

WHAT MAKES STOCK MARKET PRICES?

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P R E F A C E

I HAVE had several purposes in view in preparing this book. In the first place, I have long entertained the conviction that a better understanding of the nature of stock pools and the manipulation of stock prices which they entail is both a fascinating topic in itself and a source of important aid to the general public which is investing and speculating. A knowledge of what goes on behind the scenes in these matters is, of course, never available currently, but only historically. Yet some knowledge of this history, in so far as it can be discovered, should serve as a guide and warning to those not on the inside.

In the second place, it is not to be supposed that pool manipulations are successfully carried on in the usual case without a broad and fundamental knowledge of contemporary economic conditions. And for this reason I have, toward the end of the book, tried to state what some of these broad fundamentals are, which not only the manipulators themselves, but also all who buy and sell securities, should know in order to interpret security price trends wisely.

The book is arranged to supply first a general understanding of the different types of pools and of the different ways in which manipulation of stock prices takes place, including a consideration of the important part which short selling plays in all pool activities. This is followed by a case history of a number of important pools of different types. And the book concludes with a consideration of the fundamental economic forces which help to shape business cycles and stock market prices.

I should perhaps make clear that I am not trying to prove a case or argue a thesis. My effort has rather been to state certain facts and the principles behind them in order that the reader, whether he is a professional trader or a private investor or speculator, may be aware of some of the possible forces at work to influence individual stock prices no less than long time price trends.

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New York City,
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INTRODUCTION

BEFORE the World War investors were keenly interested in the trend of the business cycle. The basic idea was that the ups and downs of the business cycle caused inevitable swings in the stock market which were beyond the control of any man or group of men. Manipulators of stocks could merely adjust their operations to the inevitable cyclical trend. Then came the abnormalities of the World War period. From 1920 to 1924 the cyclical trend seemed restored.

After January, 1925, however, the business cycle seemed to have vanished. Manipulators of stocks set up new standards of price appraisal. No longer did investors wait for an opportunity to buy industrial stocks at ten times earnings. In 1927 Wall Street accepted the idea that industrials should sell at fifteen times earnings. In 1928 chain store stocks were considered cheap at twenty times earnings and reasonably priced at twenty-five times earnings. In 1929 a yield of 2 per cent on bank shares and utility stocks was considered adequate because of their future prospects. With old yardsticks of price appraisal abandoned investment in stocks became entirely a matter of speculation on the market trend. Investors were forced to become interested in the study of pool operations and methods of interpreting stock manipulation. In fact, that is necessary in all periods of inflation. It is desirable and necessary for intelligent understanding at any time.

In this study three channels of investigation are pursued. First, the methods employed by market traders in detecting the intentions of manipulators; second, the methods used by pool managers and professional manipulators in their manipu-

lative campaigns; third, the fundamental financial and economic factors which cause manipulators to proceed with or discontinue market campaigns.

As defined in the dictionary, to manipulate is "to influence artfully." A pool is "A collective stake in a gambling game," or "Any combination formed for a speculative operation," or "A common fund to be shared." A sponsor is "One who makes himself responsible for another." A syndicate is "An association of individuals united for the prosecution of some enterprise requiring large capital."

In stock market circles, manipulation means price control. It implies power to move a price from one level to another. A pool which is organized to provide enough money to advance the price of a stock is a "manipulative pool." Not all pools are manipulative in character. John Jones and George Brown may form an "investment pool" to purchase 5,000 shares of Steel Common. An "investment pool" merely buys the stock and waits for the price to move. A "manipulative pool" in Steel Common, however, would have to buy more than 5,000 shares in order to succeed in moving the price toward a given objective. Many manipulators do not organize pools. They operate as individuals with their personal funds or with the money of corporations under their control.

A pool, in a broad sense, is any fund specifically designated for the purchase of securities. In popular parlance, a stock pool is thought of as a fund to manipulate a given stock. The fund is not usually a fixed amount of money, but a subscription for a given number of shares, the amount of money required depending upon the number of shares actually purchased and the average price paid. Curiously enough, in the legal document which gives status to a pool member, the word "pool" is seldom used. What the member signs is a

“Syndicate Agreement.” A pool, organized by legal contract, is a syndicate.

