

CHAPTER I

What Is Speculation?

Speculation in Every Business—The Investor Cannot Escape Speculation—A Definition—Importance of Organized Markets—The Speculator Points the Way to the Investor—Speculators Help Support the Financial Machinery—The Analysis of Values

A TREATISE on investment needs no defense. 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 WHEAT

It is unfortunate that the word "speculation" immediately suggests the word "stocks" to most people. When his neighbors gather at the 19th hole of the local country club and discuss the apparent prosperity of Henry Robinson, the local miller, 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 flourishing state of his business may be due far more to his correctness in judging the wheat market than to his skill as a manufacturer or merchant. Though the speculation involved in the miller's operations is incidental to his main business, it is speculation none the less.

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 22½-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 manu-

facturer 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 pouring over the quotations in the morning paper and haunting his broker's board-room 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? Certainly 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 the 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 this volume 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, cocoanut 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 of 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 commis-

sions 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, 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, 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, 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 the 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, 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, 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, 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, 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, helping to support the financial machinery which is designed primarily for the service of the investor.