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Investment Policy in 1950

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Expert states investment will weather second half of century as it has the first half, and in any event, capital has no place to hide. In contrast to 50 years ago, common stocks constitute essential part of any investment portfolio. Bars individuals' investment in corporate senior securities. Sees stock purchases warranted at today's levels, with inclusion of numerous undervalued "secondary" issues.

I am intrigued by my topic, particularly because of the emphasis on 1950. That naturally invites comparison with beginning of the century, and since I have a vague and childish recollection of that early year I began to do some comparing of these exciting times of 1950 with the more languid days of 1900. We have made a great deal of progress since 1900. Our



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wealth and our production has grown enormously, so has our standard of living, so has our wage-scale, so have the prices of stocks. In addition to that, our national debt has succeeded in

growing from \$1 billion to over \$250 billion, our annual budget from \$500 million to \$40 billion, and other things in proportion.

If I may digress for a moment, I might recall to you that famous vaudeville skit about the suitor who was going to an important meeting with the girl's father. He brought along his best friend and told him: "I've got to be modest at this meeting, but you don't have to be modest; you make everything I say sound big." When the old man asked him "How about your business?" he answered, "Oh, I got a nice little business," but his friend exclaimed, "A nice little business? Why he's the biggest maker of buttonhole linings in the country." "How about your home?" "Nice little home," said the suitor.

*Exclusive transcript of a talk made by Mr. Graham before the Association of Customers' Brokers, New York City, Jan. 27, 1950.

"Nonsense," said the friend, "he's got the best duplex apartment in Columbus Avenue." As this went on, the suitor began to cough a little and the old man said suspiciously, "How about your health?" "Oh, I've got a little cold," said the suitor. "A little cold—nothing," cried the friend; "he's got galloping consumption!"

Similarly, despite all the wonderful things in this country, many people believe that we are galloping down the road to statism, national bankruptcy, and many affiliated ills.

The International Picture

When we turn to the international picture, the picture ranges from the alarming to the appalling. It looks as if we are in the midst of a century of revolution. But, instead of revolution toward liberty, equality and fraternity, it seems to be a revolution toward the "iron curtain," toward the slave state and general misery. We have fought and won two world wars only to find ourselves in the middle of World War 2½. The hydrogen bomb is knocking at today's headlines and at the doors of the world.

Now, in the light of that unnerving situation, if you were to face the investment problems of 1950 in the traditional way, you would think in terms of storm cellars, in terms of hiding and hoarding. Yet this is far from the actual investment climate in 1950, and I believe there is a very good reason for it. The reason may be found in the history of investment itself over the last half century. The picture of the investment markets in no way reflects the world-shaking events that have transpired over the last 50 years. You will not see World War I and World War II prominently reflected in the stock market charts. You will see an extraordinary phenomenon there between 1927 and 1933. But that

apparently had nothing to do with world events; it was rather an internally generated South Sea Bubble.

One might well say that if investment had been able to weather the storms of the first half of the century, there is reason to believe that it can weather the storms of the second half. One thing is sure—that investors will have to act from here out as if that is so, as if the rules of investment that proved sound in the first half of the century must be adhered to, because there is available no other alternative. There is no place to hide either for capitalists or for capital.

The Impact of Inflation

We do find, however, one important development in the first half of the century that should have a real effect upon investment attitudes and that is the impact of inflation upon investment results. There is no question but that the conception of bond investment as the full answer to the conservative requirements of the investor is no longer sound. Bond investments may have worked out reasonably well in terms of cash repayment, but they have not worked well in terms of value of the capital that has been put into the bonds. By contrast, common stocks, which have been subject to wide fluctuations in value from year to year, have over the last 50 years (and over the preceding 50 years) shown not only the ability to conserve their money value on the whole, but also to give a reasonable amount of protection against the over-riding factor of inflation. For that reason, authorities on investments are now almost unanimously agreed that common stocks are an essential part of any substantial investment portfolio today. Certainly, that was not the opinion 50 years ago.

The Investment Approach

Now, what about common stocks in terms of the investment approach? You gentlemen are perhaps more accustomed to think of them in terms of trading and speculation. Marshall Lyautey once said about the climate of North Africa, "People think North Africa is a hot country. It is not; it's a cold country with a hot sun." Most people think of common stocks as speculative media. They are not, in my opinion. Good common stocks are investment media which are subject to speculative influences. The speculative influences are not in the common stocks; they are in the minds of the people who buy and sell them. The problem of investment in common stocks is either to insulate yourselves from the speculative influences, or else to adjust your investment policy so that you can take advantage of the speculative fluctuations that are imposed upon the basic investment quality of common stocks. I need not remind you that the underlying quality of common stocks has improved tremendously since 1900. Not only do we have a great deal more dependable information about them, but the corporate structures upon which common stocks depend have been greatly improved in terms of conservatism, in terms of real and realizable value behind the shares. For these reasons I think the main conclusion that we can draw about sound investment in 1950 is that it must turn to a substantial degree upon the intelligent purchase of common stocks.

"Artistic-Scientific" Methods

Now, what would be the "artistic" or "scientific" methods that an investor should employ in connection with a program involving common stock investment? In the first place, the question is how far should the concept of common

stocks as a component of a portfolio be carried. We all know that the conservative investor will not be psychologically inclined to go too far in the common stock field. As a practical matter the limits of apportionment seem to run between a 75% bond portfolio with 25% in stocks, and the other proportion of 75% in stocks and 25% in bonds. When we ask about the make-up of the bond type of portfolio, we find one very basic fact confronting us: *Corporation bonds*, which were the central and almost the only component of individual investment a generation ago no longer appear to be appropriate to any extent for purchase by individuals. It is easy to show that investment in Series E Savings Bonds or Series G Savings Bonds and in tax-free municipal and state securities is a much sounder and appropriate medium for fixed-value investment than any corporation bond or corporation preferred stock.

