This PDF is a selection from an out-of-print volume from the National Bureau of Economic Research

Volume Title: Explorations in Economic Research, Volume 2, number 3 (Regional Stock Exchanges in a Central Market System)

Volume Author/Editor: NBER

Volume Publisher: NBER

Volume URL: http://www.nber.org/books/conf75-1

Publication Date: 1975

Chapter Title: The Historical Evolution of Today's Bond Market

Chapter Author: Sidney Homer

Chapter URL: http://www.nber.org/chapters/c9226

Chapter pages in book: (p. 378 - 389)

SIDNEY HOMER

The Historical Evolution of Today's Bond Market

SIDNEY HOMER: In retirement since 1971, Mr. Homer has been acting as a consultant to Salomon Brothers and others. He began his career in 1923, after graduation from Harvard College. He was president of Homer & Company, Inc., from 1932 to 1943; served with the Foreign Economic Administration from 1943 to 1945; and as manager of the institutional department of Scudder, Stevens & Clark from 1945 to 1961. From 1961 to 1971 he was a general partner of Salomon Brothers and was in charge of its bond market research department. Mr. Homer is the author of several books on the money market and is a member of the National Bureau's advisory committee on interest rates and associate editor of the *Financial Analysts Journal*.

I will start with a vignette of one phase of the American bond market in 1910 as it was described to me by my first boss. His first job was that of salesman for an old, well-known Wall Street bond firm. His territory was Connecticut. They gave him a bicycle and a list of bonds to sell. The bonds were mostly second-grade 5 percent western public utility bonds and were usually priced at par. Our grandfathers, it seems, liked good round numbers and scorned fractions. Often the bonds cost that firm, the underwriter, something like ten points lower (plus some free stock), and so the young salesman, who operated on a 50-50 commission basis, made $50 for every bond he sold.

In those days one bond a week would keep a man alive, three bonds a week would be prosperity, ten bonds a week would be affluence. So he went peddling around the state looking for prosperous storekeepers, tobacco farmers, druggists, who might buy one or two bonds, or country banks that might buy five or more. He did well, and in five years of so he had accumulated enough capital to start his own firm. That is a picture of a retail bond market, perhaps not entirely representative, but in the main valid.

Those were not high-grade bonds and so had to be retailed in out-of-the-way places to private investors. However, the record of those western utilities was excellent, and twenty years later many of them were called and others eventually became legal. The prime bonds, in the decade ending in 1910, were the rails, like the New York Central first 3½s of 1997 noncallable. Prime new issues were also underwritten on a negotiated basis, but these were listed on the New York Stock Exchange, grabbed up by sophisticated investors, and if well priced they sold at quick premiums. Indeed, between 1880 and 1900, when prime yields moved from 4½ percent to 3⅛ percent, fortunes were made by capitalists carrying big blocks of such bonds on credit. They were usually 100-year maturities and noncallable. One popular issue matured in 2361. The basic business was retail—small, country investors or big-city investors. Underwriting spreads were so large as to make methodical widespread distribution profitable to dealers even if unit transactions were small. This is not true today.

THE 1920S

I will now jump to the mid-1920s when I began my career in Wall Street. From 1923 to 1930 prime, long-term bond yields were remarkably stable at about 4¼ percent. I do not recall much interest rate speculation; probably the memories of the bond market collapse of 1920 were still green, when yields soared to 5½ percent and the old prime 3½ percent bonds declined briefly to a price of 64. But there was a good active bond business and lots of underwriting and distribution to private investors and now also to institutions. Good bonds were mostly listed, and the private investors bought and sold on the exchange.

Institutions, however, liked round lots (in those days this usually meant a hundred bonds, occasionally $1 million), and it was hard to buy such lots on the exchange except for a few very active issues—usually relatively new issues. So institutions often waited for new issues where they could buy in size. At times they could buy new issues at a lower wholesale price and sometimes became underwriters. However, there were a few bond-trading firms that made it their business to accumulate bonds on the exchange, maybe one to five at a time, until they had collected 100-bond lots or more; and then they put the block on their list at a worthwhile markup and sold the block to some savings bank or insurance company. It was usually recognized that in a stable market a seasoned round lot was worth more than an odd lot. Such trades then began on the floor (accumulation) and ended over the counter (distribution).

