Collectible Stocks and Bonds from North American Railroads

# UPDATE

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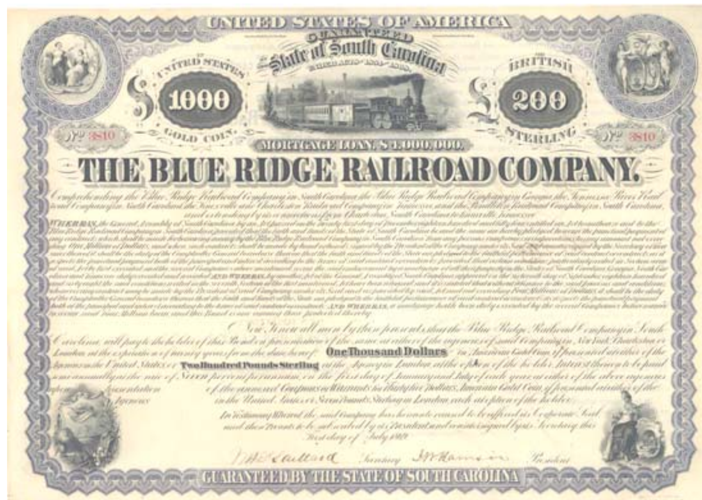
## *Understanding bonds*




*"Train of Cars" on 20-year bonds from The Blue Ridge Railroad Company. These bonds are typically signed on the back by Henry Clews. 1869. 7% interest.*

For years, collectors have asked countless questions about bonds, including why many unissued bonds are missing one or more coupons. The bond market is not easy to understand, so let's begin with an imaginary company.

Let's pretend we are founding a rather ordinary railroad company. The date is early 1890. We think the company has promise, but it will probably not be anything special. We think the company will attract a reasonable amount of freight and passenger traffic. We don't see any evidence that a competitor will build into our service area. Our management is adequate, but we don't have any well-known administrators on the board or in day-to-day management.

Let's face facts. Banks do not thrill at the thought of loaning money to risky ventures like ours. So, our company decides at the June, 1890 board meeting to *float* a first mortgage bond issue. That means bond holders will hold a mortgage on our company's property, including right-of-way, land, buildings, bridges, rolling stock, and receivables. If our company goes bust, the court will appoint a receiver who will probably sell all our property at public auction. Bond holders will be first in line to receive money that will, hopefully, repay their investment.

It appears that most railroad bonds being sold this year carry interest in the range of 5% to 6%. We see that New York Central's bonds carry lower interest, but it is a well-established company with an excellent reputation. The board decides that 6% bonds stand a fair chance of being sold.

## *178 new certificate varieties since December*

| | Last letter | This letter |
|---|---|---|
| Total certificates in database counting *all* variations (issued, unissued, specimens, etc.) | 20,783 | 21,028 |
| Distinct varieties of certificates | 15,778 | 15,956 |
| Certificates with celebrity autographs | 1,577 | 1,595 |
| Celebrity autographs known | 337 | 339 |
| Railroads and railroad-related companies known | 25,166 | 25,207 |
| Companies represented by at least one certificate | 6,670 | 6,731 |
| Serial numbers recorded | 72,522 | 73,145 |

## *Contributors since Sep, 2005*

David Adams
Vern Alexander
Bentley Hist. Library
Colin Bruce III
Guenter Brueckner
William Cannon
Ed Costanza
Dennis DeJesus
Denver Stock Exchange
Lawrence Falater
Martin Fischer
Willi Frei
Frank Hammelbacher
Kenneth Holter
Barry Householder
Bob Kerstein
William Knadler
Franky Leewerck
Edward Lewis
Aspesi Luca
John Mallinson
Mack Martin
Douglas McDonald
Horst Nakonz
Ron Phillips
Pete Richards
Steve Ryder
Matthias Schmidt
John Szabol
Adam Tripp
Robert Underhill
Jürgen von der Brake
Eric Zabilka
Martin Zanke

Sincere thanks to these dealers who send me their catalogs and help keep me apprised of happenings in the hobby!

Mario Boone
Clinton Hollins
Historisches Wertpapierhaus, AG
Freunde Historische Wertpapiere
George LaBarre Galleries, Inc.
R.M. Smythe, Inc.
Scripophily.com
Scott J. Winslow Associates, Inc.

