Some Critical Views on the Melbourne Symposium


This is a useful paper for it does raise and candidly comment upon several of the important questions currently affecting the Stock Exchanges. It is a pity though that the comments are sometimes spoilt by their too obvious bias, their occasional triviality, and their inaccuracy.

The Economic Functions of the Stock Exchange

As Mr. Fitzgerald says, Mr. Macindoe mostly judges developments concerning the Stock Exchanges from the position of company management although, when discussing brokerage, commission charges and underwriting, he does take a wider view. At no stage, however, does Mr. Macindoe discuss his points against a set of economic standards. This economic point of view is not, of course, the only view to consider, but it does provide one of the more important sets of criteria by which current developments in the Stock Exchanges should be examined. And such an approach does lead to some conclusions which are different from Mr. Macindoe’s.

Briefly, the Stock Exchanges have three economic functions. They are first of all one of the institutions in the capital market helping to provide new funds for investment, thus enabling greater specialisation of function between savers and investors. Life offices, for example, can concentrate on the provision of capital, gathered from many sources, whilst companies and governments can get on with building factories and roads. The role of the Exchanges in this new issue market varies from year to year due to the changing importance of retained profits and depreciation and, more recently, direct borrowing from institutions. But the public new issue market can be particularly important to those firms growing very rapidly and needing to finance their growth from external sources.

Their second function is to reduce the risks of illiquidity involved in holding shares or bonds. If these securities were completely illiquid titles to wealth, savers would not hold nearly as great a percentage of their savings in this form, companies wishing to raise capital would have to offer much higher yields than current ones, and owners of bonds and shares would find such titles much less suitable as security for borrowing purposes.

The third and important advantage of having the market provided by the Exchanges is to direct resources to the companies which will be the most efficient users amongst those seeking funds. Savers and investors do this by showing their preferences in the market for both existing securities and new ones thus encouraging some issues and discouraging others.

Now Mr. Macindoe expresses his dislike of the current trend towards more frequent and fuller disclosure of information by companies on the grounds that the Stock Exchanges encourage these practices for the purpose of stimulating turnover. There are many other commentators on the financial scene who believe he is wrong in his judgment of the forces motivating brokers towards fuller disclosure, but even if he were right, in the light of the third function of the market expressed above, we must welcome the increasing trend towards half-yearly reports and other published information. For it is only on the basis of such information, regularly produced, that those with funds to invest can make informed decisions.

The purpose of this article is critically to review one of the papers delivered at the Melbourne Stock Exchange Symposium, “Investment in Australia,” held during February this year, where questions are raised affecting the Australian capital market and especially the Stock Exchanges. The discussion is, in the main, based on one of the two papers which specifically deal with the Stock Exchanges but some comments are drawn from the other papers, where these are relevant to the argument.

Mr. Mellor was much too hopeful when he suggested that the Symposium papers might be referred to as a textbook; very few indeed are of this standard. But they do show that there are many important developments taking place in the institutional structure of our capital market, and we should be pleased that the Melbourne Stock Exchange has invited discussion on these developments by both holding its Symposium and publishing the proceedings.

By P. J. ROSE
University of Melbourne.

The Exchanges in Australia also have a role to play in providing part of the market for Commonwealth Bonds in which the Reserve Bank and Treasury can operate for purposes of national debt management and monetary policy.

Life offices, companies and governments do, of course, combine both functions to varying extents; that is, they both save and invest.
national choices. And Mr. Looker is right in pointing out that increased turnover is not in itself to be condemned: for the more active the market the more the risks of illiquidity are reduced and the more readily savers may express their preferences.

Professor Chambers in his paper to the Symposium suggests that the Exchanges should do more about disclosure than they are doing now.

In particular he wants them to play a more important part in improving the comparability of the financial statements which are already being published. This step he believes is necessary for the securities market to play its part in controlling the distribution of investable funds. Shareholders in most countries today are tending to leave this function more and more to the Stock Exchanges and other professional groups such as accountants, and the increasing institutional influence in the market is not altering this trend.

Mr. Fitzgerald gives a further reason for demanding more frequent information. He is disturbed that without such disclosure “insiders” will continue to have too much opportunity to benefit themselves at the expense of the market—a matter with which the Victorian Government is currently concerned.

