MARKETPLACE CLASSICS

THE ART OF SPECULATION

PHILIP L. CARRET

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BY
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BARRON'S
The National Financial Weekly

BOSTON NEW YORK PHILADELPHIA

1927

Marketplace Books
Columbia, Maryland

The Art of Speculation
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ISBN 1-59280-261-3
ISBN 978-1-59280-261-6

Printed in the United States of America.

1 2 3 4 5 6 7 8 9 0

Preface

The man who looks upon speculation as a possible means of avoiding work will get little benefit from this book. It is written rather for the man who is fascinated by the complexity of the forces which produce the ceaseless ebb and flow of security prices, who wishes to get a better understanding of them.

Successful speculation requires capital, courage and judgment. The speculator himself must supply all three. Natural good judgment is not enough. The speculator's judgment must be trained to understand the multitudinous facts of finance. It is the hope of the author that this book will be of assistance in this connection.

P. L. C.

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optimism, their naiveté—and eventually—exactly when they would panic and sell, or with what intensity the masses would cling to a stock like needles to a magnet.

But just like any great leader, a developed intuition is not the only making of success on the trading floor Successful leaders in any discipline—boardroom or battlefield—must have a complete knowledge of the intricacies of their business. They must know the history of their profession and most importantly, they must know the terms and tools of their trade. Carret makes this point often and he reviews the fundamentals of the core stockpile of the trader's arsenal: bonds, securities, derivatives, and stocks. This book doesn't miss a detail.

Warren Buffet, a man who many consider a virtual Patton of the financial battlefield, once said that Carret had the best record of any long term investing going. This is no slight praise, especially because he rode the financial catastrophe of 1929 in a manner unshaken by the banter of Wall Street critics and the downtrodden trader masses. Philip L. Carret loved to trade. It's as simple as that. You'll see his passion in every word of this book. He understood the prime factor in winning: keep your eyes on the prize. Sports players call it "the zone," and for him, it was his "money mind." Whatever the final phrase may be, this book will teach, elevate, and inspire.

Chapter I

What Is Speculation?

A treatise on investment needs no defence. Everyone who is not a socialist or communist realizes more or less vividly the vital part which capital plays in the modern world. It is readily admitted that the investor is entitled to a fair return for the use of the wealth accumulated by his self-denial. The average intelligent person recognizes fully the justice of permitting the hundreds of thousands of investors who make possible the unceasing growth of our telephone system a return, on the average, of 8% on their money. Such a person also recognizes the necessity of supporting the elaborate machinery which transmutes the hard-saved thousand dollars of a New York school-teacher into the equipment of a California hydro-electric plant. It is only the economically illiterate who regard bond salesmen, brokers and the other specialists of the financial world as "parasites" or "non-producers."

The case is different with speculation. It is by no means clear to the average man that the successful speculator contributes anything to the world's welfare by way of compensation for his financial gains. So far as he is personally familiar with speculative operations the average man sees more of losses than of gains. As there seems, on superficial consideration, to be no benefit to society from speculative operations, it is commonly believed that in speculation as in gambling the gains of the successful merely offset the losses of the unsuccessful. It is small wonder that Jay Gould, Daniel Drew and other noted speculators have never been popular figures.

A Flyer in Lumber

It is unfortunate that the word "speculation" immediately suggests the word "stocks" to most people. When his neighbors read in the local paper the income tax returns which show that Henry Robinson, the well known lumber dealer, paid a large sum to the public treasury last year, their natural comment is that Henry is a shrewd business man. It occurs to no one to say that Henry is a successful speculator, though the profits indicated by his income tax return may be due quite as much to a rise of $2 a thousand feet in the value of Henry's inventory as to his business acumen. In such a case a large part of the lumber dealer's profits are essentially speculative, though the speculation is incidental to his main business.

The "Dance of the Millions"

No profound research is necessary to indicate that this sort of speculation enters in very large degree into the operations of every business. On the rising sugar market that culminated with $22^1/_2$-cent sugar in 1920 it was literally impossible for any producer or refiner of sugar in the world to escape a fleeting prosperity. There resulted in Cuba the orgy of extravagance known as the "Dance of the Millions." In the debacle of 1921, with sugar at two cents a pound, it was quite as impossible for any sugar producer to make money. Such extremes as these are fortunately unusual, but fluctuations in the prices of every commodity are constantly occurring. In varying degrees every business man, whether he be a manufacturer of steel or the proprietor of a notion shop, is affected by price fluctuations of the things in which he deals.

Speculators by Necessity

It is a commonplace that the success of a cotton mill depends almost as much on the shrewdness with which its manager purchases his raw material as on the efficiency with which he operates his plant. The successful manufacturer of cotton textiles must then be to a considerable degree a successful speculator in raw cotton. If he buys cotton at the wrong time or fails to buy it at the right time, his profits will be small, or non-existent.

