WHY AN INVESTMENT COUNSELOR?

A talk by Bosworth M. Todd, Jr., President of Todd-Boston Company, Inc., to the students in the senior investment course at the University of Kentucky on April 5, 1968.

I appreciate the opportunity which you and Professor Carpenter have given me to meet with you here today. When I asked Dr. Carpenter what he wanted me to talk about he said, "I think people are usually most interesting when they talk about what they do". Therefore I hope to tell you what an investment counselor is, and why I started my firm, the Todd-Boston Company, in Louisville. In addition, if time permits, I hope to tell you something about our investment philosophy at Todd-Boston. I'll also try to answer any questions you may have.

First of all, let me tell you what an investment counselor is. The Todd-Boston Company, as investment counselor, provides professional, continuous, confidential supervision of our clients' investment portfolios. We serve as adviser to individuals, and institutions in their selection of stock and bond investments. When properly authorized we place orders for the client directly with his broker. We may be given discretion by the client to make purchases and sales after which the client is immediately advised of the action taken. In other words, he receives a duplicate copy of the broker's confirmation. On the other hand, where the customer desires, his prior approval may be obtained before action is taken. Phone calls, rather than letters, are the most frequent means by which we seek this approval. It's much quicker, we can answer any question that the customer may have.

The investment counselor does not take custody of the securities. In most cases a bank or broker holds the securities on a custody basis, but without investment authority. The client simply instructs the custodian, in writing, to accept orders in his account from Todd-Boston Company. We have, in a few instances, accepted accounts from clients who prefer to keep their securities in their own lock box. This can present problems and its effectiveness is directly related to how conscientious the client is in handling the details of security transactions himself. Too often, we have discovered that the client's own dislike for carrying out transactions himself have caused him to make very few changes in his account. Usually investment performance suffers.

We believe that the key to satisfactory investment results is attention to the needs of the client. The client's interests, in our opinion, are best served by limiting the number of accounts per advisor to about fifty. This is a very personal business and in that respect, it's like being a doctor or a lawyer. It takes a while to get to know the client. You can't simply ask him if his investment objective is safety, growth, or income, and take it from there. These words have different meaning to different people. One client may say he wants maximum capital appreciation but is later reluctant to make changes which result in a reduction in current income. Another client may indicate that he wants a conservative program and then later becomes restless with the modest growth such a program implies.

Obviously we all want to buy Xerox at 15 times earnings to yield 4%, but there's just no such animal available to my knowledge.

Our fees at Todd-Boston are pretty typical of most counselors. We charge a semi-annual fee, in advance, based on the market value of the securities which the client turns over to us for management. This semi-annual fee is 1/4 of 1% on the first $1,000,000, 1/8 of 1% on the second $1,000,000, and negotiated on amounts in excess of that. Since our fee, under federal and state income tax law, is a deductible expense, this means that for many of our clients the tax savings offsets about half the fee. Our fees are higher than for an investment management account at a bank even though we don't provide for custody of the securities, and our minimum fee is about twice that of the typical bank. The reason is simple, a counselor will run 50 accounts instead of 500.

Assume that as a money manager you divide your time evenly between investment research and managing accounts. If you work 2,000 hours a year this means you have 1,000 hours to spend on accounts. So in one instance you have two hours a year per client, and in the other instance, twenty hours. This is what we mean by attention.

Before starting this company five months ago we had the chance to visit eleven different investment counselors in six cities, ranging from the most aggressive gun slingers to the most conservative hand holders, and from very large to very small firms. I think the following observations can be made about the investment counsel profession:

1) The profession is growing quite rapidly. A recent issue of "Fortune" magazine estimates that 1/3 or more of the money invested by individuals involves counsel by money managers - aside from the counsel offered by stock brokers.

