

When Ben Graham's three part series, "Is American Business Worth More Dead than Alive?" was published in Forbes magazine, America, and indeed the world, had gone through the punishing stock market crashes of 1929 and 1930 and was in the depths of the Great Depression. Though the Depression continued until nearly the end of the decade, Graham's articles signaled to investors that it was now safe to return to the stock market. At that time, Graham pointed out, more than 30 percent of the companies listed on the NYSE were selling at less than what they would be worth if they were broken up and sold. In this series of articles, Graham took corporate management to task for taking advantage of investors and putting their own welfare ahead of that of the shareholders.

FORBES published a series of three articles by Benjamin Graham written at the bottom of the Great Crash. This is the first, Are Corporations Milking Their Owners?

Inflated Treasuries and Deflated Stockholders (Article 1) by Benjamin Graham on June 01, 1932

SELLING AMERICA FOR 50 CENTS ON THE DOLLAR

More than one-third of all industrial stocks are selling in the open market for less than the companies' net quick assets¹.

Scores of common stocks are selling for less than their pro-rata cash in the company's treasury.

Corporations who are good risks for commercial loans do not need to borrow. They still have large unused cash balances furnished by their stockholders in the New Era days.

Corporation treasurers sleep soundly while stockholders walk the floor.

Banks no longer lend directly to big corporations. They lend to stockholders who have over-financed the companies through rights to buy stock at inflated prices.

What the responsibilities of the corporation, its directors, its stockholders? What is the proper way out? Are stockholders part-owners of their companies, or just suckers?

Shall companies reverse the 1929 method—give the stockholder rights to sell back the stock he bought, reduce capitalization, and equalize the burden between the corporations and the stockholder?

If market quotations discount huge cash reserves due to probable long continued future losses then should not the stockholder demand liquidation before his money is thus dissipated?

Are corporation playing fair with their stockholders?

Suppose you were the owner of a large manufacturing business. Like many others, you lost money in 1931; the immediate prospects are not encouraging; you feel pessimistic and willing to sell out--*cheap*. A prospective purchaser asks you for your statement. You show him a very healthy balance sheet, indeed. It shapes up something like this:

¹ **Net Quick Assets:** cash, marketable securities, and accounts receivable minus current liabilities. Inventory is excluded in order to determine whether, if sales evaporate, a business could meet its current liabilities with the readily convertible (to cash) assets on hand.

Cash and U.S. Gov. Bonds	\$8,500,000
Receivables and Merchandise	\$15,000,000
Factories, Real Estate, etc	+ \$14,000,000
	\$37,500,000
Less owing for current accts	<u>-\$1,300,000</u>
Net Worth	\$36,200,000

The purchaser looks it over casually, and then makes you a bid of \$5,000,000 for your business--the cash, Liberty Bonds and everything else included. **Would you sell?** The question seems like a joke, we admit. No one in his right mind would exchange 8 1-2 millions in cash for five million dollars, to say nothing of the \$28 millions more in other assets. But preposterous as such a transaction sounds, the many owners of *White Motors* stock who sold out between \$7 and \$8 per share did that very thing--or as close to it as they could come.

The figures given above represent *White Motors* condition on December 31st last year. At \$7 3/8 per share, the low price, the company's 650,000 shares were selling for \$4,800,000--about 60 per cent of the cash and equivalent alone, and *only one-fifth of the net quick assets*. There were no capital obligations ahead of the common stock, and the only liabilities were those shown above for current accounts payable.

The spectacle of a large and old established company selling in the market for such a small fraction of its quick assets is undoubtedly a startling one. But the picture becomes more impressive when we observe that there are literally dozens of other companies which also have a **quoted value less than their cash in bank**. And more significant still is the fact that an amazingly large percentage of all industrial companies are selling for less than their quick assets alone--leaving out their plant and other fixed assets entirely.

This means that a great number of American businesses are quoted in **liquidating value**; that in the best recent judgment of Wall Street, *these businesses are worth more dead than alive*.

For most industrial companies should bring, in orderly liquidation, at least as much as their quick assets alone. Admitting that the factories, real estate, etc. could not fetch anywhere near their carrying price, they should still realize enough to make up the shrinkage in the proceeds of the receivables and merchandise below book figures. If this is not a reasonable assumption there must be something radically wrong about the accounting methods of our large corporations.

A study made at the *Columbia University School of Business* under the writer's direction, covering some 600 industrial companies listed on the New York Stock Exchange, disclosed that over 200 of them--or fully one out of three--have been selling at less than their net quick assets. Over fifty of them have sold for less than their cash and marketable securities alone. In the Appendix at the end of this document is given a partial list, comprising the more representative companies in the latter category. What is the meaning of this situation? The experienced financier is likely to answer that stocks always sell at unduly low prices after a boom collapses. As the president of the *New York Stock Exchange* testified, "in times like these frightened people give the United States of ours away." Or stated differently, it happens because those with enterprise haven't the money, and those with money haven't the enterprise, to buy stocks when they are cheap. Should we not find the same phenomenon existing in previous bear markets--for example, in 1921?

The facts are quite otherwise, however. **Stocks sold at low prices in the severe post-war depression, but very few of them could be bought on the Stock Exchange for less than quick assets, and not one for less than the company's available cash.**

The comparative figures for both periods, covering representative companies, are little short of astounding, especially when it is noted that they showed no materially poorer operating results in 1931 than in 1921. Today,

these companies are selling in the aggregate for half their working capital; ten years ago working capital was only half the bottom prices. With respect to cash assets alone, present prices are relatively *six times* lower than in 1921.

We must recognize, therefore, that the situation existing today is not typical of all bear markets. Broadly speaking, it is new and unprecedented. It is a strange, ironical aftermath of the "new era" madness of 1921-1929. It reflects the extraordinary results of profound but little understood changes in the financial attitude of the people, and the financial fabric of the country.

Two plausible and seemingly innocent ideas, the first, that good stocks are good investments; the second, that values depend on earning power--were distorted and exploited into a frenzied financial gospel which ended by converting all our investors into speculators, by making our corporations rich and their stockholders poor, by reversing the relative importance of commercial loans and Wall Street loans, by producing topsy-turvy accounting policies and wholly irrational standards of value--and in no small measure was responsible for the paradoxical depression in which we find ourselves submerged.

Behind the simple fact that a great many stocks are selling for much less than their working capital lies a complex of causes, results and implications. The remainder of this article will deal with the causes of the present unique situation, while other ramified aspects will be developed in succeeding articles.

The current contrast between market prices and liquid assets is accounted for in large measure by the huge flood of new cash which stockholders in recent years have poured into the treasuries of their corporations by the exercise of **subscription rights**. This phenomenon, which was one of the distinguishing features of the 1928-1929 bull market, had two quite opposite consequences. On the one hand the additional funds received greatly improved the companies' cash and their working capital position; on the other hand the additional shares issued greatly increased the supply of stocks, weakened their technical position, and intensified their market decline. **The same circumstance, therefore, served both to improve the values behind a stock and to depress the price.** (*This circumstance occurs today with "Busted IPOs" when after raising substantial amounts of cash from the public when going public, the company has a hiccup in operations and/or markets turn down and the IPO's price declines significantly*).

It is doubtful, however, that the declines would have gone to the current extraordinary lengths if during the last decade investors had not lost the habit of looking at balance sheets. Much of the past year's selling of stocks has been due to fear rather than necessity. If these timid holders were thoroughly aware that they were selling out at only a fraction of the liquid assets behind their shares, many of them might have acted differently.

But since value has come to be associated exclusively with earning power, the stockholder no longer pays any attention to what his company owns--not even its money in the bank.

It is undoubtedly true that the old-time investor laid too much stress upon book values and too little upon what the property could earn. It was a salutary step to ignore the figures at which the plants were carried on the books, unless they showed a commensurate earning power. (*The asset values should earn at least their cost of capital.*)

But like most sound ideas in Wall Street, this one was carried too far. It resulted in excessive emphasis being laid on the reported earnings--which might only be temporary or even deceptive--and in a complete eclipse of what had always been regarded as a vital factor in security values, namely the company's working capital position.

Businesses have come to be valued in Wall Street on an entirely different basis from that applied to private enterprise. In good times the prices paid on the Stock Exchange were fantastically high, judged by ordinary business standards; and now, by the law of compensation, the assets of these same companies are suffering an equally fantastic undervaluation.

A third reason that stocks now sell below their liquid asset value is the fear of future operating losses. Many readers will assert that this is the overshadowing cause of the present low market level. These quotations reflect not only the absence of earning power, but the existence of "losing power" which threatened to **dissipate the working capital behind the shares today**.

Is it true that one out of three American businesses is destined to continue losing money until the stockholders have no equity remaining? This is what the stock market says in no uncertain terms.