The reasoning here goes something like this: If you buy a corporation security of the highest grade you do not get any better return than you can in Government bonds; and, if you are in the high bracket your net return is much less than you would get in tax-free securities. On the other hand, if you buy a corporation bond or preferred stock of medium grade in order to "sweeten the yield" somewhat, you are assuming a risk which much more than compensates for the additional yield which you may obtain. That reasoning is undoubtedly sound with respect to individual investment in 1950. It may not be true in 1955; but as long as the present relationship of corporate yields and government yields is maintained I think we should rule out individual investment in corporation senior securities.

Institutional Investment

As far as institutional investment is concerned, that is another

that type of research, and a good deal of it is valuable. Unfortunately, the difficulty is to distinguish between the research which is going to be valuable and the research which is going to prove deceptive. When you place your emphasis mainly on the future the first thing you must realize is that you cannot control the future, and therefore you cannot control your material or your results. My observation in that area has been that the basing of investment primarily upon changes to be expected in the future will on the whole not yield satisfactory results, when you take a census of operations over many years and including many companies. (One criticism that I have to offer of the Wall Street approach—which applies to security analysts, investment companies, and everybody else—is that so little effort is made to keep track of what has happened in the large number of analyses that have been made year after year—how they actually worked out.)

The emphasis upon future prospects can turn out to be very deceptive indeed. I was impressed by reading yesterday of the passing of dividend by Heyden Chemical Co., as an example of what disappointment can occur in a field which is supposed to be almost fool-proof. The contrast between the behavior of the airline stocks, so far as their earnings are concerned since 1940, and the behavior of the coal stocks in that period is an extraordinary example of the divergence between expected action and actual action when you are forecasting the future. Therefore my point of view with respect to investment in 1950 tends to concentrate as far as possible upon the establishment of values which are grounded in the company's own performance up to date and in its own balance sheet.

The Balance Sheet Approach

Now let me put in a word for an approach which is almost forgotten in Wall Street, and that is the balance sheet approach. A prime weakness in the point of view that is generally expressed down here is the divergence between the valuation of businesses as they are considered in Wall Street and the valuation of the same kind of businesses that would be made by a private owner of that business. You all know that if you own a business yourself you start to find out what it is worth by looking at the balance sheet figures, and you either increase or decrease them, depending upon your view of the quality of the enterprise. To my mind that is the soundest approach to every kind of business and to every kind of stock, whether it is dealt in actively in Wall Street or not. By no means do I suggest that every business is worth its book value, but I do feel that the greatest mistakes in the Street will be avoided if you start in the same way that businessmen always start, by looking at the balance sheet and making your changes from there. I would like to suggest, as a practical approach toward making money in Wall Street, the idea of trying to find a group of stocks which appear to be worth pretty much what their balance sheet shows. (That would not be every stock by a long shot, but it might be a third of the total.) You would then observe how over the years the price of these shares tends to fluctuate below and above the book value—indicating that you have a recurrent opportunity to buy them when Wall Street is valuing them too low as against Main Street, and you have another opportunity to sell them recurrently when Wall Street is valuing them too high in relation to Main Street. I might say, if you want to be a little cautious in your approach it is not necessary

to wait until Wall Street values these stocks much too high. If you sell them only at a reasonable price you will find that you will obtain a very nice profit on your investment because you have bought them so low.

The Margin of Safety

The concept of buying securities at less than their indicated value includes what I have always regarded as the most dependable assurance of success in every form of investment—whether it be bonds or stocks—and that is the concept of margin of safety. In bonds, as you are aware, you want to buy bonds which cover their interest charges with a goodly margin, because that indicates that even though things may not work out so well in the future, your bond will remain a sound bond. The same concept can be applied to common stock investment, and I think you will find if you study the subject, that it has stood up extremely well over the last 50 years. When you have such a margin on a common stock purchase, then if things do not work out as well as you expect them you still have a cushion to absorb this disappointment. You can end up, if not with a profit, at least with no loss. But that can not be done when you are operating in the stock market either on the basis of anticipating what the market is going to do very soon, or on the basis of how the company is going to fare over the next few years. If you are wrong on either of these approaches then you are almost sure to lose money, because you have no margin of safety to fall back upon.

The "Grocery" Approach

I had the pleasure last week of talking to a group of ladies only for the first time in my career. Trying to bring this subject home to them by some analogy with a

feminine quality, I pointed out to them that there were two ways of buying stocks: either on the basis that they buy groceries, or on the basis that we men buy perfume for them. When you buy stocks on the grocery basis you try to get adequate quality at a reasonable price. When you buy on the perfume basis you try to buy the stock which is most popular and which gives the most prestige; you pay comparatively little attention to price; in some respects, the more the price you pay the better you seem to like it. I suggested to the ladies that if they would take the grocery approach to the selection of securities they would probably do a very substantially better job in investments than we men do, because they are more likely to see, appreciate and take advantage of a true bargain whenever they see one.

