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Which Way to Relief from the Double Tax on Corporate Profits?

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A TAX REFORM BILL is on the way, and it is universally expected to provide some relief from the double dividend tax. Apparently no one supports the principle of the "double bite"; its only excuse is the need for revenue. To eliminate the second tax entirely would cost the Treasury at least \$3½ billion. In today's budget picture so large an annual sum can be neither foregone nor replaced by other levies. Investors must limit their initial hopes, therefore, to partial relief amounting perhaps to one fifth of the total involved. The prediction most generally made is that taxpayers will be allowed a credit against their tax bill of 5 to 10% of dividends received. This type of relief has already been granted by Canada. Others expect a flat exemption of a small amount of dividend income—say 10% or \$200, whichever is less.

Much more effort has gone into condemning the double tax as unfair and destructive than into thinking about the most practicable and desirable forms of relief. It should be borne in mind at the outset that there are two basically different approaches to the problem. The first would tax the corporation only; the second would tax the stockholder only and exempt the corporation to the extent that profits are distributed. Both of these approaches have a background in our tax history, and have analogies in our present tax law. Each also has its own advantages, particularly in the direction of remedying unsound viewpoints and practices that have been generated by the heavy rates of tax.

In this article we shall consider some specific implications of the present system of double taxation, in relation to business and investment policies. We shall not discuss the generally discouraging effect on business enterprise of the heavy combined burden. This is a familiar subject of complaint. Contrariwise, the point should be noted that no substantial contraction in over-all business activity can so far be identified and blamed on the tax rates. This fact may be explained in part by the large nonmonetary or noncalculating component in American business, especially large-scale business—a theme not adequately explored by our economists and sociologists. More important, probably, is the factor of inertia or delayed reaction. Businessmen and investors do not now act as tax logic would have them act, because it takes a long time for an external consideration like tax rates to change ingrained attitudes and habits of business and life.

This will account also for the rather surprising failure of businessmen and investors to adopt specific policies—in the fields of organization form, capital structures, dividend attitudes and procedures, and so on—designed to minimize the tax impact as far as feasible. But, unless the

burden is lightened in the future, it is safe to predict that these adaptations will be made at an increasing rate of speed. If our economy should ever come to be really controlled by tax factors—if all the implications of our tax laws and regulations should be fully reflected in our business and investment activities—the United States would find itself in a pretty pickle.

REACTIONS TO THE CORPORATE INCOME TAX

The corporate-tax portion of the double impost should logically produce two major counter-reactions or tendencies. The first should be the replacement of the corporate form, wherever practicable, by the partnership form—especially the limited partnership form. The second should be the introduction of the largest possible component of interest-bearing securities in the capital structure—preferably, income bonds—in order to enjoy the interest deduction from taxable profit.

There are limitations on the availability of both of these methods of defeating the corporate tax. It is inconceivable, of course, that our large corporations could ever be transformed into any form of partnership. But, when it is recalled that there are some 500,000 incorporated businesses in the United States, covering every possible gradation of size and ownership structure, it becomes apparent that there is room for far-reaching changes in the organizational forms of business. The recent imposition of an excess-profits tax—for the fourth time in about a generation, and in the last three instances applied only to corporations—has given an extra dimension to the gulf between corporate and partnership tax rates.

Years ago incorporation was adopted widely to *reduce* the tax impact on private business. With reinvestment of profits, thus avoiding the dividend tax, and with the corporate levy at the rate of 15% or less, arithmetic clearly favored a corporation over a wealthy partnership. Today, assuming no dividends at all but ultimate realization of profits through a capital-gains sale, the typical corporate proprietor faces a tax of about 63%. In most cases the effective tax burden is even higher.

It is fundamentally unsound to have the corporate and noncorporate forms of business affected by completely different tax systems. We shall comment on this point again later.

Bond interest is tax-deductible by a corporation; preferred and common dividends are not. Thus, if all present dividends could be paid in the form of bond interest, double taxation would be ended. For, by our assumption, whatever was paid out would be free of corporate tax, and whatever was retained would be free of individual tax. There are two ways in which this result could conceivably

be attained. The first is by changing the law to put dividend payments on the same tax basis as interest payments; the second is by changing corporate capital structures so that all but a nominal amount of present capital is transformed into debt—presumably income bonds of long maturity.

The way in which traditional or "institutional" thinking prevents prompt adjustment of policy to new conditions is well illustrated by the failure of corporations to make use of the income-bond device for its tax-saving value. (The generally bad repute of income bonds is a strong factor here, of course, but a few issues put out by really strong companies would go far to break down this barrier). The Treasury and the courts will not permit the income-bond stratagem to be carried beyond certain limits—not as yet clearly defined—but the decisions on record clearly give far more leeway here than corporations are willing to accept.

Our prediction would be that the weight of double taxation will eventually overcome the traditional objections to income bonds—or other debt with "escape clauses" for the issuer—and that, once the new procedure is firmly established, it will spread more and more rapidly. This will serve to create a tax gulf between companies with and those without full-scale debt structures. Such a development could hardly be welcomed. For much too much of apparent earning power and investment value would then depend on the choices made concerning capital structure. Furthermore, the contribution of different companies to tax revenues would vary widely and undeservedly.

This analysis suggests that one of the best ways to grant relief from double taxation would be to allow as large a portion as possible of dividend payments to be deducted from taxable income. If we assume that the Treasury's loss is to be limited at the outset to, say, \$500 million, the initial deduction or credit could be no more than about 10% of the distributions. But just as with other possible forms of relief, this percentage could be increased when and as Congress decides that further reform is feasible.

