

THE WAR ECONOMY AND STOCK VALUES

By

BENJAMIN GRAHAM



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WHEN THE KOREAN CRISIS burst upon us last June, Wall Street analysts rightfully began to forecast a near-war or full-war economy, complete with price controls, at least some rationing, and a heavy excess profits tax. Granting that the volume of business would be tremendous, they still were inclined to anticipate a serious reduction in corporate net after taxes. This prospect, combined with the war situation itself, led to widespread predictions of lower stock prices.

STOCK MARKET HAS GONE UP

The stock market, proceeding with its usual disregard of the majority views of experts, has gone up instead of down in the past six months. By this behavior it has displayed two characteristics hitherto rather foreign to the security exchanges. The first has been the absence of panicky or deeply pessimistic reactions to international developments of the most disquieting sort. We cannot ignore the fact that the United States faces the new and harrowing danger of large-scale physical destruction and civilian casualties of inestimable magnitude. This possibility would justify—by past traditions it would almost demand—a severe and prolonged case of jitters among both speculators and investors. Secondly, the market seems to have been subordinating medium-term to really long-term considerations. For it is fair to assume that the recent rise in stock prices has reflected essentially the public's conviction that a war economy is an inflationary economy, and that, *in the long run, inflation means higher average prices for common stocks.*

GIVES RISE TO TWO QUESTIONS

This interpretation of the recent course of the market gives rise to two questions: First, is the long-term bullish view of stock values a valid one? Second, even if it is, how did it happen that stocks have been acting in a response to this view, instead of giving way first to short-term pessimism and even to panic? In this short article I shall try to find answers to these two questions.

Historically the broad pattern of war—with which this generation is now all too familiar—is that of inflation followed by deflation. The inflation may be "contained" by rigid controls during the period of hostilities, as it was during World War II and is likely to be during the present imbroglio. But, at the war's end, controls are relaxed, and then the pressures generated by deficit financing are likely to vent themselves in an explosive rise of general prices. War weakens and cheapens the dollar—especially if it is a paper dollar.

Is it not reasonable to expect that stock prices as a whole must rise, sooner or later, to reflect this cheapening of the dollar? The course of the stock market from 1900 to date shows a fairly close *over-all* correspondence between the rise in stocks and in general prices, although there have been significant divergencies for fairly long

periods. Business has been able to adjust itself not too badly to higher costs, notably higher wage scales, and even to a progressively increasing burden of income tax. But the combination of a sharp increase in the normal tax rate plus a drastic excess profits tax now appears certain to reduce corporate earnings below the average of recent years. Thus not only is it easy to imagine the tax take rising to a level that will prevent corporate net from keeping pace with inflation but also one can even envisage a decline in earning power, despite an ostensible increase in the value of business assets. Since earnings have a far greater influence on stock prices than have asset values, such a development would apparently justify a bearish view on the long-term course of the stock market.

WEIGHT OF PROBABILITIES

That war conditions *could* be destructive of stock values is hard to deny, but the mere possibility proves nothing of significance. It is the weight of *probabilities* that we are interested in. In reflecting on this question, we would do well to start with past experience. We have been unfortunate enough to have undergone two world wars in our own lifetimes; the least we should have to show for this travail is some added knowledge and perhaps some access of wisdom. It is fashionable to insist that a third world war will be completely different in its economic impact from the first two. This is a statement that requires proof. In its absence, it is better to take our cue from what has gone before.

EARNING POWER WAS HELD DOWN

During World War II, the earning power of our leading companies was held down by price controls, renegotiation, and the excess profits tax. Nevertheless the Dow-Jones industrial unit averaged earnings about 20% higher than in the prewar period. Secondary or smaller companies showed, in the main, a much larger expansion of net profits. The *postwar* earnings of business as a whole proved unexpectedly large and well maintained. Conservative analysts, who allowed for a considerable falling off of long-term profits from the 1946-50 rate, were still compelled to assume a new plateau or average for earning power at least 50% above the 1936-40 figure. Thus for the Dow-Jones unit there was a tendency to estimate average peacetime profits at about \$15, against \$9 odd in the prewar years.

The average price of the Dow-Jones unit in 1936-40 was 135; in 1946-50 it was about 180. My own calculations of its central value (made as of 1947) set it at about 215.

If this over-all pattern is assumed to hold good for the looming war economy, we should then anticipate the following: (1) restricted but substantial earnings during the period of mobilization or hostilities, (2) an appreciable rise in the basic dollar earning power in the next

postwar period, as against the prewar "normal," (3) irrational or at least unpredictable fluctuations in stock prices in the next few years, (4) no sound reason to believe that stock values would be diminished by war conditions, (5) persuasive reasons to expect that the ultimate central level of stock values would be well above our recent calculations.

SOME ACTUAL FIGURES

Some of the actual figures relating to the Dow-Jones unit will point up our conclusions. For 1946-49, the earnings before taxes averaged about \$30, leaving about \$18 after taxes. At the end of 1950, they appear to have been running at a rate as high as \$60 before taxes and more than \$30 after taxes. The present maximum over-all tax rate is 62%; in World War II, it was 72%. If we assume wartime earnings before tax of, say, \$50 per unit, and an effective over-all tax of 70%, then the unit would show net profits of \$15—the same figure that was projected for average peacetime earnings after 1945. If a "normal multiplier"—related to the interest rate and the quality of the Dow group—were applied to these earnings, the result would about support the initial price level of 1951. Actual figures would probably be better than this projection. Though the effective tax rate may well rise above 70%, the earnings before taxes are also likely to exceed \$50 for the unit.

TAX SHELTER FOR RAILROADS

The excess profits tax shelter now accorded the railroads, coupled with their heavy traffic, give them possibilities of fantastically high net profits. This situation is too favorable to last, but it seems likely that the principle of tax preference will remain to their benefit, as it has for oil and mining companies through many changes in the scale of rates. The public utilities are not likely to be war beneficiaries; but they too have been given a tax shelter, and the stability of their earning power does not appear seriously threatened.

The calculations just made reflect wartime business activity rather than war-induced inflation. Judging from the past, most of that inflation will be experienced when peace is restored. No one has enough foresight to project the economic conditions that will confront us then, but I believe enough in logic to predict that stock values will stand up better than the value of the paper dollar.