Let me suggest to you as customers' brokers to include in your variety of approaches to security purchases the grocery approach. As a practical matter, I think the customers' broker should have at least two strings to his bow. No doubt he welcomes, or at least accepts, a speculative and trading attitude in his client; it is a very satisfactory source of income when things are going well. But I would suggest that the customers' broker should endeavor at the same time to cultivate a clientele which takes the grocery approach to stock investment, which is ready to buy securities after they have gone down, and which is ready to accept a further decline in the market price as an opportunity to buy more. You will find them a very comfortable kind of customer to have, and you will also find them coming in handy at the time you need them most. If you will encourage that point of view in your clientele,

story. The institutions have their own reasons for purchasing corporation securities at their present low yields, and it is not my purpose to examine into those reasons. I will say, however, that I think that trust departments which invest funds for individual beneficiaries are still too much governed by the traditional division of investments between corporation bonds, preferred stocks, and common stocks. They would be better advised to divide their portfolios solely between government bonds (or tax-free bonds) on the one hand, and common stocks on the other.

Market Forecasting Unsatisfactory

Now, with regard to the matter of investment in common stocks and the way of going about it in the year 1950. The main issue that confronts investors, and particularly confronts you as customers' brokers, is the question: To what extent shall we endeavor to anticipate what the stock market is going to do? My own views on this subject are pretty well known to all of you. I am not going to elaborate them. I believe that the endeavor to anticipate what the stock market is going to do is not on the whole a satisfactory activity. It is successful at times and it is unsuccessful at other times, but on balance it does not pay. I am an exponent of the philosophy that the main objective of common stock investment should be *pricing*, not *timing*; and by pricing I mean the endeavor to buy securities at prices which are attractive, letting timing take care of itself. It is obvious, of course, that when you buy securities at low prices—and if that happens to be a good time in relation to the future action of the market—your pricing and your timing coincide. There can be no objection to that combination. But from the viewpoint that I represent, the first and primary emphasis must be placed upon the endeavor to

buy securities at the right prices. I believe that the decision to postpone buying at the right price, because of the thought that some future time may be more propitious, will on the whole turn out to be an unsatisfactory policy for the real investor. He may thus buy his shares sooner in relation to the rise that will finally come. But unless he acquires the stock at a considerably *lower price* than he previously considered, he has made no true gain whatever. (Certainly he has lost interest on his money.)

The 200 Dow-Jones

In January, 1950, you have the problem whether a level of the Dow-Jones Average at about 200 represents a suitable price for the purchase of common stocks for investment. You also have a problem that concerns you individually very much, I am sure, whether January, 1950 represents a suitable *time* for purchase, in the light of what the market will do. In trying to answer that question I am reminded of an address I made in March, 1948, before the National Federation of Financial Analysts Societies, in which I considered the question of the purchase of General Motors at 52. I stated that, on the past record, there was danger that General Motors might well decline to 40, and a perhaps equal an opportunity for it to advance to 80. But from the investor's standpoint, if his appraisal of General Motors indicated some central value around 65, he would be intelligent to buy at 52, and ignore the risk of its declining temporarily to 40.

There is a fairly good analogy today in relation to stock prices generally. Unfortunately, you do not have as much of a margin of safety as you had in March, 1948, dealing with stocks like General Motors. As near as one is able to ascertain value, the Dow-Jones average is worth somewhat more

than 200 as a central figure. As near as one is able to project the probable range of fluctuation for the Dow-Jones average from here out, past history indicates that it would be somewhere between 140 at the bottom side and 280 at the top side—a plentifully wide range for anybody's imagination to traverse. I lunched yesterday with a Stock Exchange firm member who is sure that stocks are headed well below 140. I read an article in the "Financial Chronicle" this morning in which somebody was equally certain that stocks were heading up toward the 280 level. Unfortunately, or fortunately for me, I have no opinion on this subject whatever. I really and honestly believe that it is not impossible for stocks either to go down substantially in the next 12 months or to go up substantially or to repeat the relatively narrow fluctuations that we have been accustomed to since 1948. I think that the investor has to take into account that any one of these three diverse courses is a possibility.

Nevertheless, I believe the investor is justified in buying today on either of two alternative principles. One objective could be to buy representative common stocks at levels which are not too high, to hold them for income and for eventual capital appreciation. If that is his objective, he would be justified in investing his money at today's levels even though it is not a bargain level, and even though, as in most other times in the history of the stock market, it carries with it a risk of loss on market quotations in the same way that it carries a chance of gain.

A Below-Value Approach

The second approach is to emphasize the purchase of securities at considerably less than their indicated value—an area of activity

in which, as you know, I have been interested for a great many years. Today's situation is quite different from that of 1946, even though the ostensible market level as shown by the Dow-Jones average is almost the same as the top in May, 1946. In May, 1946, there were virtually no securities that were demonstrably selling considerably under their true value. New stock offerings were being made at prices that were far beyond the realms of conservative valuation; secondary stocks were selling at prices which might conceivably be justified, but certainly could not be characterized as bargains. Now the picture is very different. Although the leading stocks are almost as high as they were in 1946 the secondary stocks are very much lower. A great many of them would appear to be distinctly undervalued by the ordinary tests of appraisal which have worked out very well for the investor over the last 50 years. That being the case, in 1950 the investor who wants to use a superior degree of enterprise and intelligence should be able to find a rather large selection of common stocks which are selling under their indicated value. I think he would be justified in buying and holding them regardless of the possibility of a decline of substantial proportions in the stock market. (He cannot be too sure that the optimistic market expectations of the majority will prove well founded.)

Predicting Future Hazardous

Now, talking about the expectations of the majority brings me to the type of selection of common stocks which represents the most customary form of security analysis in Wall Street. That is endeavoring to pick out securities and companies which have better than average prospects for the future. A great deal of very intelligent and careful work goes into

you will not only be increasing your own earning power and value—but what is equally important from my point of view— you will be contributing to the creation of a sound and stable viewpoint toward securities in Wall Street.