The end result envisaged by such a policy would be the (approximate) equalization of tax rates for corporations and other business enterprises. For, if all dividends were eventually deductible by the company, and if the regular corporation rate were about equal to the composite individual tax rate on dividends, then the total tax take would be the same, regardless of the amount disbursed—and this take would be the same as from an equivalent amount of partnership or proprietorship income. Readers with long memories will recall that this was the avowed objective and pattern of the original Administration draft of the tax bill of 1936—which was later transformed into the undistributed profits tax provision, on which so much obloquy has been heaped. What started out as potential relief ended as penalty, because the old corporate tax was retained and the new tax added on. If this time the tax relief provisions start out modestly, they would be in no danger of distortion into an additional burden.

Current and recent tax provisions include two precedents for treating dividend payments as tax-deductible by the corporation. One was the deductibility accorded by the

Revenue Act of 1942 to certain preferred-stock dividend payments made by public utility companies. (This was limited to the so-called normal tax.) The other relates to regulated investment companies (mutual funds, etc.) under section 362 of the Revenue Code. Corporations coming under and complying with these special provisions incur no tax on profits paid out to stockholders.

An overlooked aspect of our present tax system is that it makes the Government a 50% partner with corporations in their net profits, but not a part owner of their net assets. Suppose a company can earn just enough *before taxes*—say 10%—to support the realizable value of its capital. After the 50% take these earnings are cut in two, and the value of the business as a going concern apparently becomes only half of what it would be if it sold out or shut up shop. The higher the rate of tax, the greater the percentages of businesses that are worth more asset-wise than earning-wise. An allowance or deduction for a moderate dividend on invested capital *before* dividing with the Treasury would go far to mitigate this unsound factor in the present economy.

RELIEF TO THE STOCKHOLDER

If we turn now to the stockholders' tax position, the most obvious way of easing his burden is by exempting his dividend income from the second tax. For the greater part of our income-tax history—from 1913 through 1935—such exemption was in fact accorded with respect to normal tax but not surtax. The theory was that the corporate tax about corresponded to the normal tax on individuals, so that the credit saved him from two normal taxes. This simple reasoning is no longer applicable in our present complicated system, where the corporate levy itself contains both a normal tax and a surtax, and where the corporate rate is much higher than the individual rate for some stockholders and much lower for others. Nevertheless, it would still be feasible to grant welcome relief by again exempting dividends from the lowest bracket of personal tax—now set at 20%.

There is a special economic distortion created by the present dividend tax, and that is the growing tendency of high-income investors to favor capital gains over ordinary dividend income. Since the maximum tax rate on long-term gains is now 25%, its advantage for high-bracket people is tremendous. This disparity in rates has great capacity for mischief. It can undermine sound distinctions between investment and speculation, create schizophrenic thinking on dividend policies, and set the interests of large investors in direct conflict with those of small stockholders. If the burden of double taxation is to be lightened at all, there would be a special advantage in doing so in such a way as to bridge the tax gulf between capital gains and dividends.

A neat method of accomplishing just this would be to treat all domestic dividends as the equivalent of long-term capital gains. There is a precedent for this in our present tax law, which already provides, in section 362, for "capital-gain dividends." These are distributions made by regulated investment companies out of their own capital gains, and they are taxed at *capital-gain rates* to the receiving stockholders. If this reform were adopted 100%, it would

probably reduce the present tax on dividends by about two thirds, an inadmissible concession to begin with. But any desired measure of relief can easily be accorded by designating some portion of dividend income to be treated as capital gains, the remainder to continue to be taxed as at present. Similarly, if special relief is wanted for the small investor, this could be achieved by giving, say, the first \$400 of dividend income the same tax status as capital gains.

THE TWO APPROACHES COMPARED

If we assume a retreat from double taxation, is it better to reduce the burden on the corporation or on its stockholders? Considerations of equity and broad economic strategy would favor equalizing the tax position of corporate and noncorporate business, except for a moderate franchise tax on companies, in return for their various immunities. Probably the most advantageous method of procedure would be to allow a credit to corporations for dividends paid, similar, on the one hand, to the present interest-paid

credit or, on the other hand, to the excess-profits-tax credit. We have pointed out important collateral benefits from this approach.

From the standpoint of common-stock valuation, relief given to corporate earnings will probably have a more beneficial effect than relief given to dividend recipients. The reason is that the effect of the former can be computed directly in terms of higher earnings per share, whereas a lower tax on dividend income has different results for different stockholders. But any reduction in the combined tax rate must operate to make common stocks more attractive and thus more valuable.

Tax relief to the shareholder is not so logical as equivalent relief to the corporation, but it is likely to have more of a personal or voter appeal. This probably explains why expectations always run in this direction. Even here a strong case could be made for reducing the burden by equalizing the rates on dividends and on capital gains, instead of merely granting a limited exemption of dividends from the regular tax.

1955 p

NEW HORIZONS IN INVESTMENT

by

Benjamin Graham

The word "horizon" presupposes something rather far in the distance. My emphasis, therefore, will be on the long-term future rather than on the immediate situation in securities. My topic can be divided in five parts. First, the future economic background for security investment; second, the indicated long-term investment policy that would be based on such a background; third, opportunities and hazards of such a policy; fourth, the future impact of tax considerations on investment policies; and finally, some future developments in stockholder-management relations.