In all probability it is wrong, as it always has been wrong in its major judgments of the future. The logic of Wall Street is proverbially weak. It is hardly consistent, for example, to despair of the railroads because the trucks are going to take most of their business, and at the same time to be so despondent over the truck industry as to give away shares in its largest units for a small fraction of their liquid capital alone.

But since even in prosperous times many undertakings fall by the wayside, it is certain that the number of such ill-starred ventures must now be greatly increased. The weakly situated business will find it difficult, perhaps impossible, to survive. Hence in a number of individual cases the market's prophecy of extinction will be borne out. Nevertheless, there must still be a basic error in this wholesale dumping of shares at a small fraction of liquidating value.

If a business is doomed to lose money, why continue it? If its future is so hopeless that it is worth much less as a going concern than if it were wound up, **why not wind it up?**

Surely the owners of a business have a better alternative than to give its present cash away, for fear that it is later going to be dissipated. We are back to the contrast between the *White Motors* stockholder and the individual factory owner, with which we started our article.

The issue is merely one of simple logic. Either *White Motors* is worth more as a going concern than its cash in bank, or it is not. If it is worth more, the stockholder is foolish to sell out for much less than this cash, unless he is compelled to do so. If it isn't the business should be liquidated and each stockholder paid out his share of the cash plus whatever the other assets will bring.

Evidently stockholders have forgotten more than to look at balance sheets. They have forgotten also that they are *owners of a business* and not merely owners of a quotation on the stock ticker. It is time, and high time, that the millions of American shareholders turned their eyes from the daily market reports long enough to give some attention to the enterprises themselves of which they are the proprietors, and which exist for their benefit and at their pleasure.

The supervision of these businesses must, of course, be delegated to directors and their operation to paid officials. But whether the owners' money should be dissipated by operating losses, and whether it should be tied up unproductively in excessive cash balances while they themselves are in dire need of funds, are questions of major policy which each stockholder must ponder and decide for himself.

These are not management problems; these are **ownership problems**. On these questions the management's opinion may be weighty but it is not controlling.

What stockholders need today is not alone to become "balance sheet conscious," but more than that, to become "ownership conscious." If they realized their rights as business owners, **we would not have before us the insane spectacle of treasuries bloated with cash and their proprietors in a wild scramble to give away their interests on any terms they can get**. Perhaps the corporation itself buys back the shares they throw out of irony, we see the stockholders' pitifully inadequate payment made to them *with their own cash*. (*Shareholders were desperately selling shares at prices below the net cash owned by their own companies to raise funds rather than have their management payout excess cash to them!*)

The waggish barber of the legend painted on his sign:

What, do you think --

We shave you for nothing and give you a drink!

That, without the saving comma, might well be blazoned as the motto of the stock seller of to-day, who hands over his share in inventories and receivables for less than nothing, and throws in real estate, buildings, machinery and what-not as a lagniappe or trading stamp.

The humor of the situation could be exploited further, but the need is not for witticism but for a straightforward presentation of the vitally important issues that face stockholders, managements, and bankers.

Should Rich Corporations Return Stockholders' Cash? (Article 2) by *Benjamin Graham*, June 15, 1932

FORBES presents herewith the second in this spectacular series of articles on the maladjustment between finances of corporations and their owners.

In our [first article](#), the present disparity between the cash asset position of many companies and the price of their stocks was ascribed in part to the huge issues of additional shares which transferred money from stockholders' pockets into corporate treasuries. According to the New York Stock Exchange's compilation, the funds so absorbed by listed companies alone, between 1926 and 1930, amounted to no less than five billion dollars.

The total sale of corporate securities to the public in this period exceeded twenty-nine billions, of which a small part perhaps was turned over to private individuals, but the major portion was paid into the businesses, and either expended in plant additions or added to working capital.

It must not be forgotten that other enormous sums have also been accumulated in the form of undistributed earnings. After this tremendous influx of cash it is no wonder that corporate treasuries are still bulging, despite all the money that has been spent, or lost, or paid in dividends.

But what of the people who supplied the bulk of this money; the investor who bought new offerings; the stockholder who subscribed to additional shares? They are not rolling in wealth to-day, nor burdened with a plethora of idle funds. They stripped themselves of cash to enrich their corporations' treasuries; they borrowed heavily in order that these corporations might be able to pay off their debts.

The grotesque result is that the people who own these rich American businesses are themselves poor, that the typical stockholder is weighed down with financial problems while his corporation wallows in cash. *Treasurers are sleeping soundly these nights, while their stockholders walk the floor in worried desperation.*

True, the public has more stock certificates to represent the new shares which it paid for, and each certificate carries ownership in the cash held by the company. But somehow this doesn't help the stockholder very much. **He can't borrow from the bank, or margin his existing loans, on the basis of the cash behind his shares.** If he wants to sell he must accept the verdict of the ticker. If he should appeal to the officers of the company for a little of his own cash, they would probably wave him away with a pitying smile. Or perhaps they may be charitable enough to buy his stock back at the current market price--which means a small fraction of its fair value.

Meanwhile, the prodigal transfer of cash by the public to corporations in the new-era days has not only made infinite trouble for the security holder, but it has seriously demoralized our banking structure. Commercial loans have always been the heart and the bulwark of our credit system. Loans on securities have been secondary in volume and drastically subordinated in their standing.

But what have the corporations and the public done between them in recent years? **They have paid off the cream of the country's commercial borrowings and substituted security loans in their place.** Instead of lending directly to big business, the banks have been forced to lend to their stockholders against pledges of their shares, or to purchase securities on their own account.

Some idea of the extent of this shift of banking accommodation can be gleaned from the comparative figures of the reporting Member Banks of the Federal Reserve System:

Change in the Composition of Banking Resources--1920-1932 (In Millions)

	Commercial Loans	Loans on Securities	Total
Oct., 1920	\$9,741	\$7,451	\$17,192
May, 1932	\$6,779	\$12,498	\$19,277

The whole development has proved most disastrous to stockholders and most embarrassing to the banks. **The best form of borrowing has been replaced by the worst.** The safety of the loans, and to some extent the solvency of the banks making them, has been placed at the mercy of stock market fluctuations, instead of resting on the financial strength of our large corporations.

Thousands of stockholders--*the owners of their company's business*--find themselves today in an absurd position. The market value of their stock may be, for instance, only ten \$ millions, its borrowing value at best eight millions. Yet not only may the company have fifteen \$ millions in the treasury, but it could borrow large additional amounts against its many millions of other quick assets. **If the owners of the business really controlled such a company, they could draw out not only the fifteen millions in cash but another five millions from bank loans, and still have a business in sound condition with substantial equities.** (*Graham illustrates the absurd prices—the value of a company can not be worth less than what a lender would be willing to lend against it.*)

The very banks which hesitate to lend ten dollars per share on a stock would probably be glad to lend the company itself enough to enable it to pay out fifteen dollars per share to the stockholders.

Consider on the one hand a typical standard business with its enormous cash and credit resources; and then consider the people who own this business and who poured millions into its treasury, unable to realize or borrow more than a miserable fraction of the cash value of their own property.

This is the result of undue generosity by stockholders towards their corporations in good times--and of undue parsimony by the corporations towards the stockholders today.

The banks may seem like co-villains in such a situation, but in fact they, too, are victims of circumstance--handicapped by a soundly conceived system which is out of harmony with the actualities of the present situation. They have been educated, and they are directed, to give first consideration to commercial loans.

But who now are the commercial borrowers? Strong corporations with good past (if not recent) records, requiring money for seasonal requirements? Not at all. Such corporations don't need the banks; they raised all the money they could use from the stockholders when the raising was good. (*The 1922-1928 Bull Market.*)

There are left three classes of bank borrowers: (a) Small or privately owned enterprises--maybe good, maybe not; (b) Large industrial corporations with poor records even in the late prosperity; (c) Railroads and utilities needing temporary (?) accommodation, to be paid off by permanent financing--a fruitful source of trouble for all concerned.

It must be recognized, therefore, that the replacement of good commercial loans by vulnerable loans on stock collateral has been harmful alike to our banking system and to the vast army of stockholders. Is there a remedy for this condition? There certainly is, and a very simple one.

Let corporations return to their stockholders the surplus cash holdings not needed for the normal conduct of their business.

The immediate result of such a movement would be to benefit the individual stockholder by placing funds in his hands to meet his urgent needs or to use as he sees fit. The secondary result would be to improve the price of the shares affected and the stock market generally, as the public is made aware in this forceful fashion of the enormous cash values behind American business to-day. The third result would be to improve the balance of our banking structure, making for a larger proportion of sound commercial loans (especially when business again expands) and permitting the repayment of a certain quantity of frozen security loans.