2) There basically seems to be two kinds of investment counselors - conservative hand holders who have a low minimum fee, a large number of accounts per advisor, very little turn-over in the accounts, a large number of stocks to follow, perhaps several hundred, no particular interest in having the client put his securities in custody with a bank or broker, and practically never any discretion in the accounts. These features seem to characterize many of the older, but by no means all, of the older counseling firms. By way of contrast many of the younger firms follow quite aggressive policies. This includes firms like the Ivest group in Boston, Fred Alger and John Hartwell in New York. They usually have a large minimum fee, some as high as $5,000. Hence they have very few accounts per man - usually 35 or 40. Most of the accounts are discretionary, are kept in custody with a bank or broker, a typical account may consist of 10 aggressive growth stocks, with no more than 40 or 50 different issues in all the accounts. These counselors usually have discretion as to where the brokerage is placed which is important since brokers furnish much of the investment research used by these firms. Technical as well as fundamental investment research is used. Portfolio turn-over is high, normally running 30-40% a year. Although these firms have very few accounts per man they indicate very little hand holding is done, except with the major pension fund accounts. This is probably due to the fact that a lot of time is involved in the above average activity in each account.

3) There is a growing interest in investment performance. A number of these aggressive firms have been successful in attracting institutional capital, such as

pension funds, profit sharing funds, and university endowment funds. Hence the number and size of these aggressive firms has been quite rapid in recent years. Many of these firms are now running a small, but aggressive, portion in a number of pension and endowment funds. Stanford University recently started a separate endowment fund to be managed in an aggressive manner by several west coast counselors. Yale University has turned over its $500 billion to a newly created investment counseling firm in Boston headed by Roland Grimm. Mr. Grimm is quoted as saying "Too many colleges have had back burner treatment of their investments. They deserve better than that. If they are to get first class treatment they must have professional managers who can watch the market from day to day, not meet once a month and make investment decisions." For many years Princeton University has relied upon the investment counseling firm of John Bristol & Co. to manage its $400 million endowment fund. By the way, the Bristol firm recently became a subsidiary of the Boston Company, the holding company which is also parent of the Todd-Boston Company.

Over the past ten years college expense budgets have grown 14% a year, while public schools, such as UK, have been able to offset costs by increased legislative appropriations, private schools, which have 80% of the endowment investment funds in this country, have had to boost tuitions to extremely high levels. President Kirk of Columbia University said recently that financial troubles are threatening the entire existence of private universities. There is a growing realization among college trustees that they simply have not been doing as well with their portfolios as they might have.

What turned this feeling of unspoken uneasiness into a matter of loud discussion was the criticism last spring of endowment fund management by the Ford Foundation President McGeorge Bundy. He said, "It is far from clear that trustees have reason to be proud of their performance in making money for their colleges. We recognize the risks of unconventional investing, but the true test of performance in the handling of money is the record of achievement, not the opinion of the respectable. We have the preliminary impression that over the long run caution has cost our colleges and universities much more than imprudence or excessive risk-taking.....The capital portfolios of American colleges and universities are now estimated at $12 billion at market value. If their current average annual performance, counting both interest and capital appreciation, could be improved by only one percent of capital a year, the increased return to our colleges and universities would be $120 million a year, more than twice the current budget of the Ford Foundation for education and research."

We started Todd-Boston Company because there are very few investment counselors in Kentucky yet there is a great deal of individual and institutional wealth in the state. To my knowledge there are but five men in four investment counseling firms in Kentucky who are licensed with the SEC and State of Kentucky as registered investment advisers. By way of contrast there are, according to the New York Stock Exchange fact book, about 150 registered representatives with New York Stock Exchange member firms. Furthermore, according to this publication, there are 160,000 stockholders in Kentucky, or about 1,000 stockholders for each broker. For the nation as a whole there is one broker for every 525 stockholders.

Throughout the state I would estimate that there are no more than 40 or 50 full-time investment trust officers in banks and about half of these are in Louisville.

