The early managed fund industry: investment trusts in 19th century Britain

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Abstract

The early years of the 21st century have been a difficult and challenging time for the managed funds industry. The neglected history of managed funds reveals prior episodes of sustained growth, questionable practices, upheaval and inevitably, regulation. The first fully diversified managed fund appeared in Britain in 1868, and the industry remained largely a British preserve until the rise of the investment company and the mutual fund in the United States during the 1920s. This paper documents the features of the early trusts, discusses the rise of the industry and the challenges it survived in the early years, and draws parallels with facets of the finance industry of today.

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1. Introduction

The early years of the 21st century are proving to be a difficult time for the managed funds industry. Assets under management have declined due to the prolonged bear market in world equity markets from 2000 to early 2003. Many investors responded by switching into 'safer' assets such as bonds and property, and to alternative collective investment schemes such as hedge funds. Fund managers responded by raising their fees. The General Accounting Office estimates that the largest mutual fund managers in the United States raised their fees by an average of 11 percent from 1999 to 2001. This hike in fees is on top of a longer-term trend in mutual fund participation. Since the 1950s, the average holding period for mutual fund investors has declined from 16 to 2½ years. The result is that fees are increasingly eroding returns to investors. Between 1984 and 2001, mutual fund investors made annual after-fee returns of 4.2 percent, compared to 11.5 percent for the S&P 500 (*Fortune*, 20th January 2003). Many in the industry recognize that the current state of affairs is unsustainable. A recent survey found that senior fund managers are increasingly questioning the value of their services to investors, and many do not expect to survive the next few years (Rajan and Ledster, 2003).

It is timely to reflect on the history of the managed funds industry. A historical perspective reveals that the industry has been through prior episodes of sustained growth, questionable practices, and upheaval. It also reveals that, while the majority of funds have been managed with investors' interests paramount, many have not. The most testing times for the industry have occurred in the wake of revelations of deceptive and even fraudulent practices, usually following stock market crashes. Table 1 presents an overview of the main events in the history of the managed funds industry since the first stand-alone, diversified fund was established in London in 1868. The managed funds industry was largely a British phenomenon until it established a firm foothold in the United States during the 1920s. It experienced a boom during the late 1880s, and survived a major shakeout following the recession triggered by the Barings crisis in 1890. The 1929 stock market crash and its aftermath brought about the most serious crisis in the history of managed funds, precipitating

regulation in the form of the Prevention of Fraud (Investments) Act (1939)[1] in Britain, and the Investment Companies Act (1940) in the United States.

In this paper, we focus on the early years of the British investment trust[2] industry, from its inception in 1868 until the fallout from the Barings crisis in the 1890s. We address three questions. *First*, what factors contributed to its genesis and subsequent growth? *Second*, what were the salient features of the typical British investment trust of the period? *Third*, what were the main challenges and upheavals faced by the fledgling investment trust industry during the 19th century? We begin by describing the essential elements of the investment scene in 19th century Britain. Because most early investment trusts comprised foreign securities, British (indirect) investment abroad during the 19th century is also reviewed. Section 3 describes the factors that contributed to the initial establishment and subsequent growth of the investment trust industry. Section 4 outlines the main challenges and upheavals faced by the industry by presenting a chronology of the important milestones. Section 5 documents the features of the 19th century British investment trust, concentrating on those that distinguish the typical trust of the time from modern funds. It also discusses features of the early funds that would be familiar to contemporary investors: diversification and 'professional money management.' Section 6 illustrates the depth of the industry's crisis in the 1890s by presenting a few examples of the corruptly managed trusts whose catastrophic failure and subsequent unmasking brought the industry into disrepute. The final section summarizes the paper and draws together the main findings.

2. Investment opportunities in 19th century Britain

Investors in 19th century Britain had quite different preferences and requirements from majority of today's investors. Many belonged to the upper and upper-middle classes (known as the 'leisure classes') who lived on the income from their invested capital.

[1] The enactment of the Prevention of Fraud (Investments) Act 1939 was delayed by the Second World War, and was not operational until 1944.

[2] An *investment trust* (today more commonly called an *investment company*) is the British equivalent of a closed-end fund. All of the early trusts in Britain were of this type, and most were listed on the London Stock Exchange. The open-end fund is known in Britain as a *unit trust*.

Security of capital and regular interest payments were therefore vital. Most 19th century investors put their capital and/or savings into British government bonds. The government was a massive borrower during the period, and 'consols'[3] were the most important security traded on the London Stock Exchange. The bulk of the remainder comprised foreign government bonds.

There were limited opportunities for equity investment, and public equity was regarded as highly speculative. Prior to the Companies Acts of 1856 and 1862, which gave equityholders limited liability and freed up company registration procedures, the formation of a company required a Royal charter or an act of parliament. The capital required for most local enterprise was usually within the means of wealthy individuals or small partnerships, supplemented by borrowing from local banks (Morgan and Thomas, 1962: 42), and once a business was established, retained earnings (Kindleberger, 1993: 193). The company form of business arrangement was generally seen as inappropriate for industrial development, and the onerous business of creating a company was seen as worthwhile only for large infrastructure projects with substantial capital requirements such as canals, railways and public utilities.