This is so much a matter of course that it is taken for granted, even by those who voice their disapproval of the speculator in stocks.

It will at once be suggested that there is a vital difference between the stock speculator and the business man. The latter, it will be said, is not a speculator by choice. Certain speculative risks are inherent in his business, and those he must minimize by the exercise of good judgment. They are incidental, however, to his main business. The textile manufacturer does not run a cotton mill as an excuse for speculating in cotton. He runs it to supply the world with cotton goods. The speculation is a necessary evil. The speculator in stocks, one may be told, has no such respectable excuse for his operations. He is merely a buyer and seller of intangibles which are not transformed in any way while in his possession. If the stocks he sells fall in price, he has merely enriched himself at the expense of the unlucky purchaser. If those he buys advance, no credit is due him for the fact. In fact, he is an idler who should be busy, a capitalist whose funds might more usefully be employed.

Familiar observation of the sources whence a stock broker's customers are drawn lends force to the indictment against the speculator. The lawyer whose partner neglects his practice to spend profitless hours poring over the quotations in the morning paper and haunting his broker's boardroom is one strong critic of stock speculation. The business man who has seen a promising subordinate lose interest in his job as he caught the fever of the ticker is another. Then there are the well known figures, whose origin no one seems to know, but whose authenticity no one questions, that 95% of traders in stocks lose money in the long run. These are readily available to the critics of stock speculation.

The Investor Must Speculate

Is there, however, no one to whom speculation in securities is as inevitable an accompaniment of his normal business as speculation in cotton to the textile manufacturer? There is! The investor is just as much a speculator by necessity as any business man. If he says proudly, "I never speculate," he is an ignorant speculator, and probably an unsuccessful one. Just as changes in commodity prices are constantly occurring with far-reaching effects on the fortunes of business men, so changes in security prices are likewise constantly occurring. The widow who bought 4% bonds at 95 in 1914 had an inkling of the truth when she asked her banker some time later to explain to her the phrase "yield to maturity." She was told that in addition to the $40 interest each year there was included in the return on her investment part of the $50 difference between the price she had paid and par, that her bonds were theoretically worth a little more each year as they approached maturity. "That sounds very well'" she commented, "but really they've gone down." Even in the highest-grade securities there is a certain inescapable speculative risk. It is not decreased by burying one's head in the sand like an ostrich and saying, "I never speculate !"

What the Dictionary Says

What, after all, is speculation? The redoubtable Webster gives a number of definitions. Among them we find (1) "mental view of anything in its various aspects; intellectual examination"; (2) "the act or practice of buying land or goods, etc., in expectation of a rise of price and of selling them at an advance." To the second he added the complacent observation that "a few men have been enriched but many have been ruined by speculation." According to Webster, the motive is the test by which we must distinguish between an investment and a speculative transaction. The man who bought United States Steel at 60 in 1915 in anticipation of selling at a profit is a speculator according to Webster, though he may have changed his mind about selling and added the stock to his list of permanent investments. On the other hand, the gentleman who bought American Telephone at 95 in 1921 to enjoy the dividend return of better than 8% is an investor, though he may have succumbed to the temptation of a 10-point profit a few weeks later. Although the outcome of the transaction may contradict the original intention of the party chiefly interested, it is obviously impossible to omit the factor of motive in defining speculation. For the purposes of these articles speculation may be defined as "the purchase or sale of securities or commodities in expectation of profiting by fluctuations in their prices." The purchase of a crate of eggs for the purpose of distributing them to the ultimate consumer a dozen at a time at a price a few cents higher is not speculation, though the merchant may derive a speculative profit if the egg market rises before the crate is sold. Neither is the purchase of a carload of eggs in June to be sold from storage in a carload lot in December speculation, though here again the fluctuations of the egg market vitally affect the profit involved. Pure speculation involves buying and selling in the same market without rendering any service in the way of distribution, storage or transportation.

Organized Markets

Though one may speculate in cheese, paper, coconut oil or almost any other imaginable commodity, the great bulk of speculation occurs in stocks and in commodities for which there are organized markets. The Chicago Board of Trade affords a market for the speculator in wheat, corn, oats, pork and other provisions, the Cotton Exchanges of New Orleans and New York a market for the cotton speculator, the New York Coffee and Sugar Exchange a market for trading in those commodities. To obviate the necessity of delivering huge quantities of goods or even warehouse receipts to the speculator, trading on these Exchanges takes the form of trading in contracts for future delivery. Since these contracts must be standard it is possible to organize Exchanges for trading only in commodities which may readily be graded. Such an important commodity as wool, for example, is not susceptible to such grading. There is, therefore, in the wool trade no counterpart of the Cotton Exchange.