How should this return of cash be accomplished? Preferably by the direct retracing of the financial steps which have led to the present predicament. Instead of rights to buy stocks, let companies offer their stockholders the right to sell stock in a fixed proportion and at a stated price. This price should be above the current market but in most cases below the net quick assets per share and therefore far below the book value. From the corporation's point of view the result of such repurchases at a discount will be an increase both in the surplus and in the net current assets per share of stock remaining.

A few corporations have followed this procedure, one of the earliest being *Simms Petroleum*. Recently *Hamilton Woolen* has offered to buy one-sixth of the outstanding shares pro rata at \$65, which is about equal to the net quick assets and considerably above the previous market price. This represents the return of a large portion of the new money paid in by stockholders in 1929.

Other companies have returned surplus cash to stockholders in the form of special distributions without cancellation of stock. *Peerless Motors* is a case in point, and another is *Eureka Vacuum Cleaner*, which accompanied its action by a statement recommending a similar move to other corporations as an aid in relieving the depression. A few companies, notably the *Standard Oil* pipe lines and some New England mills, **have returned surplus cash capital to shareholders by reducing the par value of the stock.**

All these methods accomplish the same purpose and the differences between them are largely technical. The repurchase of shares pro rata, which we recommend, is more practical in most cases than a reduction in par value, and it has certain bookkeeping advantages over a straight special dividend. Furthermore, as a direct reversal of the process of taking money from stockholders by issuing subscription rights, this method undoubtedly has a strong logical appeal.

A sizable number of enterprises have been employing surplus funds to acquire stock by purchase in the open market. This also represents a transfer of corporate funds to stockholders. It is undoubtedly helpful to the market price and hence to those constrained to sell, and **the repurchase of shares at bargain prices presumably benefits the surviving stockholders.** Certainly corporations using excess cash in this manner are acting more liberally than those who hold on like grim death to every dollar in bank.

But this form of procedure is open to objections of various kinds. If the price paid turns out to have been too high, the directors are subject to criticism from those whom they still represent, while those they have benefited are no longer interested in them or in the company. If, to avoid this danger, they buy only when the price is exceedingly low, they cannot avoid the appearance of having taken unfair advantage of the necessities of their stockholders. Furthermore, such undisclosed market operations may afford opportunities for questionable profit by directors and insiders.

The *Bendix Aviation Company* recently passed its dividend and concurrently announced its intention of purchasing a large block of shares in the open market. Other companies rich in cash have followed the same policy, though generally without even this saving grace of revealing their plan to buy in stock. Such a procedure contains possibilities of grave injustice to the shareholders. **When there is an accumulated surplus and excess cash on hand, the directors' first duty is to use the free cash to maintain a reasonable dividend.** (*Today—2009--paying dividends vs. buying back stock below intrinsic value may or may not be a good choice depending upon circumstances. Graham puts a premium on paying out cash directly to shareholders because he says that corporate managements may be taking advantage of selling shareholders by repurchasing their stock at low prices*).

The prime reason for accumulating the surplus in good years was to make possible the continuance of dividends in bad years. Hence the absence of earnings is in itself no justification for stopping all payments to shareholders. To withhold the owners' money from them by suspending dividends, and then to use this same money to buy back their stock at the abnormally low price thus created, comes perilously close to sharp practice.

Such considerations should make it clear why the writer does not regard open-market purchases as the best method of returning corporate cash to stockholders. Retirement of stock pro rata involves no conflict of interest between those selling out and those staying in; and it provides no opportunity for errors in judgment or unfair tactics on the part of the management.

Examination of the partial list on page 21 of companies selling in the market for less than their net current assets, as well as reference to the table offered in our first article last issue, will disclose many instances in which the **cash holdings are clearly excessive**. If stockholders will bring sufficiently strong pressure upon their managements, they can secure the return of a good part of such surplus cash, with great benefit to their own position, to stock market sentiment, and to the general banking situation.

In order to obtain these desirable results, stockholders must first be aware that surplus cash exists; and therefore they must direct at least a fleeting glance to their company's balance sheet. In recent years financial writers have been unanimous in pointing out how unimportant are asset values as compared with earning power; but no one seems to have realized that both the ignoring of assets and the emphasis on earnings can be--and have been--carried too far, with results of the most disastrous kind.

The whole "new-era" and "blue chip" madness derived from this exclusive preoccupation with the earnings trend. A mere \$1 increase in profits, from \$4 to \$5 per share, raised the value of a stock from 40 to 75, on the joyous assumption that an upward trend had been established which justified a multiple of 15 instead of 10. **The basis of calculating values thus became arbitrary and mainly psychological**, with the result that everyone felt free to gamble unrestrainedly under the respectable title of "investment."

It was this enticement of investors into rampant speculation which made possible the unexampled duration and extent of the 1928-1929 advance, which also made the ensuing collapse correspondingly disastrous, and which--as later appeared--carried the business structure down into ruin with the stock market.

A peculiar offshoot of the obsession with earnings is the new practice of writing fixed assets down to \$1, in order to eliminate depreciation charges and thus report larger profits. The theory is that by destroying asset values we can increase earning power and therefore enhance the market value. Since no one pays any attention to assets, why carry any assets on the books? This is another example of Alice in Wonderland financial logic.

It is in amusing contrast with the much berated *stock watering*² practice of a generation ago. In those days fixed assets were arbitrarily written up, in order to enlarge the book values, and thus facilitate a fictitious market price. In place of watering of assets, we now have watering of earnings. The procedures are directly opposite, but the object and the underlying deception are exactly the same.

Because of the superstitious reverence now accorded the earnings statement by both investors and speculators, wide variations in market prices can be occasioned by purely arbitrary differences in accounting methods. The opportunities for downright crookedness are legion, nor are they ignored.

One company, listed on the New York Stock Exchange, recently turned an operating loss into a profit by the simple expedient of marking up its goodwill and adding the difference to earnings, without bothering to mention this little detail. The management apparently relied, and not unreasonably, on the fact that stockholders would not examine the balance sheets closely enough to detect their charming artifice.

The disregard of assets has also introduced some new wrinkles into reorganizations and mergers. Creditors are no longer permitted to receive the cash directly available to pay off their claims; stockholders are forced into consolidations which give other securities a prior claim on cash which formerly was theirs.

The *Fisk Rubber Co.*, for example, showed around \$400 in cash on hand for each \$1,000 of overdue debt, and nearly \$900 in net quick assets, excluding the extensive factories, etc. Yet the proposed reorganization plan offers these creditors no cash at all, but only stock in a new company.

Similarly, while *Prairie Pipe Line* stockholders were taking comfort from the fact that there had lately appeared to be \$12 per share in cash equivalent behind their stock, they suddenly found themselves owners of shares in another company which had no cash at all directly applicable to their holdings, this new stock, moreover, having a total market value equal to less than half the cash equivalent alone which they formerly owned.

In the writer's view, all these strange happenings flow from the failure of the stockholder to realize that he occupies the same fundamental position and enjoys the same legal rights as the part-owner in a private business. The panoply and pyrotechnics of Wall Street have obscured this simple fact. If it only could be brought home to the millions of investors the country over, a long step would be taken in the direction of sounder corporate practices and a saner attitude towards stock values.

Treasurers Sleep Soundly While Stockholders Walk the Floor!

Why is the stockholder poor today?

Because he borrowed from the banks in 1929 to put more cash into the companies he owns. Where is that cash now? Much of it is still held intact by his company. Does the stockholder need that money more than his company? You bet he does. Has he done anything to get it? No. **He thinks his company is broke because stock prices say so.** He has forgotten asset value. He has forgotten that his officers and directors are supposed to be his own representatives, working for his own best good. **He has forgotten that he is a part-owner and manager of the company in which he owns stock.**

² This term came from the activities of Daniel Drew in the 1870s during his early life as a cattle drover - his discovery of the profit to be gained from "watered" cattle which he later used in watering the stock in the famed Erie Railroad operation. Drew would have his cattle drink lots of water after driving them to the stockyards for sale. Obviously, watering cattle artificially boosted the weight of his cattle and thus his payment.

Should Rich But Losing Corporations Be Liquidated? by Benjamin Graham, July 01, 1932 (Article 3)

Which is Right--the Stock Market or Corporation Management?

Another aspect of the current maladjustment between corporation and their stockholders is the question of possible liquidation. Many stocks sell for less than their cash value because the market judges that future operating losses will dissipate this cash.

If that is the case, then should not the stockholder demand liquidation before his cash is used up? The management says "No"--naturally, but the stock market says "Yes,"—emphatically. Which is right? What are the salient factors on both sides of the question?

Forbes presents herewith the third, and last, article in this series by Mr. Graham, which reaches down to the very roots of the present troublesome situation.

The unprecedented spectacle confronts us of more than one industrial company in three selling for less than its net current assets, with a large number quoted at less than their unencumbered cash. For this situation we have pointed out, in our previous articles, three possible causes:

- (a) Ignorance of the facts;
- (b) Compulsion to sell and inability to buy;
- (c) Unwillingness to buy from fear that the present liquid assets will be dissipated.