THE PRICE LEVEL, ASSET VALUES, AND EARNING POWER

The pessimistically minded can easily conjure up a picture of high wages and crushing taxes, which together will hold down corporate profits to a figure "lower than any assignable quantity," in spite of an extremely inflated general price level. It should be pointed out that such a result would be incompatible with the American system—which, in spite of growing governmental controls and other obstacles, has remained essentially one of free investment choices. The core or keystone of that system is the voluntary investment annually of huge sums in additional capital goods. Large-scale commitments of this kind will be made continuously *only* if the existing capital investment by and large is showing an adequate profit. This

profit, in turn, must be measured to some degree against the *replacement value* of the existing plant. In other words, an inflated price level, which raises the replacement cost of capital goods, must needs reflect itself also in a corresponding increase in the dollar profits produced by past investment.

RELATION OF ASSET VALUES AND EARNINGS

This relationship between asset values and earning power is neither precise nor uniform. In fact, the variations in earnings on invested capital are so extraordinary as to suggest that the idea of *any* relationship is a fallacious one. But, when the economy is viewed broadly, we can see that large-scale new investment presupposes adequate earnings on the *composite* or the *typical* old investment. In fact, we may suggest the rule that, as the quantity of annual new investment increases, the relationship between the earnings on old capital and the earnings on new capital tends to become closer and more logical.

ENCOURAGEMENT OF NEW INVESTMENT

The emphasis by Government on maintaining full employment makes the encouragement of new investment a primary element of state policy. This in turn sets practical limits to governmental interference with the making of a "fair rate" of profit after taxes. Here we may have in part the explanation of the paradox that, while American business was complaining in recent years about the hostile attitude of Washington, it was registering the largest recorded rate of earnings on invested capital, computed at original cost.

CONCLUSION

Our conclusion is that the public is instinctively right in its present emphasis on the inflationary aspects of the developing war economy, and its consequent bidding up of stock prices just when the rule book called for near-panic selling. It is interesting to conjecture why investors and speculators are acting logically in the present crisis, whereas under similar conditions in the past they have been dominated by the more obvious psychology of fear. Let us venture the suggestion that what we are witnessing is the maturing of inflation consciousness, which—by an awkward but not too surprising coincidence—is about contemporaneous with the maturity of the first Series E Savings Bonds. There can be such a thing as a panic to buy as well as a panic to sell. The stock market since last June is far from resembling a "buyers' panic"; but the definite signs all around us of uneasiness concerning the value of the paper dollar, and of investments tied to the dollar, suggest that a definitely new guiding force is entering into the psychology of the investing public.

The spectacular and ill-fated New Era stock market of the 1920's began about 1924 with an analogous and quite soundly documented realization of the long-term superiority of stocks over bonds. Other conditions, however, were as different from today's as one could imagine. Perhaps that is a good reason for repeating the French maxim that was made to order for Wall Street: "The more it changes, the more it's the same thing."

Toward a Science of Security Analysis

Benjamin Graham

THE SCIENTIFIC METHOD

As H. D. Wolfe pointed out in his paper in the last *JOURNAL* (*Science as a Trustworthy Tool*)¹, scientific method includes among its factors the wide observation and recording of events, the construction of rational and plausible theories or formulas, and their validation through the medium of reasonably dependable predictions. There are many varieties of scientific or quasiscientific disciplines, and the character of the predictions based on them will vary greatly from one to another.¹

At one extreme take the microphone. An electrical engineer, having rigged it up carefully, can predict that a word spoken into it will be immediately amplified. The prediction is precise; the verification prompt and unquestionable. At the other extreme let us take psychoanalysis—a discipline sometimes compared with our own security analysis. Here prediction and verification are less definite. A layman who finances psychoanalytical treatment for one of his family is apt to be slightly in the dark about such details as the nature of the illness, the method and duration of the treatment, and the extent of the cure, if any. About the only thing he can predict with certainty is how much it will cost per hour. Between these two extremes lies actuarial science, which to my mind is more relevant than the others to the scientific possibilities of security analysis. The life insurance actuary makes predictions concerning mortality rates, the rate of earnings on invested reserves, and factors of expense and profit—in all instances based largely on carefully analyzed past experience, with allowance for trends and new factors. Out of these predictions, with the aid of mathematical techniques, he fashions suitable premium schedules for various types of insurance. What is most important for us about his work and his conclusions is that he deals not with individual cases but with the probable *aggregate result* of a large number of similar cases. Diversification is of the essence in actuarial science.

Thus our first practical question about “scientific security analysis” is whether it is actuarial in character, and has diversification as its essential

ingredient. One plausible answer may be that diversification is essential for certain types and objectives of security analysis but not for others. Let us classify the things that security analysis tries to do and see how the element of diversification applies to each. At the same time we may raise other questions concerning the scientific methods and predictions operating in each of the classes.

I suggest that the end product of our work falls into four different categories, as follows:

1. The selection of safe securities, of the bond type.
2. The selection of undervalued securities.
3. The selection of growth securities, that is, common stocks that are expected to increase their earning power at considerably better than the average rate.
4. The selection of “near-term opportunities,” that is, common stocks that have better-than-average prospects of price advance, within, say, the next 12 months.

This list does not include stock market analysis and predictions based thereon. Let me comment briefly on this point. If security analysis is to be scientific, it will have to be so in its own right and not by depending on market techniques. It is easy to dismiss this point completely by saying that, if market analysis is good, it doesn't need security analysis; and, if it isn't good, security analysis doesn't want *it*. But this may be too cavalier an attitude toward an area of activity that engages the interest of a host of reputable security analysts. That stock market analysis and security analysis combined may be able to do a *better* job than security analysis by itself is at least a conceivable proposition and perhaps a plausible one. But the burden is on those who would establish this thesis to demonstrate it to the rest of us in unequivocal and convincing fashion. Certainly the published record is far too meager, as yet, to warrant conceding a scientific standing to a combination of the two analyses.