The sponsor who is responsible for the market behavior of a stock may be an individual capitalist, a pool manager or a banking house. Several years ago, during a general market reaction, practically all active stocks were attacked by bear operators. Nash Motors held at 52 while the majority of issues were declining. During a violent bear raid, a quotation for Nash appeared at a fraction above 51. “The bears have finally broken Nash,” it was said. But a representative of Lee Higginson & Co. explained that they were bidding 52 for an unlimited amount and the transaction below that figure was officially canceled. The money to buy Nash at 52 in unlimited amounts may have been provided by officers of the company engaged in factory activities in Wisconsin, but on the Stock Exchange the sponsor was Lee Higginson & Co.

The “public” includes men, women and children, insurance companies, investment trusts and estates, merchants, educators and professional people. At times public buying or selling is the dominating manipulator. At all times it is the chief concern of the pool manager.

CHAPTER I

POOL CYCLES

DOES THE PUBLIC ALWAYS LOSE?

THOSE who read accounts of pool operations for the first time may become unduly pessimistic about common stocks. They may imagine that in the majority of stocks there are manipulations in progress which will continue only until the public have bought what the pools have to sell, after which market support will disappear. But that is only half the truth. It is true that every pool is formed for the purpose of buying at low prices and selling out to the public at higher prices. But that does not mean that the public will always lose money. Many pools sell out, then reorganize and buy stock from the public at prices above their previous selling level. A pool may advance a stock from 30 to 40, sell out, and then recognize that the market is beginning a long upward swing and buy stock again at 45 to 50. This happens in times of business revival after trade has begun to recover from depression. Pools are successful only when they correctly forecast the future trend of business profits and the buying power of investors.

The investor needs only to have an independent judgment regarding the trend of business profits and an independent method of judging the trend of the stock price "averages," and he can predict what the majority of pools will do in manipulating stocks. There are many cases where the public correctly judges the outlook to be unfavorable and refuses to buy stocks, leaving the pools to "hold the bag" and suffer losses. And in many years of growing prosperity, investors

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who hold on after pools have sold out are amply rewarded when improving earnings and increased dividends produce higher stock prices.

One thing the investor and the public generally can count on is that if a stock is underpriced on any basis of analysis which is generally accepted, thousands of investors will be attracted to the stock like flies to honey. For instance, early in 1919 a pool was accumulating a stock around 110. The president wanted more stock; his friends did not control the company. A large block of stock in Europe held the balance of control. While the president was in Chicago on a business trip the stock rose from 110 to 125. The president rushed back to New York from Chicago to inspect the transfer book and learn who was buying the stock. His fear was that a new group in New York might acquire stock and join with the stock held in Europe to elect a new president. He consulted the director who represented the European stock and found him still friendly. The transfer book showed that the stock changing hands was going to a few large brokerage houses. Upon further investigation he found that the buyers were wealthy men who thought the stock was worth 200 and were buying merely for investment. They thought it was worth 200 because the balance sheet showed an enormous amount of cash and because the company's customers were certain to buy heavily for three or four years ahead. They were right. The earnings and dividends of the next four years justified a price of 200.

In 1923, similarly, the president of a utility company was amazed to see his stock advance 65 points in a few months. He saw 20 per cent of the total stock transferred to the account of a brokerage house. He was worried because he feared a change in control. He walked into the partners' quarters of

the brokerage house and demanded to know why they were buying the stock. They replied that they thought the stock was worth three times what it had been selling for and that its future prospects seemed attractive. They were buying for investment. Three years later, the stock which they purchased below 100 sold for 350.

In both the above cases large blocks of stock were purchased by men with large amounts of idle capital seeking investment. They bought to hold until market conditions would permit them to sell at a profit of 100 per cent in the first case and 200 per cent in the second case. There are always millions of idle capital on the lookout for growing stocks. A case in point was John W. Gates in 1902 after he had sold his Steel and Wire shares to the U. S. Steel Corporation. He had millions of cash. He liked Louisville and Nashville Railway stock, and bought in the open market until he owned a majority of the shares. He did not have to wait long for a profit because J. P. Morgan & Company were afraid Gates would operate Louisville & Nashville in such a way as to demoralize the Southern Railway System and promptly made him an offer. A partner of Morgan & Company called upon Gates after midnight in the old Waldorf-Astoria Hotel when it was ascertained that he had control of Louisville & Nashville. Gates was in bed but in a mood to negotiate. He said to the Morgan partner: "If you want to keep the Belmont board in control and protect the Southern Railway, I will sell my L. & N. shares for ten million more than they cost me." The proposition was accepted. The purchase money was obtained by having the Atlantic Coast Line sell a new issue of bonds and use the proceeds to buy control of L. & N. from Gates. It still owns the stock after three decades.

