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RESEARCH REPORTS

THE BACKGROUND OF INVESTMENT

The Savings-Investment Process

The success of an investment policy, like that of most other human activities, rests on adherence to basic principles tested by long experience and their practical adaptation to existing circumstances. In a study of the background of investment, it is therefore necessary to examine the basic theory involved in the investment processes before dealing with the characteristics of specific investment opportunities.

The savings-investment process is essentially simple in theory, and any elementary textbook on the science of economics affords clear illustrations of the manner of occurrence. The individual who produces more than he consumes and manages to conserve the surplus possesses something tangible that represents his savings.¹ These savings are not ordinarily retained in the form in which they came into being. Savings, together with the products of labor that must be devoted to the needs of daily living, are received or converted immediately into some forms of paper promises to deliver goods or services at some future date.

In early times of rudimentary economic development, savings existed in forms that could be more easily viewed and their values assessed. For example, the chief wealth of nomadic peoples was invested in their flocks. These of course were subject to attack by the elements, by marauders, and by disease. Nevertheless, it was easy to understand that savings invested in the then current form benefited both the saver and society. They were invested in enterprises that provided the community with its food. Also, it was already becoming apparent that growth as well as preservation was an essential element in the investment of savings. The criterion of success of the times was the increase in the size of the flock.

When populations became stabilized, the excess fruits of the people's labor gradually took the form of land improvements, dwellings, and implements of trade. Even then, investments in the modern significance of the term did not exist. There was little absentee ownership, and the relatively few people who had savings in the form of wealth created by their own labor or by the labor of those from whom it was seized were able to watch over it and to see how it operated directly to bring them returns. Even after exchange media in

¹ From the viewpoint of the *individual*, savings may be acquired in other ways, such as increases in property values and other windfalls. See "Economic Principles and Problems," by Spahr and others. Vol. II, page 164.

the form of coins came into general use, many centuries passed before opportunities for investment developed, such as are now available.

The Development of the Money-Credit System

The creation of civilizations dependent on specialized individual occupations and the amassing of plants, machinery, and other capital goods for manufacturing standardized products would not have been possible under the primitive barter system. The development of acceptable exchange media and credit instruments constituted an essential step in the process of transition from primitive society to the complicated social organization of the present time.

The money-credit conveniences developed for the promotion of trade have grown more and more complicated. They have facilitated the creation and movement of goods and have contributed immeasurably to the flexibility of the economic system. Nevertheless, as these devices have grown more complicated, they have become subject to an increasing misunderstanding of their nature and functions, as well as more susceptible to abuse. Thus, the investor must at all times keep in mind the essential nature of the financial transactions in which he participates.

Financial transactions ordinarily involve paper records that are only the symbols of goods that have been or are being produced. Current money incomes ordinarily represent current production or value added to goods by services. Consumer durable goods, such as houses, and durable producers goods, such as factories, are normally represented by the records of savings institutions and individuals in the form of mortgages, mortgage bonds, stocks and other securities. Bank accounts and investments therefore include the records of current production and past production that has been saved and still exists in the form of usable products and other durable goods.

Opportunities for Abuse

Although the essential function of the commercial banking system is the facilitation of the flow of goods to market, these banks by accepting time deposits and acquiring investment-type assets have assumed a dual function. The effect of this dual function has been the creation of an opportunity to abuse the money-credit system by the injection into it of purchasing media that do not represent the production of an equivalent volume of goods and services.

It is through this and other similar devices that speculators and politicians have at regular intervals during the course of modern economic history persuaded many people that wealth can be created merely by financial manipulation. Only the familiar devices, such as those used by the professional legerdemain artists for directing the attention of the spectators away from the object being manipulated, could make the people forget that savings, investments, wealth must be usable goods of some kind and not just pieces of paper.

Investments in the present meaning of the word only came into being with the development of private group enterprises, such as the great trading companies organized in London, the canal and railroad companies in the United States, and the industrial corporations that have played the dominant role in making great the leading nations of the present time. The scientific progress of the past two centuries has made possible great savings that have in turn created further opportunities for the accumulation of aggregate wealth.¹

The employment of savings for the benefit of the individual investor and for society during the past few generations has not been accomplished without the accompaniment of inefficiencies and abuses. For example, a considerable portion of this Nation's annual savings is dissipated in business enterprises that are not economically justified or do not produce a sufficient volume of desired goods and services to return profits. These circumstances have furnished opportunities to politicians to attack the entire system that has made this growth in wealth possible.