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THE BANKER AS AN INVESTMENT COUNSELOR

You bankers are experts on the care and multiplication of money, and therefore in the minds of the public you are eminently fitted to advise on all matters relating to investments. Your investment activities are very broad. They include not only investment for your own account, — an activity which nowadays applies to more than half of the total resources

of banks — but also investment for the benefit of individuals in the form of trust funds, pension funds, and also a considerable amount of formal or informal advice to individuals who come to you for counsel and guidance.

My assignment today is to discuss with you the scope and limitations of your activities as counselors on investment for the benefit of individuals.

This question may best be discussed under four headings, as follows:

First: How do the investment policies appropriate for individual investors differ from those appropriate for the bank's own portfolio?

Second: How does the financial position and the financial competence of the individual investor affect the policy to be chosen by or for him?

Third: How far should bankers go in endeavoring to select either (1) the best time or price level for investment for individuals; or (2) the most attractive securities for them to purchase?

Fourth: Assuming that bankers have thought through and adopted a standard pattern of investment policy appropriate for the great run of unsophisticated investors — which I shall call "defensive investors" — what should then the bankers' attitude be toward the less conventional and the more "aggressive" type of security investment?

THE COUNTRY BANKER AS INVESTMENT COUNSELOR

The fact that this audience represents banks of all shapes and sizes, great and small, raised a preliminary problem in my mind. Query: Could my discussion of investment problems be homogeneous enough to meet the needs both of smaller banks and the very large ones here in New York City? This question was answered for me by reading an article in the last issue of "The Exchange" (a magazine published by the New York Stock Exchange) written by a gentleman I know is here today, Mr. William S. Staples, Vice-President of the Exchange National Bank of Olean, N. Y. The title of his paper was, "The Country Banker Looks at Stocks," a subject not completely detached from my own subject today. It pointed out, to my gratification, that the problems and the attitudes of the country banker, in relation to individual investments, are pretty much the same as those of the city banker.

My first question was: How do the investment policies appropriate for the individual today differ from those appropriate for a bank's portfolio? There are similarities and there are differences. A generation ago, the similarities were more important than the differences. Today, I think it is the other way around.

Back in 1914, when I entered Wall Street with a firm of "bankers and brokers", the accepted investment policy for both banks and conservative individuals was pretty much the same,—namely, to put the bulk of one's money in corporate bonds, with a relatively small admixture of preferred stocks and a relatively small component of state or municipal bonds.

Today, the similarity, I think, is mainly in the area of tax-free securities. On the whole the advantages of tax-free securities to the individual investor and to the bank are rather similar, and in both cases they are not thoroughly appreciated. Mr. Wellington made a cautious reference to that fact in his address, and Dr. Bogen last year made a similar reference. When you make your calculations as to the net return, after taxes, for investments by banks and also by a large percentage of individual investors you will see that tax-free securities, on the whole, offer a much more attractive net return than other high-grade investments will provide. (If I remember rightly, last year Mr. Shapiro gave some figures on that subject that were rather startling.)

The next area of investment which is similar to both is that of U. S. Government securities. The banks are predominantly invested in government bonds, and I should say that the bulk of individuals, by number if not by amount also predominantly invest in government bonds. The policy is a proper one in both cases, but there is a fundamental difference in the type of security purchased.

If you are to advise the typical small investor on the subject of government bonds, you must conclude that there is nothing that will compare with the much admired and much maligned Series E Bond, the campaign for which has just been started again. Its combination of yield and safety cannot be matched elsewhere in the field of fixed-income investment; incidentally, although the E Bonds ostensibly do not provide a current income, this objection can be overcome by cashing in a

fraction of one's series E Bonds semi-annually during their ten-year life. In this way you can get a straight income return which is never less than $2\frac{1}{2}\%$ and which ends up with an average of 2.80% on the Series E Bonds on a semi-annual income basis.

The next similarity is of a negative sort, and that lies in the avoidance of corporate bonds and preferred stocks for both banks and individuals, with very few exceptions. This, of course, is a rather strange statement, and yet I believe that the facts of the case completely support that stand. I think Dr. Bogen last year made the point rather effectively in this seminar, that at the ruling differentials in yields between government securities (and particularly tax-free securities) and corporate issues, there is no "percentage," if I may use that word, in the selection of high-grade corporate securities by banks. There is, similarly, no advantage in their selection by individuals. Where they apparently are gravitating to a great extent, and should gravitate almost one hundred percent, is to the life-insurance companies, which have a very special yield problem and a special tax position.

The banks are not entirely in agreement with this viewpoint. Whether they have reasoned the matter out differently, or whether it is because they are accustomed to older views that are no longer relevant, is a matter for you, yourselves, to decide. But if you take the available figures for the investment of common trust funds by banks, — which indicate how they actually are administering individual portfolios — you will see a tendency to play the security types right across the board, and to place approximately a third of the money in government bonds, somewhat under a third in preferred stocks and corporate bonds, and another third, or thereabouts, in common stocks. I think that is a decision based more upon convenience than upon any logical reasoning applied to the facts.

In this connection permit me to make a special point with respect to preferred stocks. If you apply today's thinking — not the thinking of thirty years ago — to preferred stocks, you will see that they represent a special form of "tax-free issue" which is meaningless to individuals and very meaningful to corporate investors. As you know, corporate investors will pay tax on only 15% of the income from preferred stocks, whereas individuals will pay on 100% of that income. Now that fact, when taken in relation to the high rates of tax applicable today, means that, in logic, good corporate preferred stocks should be bought only by corporations that can get the very large tax benefit therefrom; and they should be avoided, for that very reason, by individuals, who cannot do so.