By the middle of the 19th century, investment opportunities in domestic infrastructure began to diminish. The railway network was largely complete, and other infrastructure and industrial development in Britain was further advanced than elsewhere in the world. It is not surprising, then, that in the mid-19th century, British investors increasingly sought investment opportunities abroad. As the world's 'superpower,' Britain was also the world's creditor nation, and it remained so until this mantle was passed to the United States after the First World War (Williams, 1928: 4, Grayson, 1928: 12).

Early in the century, foreign investment was dominated by loans to governments, and foreign government bonds were the 'junk' bonds of the day. Public interest in lending to foreign governments began in the 1820s when Barings and Rothschilds, the major merchant banks of the time, organized bond issues for the governments of Austria,

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[3] The term *consol* dates from the 1750s when several government-issued annuities were merged to form the 'consolidated bank annuities' (Morgan and Thomas, 1962: 44).

Germany, Russia and the emerging republics in Central and South America (Morgan and Thomas, 1962: 81). By 1843 British investors held £120 million (about £7.2 billion in today's purchasing power) of foreign bonds (Morgan and Thomas, 1962: 87). The period around the appearance of the first investment trusts saw the biggest boom in such lending, rising five-fold between 1860 and 1876, with over 150 foreign government loans being issued in London (Morgan and Thomas, 1962: 79).

Large-scale foreign infrastructure investment took off during the railway boom of the mid-1840s when substantial amounts of British capital went to the United States. British capital was also the cornerstone of infrastructural development in the British colonies and South America from the 1870s. The scale of this foreign investment through the second half of the 19th century is illustrated by the fact that by 1913, foreign securities comprised 60 percent of the London Stock Exchange's market capitalization. At the height of Britain's financial power, the London Stock Exchange had more than 10 separate markets, including the markets for consols, colonial stocks, Indian railroads, American and Canadian railroads, other foreign railroads, foreign government stocks, South African mines, and a group covering British Columbian, Australian and West African mines (Morgan and Thomas, 1962: 97).

Lending to foreign governments, however, was the most important investment alternative to domestic government bonds. What sorts of returns were available, and how risky was lending to foreign governments in the mid-19th century? Table 2 presents the portfolio composition of the first investment trust – the Foreign and Colonial Government Trust – as published in its prospectus in 1868. Columns 1, 2 and 3 show the issuing country, the coupon payable and the price at which the bonds were purchased by the Trust. These details are drawn from Scratchley (1875). Column 4 contains the implied bond yield. Because the maturity of the constituent bonds is unknown, these yields have been calculated assuming a term of 20 years. As can be seen the table, all (except Nova Scotia) were trading at a discount. Compared to the long-term government bond yield in 1868 of 3.2 percent, these yields reflect a substantial premium for risk. The two colonial securities in the portfolio – New South Wales and Nova Scotia – had the lowest yields at 5.08 and 5.81 percent respectively. This is consistent with evidence presented by Cairncross (1953: 234) that the British colonies almost never defaulted on their loans. The highest yielding bonds are those

issued by Southern and Eastern European governments, with yields on the Danubian, Italian, Spanish and Turkish bonds at more than 10 percent, and the Portuguese bond close to 10 percent.

Despite the default risk reflected in these yields,[4] the limited empirical research on foreign government bond performance during the 19th century shows that losses were limited, and that ex-post yields were relatively strong. In a study of 130 foreign bonds between 1870 and 1880 (conducted in 1881), they earned an average dividend yield of 5.87 percent and a gross yield of over 6 percent (cited in Morgan and Thomas, 1962: 91). This high ex-post return to foreign government bonds is explained by the fact that, despite being common enough during the 19th century, default seldom led to complete loss, and the capital in defaulted bonds was usually recovered. Cairncross (1953) concludes that

> ….there is at least a prima facie case for believing that British investment in other countries has been economically advantageous…….In the nineteenth century there were constant defaults – chiefly by South American countries – but, for the most part, with the exception of those of the 20s and 70s, of a comparatively minor character. The return, in profits and interest, was substantial. (225)

One explanation for the strong ex-post yields is that the political and financial power of Britain in the 19th century meant that there could be serious repercussions for defaulting governments. An interesting excerpt cited by Cairncross (1953) illustrates this:

> Palmerston [British prime minister 1855-65] was quite ready to give instructions for a note to be sent to a defaulting country stating 'that the patience and forbearance of His Majesty's government...have reached their limits, and that if the sums due to the British…claimants are not paid within the stipulated time and in money, His Majesty's Admiral commanding on the West India Station will receive orders to take such measures as may be necessary to obtain justice from the ----- nation in this matter.' (223)

At the very least, a defaulting government would have found it very difficult to raise money in the future. However, it is important to note that the British government's public position on the issue was that they did not guarantee foreign loans, nor would

[4] Some examples of defaults affecting the early investment trusts during the 1870s can be found in section 4.

they follow up complaints from British investors with defaulting governments (Cairncross, 1953: 222). It seems, therefore, that as early as the middle of the 19th century the British government had a good understanding of the problem of moral hazard!