Most important of the organized markets are the Stock Exchanges, headed by the New York Stock Exchange. More than a thousand stocks and an even greater number of bonds are listed on this greatest of organized securities markets. Other hundreds of securities are the subjects of trading on the New York Curb and the various provincial Exchanges. The strict rules of these Exchanges make certain requirements in the matter of publicity of the companies whose securities are listed, limit the commissions which their members may charge the trading public and in every way seek to foster the maintenance of a free and open market.

A Democratic Institution

The machinery of the Stock Exchange is available alike to the investor and the speculator. The broker neither knows nor cares into which category his customer falls. He knows, of course, whether his customer buys for cash or avails himself of the privilege of trading on margin, but even this distinction does not define the position of the customer. The purchaser for cash may buy primarily with an eye to enhancement in value, the buyer on margin may later pay the broker the debit balance, take up his stock and hold it permanently for income. One may safely assume that the man who buys nothing but high-grade bonds is primarily an investor, though even he must assume certain speculative risks. On the other hand, the margin trader who is constantly shifting his position in the market is certainly a speculator, if not a gambler. Between these two extremes are an infinite number of gradations, of buyers and sellers of securities whose motives are more or less mixed. It is quite impossible to draw a sharp line and say of those on the one side, "These are investors!" and of those on the other, "Those are speculators!"

Hope or Judgment?

The two dictionary definitions of speculation already noted are more closely allied than might appear at first glance. An "intellectual examination" of the circumstances surrounding the security or commodity in which he is to deal is the first step of the speculator. Let it be noted that Webster does not speak of the "hope" of a rise in price, but of its "expectation." The man who places $100 on "Spark Plug" at 1 to 10 odds may hope that the thoroughbred will be first at the finish. In dealing with anything so uncertain as horse flesh he can have no logical ground for expecting so happy an event. He is, therefore, a gambler and not a speculator. If this same individual buys 100 shares of Mack Trucks or any other stock on hope rather than on judgment, he is likewise a gambler. The fact that his purchase may have been stimulated by the perusal of a tipster's sheet or even the unintelligent reading of a reputable broker's market letter does not alter his status.

In fact, gambling is a common form of stock market activity. Those who decry stock market speculation usually have stock market gambling in mind. The speculators are those who use brains as well as ink in writing the order slips for their brokers. They perform a service of substantial value to society.

Advance Agent of the Investor

Just as water always seeks its level, answering the pull of gravity, so in the securities markets prices are always seeking a level of values. Speculation is the agency by which the adjustment is made. Has a new industry arisen, filling a new demand, adding new wealth to society, requiring new capital in generous volume? The alert speculator discovers it, buys its securities, advertises its prosperity to the investing public, and provides it with a new credit base. Is a once prosperous company falling upon evil days, its profits dwindling, its management declining in competence? The speculator is looking for such hidden weak spots in the market. He pounces upon it, advertises the difficulty on the stock ticker, and gives timely warning to the investor. In this fashion the speculator is the advance agent of the investor, seeking always to bring market prices into line with investment values, opening new reservoirs of capital to the growing enterprise, shutting off the supply from enterprises which have not profitably used that which they already possessed.

Increasing Marketability

One great benefit stock speculation and stock gambling alike confer upon the investor is increased marketability of his holdings. Other things being equal, the greater the number of people interested in a given security the better will be its market. Perhaps marketability may be defined as the ability of a security to maintain its price level in the face of an unusual volume of offerings. It is probable that the market for United States Steel common would yield less under the impact of a sudden offering of 10,000 shares than a gilt-edged well known railroad bond like Atchison general 4s under pressure of offering of a $1,000,000 block. This high degree of marketability for the stock is principally the result of speculative activity.

In his work of bringing prices into line with values, the speculator is psychologically akin to the investor who seeks to obtain a better than average return on his money. The intelligent investor who succeeds in this quest is sure to grow a crop of speculative profits. Being an investor by intent he may not be so quick to reap his harvest as the avowed speculator, but it is apparent that the successful investor differs from the intelligent speculator in degree rather than in kind.

Speculation and the Cost of Living

"It is easier to make money than to keep it" is the frequent plaint of the man who has made his "pile" and is somewhat bewildered as to the best means of preserving it. His problem is not made less difficult by the recent researches of such students of investment as Kenneth S. Van Strum, whose "Investing in Purchasing Power" first appeared in *Barron's*. This and other studies of the subject stress the necessity not only of maintaining intact the dollar value of an investment fund but of maintaining its purchasing power in the face of constant fluctuations in the cost of living. The traditional policy of making bonds and mortgages the exclusive vehicles of conservative investment has suffered a rude blow at the hands of these modern authorities. They insist that sound investment policy requires the inclusion of common stocks in any fund. A sustained advance in the cost of living will then be offset by a compensating rise in the value of and dividend income from these stocks. In other words, the conservative investor must give himself an opportunity to reap speculative profits if he would maintain the real as well as the nominal value of his fortune. By this doctrine the difficulty from a practical standpoint of differentiating between the investor and the speculator has once more been emphasized.