At this point I should mention a fact that is often overlooked: American business obtains its external financing primarily in the over-the-counter market through underwritings of bond and stock issues or direct borrowing from institutions. It much less often looks to the exchanges for large amounts of new capital and then mostly from rights issues. The importance of our secondary markets, both listed and unlisted, is chiefly to provide the initial investors with liquidity. If there were no secondary markets, not so many investors would buy new issues of either bonds or stocks. Good secondary markets are basic to our economy, but are not primarily a direct source of new capital.

THE DEPRESSION

I will now pass to the 1930s, a period which separated the sheep from the goats: in the panic, the yields on sound medium-grade bonds, say A rated, rose from 5 percent to as much as 15 percent (a price decline of perhaps 70 percent), while at the very same time prime corporate bond yields declined from 4½ percent to 2¾ percent (a price rise of perhaps 42 percent if noncallable). Most of those bond issues that had been distributed to the public in earlier decades suffered one of four fates: they defaulted, or they lost caste and declined steeply, or if they did not lose caste rose steeply in price, or they were called if callable.

According to Brad Hickman's wonderful corporate bond studies,[1] between 1900 and 1943, $71 billion par value of straight bonds of American corporations were sold, of which 18 percent defaulted, 12 percent were paid in full at maturity, 37 percent were called, and 26 percent were outstanding at the end with a perfect contractual record. These figures seem to reveal the processes by which private investors, once the mainstay of the corporate bond market, lost three-quarters of their bondholdings: by default, by call, and by maturity.

During those depression years, indeed, private investors virtually abandoned the corporate bond market—discouraged, of course, by the calls, the defaults, the declines, the low prime rates, and the income tax—while institutions grew rapidly and absorbed almost all of the small supply of new bond issues and also bought seasoned issues that were being sold at depressed prices by other institutions and private investors. At that time competitive bidding for new issues became common, and some institutions experimented with bidding, often to their sorrow. There were also a few "best efforts" new issues.

The corporate bond business became almost wholly an institutional business in the 1930s. Often the dealers bought blocks of bonds at deeply depressed prices from deposit institutions that were forced by examiners to liquidate, and the dealers then sold the bonds to strong life insurance companies. In those days, although most large corporate bond issues were still listed, block transactions in high-grade bonds were mainly over the counter while low-priced, active, speculative bonds traded partly on the exchange and partly over the counter. The exchange tried hard to retain its bond business by means of a series of regulations requiring members to trade smaller lots on the exchange, or at least try to, but those efforts did not affect trades in large lots and without the public the small-lot business dried up, and the large-lot business came to dominate the market.

In the worst part of the depression a great deal of round-lot bond business was done with institutions on an order basis without involving dealer capital, that is to say, a liquidating institution would give a dealer a firm order to sell a block of inactive bonds at a price higher than was obtainable from dealer bids, and the dealer would check his institutional customers in an effort to find a buyer and often succeeded.

To large institutions the advantage of over-the-counter bond transactions became obvious. Imagine for a moment that you are the trader for a life insurance company. One morning your boss walks up to you and says, "We just approved $1 million X 7s at about 90." The bonds are listed, and you could call your broker and find that on the board the bonds are quoted 90–90½, ten up. You could buy the ten bonds and put him to work buying 990 more at about the same price. It might take a month, and your persistent buying would surely push the market up. Alternatively, you could call the right over-the-counter dealer, dicker with him, and buy the whole million in five minutes. Thus, the bond market on the floor was suitable for private investors, but not for institutions, with the exception perhaps of extremely active issues and convertibles. For these reasons, the market for high-grade bonds left the floor and came almost entirely to the over-the-counter market where buyer and seller could come face to face and talk in size. People love to dicker, and you cannot dicker very well at second hand, or third hand, with the whole world listening in.