Mr. Macindoe does not include in his printed paper his sceptical remarks about the usefulness of security analysts but these, too, missed the important point. The increasing number of analysts is a sign that our securities industry is becoming more professional, and that more funds are being invested in new and existing ventures after a systematic study has been made of long-term prospects rather than on the basis of short-term speculative chances or because of personal contact at management level. It is made clear in the papers of the overseas speakers that Australia, at least in the short term, will have to rely more on her own resources than she has in the recent past, and this makes even more essential the need to deploy our savings wisely if we are to achieve a fast rate of economic progress. We must stop more of our companies retaining funds on which other investment opportunities are unexploited offering much higher potential. It is against this background that the role of the security analyst should be discussed.

What has just been said does not mean there is no place for the short-term professional speculator in our market. There is an important part to be played by such firms in both shares and bonds and some thought will have to be given as to what extent this function can be filled in Australia and whether some alteration of existing financing and trading facilities will be necessary. It is these short-term operators who should improve the liquidity of securities by either buying or selling securities when there is a temporary irregularity between demand and supply on a particular day. In the share market the increasing influence of institutional and overseas buyers and sellers has made the need for this service more apparent in recent years. Overseas investors in particular like to deal in large parcels with firm offers for both buying and selling orders. “On change” it is mainly the smaller brokers who tend to even out the daily fluctuations in share prices by taking positions as principals. There are a number of brokers who are very active in this way. “Off change” it is some of the larger brokers who provide a limited jobbing service in the more frequently traded stocks by being prepared to absorb large quantities which may be in excess of £500,000 with a view to off-loading them, probably in smaller parcels, during the following days or even months. There are as yet few brokers who consistently run a “book” of shares of more than £100,000, and the rules of some Exchanges continue to forbid brokers selling short in either shares or bonds.

TABLE 1

<table>
<thead>
<tr>
<th>MELBOURNE STOCK EXCHANGE 1963/64</th>
<th>Total market value of listed securities £M</th>
<th>No. of sales transactions reported</th>
<th>Estimated Av. size of sales transaction reported £M</th>
<th>Value of reported sales £M</th>
<th>Sales in units of 1 million</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) (b) (c) (d) (e)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Commonwealth Loans ..........</td>
<td>3,331</td>
<td>17,677</td>
<td>3,677</td>
<td>65</td>
<td>65</td>
</tr>
<tr>
<td>Semi-Government Loans .......</td>
<td>353</td>
<td>3,703</td>
<td>621</td>
<td>2.3</td>
<td>2.3</td>
</tr>
<tr>
<td>Debentures .................</td>
<td>262</td>
<td>4,2</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unsecured Notes ..........</td>
<td>94</td>
<td>6,262</td>
<td>1,117</td>
<td>1.7</td>
<td>7.4</td>
</tr>
<tr>
<td>Convertible Notes ........</td>
<td>68</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pref. Shares ............</td>
<td>80</td>
<td>4,345</td>
<td>506</td>
<td>2.2</td>
<td>2.5</td>
</tr>
<tr>
<td>Ord. Shares. Rts. Options</td>
<td>4,737</td>
<td>408,874</td>
<td>297</td>
<td>148.5</td>
<td>153.1</td>
</tr>
<tr>
<td>Mining Shares ............</td>
<td>299</td>
<td>90,913</td>
<td></td>
<td>33.2</td>
<td></td>
</tr>
</tbody>
</table>

Sources: Columns (a) (b) (e) and total for (d)—Melbourne Stock Exchange

(The table continues on the next page.)
A company which is being managed for the benefit of its shareholders should consider the addition of new assets only if the earnings yield on the cost of these assets exceeds the existing earnings yield on the company’s shares, or what earnings yields are offering elsewhere. This argument remains true regardless of whether the funds come from the retained earnings or the proceeds of new issued capital.\(^1\)

Now if a company has satisfied itself on the above point, and decided to finance expansion from the proceeds of a rights issue, then it makes no difference to the shareholders whether the issue is at a par or a premium. This assumes that the same amount of money is raised whatever the technique used, that the proportion of earnings paid out as a dividend remains the same, and that the market continues to value the company on the same earnings yield basis regardless of the method of issue. It makes no sense to prefer a par issue because this allows shareholders to sell rights for a tax free “profit”—shareholders can just as well sell shares.

Australian investors, however, have one good reason for preferring a par issue to a premium issue. This is because the par issue has often meant a higher proportion of earnings have been paid out as dividends after the issue, and as investors tend to value one pound of dividends more than one pound of earnings a par issue has often meant a rise in the market price of the company’s shares. The premium issue on the other hand has tended to be associated solely with the need for finance, whether this be for liquidity or expansion reasons, rather than a higher dividend payout.

