THE COLLECTED WRITINGS OF

JOHN MAYNARD KEYNES

VOLUME XII

ECONOMIC ARTICLES AND CORRESPONDENCE

INVESTMENT AND EDITORIAL

EDITED BY

DONALD MOGGRIDGE

Palgrave Macmillan

INVESTMENT POLICY AND INSURANCE

From the Nation and Athenæum, *2 May 1925*

AN AMERICAN STUDY OF SHARES VERSUS BONDS AS PERMANENT INVESTMENTS*

The author of this interesting little book set out on his inquiry with the idea that, whilst it was to be expected that an investor in common stocks would do better than an investor in bonds during a period of rising prices, yet the opposite would probably be true during a period of falling prices. To test this he embarked on a series of investigations to trace the history of the two classes of investments over different periods between 1866 and 1922, selecting his sample lists of securities by various objective tests, such as those which were most actively dealt in at the date of investment;—thus keeping to the best-known companies, in which an intelligent investor would have been most likely to invest at the dates in question, and avoiding any bias of the kind sometimes known in this country as 'jobbing backwards', that is to say, the selection of investments in the light of subsequent events.

The results are striking. Mr Smith finds in almost every case (in ten tests out of eleven), not only when prices were rising, but also when they were falling, that common stocks have turned out best in the long run, indeed, markedly so; whilst in the odd case there was not much to choose between the two. Having got so far, he applied a more rigorous criterion. Were the superior average results obtained at the cost of an inconvenient irregularity of income as between one year and another? On the contrary, he found that, even in the worst years, his index of ordinary shares gave, almost invariably, a better yield than his index of standard bonds.

This actual experience in the United States over the past fifty years affords *prima facie* evidence that the prejudice of investors and investing institutions in favour of bonds as being 'safe' and

* *Common Stocks as Long-Term Investments.* By Edgar Lawrence Smith. Pp. ix+129. (New York and London, Macmillan), 1925.

against common stocks as having, even the best of them, a 'speculative' flavour, has led to a relative over-valuation of bonds and under-valuation of common stocks.

It is dangerous, however, to apply to the future inductive arguments based on past experience, unless one can distinguish the broad reasons why past experience was what it was. Otherwise there is a danger of expecting results in the future which could only follow from the special conditions which have existed in the United States during the past fifty years. Mr Smith claims that the general causes for the relative advantages of common stocks are discoverable, and that they are of a kind as likely to operate in the immediate future as in the immediate past. I may summarise these causes, expressing some of them in my own way and some of them in his, as follows:—

(1) An investment in common stocks is an investment in real values. An investment in bonds is an investment in money values. Obviously there are advantages in the former, if the long-period trend of the value of money in terms of goods is downwards; and also contrariwise. Nevertheless, there is a presumption in favour of real values over money values: firstly, because the value of money can, in certain circumstances, fall indefinitely, as has happened in Europe since the War (and in the light of past history this is an appreciable risk against which it is worthwhile to be safeguarded), whereas a corresponding rise is out of the question; secondly, because, quite apart from catastrophes, the classes in the community who benefit from a falling value of money are stronger than those who benefit from a rising value,—'All lenders of money, particularly bondholders, favour an appreciating currency. No other class is always actively in favour of an appreciating currency. In theory they all believe in sound or stable currency, but each, in his efforts to widen the margin of profit that he makes in relation to profits in other lines, at times subscribes to activities which tend towards depreciation' (p. 88).

(2) Even in the most carefully selected list of bonds, one or other of them will occasionally go wrong. But whilst the possibility of default cannot be ruled out, no bond ever pays *more* than the stipulated rate of interest. Thus there can be no exceptional successes to average out with exceptional failures. The purchaser of a selection of common stocks can afford to make an occasional mistake; the purchaser of bonds cannot. In other words, the actual average return from bonds, after allowing for unavoidable losses, is always somewhat less than the apparent average rate of interest at the date of investment.

(3) The 'human factor' in the management of the companies concerned favours the shares. 'The management of every company is on the side of the common stock and opposed to the interests of the bondholders. The management does not want the bondholders to get more benefit from the operation of the company than is absolutely necessary to make it possible for the company to sell more bonds if such additional sale of bonds can be made to show a profit to the stockholders' (p. 85). In particular, the management will avail themselves of their rights to repay bonds at dates most advantageous to the shareholders and most disadvantageous to the bondholders.

(4) 'In buying bonds, the investor agrees that the issuing companies may retain all earnings over and above the income return which he has agreed to accept. He establishes no reserves of his own, and relinquishes all title to the reserves that are established for him. Such reserves, while protecting his income, accrue to the benefit of the stockholders of the companies whose bonds he holds. The purchaser of a bond is an investor, but he exercises none of the functions of investment management with regard to his invested funds. He pays the corporation which issues the bonds a substantial sum for exercising this function for him, and a survey of the prices at which bonds in different industries sell discloses the fact that he pays on the average more for this service in those industries whose stabilised earnings call

for the least responsibility on the part of the issuing companies' (pp. 114, 115).