With regard to the future economic climate, I start with the necessary assumption that there will be no atomic war. This is about the same as saying that the heavens will not fall. But what was once a humorous cliché, in our childhood, has now become, I'm afraid, almost an act of faith.

My second postulate I accept more willingly and not perforce. It is that we shall have a dynamic America, with Gross National Product growing quite steadily through increasing productivity, and supported by government commitments to maintain nearly full employment. I think there is more possibility of large-scale inflation in the future than there is of large-scale unemployment and deep depression.

As a third guidepost to the future, we might use the projections of the Congressional Joint Committee on the Economic Report. These describe the economic patterns that may prevail in 1965, assuming reasonably full employment. They are of course not intended to be a prediction - merely an indication of potential performance, based on carefully chosen assumptions. These projections are, among other things, very encouraging for corporate profits. Here are a few of the relevant figures:

The projected growth in Gross National Product from 1954 to 1965 is 47 percent - to \$535 billion. A breakdown of the components, which includes corporate profits before and after taxes, shows that before taxes corporate profits of \$56 billion are projected for 1965, against \$39.5 billion in 1953 - an increase of 42 percent. A projection of after-tax profits shows \$30 billion in 1965 as against \$18.3 billion in 1954, or a 64 percent increase. Dividends show an increase of 90 percent - \$18 billion as against \$9.4 billion. However, I shall have a caution later on the matter of the dividend factor which, if I am correct, may change that particular figure, or at least the way dividends are handled.

In this analysis, the corporate picture as a whole shows a greater projected rate of growth than that of the other parts of the economy. The larger percentages indicate, to my mind, the indispensable role of capitalism and of corporate profits in furthering the expansion of the United States economy. In spite of the political weakness of American business, it has forged ahead since 1933, and I believe it will continue to do so in the future because the country needs it.

II.

What future investment policy is called for by these optimistic projections? Essentially, it is very much like the policy that has been formulated by most authorities in recent years. Briefly, it can be condensed into a statement that:

The average representative investor will divide his funds somewhere between one-third in government bonds or tax-exempt securities and two-thirds in equity securities, at one extreme; or two-thirds in government securities or cash equivalents and one-third in equities, at the other extreme.

What the actual proportion of equity investment may be will depend on a number of individual judgments, among them expectations concerning the future inflationary potential. It is quite obvious that the people who failed to include common stocks in their portfolios in recent years were very remiss - they did not read the signs of the times, they did not read the convincing evidence of past experience. These speak very strongly for every investor's having a basic common stock component in his portfolio.

On the other hand, you can also go too far in this respect. The possibility of inflation in the future does not mean that what used to be regarded as very definitely excessive levels of the stock market will no longer be excessive levels. I want to stress this point, though it is based more on experience than anything else. When you have security price levels which in the light of the past are very high, there are always "good" reasons for them. One reason readily given as the motivation behind the present bull market, for example, is the inflation factor, and the fact of full employment threatening more inflation. But there is a danger in accepting this explanation one hundred percent, because the time comes when that factor, though it may still be just as true as it ever was, no longer controls stock prices to the same extent that it did. Something else comes in - namely, higher interest rates, or some temporary business setback, or some reappraisal of the situation, and that will cause a break in stock prices.

As far as common stock holdings are concerned, future investments may be viewed as starting from a typical current investment-

fund portfolio. Usually, such a portfolio has a selection of securities such as appear in the Dow-Jones industrial list; an assortment of public utilities - which are, of course, more homogeneous than the industrial list; a relatively few leading railroads; and a fairly wide choice among banks and insurance companies, to the extent that the investor wants to have that type of security in his overall portfolio.

There are obviously many departures from this standard pattern - there must be, since there are thousands of companies not included there, all of which have to be owned by some people. But those departures will require special reasons - not only special reasons but a special equipment in the form of training and skill by the investor. I want to amplify that just a little. I have in mind particularly two types of departure from standard policy. On the one hand, there is the emphasis that might be placed on growth or quality stocks, which are higher-priced in relation to earnings than the typical or representative security. On the other hand, you may have emphasis on secondary or bargain issues, which are relatively low-priced. In either event, investment in those areas should be motivated only by careful thought and adequate equipment.

As far as the high-priced issues are concerned, I feel as a practical matter that it is dangerous for the individual investor to take the stand that if he likes Company A he should buy it regardless of its price. And since he cannot take that stand, it seems very difficult to me to decide just how big a premium he should pay over normal multipliers in order to get a good company. In other words, I do not believe that the field of growth stocks, attractive as it is, is a very practical field for the average investor to operate in continuously over the years.

However, a separate case might be made for a concentration on public utility common stocks by the average run-of-the-mill investor. It might be said that this group occupies a special position. It combines almost a guarantee of adequate stability with a satisfactory rate of growth. The rate of growth will probably not be as large as that which might be experienced in industrial issues, if the selection is especially good or even perhaps only average. But the stability factor will probably be greater. One could very easily justify a determination to concentrate one's equity proportion of the portfolio in the public utility field under present market conditions.

I see no justification, at least in the near-term future, for individual investors to buy corporate bonds and preferred stocks, rather than U.S. savings bonds and tax-exempt securities. The reason is this: The higher yields that might be obtained are not sufficiently attractive to compensate either for the risk incurred -

partly a true risk and partly a risk of market fluctuation - or the amount of skill that is needed in order to get the higher yield without undergoing the greater risk.