\(^1\) The argument here is, in a sense, a static one and it would be more correct to allow for increases or decreases in earnings from both existing assets and those acquired with expansion.

Now there are disadvantages in financing expansion with par issues. Dividend yields become distasteful and the market is more inclined to play the game of looking for the company which will be likely to make a par or bonus issue (a bonus issue has often had the same result on dividend payout as the par issue) rather than looking to the important underlying long-term earning potential. The answer is for companies to issue shares at fairly high premiums and gradually to increase their dividends, thus helping to restrict some of the short-term speculative movements in share prices.

### NEW MEMBERS:
(Sydney)

**REGULAR**


**ASSOCIATE**

J. M. BURKE, N. P. J. GOULD, J. WILLS.

If an ordinary share issue is made to other than existing shareholders then the present owners are allowing others to share in current and future profits. Existing shareholders will not find such an issue to their disadvantage so long as the earnings yield on the cost of the new assets acquired is an improvement on the present earnings yield on the company’s shares. Though it is reasonable to argue that if new shareholders find a new issue and the accompanying expansion project attractive enough to support so would the old shareholders, the occasion can arise when the only way of financing profitable expansion is by introducing new shareholders. This may come about because the volume of funds needed is more than existing shareholders can be expected to provide, or because the owners of the assets which are to be purchased will only accept shares as payment.

When shareholders are considering whether a private placement and the project this finances is in their best interests or not, regard must be given to the price at which new shareholders acquire the new shares. If 50,000 shares with a market value of one pound are issued to acquire £5,000 of earnings then the earnings yield on the new investment is 10%. If, however, 60,000 of the same shares, each with a market value of one pound, are issued either directly to the vendors, or to institutions which pay £50,000 in cash which is then given to the vendors, the earnings yield which the old shareholders should use in measuring the cost of this new project is not 10% but 8\(\frac{1}{2}\)%.

It is sometimes claimed that a rights issue at a high premium tends to cause a fall in the market price of a company’s shares which will be greater than any fall following a private placement of the same number of shares at the same price. This argument seems to be based on the belief that there is greater selling in the market as the result of a rights issue than there is with a placement which is, typically, made to institutions. The theory is untested and over the last year there has been evidence to the contrary, especially when placements have been made outside a limited range of institutions. But even when a placement is made to institutions, there may still be a fall in the market due to the lack of buying support from these institutions which may well have purchased, by means of the placement, their year’s buying quota in one transaction.

If, however, there is some disadvantage in rights issues at high premiums compared to private placements due to irrational mar-
on these matters. A large part of the confusion arises from the use of the par concept and it may lead to an improvement in our financial practices if we adopted the recommendation of the Jenkins Committee, and also Professor Chambers, and introduced the no par value share. At times this par value concept of accountants and lawyers prohibits sensible financial criticism. Dividends and earnings are mostly expressed as a percentage of par value and though this is a useful way of looking at the dividend cover it can be a very misleading way of examining a company’s earning capacity over time or comparing one company with another to see which is using new funds most efficiently.

**The Stockbroker-Underwriter relationship**

In London brokers may at certain times share their brokerage with other institutions and Mr. Macindoe asks why Australian brokers should not be allowed to do the same. This question is separate from, but in addition to, his point about lower brokerage. The case for sharing commissions is not made clear. Why, for example, should a pension fund get a “kick-back?” The question was unanswered by any of the other speakers. Mr. Macindoe does claim that some brokers when dealing as principals do so with a view to sharing commission. This may be correct in some cases but I think its importance is over-rated and there are other and more important reasons which explain why brokers take positions as principals.

Mr. Macindoe’s case for “kick-backs” probably rests on the fact that some specialised institutions introduce new business to brokers such as an investment banking house buying shares on behalf of a managed pension fund client. Institutions, solicitors, accountants and foreign brokers in London get rebates on this basis though not when buying or selling for their own account. But it is important to remember with this London system that a broker, if he gives a rebate, will not also give the lower brokerage terms applicable on the larger deals. This means the purchaser, who is the beneficial owner of the shares bought, pays more in brokerage in order to allow the institutional agent to get a “kick-back”. It thus operates as a way whereby the managers of portfolios get rewarded for their work.