The Private-Enterprise System

The attacks on the private-enterprise system that have been frequently encountered during the past decade suggest the importance of examining the social basis for privately owned investments. It is obvious that the existence of savings and in turn the functioning of the modern economic system are possible only because people have produced more goods than they have consumed. The advocates of socialistic forms of managed economy appear to believe that people would continue to produce more than they needed for their own requirements even if the surplus is confiscated by the State. Any student of human nature who adopts an objective attitude understands that personal aggrandizement is the primary motivating factor in human behavior and that incentives for extra production must be based on this truth. There have been a sufficient number of experiments in communities organized on socialistic lines to demonstrate that productive processes quickly break down when the profit motive is removed.

It is especially irritating to adherents to socialistic doctrines that investors should expect any return in the form of interest, dividends, and other income from the investment of their savings. They contend that possessors of wealth should be satisfied to preserve their assets in any convenient form that would entail the return of capital intact when it is needed. However, apart from the additional incentive to induce savings that returns on capital investments provide, the investment of savings in productive enterprise rather than in forms of hoarding is necessary in order to provide the maximum benefit both to savers and to society.

¹This development is described in "Capitalism, the Creator," by Carl Snyder, the Macmillan Company, 1940.

Future Investment Opportunities

Such social experiments as President Roosevelt's New Deal has had incorporated into Federal legislation during the past decade, together with utterances of some of this party's leading proponents, and such reports as that of the National Resources Planning Board recommending the permanent injection of Government into private business, have led discouraged investors into questioning the possibility of preserving private investments in any form. Before going to such an extreme of pessimism, it should be kept in mind that some form of capitalistic system is necessary to support the civilization that private enterprise has made possible. The alternative to private capitalism is a system of State capitalism, such as was tried and found unworkable in Russia. There is a large body of people in this country who have fought and stand ready to fight against the destruction of our Constitutional safeguards.

The shortcomings of socialistic policies that have been put into effect in the United States during the New Deal Era are gradually being revealed even to recipients of preferred treatment. It is possible that there will consequently be a reaction in popular political thinking and that a trend toward more conservative and orthodox economic policy is now developing. In spite of the threats of inflation, of higher taxation, and of some forms of confiscation, we cannot agree with the extreme pessimists who counsel individuals to squander their savings in despair of being able to preserve any of them through the difficult times ahead.

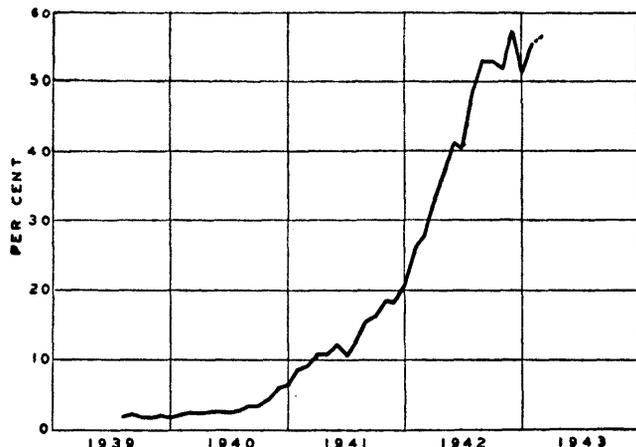
This does not mean that we are unaware of the extraordinary hazards that confront the investor at the present time. We believe that these very circumstances make it essential for individuals who have savings to adapt their programs to the changing circumstances. In the next discussion in this series, the various investment media now available will be considered with respect to their position in view of present-day economic trends.

Proportion of the National Economy Devoted to War Activities

It is impossible to measure accurately the extent to which the Nation's entire productive resources are devoted to waging war. Production for war activities is not shown separately from production for private use in data published by the United States Department of Commerce. Furthermore, the great diversity in the units of materials produced makes it impossible to derive a common denominator expressed in physical terms for the war effort. However, statistics expressed in dollars provide a rough measure of the extent to which the Nation's productive capacity has been diverted from peacetime utility to the creation of the means for waging war.

