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## **Opportunity Cost and Risk: The Parallel Stories of Carl Laemmle and Adolf Zukor**

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## ***Opportunity Cost and Risk: The Parallel Stories of Carl Laemmle and Adolph Zukor***

In this age of risk aversion, with Treasury Bills yielding one basis point and gold trading above \$1100 per ounce, one might do well to be reminded of an age when the understanding of financial risk, such as it was, assumed a different aspect. The modern approach is to avoid risk by asset allocation, if possible, or by hedging, if necessary. The classic financial histories such as John Kenneth Galbraith's *The Great Crash*, Charles Kindleberger's *Manias, Panics and Crashes*, Edward Chancellor's *Devil Take the Hindmost*, or the seminal book by Charles Mackay entitled *Extraordinary Popular Delusions and the Madness of Crowds* have instructed a generation of financial professionals of the consequences of poor risk control. It is not the function of this paper to gainsay in any manner these marvelous books.

Nevertheless, there is such a thing as opportunity cost. Very little has been written upon the subject of the unwillingness to assume risk. The poet John Greenleaf Whittier once wrote that "For all sad words of tongue or pen, the saddest are these, 'It might have been!'" It is for this reason that there follows a comparison of the careers of Carl Laemmle and Adolph Zukor. Both were founders of the American movie industry. Most financial analysts would agree that movie production is, even in the best circumstances, a rather high risk undertaking. Though he was the founder of Universal Pictures, Laemmle is entirely forgotten except by movie historians. Adolph Zukor might be known to students of business history as the founder of Paramount Pictures. A comparison of the approaches taken to risk and risk aversion by these two men is instructive. The ultimate thesis is that, in many cases, risk avoidance is actually a form of risk.

Laemmle was born in Germany in 1867 and immigrated to the United States in 1884. He opened a clothing store and earned a meager livelihood in Osh Kosh, Wisconsin. He first discovered the existence of a nickelodeon<sup>1</sup> during a trip to Chicago in 1905. A nickelodeon was a small neighborhood movie theater in which a short film was accompanied by live music from a piano or an organ. Laemmle was immediately attracted by the alluring economics of the nickelodeon as opposed to his clothing store. Shortly thereafter, in 1906, he opened his own nickelodeon. Entrepreneurs who were familiar with merchandising at the time generally recognized the favorable economics of the business. Hence, the business attracted such individuals as Samuel Goldwyn, who left the glove business for motion pictures, and Louis B. Mayer, who left the junk dealer business in 1907 when he renovated a decrepit burlesque theater in Haverhill, Massachusetts and renamed it the Orpheum. Unfortunately, very few of the original film entrepreneurs left letters, diaries or memoirs describing their reasoning behind the decision to make the transition from merchandising

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<sup>1</sup> The name nickelodeon has its origin in the fact that the price of admission was a nickel and the Greek word for theater is odeon.

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to films. Samuel Goldwyn only made the perfunctory, and possibly apocryphal, remark that "I paid too much for it, but it's worth it." Fortunately Adolph Zukor wrote an autobiography entitled *The Public is Never Wrong*<sup>2</sup>.

Zukor emigrated from Hungary in 1889 at the age of 16. He worked in the upholstery business until he met another immigrant named Morris Kohn. Kohn had originally settled on a farm in Devil's Lake, North Dakota where he began trading farm produce for raw fur pelts with the local Indians of the Sioux Tribe. He thus acquired a knowledge of furs and went on to become a furrier in Chicago. It was there that he and Zukor met. The two became partners in the fur business, and eventually relocated the business to New York, since that city was the capital of the garment industry.

Zukor had a cousin named Max Goldstein. This gentleman was acquainted with Mitchell Mark, who had opened the first bona fide movie theater in Buffalo, New York. Goldstein wished to open such an establishment in New York City, but needed to obtain a loan from his cousin, Zukor. Goldstein invited Zukor to see a small arcade that he had opened on 125<sup>th</sup> Street. As a result, Zukor invested in the project and describes his investment rationale in his autobiography. Goldstein wanted to open the establishment on 14th Street and Broadway. That area of Manhattan, which was north of Canal Street and south of 14th Street, was very impoverished in 1903 when these events took place. The area was filled with tenements and sweatshops (Zukor 35-40). Thus, 14th Street stood at the periphery of a huge market in search of very inexpensive entertainment.

According to the Zukor autobiography, the capital cost of the 14th Street nickelodeon was \$75,000, and the daily "take," or revenue, was \$500 to \$700 per day. Since the kinetoscopes for the nickelodeon were purchased from the Edison Company, the primary costs were rent for the building, a modicum of labor and inexpensive candy that was used to restock the various vending machines. This was much more profitable than conventional merchandising. Although Carl Laemmle left no memoirs with such calculations, it is no more than a reasonable conjecture that he thought along rather similar lines.