As far as investment in foreign enterprises is concerned, I am perhaps a very bad man to speak about it, because I have been down in Wall Street for forty years and the experience of investors in foreign countries in those forty years has, on the whole, been a bad one. It might be argued that it hasn't been so bad financially. But certainly it has been bad psychologically, as a whole. I think we will probably see growing foreign investment, nonetheless. But whether it will turn out to be sound, whether the investors will be happy about it in the future - I am inclined to be somewhat skeptical.

III

My third topic concerns the stock market of the future. What kind of behavior might be expected of it? Can we expect it to parallel fairly closely the performance expected from business? That would mean that it would advance fairly steadily and would experience at worst only minor setbacks.

This is a charming prospect. I think there is a current tendency to embrace it, among people in the stock market. But, personally, I do not believe in it. I think that it is perfectly true that the general rate of growth of American business profits will undoubtedly control the future rate of growth of representative common stocks, their earnings, dividends, and prices. But the fluctuations of the stock market will not be governed solely, or even perhaps predominantly, by the fluctuations of business.

There is a large component of stock market fluctuations that will continue to come from the attitudes of investors and speculators, from the subjective element in stock prices. The excesses of optimism and pessimism will, I am sure, continue to produce the excesses of over-valuation and under-valuation in the market to which we have long been accustomed. The market cycle of the future may prove to be surprisingly independent of the business cycle, and it may even exist if there is no business cycle - which is in itself quite an assumption, but not an entire impossibility. I am not yet ready to give up what has long been my favorite description of Wall Street - "plus ca change" - the more it changes, the more it's the same thing.

Let me try to throw some light - and one or two paradoxical sidelights - on common stock price fluctuations. This subject is actually more interesting and more complicated than any of the problems I have covered up to now.

What we call the excessive price levels reached in bull markets are excessive primarily in the light of experience. They are not excessive by a a priori logic or reasoning. It is easy to prove, to any professor's satisfaction, that dividend yields should properly be no higher than bond yields. - the phenomenon that you find at the top of bull markets. You could well argue that a representative stock investor, at those prices, receives not only the same income he would get from bonds, but in addition gets the benefit of re-invested earnings, a participation in the growth of the country, and a protection against inflation. And it is easy to argue, therefore, that if you have a good stock that yields you the same amount as a bond, you have a better investment than you have in a bond.

Undoubtedly, reasoning of this kind is implicit in the recurrent willingness, not only of speculators, who may be called the heedless type, but also of fairly conservative and experienced investors, to buy and hold stocks at the top of each successive bull market. This gospel of "the good stock", because it has a good deal of persuasiveness, almost conviction, to it, finds ready acceptance in bull market periods.

Past experience, on the other hand, shows clearly that the "normal" or "average" price of common stocks tends to be well below this theoretical long-term value. The reason for it is easy to understand. There is an element of "insurance premium" that enters into the common stock picture. In normal times the investor insists on being paid something extra above value for assuming the psychological hazards of a stock program - hazards associated, first, with temporary market shrinkages in securities as a whole, and secondly, with the possibility of a permanent or semi-permanent loss of value in some of his individual commitments. The market pays the investor a special premium for such risk-taking - a very substantial premium above the actuarial exposure to risk.

There is an interesting and very close analogy here to the field of casualty and fire insurance rates. Fire insurance companies receive premiums equal to about twice their actual loss experience or exposure (exclusive of operating expenses). You pay that extra premium - the word premium itself is an interesting word, it really means an amount paid in excess of calculated risk - you pay this premium willingly to be relieved of the psychological hazards involved in having an uninsured house, or automobile.

In a somewhat converse but analogous way, in normal or average markets the stock investor obtains a similar extra premium or reward for his gumption, aggressiveness, and so on, in going into stocks, as against the bond investor. My theory is that this inherent over-estimation of common-stock risks will continue to be a feature of the stock market over the long pull.

To some degree it is the consequence of the very instability of investors' thinking - the very variation in investor confidence - which leads them to view the picture through rosy glasses one year and through dark glasses the next year. This truly subjective element detracts from the objective or independent quality of common stocks as a whole, and creates what I like to call the "built-in discount factor" in common stock prices.

There is a second paradox related to the structure of common stock prices that I would like to point out. Under the modern attitude toward common stock valuations, the higher the quality of a company the more inescapable is the speculative component in its price, and the more subject it is to wide price variations.

The value of a common stock has come to be defined and accepted as being based upon the future earnings of the business capitalized at a rate appropriate to the quality of the company. When we are dealing with a very strong company we are dealing with a company in which there is the greatest confidence both as to the growth and stability of its future earnings. Hence the willingness exists to capitalize these earnings on an extremely liberal basis.

But both of these judgments are essentially subjective. There is no way in which anyone can tell precisely what those future earnings are going to be. Much less can you tell precisely what the correct capitalization rate is to apply to such earnings.

My own method for finding a "normal multiplier" is to take a group of securities like the Dow-Jones Industrials as a whole, which is a better than average group of stocks but does not consist of only the very best. A multiplier about equivalent to twice the long-term interest rate on high-grade bonds would yield a pretty good idea of the normal value of this group. That multiplier should be applied to ten-year average earnings rather than to single-year earnings, which cannot be accepted as the basis for sound valuation. This procedure would currently yield multipliers of between 15 and 17 for the Dow-Jones group.

One might say that securities of a better quality than this list as a whole would be entitled to a higher rate. But I have found from experience that when you get beyond a multiplier of 20 you are definitely moving over into the subjective or speculative area. You are beginning to rely a good deal on what investors are likely to think of your stock in the future. Conversely, of course, companies of poorer quality than the Dow-Jones list may be expected to have lower multipliers, going down to as low as 10 or 8.