There is a close analogy here with tax-free bond issues. It evidently makes no sense at all for an educational or charitable organization to buy tax-free issues from which it obtains no tax-benefit; as compared with other securities with considerably more yield and equal safety, for which other people would pay a very heavy tax burden.

The main difference between the investment policies for banks and for individuals lies, as you all know, in the area of common stock investment. A genera-

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lies in the avoidance of corporations, with very few exceptions, and yet I believe that the Dr. Bogen last year made the following differentials in yields (see securities) and corporate bonds, in the selection of high-yield securities, no advantage in their selecting to a great extent, and in the life-insurance companies, in their tax position.

is viewpoint. Whether they are correct is because they are accustomed to the matter for you, yourselves, and the investment of common trust funds are administering individual securities types right across the board in government bonds, some-thing bonds, and another third, or more based more upon conven-

is in-ent with respect to preferred securities of thirty years ago — to the special form of "tax-free issue" which is so popular to corporate investors. The fact that only 15% of the income from such securities is taxable to 60% of that income. Now that the tax law applicable today, means that, the fact that not only by corporations that should be avoided, for that

and issues. It evidently makes a strong case for the taxation to buy tax-free issues which are other securities with corporations. The fact that people would pay a very

and policies for banks and for investment in stock investment. A general-

tion ago, common stock investment was not considered suitable for conservative people, the kind whom banks would advise. Today, the attitude has changed very much. Incidentally, it has changed not only with respect to individuals, but for various types of institutions other than commercial banks. You know, of course, that in New York State restricted trusts are now permitted to invest up to 35% of the total fund in common stocks. You know that life insurance companies are now permitted to invest a small amount — I think it is 2% — of their resources in common stocks. There is a bill pending to permit savings banks to make moderate investment in common stocks.

Pension funds are now very definitely committed to the common stock approach in investment. The figures are not available, but I am sure that equities now represent a substantial part of the current purchases. Finally, the mutual-fund movement, which has been gathering momentum in recent years, is a kind of institutionalization of the idea of common stock investment for the benefit of individuals. Thus it is quite clear that common stocks are now definitely established as an element in conservative investment for individual investors.

It is worth taking some time, I think, to examine into the pros and cons of common stock investment, in order that you, as bankers and advisors, might have a sound and balanced approach to this very important question.

There are great disadvantages in common stock investment. They are found, mainly, I would say in the following three areas:

First: Common stock investment often creates common stock speculation and speculative losses.

Second: There is a tendency for the typical common stock investor to be sold low-grade securities at excessive prices.

Third: There is a considerable tendency for common stock investors to do the greater part of their buying, both of "good" and "bad" securities, at high levels of the market. They are equally inclined to do the greater part of their selling at low levels of the market, a procedure which is not conducive to successful results.

As against these drawbacks, we know that, basically, common stocks have a number of important advantages as investment media. Over the years, they have given substantially higher income return than bonds; they have shown a secular growth in market value which has been important, in itself, and which is particularly important in the minds of people today because that growth in market value is considered to be an offset to the impact of inflation. The figures, when viewed over a fifty-year period, show that the rise in the level of stock prices as a whole has, somewhat irregularly but nonetheless definitely, paralleled the rise in the price level of commodities and the fall in the purchasing power of the dollar.

I would like you to pay special note to this fact: The disadvantages which I have listed for common stock investment are all psychological in their origin, while

the advantages which I have listed are all economic and objective in their nature. In other words, if investors weren't people, common stock investment would be a 100% sound proposition. Unfortunately, investors *are* people, and they have a great tendency to do the wrong thing when they enter the field of common stocks.

Let us point out that on the whole, the public's attitude toward inflation today is itself more psychological than objective. People are talking about inflation as if it were something that had just developed with Korea in June, 1950. I wonder how many of you here are familiar with the data showing how much inflation we had in the first twenty-five years of this century, as compared with how much inflation we have had from 1925 up to date? The figures may startle those of you who haven't looked at them. Let me read them:

On wholesale prices: From 1900 to 1925, the rise was 84½%. From 1925 to June 1951 (the last figures I have) including World War II and Korea, the rise was 75½%.

On the cost of living, or the so-called consumer price index: From 1900 to 1925, the rise was 122%. From 1925 to June 1951, the rise was 47%.

These indexes may not be entirely accurate but they can not be so far off as to distort what has actually happened. We experienced more inflation from 1900 to 1925 than in the period of 1925 to 1950.

Inflation for us then is nothing new. We have lived with it since the turn of the century, as a long-term trend. Nevertheless in the same period of time we have been subjected to the most serious deflationary influences that we have seen in the entire history of this country. That of course was the deflation that started in 1929.

What that contradiction means is that while inflation is real, it is something that has to be viewed with care; it has to be viewed warily, and particularly in a historical perspective. You bankers are the people who can do this, I am sure. I do not believe you are going to be carried away by the tide of feeling and irresponsible conversation on the subject.

My conclusion on the pros and cons of common stocks has to be expressed in this form:

In a sense, the argument for common stock investment is too good. It tends to make for over-confidence in common stocks at the wrong time. That is to say, it gives too great theoretical support to what is almost certain to end up as excesses of speculation.