3. The genesis and growth of investment trusts

There are related explanations for why the first trusts appeared during the second half of the 1860s. The first relates to falling yields in the government bond market. A second, related factor is that a series of speculative manias and subsequent panics during the first half of the century – particularly in foreign investment markets – led investors to search for a way to earn higher returns while minimising the chance of loss of both capital and income.

In the early 1800s, consols yielded between 4 and 5 percent. For most of the 19th century, the consol yield trended downward, and by the early 1890s it was close to 2 percent. This is shown in Figure 1, which depicts the annual consol yield from 1800 to 1920. As yields fell, the British government conducted a series of debt conversions in which existing bonds were swapped for new issues bearing lower coupon rates. This began in 1822 with the conversion of an issue known as the 'navy five percents,' which were replaced with bonds paying 4 percent (Steiner, 1929: 18). It was followed two years later by the conversion of a 4 percent consol issue for bonds paying 3½. The converted 'navy fives' were again converted to 3½s in 1830 (Morgan and Thomas, 1962: 115). These conversions would have substantially reduced the incomes of people relying on the interest from government bonds for their living expenses. Consider the plight of a widow with an endowment of £10,000 invested in the 'navy fives'. Her income would have fallen from £500 in 1820 to £350 in 1830 – a reduction of 30 percent.

Several economic historians have at least partly attributed several periods of speculative mania and panic between the 1820s and the 1840s to investors seeking higher returns in order to retain the living standards that they enjoyed before the government bond conversions (Steiner, 1929; Morgan and Thomas, 1962; Kindleberger, 1993, 1996). In the 1820s and 1830s, the craze was for foreign

government bonds as well as company stocks, while the boom of 1845 and the subsequent panic of 1847 was the first of the railroad bubbles. During the 1860s, following the passage of the Companies Acts, a boom in registration of limited liability companies was followed by a panic in 1866 (Morgan and Thomas, 1962: 131).

The early investment trusts appeared after an unprecedented four decades of speculative manias and panics, and only two years after the first crash in the stocks of limited liability companies. It had been recognized for some time that the consistent survivors of these episodes were the very wealthiest individuals holding a spread of investments. Then, as now, investors of smaller means did not have the ability to reduce risk by diversifying. Scratchley (1875) enumerated the investment opportunities available at the time, when government bonds were paying 3 percent, and he explains the appeal of investment trusts:

> The introduction of an entirely new form of investment within the last six years has undoubtedly met the requirements of a large class of persons, and has probably been the means of profitably employing money which would otherwise have been employed in some less secure manner….The investors to whom these trusts are chiefly a boon are that very numerous class who require a return of more than 4 percent on their capital, but to whom a practically secure income is also of the utmost importance….The investments which can now be purchased to pay 5 or 6 percent are of quite a different character than that required by the class of persons who want absolute security with a higher rate of interest than they know how to obtain. There are, indeed, a certain number of securities which may be purchased to pay 5 percent….but there is risk attached to them….These securities are chiefly 'foreign government loans' of the best class, 'American government' and 'railway securities', 'foreign railway obligations' and some others. (Scratchley, 1875: 6-7).

Consistent with the general opinion of the time, Scratchley recommended against investment in the shares of joint stock companies. Insurance companies were an additional alternative for long-term savers. Life assurance products, however, were very conservatively managed, and the widespread acceptance of the benefits of holding a portfolio of liquid securities came decades later to the insurance industry (Scott, 2002).

The period of greatest growth in investment trusts coincided with the biggest debt conversion of the 19th century. Falling yields during the late 1870s and 1880s allowed

the British government to convert almost all of its long-term debt from 3 percent to 2¾ percent, reducing to 2½ percent by 1903 (Morgan and Thomas, 1962: 116, Burton and Corner, 1968: 29). As with the earlier bubbles, the speculative mania of the late 1880s has been attributed to this conversion. The burgeoning of investment trusts accompanied this boom. While it is difficult to disentangle these two effects – the conversions leading to the search for higher returns while minimising risk, and the growth of the managed funds industry alongside the boom of the 1880s – it is probably safe to conclude that both of these effects drove the early development and growth of the investment trust industry.

4. Challenges and upheavals: a chronology

In 1863, two collective investment vehicles were established in London: the International Financial Society and the London Financial Association. These organisations raised capital via public subscription and on-lent mostly to railroad companies. Being undiversified, they were not considered to be true investment trusts (Grayson 1928; Steiner, 1929). The earliest fully diversified fund was the Foreign and Colonial Government Trust, which was formed in 1868. It was established by Lord Westbury, who was the Lord Chancellor[5] – an attribute that would have assured potential investors of the respectability of the venture. As the name implies, this trust invested in the bonds of foreign governments, and diversification was assured by a promise in the trust's prospectus that no more than 10 percent of trust assets would be invested in any particular security. The Foreign and Colonial Government Trust proved popular, and over the next few years the founders launched four more 'issues,' which were essentially separate trusts under the same management.