The public has a chance if it buys underpriced stocks. Such

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stocks will sell higher in the next favorable market. By and large, however, the "public" does not have the funds or the inclination to buy until conditions are good and prices have been marked up. In that respect the public does not have much chance. It will always be worth while for the rank and file of investors to know something of the methods of interpreting the trend of manipulation.

OTTO H. KAHN ON MANIPULATION

It is wrong to believe that pools and "big men" can manipulate the market as a child would handle a toy. Speaking on this subject in January, 1917, Mr. Otto H. Kahn said:

"The current which sends market prices up or down is far stronger than any man or combination of men. It would sweep any man or men aside like driftwood if they stood in its way or attempted to deflect it.

"True, men sometimes discern the approach of that current from afar off. They may hasten a little the advent of that current, but they have not the power to loosen it or stop it."

The "current" which Mr. Kahn mentions is the long pull trend of the market. This underlying trend over a year or more is traversed by the swings in the stock market as manipulation first carries prices above the trend axis, hastening the rise of the current, and then below the trend axis as manipulators drop prices to a buying level. The operations of manipulators, as adjusted to the current, cause oscillations above and below the trend axis. These oscillations, or pool cycles, appeared twice in 1922 and twice in 1928 (See Plate 1).

HENRY CLEWS ON "SQUALLS"

About twice every year the stock market declines to a level where investors can buy stocks to advantage. About twice

every year prices are pushed up to levels where stocks can be sold with a reasonable expectation of buying back cheaper. The upward movements develop because pools advance prices with the expectation of selling out at least a part of the pool holdings to the public. The declines set in because the pools discontinue support when public selling and short selling aggregate more volume than they care to absorb. These ups and downs, therefore, may be called "pool cycles."

A pool cycle is a price oscillation whose upswing rises above the axis of the market trend and whose downswing carries the price below the axis of the market trend.

In prosperous years the upswings are prolonged and the declines are brief. Holders of stocks should be patient and not sell quickly. In years of adverse trade conditions the upswings are brief and the declines are prolonged. Investors should be quick to sell on upswings and exercise patience in making purchases. Since patience is lacking in 90 per cent of us, it is easy for calculating pool managers to unload stocks at high prices upon buyers who lack patience to wait for a decline, and to buy back at low prices from tired holders of stock who lack the patience to wait for a rally. Pool cycles are largely due to the success of pool managers in taking advantage of the public's natural-born impatience. The pool manager is like an artist with an audience which pays to see him work.

Patience is an acquired virtue. Men of action acquire it along with gray hairs and stiff joints. The value of patience in taking advantage of pool cycles was well stated by that noted Civil War banker, Henry Clews, some years before the New Era philosophy developed. He wrote:

"There has hardly been a year within my recollection, going back nearly thirty years, when there have not been two or

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three squalls during the year, when it was possible to purchase stocks below their intrinsic value. The question of making money, then, becomes a mere matter of the number of squalls that may occur in any particular year. The old veterans of the Street usually spend long intervals of repose at their comfortable homes, and during these squalls come hobbling down on their canes to their brokers' offices. They buy good stocks to the extent of their bank balances, which have been permitted to accumulate for just such an emergency.

"If young men had only the patience to watch the speculative signs of the times as manifested by the periodical visits of these old speculators, they would make more money at these intervals than by following those specious frauds who pretend to be in the councils of big operators and of new 'pools' in process of formation."

In brief, the problem of the investor is to sell when the pools are unloading and buy when the pools are accumulating. Some investors find this impossible to do even after they understand the idea in principle. At the top the pools match sales in 10,000 share lots, giving the impression of powerful buying and the suggestion of a further advance. The investor holds on. At the bottom the stock becomes inactive and appears abandoned, giving the impression of weak support and the suggestion that something is wrong with the company. The investor does not buy. He wants to be assured by a strong market that the stock is all right. He feels better if he buys at higher prices. There will always be pool cycles because human nature will never change.

POOL CYCLES AND BUSINESS CYCLES

A business cycle passes through four periods: 1. Revival. 2. Prosperity. 3. Reaction. 4. Readjustment. Likewise a pool cycle

may be divided into four periods: 1. Accumulation. 2. Marking up. 3. Unloading. 4. Reaction.