The situation today may not be too different from that in 1924-1926, when we had the development of a philosophy of common stock investment which was entirely sound in its theoretical basis. That theory was set forth in an excellent small book by Edgar Lawrence Smith, called, "Common Stocks as Long Term In-

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m that in 1924-1926, when stock investment which was as set forth in an excellent on Stocks as Long Term In-

vestments," an original edition of which I treasure in my library. There was nothing wrong with that book except that too many people believed in it and didn't read it carefully. The result was that the same common stocks which were sound investments in 1924 ended up by becoming dangerously unsound speculations in 1928 and 1929.

You bankers, I urge, should accept the theory of common stocks as a medium of investment; but accept it warily, not as a Gospel, but as a business proposition subject to continuous business test.

Please do not forget that as the common stock level advances, the advantages of common stocks appear to be more attractive and the basic need for owning them becomes more persuasive in everybody's reasoning. Yet in fact, common stocks undoubtedly become riskier as the price advances, and thus the risk increases as the widespread acceptance of common stock develops.

With that qualified endorsement of the common stock theory, I would like to go back to the basic question of individual investment policy. This seems to me to come down to the rather simple formula of dividing the fund into two perhaps more or less equal categories: The first consists of tax-free bonds or government bonds — government bonds being primarily U.S. Savings Bonds; the second consists of common stocks, which are to be bought with some emphasis on the endeavor not to pay to high a price for them as a whole.

That would be the standard pattern of defensive investment. By defensive investment, I mean investment suited to an individual who does not go into securities as a business, is not thoroughly versed in the art of selecting securities, and who wishes to make his commitments primarily on the basis of avoiding risk and also avoiding undue difficulty in the selection and in the watching of his investments.

The second question that I raised was what kind of distinctions should the banker make in his investment counsel because of the financial position and competence of the individual investor whom he is advising or for whom he is acting? It was customary years ago to consider that the risk taken should correspond more or less with the financial position of the investor. Those of the typical "widow and orphan" variety, who couldn't afford to take risk, shouldn't take any and should accept very low returns. On the other hand people like businessmen who could afford to take chances could properly look for higher income and for principal profits.

My own opinion is that such a distinction does not work out well in practice and that it is logically unsound. The only sound distinction in investment policies for one type of investor or another is based not on his financial position but on his financial competence and financial preparation. The people who do not understand securities should be defensive, conservative investors; but those who do understand securities, who are prepared to go into securities as a business man goes into his own business, can make purchases which are not riskier than others but rather which offer better opportunities than others.

I don't think the objective of investment should ever be to take a risk in order to get a return. I think the objective of shrewd investment should be to find opportunities which offer a larger return than the average, combined with adequate safety.

Consequently, the pattern of defensive investment which I have been speaking about should be just as appropriate for a widow whom you might advise or for a businessman, if the latter does not want and is not prepared to go into investment as an additional business operation of his own.

I might point out, incidentally, the one great difficulty of advising widows, which you have probably had in many cases, is that they don't have enough money nowadays to live on, on the basis of the all-bond type of investment. On this point I think the greatest mistake in the world would be to advise widows to risk their principal in order to get a greater income.

Whenever you talk to a widow about the idea that maybe she ought to reduce her principal a slight amount annually in order to meet her living requirements, that is looked upon as almost an unthinkable step. Yet I would like to underline the fact that if there is no other way to meet the financial requirements with soundness, the gradual use of principal is far superior to the taking of admitted risks in order to get a moderately higher income return.

Fortunately, under the conditions prevailing for many years past a combination of a government bond portfolio and a common stock portfolio, selected along conventional lines, will have given at least a respectable income return on the investment fund.

The third question we raise is how far can bankers go in selecting the price levels at which to buy or sell stocks, and in selecting the individual securities.

Let us start with the price level. I imagine you all agree with me that bankers cannot be expected to forecast the price movements of the stock market. That's easy enough to say. If you have any opinion about the level of prices, it should be an opinion based upon your concept of the values of securities in relation to price, rather than on any prophecy or expectation of changes or of the continuance of a given movement.

There are, of course, people in Wall Street who would disagree with this view. They feel that analyzing the stock market is just as necessary and just as respectable as analyzing individual securities and security values. I am not going to go into the details of the controversy, but I will say that I am skeptical about stock-market forecasting by anybody, and particularly by bankers.

Nevertheless, there is a very practical question confronting us, and that is, if you were asked about the level of stock prices as of today, from the standpoint of conservative investment, what would you say — and what can I say — on that subject? First let me remark about that, that I wish I were talking a couple of years

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ago, when the price level was 175 for the Dow-Jones Industrial Average. At that time, it was not difficult for me, and I assume for many others, to express the considered view that all the elements of value we were able to take into account indicated that the conservative investor would not be making a mistake, value-wise, in making commitments in the Dow-Jones Average stocks at their level of 175.

Today, it is 275 — and that is quite a different price. I happened to be looking yesterday at a calculation of the central value of common stocks which was worked out in a book of mine, called "The Intelligent Investor" a few years ago and it is being carried out to the year 1951 in the forthcoming new edition of "Security Analysis," which we hope to have published in November. The last line in that Table gives the central value of the Dow-Jones Average for 1951. The figure happens to be 278. That would indicate that stock prices are not over-valued, because yesterday they sold at 277.

The margin of safety is not large; in fact, it is inconveniently small. On this calculation we could hardly express an opinion that stock prices at this level are fully protected by values. Common stocks, in terms of the Dow-Jones Average, are selling at about ten times the expected earnings for this year, and that is by no means a high figure. On the other hand, they are selling at about seventeen times the average earnings for the past ten years. And while that too may not be a particularly high figure, it would be high if those earnings are in themselves regarded as abnormally good due to protracted but not permanent prosperity. It is not a low figure from any method of calculation.