In the preceding articles [Inflated Treasuries And Deflated Stockholders](#) (Article 1) and [Should Rich Corporations Return Stockholders' Cash?](#) (Article 2) we discussed the first two causes and their numerous implications. But neither the ignorance nor the financial straits of the public could fully account for the current market levels.

*If gold dollars without any strings attached could actually be purchased for 50 cents, plenty of publicity and plenty of buying power would quickly be marshaled to take advantage of the bargain. Corporate gold dollars are now available in quantity at 50 cents and less--but they *do* have strings attached. Although they belong to the stockholder, he doesn't control them. He may have to sit back and watch them dwindle and disappear as operating losses take their toll. For that reason the public refuses to accept even the cash holdings of corporations at their face value.*

In fact, the hardhearted reader may well ask impatiently: "Why all this talk about liquidating values, *when companies are not going to liquidate?* As far as the stockholders are concerned, their interest in the corporation's cash account is just as theoretical as their interest in the plant account. *If* the business were wound up, the stockholders would get the cash; *if* the enterprise were profitable, the plants would be worth their book value. "If we had some ham, etc., etc."

This criticism has force, but there is an answer to it. **The stockholders do not have it in their power to make a business profitable, but they do have it in their power to liquidate it.** At bottom is not a theoretical questions at all; the issue is both very practical and very pressing.

It is also a highly controversial one. It includes an undoubted conflict of *judgment* between corporate managements and the stock market, and a probable conflict of *interest* between corporate managements and their stockholders.

In its simplest terms the question comes down to this: Are these managements wrong or is the market wrong? Are these low prices merely the product of unreasoning fear, or do they convey a stern warning to liquidate while there is yet time?

To-day stockholders are leaving the answer to his problem, as to all other corporate problems, in the hands of their management. But when the latter's judgment is violently challenged by the verdict of the open market, it seems childish to let the management decide whether itself or the market is right. This is especially true when the issue involves a strong conflict of interest between the officials who draw salaries from the business and the owners whose capital is at stake. **If you owned a grocery store that was doing badly, you wouldn't leave it to the paid manager to decide whether to keep it going or to shut up shop.**

The innate helplessness of the public in the face of this critical problem is aggravated by its acceptance of two pernicious doctrines in the field of corporate administration. The first is that directors have no responsibility for, or interest in, the market price of their securities. The second is that outside stockholders know nothing about the business, and hence their views deserve no consideration unless sponsored by the management.

By virtue of dictum number one, directors succeed in evading all issues based upon the market price of their stock. Principle number two is invoked to excellent advantage in order to squelch any stockholder (not in control) who has the temerity to suggest that those in charge may not be proceeding wisely or in the best interests of their employers. The two together afford management perfect protection against the necessity of justifying to their stockholders the continuance of the business when the weight of sound opinion points to better results for the owners through liquidation.

The accepted notion that directors have no concern with the market price of their stock is as fallacious as it is hypocritical. Needless to say, managements are not responsible for market fluctuations, but they should take cognizance of excessively high or unduly low price levels for the shares. They have a duty to protect their stockholders against avoidable depreciation in market value--as far as is reasonable in their power--equal to the duty to protect them against avoidable losses of earnings or assets.

If this duty were admitted and insisted upon, the present absurd relationship between quoted prices and liquidating values would never have come into existence. Directors and stockholders both would recognize that the true value of their stock should under no circumstances be less than the realizable value of the business, which amount in turn would ordinarily be not less than the net quick assets.

They would recognize further that *if the business is not worth its realizable value as a going concern it should be wound up*. Finally, directors would acknowledge their responsibility to conserve the realizable value of the business against shrinkage and to prevent, as far as is reasonably possible, the establishment of a price level continuously and substantially below the reasonable value.

Hence, instead of viewing with philosophic indifference the collapse of their stock to abysmally low levels, directors would take these declines as a challenge to constructive action. In the first place, they would make every effort to maintain a dividend at least commensurate with the minimum real value of the stock. For this purpose they would draw freely on accumulated surplus, provided the company's financial position remained unimpaired. Secondly, they would not hesitate to direct the stockholders' attention to the existence of minimum liquidating values in excess of the market price, and to assert their confidence in the reality of these values. In the third place, wherever possible, they would aid the stock-holders by returning to them surplus cash capital through retirement of shares pro rata at a fair price, as advocated in our previous article.

Finally, they would study carefully the company's situation and outlook, to make sure that the realizable value of the shares is not likely to suffer a substantial shrinkage. If they find there is danger of serious future loss, they would give earnest and fair-minded consideration to the question whether the stockholders' interest might not best be served by sale or liquidation.

However forcibly the stock market may be asserting the desirability of liquidation, there are no signs that managements are giving serious consideration to the issue. In fact, the infrequency of voluntary dissolution by companies with diversified ownership may well be a subject of wonder, or of cynicism. In the case of privately owned enterprises, withdrawing from business is an everyday occurrence. But with companies whose stock is widely held, it is the rarest of corporate developments.

Liquidation *after* insolvency is, of course, more frequent, but the idea of shutting up shop *before* the sheriff steps in seems repugnant to the canons of Wall Street. One thing can be said for our corporate managements--they are not quitters. Like Josh Billings, who in patriotic zeal stood ready to sacrifice all his wife's relations on the altar of his country, officials are willing to sacrifice their stockholders' last dollar to keep the business going.

But is it not true that the paid officials are subject to the decisions of the board of directors, who represent the stockholders, and whose duty it is to champion the owners' interests--if necessary, against the interests of the operating management? In theory this cannot be gain-said, but it doesn't work out in practice.

The reasons will appear from a study of any typical directorate. Here we find: (a) The paid officials themselves, who are interested in their jobs first and the stockholders second; (b) Investment bankers, whose first interest is in underwriting profits; (c) Commercial bankers, whose first interest is in making and protecting loans; (d) Individuals who do business of various kinds with the company; and finally--and almost always in a scant minority--(e) Directors who are interested only in the welfare of the stockholders.

Even the latter are usually bound by ties of friendship to the officers (that is how they came to be nominated), so that the whole atmosphere of a board meeting is not conducive to any assertion of stockholders' rights against the desires of the operating management. Directors are not dishonest, but they are human. The writer, being himself a member of several boards, knows something of this subject from personal experience.

The conclusion stands out that liquidation is peculiarly an issue for the stockholders. Not only must it be decided by their independent judgment and preference, but in most cases the initiative and pressure to effect liquidation must emanate from stockholders not on the board of directors. In this connection we believe that the recognition of the following principle would be exceedingly helpful:

The fact that a company's shares sell persistently below their liquidating value should fairly raise the question whether liquidation is advisable.

Please note we do not suggest that the low price proves the desirability of liquidation. It merely justifies any stockholder in raising the issue, and entitles his views to respectful attention.

It means that stockholders should consider the issue with an open mind, and decide it on the basis of the facts presented and in accordance with their best individual judgment. No doubt in many of these cases--perhaps a majority--a fair minded study would show liquidation to be unjustified. The going concern value under normal conditions would be found so large, as compared with the sum realizable in liquidation, as to warrant seeing the depression through, despite current operating losses.

However, it is conceivable that under present difficult conditions the owners of a great many businesses might conclude that they would fare better by winding them up rather than continuing them. What would be the significance of such a movement to the economic situation as a whole? Would it mean further deflation, further unemployment, further reduction of purchasing power? Would stockholders be harming the country while helping themselves? Superficially it might seem so, but powerful arguments can be advanced to the opposite effect.

The operation of unsoundly situated enterprises may be called a detriment, instead of an advantage, to the nation. We suffer not only from over-capacity, but still more from the disruptive competition of companies which have no

chance to survive, but continue to exist none the less, to the loss of their stockholders and the unsettlement of their industry.

Without making any profits for themselves, they destroy the profit possibilities of other enterprises. Their removal might permit a better adjustment of supply to demand, and a larger output with consequent lower costs to the stronger companies which remain. An endeavor is now being made to accomplish this result in the cotton goods industry.

From the standpoint of employment, the demand for the product is not reduced by closing down unprofitable units. Hence, production is transferred elsewhere and employment in the aggregate may not be diminished. That great individual hardship would be involved cannot be denied, nor should it be minimized, but in any case the conditions for employment in a fundamentally unsound enterprise must be precarious in the extreme. Admitting that the employees must be given sympathetic consideration, it is only just to point out that our economic principles do not include the destruction of stockholders' capital for the sole purpose of providing employment.

We have not yet found any way to prevent depression from throttling us in the midst of our superabundance. But unquestioningly there *are* ways to relieve the plight of the **stockholders who today own so much and can realize so little**. A fresh viewpoint on these matters might work wonders for the sadly demoralized army of American stockholders.