FOUR CATEGORIES

To return to our four categories of security analysis, choosing safe bonds and preferred stocks is certainly the most respectable if not the most

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exciting occupation of our guild. Not only has it major importance of its own, but also it can offer useful analogies and insights for other branches of our work. The emphasis of bond analysis is on past performance, tempered by a conservative view of future changes and dangers. Its chief reliance is on a margin of safety that grows out of a small ratio of debt to total real value of the enterprise. It requires broad diversification to assure a representative or average over-all result. These viewpoints have made bond investment, as practiced by our financial institutions, a soundly scientific procedure. In fact, bond investment now appears to be almost a branch of actuarial science. There are interesting similarities (as well as differences) between insuring a man's life for \$1,000 against a premium of \$34 per year, and lending \$1,000 on a long-term bond also paying \$35 per year. The calculated mortality rate for men aged 35 is about 4 out of 1,000, or 4/10% per year. A comparable "mortality rate" might be applied to corporate enterprises in the best financial and operating health, to estimate the risk attaching to high-grade bond investment. Such a figure, say 1/2%, might then properly measure the risk and yield differential between the strongest corporate bonds and U. S. Government obligations.

BOND INVESTMENT: A SCIENTIFIC PROCEDURE

Bond investment should take on more of the character of a scientific procedure when the monumental corporate bond study, carried on by the National Bureau of Economic Research and other agencies, is finally completed and the mass of statistical data and findings is made available to security analysts. The greatest weakness of our profession, I have long believed, is our failure to provide really comprehensive records of the results of investments initiated or carried on by us under various principles and techniques. We have asked for unlimited statistics from others covering the results of their operations, but we have been more than backward in compiling fair and adequate statistics relating to the results of our own work. I shall have a suggestion to make on that point a little later.

SELECTION OF UNDERVALUED SECURITIES

The selection of undervalued securities appears next on my list because of its logical relationship to investment in safe bonds or preferred stocks. The margin-of-safety concept is the dominant one in both groups. A common stock is undervalued,

typically, if the analyst can soundly establish that the enterprise as a whole is worth well above the market price of all its securities. There is a close analogy here with bond selection, which also requires an enterprise value well in excess of the debt. But the rewards for establishing that a common stock is undervalued are, of course, incomparably greater; for in the average case all or a good part of the margin of safety should eventually be realized as a profit to the buyer of a truly undervalued issue.

In this connection I want to throw out a broad and challenging idea—that from a scientific standpoint common stocks *as a whole* may be regarded as an essentially undervalued *security form*. This point grows out of the basic difference between individual risk and overall or group risk. People insist on a substantially higher dividend return and a still larger excess in earnings yield for common stocks than for bonds, because the risk of loss in the average *single* common stock issue is undoubtedly greater than in the average *single* bond. But the comparison has not been true historically of a *diversified group* of common stocks, since common stocks as a whole have had a well-defined upward bias or long-term upward movement. This in turn is readily explicable in terms of the country's growth, plus the steady reinvestment of undistributed profits, plus the strong net inflationary trend since the turn of the century.

FIRE AND CASUALTY RATES

The analogy here is with fire and casualty insurance rates. People pay about twice as much for fire insurance as their own actuarially determined exposure would indicate—because they cannot soundly afford to carry the individual risk themselves. For similar reasons the overall return on common stocks appears to have been at least twice as much as their true overall risk has required. An interesting relationship at this point appears from the Keystone chart showing the trend of the Dow-Jones industrial average since 1899. Both the upper and lower lines happen to rise at the rate of one third every ten years. You will recognize this as the 2.90% rate of compound interest realized on U. S. Savings Bonds, Series E. What this means is the consistent Dow-Jones investor has obtained the same increase in *principal value* as the savings bonds offer in lieu of interest; and in addition the Dow-Jones stock investor has obtained all the annual dividends from his holdings as a bonus above the Government bond interest rate.

The reasoning I have just indulged in is, I

believe, both scientifically valid and psychologically dangerous. Its validity depends on the maintenance in the stock market of the substantial disparity between bond yields and the price-earnings ratios on stocks. If—as happened in the 1920s—this very thesis is twisted into the slogan that common stocks are attractive investments, regardless of how high they sell, then we would find ourselves beginning as scientists and ending as heedless and ill-starred gamblers. It may be a fair generalization to assert that the top levels of most “normal” bull markets are characterized by a tendency to equate stock risks with bond risks. These high valuations may indeed have some justification in pure theory, but the important thing for us to bear in mind as practicing analysts is that, when you pay full value for common stocks, you are in great danger of later appearing to have paid too much.

INDIVIDUAL UNDERVALUATIONS

Turning now to the field of *individual* undervaluations, we find ourselves on more familiar ground. Our work with this group readily admits of the scientific processes of wide observation and the testing out of predictions or hypotheses by their sequels. The theory of undervalued issues must necessarily require an explanation of their origin. The explanations are in truth quite varied and taken together form what may be called a “pathology of market prices.” They range from obvious causes, such as an unduly low dividend or a temporary setback in earnings, to more subtle and special conditions such as too much common stock in the capital structure or even too much cash in the bank. In between lie numerous other causes such as the presence of important litigation, or the combination of two dissimilar businesses, or the use of the now discredited holding company setup.

ORIGINS OF UNDERVALUATION UNDERSTOOD

The origins of undervaluation are pretty well understood by now and could no doubt be set forth in an acceptably scientific study. We do not know as much about the cure of undervaluations. In what proportion of cases is the discrepancy corrected? How or why does the correction occur? How long does the process take? These questions remind us somewhat of those we raised about psychoanalysis at the outset. But one thing of importance we do know, and that is that the purchase of undervalued issues on a diversified

basis does produce consistently profitable results. Thus we have a worthwhile field for more scientific cultivation. Here inductive studies carried on intelligently and systematically over a period of years are almost certain to be rewarding.

