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Supplemental Musings

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Murray's Musings

Essay: Roger W. Babson Investor

The name Roger W. Babson is virtually unknown in the contemporary era, though readers of standard histories of the period leading to the 1929 stock market crash will recognize this name. Those histories include John Kenneth Galbraith's *The Great Crash* and Frederick Lewis Allen's *Only Yesterday*. Babson began warning of a stock market crash as early as 1926. Thus, in 1929, he became legendary as the man who had predicted the crash. He was also the founder and author of the *Babson Report*. Babson published various financial statistical reports and created an investment advisory company in 1927. He was thus faced with the problem of investing his own wealth and that of his clients during a very tumultuous time in American history.

Babson published an autobiography rather late in life. He was born in 1875 and died in 1967. As an investor, he witnessed the transformation of the United States from an essentially agrarian nation to a very technologically sophisticated society. His perspective would be interesting if merely confined to these dynamics; however, Babson was much more than an investor. He had a variety of interests and experiences. For instance, he was one of the few persons to be diagnosed with tuberculosis in the early 20th century who managed to survive to old age in remarkably good health. This was a notable feat since prior to the advent of antibiotics in the late 1930s, tuberculosis was almost invariably fatal.

It is also interesting that Babson was the Prohibition Party candidate for President of the United States in the 1940 election. He and his party wanted to reestablish the 18th Amendment to the U.S. Constitution that had originally imposed Prohibition in 1919, but had been repealed by the 21st Amendment in 1933. Babson was on friendly terms with many of the elite of the early 20th century, including J.P. Morgan and President Woodrow Wilson. Most interesting is that Babson did not confine his writings to investment topics. For example, he published a series of articles in the *New York Times* in which, during the spring of 1913, he clearly forecast the outbreak of the First World War

It is for such reasons that Babson's investment philosophy and methodology should prove interesting. His principles of investment are scattered throughout his autobiography entitled *Actions and Reactions*[1]. Modern students of the investment art might find the Babson approach somewhat bizarre. To some extent, it involves calculating areas on stock price charts in accordance with a very metaphysical interpretation of the Newtonian laws of physics. Yet, distilled to its essentials, the Babson approach involved owning a diversified portfolio for a rather long period of time. It is also fair to note that the Babson

[1] Babson, Roger. *Actions & Reactions*. New York: Harper & brothers, 1950.

philosophy, such as it was, could be somewhat reduced to a belief in an eventual regression to the mean.

An interesting aspect of the Babson approach was to assign a qualitative character to corporate strategies and corporate earnings. For instance, he drew a very sharp distinction between so-called "repeat" stocks and "equipment" stocks. The former produced products that were constantly being consumed such as paper, electricity or food. The latter category produced goods that a given consumer only purchased occasionally, such as an automobile. In Babson's estimation, the latter category is therefore more cyclical than the former. In the contemporary era the paper industry is considered to be rather cyclical. Subsequent to deregulation, electric utility firms became cyclical in many instances. Indeed, electrical utilities proved to be extraordinarily cyclical during the Great Depression due to extreme financial leverage.

Babson placed great value upon a corporate trademark. In 1950, in the second revised edition of his autobiography, he wrote that "a trademark is of greater value than real estate, machinery, or even money itself." (120)[2] However, he would not carry his investment philosophy to extreme and refused to purchase so-called "equipment" stocks. Chapter XV is almost entirely devoted to the purchase of an enterprise known as the Gamewell Corporation. This enterprise manufactured fire alarm boxes and sprinkler systems. Babson describes in great detail his reasoning for the Gamewell purchase. The origin of the investment was his study of actuarial statistics calculated by insurance companies due to loss from fire. It should be recalled that Babson was first and foremost a research analyst and that his research company, known as the Babson Statistics Organization, was one of the first companies to make industry statistics available to the investment management community of the early 20th century.

He calculated that in 10 years fires destroy enough capital to employ 3,000,000 people for one year at what was a middle class wage in the 1920s. A modern analyst might reflect on the problem somewhat differently. For instance, many persons remarked that the destruction caused by Hurricane Katrina should be a stimulant to GDP growth. In any event, he had a statistical understanding of the magnitude of property loss from fire, so he searched for a firm dedicated to loss prevention. He discovered such a company located less than four miles from his main office in Wellesley, Massachusetts. He then proceeded to acquire various blocks of stock despite his awareness of recent actions by management to "water" the stock in the course of a recapitalization. "Watering" was the term used in the late 19th and early 20th centuries to denote dilutive capital transactions.

Babson immediately began to quarrel with both the board and the management, because of the use of preferred stock to finance an acquisition. He decided to conduct a proxy fight, which he lost. Babson held the investment despite its cyclical characteristics and his disputes with management. In fact, in his autobiography he makes the extraordinary

[2] ibid.

statement that, "Not until the fatal year of 1932, when new building fell off 80% from its previous high, did we give much, if any, thought to equipping existing buildings." (129)[3] Thus, Babson was quite capable of violating, in the most obvious manner, his own philosophy of avoidance of business cyclicality. His patience with such philosophical diversions appears to have been financially remunerative. His lack of investment consistency and his philosophical eclecticism are strangely refreshing.