Appendix:

Table 1: Some Stocks Which Are Selling for Less Than Their Cash Assets

Company	1932 Mkt. Low	(\$000s omitted) Mkt. Val. of Co. at L. Pr.	Mkt. Val. % Cash and Mkt. Secs.	(\$000s omitted) Cash Mkt. Secs.	MV %. Of CA -all Liabs.	(\$000s omitted) CA - All Liabs.	ML Pr. % of Cash A. /Sh.	Cash A. Per Share	ML Pr. as % Cash A/Sh.	Net Quick Assets per sh.
Am. Car & Fdry Pref.	\$20.25	\$9,225	61.71%	\$14,950	46.23%	\$32,341	40.5%	\$50.00	18.8%	\$108.00
Am. Locomotive Pref.	30.25	14,709	99.19%	14,829	65.53%	22,630	73.8%	41.00	48.0%	63.00
Am Steel Fdry Pref	60.00	8,021	99.69%	8,046	68.65%	11,720	46.9%	128.00	32.3%	186.00
Am Woolen Pref.	15.25	8,354	57.21%	14,603	35.82%	40,769	50.0%	30.50	17.9%	85.00
Congoleum	7.00	10,078	93.30%	10,802	66.32%	16,288	100.0%	7.00	58.3%	12.00
Howe Sound	6.00	2,886	58.78%	4,910	93.45%	5,254	60.0%	10.00	54.5%	11.00
Hudson Motors	4.12	6,377	75.36%	8,462	79.00%	10,712	74.9%	5.50	58.9%	7.00
Hupp Motors	2.00	2,664	36.82%	7,236	72.36%	10,000	36.4%	5.50	26.7%	7.50
Lima Locomotive	8.50	1,581	43.67%	3,620	53.46%	6,772	44.7%	19.00	23.6%	36.00
Magna Copper	4.50	1,836	48.69%	3,771	78.16%	4,825	50.0%	9.00	37.5%	12.00
Marlin Rockwell	7.50	2,520	65.73%	3,834	88.96%	4,310	65.2%	11.50	57.7%	13.00
Motor Products	13.00	2,457	83.29%	2,950	81.60%	3,615	83.9%	15.50	68.4%	19.00
Munsingwear	10.87	1,805	62.50%	2,888	50.06%	5,769	63.9%	17.00	32.0%	34.00
Nash Motors	10.00	27,000	73.85%	36,560	98.61%	37,076	74.1%	13.50	71.4%	14.00
NY Air Brake	4.50	1,170	79.38%	1,474	62.27%	2,367	90.0%	5.00	50.0%	9.00
Opphm Collins	5.00	1,050	52.08%	2,016	64.00%	3,150	52.6%	9.50	33.3%	15.00
Reo Motors	1.50	2,716	51.04%	5,321	51.50%	10,332	50.0%	3.00	27.3%	5.50
S.O. of Kansas	7.00	2,240	81.16%	2,760	61.65%	4,477	82.4%	8.50	50.0%	14.00
Stewart Warner	2.38	3,023	65.04%	4,648	55.98%	8,303	68.0%	3.50	34.0%	7.00
White Motors	7.75	4,938	57.29%	8,620	38.89%	22,167	59.6%	13.00	22.8%	34.00

Inflated Treasuries and Deflated Stockholders

Are Corporations Milking Their Owners?

SUPPOSE you were the owner of a large manufacturing business. Like many others, you lost money in 1931; the immediate prospects are not encouraging; you feel pessimistic and willing to sell out—*cheap*. A prospective purchaser asks you for your statement. You show him a very healthy balance sheet, indeed. It shapes up something like this:

Cash and U. S. Gov. Bonds..	\$8,500,000
Receivables and Merchandise.	15,000,000
Factories, Real Estate, etc....	14,000,000
	\$37,500,000
Less owing for current accts...	1,300,000
Net Worth	\$36,200,000

The purchaser looks it over casually, and then makes you a bid of \$5,000,000 for your business—the cash, Liberty Bonds and everything else included. Would you sell? The question seems like a joke, we admit. No one in his right mind would exchange 8 1-2 millions in cash for five million dollars, to say nothing of the 28 millions more in other assets. But preposterous as such a transaction sounds, the many owners of White Motors stock who sold out between \$7 and \$8 per share did that very thing—or as close to it as they could come.

By BENJAMIN GRAHAM

With this article The Editors introduce a series on one of the most amazing, far-reaching and important situations which business and financial America has ever witnessed, a situation whose solution affects the interests of every investor.

Read the points mentioned under the caption below, and you will quickly discover why this series is one of the timeliest and most significant which could be proposed.

The author, a lecturer at Columbia University, and with many years of practical experience and study in business, finance and stock markets, will lead you through an amazing consideration of facts, to equally amazing conclusions regarding your rights and duties as a stockholder.

Most of these facts, while logical and apparent, have received scant attention in public print. **FORBES** takes pleasure in offering this expose of injustice and maladjustment in the stock and corporation world, presented in a fearless, frank and interesting series, of which this is the first article.

The figures given above represent White Motors condition on December 31st last. At \$7 $\frac{3}{8}$ per share, the low price, the company's 650,000

shares were selling for \$4,800,000—about 60 per cent. of the cash and equivalent alone, and only *one-fifth of the net quick assets*. There were no capital obligations ahead of the common stock, and the only liabilities were those shown above for current accounts payable.

The spectacle of a large and old established company selling in the market for such a small fraction of its quick assets is undoubtedly a startling one.

But the picture becomes more impressive when we observe that there are literally dozens of other companies which also have a quoted value less than their cash in bank. And more significant still is the fact that an amazingly large percentage of *all* industrial companies are selling for less than their *quick* assets alone—leaving out their plants and other fixed assets entirely.

This means that a great number of American businesses are quoted in the market for much less than their liquidating value; that in the best judgment of Wall Street, these *businesses are worth more dead than alive*.

For most industrial companies should bring, in *orderly* liquidation, at least as much as their quick assets alone. Admitting that the factories, real estate, etc., could not fetch any-

Selling America for 50 Cents on the Dollar

MORE than one-third of all industrial stocks are selling in the open market for less than the companies' net quick assets.

Scores of common stocks are selling for less than their pro rata of *cash* in the company's treasury.

Corporations who are "good risks" for commercial loans do not need to borrow. They still have large unused cash balances furnished by their stockholders in the "new era" days.

Corporation treasurers sleep soundly while stockholders walk the floor.

Banks no longer lend directly to big corporations. They lend to stockholders who have over-financed the companies through rights to buy stock at inflated prices.

What are the responsibilities of the corporation, its directors, its stockholders? What is the proper way out? Are stockholders "part-owners" of their companies, or just "suckers"?

Shall companies reverse the 1929 method—give the stockholder rights to sell back the stock he bought, reduce capitalization and equalize the burden between the corporation and the stockholder?

If market quotations discount huge cash reserves due to probable long-continued future losses then should not the stockholder demand liquidation before his money is thus dissipated?

Are corporations playing fair with their stockholders?

Read this and future articles.

here near their carrying rice, they should still realize enough to make up the shrinkage in the proceeds of the receivables and merchandise below book figures. If this is not a reasonable assumption there must be something radically wrong about the accounting methods of our large corporations.

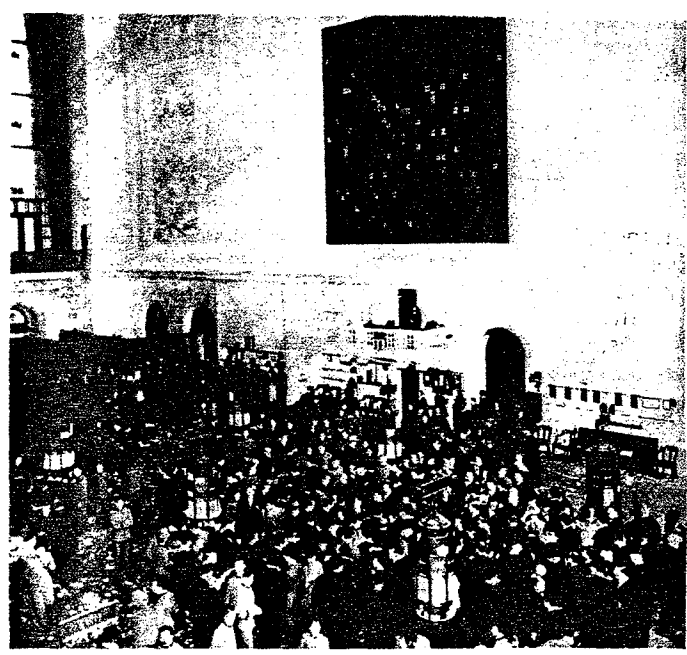
A STUDY made at the Columbia University School of Business under the writer's direction, covering some 600 industrial companies listed in the New York Stock Exchange, disclosed that over 200 of them—officially one out of three—have been selling at less than their net quick assets. Over fifty of them have sold for less than their cash and marketable securities alone. In the appended table is given a partial list, comprising more representative companies in the latter category.