You can also value good stocks not by taking past earnings and applying a high multiplier, but by taking estimated future earnings which are high and using a normal multiplier. Now what actually

happens - the way the stock market often does it - is to estimate high future earnings and to use a high multiplier in addition. There is then a tendency to count the same trick twice. As a result, you find that the larger part of the price of high-grade companies may reflect merely the subjective views of the investors, and the degree of confidence that they have at the moment in the future of these companies. That is the characteristic which is subject, inescapably, to a wide degree of variation. The psychological mood of people changes more drastically than anything else in finance. Human nature changes least of all. So what you have is a combination of great fluctuations in the mood of investors, and practically no change at all in their essential characteristics. That is the "built-in destabilizer" of the stock market - the factor that can make for market fluctuations irrespective of overall economic stability.

Let me add just a word as to the role of mutual funds in this picture. I think that on the whole they will be a strengthening element rather than a weakening element in the future, in comparison, at least, with the ownership of the same securities by individuals. The easiest way to talk about this is to compare the typical public owner of a mutual fund security with him as the direct owner of the same securities in the fund's portfolio. I think he is much more likely to sacrifice his direct security and act unwisely in relation to it than he is to act unwisely in relation to his mutual funds. An there are reasons for it - especially because it is much easier to be scared about one security that you own than it is to be scared about a hundred.

IV

We must turn now to a discussion of the impact of tax considerations on investment policies and corporate policies in the future. One of my primary reasons for cautioning against thinking that the stock market will be stable in the future because it looks as if the business scene will be stable, is the inexcusably slow reaction of both investors and corporate managements to the impact of tax developments over the past twenty years or more. My point is that if it is going to take more than thirty years for investors to realize what the new tax structure actually means for investment and corporate policies, it might take them another thirty years, or fifty years, before they realize that common stocks are really as good as we may feel they have already proved they are. We have to allow in our thinking for that long a time lag.

We are just beginning to realize that the basic 52 percent corporate tax rate, plus individual tax rates reaching 50 percent on a taxable income of \$18,000 for single individuals - that those large rates require rethinking both as to corporate financial policy and investors' attitudes, in comparison with the habits of, say, 1925 or 1900.

Business is now developing some ways of escaping - legitimately, of course - the double tax on corporate earnings. To a small extent this escape may come from statutory relief such as under the 1954 tax bill, which received so much attention. That was a very minor amount of statutory relief. Yet it has already generated considerable political reaction against it, and it seems to me that not a great deal can be expected in that area.

To a much greater extent, I believe, this escape will develop out of a change in corporate and investor policies - a change which will not be interfered with by Congress or by the Treasury because Washington has a bad conscience on this matter of double taxation of corporate profits.

If either the corporate impost or the individual impost on earnings can be saved, the net result is typically a doubling of the effective income of the present stockholder. That is a very important objective, and I think that the inducement is so great that the people in Wall Street will finally be moved to do the correct things instead of the foolish things in corporate policy, in spite of their laziness in thinking and acting.

This escape will take one of two forms: either escaping the corporate tax on some of the earnings, or escaping the individual tax on those earnings. The saving in corporate taxes will be effected by the substitution of debt - primarily income debt - for preferred stocks and for guaranteed or preferred securities; and to some extent, I believe, by the substitution of a certain degree of debt for common stocks in present, all common-stock capitalization structures.

1. Corporations have been accustomed to use preferred stocks in place of income bonds because preferred stocks were not a contractual obligation for either interest or principal, and bonds were. It seemed to be, and of course it was, more prudent for corporations to issue preferred stocks if they could sell them at reasonable prices. There is now a penalty on this which did not exist thirty years ago, namely, that it costs the corporation twice as much for its money when it sells preferred stock as when it sells a bond with the same interest rate.

It's interesting to note, first, that most bonds carry lower interest rates than preferred stock, so that the actual ratio is even higher than two to one in cost. Secondly, the income bond that has been developed now virtually relieves the corporation from any important or serious obligation that is heavier than exists in a good preferred stock; because the interest has to be paid only if earned, the principal is due many years hence, and the income tax saving itself can be used to pay off the principal, so that by the time the maturity arrives you have nothing to pay off. The tax

saving on an income bond, if substituted for a preferred stock, will, if used as a sinking fund, retire the entire principal amount of the security within about a 22-year period in a typical case.

This combination of factors has, I think, very great advantages for a corporation. For the individual investor there are advantages too. He of course tends to have a somewhat better security in a typical income bond than in a typical preferred stock of the same kind of corporation. That does not mean that a preferred stock of a strong corporation is not as good as an income bond of a bad one. But in the same situation, the income bond is somewhat better because there is somewhat more assurance of regularity of interest payment even though the corporation may not absolutely have to pay it. And eventually I think you will see - and this won't take very long - that income bonds will be appraised in terms of the actual financial position of the corporation issuing them instead of in terms of the prejudice against the income bond as a vehicle itself or as a form of security. The individual pays no higher tax on income bond interest than he does on preferred stock - except for the small credit allowed in the 1954 law - and the differences in yield are a pretty minor matter as it stands now. Corporations, of course, have a greater tax advantage in owning preferred stocks as against owning income bonds, but there are not many corporate owners of importance of preferred stocks.

