South Sea Company

FULIAN PAN

ECON 4905

Agenda

- Historical Background of 18th Century Great Britain
- Rise of the South Sea Company
- South Sea Bubble
- The Crash of the South Sea Company
- Peter Garber & Bubbles

A little background…

- At the around the time when the South Sea Company started, Great Britain was in the middle of many wars
  - English Civil War (1642-1651)
  - Great Northern War (1700-1721)
  - War of the Spanish Succession (1701-1715)
    - Louis XIV of France V. Austrian emperor Leopold I
    - **Treaty of Utrecht** ended the war
- Great Britain was in great national debt

South Sea Company: The early beginning

- August 1710, Robert Harley was appointed Chancellor of the Exchequer
- He was seeking new ways to improve the national finances (~ £9,000,000 in debt)
  - Harley was met with many problems
  - Government accounting job was poor, Britain didn’t have a unified budget
  - House of Commons deeply divided (Tory V. Whigs) The Tory’s were now in power busy trying to impeach previous Whigs. This made raising taxes to pay off the debt difficult
  - Bank of England (Whig-controlled institution)
- Harley turned to John Blunt (Hollow Sword Blade Company) to raise capital. He needed money badly to pay off not only LT debt but also ST payments to fund the British army
  - Harley granted Blunt the authority the sell England’s lottery tickets
  - Blunt enticed the buyers of the lottos by saying that *every* ticket won something (prizes ranged from at least £10 - £20,000)
  - Government received an influx of capital