What is the meaning of this situation? The experienced financier is likely to answer that stocks always fall at unduly low prices after a boom or collapses. As the president of the New York Stock Exchange testified, "in times like these frightened people drive the United States of ours away." Or stated differently, it happens because those with enterprise haven't the money, and those with money haven't the enterprise, to buy stocks when they are cheap. Should we not find the same phenomenon existing in previous bear markets—for example, 1921?

THE facts are quite otherwise, however. Stocks sold at low prices in the severe post-war depression, but very few of them could be bought on the Stock Exchange for less than their net quick assets, and not one for less than the company's available cash.

The comparative figures for both periods, covering representative companies, are little short of astounding, especially when it is noted that they showed no materially poorer operating results in 1931 than in 1921. To-day these companies are selling at the aggregate for half their working capital; ten years ago working capital was only half the bottom prices. With respect to cash assets alone, present prices are relatively *still lower* than in 1921.

We must recognize, therefore, that the situation existing to-day is not typical of all bear markets. Broadly



The floor of the New York Stock Exchange

speaking, it is new and unprecedented. It is a strange, ironical aftermath of the "new era" madness of 1928-1929. It reflects the extraordinary results of profound but little understood changes in the financial attitude of the people and the financial fabric of the country.

Two plausible and seemingly innocent ideas—the first that good stocks are good investments; the second, that values depend on earning power—were distorted and exploited into a frenzied financial gospel which ended by converting all our investors into speculators, by making our corporations rich and their stockholders poor, by reversing the relative importance

of commercial loans and Wall Street loans; by producing topsy-turvy accounting policies and wholly irrational standards of value—and in no small measure was responsible for the paradoxical depression in which we find ourselves submerged.

BEHIND the simple fact that a great many stocks are selling for much less than their working capital lies a complex of causes, results and implications. The remainder of this article will deal with the causes of the present unique situation, while other ramified aspects will be developed in succeeding articles.

The current contrast between market prices and liquid assets is accounted for in large measure by the huge flood of new cash which stockholders in recent years have poured into the treasuries of their corporations by the exercise of subscription rights. This phenomenon, which was one of the distinguishing features of the 1928-1929 bull market, had two quite opposite consequences. On the one hand the additional funds received greatly improved the companies' cash and working capital position; on the other hand the additional shares issued greatly increased the supply of stocks, weakened their technical position, and intensified their market decline. The same circumstance, therefore, served

Some Stocks Which Are Selling for Less Than Their Cash Assets

Company	1932 Market Low	Mkt. Value of Company at Low Price	Cash and Mktble Sec's.	Current Assets Less All Liabilities	Cash Assets per Share	Net Quick Assets per Share
(000 omitted)						
*Am. Car & Fdry.....	20 1/4	\$9,225	\$14,950	\$32,341	\$50	\$108
*Am. Locomotive	30 3/4	14,709	14,829	22,630	41	63
*Am. Steel Foun.....	60	8,021	8,046	11,720	128	186
*Am. Woolen	15 1/4	8,354	14,603	40,769	30 1/2	85
Congoleum	7	10,078	10,802	16,288	7	12
Howe Sound	6	2,886	4,910	5,254	10	11
Hudson Motors	4 1/8	6,377	8,462	10,712	5 1/2	7
Hupp Motors	2	2,664	7,236	10,000	5 1/2	7 1/2
Lima Locomotive	8 1/2	1,581	3,620	6,772	19	36
Magma Copper	4 1/2	1,836	3,771	4,825	9	12
Marlin Rockwell	7 1/2	2,520	3,834	4,310	11 1/2	13
Motor Products	13	2,457	2,950	3,615	15 1/2	19
Munsingwear	10 7/8	1,805	2,888	5,769	17	34
Nash Motors	10	27,000	36,560	37,076	13 1/2	14
N. Y. Air Brake.....	4 1/2	1,170	1,474	2,367	5	9
Opp'hm Collins	5	1,050	2,016	3,150	9 1/2	15
Reo Motors	1 1/2	2,716	5,321	10,332	3	5 1/2
S. O. of Kansas	7	2,240	2,760	4,477	8 1/2	14
Stewart Warner	2 3/8	3,023	4,648	8,303	3 1/2	7
White Motors	7 1/4	4,938	8,629	22,107	13	34

*Preferred stock.



both to improve the *values* behind a stock and to depress the *price*.

It is doubtful, however, that the declines would have gone to the current extraordinary lengths if during the last decade investors had not lost the habit of looking at balance sheets. Much of the past year's selling of stocks has been due to fear rather than necessity. If these timid holders were thoroughly aware that they were selling out at only a fraction of the liquid assets behind their shares, many of them might have acted differently.

But since value has come to be associated exclusively with earning power, the stockholder no longer pays any attention to what his company owns—not even its money in bank.

It is undoubtedly true that the old-time investor laid too much stress upon book values and too little upon what the property could earn. It was a salutary step to ignore the figures at which the plants were carried on the books, unless they showed a commensurate earning power.

But like most sound ideas in Wall Street, this one was carried too far. It resulted in excessive emphasis being laid on the reported earnings—which might only be temporary or even deceptive—and in a complete eclipse of what had always been regarded as a vital factor in security values, namely the company's working capital position.

Businesses have come to be valued in Wall Street on an entirely different basis from that applied to private enterprise. In good times the prices paid on the Stock Exchange were fantastically high, judged by ordinary business standards; and now, by the law of compensation, the assets of these same companies are suffering an equally fantastic undervaluation.

A THIRD reason that stocks now sell below their liquid asset value is the fear of future operating losses. Many readers will assert that this is the overshadowing cause of the present low market level. These quotations reflect not only the absence of earning power, but the existence of "losing power" which threatens to dissipate the working capital behind the shares to-day.

Is it true that one out of three American businesses is destined to continue losing money until the stockholders have no equity remaining? This is what the stock market says in no uncertain tones.

In all probability it is wrong, as it always has been wrong in its major judgments of the future. The logic of Wall Street is proverbially weak. It is hardly consistent, for example, to despair of the railroads because the trucks are going to take most of their

business, and at the same time to be so despondent over the truck industry as to give away shares in its largest units for a small fraction of their liquid capital alone.

But since even in prosperous times many undertakings fall by the way-side, it is certain that the number of such ill-starred ventures must now be greatly increased. The weakly situated business will find it difficult, perhaps impossible, to survive. Hence in a number of individual cases the market's prophecy of extinction will be borne out. Nevertheless, there must still be a basic error in this wholesale dumping of shares at a small fraction of liquidating value.

If a business is doomed to lose money, why continue it? If its future is so hopeless that it is worth much less as a going concern than if it were wound up, why not wind it up?

Surely the owners of a business have a better alternative than to give its present cash away, for fear that it is later going to be dissipated. We are back to the contrast between the White Motors stockholder and the individual factory owner, with which we started our article.

The issue is merely one of simple logic. Either White Motors is worth more as a going concern than its cash in bank, or it is not. If it is worth more, the stockholder is foolish to sell out for much less than this cash, unless he is compelled to do so. If it isn't, the business should be liqui-

dated and each stockholder paid out his share of the cash plus whatever the other assets will bring.

EVIDENTLY stockholders have forgotten more than to look at balance sheets. They have forgotten also that they are *owners of a business* and not merely owners of a quotation on the stock ticker. It is time, and high time, that the millions of American shareholders turned their eyes from the daily market reports long enough to give some attention to the enterprises themselves of which they are the proprietors, and which exist for their benefit and at their pleasure.

The supervision of these businesses must, of course, be delegated to directors and their operation to paid officials. But whether the owners' money should be dissipated by operating losses, and whether it should be tied up unproductively in excessive cash balances while they themselves are in dire need of funds, are questions of major policy which each stockholder must ponder and decide for himself.

These are not management problems; these are *ownership problems*. On these questions the management's opinion may be weighty but it is not controlling.

WHAT stockholders need to-day is not alone to become "balance sheet conscious," but more than that, to become "ownership conscious." If they realized their rights as *business owners*, we would not have before us the insane spectacle of treasuries bloated with cash and their proprietors in a wild scramble to give away their interest on any terms they can get. Perhaps the corporation itself buys back the shares they throw on the market, and by a final touch of irony, we see the stockholders' pitifully inadequate payment made to them *with their own cash*.

The waggish barber of the legend painted on his sign:

What, do you think—

We shave you for nothing and give you a drink!

That, without the saving comma, might well be blazoned as the motto of the stock seller of to-day, who hands over his share in inventories and receivables for less than nothing, and throws in real estate, buildings, machinery and what-not as a lagnappe or trading stamp.

