[Vanderbilt Law Review](https://scholarship.law.vanderbilt.edu/vlr)

Volume 1
Issue 4 *Issue 4 - June 1948*

Article 2

6-1-1948

American Business and Risk Capital

Emil Schram

Follow this and additional works at: https://scholarship.law.vanderbilt.edu/vlr

Part of the Banking and Finance Law Commons

Recommended Citation
Emil Schram, American Business and Risk Capital, 1 *Vanderbilt Law Review* 512 (1948)
Available at: https://scholarship.law.vanderbilt.edu/vlr/vol1/iss4/2

This Article is brought to you for free and open access by Scholarship@Vanderbilt Law. It has been accepted for inclusion in Vanderbilt Law Review by an authorized editor of Scholarship@Vanderbilt Law. For more information, please contact mark.j.williams@vanderbilt.edu.

AMERICAN BUSINESS AND RISK CAPITAL

EMIL SCHRAM *

In the midst of a nation-wide business surge—in building, in steel, in automobiles and petroleum production and farming—our capital markets stand alone as the one "depressed area" in the national economy.

It is due to the failure of many of those who call the tune on our country's fiscal and credit policies to realize that they are sluicing off the top soil from a resource as definite and tangible as our farms; they are eroding something as measurable as our grazing lands; they are pumping off onto barren ground something as exhaustible as our oil wells.

I am speaking of that peculiarly American resource—the willingness and ability of our people to take risks in the hope of profit if they but be given the opportunity.

In simple truth our whole history has been enacted against a back-drop lettered with the words: "Nothing ventured, nothing gained." Yet, what account is being taken today of the dynamics of risk capital as the driving force of our national economy?

The only purpose for which capital markets exist, whether in New York, or in Chicago, or in St. Louis, or in Tulsa, is to bring together the investable funds of the people and the instruments in which those funds may be employed. Money left idle is merely a store of value, or a claim on goods and services. Surplus funds are placed in the hands of those who build public works—through the purchase of municipal, state and federal bonds. They go into the building of dams or steam generating systems—through the purchase of public utility securities. They go into railroad property—through railroad bonds or shares. They go into farm property—through the vehicle of the farm mortgage. They drill oil wells, build steel mills and factories, develop mines, construct ships, make possible new and useful chemical processes, and provide the funds to establish those many new enterprises without which there could be no progress.

At present, and for some time, Wall Street has been finding a ready market for bonds, notes, mortgages and non-risk securities, or, perhaps more accurately, securities thought to involve smaller risks. At present, and for some time, however, both Wall Street and corporations seeking new venture capital have encountered a reluctant market for stocks. In other words, there is plenty of "sacred money" available for investment, but a real shortage of "risk" money, or venture capital. This, of course, is far from an ideal condition in a dynamic economy.

In 1945, when the stock market was good, 52 per cent of all the new money raised publicly by corporations was obtained through the sale of common

* President of the New York Stock Exchange.

and preferred stocks. In 1946, when the stock market was active and strong only a few months, 42 per cent of the money came from the sale of stocks; but in 1947, when earnings were higher than in either year, only 26 per cent of new funds were derived from the sale of shares and 74 per cent came from the sale of bonds and notes.

At present, not a few leading corporations have reached the point where they will not attempt to obtain equity capital. They still need capital funds, but market conditions are unfavorable to the sale of additional shares.

Today, scores of leading companies would like to sell additional shares to obtain money to buy machinery, erect plants and augment working capital. However, the market for equity securities is so anemic that it can absorb only a limited volume of new shares.

Never before has there been a time in stock market history when the stock market has declined so long and so far without the decline being accompanied by a decline in business and earnings. It is now 25 months since the peak of the 1946 bull market and 18 months since the September, 1946, decline in prices; yet the Federal Reserve Board Index of Production is at or near its post-war peak.

All the evidence, it seems to me, justifies a recent observation that the trend in stock prices temporarily has become divorced from the trend in business. The only reason for this divorcement in trend, I think, is that those who in the past have supplied the risk capital for American business are unable to accumulate money under the present tax structure or that they are unwilling to invest when the prospects for a reasonable return are so poor. Again this can be blamed upon our tax policies. The sources of venture capital have dried up or have backed away because the incentives are no longer present.