The board wants to raise $250,000, so decides to issue 300 bonds in the denomination of $1,000. The board figures they will probably need to pay an underwriter 10%, maybe 15%, to sell the bonds. The board decides to have the bonds pay semi-annual interest in June and December of each year. This will obligate the company to redeem coupons for $30 each, twice a year. After discussion, the board decides to issue 30-year bonds, a term shorter than the industry-average.

The next step is to print bonds. The board orders bonds be printed by one of the well-known bank note companies. They decide they can save money by contracting with Hamilton Bank Note Company instead of American Bank Note Company. Hopefully, our company can get a well-engraved certificate that will enhance our reputation.

After fighting over wording and terms of the mortgage, the order for 300 bonds finally goes out in August. The engraving company promises to deliver 300 serially numbered bonds plus 12 specimens in mid-September, 1890.

The bonds arrive on schedule. The president signs all 300 bonds. The treasurer will sign bonds and impress the corporate seal whenever they are actually sold.


*20-year Erie and Union Company trust mortgage bond. 1909. 5% interest.*

Board members agree to purchase 30 bonds at $900 each. Local big-wigs, including a mayor, a mine owner, and some bankers agree to buy 20 bonds at an average price of $930 each. Where can our company sell the remaining 250 bonds?

New York is where the money is, but our company has no easy access to the market. The board chairman contacts the firm of J.P. Morgan, but Morgan’s company is more interested in oil, steel, and very large rails at this time. By now, it is late October.

Throughout November and December, numerous contacts are made with several brokers and investment banks in New York, Philadelphia, and Boston. Some wish us well, and some agree to take ten or twenty bonds. Some agree to buy only if all 300 bonds are sold. Their average offer is $900. The company needs to sell 180 more bonds.

By January, 1891, it appears our company might be able to make a deal with an “up and coming” investor, but not until February or March. Our company has continued to acquire right-of-way, a used locomotive, and some rolling stock, all the while trying to grade and lay steel. Unfortunately, the company coffers are almost bare, even though the board has already authorized one stock assessment.

The board decides one more assessment should keep the company limping along for another three months – maybe. Even if all 180 bonds are sold by mid-March, it will be a serious hardship to pay all interest scheduled for June. Board members agree to forego their own interest and orders coupon #1 to be removed from all unsold bonds.

Finally, the new investor comes through. In late-March, 1891, he agrees to underwrite the purchase of 175 bonds at $850 apiece. He understands that coupon #1 has already been clipped and he will receive his first interest payment in December.

At the June, 1890 board meeting, there had been much discussion about interest rates before deciding on 6%. Ultimately, 295 of the original 300 bonds were sold. Even though the face value is $1,000, the company sold them at an average of $872.37 each. Not counting printing and travel expenses, the company banked $257,350.

The company must still pay $30 for every coupon redeemed in June and December of each year. Plus, if our company manages to survive until December 31, 1921, it will need to repay $1,000 for every bond redeemed. Was the discounting too deep? Was the bond issue a good deal or a bad one?

In 1921, the company will need to repay $1,000 for every certificate redeemed, even though it only received $872.37. On the surface, that seems like a poor decision. However, taking the long view, spreading the $127.63 difference over 30 years is like adding only $2.16 to each coupon redemption.

Looking at the finances this way, the penalty to the company's actual interest rate was minimal: the equivalent of paying 6.43% versus 6%. Not bad at all.

We need to understand that our company's bond issue is an interest-only loan. Our company will not repay a single cent of principal until bonds are redeemed in 1921.


*Common 100-year bond from the Cleveland Cincinnati Chicago and St Louis Railway Co. The central vignette is one of Smillie's most recognizable images, The Reapers. Flanking them are two train scenes, both of which are parts of larger images found on other stocks and bonds. 1893. 5% interest.*

## *Collectors and dealers*

We talk about collectors and dealers as if they are different animals. Truth be told, I see them as very similar. I personally don't think many pure collectors or pure dealers actually exist. Let me explain.

In my world, "dealers" are people whose primary motivation is selling. Everything in their inventory is for sale. Cash flow is king. They thoroughly understand the concept of the *time value of money*. Their goal is year-end profit, not single-item profit. If they occasionally overpay for inventory, they will sell at losses to recover their investment and move on to new acquisitions. Ideally, the shorter the period between acquisition and liquidation, the better their net profit.