A more interesting philosophical departure was the Babson investment in Florida real estate that commenced in 1922. Originally, the purpose of the Florida real estate investment was to provide a property where Babson could write outdoors during the winter months. It will be recalled that Babson had been diagnosed with tuberculosis as early as 1902, and it was then believed that the only possible cure was fresh air.

Many of the purchases were in the Mountain Lake area which is 50 miles south of Orlando. Much of the land eventually became the community of Babson Park, Florida. Babson purchased much more land than was necessary for health purposes. It was his intention to build a college on at least some of the property. In fact, this vision was eventually realized; Webber International University now exists in Babson Park.

Babson joined various syndicates that made land investments in Florida. For example, in 1924, his syndicate purchased 7,000 acres of land 15 miles east of Lake Wales in Central Florida. The syndicate paid $15 per acre. In 1926 the property could have been sold for at least $50 an acre, but no sale was accomplished. In 1929, prior to the stock market crash, the same sort of land traded at $5.00 per acre due to the prior collapse of Florida real estate. Babson did not sell his Florida real estate, though he clearly realized that there was an unsustainable boom in Florida real estate by 1926.

Part of Babson’s decision to defer sale was based in part on his notion of marketability, which is synonymous with the modern word liquidity. He was perfectly willing to trade a stock if it were one of the most liquid stocks listed on the New York Stock Exchange. If it were a less liquid company that traded, so to speak, over the counter, or a piece of land, he would decline to trade it and would hold it for long term investment purposes. His rationale was that these parcels of land might never again become available on the market and, therefore, he needed to hold the investment, despite its decline in market value, as a way of maintaining his position for long term investment purposes.

One of the many interesting features of reading autobiography as a supplement to history is that in the case of the latter much detail that explains the era is reduced to statistics. For example, a historian will record that, in 1926, Miami beachfront property traded at $500 a front foot. Very few history books record that Florida suffered a freeze in 1927 that destroyed much of its citrus crop. This fact is important, because real estate speculators holding land in inventory for future development required the earnings of an agricultural

[3] ibid.

activity to pay property taxes and to pay the carrying costs of debt financings used to hold the land. More interestingly, historians overlook the appearance of the fruit fly in 1928. In that year, because of the appearance of the fruit fly, the Federal Government placed an embargo on all export of fruit from Florida to other states. Thus, there was a relationship between agriculture and investment land that is not well understood as part of the Florida land collapse of that era.

Babson believed that Florida land prices would fall considerably. He began to buy Florida municipal bonds at this time. He selected Florida issues with very little indebtedness. Nevertheless, during the Great Depression approximately seven-eighths of such issues purchased by Babson were in default according to the autobiography. (243)[4] The problem was to be found in the types of expenditures made by the municipalities. In many instances, the proceeds of the bond offerings were used to build roads through undeveloped property to make development possible. Once the land prices declined, such development would, in most instances, not be possible for decades. Consequently, the municipalities, and by extension the taxpayers, found themselves in the position of paying interest on bonds and maintenance charges on roads for which they could see no conceivable benefit. Therefore, the temptation was almost irresistible to default on the bonds. Many politicians ran for election on the promise that they would default on the bonds. The issue was not the ability to pay; it was that the taxpayers, who happen to have also been the electorate, were convinced by the politicians that they had been defrauded by being encouraged to borrow money to finance impractical public works. Fairness demanded that they be relieved of this obligation, irrespective of their ability to pay the obligation.

The result was that Babson's Florida municipal bond investments soon sold at between 10% and 20% of par value. Babson clearly understood the deflationary pressures of the era. He understood that bonds of quality issuers were, in principle, an arithmetic hedge against land investments that he decided to retain. Nevertheless, the hedge was not effective despite his efforts to choose highly creditworthy instruments. The problem was that the definition of creditworthiness is founded upon an objective analysis of the *ability* of the borrower to pay. It is much more difficult to conduct an analysis of the *willingness* of a borrower to pay under certain fairly unusual circumstances. This example illustrates the infinite variety of the human experience that makes genuinely hedged portfolios so difficult to construct in practice as opposed to in theory. It also offers another example of the role autobiography plays as a supplement to standard financial history, which provides detailed figures on municipal bond defaults in various eras, but makes no distinction between communities that cannot service bonds, and those that did not wish to service bonds.

This was a distinction not lost upon Roger Babson. He realized that the market would not permit a community to issue new debt if it had simply renounced its existing debt. Thus, it

[4] ibid.

was reasonable to assume that such communities would eventually find it in their own interest to honor the bond obligations. It was for this reason that Babson began to heavily buy such defaulted bond issues, though one might argue that this action was in conflict with his own philosophical predilection for solely creditworthy bond issues.

The story ended happily with Babson making a very substantial profit on those investments. The lesson to be learned is that even prophetical insight and careful diversification are not a substitute for patience. It was the latter virtue that ultimately proved to be decisive. Roger Babson died in 1967 at the age of 91. As far as can be determined, he was happy, quite prosperous and unregenerately eclectic.