Expenditures for war activities expressed as a per cent of the Nation's total income payments (which include payments for war activities in the total) are plotted in a monthly series on the accompanying chart. The period covered begins in July 1939 just before the start of the war in Europe, and the latest point shown represents February 1943. Only preliminary estimates of income payments are available for the last month, although expenditures for war activities are known.

PER CENT OF TOTAL INCOME
FOR WAR ACTIVITIES



Within a period of about two years, the great resources of this Nation's economy have been so extensively mobilized for the prosecution of the war that more than half of all our activities are now being devoted to the major objective of winning the conflict. The rate of war spending increased most rapidly during the second half of 1941 and the first half of 1942. About August last year, the trend of the curve of per cent of total income for war activities began to fluctuate within a range between fifty and sixty per cent. According to statements published in England, this situation has existed in the British economic activity for more than two years. It is apparent that the Nation has about reached the practical limit of full economic mobilization for war.

The following statistical summary shows the expenditures for war activities for each month during 1942 and for the first two months of 1943, as reported by the United States Treasury. Estimates of total income payments made by the United States Department of Commerce are also shown. The income-payment figures for February are a preliminary estimate.

	Expenditures for War Activities	Income Payments
	(In Billions of Dollars)	
1942		
January	2,101	8,411
February	2,201	8,026
March	2,797	8,714
April	3,231	8,811
May	3,553	8,670
June	3,823	9,647
July	4,494	9,508
August	4,882	9,357
September	5,384	10,243
October	5,481	10,603
November	6,042	10,430
December	5,825	11,524
1943		
January	5,947	10,769
February	5,770	(Est.) 10,250

BUSINESS

Advertising in War Time

An article in the current issue of *Domestic Commerce*, published by the United States Department of Commerce,¹ describes the drastic restrictions on advertising

¹"Freedom of U. S. Advertising Accentuated by Australia's De-Glamorizing Edict," *Domestic Commerce*, March 11, 1943, pages 9-11.

imposed by the Australian Government. Restrictions apply primarily to rationed articles, and controls affect radio and billboard advertising, as well as periodical and direct-mail forms. The distribution of mail-order catalogs is forbidden within urban limits. Illustrations must be omitted from poster, newspaper, and periodical advertising, and "persuasive phrases" are not allowed to be used.

Fortunately, the article points out: "The over-all more favorable position of America in both rationed and nonrationed commodities bids fair to make unnecessary any such stringent advertising restrictions as those imposed on Australian businessmen." Although this statement is reassuring, it is sufficiently ambiguous as to suggest that the Government contemplates the imposition of less drastic restrictions on advertising in the United States. Retail merchants have generally been careful to conform to standards that are consistent with the war effort. Any departure from this policy would soon occasion admonitions, if not mandatory orders.

THE FUNDAMENTALS

Supply

The steel-ingot production rate was estimated to be 100½ per cent of theoretical capacity last week. This was one-half point higher than the rate that prevailed during the preceding three weeks. The approach of the April 1 deadline for settlement of the bituminous coal miners' agreement emphasizes the seriousness of a threat to the maintenance of the steel industry's present record high production schedules. Government authorities have cooperated with the steel companies in efforts to amass stocks of fuel, but reserves are reported to be smaller this year than they have been in former periods of strike threats. The consumption of coal at present operating rates is so great that a continuous flow to the mills is essential, inasmuch as substantial piles would quickly melt away if not replenished. It is obvious that the miners have a strong bargaining position.

	1929	1932	1937	1938	1942	1943
Per Cent of Capacity	94.5	25.0	89.0	33.0	97.0	100.5

(Latest 1943 weekly data; corresponding week earlier years)

Electric power generated last week exceeded output in the corresponding week of 1942 by 17½ per cent. The gain was the largest reported this year. The electric-power industry's record is fortunately refuting the contention of some Government authorities made before we entered the war that private power plants would be unable to meet the requirements of war production. Public utterances of some of the New Deal spokesmen indicate that the Administration would welcome an opportunity to nationalize the electric-power industry as an emergency measure. However, it is improbable that such action would be sanctioned by Congress so long as private industry is functioning satisfactorily.