The humor of the situation could be exploited further, but the need is not for witticism but for a straightforward presentation of the vitally important issues that face stockholders, managements, and bankers. These will be dealt with in succeeding articles.



Ewing Galloway Photo

Should Rich but Losing Corporations Be Liquidated?

THE unprecedented spectacle confronts us of more than one industrial company in three selling for less than its net current assets, with a large number quoted at less than their unencumbered cash. For this situation we have pointed out, in our previous articles, three possible causes: (a) Ignorance of the facts; (b) Compulsion to sell and inability to buy; (c) Unwillingness to buy from fear that the present liquid assets will be dissipated.

In the preceding articles we discussed the first two causes and their numerous implications. But neither the ignorance nor the financial straits of the public could fully account for the current market levels.

If gold dollars without any strings attached could actually be purchased for 50 cents, plenty of publicity and plenty of buying power would quickly be marshalled to take advantage of the bargain. Corporate gold dollars are now available in quantity at 50 cents and less—but they *do* have strings attached. Although they belong to the stockholder, he doesn't control them. He may have to sit back and watch them dwindle and disappear as operating losses take their toll. For that reason the public refuses to accept even the cash holdings of corporations at their face value.

IN fact, the hardheaded reader may well ask impatiently: "Why all this talk about liquidating values, when companies are not going to liquidate? As far as the stockholders are concerned, their interest in the corporation's cash account is just as theoretical as their interest in the plant account. If the business were wound up, the stockholders would get the cash; if the enterprise were profitable, the plants would be worth their book value. "If we had some ham, etc., etc."

This criticism has force, but there is an answer to it. The stockholders do not have it in their power to make a business profitable, but they do have it in their power to liquidate it. At bottom it is not a theoretical question at all; the issue is both very practical and very pressing.

It is also a highly controversial one. It includes an undoubted con-

By BENJAMIN GRAHAM

lict of *judgment* between corporate managements and the stock market, and a probable conflict of *interest* between corporate managements and their stockholders.

IN its simplest terms the question comes down to this: Are these managements wrong or is the market wrong? Are these low prices merely

Which Is Right—the Stock Market or Corporation Management?

ANOTHER aspect of the current maladjustment between corporations and their stockholders is the question of possible liquidation. Many stocks sell for less than their cash value because the market judges that future operating losses will dissipate this cash.

If that is the case, then should not the stockholder demand liquidation before his cash is used up? The management says "No,"—naturally. But the stock market says "Yes,"—emphatically. Which is right? What are the salient factors on both sides of the question?

Forbes presents herewith the third, and last, article in this series by Mr. Graham, which reaches down to the very roots of the present troublous situation.

the product of unreasoning fear, or do they convey a stern warning to liquidate while there is yet time?

To-day stockholders are leaving the answer to this problem, as to all other corporate problems, in the hands of their management. But when the latter's judgment is violently challenged by the verdict of the open market, it seems childish to let the management decide whether itself or the market is right. This is especially true when the issue involves a strong conflict of interest between the officials who draw salaries from the business and the owners whose capital is at stake. If you owned a grocery store that was doing badly, you wouldn't leave it to the paid manager to decide whether to keep it going or to shut up shop.

The innate helplessness of the pub-

lic in the face of this critical problem is aggravated by its acceptance of two pernicious doctrines in the field of corporate administration. The first is that directors have no responsibility for, or interest in, the market price of their securities. The second is that outside stockholders know nothing about the business, and hence their views deserve no consideration unless sponsored by the management.

By virtue of dictum number one, directors succeed in evading all issues based upon the market price of their stock. Principle number two is invoked to excellent advantage in order to squelch any stockholder (not in control) who has the temerity to suggest that those in charge may not be proceeding wisely or in the best interests of their employers. The two together afford managements perfect protection against the necessity of justifying to their stockholders the continuance of the business when the weight of sound opinion points to better results for the owners through liquidation.

THE accepted notion that directors have no concern with the market price of their stock is as fallacious as it is hypocritical. Needless to say, managements are not responsible for market fluctuations, but they should take cognizance of excessively high or unduly low price levels for the shares. They have a duty to protect their stockholders against avoidable depreciation in market value—as far as is reasonably in their power—equal to the duty to protect them against avoidable losses of earnings or assets.

If this duty were admitted and insisted upon, the present absurd relationship between quoted prices and liquidating values would never have come into existence. Directors and stockholders both would recognize that the true value of their stock should under no circumstances be less than the realizable value of the business, which amount in turn would ordinarily be not less than the net quick assets.

They would recognize further that if the business is not worth its realizable value as a going concern it should be wound up. Finally, direc-

tors would acknowledge their responsibility to conserve the realizable value of the business against shrinkage and to prevent, as far as is reasonably possible, the establishment of a price level continuously and substantially below the realizable value.

HENCE, instead of viewing with philosophic indifference the collapse of their stock to abysmally low levels, directors would take these declines as a challenge to constructive action. In the first place, they would make every effort to maintain a dividend at least commensurate with the minimum real value of the stock. For this purpose they would draw freely on accumulated surplus, provided the company's financial position remained unimpaired. Secondly, they would not hesitate to direct the stockholders' attention to the existence of minimum liquidating values in excess of the market price, and to assert their confidence in the reality of these values. In the third place, wherever possible, they would aid the stockholders by returning to them surplus cash capital through retirement of shares pro rata at a fair price, as advocated in our previous article.

Finally, they would study carefully the company's situation and outlook, to make sure that the realizable value of the shares is not likely to suffer a substantial shrinkage. If they find there is danger of serious future loss, they would give earnest and fair-minded consideration to the question whether the stockholders' interests might not best be served by sale or liquidation.

HOWEVER forcibly the stock market may be asserting the desirability of liquidation, there are no signs that managements are giving serious consideration to the issue. In fact, the infrequency of voluntary dissolution by companies with diversified ownership may well be a subject of wonder, or of cynicism. In the case of privately owned enterprises, withdrawing from business is an everyday occurrence. But with companies whose stock is widely held, it is the rarest of corporate developments.

Liquidation after insolvency is, of course, more frequent, but the idea of shutting up shop before the sheriff steps in seems repugnant to the canons of Wall Street. One thing can be said for our corporate managements—they are not quitters. Like Josh Billings, who in patriotic zeal stood ready to sacrifice all his wife's relations on the altar of his country, officials are willing to sacrifice their stockholders' last dollar to keep the business going.

But is it not true that the paid

officials are subject to the decisions of the board of directors, who represent the stockholders, and whose duty it is to champion the owners' interests—if necessary, against the interests of the operating management? In theory this cannot be gained, but it doesn't work out in practice.

THE reasons will appear from a study of any typical directorate. Here we find: (a) The paid officials themselves, who are interested in their jobs first and the stockholders second; (b) Investment bankers, whose first interest is in underwriting profits; (c) Commercial bankers, whose first interest is in making and protecting loans; (d) Individuals who do business of various kinds with the company; and finally—and almost always in a scant minority—(e) Directors who are interested only in the welfare of the stockholders.

Even the latter are usually bound by ties of friendship to the officers (that is how they came to be nominated), so that the whole atmosphere of a board meeting is not conducive to any assertion of stockholders' rights against the desires of the operating management. Directors are not dishonest, but they are human. The writer, being himself a member of several boards, knows something of this subject from personal experience.

The conclusion stands out that liquidation is peculiarly an issue for the stockholders. Not only must it be decided by their independent judgment and preference, but in most cases the initiative and pressure to effect liquidation must emanate from stockholders not on the board of directors. In this connection we believe that the recognition of the following principle would be exceedingly helpful:

The fact that a company's shares sell persistently below their liquidating value should fairly raise the question whether liquidation is advisable.

PLEASE note we do not suggest that the low price proves the desirability of liquidation. It merely justifies any stockholder in raising the issue, and entitles his views to respectful attention.

It means that stockholders should consider the issue with an open mind, and decide it on the basis of the facts presented and in accordance with their best individual judgment. No doubt in many of these cases—perhaps the majority—a fair minded study would show liquidation to be unjustified. The going concern value under normal conditions would be

found so large, as compared with sum realizable in liquidation: to warrant seeing the depression through, despite current operating losses.

However, it is conceivable that under present difficult conditions owners of a great many businesses might conclude that they would be better by winding them up rather than continuing them. What would be the significance of such a movement to the economic situation as a whole? Would it mean further depression, further unemployment, further reduction of purchasing power? Would stockholders be harming the country while helping themselves? Superficially it might seem so, but powerful arguments can be advanced to the opposite effect.

The operation of unsoundly operated enterprises may be called a detriment, instead of an advantage, to the nation. We suffer not only from over-capacity, but still more from disruptive competition of companies which have no chance to survive, continue to exist none the less, to the loss of their stockholders and the settlement of their industry.