SELECTION OF GROWTH STOCKS

The third objective of security analysis is the selection of growth stocks. How scientific a procedure is this now, and how scientific can it be made to be? Here I enter difficult waters. Most growth companies are themselves tied in closely with technological progress; by choosing their shares the security analyst latches on, as it were, to the coattails of science. In the 40 or more plant inspections that are on your scheduled field trips for this convention week, no doubt your chief emphasis will be placed on new products and new process developments; and these in turn will strongly influence your conclusions about the long-pull prospects of the various companies. But in most instances this is primarily a *qualitative* approach. Can your work in this field be truly scientific unless it is solidly based on dependable *measurements*, that is, specific or minimum projections of future earnings, and a capitalization of such projected profits at a rate or multiplier that can be called reasonably conservative in the light of past experience? Can a definite *price* be put on future growth—below which the stock is a sound purchase, above which it is dear, or in any event speculative? What is the risk that the expected growth will fail to materialize? What is the risk of an important downward change in the market’s evaluation of favorable prospects? A great deal of systematic study in this field is necessary before dependable answers to such questions will be forthcoming.

STOCK INVESTMENT IN PRESCIENTIFIC STAGE

In the meantime I cannot help but feel that growth stock investment is still in the prescientific stage. It is at the same time more fascinating and less precise than the selection of safe bonds or undervalued securities. In the growth stock field, the concept of margin of safety loses the clarity and the primacy it enjoys in those other two classes of security analysis. True, there is safety in growth, and some of us will go so far as to declare that there can be no real safety except in growth. But these sound to me more like slogans than scientifically formulated and verified propositions. Again, in the growth field the element of selectivity is so

prominent as to place diversification in a secondary and perhaps dubious position. A case can be made for putting all your growth eggs in the one best or a relatively few best baskets. Thus in this branch of security analysis the actuarial element may be missing, and that circumstance undoubtedly militates against truly scientific procedures and results.

INVERTED RELATIONSHIP

There is undoubtedly an organic but inverted relationship between the growth stock concept and the theory of undervalued securities. The attraction of growth is like a tidal pull which causes high tides in one area, the assumed growth companies, and low tides in another area, the assumed nongrowth companies. We can measure, in a sense, scientifically the distorting effect of this influence by using as our standard the *minimum business value* of enterprises in the nonfavored group. By way of illustration let us apply that thought to three California concerns. The shares of Roos Brothers, a local retail enterprise, will in the nature of things tend to sell below their analytically determined value for basically the same reasons that are bound to produce overvaluations in the shares of Superior Oil or Kern County Land.

I come finally to the standard occupation of brokerage house analysts and advisory services, namely, the selection of issues favorably situated for a near-term market advance. The usual assumption here is that, if the earnings will improve or the dividend will be raised, then the price will improve. Thus the process consists essentially of locating and recommending those companies that are likely to increase their earnings or dividends in the near term. You all know the three basic hazards encountered in this work: that the expected improvement will not take place, that it is already discounted in the current price, that for some other reason or for no known reason the price will not move the way it should.

It may be that despite these hazards it is possible to obtain worthwhile results on the average from competent short-term analyses and pre-

dictions. Who of us can say whether or not this is true? In view of the importance of this analytical work, in terms of time, energy, and money cost, it might not be a bad idea to subject it to a thoroughgoing evaluation.

SEARCHING SELF-EXAMINATION

This brings me to my conclusion and my one concrete proposal. Security analysis has now reached the stage where it is ready for a continuous and searching self-examination by the use of established statistical tools. We should collect the studies and recommendations of numerous analysts, classify them in accordance with their objectives (perhaps in the four groups suggested in this paper), and then do our best to evaluate their accuracy and success. The purpose of such a record would not be to show who is a good security analyst and who is a poor one, but rather to show what methods and approaches are sound and fruitful and which ones fail to meet the test of experience.

This suggestion was originally made in the articles published under the pseudonym of *Cogitator* in *THE ANALYSTS JOURNAL* six years ago. At that time I wrote: "It is unlikely that security analysis could develop professional stature in the absence of reasonably definite and plausible tests of the soundness of individual and group recommendations."² The New York Society is now taking the first positive steps to establish a quasiprofessional rating or title for security analysts who meet specified requirements. It is virtually certain that this movement will develop ultimately in full-fledged professional status for our calling. The time may well be ripe for the Federation and its constituent Societies to begin a systematic accumulation of case histories, which should make possible the transmission of a continuous, ever-growing body of knowledge and technique from the analysts of the past to those of the future.

When this work is well under way security analysis may begin—modestly, but hopefully—to refer to itself as a scientific discipline.

FOOTNOTES

1. H.D. Wolfe, "Science as a Trustworthy Tool," *The Analysts Journal* (March 1952):45-49.
2. Cogitator, "On Being Right in Security Analysis," *The Ana-*

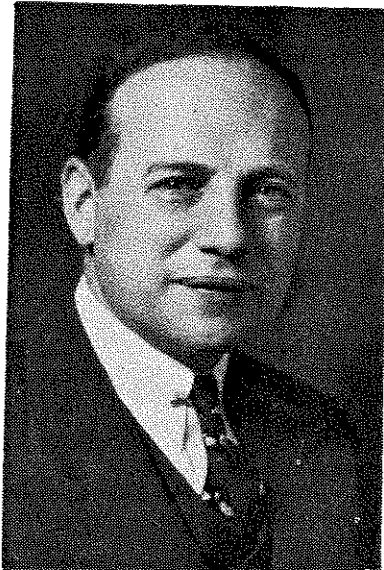
lysts Journal (1st Quarter 1946):18-21, especially at p. 18 for quoted material.

DICTA

CONTROLLING VERSUS OUTSIDE STOCKHOLDERS

By Benjamin Graham

* * *



Mr. Benjamin Graham is President of Graham-Newman Corporation, an investment company organized in 1936 and registered with the Securities and Exchange Commission as an open-end investment company. Mr. Graham is a Director and member of the Executive Committee of the Atlantic Gulf and West Indies Steamship Lines; a director of the New York & Cuba Mail Steamship Company; Chairman of the Board of Government Employees Insurance Company; and President and Director of Market Street Railway.

He is the senior author of "Security Analysis" by Graham & Dodd, co-author of "Interpretation of Financial Statements," and author of the "Intelligent Investor," of "Storage and Stability," and of "World Commodities and World Currency."

* * *

The practical working of corporate democracy is intimately bound up with the question of corporate control. If the average or outside stockholder of a given company has no real power to influence the choice of its directors, then the basic concept of democracy or ("power of the people") is there inapplicable. The mass of stockholders may demand information, they may assert the right to discuss and criticize at annual meetings, but they cannot govern or control a single corporate decision—except sometimes, in a negative sense, those requiring a two-thirds or three-quarters approval.