In order not to avoid this important question I must give you the best conclusion I can reach. If an investor is definitely committed to a standard investment policy, which includes a proportion of common stocks, it is probably better for him to make some purchases at these levels than to keep his money idle waiting for an opportunity to invest at lower prices. But the investor must recognize that he would be doing his investing not under definitely favorable conditions, but more likely the reverse. He has to be prepared psychologically for fluctuations in market prices in either direction, and he may conceivably have more of a problem if prices should go up a great deal than if they should go down a great deal. It might be better for him to set up his program so as to divide his stock purchases evenly over the next year or so. This would give him the psychological advantage of having obtained average prices over a period of time, rather than making all his commitments at the current level, which is not a particularly low one.

The market advance and its attendant problems suggest that there are real advantages in those mechanical methods of investment known as "formula investment" and "dollar averaging". Both of them are, unfortunately, more attractive in theory than they are likely to work out in practice.

I should explain that dollar averaging consists of putting a certain amount of money every month or every quarter into common stocks and getting more shares

when the market is low and fewer when the market is high. This will result in a satisfactory average over a period of years. It is indeed a lovely proposition, if you can view it philosophically over a twenty-year period, and pay small attention to the fluctuations from year to year.

For example, on Monday of this week, Norman Stabler, in *The New York Herald-Tribune*, submitted a calculation made on that basis. He showed that even if you had started at the top in 1929 and had put \$100,000 into the stock market every year, you would end up by having invested \$2,300,000, with a current value of \$4,200,000, in addition to an excellent dividend return. On this basis common stock investment is easy and most attractive. All you need is \$100,000 a year to invest.

Of course, one should mention that, even under this method, at the end of 1932 you had \$400,000 invested with only \$195,000 of current market value. And while we can be very philosophical about the thing now, I don't know how philosophical you would have been about it at the end of 1932.

"Formula investment", which consists of buying on a scale down under a pre-determined "central value" and selling on a scale up, is something I believe in and actually practice for an insurance company and for a philanthropic organization with which I am connected. I think it is a good idea, and I suggest that you look into it. But, naturally, it is not a complete answer to the problem of sound investment in common stocks in the face of changing conditions.

The second half of this third subject is the matter of the selection of individual issues. You bankers are supposed to know the "good companies". Your clients come to you and ask "What stocks should I buy now?" and you are supposed to give them the answer.

I am going to say something unpopular at this point. I don't think you bankers can answer that question any better than you can answer the question as to what the market is going to do in the next two months or three months. That may be a little exaggerated. I should say you can't do it *much* better. And let me tell you why.

It is easy, of course, to pick out good companies, companies that are better than other companies. But that is not the same thing as picking out good stocks to buy at their current prices. The reason should be obvious. The good companies sell at high prices in relation to what they show, and the companies that are not so good sell at low prices in relation to what they show. And which one is the better one to buy cannot be decided in any simple, offhand manner such as saying that it is always better to buy your jewelry at Tiffany's than at Macy's. That may or may not be true.

I would like to give you a concrete illustration of this fact by means of a quick thumb-nail security analysis comparison. I am taking two companies at the beginning of the stock list. One is Allied Chemical & Dye, and the other issue right

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after it is Allied Kid Company. The first one you have all heard of; the second one some of you may not have heard of. Allied Chemical & Dye is selling for \$664,000,000 in the market, and Allied Kid is selling for \$5,300,000 in the market. Apparently, Allied Chemical is a much better company than Allied Kid; certainly, it is larger; certainly, it is stronger; not only that, it has a more stable record; it is in a better industry.

Does that mean that it is obviously better to buy Allied Chemical at 75 than Allied Kid at 21? The answer to that question is not quite so clear. Let me give you some figures to indicate why that is so.

Allied Chemical earned \$5 in the last twelve months; Allied Kid, \$3.50. Allied Chemical earned on the average \$3 in the last ten years; Allied Kid average earnings were \$2.78. Allied Kid has \$30 of net working capital available for the stock selling at \$21; Allied Chemical has \$14 for its stock selling at \$75. The net tangible assets of Allied Kid are about \$34 per share and those of Allied Chemical are also about \$34.

Hence what you find is that, per dollar of earnings, of dividends, and of assets, you would get between $2\frac{1}{2}$ and $3\frac{1}{2}$ times as much if you bought Allied Kid at \$21 as you would get if you bought Allied Chemical at \$75. But in Allied Chemical you are getting a better company. Is it worth paying $2\frac{1}{2}$ to $3\frac{1}{2}$ times more on a dollar for dollar basis? That is a matter for you to decide. I suggest that the answer is not quite so easy.

That problem exists in the market right along. For example, take the chemical company, of which Allied Chemical is an illustration. We know that they have been very successful; we know they have been very popular in the stock market. Yet if you look at the record of stock prices you will find that while the chemicals have done somewhat better than the industrials as a whole since the prewar period as measured by the Standard & Poor's averages there are at least a dozen industry groups which have done a great deal better in the market than the chemicals. Here are a couple of examples:

Take the 1935-39 average of stock prices as 100. The chemical stocks and the ethical drug stocks are selling, respectively, at 256 and 262, which is very nice. But the paper stocks are selling at 619; rayons at 615; coal at 455; distillers at 477; tires and rubber at 428; fertilizer at 441; oil at 311; air transport at 355; cotton goods at 309.

You have a dozen industries, most of them not at all popular in character, which over the past twelve years have behaved in the stock market better than the chemical stocks.