I will pass over the 1940s, 1950s, and 1960s quickly, as you are all familiar with those markets. Our corporate bond markets were almost entirely institutional affairs. Private investors ignored high-grade corporate bonds, and speculators concentrated on governments, where they often fared poorly. New-issue underwriting at times reached massive volume. Secondary markets were often active, but almost entirely in round lots because the buyers and sellers both were institutions. It was usually very hard to buy or sell small lots on or off the board. Private placements became common.

THE PRESENT

I now come to the period from 1968 to date. In 1969 institutions either ran out of funds or concentrated on equities in which experience had been excellent. When bond yields soared to 6 percent, 7 percent, 8 percent, 9.35 percent, private and miscellaneous investors returned to the bond market in size, at times taking almost half the total offered. Those were the days of disintermediation. As a result the bond market found a floor. After a rally of a few years the market again declined to new low levels. Yields rose higher than ever, and private investors were again very active buyers.

Private and miscellaneous investors' net purchases of corporate bonds rose from $2 billion in 1968 to $7 billion in 1969 and to $10 billion in 1970 (when a grand total of $30 billion was poured by these new buyers into all sorts of credit instruments).[2] Ever since, private and miscellaneous investors have been putting $6 billion to $10 billion a year net into corporate bonds, and that represents about a third of the net new issues of corporate bonds.[3] This year their total input into this market will, no doubt, set a new high record. They now own an estimated $73 billion of corporate bonds which about equals the holdings of all pension funds and retirement funds, approaches the holdings of all life insurance companies, and about equals in size the entire corporate bond market of ten years ago.[4] Thus, we can conclude that private investors will be a major factor in our corporate bond market for many years to come—we are not talking about a freak temporary phenomenon, but about a basic mutation.

Now we might expect, with this upsurge of purchases by individuals, that the secondary market for corporate bonds might have returned to the floor of the stock exchanges. However, the volume figures do not bear this out. Bond volume on the New York Stock Exchange did rise from about $3 billion in 1965 to $6.6 billion in 1971 (aided by activity in convertibles) and then fell back to $4.4 billion in 1973.[5] Private investors probably accounted for most of this. But these volume figures are trivial for such a gigantic market. While there are no volume data for the corporate bond turnover over the counter, I have attempted some estimates based on the turnover of one bond firm I know. From this I guess that the total turnover for all firms might have been $150 billion. Since these figures count both purchases and sales as separate trades—which they are when dealer positions are involved—we probably should double our NYSE volume figures for purposes of comparison. Thus we can say: exchange volume in 1973 amounted to $9 billion; total turnover, $150 billion. Finally, gross new corporate bond issues came to $22 billion. Clearly the bond market has not returned to the exchange in spite of the large influx of private investors.

While there are no accurate statistics, I suspect that most of those recent purchases by private investors were of new issues—that is to say, over-the-counter transactions. Many new issues have been listed, but the secondary market for odd lots is still poor. Thus we are in a dilemma: our secondary market machinery is beautifully adapted to trading large lots with institutions, and at the same time a large part of the buyers now want small lots. Underwriting spreads have adjusted down to a level where institutional round-lot business is worthwhile, but where small-lot business often does not pay for itself.

Take the example of a hungry registered representative at a regional office whose good friend walks in one day and asks advice on how to invest his first $10,000. If the salesman mentions mutual funds, his gross commission earnings will be $800 or so for his firm; if he mentions listed stocks, they may be $300; if he mentions high-grade new-issue bonds, they may be $100; and if seasoned bond issues, they may only be $50. And yet the least rewarding of these securities might be the best investment. There is something wrong with a commission schedule covering such a wide range.