Financial men distinguish between three kinds of corporate control—"absolute," where an individual or cohesive group owns a majority of the stock; "working," where as little as 20% of the shares, so concentrated, may actually "run the company"; and "open-market," where the holdings of the "insiders" are so small that an outside group can acquire control by steady purchase. Interesting enough, the latter category does not envisage actual exercise of control by the outside or public stockholders acting en masse and independently of management. The latter is theoretically possible, and has actually been known to occur. But such definitive exercises of corporate democracy are exceedingly rare. In most cases of the kind, the

VIRGIN

Vol. V, No. 21

Third Year Class Makes Plans For Mutual Gift Fund

Dividends Accrued Over Twenty-Year Period To Buy Gift In '73

At a meeting held shortly before the Easter vacation, the Third Year Class decided to accumulate funds for a class gift to the Law School by investing individual contributions in a mutual fund company over a twenty-year period.

The class was almost unanimous both in its decision to make some sort of gift, and in its approval of the Mutual Fund plan. This investment plan was favored over three other proposals because of its great flexibility. As a result, the success of the plan as a whole cannot be jeopardized by the unforeseen failure of individual members to meet their pledges.

Profits Accrue Steadily

Each member of the class will be asked to pledge a definite annual contribution to the Fund. Each year, all the contributions

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Thus we are very far from having a corporate democracy in any sense analogous to our political democracy, in which the full power to choose leaders and pass upon major policies resides in and is wielded by the mass of the citizens. Such a condition can arise in corporate affairs only when both (a) there is no absolute or strong working control, in the hands of insiders, and (b) the outside stockholder is able and willing to form independent judgments about specific corporate questions. To translate theoretical power into effective democratic action will require a great advance in stockholder education. This writer believes, further, that the initiative and direction in this area will have to come from the numerous agencies that have special qualifications to form expert and impartial opinions on corporate issues—e.g., investment fund managements, investment counsel, Stock Exchange houses, security-analysts groups.

Something of a paradox emerges out of this rather pessimistic view of the present state of corporate democracy. It is possible that the outside stockholder may derive more positive protection out of the *trusteeship obligation* of majority interests towards the *minority*, than through exercising his potential right to form a controlling majority of his own by joining with his fellow outsiders. The fiduciary obligations of the majority are a matter of legal principle, subject to widening judicial interpretation. If the minority is mistreated—as mistreatment has been and will be defined

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This year's over-all topic for DICTA examination is
Corporate Democracy

Baseball Fracas Cements Bonds Of Sigma Nu Phi Fraternity

Sigma Nu Phi pledges romped over their elder brethren to win the keg of beer staked on the result of their inter-fraternity softball game on Saturday afternoon.

Although the exact score was somewhat in question due to the fact that the old men had one of their stooges on the score pad, most reliable observers place the score at approximately 16-11 in favor of the peach-fuzzed juveniles. The oldsters reluctantly concede this score to be correct, so it is safe to conclude that they were soundly drubbed.

Forbes Sticks Out

Dan Ely after a wicked but successful slide into second now finds

the regulation three, outs were recorded.

"Harry Gams" Forbes was setting the sartorial style in his hyper-abbreviated shorts.

Jack Barret, Bill Ballance, Mike Kahn, and Ed Large were all good for circuit clouts for the new members, but the bearded wonder had a surprise in the person of aging Homer Grasberger. This shiney-domed relic made three mighty connections at the plate and each time forgot his sea legs long enough to scamper off in the general direction of first base.

The old men even while licking their wounds of defeat are now conspiring for a return engage-

vestment plan with three other programs its great flexibility the success of the plan cannot be jeopardized by foreseen failure of members to meet their plan

Profits Accrue Steadily

Each member of the class be asked to pledge a definite annual contribution to the fund. Each year, all the contributions

(Continued on page 3)

Delta Theta Phi's Initial Luncheons Feature Speakers

Delta Theta Phi's recently initiated program of bi-weekly fraternity luncheons has proved so successful that it will be continued, according to John H. Young III, Dean of Lee Senate.

The first of the legal fraternity's luncheons was held at the Varsity Grill shortly before Easter Vacation. Featured in the speaker's role was Jack Kegley, '51, a member of Delta Theta Phi, and now assistant Commonwealth Attorney for Albemarle County. In his informal talk, Mr. Kegley regaled his audience with incidents from some of the more amusing cases he has handled since beginning his practice, and emphasized the examination of witnesses on the stand as one of the more enjoyable duties of his present post.

Priest Speaks

At the more recent meeting last Thursday at the Albemarle Hotel Associate Professor A. J. Gustin Priest highlighted the affair with an informative and amusing discussion of the art of cross-examination.

Introduced by Homer Eliades, Mr. Priest responded that he was probably one of the few fortunate professors to have both a Homer and a Plato in his classes. Thus setting the tone for his talk, Professor Priest went on to discuss the damaging results of asking a witness one question too many or of failing to ask the essential question. He drew from his personal experiences and from those of outstanding English, Canadian, and American prosecutors and advocates to illustrate his talk.

Illustrates Point

To illustrate the sin of the superfluous question, Professor Priest recalled an assault and battery case in which the defendant was charged with biting off the plaintiff's ear in a fight.

"Did you actually see the defendant bite off the plaintiff's ear?"

Prettyman Before Law Class

Barrett Prettyman of the Circuit Court of Columbia, will ministrative Law subject, "Effective in Administrative Law morning at members of the Year Class are

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an has been on 945. Before his practiced law in Virginia. He re- from Randolph 1910, and five his L.L.B. from 1946 he received or of Laws from as written many les in various one of his latest servations Con- Advocacy," soon April, 1953, edi- ia Law Review.

Gift Fund . . .

(Continued from page 1)

will be invested in shares of stock in a mutual fund company, which in turn invests all its capital in stocks and bonds. All dividends accruing to the Fund will be automatically re-invested. At the end of twenty years, a class reunion and meeting will be held to decide what to do with the Fund.