The substitution of income debt for preferred stock (and of other debt for guaranteed stocks), is already in full swing in the railroad field. One of the astonishing things, to me, is the rapidity with which railroads have been substituting income bonds for preferred stock in the last year or two. I have had some personal contact with it because I am a director of the Western Pacific Railroad and we were the first railroad to retire our preferred stock and issue income bonds in place of it. I foresee the fairly rapid extension of this development to non-railroad companies. But it will require the abandonment by investors of their prejudice against income bonds, which they have generally felt are inferior in quality to preferred stock - a prejudice which grew out of the fortuitous circumstance that, in the past, income bonds were mainly the product of railroad reorganizations and therefore a product of financial troubles of the companies involved.

2. The other avenue of escape from double taxation for individuals is via the acceptance of stock dividends - or even no dividends - in place of cash dividends. In the dynamic parts of our corporate economy, notably in the public utilities field, the present practice of paying cash dividends and then taking the same money back from the same people through the sale of new common stock is really a very ingenious device for paying double taxes without any necessity or real excuse. It should be borne in mind that large-scale corporate expansion is an essential ingredient in any future

prosperity and employment, and consequently many corporations will need in the future, as they have in recent years, to continue to increase their equity capital regularly. I am sure that before too long they will devise practical and painless measures for substituting periodic stock dividends or perhaps some other device for the customary but quite irrational practice of paying cash dividends subject to personal income tax, and then selling the equivalent amount of stock to the same people who get the dividends.

I am well aware that in the past investors had a very large preference for dividends, especially as compared with undistributed earnings. My studies show that in the past the ratio was as high as 4 to 1, for the value of a dollar of distributed earnings against undistributed earnings. But I think that this is changing. It may change very rapidly, and this development will be aided by the device of the periodic stock dividend, which is a very convenient way of letting the stockholder eat his cake and letting the corporation have it too. I believe that this device, when its practical merits are understood, will eventually reach the stage where the stock dividend will be accepted as fully equal to a cash dividend.

To understand this point better, let us take public utility common stockholders as a whole. It should be quite obvious that they do not buy their stocks for income. While they may think they buy them for income, they do not do so in actual fact - that is, for income to live on - because practically all the utilities are constantly offering additional stock to their stockholders, and these are using their money - their dividend money, let us say, diminished by taxes - to buy the additional shares. The greater proportion of stockholders are doing that. In the case of Pacific Gas and Electric, for example, about 60 percent of their stockholders actually exercise these recurrent rights. That really means that these stockholders have to put up twice as much money, or more, for the new stock than they're getting in dividends. There are a number of individual cases, of course, where people do need dividend income for living purposes. But I think that if anyone took a census he would be surprised at how few there really are in relation to the total. These people could easily get the equivalent of their cash income, by selling their stock dividends currently; and not only would they get the same income but they would have to pay a very small tax indeed on the proceeds as against paying a larger tax on an equivalent amount of dividends.

As a sidelight on this issue, I might mention the recent successful sale of stock issues in Canadian investment funds, where the investor is told that he will not receive any dividends at all. Yet he is happy to buy on that basis, because all his profits will eventually be realized in the form of capital gains subject to a much lower tax. The amusing thing about it is that it all depends on the language used to sell and the consequent attitude of the

investors. For, if another company came along and said, "I have good news for you stockholders - we're not going to pay you dividends any more," the reaction would be completely different.

There is an additional important factor in the business picture which is in part related to the tax situation but mainly to other considerations. In the past few years new capital spending has been pretty well pegged at the enormous figure of some \$25 to \$28 billion annually, which is about five times the 1939, or pre-World War II level. This is beginning to have a consequence in the corporate field, and the field of investment security values, which some of us foresaw a number of years ago and which we were surprised to see so long delayed. That is a tendency, developing apace, for profitable, prosperous, expanding companies to acquire smaller and less profitable ones as a partial substitute for the construction of new facilities and other types of expansion. Most of these acquisitions have been possible at a price far below the present construction costs of new fixed assets. In addition to acquiring the assets themselves, not perhaps of an ideal character but nevertheless usable, at a low cost, the acquiring corporation obtains an established sales volume, experienced personnel, and other advantages.

This trend is important for the more sophisticated investors to watch. It represents, in effect, a partial offset to the contrary tendency for profitable companies to sell at increasing premiums in the stock market, while the less profitable companies tend to sell at increasing discounts - I refer to premiums or discounts from book value or from any other established norm of value.

To an important degree the tax factor also enters into this picture of corporate acquisitions. It is not only the operating losses of the past, but even losses in going-concern value as against cost or other income-tax-base values, which may be recouped to the extent of about 50 percent by various types of permissible inter-business deals. This factor tends to mitigate to some extent the shrinkage in value of unprofitable businesses. What I am really driving at is the fact that, in theory, any corporation which started out with dollars of value and now has only 60 percent in going-concern value can in one form or another recoup one-half of that loss through the proper arrangements with other corporations. That is very theoretical, but it has a number of practical implications which the experienced investor should watch rather carefully.

V

My final point is related directly to the subject of non-prosperous businesses. I see on the investment horizon a slow development of a commonsense attitude in the field of management-stockholder relations. The present flurry of proxy battles and endeavors to capture control of businesses are indications of something approaching a stockholders' revolution. The issues are easily confused by personal factors and by personal attacks of all sorts, but at the bottom they are quite simple. Stockholders have a right to ask for efficient management and for successful results within the limits imposed by the economics of their industry. If the results are not satisfactory, the least the management can do is to show convincingly that it is aware of the fact, and that it is making every effort to remedy the situation.