A business cycle, however, may cover a period of three years or more, while a pool cycle may last only 3 to 6 months. *There may be five or six pool cycles in one business cycle.*

The professional trader attempts to take advantage of the upswing and the downswing in each pool cycle. A business man, however, may be out of town or engrossed in a business problem when a pool downswing begins and will prefer to keep his mind on his business. He may prefer to sit through the brief reaction of a pool cycle if the general trade outlook is favorable and there is reason to expect the next pool cycle to carry prices to new high levels. He has the mental attitude of the long pull investor who waits for the crest of the business cycle, although occasionally he may admit that the temporary reactions are somewhat unpleasant. The shrinkage in value may more than offset the dividends received.

Actually the purchase of an investment stock which pays a \$6 dividend and declines \$15 per share is no investment purchase at all. The net result is not a real yield of 6 per cent but a net loss of \$9 per share. Instead of income the investor has the same result as if there were no dividend and an assessment of \$9 per share. An investment in common stocks is not an investment if the market price is going to fall well below the purchase price. Safety of principal is essential to investment. A man is deluding himself if he calls a stock an investment when a 6 per cent yield is wiped out by a 20 per cent decline in price. The best of common stocks are nothing but claims on net income. No common stock is sound enough to buy at any time regardless of price. Certainly they should be sold before the bear market phase of a business cycle. The general relation of investment policy to the periods of the business cycle should be as follows:

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<i>Periods</i>	<i>The Business Cycle Characteristics</i>	<i>Investment Policy</i>
1st Period	Business Revival: Production and Employment show a pronounced general trend upward.	Buy stocks of companies which have turned the corner in two respects: <ol style="list-style-type: none"> 1. Depression is over and earnings are beginning to increase. 2. Bad news is all out relative to dividend cuts and poor earnings reports.
2nd Period	Prosperity: Production and Employment at high tide; increased profits in evidence. Numerous dividend increases rumored.	Plan to sell stocks when peak earnings seem discounted. Accumulate cash or reinvest cautiously on reactions. Stocks may pass through several short cycles during the prosperity period of the business cycle.
3rd Period	Reaction: Production declines; many commodities slump.	Hold funds in cash or short term low-interest securities. Safety of principal with 2 per cent interest is better than a stock paying 6 per cent which declines 20 per cent.
4th Period	Readjustment: Production and Employment subnormal while expenses are being reduced in adjustment to lower volume of business. Some industries show moderate recoveries.	Gradually shift funds from short term issues to stocks which evidence stability of earnings and safety of dividends.

POOL CYCLES DURING BUSINESS REVIVAL

Optimism prevails at the beginning of a period of business revival. Pools buy stocks. Investors hold what they have and buy more. Merchants make more money and increase their participation in market trading. The upswing of a pool cycle gathers momentum. It may last several months. The downswing may last only a few weeks. The pools find good buying when they sell. On each reaction they accumulate quickly and resume bullish manipulation. The slope of the axis of a pool cycle is upward in a period of business revival. Let us refer to the years 1922 and 1928. (See Plate 1.)