While London remained the main centre for trust development, several investment trusts were established during the 19th century in Scotland. The First Scottish American Investment Trust was founded in 1873 by merchant Robert Fleming in the wealthy Scottish city of Dundee. Having discovered the investment potential of the United States during a visit a few years earlier, Fleming's trusts specialized in American securities, particularly railroad bonds. The prospectus for the First Scottish American Investment Trust specified a capital raising of £150,000, but the response

[5] The role and position of Lord Chancellor is similar to that of an attorney general.

from potential investors was so great that this was increased to £300,000 (Fowler, 1928: 345). The trust started out with 30 stocks, each comprising no more than 7 percent of the portfolio (Burton and Corner, 1968: 20).

At the time of publication of Arthur Scratchley's (1875) book *On Average Investment Trusts*, the industry was in the midst of its first major challenge. In only 7 years, the industry had grown to 23 (London-based) trusts with a total market capitalization of £32,131,640, which was 0.6 percent of the market value of the London Stock Exchange (Scratchley, 1875: 8). The years 1874-1876 saw a severe recession, and numerous foreign governments and railroad companies defaulted on their bonds. Several securities held by the 4th issue of the Foreign and Colonial Government Trust were in default: the Alabama 8 percents, the City of Mobile 8 percents (Alabama), the Louisiana 8 percents, the Louisiana 6 percents and the Spanish 3 percents. The American Investment Trust, which specialized in railroad bonds, suffered from defaults on the bonds of

> ….the Detroit and Milwaukee, the Gilman, Clinton, and Springfield, Missouri, Kansas, and Texas, and Mobile and Montgomery railroads, and upon the shares of the Michigan Central railroad company, and from only one half-year's interest having been received upon the Canada Southern, Toledo, Peoria and Warsaw, and Toledo, Wabash and Western railroad companies. (Scratchley, 1875: 25).

Despite these and other defaults, in 1875 all of the trusts paid their dividends and expenses in full (Scratchley, 1875: 21-33). The early funds retained a portion of their earnings as reserves for such contingencies. But the recession worsened, and in 1876 several trusts went into default or partial default. These included the Governments and Guaranteed Securities Permanent Trust, which had a particularly risky capital structure.[6] A group of stockholders tried to get the trust wound up, and eventually took legal action against the trustees in 1879 (Walker, 1940: 348).

The legal case that resulted threw up a second major challenge to the industry within a few years of the first. As noted in section 3, soon after the Companies Acts gave equityholders limited liability, a period of speculative mania followed by panic left the limited liability company with a severely damaged reputation. According to *The*

[6] The capital structure of the 19th century trusts is discussed in section 5.

Economist, the reason most of the early funds were established as trusts rather than companies was "an evident attempt to avoid the now unpopular name of company." (cited in Walker, 1940: 341). The judgment in the Governments and Guaranteed Securities Permanent Trust case decreed that the trust was illegal, being an "association of more than twenty persons for the acquisition of gain" (Stutchbury 1964: 2). Most of the investment trusts responded by incorporating. The Submarine Cables Trust, however, refused to incorporate, and after an order for it to be wound up, the trustees appealed and the original judgment against the Governments and Guaranteed Securities Permanent Trust was reversed (Fowler, 1928: 349). By that time, however, all of the other trusts had converted to companies, and the Submarine Cables Trust was the only fund to remain a trust. The term *investment trust*, however, continued to be used by the industry.

Having survived this legal challenge to their existence, investment trusts experienced a boom during the 1880s. In 1888 the London Stock Exchange established a separate official list for investment trusts (Steiner, 1929: 25). Estimates of the extent of the boom differ. Fowler (1928) asserts that by 1890 there were 55 British investment trusts. Most of this growth occurred in the last few years of the decade. Burton and Corner (1968) suggest that at the end of 1886 there were 28, and that between 1887 and 1890, 70 new funds were formed. This gives a total of nearly 100 by 1890 - vastly more than the number estimated by Fowler (1928). Burton and Corner (1968) admit, however, that some of these were probably not pure investment trusts, and may well have been mixtures of holding, finance and investment companies.

The Barings crisis of 1890 pricked the speculative bubble of the late 1880s, and with it the investment trust boom. The merchant bank Barings Brothers was heavily invested in South American securities, and after the political turbulence and collapse in asset values in Argentina, Barings faced a severe liquidity crisis. Barings was subsequently rescued by the Bank of England (Morgan and Thomas, 1962: 95), but the effect on markets was severe. The investment trusts holding South American securities were the first to encounter trouble (Burton and Corner, 1968: 35). As the crisis turned into a major economic downturn, and as the United States followed Britain into recession in 1893, all of the trusts were adversely affected to a greater or lesser degree. Dividends were suspended and stock values slumped. Those that had

been long established (having purchased their portfolio securities before the late 1880s boom) were the least effected, but even some of the more respectable trusts saw their equity entirely wiped out. Among the best trusts, only 7 had a value greater than the issue price (Steiner, 1929: 29). Others were liquidated or merged. In the fallout, it became clear that several trusts had been near-fraudulently managed, engaging in several high-risk activities other than fund management, and fleecing stockholders in the process. We will give some examples of these trusts in section 6.