When the investor has fully grasped the point that he must buy with an eye to at least occasional speculative profit he is likely to go one step further. Both to protect himself against the rare casualties which occur even among "gilt-edged" securities and to protect the real value of his funds against possible increased living costs, the investor must purchase at least a portion of his securities with the expectation of profit. It will not be possible for him to reap profits which will exactly offset the occasional losses and the increased living cost. In the face of this impossibility he will naturally wish to err on the safe side, to produce some net gain in his fund over a period of years. He has now crossed the border line. In some degree he has surely become a speculator. The degree to which he will seek capital gains will depend in part upon temperament, in part upon the amount of time and effort he will be able to give to the study of security values.

The Road to Success

The road to success in speculation is the study of values. The successful speculator must purchase or hold securities which are selling for less than their real value, and avoid or sell securities which are selling for more than their real value. The successful investor must pursue exactly the same policy. The one seeks primarily the increased return over a period of years which may be expected from an undervalued as compared with a fully valued security; the other seeks primarily the capital gain which will accrue to him when the price of the undervalued security adjusts itself to the line of values.

The time requisite for the accomplishment of the adjustment of prices to values is a factor of great weight with the speculator. Here he parts company with the investor, to whom it is of little concern, while adding to the complexity of his problem. There are styles in securities as there are in clothes. A security may be undervalued, but if it is also out of style it is of little interest to the speculator. He is, therefore, compelled to study the psychology of the stock market as well as the elements of real value.

How Stocks Resemble Real Estate

Innumerable factors affect the value of securities. The amateur trader who expects to become a successful speculator will not find the study of values an elementary one. He will find it fascinating and profitable, however, as well as intricate. Essentially the determination of values in securities is a matter of comparison, just as it is in any other field. The competent real estate appraiser compares a given piece of property with others in the same neighborhood whose value he knows by recent sales. It is not exactly like any one of them, but by making proper allowance for the points of unlikeness the expert can make a reasonable estimate of its true value. In the securities market the competent trader similarly compares one security with others as nearly like it as he can find and allows for the unlikenesses and estimates a figure at which it should be selling. He is also vitally concerned with the trend of the general level of security prices. Here again he must determine the trend by a comparison of current conditions in the securities market with periods in the past when like conditions prevailed.

In a single chapter it would be impossible to discuss even the most important factors affecting the value of securities and the trend of the price movement. Perhaps enough has been said, however, to answer the question, "What is Speculation?" In fact, speculation is inseparable from investment. The investor must assume some degree of speculative risk, the intelligent investor will seek a certain measure of speculative profit. If he has the time, the temperament, the ability, the investor may go a step further and seek speculative profit in preference to dividend and interest income from his capital. In so doing he is performing a valuable service to the investor, acting as his advance agent in seeking the most profitable channels of investment, increasing the marketability of investment holdings, and helping to support the financial machinery which is designed primarily for the service of the investor.

Chapter II

The Machinery of Markets

Go into the financial district of any of the dozen largest cities of the country and look at the signs on the doors and windows which are visible to the passerby. Under the firm and corporate titles there will be seen a great variety of legends. "Members of the New York Stock Exchange" will be seen frequently. Among other descriptions will be found "Brokers," "Investment Securities," "Investment Bonds," "Bankers," "Dealers" and "Specialists" in securities of various types. Two firms which use exactly the same word or phrase to describe their business may actually be as far apart as the poles in the type of securities they handle, the quality of service they render their customers. The multitude of firms who thus offer their services to the investor or speculator are a part of the great machinery of investment and speculation which distributes $6,000,000,000 annual savings of the American people into more or less profitable channels and maintains a market for the still greater billions of securities already outstanding. So complex is this machinery, so numerous its possible points of contact with the individual, that it is not surprising that blind chance rather than intelligent choice most frequently determines into which door the individual with ready money shall turn his steps.

The Glorified Errand-Boy

Generally speaking those who deal in securities may be divided into two classes: merchants, or so-called investment bankers, and brokers. Firms of the former type buy securities on their own account in large blocks and resell them to the investing public in smaller amounts. Fundamentally this is exactly the same type of business as that of the corner grocer who buys sugar by the barrel and retails it in five-pound lots. The broker renders an entirely distinct type of service. He is a sort of glorified errand-boy. On receiving a buying or selling order from a customer he seeks to find a buyer or a seller at the most advantageous price to his customer. For this service he receives a small commission. In relation to the amount of money involved in the transaction the broker's commission is usually only a small fraction of the profit legitimately taken by the investment banker. Despite the fact that the functions of broker and investment banker are distinct, many firms are engaged in both types of business. The leading firm of brokers in the country is also active in merchandising securities, both bonds and stocks. One of the leading bond houses of the country has an active stock department which will execute orders on a commission basis in any of the leading markets.