As I see the future - and this is quite a jump ahead to far horizons - we shall gradually develop some simple and workable criteria to determine whether or not a company is being properly run, and then certain standard procedures for remedying the situation where it needs to be remedied. For countless years past it has been customary for the disgusted stockholders of a badly managed company to part with their shares. In the future, the stockholders of such a company may decide instead to part with their management.

To sum up what I have had to say: Barring atomic war, I see a generally favorable future for long-term investment, particularly investment in common stocks, which is now about the only interesting part of the whole field. My one unfavorable prognosis is that we shall continue to have bull and bear markets in the future as in the past, and that for every 10 percent of over-valuation in bull markets we are still likely, as before, to see a corresponding 10 percent of under-valuation in the succeeding decline. I predict a gradual but decisive change in corporate practices and in investment policies, to adapt both of them to the realities of our tax structure. I foresee also an important movement in the direction of a more effective check by stockholders on the stewardship of corporate management.

The Stock Market Situation

By BENJAMIN GRAHAM*

Chairman of Graham-Newman Corporation
(a registered investment company)

Adjunct Professor of Finance,
Graduate School of Business, Columbia University

Mr. Graham analyses the present level of stock prices based on relationship between price and value, and causes of the market's rise; and suggests methods of controlling excessive speculation. Maintains that while stocks are not as high as they look, nevertheless on the basis of various quantitative criteria the prudent investor should lighten his holdings. Asserts the fundamental reason for the market rise since September 1953, was the swing from doubt to confidence, with public's emphasis concentrated on opportunities rather than risks in common stocks. Contends that net result of possible abolition of capital gains tax cannot be foretold, suggests President might be given power to make changes in effective rate, within specified limits.

This statement will address itself mainly to three points:

(A) The present level of stock prices from the standpoint of the relationship between price and value.

(B) Causes of the rise in the market since September 1953.

(C) Feasible methods of controlling excessive speculation in the future.

(A)

The Present Level of Stock Prices

Common stocks look high and are high, but they are not as high as they look. The market level of Industrials stock is far above the 1929 high as shown by the Standard & Poor's index of 420



The Dow-Jones Industrials are now at a lower ratio to their average earnings in the past than they were at their highs in 1929, 1937 and 1943. The same applies to General Electric as an individual stock. It is clear that the issues referred to—which may be considered as reasonably representative of the larger Industrials as a whole—have a considerable way to go before reaching the ratios shown at their former tops. It should be pointed out also that high-grade interest rates are now definitely lower than in previous bull markets except for 1946. Lower basic interest rates presumably justify a higher value for each dollar of dividends or earnings.

Much has been made of these relationships as indicating that the market is still on safe ground. However, such comparisons fail to take into account the extent of the subsequent declines from

10 years ending in 19 obtain average earnings include any period of depression. In a sense the soundness of this Central Value is bound our ability to escape a business depression in the we have in the recession is probably fair to say market is not too high we have really managed the business cycle.

Although such a break with the past prepared to deny its There is some reason including that in the future depressions will be not by the natural American business, the governmental intervention of inflationary above analysis is by unfavorable to the of stock prices. If reaching my overall on the subject, I am

All of it.

NOT NEW I

Benjamin Graham

(The present figure is above 300 as compared with the 1929 high of 195.) The Dow-Jones Industrials Average at about 410 is now only moderately above its 1929 high of 382, but the difference would be much larger except for the substitutions made in the Average. However, the railroad and utility issues as a whole are well below their 1929 highs.

The true measure of common stocks values, of course, is not found by reference to price movements alone, but by price in relation to earnings, dividends, future prospects and, to a small extent, asset values.

Present concepts of common stock valuation turn largely on estimating average future earnings and dividends and applying thereto a suitable capitalization rate or multiplier. Since these elements are all matters of prediction or judgment, there is room for a wide difference of informed opinion as to the proper value for a single stock or group of stocks at any time. Uninformed or speculative opinion will, of course, cover an even wider range as the market swings from the depth of pessimism to the heights of optimism.

As a guide to identifying the present level of stock prices in the light of past experience, I have made two sets of comparisons—one relating to the Dow-Jones Industrial Average, the other to General Electric, a component of that Average and an outstanding "blue chip" issue. I have related the present prices and the high prices in 1929, 1937 and 1946 to earnings of the preceding year, the preceding five years and the preceding 10 years. This information, together with certain other data, appears on the appended table.

*Mr. Graham's statement at the Hearings on the Stock Market Study before the Committee on Banking and Currency, U. S. Senate, March 11, 1955.

past Dow Jones Average lost 90% of its price from 1929 to 1932, it is evident not only that 381 was much too high in 1929, but that the market had entered dangerous ground at a point far below that figure.

I have found it useful to estimate the "Central Value" of the Dow-Jones Industrial Average by the simple method of capitalizing 10-year average earnings at twice the interest rate for high-grade bonds. This technique presupposes that the average past earnings of a group of stocks presents a fair basis for estimating future earnings, but with a conservative bias on the low side. It also assumes that by doubling the capitalization rate presented by high-grade bonds, we allow properly for the differential in imputed risk between good bonds and good stocks. Although this method is open to serious theoretical objections, it has in fact given a reasonably accurate reflection of the Central Value of Industrial common stock averages since 1881. It may be interesting to note that the Central Value found by this method in 1929 was 120, which happens to be about the geometric mean between the high of 381 and the subsequent 1932 low of 41. Similarly, the Central Value in 1936 was 138 (higher than in 1937) and this proved to be about the mean between the 1937 high of 194 and the low of 99 in 1938.