By the turn of the century, a smaller, more conservatively managed investment trust industry emerged from its third and most serious crisis of the 19th century. Of the 100 companies estimated to have been in existence in 1890, 50 had been liquidated or merged by the 1920s. Thirty of these disappeared before the end of the 1890s (Burton and Corner, 1968: 42). In 1903 the remaining trusts had a total capital value of £60 to £70 million, which was approximately 1 percent of the market capitalisation of the London Stock Exchange (Burton and Corner, 1968: 45).

5. Typical features of the early trusts

The fee structure of the 19th century trusts was similar to those of many modern funds. They had an up-front fee that was typically ½ percent of the amount subscribed (Scratchley, 1875: 4) and an annual management fee, a maximum for which was specified in the prospectus. In capital structure and management style, however, they were very different from the investment funds of today. Several features of the early trusts have been discarded by modern fund managers. *First*, they paid a fixed dividend. This would have appealed to investors living on the interest from their investments. Fixed dividends also had the advantage of familiarity because the stock exchange of the time comprised mostly fixed interest securities. To ensure the payment of the fixed dividend, the trusts held excess funds as reserves in case of default by issuers of the portfolio securities. *Second*, not only was the promised dividend fixed; most of the early trusts were 'fixed' in the sense that the composition of the portfolio could be changed only in exceptional circumstances. Except for the Scottish trusts, managers had virtually no discretion to alter the trust's portfolio. But even in Robert Fleming's trusts there was little portfolio turnover. Fleming 'always insisted on a most careful and thorough investigation before making a purchase.'

(Gilbert, 1939: 16). This feature of the early funds, however, was relaxed over time. By the late 1880s and into the 1890s, investment trusts were being more actively managed, and managers were increasingly reluctant to reveal the composition of their portfolios. This was a major shortcoming of the industry, and it was widely criticized, particularly during the boom of the 1880s when *The Economist* labelled such funds 'blind pools' (Burton and Corner, 1968: 30).

A *third* feature of the early trusts was that they were established with limited lives. Most provided for the disposal of excess cash by redeeming a proportion of certificates at (or above) par each year. As most trusts issued their securities at a discount (in many cases quite a deep discount), early redemption was a bonanza for the lucky early redeemers, who were commonly chosen by lottery. The trusts were to be terminated after redemption of all of the trust certificates. Prospectuses contained an estimate of the length of the fund's life, which was typically between 20 and 30 years. Any residual monies would be paid either to the final certificate holders, or alternatively to all stockholders, in which case the original documentation came with 'reversion coupons' which were payable when all the certificates had been redeemed. However, like the fixed portfolio composition feature of the early trusts, this feature altered over time. Most investment trusts formed after the legal challenges of the late 1870s were established as perpetual.

A *fourth* difference between 19th century investment trusts and the norm in fund management today is the use of leverage. Current mutual fund/unit trust regulation in Britain and the United States disallows borrowing, although leverage is permitted in listed investment vehicles. The Share Investment Trust, launched in 1872, was the first to use leverage. This trust issued what would be known today as a 'stapled' security. Each £100 subscribed gave the investor a preference share certificate promising a fixed coupon of 6 percent, and a 'deferred' certificate that gave the holder entitlement to 'surplus income' (Walker, 1940: 346). Debt was also common in the early trusts, and fund managers of the time well understood the effect of leverage on returns to shareholders (Burton and Corner, 1968: 49). Most funds issued a range of securities, and the capital structure often included ordinary shares (sometimes called deferred shares), preference shares and debentures.

It may not be widely appreciated by today's finance academics and practitioners that although Markowitz's celebrated portfolio theory paper dates from 1953, 19th century fund managers had a good understanding of the value of diversification. Most trust deeds limited the holding of any one security to between 3 and 10 percent of the portfolio, and the benefits of diversification (or 'averaging' as it was then called), particularly for small investors, was the main selling point used by trust promoters. This is clear from the prospectus of the first trust, the Foreign and Colonial Government Trust:

> The object of this Trust is to give the investor of moderate means the same advantages as the large capitalist, in diminishing the risk of investing in Foreign and Colonial Government Stocks, by spreading the investment over a number of different Stocks…(with) not more than £100,000 being invested in the stock of any one government. (Scratchley, 1875: 12-13).

The other major benefit claimed by 19th century investment trust promoters was the professional, expert management of investors' money. While the claim of 'superior management' will be familiar to contemporary investors, the mediocre performance of much of the industry casts doubts on its validity today. In the 19th century, however, the argument might have been more compelling.