Given the low cost and high margin nature of this business, one must suppose that it was only a matter of time until the profitability would attract the interest and envy of others. A serious threat along these lines emerged in December 1908 when Thomas Edison, Eastman Kodak and all of the major American film companies, including Vitagraph, Biograph, Essanay, Selig, Kalem, American Star and American Pathé, formed the Motion Picture Patents Company. Edison owned most of the patents for the motion picture technology of that time. The Patents Company united the patent holders to enforce patent rights against the exhibitors in a manner that would transfer the bulk of the profit to the Patents Company. This was a very powerful combination, since the film production companies

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<sup>2</sup> Zukor, Adolph. *The Public is Never Wrong: the Autobiography of Adolph Zukor*. New York: G.P. Putnam, 1953.

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were now aligned with Edison in the form of a trust that was sometimes called the Edison Trust.

The Patents Company would not, under any circumstances, sell movies to exhibitors; they could only be rented. They also established a uniform rental rate so that effectively exhibitors could not bargain with film production companies over price. This was indeed a most serious risk to the movie exhibition business, and the difference between the responses to this risk of Laemmle and Zukor may well instruct the modern investment student in the infinite variety of approaches to risk. The natural tendency is to view risk as potential danger, and the human proclivity is to flee danger.

Laemmle came to the conclusion that it was necessary to establish a source of supply independent of Edison for films. Hence, Laemmle started the Yankee Film Company in June 1909. At this point, it is important that the reader understand that the movies of 1908-1909 were very different from modern films. By design, the films were very short and of very poor artistic quality. Audience turnover was considered the secret to the high profitability of the nickelodeon. It was believed that a lengthy film would limit audience turnover, and thus serve to reduce exhibitor profitability. At this time, a motion picture was known in the business as a “chaser.” The film was intended to be sufficiently boring to cause patrons not to linger at the nickelodeon. They would leave, and make room for others (Zukor 49).

Hence, the challenge for Carl Laemmle was not merely to make films, but to make films very inexpensively. In this sense, his production efforts were not radically different from the actions of Hershey, Nestle or Cadbury in buying cocoa futures. Moreover, in principle, it is not very different from the actions of a modern portfolio manager who requires a benign interest rate and inflation environment for portfolio success, and thus purchases an interest rate swap, or a commodity linked derivative.

Laemmle gathered several other independent entrepreneurs into a consortium to battle the Edison Trust. He called the group Universal, and thus was created Universal Pictures. He also commenced making films in Southern California. Historians dispute the logic of the latter move. Some plausibly argue that it made it more difficult for the Edison Trust to serve a legal summons in Southern California. Others argue that it was a relatively inexpensive location in which to make films. Still others argue that attorneys advised Laemmle to locate to California since it is covered by the Ninth Circuit Court of Appeals, which was rather reluctant to enforce patents at the time. However, other historians have concluded that Southern California was sufficiently close to the Mexican border that the independents could flee if certain less gentlemanly representatives of the Edison Trust were to visit.

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In any event, the Motion Picture Patents Company, or the Edison Trust, was found to be in restraint of trade under the provisions of the Sherman Anti-Trust Act on October 1, 1915. Not coincidentally, at about this time, Laemmle purchased a 230 acre farm not far from Hollywood to use as a film production center. It is now known as Universal City. Consequently, one might say that the hedge of making independent films at a low cost was remunerative. Thus, it became a permanent feature of the Laemmle organization.

The firm would eschew risk; it would not, under any circumstances, assume financial leverage. It would not embark upon high cost productions. The aim was to be cautious and avoid risk but, oddly, it has become apparent that the unwillingness to assume risk is itself a risk. For instance, Laemmle, via his partner Charles B. Mintz, refused the request of a young animator for a 20% increase in the budget for a cartoon known as *Oswald the Lucky Rabbit*. Universal opted to have the cartoons made by others in its own studio and fired the young animator, otherwise known as Walt Disney.

The cartoons were drawn by another young animator at Universal named Walter Lantz. Laemmle then realized that risk could be further reduced if Lantz were merely reduced to so-called freelance status. Lantz would thereby be dependent upon Universal for periodic assignments. Of course, this forced Lantz to seek projects outside Universal resulting in the creation in his own production studio of the cartoon *Woody Woodpecker*. It was merely distributed by, not owned by, Universal.

The emphasis upon the low cost hedge created disputes with various universal producers, including Irving Thalberg. In 1924, Thalberg left Universal to work at MGM and created films such as *Tarzan the Ape Man*, *Tugboat Annie*, *The Merry Widow*, *Mutiny on the Bounty*, *Romeo and Juliet*, *The Good Earth*, *A Night at the Opera*, and *A Day at the Races*. The last two films starred the Marx Brothers.

Laemmle's executive secretary was likewise disconcerted with the Universal policies. He was named Harry Cohn. In 1924 he resigned to found Columbia Pictures. Incidentally, during the Great Depression, the young Walt Disney wished to borrow money to make a feature length cartoon. He found this to be almost impossible, though the project was called *Snow White*. Yet, Disney eventually met an iconoclastic banker who was the president of a San Francisco bank called the Bank of Italy. The banker was named Amadeo P. Giannini, and he made the loan to Disney. He made other successful high risk loans at the time, and he was emboldened to merge his bank with a small Los Angeles Bank called the Bank of America.