Since no specified amount of money must be invested with the company annually, occasional defaults on pledges will not seriously endanger the success of the Fund. Adverse effects of stock market fluctuations will also be minimized, because investments will be made continuously over a twenty-year period. If the Class contributes about \$1,000 each year, the Fund will probably be worth about \$30,000 or \$35,000 by 1973.

Committees Handle Details

A committee composed of Robert Tinsley, Robert Arnold, Pat Charles, John Ewald, F. Richards Ford, Dan Mahoney, Daniel Payne, and James Trinkle, is working out details of the plan now. They will probably settle most of the major problems at a meeting to be held this week.

It is anticipated that Tinsley, the Class President, will appoint a permanent committee to supervise the operation of the Fund until the reunion in 1973. The work of the permanent committee will be purely administrative—they will supervise the collection of individual contributions, but will merely turn them over to the company for investment. Plans are also being considered to charge the committee with the duty of sending out a class news letter each year along with the bills to contributors.

Postscripts

CPL. JOHN BLAKE LOWE, JR., here in 1950-51, has just changed his address from Have- lock, North Carolina, to First Marine Aircraft Wing, c/o Fleet Post Office, San Francisco, Cali-

DICTA . . .

Cite as "Graham, Virginia Law Weekly *DICTA*, Vol. V, No. 21, (1953)"

(Continued from page 1)

—then a *single* stockholder may obtain court relief for all the minority. But if the public holders constitute a numerical majority, the courts may well require that abuses be cured via a stockholder vote overruling and possibly replacing the management. This is exasperatingly difficult to obtain, even when the issues appear crystal clear.

This paradox is actually operative in two important sectors of the corporate front—Chapter X reorganizations and break-ups or recapitalizations under the Public Utility Holding Company Act of 1935. Here the ideal of corporate democracy is sharply circumscribed by the realistic concept that public securityholders cannot be trusted to vote in their own interest without the guidance and superior control of the SEC and the courts. No matter how large a majority may favor a plan or deal, it may still be turned down if found unfair or unfeasible by the regulatory bodies. As a consequence, a single determined securityholder, with right on his side, may prevail against overwhelming numerical odds. This possibility, in turn, makes majority groups more attentive than otherwise they might be to the views of minority holders.

In ordinary corporate affairs, however, a dissatisfied individual holder, or minority group, has no legal forum for a complaint, unless it relates to certain specific and limited types of overreaching by those in control. As this layman understands the case, there is redress against the following: (1) Unfair business transactions between the company and controlling persons, including payment of clearly excessive compensation. (2) The diversion of "corporate opportunity" from the company to a controlling person. (3) By statutory provision or (Sec. 16b, etc., of the Securities Exchange Act of 1934), the making of short-term profits in the purchase and sale of the company's securities. Relief under the first two categories is clearly appropriate; that under the third is open to objection, I think, as implying wrongdoing in transactions that may be entirely innocent.

However, it is our thesis that there are far more important areas of conflict of interest between controlling and outside stockholders, which have so far escaped legal recognition and which therefore permit overreaching of the less powerful by the more powerful group. These areas relate to competence of management, to control of assets, and to dividend policy. Of these, the most obvious is dividend policy, and I shall devote most of my attention to this question.

The outside stockholder is harmed by an inadequate dividend when the company's position would permit payment at an adequate rate. He suffers both in income and in the market value of his holdings. Since these are the only two places in which he can obtain concrete benefit from his investment, the damage done him by an unduly low dividend is comprehensive. It may be made up later, of course, by a more liberal dividend policy; but since low dividends almost

Libel Show

(Continued

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Postscripts

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OLIVER J. NEIBEL, JR. (LL.B., '52) received word on March 14th that he had passed the Washington State Bar Examination, which he had taken on January 22nd.

ALFRED U. KREBBS, Class of 1932, has changed his address from 1407 N. Glebe Road, Arlington, Virginia, to 3220 N. Albemarle Street, Arlington.

Phi Delta Epsilon

The initiation of new members into Phi Delta Epsilon fraternity will be held at 4:15 P. M. today at Madison Hall.



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The position of a controlling stockholder, as regards dividends, is completely different. He has the right to view the concern as one would his private business. In the typical case dividends are not needed to meet his living expenses, and they do involve a high-bracket tax. The inclination, therefore, is often strongly towards a "conservative" dividend policy, which means that almost any excuse is welcomed for keeping the dividend down. Such excuses are always easy to find; in fact, one may be readily manufactured at any convenient time by a simple decision to expand the scope of the business, thus increasing the need for retaining earnings.

Controlling stockholders may not be as much concerned as outside holders by the unduly low market price that follows in the wake of an unduly low dividend. For the most part, the former's investment is permanent and unmortgaged. Low market prices make for lower gift and estate taxes; they may also create opportunities to acquire additional shares on a bargain basis. If those in control desire to "cash in," they usually arrange a merger or sell out at a realistic price related to earning power and assets, and thus far above the market levels prevailing for some time past. If necessary for sale or other purposes, the dividend may always be increased to a suitable figure.

To what extent do we actually find a policy of inadequate dividends carried out apparently in the interests of controlling stockholders and contrary to that of the outside or public owner? The occurrence would seem to vary about inversely with the size of the enterprise. Most of the really large companies endeavor to be entirely fair in their disbursement rate; they are conscious of an obligation to protect the position of all stockholders; where the pay-out is rather low—as it has been in many cases since 1946—the reasoning behind the policy is tenable if not always convincing.

Most of the abuses in the field of dividend policy have occurred among the smaller corporations, especially in cases where there is concentrated control in a single family. A typical case is Company D, now listed on the New York Stock Exchange. In 1946, shares were sold to the public, apparently for the first time, and priced at 23. The book value was 22½, the last year's earnings (adjusted) \$2.41, the currently declared dividend at the rate of \$1.00 annually.

(Continued on page 4)

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Kenneth Redden and Alexander Thelen

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October, 1952

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DICTA...

Cite as "Graham, Virginia Law Weekly *DICTA*, Vol. V, No. 21,
(1953)"

(Continued from page 3)

In 1948 the earnings were over \$3 per share (before deducting an inventory reserve, never used), and the year-end book value had increased to \$29.67. However, early in that year the dividend was omitted and the price dropped to 11. At that time, the company had no debt or preferred stock, and the net current assets alone were over \$19 per share.