"Collectors," on the other hand, collect; they don't sell. Collectors generally specialize, and they will try to acquire everything in their specialties. It is not unusual for them to *pay too much.* The longer the period between acquisition and liquidation, the better their collections. Immediate profit is never mentioned. Rarity is very important.

Humans are too complex to be so one-dimensional.

I don't think I've ever met a dealer who didn't collect something. Nor have I knowingly met a collector who has not sold – or intends to sell – something. From my perspective, there is a continuum from *collectors* to *dealers* with many people in the middle and few, if any, at the extremes.

It seems to me that hobbyists, dealers and collectors alike, (and I include myself here) have competing and conflicting interests. That is why so many of us make such strange decisions relative to collecting.

Take dealers who establish high minimum or list prices. When they refuse to lower prices to the points where items will sell, they are acting like collectors. For them, avoiding selling rarities too cheaply is more important than cash flow.

How about collectors who buy multi-item lots simply to acquire single items? Collectors rationalize by saying they will sell extra items and keep desirable ones. A good idea. But, really, how many collectors do that effectively?

Do not get me wrong. I am not saying this behavior is wrong or abnormal. Quite the opposite. I contend this behavior is normal and typical. I suggest that collectors and dealers are much, much closer in attitude and motivation than beginners and outsiders realize.

Collectors, especially new collectors, routinely complain to me about one dealer or another. Generally, they complain about attitudes and prices. Sometimes there are clear-cut clashes of personalities. More often, disagreements revolve around the concept of "value." I will go even further to suggest that disagreements about value are really nothing more than unequal distributions of knowledge and experience.

Similarly, more than a few dealers have complained to me about collectors, especially new collectors. It is not that dealers don't want to help. Rather, they often find it hard to communicate the concept of rarity, limited supply, and the difficulty of replacing inventory. I also see great reluctance among dealers to talk about their necessity for profit. *Profit* is the elephant in the room that no one wants to talk about.

Sometimes I feel like Dr. Phil without the hot glare of TV cameras. That's okay. I enjoy being in the middle, trying to understand the perspectives of each side.

From the middle, I see how similar the two sides are. Dealers and collectors have many of the same motivations and nearly identical fears. They desperately need each other. From the middle, it is really quite apparent that dealers and collectors, whether beginning or expert, are merely separated by time and money.

Their enthusiasm and love of the hobby are the same.

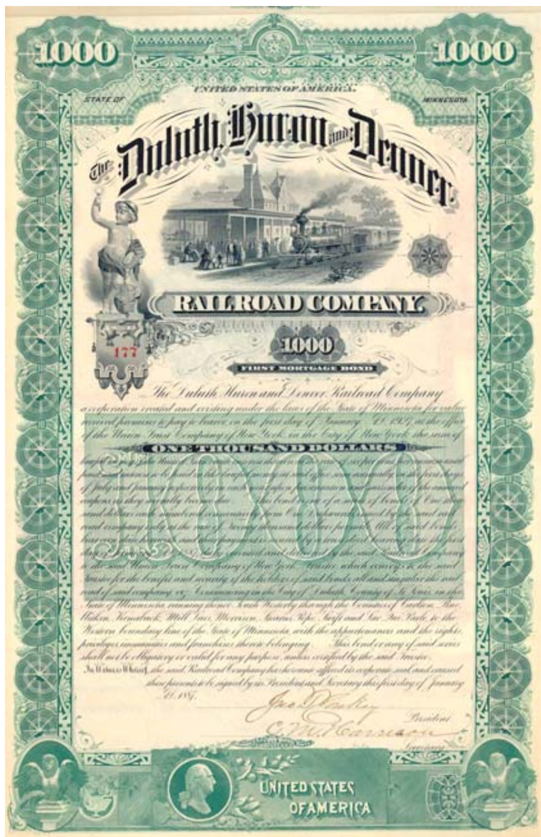
Starting from that common point, it is less challenging to understand both sides.

Collectors need help and insight.

Dealers need fair profit.

Neither side wants to be taken advantage of. Both sides want – and deserve – respect.

What is so hard about that?




*40-year bond from the Duluth Huron & Denver Railroad Company. 1887. 6% interest.*

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**Address correction requested**