Merchant Bankers

The merchants of securities are for the most part bond houses. The long-term loans which our cities, towns, counties and states, our railroads, public utility and industrial corporations raise are almost invariably obtained by the process of selling bond issues to the great merchant bankers of the country. Stock issues are seldom created in this way, rarely distributed to the investing public in the same manner as bonds. A large number of investment banking houses consequently deal exclusively in bonds and there are hundreds specializing in one or another type of bond, as in municipals, in real estate mortgage bonds, or in public utilities. The bond houses send out thousands of salesmen to seek out investors in their homes, shops and offices, to sell securities which they have bought and must resell at a profit. Such salesmen, and the firms they represent, are primarily interested only in the securities which they have purchased. They are not likely to have detailed knowledge of or, informed opinion about other securities.

The Amateur in Bonds

Bond houses are concerned little or not at all with the speculator. The securities they offer carry for the most part a fixed return and afford little opportunity for capital appreciation. It may sometimes happen in an advancing bond market that an issue of bonds will be received with such enthusiasm that the market price will immediately advance two or three points. The investor who habitually takes his small profit in such cases is not regarded as a desirable customer by the bond houses. They prefer customers who buy bonds for income and usually hold them more or less permanently. The man who buys bonds for a quick profit is dubbed a "rider." He seldom makes any substantial profits by such trading and usually places himself in a position where he cannot expect favors from any of the houses with whom he deals. Speculative operations of this character are typical of the amateur bond buyer who has acquired just sufficient smattering of bond lore to fancy himself a professional.

Stock Financing

The average bond house handles an occasional issue of preferred stock as well as the senior type of security. Preferred stock issues are created and sold in the same manner as bonds by companies which wish to raise new capital. In order to maintain a strong capital structure the growing corporation which must look to the public for new capital is compelled to sell a certain amount of stock, common or preferred, to support its growing funded debt structure. In recent years the public utility companies have found it possible in many cases to sell their own stock directly to their customers, maintaining permanent departments for handling such flotations. A company which needed new capital only at occasional long intervals could obviously not afford to use anything other than the conventional method for disposing of its stock.

Common stock equities, particularly in the case of industrial companies, are ordinarily built up by the continual reinvestment in the business of surplus earnings. The company which finances its capital requirements by the sale of common stock is the exception rather than the rule. The unusually successful company, such as American Telephone & Telegraph, is able to do so, but this sort of financing is far from common. When it does occur the offering of stock is usually made direct by the company to its existing stockholders rather than to the general public. An offering of this sort may be underwritten by investment bankers, who agree for a small commission to take any stock not subscribed by stockholders.

How Common Stock Issues Originate

The sale of a large block of common stock by a firm of investment bankers usually results from the disposal by the dominant interests in a company of all or a part of their stock. An individual who has built up a successful business may wish to retire and put his estate in more liquid form through reinvestment in diversified securities. A large corporation may sell the stock of a prosperous subsidiary whose control is no longer essential to the parent company. The recent sale to the public of a large block of stock of the National Cash Register Co. is a concrete example of the first type mentioned. A year or two ago a large block of stock of the Eastman Kodak Co. was sold by the educational institutions which had acquired it as a gift from Mr. Eastman and offered to the public by banking houses. Usually firms which are engaged in business both as brokers and as bankers make such offerings.

Organized Markets

Besides the firms which acquire securities—bonds or stocks—in wholesale lots and retail them to their customers, there are a great many firms which serve exclusively as brokers. The bulk of these firms are members of one or more of the organized Stock Exchanges of the country, chief of which is the New York Stock Exchange. Besides the premier Stock Exchange of the country, the New York Curb provides an organized market for an ever-growing list of securities, and in all the other important cities from Boston to San Francisco there are Exchanges of greater or less importance. By far the greatest volume of speculation in securities occurs in the form of trades made on the floors of these Stock Exchanges.

Under the Buttonwood Tree

The New York Stock Exchange proudly traces its history back almost to the American Revolution. Like every other war, that struggle was followed by the funding of the national debt. In this case $80,000,000 in 6% stock was issued and absorbed by the investing public. The close of the war was also speedily followed by the organization of banks, both in Philadelphia and in New York. Inevitably a market for government securities and for bank stocks was created and a number of individuals were soon making their living by acting as brokers for the buyers and sellers of these securities. By some accident of chance they formed the habit of meeting under an old buttonwood tree which stood at what is now 68 Wall Street. Doubtless some among them were tempted to seek business by cutting the commissions charged their patrons to an unremuneratively low level. Whatever the cause they were impelled to form some crude sort of organization. Accordingly on May 17, 1792, twenty-four of them signed the following agreement:

> We, the Subscribers, Brokers for the purchase and sale of Public Stock, do hereby solemnly promise and pledge ourselves to each other that we will not buy or sell, from this day, for any person whatsoever, any kind of public stock at a less rate than one quarter per cent, commission on the special value, and that we will give preference to each other in our negotiations.