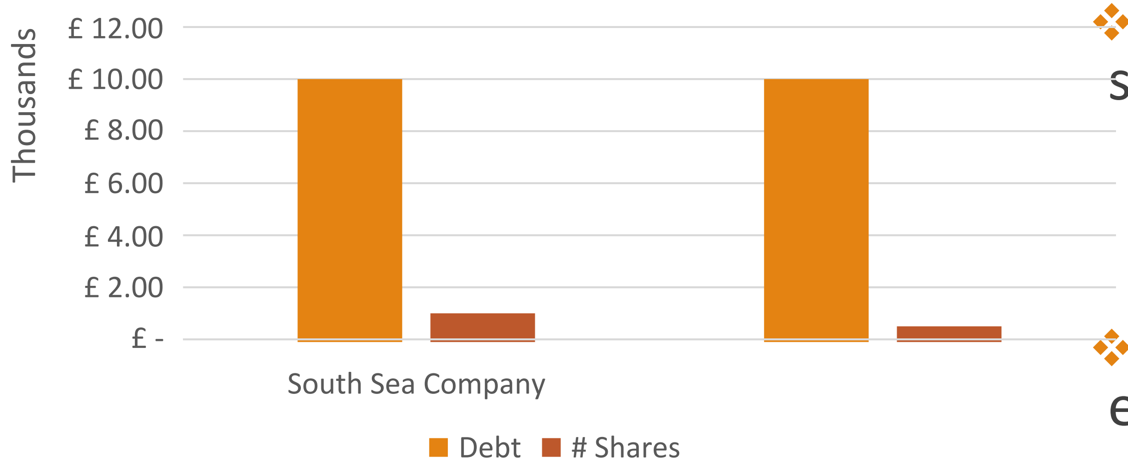
South Sea Company

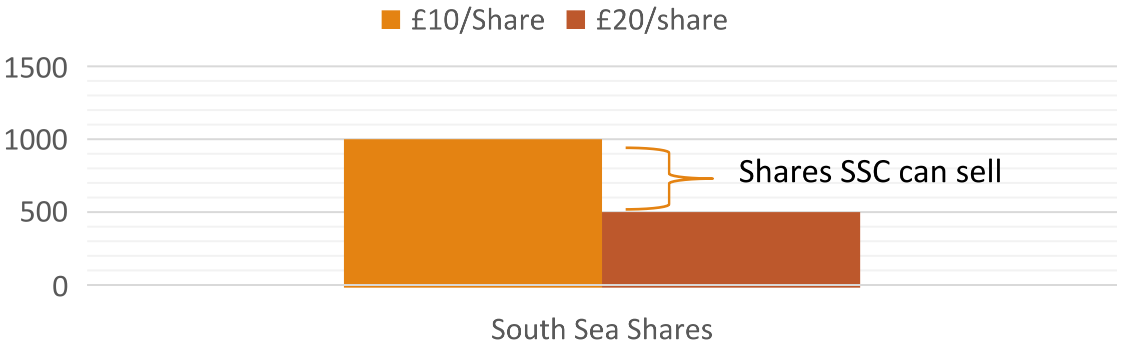
- Harley and Blunt decided that selling the lottery wasn't enough. They took it in their own hands to create a trading company that would assume the national debt.
- Blunt drew up the charter for the SSC in 1711
- How SSC worked:
  - Anybody who owned government debt was given the option to exchange it for a shares in the company
  - Government pays 6% interest to SSC on the debt
  - Company uses the interest to pay dividends to its investors
  - The British government to grant them a monopoly on trading in the South Seas

South Sea Company Continued

- For the British, the 18th century was considered to be a time of optimism and prosperity. Many people were looking forward to investing their money
- During this time, the East Indian Company was doing very well. The East Indian Company ”account[ed] for half of the world’s trade, particularly in basic commodities including cotton, silk, indigo dye, salt, tea and opium.”
- Everybody was eager to invest in SSC thinking that it would do great, just like the East Indian Company
- BUT, recall the **Treaty of Utrecht**
  - granted Britain the right to trade slaves in the South Seas (Buenos Aires, Caracas, Cartagena, Havana, Panama, Portobello, Vera Cruz)
  - ”One ship of no more than 500 tons can be sent to one of these places each year”

South Sea Company Continued





- The government allowed SSC to issue an amount of stock = to the value of debt
  - If government debt = £10,000, and South Sea stock was worth £10/share
  - Then SSC can issue 1000 shares of new stock
- But, the SSC also offered debt holders the option to exchange their debt for the current value of the stock.
  - If the stock price increases, SSC wouldn't have to trade as much stock for the debt as the government originally calculated
  - This gave SSC the ability to sell off the rest of the stock at market value and keep the profit
  - Example: If share price of the stock increased from £10/share to £20/share, SSC would only have to sell 500 shares of stock (of their original 1000 shares) to cover the price of the debt. The other 500 shares of stock could then be sold and SSC can pocket the profit

South Sea Company & Government Debt

- The SSC started off by assuming 3/5ths of the national debt (~ £9,000,000)
- In 1717, SSC assumed an additional £2,000,000 worth
- In 1719, SSC made another proposal in which it would purchase over half of the British national debt with new shares, alongside a promise to the government that the interest rate on the debt would be reduced to 5% until 1727, and 4% for the years after
- Recall that when the price of the South Sea stock increases, SSC wouldn't have to trade as much stock for the debt
    - This gave SSC the incentive to convince the government to let them assume more national debt.
    - Higher the price of stock at the time of conversion, the greater the profits which would accrue to the SSC

South Sea Bubble

- Speculative frenzy
- The stock prices soared from £128 in January to £175 in February, to £330 in March and £550 in May.

South Sea Bubble Continued

- What caused the increase in stock prices?
  - The King and the Parliament granted SSC £70mm in funds for the purpose of commercial expansion
  - Blunt offered to allow investors to pay for their stocks in installments
    - Offered the chance for people to buy shares by putting 20% down payment and make regular payments on the remainder over the next couple of years
    - This allowed people to buy more stocks than they can afford
    - But so long as the price continued to increase, many can sell (when the price of the stock rose) to cover their initial purchase and maybe even keep the profit
    - As people profited from arbitraging, they continued to reinvest their profits into the company
  - Blunt also offered loans for people who want to buy a South Sea stock
  - Company shares were "sold" to politicians at the current market price
    - But in truth, politicians didn't pay for the shares, the recipients simply held on to the shares they were given with the option of selling them back to the company whenever they wanted
    - This not only won over the parliament members, but it also had the advantage of binding their interests to the interests of the company – to secure profits, they had to drive up the price of the stock