So much for the money managers. Now, how much money is there to manage in Kentucky? According to the Department of Revenue in Frankfort, Kentucky's intangible property tax last year was $10 million. Since this tax is 25¢ per $100 of market value, this implies a value of $4 billion in stocks and bonds held by approximately 100,000 individual taxpayers in Kentucky. Half of this tax was paid by Jefferson County, although it represents but one-fourth of the state's population. The average taxpayer had about $40,000 in securities, not including the value of any stocks of Kentucky based companies or Kentucky municipals, both of which are exempt from this Kentucky tax.

It is more difficult to estimate the institutional wealth, that is pension funds, profit sharing funds, and endowment funds. However, as a rough guess, I would estimate that there is in excess of $1 billion in institutional funds in Kentucky. So that's a total of $5 billion in securities in Kentucky. That's over $100 million for every counselor and investment trust officer in Kentucky. So, I think it's safe to say, this is an attractive market.

While we're on the subject of the size of the wealth in Kentucky, let's look at the national picture. Not only is a large part of the corporate wealth in this country represented by stocks listed on the New York Stock Exchange, but a large portion of that, in turn, is represented by the value of very few companies. Less than 1/10 of 1% of all American companies are listed on the big board, about 1,300 names. Yet they represent 30% of the assets and 45% of the profits of all U. S. corporations. It is interesting to note that the 50 stocks on the New York Stock Exchange with the largest aggregate market value, that is the number of shares outstanding times the market price per share, at the end of 1966 amounted to $225 billion, or half the $482 billion value of all listed stocks at that time. It is estimated that IBM today is worth about 6% the value of all listed stocks. It has just under 60 million shares outstanding, selling for in excess of $600 a share, or $36 billion.

There are about 20 million stockholders in the United States who own almost $600 billion today in value of listed stocks.

Now a word about investment research, the most important aspect of any counseling firm. In this country investment research is concentrated in the east. In fact, one-third of all security analysts are in New York City, another 5% in Boston. At least their names take up that portion of the space in the National Security Analysts Federation roster of names. Therefore it is difficult for the regional investment adviser to be an effective money manager unless he has access on a continuous basis to investment ideas from a good institution in the east. Likewise it is equally difficult for a counselor or banker in New York or Boston to come into Kentucky and solicit clients. This is why we formed our company as a wholly owned subsidiary of The Boston Company rather than starting up on our own.

Since the formation of the Boston Company three years ago, seven investment counseling firms in six cities, including mine, have been acquired. They have also acquired the Boston Safe Deposit and Trust Company. A no-load mutual fund, the Johnston Fund, has been acquired. Economic and financial counsel is provided by Rinfret-Boston Associates, an

affiliate headquartered in New York headed by Dr. Pierre Rinfret. Dr. Rinfret, formerly chairman of the Board of Lionel Edie, also serves as economic adviser to The Boston Company and its affiliates. His weekly two-page memos have been very helpful to us, particularly during this period of the British devaluation and the recent gold rush.

We believe the quality and quantity of the investment research material we receive is unparalleled in Kentucky. In January and February alone we received investment comments from The Boston Company on 233 stock issues. We subscribe to the usual Moody's Manuals, Standard Corporation Records, Value Line reports, Barrons, The Wall Street Journal. We also find that the London Economist and the daily New York Times are quite helpful, even though they come in a few days late. We're currently receiving the stockholder material from about 200 companies, including annual reports and quarterly reports. Last, but not least, is the research material we receive from brokers. In addition to the material we receive from the Kentucky brokers, we obtain research from over 30 brokers in New York. In fact, at this point, we have more brokers than clients. Some of the finest research in the country, in my opinion, is done by brokers who specialize in serving the needs of institutional clients. For example, this week we received an excellent 18 page memo on Memorex Corp. from one broker, and from another, a 33 page study on General Electric.

We also seek out our own ideas by calling on companies and interviewing management, but we spend the majority of our time applying judgment to the investment research ideas of others.