Furthermore, the day-to-day changes in the bond market do not suit the modus operandi of the private investor. If on thinking things over he decides to buy a new corporate bond issue mentioned to him last week, by the time he gets back to his broker it is apt to be gone and a newer new issue will be mentioned. In Europe, I understand, and I am not up to date on this, new-issue books are often kept open for a month or two and underwriting spreads are large; so a private investor business is very worthwhile. It will be important for us to perfect a market mechanism which can serve both institutions and individuals and adequately reward both types of dealings. Sooner or later the private investor must pay for the service he receives or do without.

RELEVANCE TO THE STOCK MARKET

For a number of years now, many observers have predicted that in time the stock markets will follow the example of the bond market and leave the exchanges. In the over-the-counter market, the large institutional investor would obtain privacy along with ability to negotiate both price and commission and the opportunity to trade in size with trading partners of his own choosing. An important start in this direction has already been made, and if it were not for the advent of block positioning, institutional stock trading would no doubt have gone much further than it has toward the over-the-counter market.

At this point, however, the government entered the picture. All of those advantages of over-the-counter trading to institutions are disadvantages to the private investor. He is in a poor position to negotiate either price or commission, and privacy is a danger to him rather than an advantage. The tape is an invaluable protection to him provided it is carefully policed and not used for misleading advertisements. A centralized auction market is an invaluable advantage to him if the alternative is shopping around in a dealer market, especially as few dealers would be interested in trading small lots at good prices. And the private investor, large and small, remains an important factor in our capital markets and our economy.

For these reasons, an effort is now underway by the exchanges, the SEC, and the Congress, to reorganize our methods of stock trading, so that the private investor as well as the institutions will be protected and, indeed, encouraged. This symposium reflects our interest in that effort. I gather that a unified tape or tapes are in prospect which would bring large parts of the over-the-counter market into the full light of publicity and thus protect private investors and deprive institutions of their privacy. This, however, would require far more rigorous policing than ever before, since all sorts of people might have access to those tapes. This is also true of the proposed consolidated quotation system. Under these innovations and especially if commissions are negotiated, there seems little reason to suppose that trading in listed stocks will abandon the exchanges. In the meantime, however, our market will continue far from perfect. I have seen no proposal that would provide a large-sized institutional market with adequate dealer capital. There is an irreconcilable difference between the trading preferences of large institutions and of private investors, and this will probably continue indefinitely.

THE ORIGINS OF THE BOND MARKET

Now I am going to take you way back several centuries to the origin of our capital markets because I believe it contains some important lessons for us today and some suggestive analogies. I will start with the Reformation, circa 1550. Before that time credit was illegal, or illicit, in most of Europe;

there was plenty of credit, but it was under the counter. Bankers were ashamed of their profession and purchased forgiveness by financing lots of lovely cathedrals. There were trade bills and foreign exchange transactions between merchants at high rates. The credit of princes was wretched—royal defaults were common. The credit of bankers and of the free cities of northern Europe and Italy was much better.

Then came the Reformation and the whole credit picture was altered. Martin Luther and other reformers said credit was licit at moderate rates: Luther liked 5 percent, Calvin went up to 6 percent. Just at that time trade with the New World and the Indies became active and merchant adventurers demanded credit.

The first nation to set up a real capital market was the new little Dutch republic. This was an amazing episode. The new country was only a few sandy islands in the North Sea, and it was in the midst of an eighty-year war of liberation from the vast Spanish Empire. It needed money to hire German mercenaries to help fight the Spanish on land. The Dutch themselves could manage things at sea. The Bank of Amsterdam was set up to receive deposits, and it was so meticulous that its drafts often commanded premiums over gold and silver coinage. The provinces of the republic borrowed on long term. They sold what they called perpetual annuities secured only by the general credit of the province or city or of the country as a whole. These were in effect perpetual bonds with a fixed rate of interest. They had no maturity dates at all, but carried the privilege of the debtor to redeem on or after some future date, the further away the better.

These perpetual annuities proved very popular with the wealthy Dutch burghers who were growing rich with their South Sea trade. Through them it was possible to retire from trade with a good income and provide for one's family. Since the burghers controlled the government, they were really lending to themselves, and they had absolute confidence in their brother officials. Large amounts were sold, but the totals were never revealed.