One reason for this is the difference in the availability of information. With the advance of sophisticated international telecommunications systems that facilitate cheap, instantaneous transfers of information, claims of superior access to information by modern fund managers are becoming less and less credible. Obtaining information in the 19th century, however, particularly about foreign stocks and bonds, would have been difficult, slow and costly. This point was emphasized by Grayson writing in 1928:

> …one great drawback, however, to the growing policy of capital export in the form of foreign loans, both public and private … was the difficulty of obtaining sufficient information concerning foreign borrowers, the circumstances surrounding the loan applications, and the conditions – political, financial and economic – affecting British capital in foreign lands (13).

It must be remembered that because most trusts had a fixed portfolio of securities, a stock selection ability would have been necessary only as a once-off. Most of the early trust managers made no claims about an ability to 'pick winners.' The claim of 'superior management' by investment trust managers predominantly encompassed a

conservative approach to ongoing cash flow management by ensuring sufficient reserves for periods when defaulting borrowers led to cash shortfalls.

The difficulty of obtaining information on foreign investments in the 19th century, coupled with the perception of riskiness that decades of default had engendered, probably made investors extremely wary of investing in foreign securities independently. This may explain why investment trusts in the 19th century largely comprised foreign securities. It is plausible that investment trusts appealed to a public that was confident enough investing individually in domestic enterprises, but felt genuinely ill-equipped to evaluate the large range of foreign securities that were available.

6. Scams and profiteering: early episodes and modern parallels

Although most 19th century investment trusts were prudently and respectably managed, many were not. For managers wishing to enrich themselves at the expense of shareholders, the method of choice was the *founder's share*.[7] Founders' shares had special features and were issued to trust founders in return for the payment of preliminary expenses, and for underwriting the fund. They were also issued to well-connected individuals who were willing to put their names to the venture. The holders of founders' shares received dividends only after preference and ordinary shareholders received their agreed dividend payment. The Railway Debenture Trust Company, formed in March 1873, had a particularly innovative capital structure, and was the first to issue debentures. It was probably also the first to issue founders' shares. Its capital structure comprised 150,000 shares with a par value of £20 each, and 200 founders' shares of £1 each.[8] In common with other trusts of the time, diversification was guaranteed by specifying in the prospectus a limit of 10 percent to be invested in any one security. Where this fund differed from earlier funds was the plan to massively lever the portfolio; the prospectus allowed for the future issue of debentures to an amount not exceeding *five times* the subscribed ordinary capital. The

[7] Echoes of the founders' share were subsequently to be found in the capital structures of several of the less respectable United States trusts during the 1920s; see Flynn (1930).

[8] This information is drawn from Scratchley (1875), who describes the 23 London-based trusts that were in existence at the time, and Burton and Corner (1968).

ordinary shareholders of this fund actually bore even more risk than this leverage implies, because the ordinary shares were only partly paid. But the founders' shares were, of course, fully paid and the prospectus granted founders 10 percent on the profits in every year in which not less than 6 percent was declared on the ordinary paid-up capital. The founders of the Railway Debenture Trust Company profited substantially in the two years after its formation. For an investment of £200, the founders received £3,500 (a return of 1,650 percent) in each year!

Abuses relating to founders' shares worsened, and the boom of the late 1880s culminated with several trust founders engaging in near-fraudulent profiteering. As an example, *The Economist* (June 14th 1890) describes the returns to founders in the Trustees, Executors and Securities Insurance Corporation, in 1889: the holders of £1,000 of founders' shares earned £84,000, or 8,300 percent. In another example, the Commercial Union Brewery Investment Corporation in 1889 granted founders a dividend of £9,435 on 200 £1 fully paid shares (*The Economist*, July 12th 1890) – an annual return of over 4,600 percent.

These colossal returns are clearly not merely the result of leverage. Given that dividends were paid to founders after preference and ordinary shareholders received their fixed dividends, the use of founders' shares (unsurprisingly) encouraged excessive risk-taking, and managers undertook all sorts of activities unrelated to trust management. These included

> …acting as trustees or executors; hiring safes and acting as custodians of valuables; investing in securities; making advances on security of real estate; dealing in securities, land and mortgages, bills, promissory notes; …issuing shares on commission; promoting new companies and acting as underwriters of new capital issues. (Burton and Corner, 1968: 30).

The worst abuses occurred in the new issues market. *The Economist* (March 15th, 1890) estimated that at least 90 percent of the profit of the Trustees, Executors, and Securities Insurance Corporation was earned from company promotions and underwriting. Investment trusts had a particular advantage as underwriters; if an issue was not fully subscribed, unsold shares could simply be absorbed by the trust. Several trusts promoted companies of very doubtful worth, and shareholders became the unwitting owners of illiquid, low-value share certificates. After the Barings crisis

and the subsequent collapse in financial markets, the £10 ordinary shares of Trustees, Executors, and Securities Insurance Corporation were trading at *minus* £2. The negative value is explained by the fact that the £10 par value was only partly paid. The company had called the £7 unpaid portion of the share in order to repay debenture holders, after which shareholders were willing to pay £2 to be relieved of this commitment (Burton and Corner, 1968: 36).