In Australia institutions such as

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**TABLE 2**

**BROKERAGE RATES ON VARIOUS SWITCHES OF GILT-EDGED BONDS**

(Calculated as a percent. of aggregate stock in complete switch)

<table>
<thead>
<tr>
<th>Maturities up to 1 year</th>
<th>Maturities 1-5 years</th>
<th>Maturities over 5 years</th>
<th>Maturities over 5 years</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deal:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>£100,000 each way</td>
<td>£100,000 each way</td>
<td>£250,000 each way</td>
<td>£31,250 each way</td>
</tr>
<tr>
<td>Banks: 1/3%</td>
<td>Banks: 1/3%</td>
<td>Banks: 1/3%</td>
<td>Banks: 1/3%</td>
</tr>
<tr>
<td>At discretion</td>
<td>At discretion</td>
<td>2/6%</td>
<td>2/6%</td>
</tr>
<tr>
<td>probably about 2d%</td>
<td>probably about 2d%</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

(a) For loans over 12 months currency 5/-% up to £50,000 For banks, all loans, 2/6% on next £200,000, 1/3% on balance 2/6% up to £250,000 1/3% over £250,000 For switches half these rates to both sale and repurchase.

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14 May, 1965

(The Australian Security Analysts' Journal)
non-broker underwriters do, and sometimes must, introduce business to brokers by having to appoint an official broker to a new issue with whom underwriting commission is shared. However, brokers do not, or are not allowed to give a quid pro quo by sharing their brokerage with non-members who introduce business. Because so little is known about the new issue market it is difficult to say whether these arrangements between Stock Exchanges and non-broker new issue firms give brokers the privileged position in underwriting which Mr. Macindoe claims they have.

Although Mr. Macindoe does not want to exclude brokers from underwriting he does question whether brokers, except for the big ones, have the skill and financial resources necessary to combine both jobs. He also doubts if a broker when planning an issue is able to take the long-term view necessary in the interests of the company and, after the issue, give unbiased advice to investing clients.

The argument that only big firms of brokers have the expertise makes no allowance for the forces of competition and the growth of the small efficient underwriter whether it be a broker or non-broker. This is an important consideration which should not be overlooked for over the last few years several new underwriters have successfully entered this market and some of these firms were either very small or not in existence ten years ago.

Mr. Fitzgerald is not worried about the underwriting broker relationship and quotes the case of New York where it is the brokers who have introduced new forces of competition into the new issue market. In Australia it is surely the continuation of this same competitive element that will answer Mr. Macindoe's worry about some firms only underwriting certainties and, as we shall see below, lower the costs of making new issues.

Mr. Looker suggested that the conflict of interest both before and after the issue also exists for a non-broker underwriter and a broker may still be involved in such an issue due to his role as "broker to the issue". The answer to this latter worry may be to do away with the necessity of having brokers in this capacity. But before suggesting such a course we really need more idea of what the official broker does. Mr. Looker also says, and we know this is true from past and recent experience, that the new issue and brokerage industry is competitive and that inefficient or unsuccessful firms will lose their company clients, their broking clients, or both. Institutions and individuals can, if they wish, deal with good brokers, large and small, who specialise in stock-broking and avoid the new issue and underwriting market. On the other hand there are institutions, and often the most progressive ones doing a lot of research themselves, who are glad to be able to have contact with some brokers who have close connections with some companies. Brokers may of course obtain their knowledge in ways other than underwriting, but from the point of view of an institution taking a five year view, and with the ability to check a broker's judgments, the fact that some advice comes as the result of being an underwriter is not necessarily a disadvantage.

At a time when many new and varied demands are being made on the capital market, and while there is a shortage of expertise, it seems better to retain these forces of competition rather than limit them by formalising our institutional structure into a more rigid pattern. This view is still compatible with having adequate checks on the financial structure of private broking partnerships if they wish to combine with broking the serious risks involved in bond jobbing, share jobbing and underwriting.

Mr. Macindoe's suggestion that brokers be kept off the boards of investment companies should also be carefully examined. These companies already have but limited scope to manipulate prices, or take up unsuccessful new issues sponsored by a broker, for the Companies Act sets various limits to individual share holdings, and underwriting and commissions paid to a broker/director must be disclosed. It was this investment company and broker connection which was the origin of some of our leading and most enterprising financial houses and in many cases still gives the financial strength to brokers who wish to develop underwriting, new issue and placement business. If we want to have Australian owned investment houses in the future we might not do better than let the process continue subject to sensible checks and controls.