We also write and send to our clients short memos from time to time. In the past four months we have sent our clients two studies on the devaluation of the pound, four memos on the recent gold rush, two studies on Vietnam, and one study on the rewards of investing in small technologically based companies.

And now for the second feature of our twin bill, I'd like to tell you a little bit about our investment philosophy. We believe that over the longer run common stocks are more attractive than bonds, even though there may be periods, such as in the past few years, when bonds yield about twice that of the typical stocks. Over the past century common stocks have provided a total return, that is yield plus growth, of about 10% a year. In contrast bonds normally yield about 5% a year. The 10% total return on common stocks on average coincides with the 10% return on net worth which the typical company enjoys, that is net profit after tax divided by shareholder equity.

To go further we think the stocks of rapidly growing companies are more attractive than the average stock, and certainly more attractive than rare paintings as an investment hedge. You may remember the publicity a few months ago when the Reverend Theodore Pitcairn sold his Monet painting at a London auction for $1,400,000. He purchased this painting in New York in 1926 for $11,000. This increase in value over a 41 year period represents but a 13% annual compound rate of growth. Had he invested the same $11,000 in IBM in 1926 he would now have $10,000,000 worth of this stock. This is a 19% annual growth rate and I'm not even including the dividends.

We agree with Godfrey Howard, head of investment research at the Boston Company, who talks about the obsolescence of size. It is very difficult, he says,

for a company with $1 billion in sales to grow 10% a year on a sustained basis. It is much easier for smaller companies to show above average growth. Furthermore, according to a report issued last year by the Commerce Department, they came to a startling conclusion about the relation of company size to technological advance. Their findings are quoted as follows: "These studies were unusually consistent in indicating that independent inventors in small technologically based companies are responsible for a remarkable percentage of the important inventions and innovations of this century". Technology is the driving force of our economy. Three industries which did not even exist in 1945, computers, jet aircraft, and television, accounted for $13 billion of our Gross National Product in 1965. There is now an acceleration of history and the risk takers are in a stronger position than they used to be. The final third of the 20th century is no time to be playing it safe. Research and development expenditures will continue to grow. Herman Kahn, in his new book, "The Year 2000", thinks such expenditures will reach 10% of Gross National Product by the end of this century.

If we think changes are too drastic even now, just wait for a few years. While we will be able to cope with these changes in the years ahead, the road behind us is going to be strewn with the wreckage of muscle bound corporations who resisted change.

As Godfrey says, an emphasis on smaller companies obviously magnifies the risk factor, but if our portfolios are going to keep in step with our changing environment, we will just have to accept it. The security analyst will have to be all the more careful about balance sheets, maintain continuing access to management, and examine the company's products and markets with extreme care.

We think it's a mistake to pay too much attention to the trend of the general market. For example, the Dow Jones Industrial Averages have been flat for the past four years. Selectivity is the key. IBM, for example, has gone from 300 to 630 during this period, a gain of 110%, while du Pont and Telephone have each dropped one-third in value during this same period. Polaroid, for example, benefiting from new product introduction, has increased its earnings and market price five-fold during this same four year period.

Because of our concern about inflation, war fears, and anxiety over possible devaluation of the dollar, it is interesting to look at the experience of the British investor, where these problems have been prominent for the past 50 years. Mr. William Biggs in a recent memo from The Bank of New York made the following statement:

"In connection with the British experience, a word of cheer for shareholders may be in order. Britain, in the period of the last 50 years, has had three Labor Governments, which devalued three times, and was in a major war (which seems to have been lost, because of its cost, although everybody thought it was won). During this period Britain also lost her Empire and her industrial and trade supremacy.