Bubbles

- The growth of SSC's stock price made other companies also want to join in and take advantage of the "investment fever to launch a whole range of companies with little or no prospect of commercial success"
  - "All one had to do was to find a person of known substance to act as a sponsor, advertise the project in a newspaper, turn up at the appointed place and time to issue receipts against investors' down-payments.."
- Many companies made "outrageous and often fraudulent claims" to try to raise capital and boost stock prices
- List of Companies' business proposals
  - For supplying the town of Deal with fresh water
  - For insuring of horses
  - For improving the art of making soap
  - For improving of gardens
  - For a wheel for perpetual motion
  - For importing walnut-trees from VA
  - For assuring of seamen's wages
  - …
- Even companies that "promised to reclaim sunshine from vegetables" and "build floating mansions to extend Britain's landmass" sold like crazy
- All these highly speculative companies were nicknamed "Bubbles"

Bubble Act (1720)

- The increase of new companies means that SSC would lose out on investor money
- SSC urged Parliament to pass the Bubble Act
- Bubble Act was passed on June 11, 1720
  - It required all joint-stock companies to have a royal charter
- For a brief moment, with no rivals on the market, the SSC stock price continued to rise
  - The share price skyrocketed from £550 to £830 in the span of a week
  - Towards the end of July, SSC share price peaked at £1000/share
- “At this point, SSC was valued at £420mm – twice the value of all land in Britain”
  - SSC’s “main asset consisted of £37.8mm of government debt yielding a modest interest of 4% annually”

The South Sea Crash

- While SSC shares were at its peak, problems continue to culminate underneath the surface
  - SSC's installment plan and offering of loans for investors to buy stock meant that the company had little to no reserve left
  - Furthermore, SSC continued to be unprofitable, generating no revenue from its trades – ”value of personal shares in no way reflected the actual value of the company or its dismal earnings”
- With the implementation of the Bubble Act came panic
  - As the companies failed and were shut down by the government, investors who invested in these bubbles lost a great deal of money and started to sell their South Sea shares to cover their loss
  - The share price dropped to £150/share in September 1720
- Investor outrage led to formal investigations of the SSC
  - Exposing the company as a ”web of deceit, corruption and bribery”
  - SSC terminated with a liquidity crisis and the withdrawal of parliamentary support

Peter Garber’s Interpretation of Bubbles

“INTRINSIC VALUE OF THE VENTURE FROM THE POINT OF VIEW OF THE NEW INVESTORS IS THE CRUX OF THE MATTER”

Situation 1

- If investor A falsely claims that the venture promised great dividends (even though it is not realized yet), investor A would be committing a fraud
- The subsequent investors would base their decisions on their perception of market fundamentals.
- Situation 1 – Not a bubble, but a situation of asymmetric information

Situation 2

- Investor A use some of the proceeds from the stock sales to pay high dividends to the early investors
- This high dividend payments create evidence of great prospects of the venture to later new investors
- Situation 2 – Not a bubble, but a Ponzi scheme