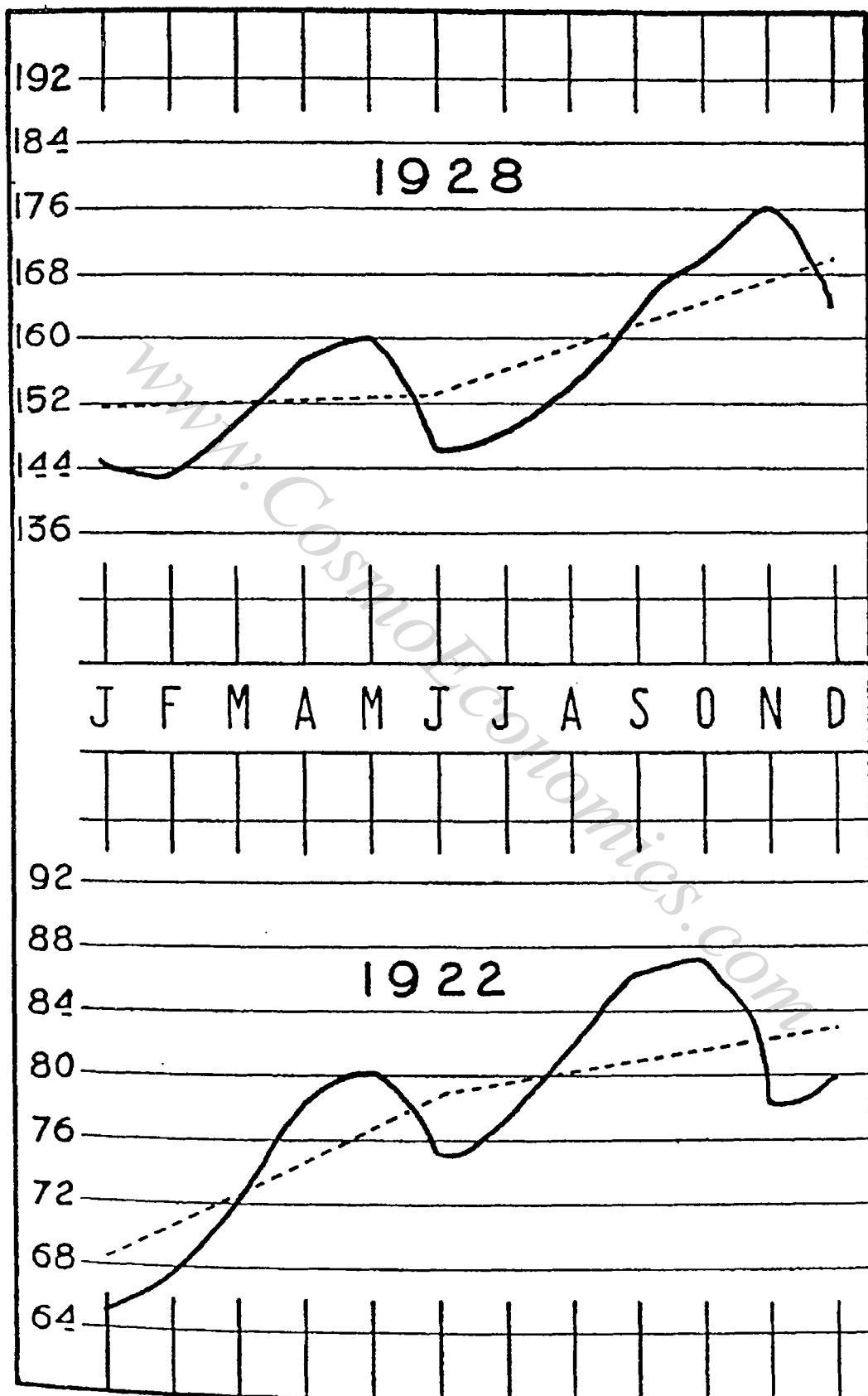


PLATE I.—POOL CYCLES. ASCENDING AXIS

In 1922 an average of 100 stocks rose from 65 in January to 80 in May, an upswing of over four months. The average dropped from 80 in May to 75 in June, a brief decline stopping ten points above the January starting point. The next pool cycle found stocks rising rapidly in the autumn, but the decline in November was worth avoiding.

In 1928 also there were two pool cycles. In the first, the reaction came in June and was extensive, while in the second cycle the reaction came in December and was brief. It was worth while selling in May to avoid the decline in June, 1928, although the long pull holder was rewarded by still higher prices in October and November.

There is something to be said for the long pull attitude in a period of business revival, but the reactions should be prepared for by building up cash reserves through the sale of at least a part of one's stock when the top of each pool cycle is indicated.

The accompanying chart of 100 stocks includes 70 industrials and 30 rails as compiled by the New York *Herald Tribune*.

POOL CYCLES DURING BUSINESS DEPRESSION

Upon the approach of a slump in trade, stocks decline and pools are rather timid about working for a rally. In each pool cycle the decline is sustained and the upswing is brief. The axis of the pool cycle slopes downward. (See Plate 2.) The investor should buy stocks slowly if at all. A quick trader can detect signs of a halt in the decline and try for the rally; but, logically, if he is to go with the trend, he should only sell short on rallies and cover when declines seem halted. This is merely the reverse of the policy appropriate during a period of business revival.