From this small beginning, progress was for many years slow. Not for twenty-five years did the member brokers find it necessary to provide a roof over their heads. Of the early years of the Stock Exchange but meager records remain. The infant institution seems to have occupied many quarters, including at one time following a fire temporary refuge in a hayloft. The great institution whose marble palace towers aloft at Broad and Wall streets, upon whose floor billions in securities change hands each month is thus after all of humble origin. Its growth has been an inevitable consequence of the growth of the United States. Such a free market as it provides for instruments of credit and of ownership is an absolute necessity to modern civilization.

A Strict Code of Ethics

On reading the original agreement of organization of the Stock Exchange, it appears that two motives actuated its founders, protecting their scale of commissions and guarding against competition from outside their membership. The elaborate constitution of today likewise fixes a scale of commissions and in effect secures to members a monopoly of dealing in securities admitted to trading on its floor. In line with modern business practice it is also largely concerned with protecting the interests of the customers of member brokers. Probably no business today is conducted on a higher plane of ethics than that of the members of the New York Stock Exchange.

Perhaps the Stock Exchange may logically be regarded either as a trade union or as a private club. The latter is the usual simile.

The Exchange is an association of 1100 members. It furnishes the mechanical facilities for the transaction of their business and prescribes high standards for their business conduct toward one another. An additional professed object is "to promote and inculcate just and equitable principles of trade and business." A governing committee with despotic powers and various subsidiary committees control the government of the Exchange. A member found by a majority of the governing committee guilty of a wilful violation of the constitution or of any resolution of the governing committee or of any conduct "inconsistent with just and equitable principles of trade" may be suspended or expelled. Not only is a misdemeanor on the part of any member visited with swift and severe punishment but the Stock Exchange authorities are equally swift to take any action necessary to maintain the Exchange as a free and open market. If some misguided individual attempts to corner a listed stock, he may suddenly find himself with no market for his holdings as a result of action of the governors in suspending trading in the issue. There have been one or two occasions of extreme crisis when the Stock Exchange itself was suspended, notably for several months following the outbreak of the war in 1914.

Broker Starts in Business

A broker who wishes to become a member of the Stock Exchange must first purchase a "seat" from some retiring member at a figure ranging up to $150,000, depending on market conditions. He must then convince two-thirds of the committee on admissions that he is a citizen of high character and otherwise eligible. Having passed these tests he may now put the legend "Members of the New York Stock Exchange" under the firm name on his office door or window. He has now the right to go upon the floor of the Exchange to execute the orders of his customers. In case he finds it to his advantage to seek orders rather than to execute them he may instead handle all his customers' orders through a "two-dollar broker." The latter is a broker who executes orders for other members, charging them a fraction of the commission paid by the non-member customer with whom the transaction originated.

The Broker's First Order

Let us suppose that J. Madison & Co. have just become members of the Stock Exchange through the election of James Madison. He is now upon the floor of the Exchange when the firm's first customer enters the office and gives an order for the purchase of 100 shares of Atchison. The order is immediately transmitted by private wire to the firm's telephone booth on the edge of the floor. The telephone clerk has Mr. Madison's number flashed on the two annunciator boards on the wall and the broker hastens to the booth and gets the order. Next he goes to the Atchison post. He may find there another broker with a selling order or he may purchase from the specialist in Atchison. If the order is limited by his customer at a price some distance away from the market at the moment, Mr. Madison may leave the order with the specialist, who enters it in his book and ultimately executes it in the role of a two-dollar broker. The specialist is a dealer in Atchison and perhaps in several other stocks dealt in at that post. He may either buy or sell for small profits on his own account or act as a two-dollar broker. Orders given him for execution in the latter capacity take precedence under Stock Exchange rules over his own trades and he is also forbidden to make both a dealer's profit and a commission on the same transaction. The existence of the specialist assures the maintenance of a continuous market in each listed security.

Handling an Odd Lot

The next order received by J. Madison & Co. may be for the sale of 25 shares of General Electric. This order is promptly relayed by the telephone clerk at the edge of the floor to the representative at the General Electric post of the odd-lot house with which J. Madison & Co. deals. There are a number of such odd-lot houses, which stand ready at all times to buy or sell any odd lot—less than 100 shares—of any stock. If the next sale of General Electric is at 82, the odd-lot house will take the 25 shares at $81^7/_8$. The eighth—increased to a quarter or more in the case of higher-priced or less active stocks—compensates the odd-lot house for the risk that by the time it has purchased in this way 100 shares the market may have declined below this purchase price. Thanks to the odd-lot houses, the small investor or trader is able to buy or sell listed stocks at a minimum disadvantage as compared with the customer whose orders are for a 100-share lot. Odd-lot trading is an important factor in broadening and stabilizing the market for listed stocks, contributing a large part of the total volume of business. Mechanical limitations forbid the reporting of odd-lot transactions by the stock ticker, which is barely able in an active market to handle the transactions in round lots.

