History is full of bubbles, booms and busts, corporate collapses and crises, which illuminate the present financial world.

At Stewart Investors we believe that an appreciation of financial history can make us more effective investors today.

Scotland's greatest corporate disaster highlights the importance of management, franchise and financials in any commercial enterprise.

Mylne's Court, Edinburgh, March 1699. The directors of the Company of Scotland were summoned to an impromptu meeting to welcome Alexander Hamilton, a messenger from the other side of the Atlantic Ocean. He was the bearer of exciting news – the Company had achieved its ambition of establishing a colony at Darien on the isthmus of Central America, in modern day Panama. It was an important moment in Scottish history.

The Company of Scotland trading to Africa and the Indies was established by Act of Parliament in 1695

The Company of Scotland trading to Africa and the Indies was established by Act of Parliament in 1695, the Act providing it with a monopoly on trade to Africa, America and the Indies for 31 years and tax exemptions for 21 years. The Company was envisaged as a rival to the Dutch and English East Indies companies and as a way of boosting the Scottish economy.

After an attempt to raise capital in London failed in 1696, the promoters returned to Scotland and sought money from shareholders from across the country. Guided by financial guru William Paterson, the Scots surprised contemporaries by taking subscriptions for the very large amount of £400,000 sterling despite not being among the major financial powers. This was a substantial proportion of the wealth of the Scotland at the time. The Company was lauded in poem and song, ministers offered prayers in their sermons and university students wrote theses about it, as the country was swept by a mania for joint-stock investment. Shareholders included widows and ministers as well as merchants, lairds and nobles.

Thereafter things did not go to plan. Under severe pressure from disease and a lack of provisions, the colony was abandoned after only seven months in June 1699. Hundreds had already died on the isthmus and hundreds more succumbed as they sailed north across the Caribbean. A second expedition, which arrived at Darien not long after the abandonment, experienced a similar fate and was forced to surrender to a superior Spanish force after only four months.

What went wrong?

Huge sums were spent on a fleet of ships. The Company flagship, the Rising Sun, which could not be completed in time to sail on the first expedition because of a lack of money, eventually cost £14,946 making it one of the most expensive merchant ships of the period. It was said at the time that the Company built very expensive ships to attract the attention of potential foreign investors in Amsterdam and Hamburg, but it could have saved substantial sums by sending a less expensive fleet to Darien.

There were problems persuading shareholders to hand over cash to the Company as the economic climate deteriorated across Western Europe in 1696-7. The situation in Scotland was made worse by a series of harvest failures which sent the price of corn through the roof and led to famine in some areas of the country.

To make matters worse, 10% of the Company’s capital was lost in a financial scandal involving a dodgy director, James Smyth. Disastrously, a large proportion of the money was placed in Smyth’s care in London and simply disappeared. It later emerged that he was declared bankrupt in France a few years before and was accused of involvement in a counterfeit bond scam in 1695.

Disaster in Darien

As a result of mismanaging its capital, the Company almost ran out of money in 1697. The directors responded with a policy of retrenchment – attempting to sell assets to raise cash while abandoning Paterson’s expensive Darien scheme. However, they changed their mind at the last moment and reverted to the Darien project despite being short of capital, thus pursuing the high risk option of establishing a colony to placate angry shareholders frustrated by the lack of progress on a colonial venture.
There were a series of further problems with the location of the colony. Perhaps most importantly, the territory was in the middle of the Spanish Imperial economy; Spain was still shipping South American silver across the isthmus a bit further north. The directors took the view that Spain was in decline and would not attempt to dislodge the Scots from the settlement by military force. This turned out to be a serious misjudgement.

The climate in Darien proved deadly with many colonists succumbing to a variety of tropical diseases such as malaria and yellow fever. Ships found it difficult to get out of the harbour at certain times of the year because of the direction of the wind. The provisions were inadequate to sustain the colonists for more than a few months and they could find no market for their cargoes. Rumours of gold mines nearby proved false. There was no communication network available to the Scots in the Caribbean, especially after orders from the English government that plantations like Jamaica should not come to the aid of the Scots. None of the assets purchased by the Company were insured, probably because of a lack of capital.

Finally, the notion that a Company from a relatively poor nation with very limited naval power could control both sides of the isthmus of America at a time of intense international rivalry was a delusion typical of a financial mania.

About 2000 men and women lost their lives in the attempt to establish a colony at Darien (71% of those who sailed from Scotland). Of the 14 Company ships, 11 never returned, a loss rate of about 80%, which compares very unfavourably to a rate of below 5% for the Dutch East India Company during the 17th century.

Back home in Scotland the failure of the colony produced a political storm. The directors blamed the English government for its demise, while some shareholders pointed to the mismanagement of the directors. Edinburgh was rocked by rioting in June 1700 as the political atmosphere turned sour. The drawn out crisis would result ultimately in union between Scotland and England in 1707. In Scotland, Darien entered the popular psyche as an example of English treachery.

**Lessons for investors**

The Darien Disaster has lessons for investors today. It is a reminder of the importance of management in any financial venture, and in particular that a clear appreciation of the risks involved is vital. It also highlights that when capital is too easily obtained it can be carelessly squandered.

The directors proved to be disastrous stewards of the shareholders’ wealth, with every penny of the capital lost. In the late 1690s the Scots learned, probably more painfully than any group of investors before them, the destructive power of the new financial world.

However, there was a final twist in the tail. The shareholders, having thought for years their shares were worthless, were eventually compensated in 1707 from a bail-out fund called the Equivalent. They received a very generous rate of 142 pence in the pound, as part of the Treaty of Union between Scotland and England which created the United Kingdom – but that’s another story!

The failure of the Darien Scheme shows the importance of management quality, franchise strength and sound financials when making any investment. At Stewart Investors we believe this is as true today as it was at the end of the seventeenth century.
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Contact details

Edinburgh
23 St Andrew Square
Edinburgh EH2 1BB
United Kingdom
t. +44 (0) 131 473 2900

London
Finsbury Circus House
15 Finsbury Circus
London EC2M 7EB
United Kingdom
t. +44 (0) 207 332 6500

Singapore
58 Duxton Road
2nd & 3rd Floor
Singapore 089522
t. +65 680 59670

Sydney
Suite 10, Level 3
13 Hickson Road
Dawes Point
Sydney NSW 2000
t. +61 2 8274 8000

info@stewartinvestors.com
stewartinvestors.com

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