My own opinion is that the selection of individual securities is a matter partly of a special kind of judgment and insight, and partly of a good deal of security analysis training. On the whole it is not done too successfully by bankers, and they should not concentrate their efforts in that direction. I think they would render

an excellent service to their clients if they emphasized, rather, the importance of diversification in the field of sound, leading, primary securities, where the opportunity for making any serious mistake is relatively small, and where the investor is assured of getting a satisfactory average return. This is all that the investment public as a whole can expect to accomplish, because investors cannot get rich by being smarter than each other.

The foregoing expresses my view as to the advice that bankers should give to the typical defensive investor whose emphasis is not on investing his ability but only on investing his money in securities.

Now, what about the attitude of bankers toward the other type of investment, which I call "aggressive investment" — to be carried on by people who want to take a true business attitude towards securities, in the same way that you bankers are now taking a true business attitude towards the purchase of government bonds and tax-free securities for your institutional account?

You spend hours calculating the pros and cons relative to the various kinds of government bonds and similar types of investments. You get instruction of value in Seminars such as this. There must be something corresponding to that attitude in the area of securities which are not government bonds, which do not yield from 2½% down to 2%, but perhaps yield 10%, perhaps offer 100% profit possibilities, or something in between.

Let us talk for a moment of some philosophical implications in that area in the security markets. One point seems to me to be obvious. If it is true that the kind of investment counsel that you are going to give (and that professional investment advisors in general are going to give) will necessarily stress the purchase of leading, prominent, *primary* securities, the effect must be that, on the whole, the *secondary* issues will sell at comparatively undervalued prices. I think that follows as a kind of mathematical result of the law of supply and demand. If all the demand is for the high-grade securities, then the supply of low-grade securities must result, relatively at least, in an under-valued price a good part of the time.

One of the unexplained riddles of the stock market is why that doesn't happen all the time. As a matter of fact, it doesn't. Strangely enough, in the upper levels of bull markets, there is a tendency for speculation to go over into the secondary issues to a degree at least comparable to that in the primary issues, and so you have over-valuation in the secondary issues as well as in the leaders. That happened very noticeably in 1946. Incidentally, it is not true today and I think that is one of the reasons why, as far as the application of technical tests of the market's position is concerned, one cannot be too negatively disposed towards commonstock investment at today's levels, in spite of the advance of the higher-grade issues. The lower grade securities have not kept pace with them.

The general explanation of that phenomenon is related to the fact that you bankers, to the extent that you administer pension funds are putting the common-

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stock component in the "blue chips," so-called, or the highest grade issues. The same thing is going on with most of the money that the mutual funds are raising month by month from the public. Thus the emphasis on the "blue chip" issues is very great; and there is comparatively little attention being given to other types of securities.

This may explain the under-valuation of common stocks of the secondary grade.

This point was illustrated, I believe, by our Allied Kid example. From the business standpoint, that issue must be worth more than \$21 a share if it has the statistical factors I have enumerated; unless you have positive reason to think that the business itself is definitely destined to go downhill.

Interestingly enough, I think that you bankers are better qualified than most other advisers to take a balanced view of this very question. The ordinary individual investor, if you mention a secondary security to him, will say, "Oh, that's not much of a company. I don't think it has any future. I mistrust its prospects, and I don't want it." You, as bankers, are highly experienced in the matter of lending money to enterprises of this very type, and in the majority of cases, to companies of smaller size than the one I have mentioned. Thus you should be able to take an objective, non-prejudiced view as to the long-term possibilities of companies in this area. In that respect, you are really better suited to be good security analysts, as I conceive the term, than the average professional in Wall Street; for he is so much influenced by the prevailing preference for the very large companies that he loses his sense of balance with respect to the smaller ones.

We have here a paradox, a contradiction, which in a sense is rather tragic. The professional investment counsel, who have the best financial and business equipment to reach sound views as to security values, tend to limit what they do to the very simple and obvious area of the leading companies, such as General Motors and Standard Oil, which everybody knows about. Almost necessarily they turn their backs on the more interesting and more promising area of securities wherein the right kind of analysis could be productive of very good investment results.

I would like to give another broad illustration of the kind of opportunity that occurs to the aggressive investor in Wall Street which you bankers would be thoroughly able to understand. The *form* of securities has a great effect on the price, regardless of value factors. Am I wrong in saying that the Federal Housing Bonds which sold recently as high as a 2.25% basis, tax-free, were certainly out of line, intrinsically, with direct government bonds, fully taxable, at a 2.40% basis? That discrepancy arose because of the fact that there were uncertainties with respect to the character of the government's guarantee of the housing bonds. The obligation was not sufficiently clear-cut. And whenever you have a complication of this sort, value gets lost; that is, value does not reflect itself in price.

We have a number of simple and striking illustrations of that kind, — for example in the field of guaranteed railroad stocks. They may not be the best kind

of securities; but when you find that a security guaranteed by the Reading Co. sells at a *higher yield basis* than its own non-cumulative preferred stock, it is quite clear that there is a discrepancy between price and value which develops out of the fact that the *form of security* of the guaranteed issue is not fully recognized. As you study the field of security values you will find it replete with discrepancies between price and value that aggressive investors, properly equipped, with the right kind of intelligence and courage, will be able to take advantage of.

Now what does that mean from the standpoint of bankers as investment counsel? Unfortunately, it doesn't mean too much, and yet it means something. I don't imagine the bankers can very well take the initiative in aggressive investment by trying to get their people to take advantage of the numerous disparities between price and value. But I do think that they can be sympathetic and helpful rather than discouraging to those clients of theirs who are endeavoring to develop true competence in the field of security values, and who may come to their banker for a check on their own evaluation of security situations and security opportunities.