Another kind of example was provided in a recent article by Norvin Greene, appearing in the November 1952 issue of *The Analysts' Journal*. Here compared companies X and Y, in the same business, of almost the same size, and sharing similar operating results and financial position. Yet Company X sold at 24 $\frac{3}{4}$ (against book value of \$16.60), while Company Y sold at 15 $\frac{3}{4}$ (against book value of \$18.60). The difference was clearly due to the "investor relations," including notably the respective dividend policies. Company X had paid \$2.15 in 1951 while Company Y paid only \$1.40. Other differences—in the place of listing, frequency of reports, data given in reports—also favored Company X.

No doubt scores of instances could be given of lesser-sized companies which have sold shares to the public at very full prices, and have later pursued dividend policies which are completely inadequate in relation to the price paid by the outside stockholders, and which inevitably entailed a drastic shrinkage of market value of their investment. Some of these unfortunate happenings may be justified by adverse business developments; but in many more cases, the average earnings were sufficient to pay an adequate dividend, and the low rate was defended in terms of the need for larger capital. Is it too much to say that in the latter instances, the business was being run in a way to confer benefits on the controlling stockholders and to inflict injury on those outsiders who in good faith had contributed capital to the enterprise?

It is interesting to speculate on the possibility that some day the doctrine of the fiduciary obligation of controlling persons toward minority stockholders may be expanded to protect the latter against serious loss due to an essentially arbitrary or selfish dividend policy. Perhaps conscientious underwriting houses—recognizing how vulnerable is the price of newer common-stock issues to unfavorable developments of all sorts—will in due time require managements to express their intention of maintaining a reasonably adequate dividend, unless unsatisfactory business conditions make such a dividend clearly inadvisable. A representation of this kind would make controlling interests think twice before they jeopardized the dividend rate by expansion or by other avoidable decisions. It would also bring into clearer focus the right of minority holders to legal relief if they suffered from dividend policies which at the same time helped rather than hurt the insiders.

One of the anomalies of the dividend problem is that it results in large part from failure on the part of the

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One of the anomalies of the dividend problem is that it results in large part from failure on the part of the entire financial community to think through the proper role of dividends in investment policy under present conditions of high tax rates and high reinvestment needs because of expansion and inflation. Most of the underlying conflict of interest between insiders and outsiders in the matter of dividends could be neatly resolved by resort to a carefully formulated and clearly expressed policy of periodic stock dividends representing the retained portion of current earnings. But new thinking to meet new underlying conditions comes very slowly to Wall Street.

The second broad area in which insiders may benefit while outside stockholders are penalized, is that of control of assets. The right to hold and administer corporate assets is a normal perquisite of control; that it confers certain advantages—e.g., the right to place insurance etc.—may hardly be gainsaid, but these are not objectionable per se if the business is a sound one, properly run. But there have been numerous instances in which the structure of the business itself is demonstrably of value only to those in control, and the outside stockholder loses through its continuance. Holding companies belong in this general category. The classic example, I think, is that of Mission Corporation—because the inherent unfairness of the set-up to minority owners was forcibly expressed by its own president at a time when he was opposing a highly unusual merger deal proposed by the controlling stockholder. The details of this case—on which finis has not yet been written—will repay careful examination by students of the question of control.

Probably the most controversial idea of all would be that outside stockholders are entitled to relief from poor management by the controlling people. It is generally held that a minority holder accepts the management of the majority for better or for worse; only in the rare instances of a clear-cut wastage of assets by an equivalent of gross negligence can he hope for some legal protection. (The pending move for a receiver to take over the R-K-O Pictures Corp. is an example—necessarily somewhat spectacular—of such a situation.) It is conceivable, however, that in due time minority stockholders as a class will establish in the courts their right to at least *reasonably good* management—on the ground that the perpetuation of its own inferior management by the majority represents the placing of its own selfish interest

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Stock Dividends

They Can Save the Investor Many a Tax Dollar

By BENJAMIN GRAHAM

GIVEN an expanding company, which needs to add substantially to its equity capital, both the management and the stockholders face a dilemma in the matter of dividend policy. If the dividend is held down below a reasonable return on the fair value of the enterprise, the rank and file of the stockholders lose twice—first, by inadequate income, and second, by an unduly low market price for the shares.

On the other hand, if the company follows what used to be considered the preferable policy—namely, to pay a fully adequate dividend, but then to build up its equity capital by selling additional shares—the result makes no sense at all from the income-tax angle. For in that case the stockholders receive a good dividend, pay a high average personal tax thereon, and concurrently are called upon to put the same money, tax diminished, back into the business.

The simple solution of this dilemma lies in the use of *non-taxable stock dividends* to represent that part of the earnings which ordinarily would be paid out in cash, but are now required by the company for purposes of expansion. However, in the present state of investors' thinking on the matter of dividends, the stock-dividend solution is unattractive. A recent incident will illustrate this point.

The Caterpillar Tractor Co. is a strong and successful enterprise which has paid dividends continuously since 1914. In June, 1953, it cut its quarterly cash dividend from 75 cents to 50 cents, but at the same time paid a stock dividend of 4%. In the accompanying statement the management explained that it needed to conserve cash for the building of a large additional plant. It added that the stockholders would be better off with a \$2 annual rate in cash, plus a 4% stock dividend, than they were with the straight \$3 cash disbursement, since those who wish to can realize more than the \$1 difference by the sale of their stock dividends.

Apparently, the stockholders did not accept this reassurance at face value, however, for immediately following the announcement (in a generally weak market) the shares declined a full 10%. It would appear from this incident, and from others like it, that investors do not regard a stock dividend as a desirable substitute for a cash payment, even though the former may have a higher value taken at market. We believe the public is wrong in this matter. Under present conditions of taxation and corporate expansion needs, a stock-dividend policy of the right kind is in many cases more logical and more advantageous than

Benjamin Graham is the author of such well-known works as *The Intelligent Investor* and the classic *Security Analysis*, as well as the head of a successful investment fund. In this article, the first of two that will appear in *Barron's*, Mr. Graham cogently argues that the financial community, corporate management and shareholders alike, should revise their thinking on dividends that are paid in stock rather than in cash.

a cash-dividend policy. It is not too difficult, we think, to demonstrate that this is true. But it will be much more difficult to change the thinking and the traditional reactions of the financial community in the matter of dividends.