Periods of depression, however, are seldom alike. Some consist merely of brief periods of curtailed production with no

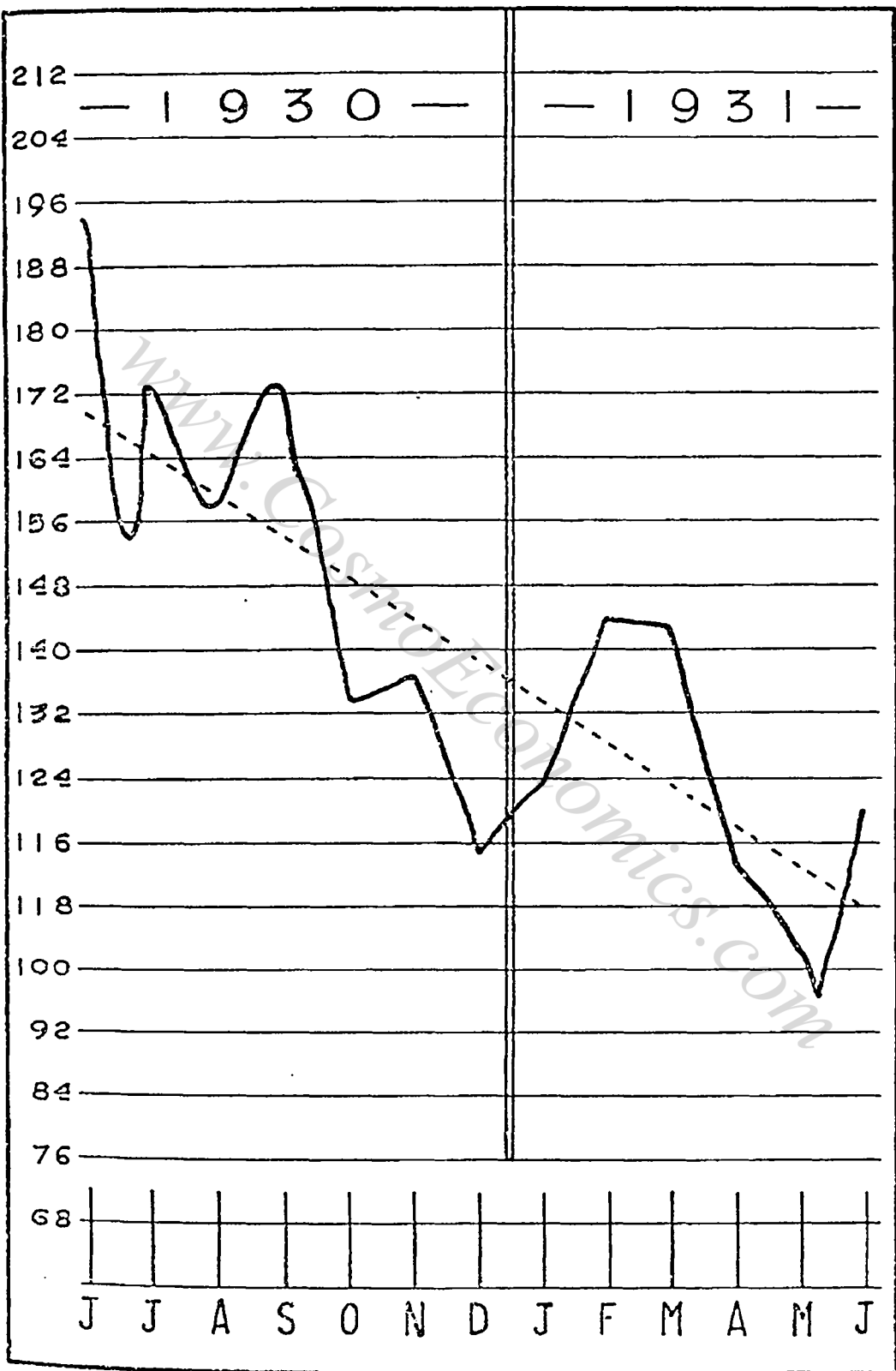


PLATE 2.—POOL CYCLES. DESCENDING AXIS

prolonged decline in commodity prices, as in 1924. The depression of 1930-31, however, found commodities in a worldwide deflation movement similar only to the declines of 1820-21, 1840-41 and 1876-78. A major change in monetary conditions produced all of these deflation periods. They were more than mere downswings of a trade cycle. And the same was true of the deflation of 1930-31. In such a major change in price level, a different policy is needed as compared with the policy to be followed during a minor trade reaction.