In the case of the 100-share purchase of Atchison the seller may be neither the specialist nor another commission broker but a floor trader. Such a trader is a member of the Stock Exchange who trades for his own account, seeking only small, quick profits. He roams the floor ever on the alert for opportunities for a "turn." Stock transfer taxes are a serious handicap to the floor trader. On each sale of 100 shares of $100 par value the state and federal governments levy a tax of $4. A gross profit of ⅛ on 100 shares thus becomes a net profit of $8.50, while a loss of ⅛ is equal to a loss of $16.50. Barely to break even the floor trader must thus be right in his judgment on two out of three trades. Before the imposition of these taxes there were upward of 200 floor traders, but today the number is greatly reduced.

Strict Delivery Rules

When James Madison has purchased a block of stock for a customer from another commission-house broker, from the specialist in the stock, from a floor trader, from an odd-lot house or through a two-dollar broker there is still much to be done before the transaction is completed. The next step is delivery. Under the rules of the Stock Exchange the seller must deliver the stock to the purchaser by 2 p. m. on the following day. This is "regular" delivery. The buyer and seller may contract otherwise. An investor in California with his securities in a San Francisco safe-deposit box obviously cannot make delivery on the day following the sale. Possibly the New York office of his broker may have sufficient of the stock in its possession on behalf of other customers to make delivery, borrowing enough stock temporarily from other accounts pending arrival of the western customer's certificates. If this arrangement is not feasible, the sale may be made "seller 7 days," giving the seller the extra time in which to get his stock to New York. The price will obviously differ somewhat from the price for regular delivery. In the case of a sale for regular delivery the purchaser has the right to buy in the stock "under the rule" if the stock is not forthcoming on time. Traders who sold Northern Pacific against expected later delivery from European holders in the famous corner of 1901 received an expensive lesson in the rigidity of the Stock Exchange's delivery rule.

Clearing Stock Transactions

To minimize the actual labor in delivering certificates of stock following transactions on the floor of the Stock Exchange in 1892 organized a system of clearances. All the most active listed stocks are cleared for members by the Stock Clearing Corporation. Suppose J. Madison & Co. sold 300 shares of U. S. Steel to John Q. Adams & Co. while the latter firm had sold 300 shares to B. Franklin & Co. Each firm would send the clearing corporation at the end of the day a deliver ticket for each block of stock it had sold and a receive ticket for each lot it had purchased. The deliver ticket would order the clearing corporation to deliver stock to the purchaser for account of the seller, the receive ticket would order the clearing corporation to obtain stock from the seller for account of the purchaser. On comparison of the tickets received from all clearing members it would be found that many could be canceled. In the instance given the clearing corporation would direct J. Madison & Co. to deliver the 300 shares of Steel to B. Franklin & Co. direct, thus saving one delivery which would be necessary without a clearing system.

The Board and the Ticker

Having described very sketchily what takes place on the floor of the Stock Exchange and how deliveries between brokers are effected, let us return to the broker's office. The average customer seldom understands the complicated mechanics behind the scenes. In the typical broker's office will be found a board-room with a large black-board on which transactions in leading stocks are posted. A clerk stands at a ticker, which prints on a strip of paper transactions in stocks as they occur on the floor of the Stock Exchange. He reads off transactions in leading stocks and boys post the latest prices on the board. The customers standing in front of the board have at any time a history of the market for leading issues for the day, opening, high, low and latest quotations of the stocks quoted. The board shows the daily history of the market, the ticker itself a picture of the market at the moment. So speedy are executions on the floor of the Stock Exchange, so perfect the reporting system, that a trader in a distant city may under normal conditions put in an order, receive a confirmation of its execution and watch the report printed on the ticker, all within two minutes. Unfortunately the rapid increase in the number of stocks listed and the growth in the volume of trading has outstripped the ability of the ticker to report in active markets. On such a day as March 2, 1926, when an avalanche of stocks were sold in a frenzy of liquidation, the ticker may sometimes be fifteen or twenty minutes behind the actual market. Under such conditions the trader may by no means be sure that his order will be executed within a fraction of the price quoted on the ticker at the moment of giving it.

Trading on Margin

The customer who gives an order for the purchase of 100 shares of Steel may be a cash customer, but it is more likely that he is buying on credit. In certain unenlightened sections of public opinion it is regarded as a reproach to a man that he trades in securities on margin. It is unfortunate that the word is used only in connection with securities. One never says that a man has bought a house, a car, a radio set on margin. The use of credit in the case of such forms of wealth differs not at all fundamentally from the use of credit in connection with the purchase of securities. In each case an initial cash deposit is required. With such rapidly depreciating forms of wealth as cars and radio sets repayment in full of the loan made to the buyer by the seller must be made by installments. A house is a more permanent form of wealth and a mortgage for a moderate proportion of its value may run indefinitely. When securities are bought on credit the broker merely requires that the margin between their value and his loan shall be kept good.