These perpetual annuities soon developed a secondary market and sold at premiums or discounts. Their market, however, was of a very primitive sort since each annuity contract was individual to itself. At first the rates they paid were medieval rates, usually 8⅓ percent. However, the Dutch perpetuals became so popular in the seventeenth century that a series of remarkable refundings in Holland brought the rate down to 6 percent, then 5 percent, then 4 percent—without any official manipulation. The wealthy Dutch wept at the interest cuts, and there were investor riots. But they ended up accepting the cuts. At that time short-term trade credits were available in Holland at rates as low as 3 percent. The Amsterdam Stock Exchange went indoors in 1613, and soon began to trade those annuities as well as stocks in the overseas trading companies. The Dutch at that time developed most of our modern stock-trading techniques: auctions, bulls, bears, margins, short selling, options, market letters and, I do not doubt, touting, promotion, and manipulation.

In those financial innovations, we find one reason why tiny little Holland won its war with the gigantic Spanish Empire. At the very same time that the estates of Holland were borrowing at 3 percent short and 4 percent long, the king of Spain was paying 60 percent for illicit loans and then defaulting—in spite of all the gold and silver of the New World.

Of course, it was not long before the Dutch financial system was imitated elsewhere. In 1688 William of Orange, the Dutch stadholder, became William III of England, and he brought with him what the Tories sneeringly called "Dutch finance." Soon the Bank of England was founded, and interest rates came down from medieval levels. English perpetual annuities were sold, first at 8 percent, then 7 percent, then 4 percent. Finally in 1752 most of the English national debt was refunded as a single issue of perpetual marketable bonds, the famous Consols, which are still outstanding. They were 3s at par and were later to be refunded as 2½s. They were very popular and sold at small premiums in times of peace and big discounts in times of war, and they are now at 22.

The British made two improvements on the Dutch annuities. The first was uniformity: the Consols were interchangeable and could be actively traded. The second was full disclosure of public finance. The Dutch estates kept their total credit secret. Here, too, the British Whigs had confidence in their government, since they controlled it. There were no more divine rights of kings, no more royal defaults. They loved the idea of taxes for their own benefit, and soon Consols were the most popular of investments.

In this way over the next two centuries the British floated a vast quantity of debt. By this means they not only financed their industrial revolution, but bought an empire on the cuff.

Of course, in the nineteenth century Dutch-British finance spread around the world wherever there were strong stable governments which commanded confidence. Alexander Hamilton brought the system over here, although it was some time before it was fully adopted. All of his original bond issues were perpetuals (usually 6s) with no maturity date, but redeemable after a long period of years at the discretion of the government. All were redeemed by 1835 or so.

I am always surprised, as I read this old history, how little our present-day financial market system differs from those in the London of the eighteenth century and the Holland of the seventeenth century—except, of course, in size and in the development of our institutions. One of the few changes was the evolution in the nineteenth century from perpetual bond issues to issues with fixed maturity dates. This occurred here and in London around midcentury, and at first the maturities often ran to a hundred years or so, but later came down. We in the United States have, of course, relied on this credit system not only to help win two world wars, but also to grow rapidly and to extend our influence far and wide around the world. I am sorry to say I fear we have also overexploited our fabulous money markets.

CONFIDENCE AND BUSINESS ETHICS

Now I come to the point of all this history. There were certain essential common denominators, certain intangibles, that made those capital markets possible in Holland, then England, then here and elsewhere. It is no accident that it all started with the Reformation and the development in northern Europe of limited monarchies and semidemocracies and with them standards of business ethics for governments and for individual traders. There was for the first time confidence between governments and subjects and among the leaders of the various business communities. This was an essential prerequisite to an effective capital market. The Dutch could do it only when they governed themselves and could set up a trading community based on mutual confidence. The British could only follow suit when they had deposed the Stuart kings and established a constitutional monarchy and a City of London where men could trade together freely and with confidence that contracts, even verbal contracts, would almost always be honored. Democracy and the rule of law was, no doubt, a big factor. Confidence in government was essential.