These questionable practices have two contemporary parallels. The first relates to hedge funds. While comprehensive and stringent regulation of mutual funds and unit trusts now prevents these sorts of abuses, there have been several recent cases of fraud amongst hedge fund managers. Hedge funds, which are mostly US-based, circumvent mutual fund regulation by limiting participation to wealthy investors and institutions, and promising not to advertise their services. Although hedge funds are not exempt from the anti-fraud provisions of the Investment Advisors Act (1940), hedge fund fraud is on the increase. In 2002, the SEC brought charges of fraud against 12 hedge funds, up from 5 in 2001 (*The Economist*, 27th May, 2003). Fraud is more likely to go undetected in hedge funds because, unlike mutual funds, they are not required to report to the SEC, and they are not subject to compulsory audit. The SEC is concerned about the rise of hedge fund fraud, and there is currently a proposal to require hedge funds to register as investment advisers and to permit SEC inspections (Wall Street Journal, August 26th, 2004).

The second contemporary parallel relates to conflicts of interest in investment banking. Strictly speaking, the founders' shares racket of the 1880s could not be called fraud because the managers were not stealing from their clients. Rather, they established a capital structure in which risk was borne by ordinary shareholders. The managers then ramped up the risk of their portfolios in order to earn short-term supernormal profits. The profits derived from sponsoring and underwriting the initial public offerings of dubious companies, and the risk resulted from absorbing unsold stock into the investment portfolio. The obvious modern parallel is the conflict of interest between the investment banking and stockbroking divisions of several investment banks that came to light after the bursting of the internet stock bubble in 2000. Merrill Lynch, Morgan Stanley and Citigroup allegedly used the promise of strong buy recommendations from their analysts to sell IPO services. Although they

admitted no guilt, these firms settled cases brought against them by New York attorney general Eliot Spitzer. According to *The Economist*, Spitzer's affidavit in the case against Merrill Lynch in April 2002

> …paints Merrill Lynch's share-buying recommendations for Internet companies during 2000 as little more than a pretext to stuff gullible buyers with the shares of rotten businesses. (12th April, 2002).

The same publication more than a century earlier warned of the conflicts of interest that resulted in supernormal profits for holders of founders' shares in three named investment trusts:

> Of course we do not suggest that there is anything improper in these gentlemen or anybody else taking founders' shares, but we hardly appreciate the frame of mind which reconciles the holding of such shares with the occupation of the fiduciary position of a director. In our view, a company director should have no rights, except to be paid his fees, which are not shared by the general body of proprietors. And, apart from that consideration, it is quite obvious that the joint stock principle could not be carried out successfully if it were subjected to *such a process of milking* as the three companies referred to, where the founders or their representatives, for an investment of £1,400 have received, or expect to receive, a million and a half sterling. (*The Economist*, May 3rd, 1890). (Our italics).

Conflicts of interest and fraud are clearly not just a recent phenomenon. The lesson from history and from contemporary experience is that regulation directed at removing conflicts of interest and eliminating the possibility of fraud in any person or organization entrusted to manage the public's money is vital. In situations where the potential to make supernormal profits at the expense of the ordinary investing public exists, human nature is such that there will always be people who are tempted to take advantage. The traditional pillars of financial regulation are alive and well. In addition to maintaining systemic stability and market integrity while promoting efficiency, regulators must ensure consumer protection.

7. Summary and conclusions

The managed funds industry in 19th century Britain grew out of an investment environment that saw a declining risk-free rate of interest and a broadening range of risky foreign investments. A series of speculative manias and panics in foreign securities made the concept of diversification appealing to a populace concerned with

the protection of principal as well as the ability to earn a premium over the risk-free rate. The early funds were fixed in many senses – they were established with fixed lives, they paid a fixed dividend, and in many the composition of the investment portfolio was fixed for the life of the trust. Trust promoters promised diversification as well as superior stock selection, and also conservative management that emphasized the conservation of capital. Most promised a realistic fixed rate of interest rather than stellar performance. They recognised that investors were sufficiently savvy as to understand the rudiments of risk and return and the benefits of diversification, but required assistance in stock picking at a time when information was costly and difficult to come by.

While there were several cases of questionable and even deceptive conduct amongst 19th century fund managers, this was the exception rather than the rule. Generally speaking, the trusts were competently run and their managers levied modest fees. The best survived the financial upheavals of the 1870s and the 1890s. It was due to these well-managed funds, as well as to the fact that the benefits of diversification were well understood, that the industry overcame the tarnished reputation it temporarily acquired after the revelations of profiteering during the late 1880s. The questionable practices of these 19th century investment trust profiteers have contemporary parallels. The growth in hedge fund fraud and the conflict of interest resulting from the breakdown of so-called 'Chinese walls' in investment banking show that opportunities for money-making at the expense of ordinary investors is a perennial problem in the financial services industry. Lawmakers and regulators must be vigilant in the pursuit of the regulatory goal of investor protection.