Fraudulent vendors of worthless securities frequently preach eloquent sermons against margin trading. With the unsophisticated, who confuse speculation with gambling, such sermons make a favorable impression. From the promoter's standpoint their importance lies in the fact that the stocks he is attempting to sell would not be accepted as collateral by any responsible bank or broker.

The trader who buys 100 shares of Steel at 125 as his first purchase must first have deposited a minimum sum of probably $1500 with his broker as margin. Disregarding commissions he then owes a balance of $11,000, which is supplied by his broker. The latter in turn has probably borrowed $10,000 of his bank. He will charge his customer a slightly higher rate than he pays on his bank borrowings, thus earning something on the interest account as well as by commissions. Since the broker's requirements of bank accommodation are widely fluctuating he obtains the greater part of it by demand or call loans, renewed daily. The call-loan renewal rate is published daily on the stock ticker and is one of the interesting indices of the market's technical condition watched closely by traders. Collateral loans on Stock Exchange securities are practically risk-proof and hence are utilized by banks throughout the country as a medium for the investment of their surplus funds. Though call loans provide the bulk of the sinews of speculation a considerable volume of funds is borrowed on time. The term of such loans may be sixty days or six months.

Over-the-Counter Trading

The catalogue of dealers in securities is by no means completed with a brief discussion of investment bankers and Stock Exchange firms. The thousands of stocks and bonds listed on the leading Stock Exchanges of the country are outnumbered many times over by unlisted securities which are more or less widely held by investors. Just as there are brokers who deal only or principally in listed securities so there are brokers and dealers in unlisted securities. In any financial publication the reader will notice the advertisements of such brokers in the form of long lists of stocks wanted and stocks offered. If a certain broker lists among his offerings the stock of the Continental Gadget Co., it may indicate that he is seeking a market for a customer or that he is offering stock on his own account. The investor or trader in unlisted securities should remember that the dealers and brokers are not governed in their transactions by any such rigid rules as those of the New York Stock Exchange. They seek to buy cheap and sell dear. Neither their profits nor commissions are limited by anything except their consciences and competition. In the unlisted market there is no Continental Gadget post beneath which all transactions in that stock are made under the scrutiny of a hundred eyes. *Caveat emptor* is the rule in the unlisted market.

The dealer in unlisted securities seeks to make an honest commission or profit where he can. The telephone is his principal tool. He is constantly checking the market for securities in which he is dealing by seeking quotations from other dealers. If he finds that one broker will supply him with Continental Gadget at 81 while another will take it at 82, the situation is meat and drink to him. It may sometimes happen that a broker in New York will be buying stock from a Philadelphia broker and selling it to another Philadelphia broker in the very same building at a profit. The average investor is at something of a disadvantage in dealing with so shrewd and nimble-witted a specialist, particularly if he is not a regular customer. At the same time the investor or speculator should learn to trade in the unlisted market, if only for the reason that its very obscurity often conceals genuine bargains.

The Stock Auctions

In New York, Boston and Philadelphia the auctions provide a public market for the unlisted securities which is of some importance. These auctions are usually held weekly. Odd lots of local unlisted stocks usually provide the bulk of the trading. The auctions are also a convenient dumping ground for obscure and frequently almost worthless issues when an estate is being settled. Sometimes a long list of such securities will be offered "in one lot." The auctions attract bargain-hunters who frequently find wheat among the chaff. Occasionally such a trader will buy for five or ten dollars securities which turn out to be worth thousands thereafter. In the case of well known unlisted stocks the auction prices provide a good check on the quotations of dealers.

How to Find a Reliable Broker

The great majority of the reputable investment bankers of the country are members of the Investment Bankers Association of America. Membership in this body is no such guaranty of reliability as membership in the New York Stock Exchange, but it does carry assurance that a firm has reasonably adequate capital, has been in business at least two years, bears a good reputation with its competitors. The investor is justified in making searching inquiry as to why a particular firm of investment bankers is not a member of this body. In the case of the speculator in listed securities, membership in the New York Stock Exchange may well be demanded of his broker. Under the rules of that organization members may not split their commissions with non-members. There is thus no legitimate way in which a non-member firm can profit by specializing in listed stocks. A member of an out-of-town Stock Exchange may make a reciprocal arrangement with a New York Stock Exchange firm by which he will give them all his customers' business on that board in exchange for all their customers' business on the local board. Any reputable firm will get an order in a listed stock executed as an accommodation for a customer. The firm which goes after business in listed stocks but is not a member of any Stock Exchange is a firm without visible means of support. Like a man without visible means of support, such a firm is the legitimate object of suspicion. If the amateur speculator learns nothing else of the machinery of speculation, let him at least learn enough about classifying brokers and investment bankers so that he will not be caught in the failure of a bucket-shop.