There are, of course, many countries in the world today where these preconditions for effective capital markets just do not exist. Spain has defaulted on her debt four times every century since Isabella, and her former colonies in South America have a poor record of debt service.

Some years ago the International Monetary Fund twice asked me to go to two Latin American countries to help them "set up a money market." I did not think the effort would be fruitful, so I told them what I would say: "Bring me ten men of substance who have such high integrity that they have perfect confidence in each other to the point of accepting unlimited verbal commitments from each other, and I will show them how to start a modern money market." Needless to say I heard nothing further about those proposed trips. And yet just this is a precondition of a real modern money market.

Some years ago two traders from a small Asiatic country visited me in New York in the course of a study they were making of our capital markets. They were impressed by Salomon Brothers' trading room and wanted to know just how it worked. They asked me just how we managed to get out of a trade when the market had declined by delivery date. Of course, I said we did not even try, but I could tell by their smiles that they did not wholly believe me.

Today we are inclined to take our standards of business ethics for granted. Alas, this can be dangerous. For decades the New York Stock Exchange has maintained a relatively high standard of business ethics in Wall Street—recently with the aid of the SEC—not perfect, but nevertheless relatively high compared with many other business communities. Verbal commitments are held binding, and defaults by members are rare. Other exchanges no doubt do the same thing for their communities. Institutions attempt the same thing through self-discipline and government supervision. I am not talking about a puritan ethic or a religious creed, but only simple business ethics of the sort that is essential in the worlds of finance.

Maintaining business standards between traders in Wall Street was relatively easy up to now because of the small size of the exchange community, the overriding power of the exchange, and its close and personal supervision of its members. But now that the privilege of dealing in securities and money is being considered the constitutional privilege of anybody with a little money and a seemingly clean record, the maintenance in our capital markets of the liquidity that comes only from confidence will be much more difficult, perhaps impossible.

There has been much criticism of our exchanges as clubs, and some of this criticism is valid. But there are certain advantages of clubs. Only they can pick and choose their membership according to their own standards and can exert effective hour-to-hour supervision.

I have rarely heard ethical and political standards brought into a financial discussion such as this, but yet they are basic and always have been. Today, standards of behavior are changing around the world. Some standards are relaxing, others are broadening and becoming more humane. Those who dislike the relaxations use the pejorative word "permissive"; those who like them use the approving words "reform" or "open minded." These trends of change are spreading to our great capital markets. As we go ahead democratizing our financial procedures, I hope we will not lose sight of the basic and rigid ethical standards that have always been essential to effective capital markets. I hope we do not reform ourselves to the point where we take a permissive attitude toward defaults.

I realize that our country and its capital markets have outgrown the days when they could be ruled by clubs and when the elder J. P. Morgan could set ethical standards, create financial trends, and personally provide liquidity to the financial community. In those days everybody important in finance knew personally everybody else of importance. Deviants from the accepted ethical standards of the marketplace were quickly known and shunned.

Today we have outgrown this, and we are forced to substitute some much more impersonal policing by agencies of the government and by large trade associations. We must remember that no mere policing is effective if it is not reinforced by ethical standards accepted and indeed dictated by the community as a whole. At all times social pressure is an essential support to any system of ethical standards, and an effective system of ethical standards is an essential precondition to a liquid capital market.

NOTES

1. W. Braddock Hickman: *The Volume of Corporate Bond Financing since 1900* (New York: NBER, 1953); *Corporate Bond Quality and Investor Experience* (New York: NBER, 1958); and *Statistical Measures of Corporate Bond Financing since 1900* (New York: NBER, 1960).
2. Salomon Brothers, *Supply and Demand for Credit in 1974* (New York, 1974), tables III, XII.
3. Ibid., Table XII.
4. Ibid.
5. New York Stock Exchange, *Fact Book* (New York, 1974), p. 78.