Without making any profits themselves, they destroy the possibilities of other enterprises. Their removal might permit a better adjustment of supply to demand, a larger output with consequent lower costs to the stronger companies which remain. An endeavor now being made to accomplish this result in the cotton goods industry

FROM the standpoint of employment, the demand for the product is not reduced by closing down unprofitable units. Hence, production is transferred elsewhere and employment in the aggregate may not be diminished. That great individual hardship would be involved cannot be denied, nor should it be minimized but in any case the conditions of employment in a fundamentally unsound enterprise must be precarious in the extreme. Admitting that the employees must be given sympathetic consideration, it is only just to point out that our economic principles do not include the destruction of stockholders' capital for the sole purpose of providing employment.

We have not yet found any way to prevent depression from throttling us in the midst of our superabundance. But unquestionably there are ways to relieve the plight of the stockholders who to-day own so much and can realize so little. A fresh viewpoint on these matters might work wonders for the sadly demoralized army of American stockholders.

W J Schloss

THREE INDUSTRIAL STOCK AVERAGES CONTRASTED
(by Benj. Graham and Walter Schloss)

Their Diverse Action Suggests a Clue to Investment Policies.

The use of common stock averages has passed through various stages of development. The original purpose was merely to give a concise picture of how the market as a whole is acting. A study of the behavior of the averages then suggested certain laws of conduct which had been made the basis of the so-called technical forecasts of future action. More recently efforts have been made to relate the movement of the averages to the earnings and dividends reported by the stocks comprised therein in order to reach certain conclusions as to whether stock prices as a whole seem to be intrinsically too high or too low. (Stephen M. Foster has been a pioneer in this work, concentrating on the relationship between bond yields and the price-earnings ratios of the stocks in Barron's 50-Stock Average).

In this article we propose to approach the averages from still another angle -- namely, to consider closely the relative movement of three representative indexes of industrial common stocks, to note their divergences, and to seek the reasons therefor. The three indexes are respectively, the Dow Jones Industrial Average now covering 30 stocks, The Barron's 50-Stock Average covering 42 Industrials, 4 Rails and 4 Utilities and the larger Standard Statistics' Industrial Average covering 350 stocks. It will be seen that these averages have behaved differently over a ten and a fifteen year period and that the difference in their conduct may be related to the different methods used in maintaining or modifying the issues in the averages and their weighting.

The Standard Statistics' comprehensive average differs from the others not only in the large number of stocks comprised but

W. J. Schloss

also in the fact that, substantially speaking, no change in its composition is made from year to year. Essentially, therefore, it represents the actual movement of a large part of the stock market over a period of time without intervention due to any selective principles. The Dow Jones Average on the other hand, is highly selective to begin with, because it includes only 30 issues; and more than that, it is subject to rather frequent changes designed to maintain its selectivity. (Such changes have been made on 19 dates since the 30-stock average was first adopted in October 1928) In general stocks have been dropped and others added to reflect changes in popularity and in the stock market's emphasis as measured by relative volume of trading.

Barron's Average is based upon a policy which in important respects is diametrically opposed to that of the Dow-Jones Average. In the first place there are practically no changes in the constituent stocks from year to year. But on the other hand, the theory contemplates significant modifications in the quantities taken of each stock. The general object of these changes is to maintain a rough equality in the current importance of each issue. This should be done by increasing the quantity of stocks which have fallen in price and decreasing the quantity of the stocks which have advanced. While these changes are not being made in accordance with a complete plan of equalization, the general result should be definitely in the direction of adding (i.e. buying) stocks which have declined and subtracting (i.e. selling) stocks which have advanced. But contrary-wise the periodic changes in the Dow-Jones Average have consisted mainly of dropping or selling out stocks that have declined in price and substituting more popular stocks which, because of their popularity, had advanced.

It must be pointed out, however, that the characteristics

of Barron's Average, as above described, are more interesting in theory than in their actual application to date. The reason is that Barron's Average has until recently been in something of an experimental stage. Hence it is not possible to follow it back far enough on its present basis to derive a dependable conclusion as to its results. While values may indeed be computed as of dates prior to the first use of the average --in 1930-- such comparison would include a large measure of hindsight. Obviously, a list made up in 1935 can easily be so selected as to show up remarkably well when compared with 1925. The fact that the Barron's list includes rails and utilities also prevents useful comparison with the other two averages.

In studying the actual record, therefore, we must confine ourselves to a comparison of the action of the Dow-Jones list and the Standard Statistics averages; but the Dow-Jones list itself provides a separate test of investment policies. Some unexpected and significant results will appear when the Dow-Jones list as of earlier dates are carried forward unchanged and their resulting values compared with the actual Dow-Jones Average, which, of course, reflects the result of changes made from time to time. (See Charts 2 & 3)

Returning to the theory of the three averages, it may fairly be said that in practice though not in purpose they represent -- to some extent at least -- three different policies or philosophies of investment. The Dow-Jones system undoubtedly corresponds with what the typical investor now tends to do with his common stock portfolio. On the other hand, the Barron's approach corresponds to older ideas of investment policy in which it was considered shrewder to buy things that had gone down and to sell things that had gone up. The Standard Statistics Average represents a middle or static course.

We should now be ready to apply the acid test of performance to the two types of investment policy embodied in the Dow-Jones and Standard Statistics averages, -- reserving a study of the Barron's technique for a later article. To do this we have taken two separate periods of time, in order to obtain a double check on our work. The first is the 15½ year period from June 30, 1925 to December 31, 1940. The earlier date is taken because the Dow-Jones Average stood at the same price then as at the end of 1940 -- namely 131. The second period comprises the past decade, from December 31, 1930 to December 31, 1940. The appended charts show that the most highly selective average did not fare as well as the more inclusive group. The Dow-Jones 30 stock group -- often referred to as a "blue chip" assortment, and popularly supposed to act much better than the ordinary run of stocks -- is actually found to have declined more than the 350-stock list in the ten year period. Furthermore, during the fifteen year period when it made no progress the other index showed a gain. Before commenting on the significance of these figures some questions should be raised and answered as to their accuracy. In computing results on investments, allowance must be made for dividends received as well as changes in price. Dividends are not reflected in the averages and it may be asked whether their incidence would not affect the overall result. It is manifestly impracticable to compute the dividend return on the 350 Standard Statistics stocks. We do have, however, a fairly comprehensive index of common stock dividend yields covering 125 issues and computed monthly by Moody's. With some variations from year to year it will be found that the yield on the large number of stocks is almost identical over a period of time with the yield on the smaller number in the Dow-Jones Average. (E.g., for 1931-1940 the figure was 4.56% for the 125 stocks and 4.69% for the

30 stocks. For all common stocks on the New York Stock Exchange the figure was 4.9%).

It seems fair to conclude, therefore, that the dividend return on the comprehensive Standard Statistics index of 350 issues would not have been much different than the return on the Dow-Jones list, and that therefore, the dividend factor does not affect the conclusions suggested by the market price action alone. An observation should be made, however, to the effect that the Dow-Jones Average suffered somewhat in earlier years from slight distortions in the making of substitutions. However, none of these distortions occurred since 1928 and those since June, 1925 are not very important.

We may return now to the question of the significance of the results we show. They seem very definitely to indicate that the popular method of adding and subtracting stocks in the investor's portfolio suffers from the practical handicap that it tends to buy "good stocks" after they have advanced too much and to sell "bad stocks" after they have declined too much. It would seem that it is better to hold on to a portfolio unchanged (Standard Statistics method) than to follow the customary policy of going in for favorites and dropping stocks that have acted badly. (It would be interesting to determine later whether the diametrically opposed plan of lightening up on issues which have advanced and buying more of stocks which have declined -- the Barron's Average technique -- might not yield still more satisfactory results).

We have a separate confirmation of these conclusions from the behavior of the Dow-Jones Average itself, when we contrast the action of the original stocks in the list with its actual course, which were made in the average from time to time.

- 6 -

A sidelight on the same fact is given in reverse by tracing back the value of the stocks now on the list to what they would have been in June, 1925 and December, 1930. Here we find that the present list if carried back behaved much better in the market over the past than did either the actual Dow-Jones Average or the Standard Statistics 350 stocks. The reason for this is not far to seek. The various new stocks in the present list were selected precisely because they had done well in the period before the selection. On the basis of hindsight they were very attractive commitments. But our comparison between the subsequent action of the old list and of the list as changed shows that the new stocks did not continue their superior performance after they were selected. This indicates strongly that there is an inherent tendency for the stock market to appreciate the better quality of good common stocks only after this quality has been fully discounted in the market price.

In the view of the writers the three averages have a particular value as tests of different investment policies, because they represent the actual working out of these policies without the benefit of any hindsight or artificial selection to prove a point. It may well be that other studies along these lines could profitably be made, in order to bring forward clearly what are the pitfalls in many accepted theories of common stock investment.