* * *

There are several factors that now make cash dividends less desirable than they used to be, and have enhanced the usefulness of systematic stock dividends. The first of these factors is the above-mentioned double taxation of distributed earnings, at heavy rates. The second is the continuous need for corporate expansion on a huge scale to support the full-employment principle to which both government and business are now committed. These same conditions give rise to a third factor, namely the sharpening of an inherent conflict of desire, re dividends, between the average or outside stockholder and controlling interests. Finally, we might assert that the cash dividend rate and dividend record are no longer, as once they were, the most convincing indication available of the success and the quality of a common stock investment.

Today's situation can be illustrated by almost any public utility company of the typical kind. It has satisfactory earnings; it pays a "normal" cash dividend; it is expanding at a rapid rate, and financing that expansion by the sale of bonds, preferred stock and also by offering subscription rights for new common stock to its shareholders, or directly to the public. If you examine what took place over the past seven years—the postwar period—you will find that the common stockholders as a class have given back to the company for new stock all or a large part of the cash dividends paid out to them. If you can trace the matter further you will find that the stockholders in the aggregate (other than corporations) lost in income taxes about 50% of the dividends received. This tax—piled on top of a 52% levy on the utility's net profits—was paid merely for the privilege of letting the dividend money pass into the stockholders' bank accounts

and then out again in payment for the additional shares purchased.

Could the payment of this heavy dividend tax have been avoided, with the same results otherwise to both the company and its stockholders? Yes, by the use of periodic stock dividends to take the place of that part of the quarterly cash payment that is taken back by the sale of new shares. Those stockholders who in the past have not exercised their subscription rights could obtain the same overall cash result by selling their stock dividends as received. Those stockholders—the majority, no doubt—who subscribed to the new stock would obtain the same overall result by merely keeping their stock dividends. The latter group would have no income tax at all to pay on these transactions. The former group would pay very small income taxes, on a capital gains basis, as the stock dividends are sold.

According to the Edison Electric Institute, about \$4 billion is to be spent by the industry in 1953 and at least an additional \$8 billion will be spent in 1954-56. Without question, utility stockholders will be called upon to purchase at least \$1 of new stock for each \$1 of cash dividends received. But to the extent that stock dividends are substituted for cash the sale of new stock would be correspondingly diminished—and at the same time the income tax burden on the equity owners would be reduced.

* * *

The case for adopting this kind of policy can perhaps be dramatized by taking an extreme example—that of the American Telephone & Telegraph Co. In 1946-1952 A.T. & T. paid out \$1,800 million in cash dividends at its traditional \$9 rate. During the same seven years it received from its stockholders (and their transferees) nearly \$2,700 million, paid in the first instance for convertible bonds and in the second as additional cash consideration (premiums) for the exchange of the bonds into stock. By the end of 1952 most of the bonds—as well as some previously existing—had been converted, so that the stock and premium accounts alone showed a growth of \$2,600 million.

It is clear from these figures that in the past seven years American Telephone stockholders have effectively paid over to the company a good deal more money than they have received in dividends. To the extent that non-stockholders bought rights or convertible bonds, they were in the same position as if they had bought stock from existing owners. Had the shareholders received the new stock directly from the company in the form of stock dividends—instead of via the combination of cash dividends with con-

Continued on Page 18

Stock Dividends

Continued from Page 3

vertible bond subscriptions and exchanges — *they would have been saved at least a half billion dollars in personal income taxes.*

The mechanism of a stock dividend policy by A.T. & T. is much simpler than one would imagine. The declarations would continue to fix a payment of \$9 annually, but the medium of payment would be in stock valued at \$150 per share. The same kind of dividend checks would be issued as now; but instead of calling for so many times \$2.25 in cash it would call for that many times 3/200ths of a share. The owner could either hold these dividend checks, to add to his stock interest, or else he could cash them by depositing them with any broker or even his bank. The company would presumably set up an agency to cash in or round out stock fractions for its shareholders, at no cost to them.

* * *

The cost of administering such a plan—covering the equivalent of over \$90 million in cash dividends every three months—should be a good deal less than the present elaborate financial operations entail. Stock issued via the stock-dividend route would supersede the following series of steps: (a) Payment of cash dividends; (b) issuance of subscription rights for convertible bonds; (c) transferring such rights when sold; (d) issuing the new convertible bonds; (e) paying interest on and otherwise administering the

convertible bonds; and (f) taking in the convertibles and the related cash premiums and issuing new stock in exchange — the same stock that would have been issued in the first place had a stock dividend policy been followed.

* * *

The idea proposed for A. T. & T. is indeed a revolutionary one. In view of the almost sacred character of this company's quarterly dividend of \$2.25 — a fixture since 1920 — a change might appear unthinkable. This may be true. Nevertheless, it makes better sense than the present enormously expensive shuttling back and forth of hundreds of millions of dollars annually. And if not applicable to A. T. & T., the idea would certainly fit a large number of utilities that are not bound by a particular dividend tradition. Citizens Utilities Co., a small but highly successful enterprise, has followed a combined cash and stock dividend policy with excellent results since 1946. The advantages of the policy have been fully explained to the shareholders.

The stock-dividend concept has a wider application, however, than the "subscription-right" cases we have been considering. Stock dividends should be used also, in a systematic fashion, to supplement a present low cash pay-out in relation to earnings. In the industrial and railroad fields most companies have met their need for more equity capital by holding down their cash dividend rates, rather than by paying full dividends and selling additional common stock. The overall situation in this respect is indicated by the following ratios covering the 200 stocks reported on by Moody's. In 1935-39 the pay-out averaged 81% of earnings; in 1945-49 the pay-out was only 51%. (For rails alone in 1948-1952 the pay-out rate was 37%.)

It is clear from these figures that a large number of companies have been paying out well under half of their earnings. Such a policy may be justified from the standpoint of corporate needs, but it has been unnecessarily hard upon the income and market position of the stockholders. A properly conceived and executed stock-dividend policy can conserve cash earnings for the company's requirements and at the same time give adequate recognition to the stockholders' desire for liberal distributions.