net asset value, and even then it was only in a footnote to the balance sheet. See McKendrick and Newlands, *Foreign and* Colonial, p. 106 .

[127] Allen, 'Study of American Management-Investment Companies'p. 254. See also, A Report on fixed and semifixed investment trusts, Securities and Exchange Commission, US House Document, 76th Congress, 3rd Session, No. 567, 1940.

[128] Allen, 'Study of American Management-Investment Companies', p. 240.

[129] Allen, 'Study of American Management-Investment Companies', p. 253.

[130] For example, the Investment Company Act limits holdings in other investment companies to under 3% and allows bank borrowing only if senior securities have 300% asset coverage.