Certain studies have been made of the performance of British common stocks during this period. A study by the well known London stock exchange firm, de Zoete & Gorton, indicates that in the period from the beginning of 1919 to the beginning of 1968 an index of representative common stocks advanced from 100 to 978.7 or 5% a year. During this period the cost of living index increased by

250%, or 2% a year, and a dividend index increased by about seven times, or 4% annual growth. Thus, taking the period as a whole, the holder of equities came out reasonably well, although certainly adjustments must be made for higher taxes, the imposition of a capital gains tax, etc. In this period the holder of British Perpetual 2 1/1% bonds saw the price decline from 100 to 60, and the purchasing value decline from 100 to under 24."

In summary we look favorably upon companies which demonstrate the ability to maintain or increase their profit margins as a per cent of sales. In an inflationary period profit margins for the average company are squeezed by rising labor and raw material costs. There is only a limited number of companies providing a hedge against inflation - companies whose profits rise at least as fast as inflation. The emphasis is on the ability to raise profits.

As our economist, Dr. Pierre Rinfret, has noted, this type of company has certain clear cut characteristics as follows:

1) The corporation has management depth and operates on a performance basis.
2) It has a market that is fairly substantial and that market is growing.
3) Its products are unique enough to enable the company to raise the prices of its products at corporate will.
4) The products are not so simple and widespread as to have a bearing on national economic policies or objectives.
5) The corporation is continuously aware of the market price of its stock and considers that price as important as the price of its products.
6) The company is research-oriented and able to match innovations in technology with its own innovations.
7) The corporation has an internal drive and momentum not found in the conventional nine-to-five organization.
8) It cuts its losses as fast as it maximizes its gains.
9) It is not so highly diversified as to represent a small American economy.
10) It is not so huge as to be a dinosaur.

QUESTIONS

Q. Since your prospective client has to pay a brokerage commission in addition to your fee, then why wouldn't it be just as good, and certainly cheaper, for him to go straight to the broker?

A. It would be cheaper, but I don't believe it's just as good. The broker, unlike the counselor, has a potential conflict of interest with his client. As we have seen, there are over 1,000 stockholders per broker in Kentucky. Not all of them are active traders. The broker's compensation is directly geared to 1) the amount of activity he generates in the account, and 2) the type of security he sells the client. There is no evidence, to my knowledge, to show that excessive trading in an account improves the performance. Likewise the broker's commission rate is higher on a low priced than on a high priced stock, and this compensation is greater on a new issue underwriting than on a routine secondary market transactions. The counselor can provide unbiased advice on a continuous basis, rather than sporadic, and is aware of the client's total portfolio whether he manages all of it or not. He also furnishes the client with the figures he needs at year-end for tax purposes and this can be important.

Q. What do I think about the market now?

A. Guessing near term market swings is, at best, a hazardous guess. It's more important to focus on the long run and even more important to spend time appraising individual stocks rather than the over-all market.

Q. Do I have a minimum sized account?

A. No, but since I'm charging half of 1% on the first $1 million, with a $500 minimum fee, the client should be aware that since his fee is a percentage of his assets this can be rather formidable if his account is considerably less than a $100,000 in size. However we do have some $50,000 accounts even though the fee is 1% but they came in because their objectives were capital appreciation rather than income.

Q. Do I try to maximize profits before tax or after tax?

A. Obviously it is the after tax profits which are meaningful. This is why we show acquisition dates on our appraisal form. In most cases we are reluctant to take capital gains before six months because of the higher tax rate. Furthermore, the large capital gains taxes which might result from excessive activity will often eat up much of the profits - another reason to be leary of excessive trading.

Q. You indicated that you spend an average of 20 hours a year managing each client's account. Doesn't this mean that the $1 million client is paying you $250 an hour, which is higher than a bank, and yet you're not even providing custodian service. Isn't this a little high?

A. This fee is cheap if the results are there. Furthermore, this is an average, not a uniform amount. We recently spent 8 hours, for example, doing research on one stock for a major client. In addition, we should include the other half of my time which is spent on research, so that's really 40 hours per client total time.