(5) I have kept until last what is perhaps Mr Smith's most important, and is certainly his most novel, point. Well-managed industrial companies do not, as a rule, distribute to the shareholders the whole of their earned profits. In good years, if not in all years, they retain a part of their profits and put them back into the business. Thus *there is an element of compound interest* operating in favour of a sound industrial investment. Over a period of years, the real value of the property of a sound industrial is increasing at compound interest, quite apart from the dividends paid out to the shareholders. Thus whilst an index of bonds yields, as we have seen, *less* in the long run than its initial apparent rate of interest, an index of shares yields *more* in the long run than its initial apparent rate of interest. So far, therefore, from the higher apparent rate of interest on shares, as compared with that on bonds, being required to compensate the greater risk of loss, the reverse is true. Shares work out better than bonds by more than the difference between the apparent rates of interest upon each.

Mr Smith has made an estimate of what this element of compound interest has amounted to upon the average. He finds that over a long period the average rise in market value of typical common stocks is approximately equal to the value which would have accumulated on the assumption that the concerns set aside annually out of current profits a sum equal to $2\frac{1}{2}$ per cent of their capital, and retained these sums to fructify in the business. This figure is not inconsistent with what one knows as to the actual practice of conservative business. But the effect of this accumulation over a period of years is, like all compound interest effects, of startling magnitude. It is sufficient to recoup after a moderate interval even those investors in common stocks who were so imprudent or so unfortunate as to make their initial investment at the top of a boom.

Mr Smith applies one final test of comparative advantage which is the most overwhelming of all. He assumes that the ultra-prudent investor forms an investment reserve out of the surplus income of common stocks, as compared with that of an equal initial investment in bonds, regarding as income only that amount which he would have received from bonds and reinvesting the balance in additional shares. In this case the capital appreciation of his holding over a period of about twenty years varies from 104 per cent in the least favourable case to 355 per cent in the most favourable case—a calculation which certainly provides a big margin against the unexpected.

In working out his principles of investment, Mr Smith has not, particularly, in mind such institutions as insurance companies. Indeed, rather the contrary. He points out (p. 11) that, since the liabilities of an insurance company are fixed in terms of money, its criteria for safe investment must be somewhat different from those of other investors, and in particular that such a company has nothing to fear from the depreciation of money,—'The purchasing power of future dollars is of no concern to it. If dollars have shrunk in value, the beneficiary under its policies absorbs the shrinkage, the company does not.' This may have an important application to proprietary companies where the policyholders are not interested in profits. But its application to mutual life offices, for example, is, I think, very limited. In the case of these offices the object of the management must be to invest the funds to the best advantage of the members, subject to special care as to the absolute safety of the amount of the guaranteed policy. It would be poor consolation to the holder of a mutual with-profits policy, expressed in terms of francs, to know that the board have limited their attention to ensuring that he should receive at the maturity of his policy its full value in francs as stipulated before the War. If it is true that debentures are relatively over-valued, this is a conclusion of the highest interest and importance to those responsible for the investment of insurance funds.

It is unlucky for us in this country that Mr Smith's inquiry relates exclusively to American investments. It would be of great interest to know the results of a similar investigation applied to British investments. I have the impression that it might not turn out quite so favourably to ordinary shares, partly because our businesses have, for obvious reasons, not gone ahead at quite the same pace, and partly because American industrial concerns may have been rather more conservative than ours in the division of profits. I do not feel confident that the compound interest element would work out so high as $2\frac{1}{2}$ per cent per annum in the case of British ordinary shares. In any case, it is much to be hoped that the investigation will be made. It is not a particularly easy one to carry out. There is the initial difficulty of selecting a suitable index; and there is the recurrent difficulty of valuing bonus issues and other valuable 'rights', which are given to shareholders from time to time. Mr Smith puts emphasis on the importance of attending carefully to the latter, and points out that most charts of the values of ordinary shares over a long period are seriously vitiated on account of their compilers' slackness about this. But these difficulties are not insuperable, and the work would be of high educational value to anyone who aspires to understand ordinary shares. Will not the investment department of one of our great insurance companies put the work in hand? It is a task well adapted to the training and mentality of actuaries, and not less important, I fancy, to the future of the insurance industry than the further improvement of life tables.

From The Nation and Athenæum, *29 May 1926*

The Stock Exchange Official Intelligence for 1926. (London, Spottiswoode) 1926.

This splendid work of reference, produced under the sanction of the Committee of the Stock Exchange, has grown so fat that subscribers can now have it, if they like, in three volumes (for 12*s.* 6*d.* extra). The 450 new companies added this year would have brought it beyond 2,000 quarto pages, which must be