	1929	1932	1937	1938	1942	1943
Billion Kilowatt-Hours	1.68	1.54	2.21	2.02	3.36	3.94

Lumber production decreased contraseasonally last week, and the adjusted index declined from 111.3 in the preceding week to 107.0. The Chamber of Commerce of the United States last week reported that a plan has been worked out between the Government and private

enterprise in the lumber industry offering an alternative to the Government's entry into the lumber business as a war measure. Under this program, the War Production Board will assist in locating and transporting labor to the lumber mills. This agency will list stumpage available for existing operations and direct the use of available species of lumber to achieve efficient use of supplies.

	1929	1932	1937	1938	1942	1943
New York Times Index	128.5	40.3	83.6	61.9	119.9	107.0

Demand

Last week, the dollar volume of department-store sales was three per cent greater than it was during the corresponding week of 1942. The average price of department-store merchandise is about three per cent higher than it was a year ago. Apparently the physical volume as well as the dollar total of sales was at about last year's level.

Prices

Prices of commodities quoted on the exchanges tended to decline early last week but subsequently moved upward. Moody's Spot Commodity Price Index was 247.3 on March 11 and 247.5 on March 18. The Dow-Jones Index of Commodity Futures closed at 91.71 on March 11 and at 91.66 on March 18.

FINANCE

New Capital Issues

The market for new capital issues recovered only slightly during February from the lethargy that has characterized it since September 1942. The total volume increased from \$3,000,000 in January to \$11,000,000 last month. In spite of this increase, the total appeared meager in comparison with the aggregate of \$57,000,000 represented by new capital issues during February 1942.

Most of the borrowing in February was done by the railroads (about \$8,000,000) and by the public utilities (\$2,500,000). The remainder, representing financing by industrial concerns, was so small as to suggest that private financing of war plants is no longer being undertaken.

Corporate financing in February and in the first two months of each year during the past eighteen years is shown in the accompanying summary.

NEW CORPORATE FINANCING IN THE UNITED STATES

Year	First Two Months		Year	First Two Months	
	February	Months		February	Months
	(In Millions of Dollars)			(In Millions of Dollars)	
1926	379	890	1935	7	12
1927	518	1,008	1936	14	86
1928	409	781	1937	155	251
1929	614	1,166	1938	41	87
1930	456	1,022	1939	24	29
1931	72	472	1940	45	81
1932	30	86	1941	47	99
1933	1	24	1942	57	130
1934	13	19	1943	11	14

Source: Commercial and Financial Chronicle.

March 15 Income-Tax Returns

Treasury officials estimated that 45,000,000 persons were obliged to make income-tax returns in accordance with the provisions of the Revenue Act of 1942. The proportion failing to make returns and delinquencies in first payments will not be known for several weeks, but enough data will probably be analyzed before the end of this month to provide the basis for a general estimate of the situation.

The Treasury's daily statement for March 15 showed that the Internal Revenue Collectors were able to deposit with the Federal Reserve Banks only \$250,000,000, compared with deposits of about \$400,000,000 made during the corresponding period of 1942. The tardiness of returns was attributed to uncertainty over Congressional action. Congressmen, as well as Treasury officials, will no doubt follow reports of income-tax receipts as they become available. In this connection, they will also be well-advised to observe the items in the public debt account that indicate sales of tax series notes and savings bonds as well as redemptions of these two series.

SECURITIES

Bonds

Average bond prices remained about unchanged last week, although there were wide fluctuations in individual railroad issues. The Dow-Jones average of 40 bonds was 94.23 on March 11 and 94.26 on March 18.

Stocks

The long-awaited Supreme Court decisions regarding the formulation of railroad-reorganization plans were delivered last week and upheld the position taken by the Interstate Commerce Commission. The immediate effect of the rulings is to support the status of senior railroad securities. Definite progress toward the completion of railroad reorganizations should now be expedited. Inasmuch as a substantial segment of the Nation's railroad system is affected by the proceedings (twenty-seven roads are in the process of reorganization), investors can look forward to opportunities for more definite appraisals of railroad-security values.

The trend of the stock market as a whole will be determined by other events of wider scope. Investors are now probably convinced of the certainty of a United Nation's victory, although the timing remains obscure. The major conflict seems to be joined between the forces engendered by inflation and the restraints of Government controls and taxation.

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