The great danger in all of this is that, unless conditions are reversed, there may be a return to large-scale government financing. That would be the road leading to the nationalization of industry and business. Government financing, for certain projects, but not all of them that we went into, was desirable and necessary in the days of deep depression of the early thirties. Government financing was necessary during the war emergency. Unfortunately, our people, including many of our business men, got into the habit of looking to the government for the solution of their financial problems.

We simply must break ourselves of this habit. In order to do so, we must restore our private capital markets to full and vigorous health. That means prompt and resolute action on the part of Congress. The present tax legislation is merely one step in the direction of a thorough correction of the situation which is responsible for the stagnation of our markets. I am hopeful that Congress will, in the second tax bill, which is already taking shape, see to it

that the incentives essential to investment and risk-taking are supplied as soon as possible.

I appeared before the Senate Finance Committee on March 10, 1948, particularly for the purpose of directing attention to the problems arising out of the alarming shortage of equity capital. As I told the Committee, our tax structure, even in the modified form as presented to the two houses of Congress, simply does not permit those who in the past have invested in business and in securities representing venture investment to supply industry with the type of funds which it needs.

Wealth has aged noticeably in the past fifteen years and older people who are living on pensions, trust funds and accumulated or inherited capital—and there are a lot of them—are really having a struggle to keep their heads above water. There are some, termed rich, who, in order to maintain within reasonable limits their customary standard of living, to educate their children, etc., are actually using principal to meet the deficit, which really means, in large measure, to pay their taxes.

Business was fortunate in entering the post-war period in an extremely liquid position, but as a result of higher prices and an expansion of operations, cash and equivalent have run off considerably. The working capital position of industry is worsening; the extent to which this is taking place is being obscured temporarily by the sale of capital securities, in large part debt securities.

Of $4.75 billion new money raised publicly by corporations through the capital markets last year, common and preferred stocks represented only one-quarter, or $1.2 billion. According to the Securities and Exchange Commission, common stocks totalled but $784 million. Toward the closing months of the year, common stock offerings were largely confined to the larger companies in the public utility and oil industries, while the market was virtually non-existent where other stock offerings were involved. Time and time again the report of anticipated common stock financing was sufficient to depress severely the stocks of even the strongest and most successful corporations.

The stock market is also suffering from persistent foreign liquidation and the effects of sales of large holders, brought about, in many instances, by tax factors, adding to the supply of stocks without any sufficient offset from new risk funds.

The volume of trading on the New York Stock Exchange last year, as a percentage of the mean number of shares listed, was down to 14 per cent, the lowest since 1942. This year to March 1, the reported volume of trading on the New York Stock Exchange amounted to 37,018,892 shares against 47,314,680 shares in the same period of 1947, a reduction of 22 per cent. In the first two months of this year the volume of trading was at the annual rate of about 12

per cent of the number of shares listed, and only slightly above the 1942 rate which was 9 per cent—the lowest on record.

At the outset I said to the Senate Finance Committee that the risk capital problem falls into two parts: the adequate flow of such capital, and its proper function. I made two proposals that I think will make risk capital function. Neither proposal involves any appreciable loss of revenues. I refer:

1. to the injustices of the double taxation of dividends which are the reward for risk-taking; and

2. to the capital gains and losses provisions of the Internal Revenue Code which, to repeat, are a feature of the tax structure not intended to be a revenue producer.

I recommended that the maximum effective rate of taxation on long-term capital gains be reduced from 25 per cent to not in excess of 12½ per cent. I do not exaggerate in the slightest degree when I say that our markets are in such an unsatisfactory condition as to be a matter of concern to all of us.

My concern with the position of the equity investor and the capital market arises primarily out of my earnest desire for a continued high level of employment and economic progress. Jobs underlie revenues, capital values, and almost every other economic consideration. I can think of no other way of promoting continued high employment with a minimum of loss to the Treasury than to stimulate the flow of risk capital.

To enable the capital markets to perform their economic function properly is not to invite a repetition of the practices of the twenties. Effective controls preclude this possibility. It is most desirable, however, to reverse the trend of the dormant and stagnant thirties, and to resume the path of economic progress which characterized the American economy until attention was concentrated more on the division of the national product rather than on its size. Funds for business expansion cannot be met entirely through the generation of funds through internal sources, and we must:

1. make it possible for the groups which are the traditional source of venture capital to accumulate funds; and

2. provide incentives for them to invest such funds profitably.

The only other course is to have the Government provide the funds. Nowhere has this policy been compatible with the maintenance of initiative and incentive, and, in the end, of freedom.