Situation 3 & Situation 4

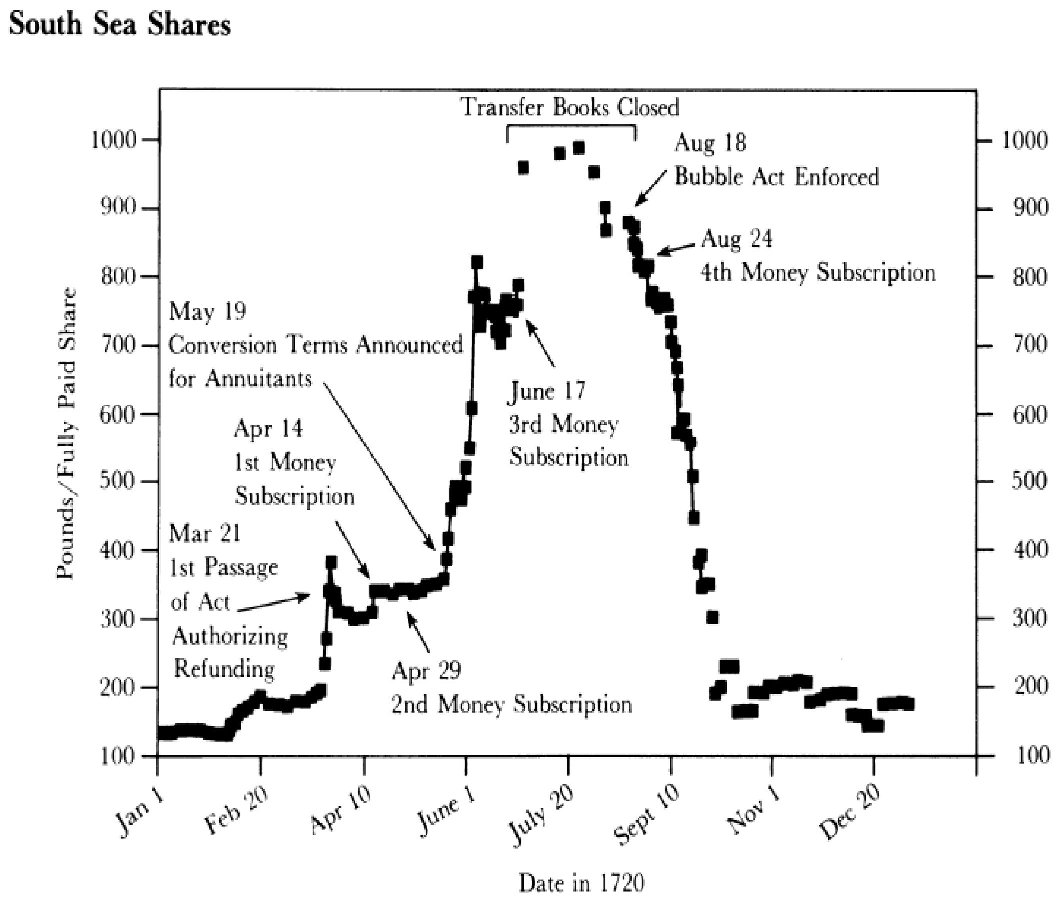
- The great future earnings may actually materialize, and satisfy all the investors.
- Situation 3 – Early stages of successful companies and the subsequent increase of stock prices would be normal

- The projected future earnings may fail to materialize. If the evidence of failure appears suddenly, the share price will decline sharply causing late buyers to regret their purchases.
- Situation 4 – If the undertaking appeared sound at start, and only looks foolish in hindsight, economists should classify this as an event driven by market fundamentals.

Situation 5

- If all investors perfectly understand that the venture has no chance of paying large dividends, but that there is sequence of share buyers at ever increasing prices, investors would buy in on the gamble believing that they will not be in the last wave of buyers.
- Situation 5 – Bubble

Is the SSC a Bubble?



- Garber argues that SSC shouldn't qualify as a bubble
- Yes, SSC's share values exceeded asset values by more than £60mm.
- But, SSC did "succeed in gathering the [commercial expansion] fund and obviously had the support of Parliament in its ventures."
  - Thus Garber believed that the pricing of the shares were not that excessive
  - There was a "great need [for] commerce in the first quarter of the 18th century [due to the] sufficiency of capital" … "It is [hard] to estimate adequately the many promising outlets there were then for the remunereative employment of capital"
  - Investors who bought the stock in 1720 for high share prices "may have been unduly optimistic, but there was at least a possibility that his confidence would be rewarded in the future"
- Garber blamed the SSC collapse on the weak financial environment
  - leveraged positions (installment payments, loans)

Questions?

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