An Australian S.E.C.

The question of an Australian S.E.C. is discussed several times in the Symposium papers. Mr. Macindoe dislikes the idea; he prefers the greater flexibility and speed of action obtained by having the Stock Exchange fulfil this function — always provided they are up to the mark. But he did have some helpful suggestions about the internal staffing and administrative arrangements of the Exchanges, and if
these ideas were followed we could expect Stock Exchange Committees to have more access to expert knowledge and thus speak with greater authority on current matters such as amendments to the Companies Act. Mr. Fitzgerald carried Mr. Macindoe's ideas further. He would like to see outside representatives from such organisations as The Reserve Bank, the Institute of Directors, accounting bodies and the Shareholders' Association, formally associated with the Exchanges, and perhaps join a Federal Committee covering all Exchanges. Such a move would help to resolve various conflicts of interest between company managers, investors, shareholders and brokers. It may also help to bring into line the many and important companies who ignore for various reasons the current listing requirements.

Underwriters and Interest Rates

Mr. Macindoe is wrong when he says "there seems to be little attempt on the part of underwriters to pitch the rate of interest close to the market or to educate the market on the matter of interest rates". The finance companies are the most constant and largest group of borrowers of money on fixed interest and they keep their interest rates and maturities very much in line with the market returns. Some of these borrowers will, if they wish to slow down the inflow of funds, marginally adjust their rates rather than withdraw their prospectuses and this suggests considerable awareness by the market of interest rate variations. And this market includes a large number of investors as is evidenced by the fact that the average size of a hire purchase deposit or debenture investment is only a few thousand pounds. There is no evidence to support Mr. Macindoe's argument that other company fixed-interest borrowers fail to keep their terms in line with the market; underwriters of such issues would hardly stay in business if they continued to give such advice. But the market terms for all this borrowing are not set on the floor of the Stock Exchange. In fact the marketability of company debentures is very poor indeed, and this, perhaps, is Mr. Macindoe's point. It should also be made clear that Mr. Macindoe's comments cannot be applied to the market for Commonwealth securities. Although the big market is off 'change the marketability of shorts in particular is very good.

The Cost of New Issues

Mr. Macindoe remarks that shares which have just been listed often open on the market at a margin of up to 50%, and sometimes more, above the price at which these shares were sold by the original vendors. Now in calculating the cost of making an issue for the purpose of listing and raising new capital, this margin between the market price and the price received by the vendors should be included. For example: if a company issues 100,000 shares to an underwriter at 25/- each, and these shares have a market price of 40/-, then the 15/- per share, or £75,000, should be counted by the company as part of the cost of making the issue and being listed. To this £75,000 must be added advertising, underwriting and brokerage charges, which can vary very considerably, depending on the method of issue, amount and market conditions, but which will probably be between 3% and 5% of the amount raised. The total cost of making the issue will therefore be about £80,000, equal to 64% of the amount raised by the vendors.

It is fair to say that issues involving costs of this size are much less common today than they have been and this is perhaps due to the increasing competition in the new issue market and the growth of competing groups of professional sub-underwriters. Some new issue firms have in mind a rough working figure of between 15% to 20% when estimating for clients the costs of an issue and listing. This may still sound high but it should be remem-bered that part of the cost is similar to an "entrance fee" and by paying it companies gain access to the advantages of being a public listed company, which should include lower costs for subsequent issues. In other words part of the costs can be considered as being spread over the life of the company, or for as long as it remains listed. There is the further point that the market, and very often the company itself, prefers the "image" created by having the newly listed shares traded at prices above what they were first sold for, rather than the reverse. Company managers generally prefer a rising share price to a falling one and for this reason they like to get their company's shares away to what they consider is this "good start".

**TIMELESS TRUTHS**

To approach the task with reasoned ideas and a planned technique is to ensure wider benefits and fewer costly failures than are likely to ensue from unreasoning acceptance of either the advice of friends or the dictates of one's own emotions. The former are seldom disinterested; the latter, in money matters, are always dangerous.

The purchaser of an Ordinary share buys the right to a fractional part of the equity in all future earnings of a particular company, subject to the satisfaction of others whose rights rank prior to his own. It is illogical to assess the value of such a share either on a single dividend which the company in question has just paid, or the next dividend it is considered likely to pay.

HARGREAVES PARKINSON—1932

"Scientific Investment"