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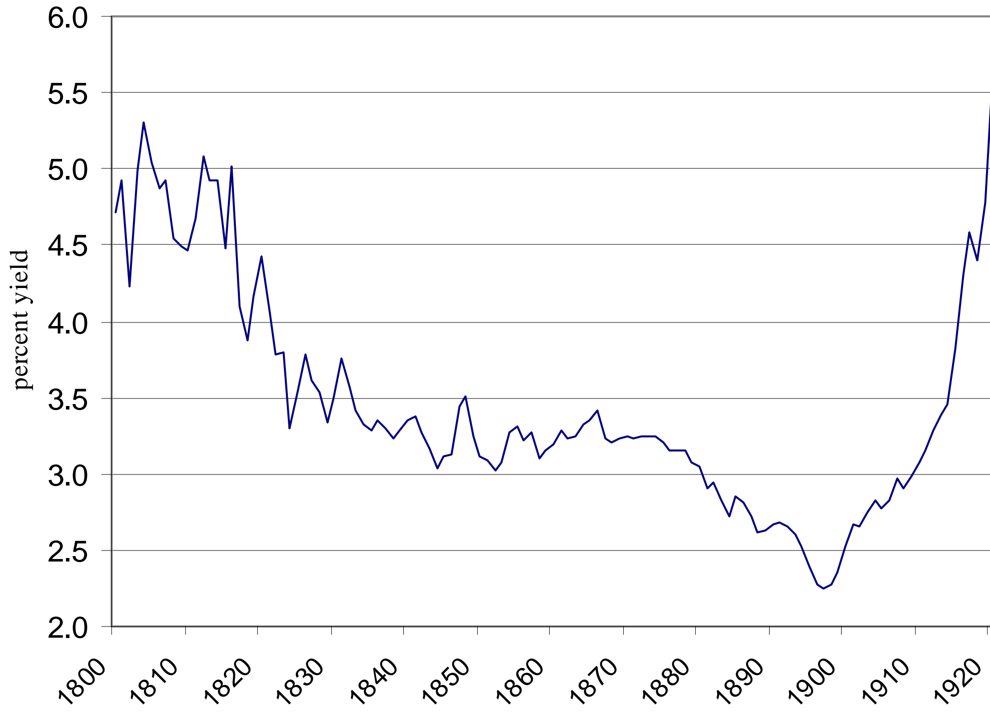
Figure 1 Annual British government bond rate 1800 – 1920



Notes. This figure plots the annual long-term British government bond yield for the period 1800-1920. Source: http://www.eh.net/hmit/interest rate.

Table 1 Chronology of some milestones in managed fund history

Year	Milestone
1868	The first investment trust established in London: the Foreign and Colonial Government Trust.
1873	The first Scottish investment trust established: the First Scottish American Investment Trust.
1879-80	Conversion of the trusts to company status.
1890-93	Shakeout and consolidation of the industry following the Barings crisis and subsequent recession.
1921	The first important American closed-end trust formed: the International Securities Trust of America.
1924	The first open-end trust formed: the Massachusetts Investment Trust.
1931	The first unit trust established in Britain: the First British Fixed Trust.
1929-33	Shakeout of the industry following the stock market crash.
1935	SEC launches an investigation into the industry.
1940	Investment Company Act (1940): start of federal regulation of mutual funds.
1944	Prevention of Fraud (Investments) Act (1939) enacted: start of regulation of investment funds in Britain.
1956	A US Federal court ruling allows firms that manage mutual funds to be bought, sold and taken public.
1976	Vanguard pioneers the index fund, tracking the S&P 500.
1982	The US Internal Revenue Service permits the use of section 401(k) of the Tax Reform Act for tax-efficient company-sponsored pension plans.

Notes. This table documents some milestones in the history of the investment fund industry. The shaded area marks the period examined in this paper.

Table 2 Coupon, price and implied yield for the bonds comprising the Foreign and Colonial Government Trust (established 1868)

[1] Issue	[2] Coupon	[3] Price paid	[4] Implied yield (%)
Argentine	6	75½	8.61
Austrian	5	68	8.34
Brazilian	5	74 ¾	7.47
Chilian	6	91½	6.79
Chilian	7	99½	7.05
Danubian	8	72	11.67
Egyptian	7	90¼	7.99
Egyptian railway loan	7	94	7.59
Italian	5	49¾	11.53
New South Wales	5	99	5.08
Nova Scotia	6	102¼	5.81
Peruvian	5	80½	6.81
Portuguese	3	41¾	9.70
Russian Anglo-Dutch	–	88¼	–
Spanish	3	38½	10.44
Turkish	5	36¼	15.43
Turkish	6	57¾	11.47
United States	–	68¾	–

Notes: This table presents the bonds comprising the Foreign and Colonial Government Trust, which was formed in 1868. Information relating to the bond issue, the coupons and prices paid is drawn from Scratchley (1875). The implied yields have been calculated assuming a term for each bond of 20 years, due to the absence of information on maturities. As the coupons for two bonds – the Russian Anglo-Dutch and the United States – were not given, the yield cannot be calculated.