By 1929, Laemmle realized that low budget films were not the low risk strategy that might have been the case in the age of the nickelodeon. That year, Universal spent a great deal of money on a film version of the Broadway musical *Show Boat*. The film did very poorly at the box office despite music by Jerome Kern. Universal tried to remake the film several

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years later, and succeeded in doing so in 1936. At that time, since the margins of Universal had been low for many years, there was no capital reserve to commit to remaking the film. Therefore, the choices were that Universal could borrow money to make an expensive film, which was one form of risk or, it could opt not to make such an expensive film, which was another type of business risk. Universal opted for the former rather than the latter, and the 1936 remake starred Paul Robeson and Irene Dunn with music by Jerome Kern and Oscar Hammerstein. By this time, Carl Laemmle was not in good health and his son Carl Jr. assumed control of Universal. As collateral for the production loan, the Laemmle family pledged their stock in Universal rather than leveraging the business. Though the 1936 remake of *Show Boat* is considered a classic and technical masterpiece that is preserved in the National Film Registry by the Library of Congress, at the time, the film did not generate sufficient revenue to service the loan. Until that point, the *Show Boat* production of 1936 was the only time that Universal had borrowed money. The loan was called in, and the Laemmle family lost control of Universal, since their stock had served as loan collateral. Universal is now 80% owned by NBC and 20% by Vivendi.

Zukor had a different appreciation of risk than Carl Laemmle. In 1908, at the time of the creation of the Edison Trust, Adolph Zukor also came to the conclusion that he required an independent source for films. However, his efforts were not undertaken as a hedge; they were undertaken as a calculated risk. He decided to invest money in an uncompleted French film entitled *Les amours de la reine Elisabeth* (The Loves of Queen Elizabeth), starring Sarah Bernhardt.

This endeavor was a risk for several reasons. First, it was generally believed that feature films were not economically viable. Second, it was believed that it was very dangerous to make use of a famous theater performer in film, since that performer would command a very high fee. Indeed, the Edison Trust never even put the names of the actors on the film credits. Third, in order to finance the production, Zukor needed to risk a substantial portion of the capital that he had amassed in the nickelodeon business. If everyone believes something to be a risk, it is not necessarily the risk that everyone believes it to be. Zukor had formed a partnership with a fellow known as Marcus Loew, who had been a furrier like Zukor, and together they had expanded the nickelodeon business. That collaboration had grown into the Loews Theater chain. Zukor needed to sell his stock in Loews to finance the Queen Elizabeth movie.

It was indeed a risk. In Zukor's autobiography, he describes the reasoning that he used to convince his wife, Lottie, that his actions were prudent. In the event of a failure, his capital would be diminished, but he would still be a wealthy person (Zukor 64). The Queen Elizabeth movie was eventually a success. The resultant funds were not added to the Zukor capital reserve but, instead, were used to start two new ventures. The first was to buy the rights to every popular Broadway play of the time with a view to ultimately making them into movies. The second was to unite the various booking agencies for actors into one

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integrated firm. Thus, he convinced the Frohman Brothers, who owned the Lyceum Theatre in New York, and the Lasky Famous Players Company to unite with him in a new firm to be called Paramount. Zukor then began signing actors with contracts including Mary Pickford, Gloria Swanson, Douglas Fairbanks and Rudolph Valentino.

The different approaches to risk adopted by Laemmle and Zukor had very different results. At Universal, Laemmle's failure to undertake risks for decades had created a very serious business risk. By the time the company did risk borrowing money to remake *Show Boat*, it was almost too late, and it caused his family to lose control of the studio. It could be argued that, if the risk had not been undertaken at that time, the traditional Universal low budget movies would not have generated sufficient revenue to permit the firm to continue its operations. Adolph Zukor believed in the opposite approach: it was to riskier not undertake financial risks. All of Zukor's accumulated risks in purchasing story rights and engaging actors in contracts represent nothing other than his concept of portfolio diversification, which is, ironically, a risk negation tool. Of course, his ventures could easily have been failures. If that had been the case, perhaps Zukor would have been just another chapter in a business history book describing the folly of risk assumption.

Fortunately for Zukor, he understood that the time to assume risk is precisely the moment when others are unwilling to adopt this posture. It was only because of this fact that he was able to orchestrate his library of story rights and his array of famous actors. Fortunately for the global economy, there are sufficient numbers of entrepreneurs who are willing to take a chance that their capital might diminish in value. Ultimately, Zukor understood that risk cannot be assessed independent of opportunity cost.

## ***Nota Bene***

This concept of risk assumption is more eloquently expressed by the author Robert Heinlein in his science fiction novel entitled *The Moon is a Harsh Mistress*. He sums the concept into one acronym: TANSTAAFL, which stands for "there ain't no such thing as a free lunch."