A Reassuring Measure

This mechanical method applied to the situation in the beginning of 1955 yields a Central Value for the Dow-Jones Industrials of 396, or only slightly under their present value. Such a figure, if reliable, would have to be regarded as rather reassuring. It would indicate that the market in terms of value is no higher now than it was in early 1926, or in early 1935, or late 1945. However, the validity of this Central Value figure may be open to question if we observe that the

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10 years ending in 1954, used to obtain average earnings, did not include any period of real depression. In a sense, therefore, the soundness of this appraisal of the Central Value is bound up with our ability to escape serious business depression in the future as we have in the recent past. It is probably fair to say that the market is not too high today if we have really managed to lick the business cycle.

Although such a development would involve a revolutionary break with the past, I am not prepared to deny its possibility. There is some reason for concluding that in the future serious depressions will be prevented, if not by the natural vitality of American business, then by governmental intervention and possible inflationary moves. The above analysis is by no means unfavorable to the present level of stock prices. However, in reaching my over-all conclusion on the subject, I am inclined to

hark back to the analysis I made of the stock market in October, 1954, at a time when the Dow-Jones Average stood at 185. (This was published in "The Commercial and Financial Chronicle," Oct. 18, 1945.) I should like to quote intact the Summary appearing at the end of that article and state that it expresses my view with respect to the stock market today.

"The three different approaches used in judging the present level of stock prices have yielded diverse indications. From the first, or historical approach, the market appears distinctly on the high side and vulnerable to a substantial setback. Contrariwise, our second category—that of appraisal based on figures and formula—about supports the present level, and suggests that the familiar bull market enthusiasm might well carry prices considerably higher. Our third approach, through guesses and projections as to future developments, sup-

plies plenty of material but is definite verdict.

"What is the net significance of this analysis for the speculator and the prudent stock investor? Let us define the speculator as one who seeks to profit from market movements, without primary regard to intrinsic values; the 'prudent stock-investor' as one who (a) buys only at prices amply supported by underlying value, and (b) who determinedly reduces his stock holdings when the market enters the speculative phase of a sustained advance.

"This speculative stage, we are convinced, is now at hand. Hence, the principles of the prudent investor will require him to lighten significantly his holdings of common stocks — the precise selling policy to depend, of course, on his individual position and methods. For the stock speculator we can say little that is helpful. We think he has a fifty-fifty chance

Continued on page 22

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March 25, 1955

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2975
HEARINGS
BEFORE THE
COMMITTEE ON BANKING AND CURRENCY
UNITED STATES SENATE
EIGHTY-FOURTH CONGRESS
FIRST SESSION

ON
FACTORS AFFECTING THE BUYING AND SELLING OF
EQUITY SECURITIES

MARCH 3, 4, 7, 8, 9, 10, 11, 14, 15, 16, 17, 18, 21,
22, AND 23, 1955

Printed for the use of the Committee on Banking and Currency



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General Wood. I think it is very good. You put your finger, as I expected you would, on the one potential weakness, which is that if somebody gets control of these big funds for selfish purposes, it would be bad.

The CHAIRMAN. That is right.

General Wood. All I can say is I think I have indoctrinated my associates and directors and officers pretty well, so that I know nothing will be done in the next 10 years. After that time I cannot answer for it.

Senator BRICKER. May I express a word of appreciation to General Wood for coming here and the information he has brought to us. It is an example of one of the great American industries.

The CHAIRMAN. Thank you very much, General. The next witness is Mr. Benjamin Graham, chairman and president of Graham-Newman Corp., of New York. Mr. Graham, we are very happy to have you this morning and are looking forward to your testimony.

Would you care to read your statement or would you rather summarize it?

**STATEMENT OF BENJAMIN GRAHAM, CHAIRMAN OF THE BOARD,
GRAHAM-NEWMAN CORP., NEW YORK**

Mr. GRAHAM. I would prefer to summarize it if I may.

The CHAIRMAN. Fine.

Mr. GRAHAM. But in the first place may I make a correction?

The CHAIRMAN. Yes.

Mr. GRAHAM. The correction is to the effect that I am not president of Graham-Newman Corp., but chairman of the board. I would like to add, if I may, I am also chairman of the Government Employees Insurance Co. of this city, which is a smaller but rather vigorous competitor of General Wood's Allstate Insurance Co., and we have paid Sears, Roebuck the compliment of patterning our profit-sharing plan very closely on theirs.

I have tried in the statement to deal with three factors: First, the question of the present level of stock prices from the standpoint of the relationship between price and value. Secondly, causes of the rise in the market since September 1953; and, thirdly, feasible methods of controlling excessive speculation in the future.

With respect to the present level of stock prices, my studies lead to the impression that leading industrial stocks are not basically overvalued, but they are definitely not cheap; and they are in danger of going over into an unduly high level.

I would like to add on this point while I deal in my statement with leading industrial stocks I am going to be criticized for not taking into account the fact that the stock market is made up of many hundreds of issues which have different price patterns. The fact remains in the last year or so the market pattern has been more uniform, I think, than it has been in most markets, and the level of advance in the market price has been fairly evenly distributed over all types of stocks—both the leaders and secondary issues.

With respect to the causes of the rise in the market since September 1953, my statement indicates I would emphasize very much the change in investment and speculative sentiment, more than any change in basic economic factors. I wanted to point out that that carries an

element of danger because a change of sentiment for the better may be followed by a change in sentiment for the worse.

Finally, in regard to the feasible methods of controlling excessive speculation in the future, I am in sympathy with the action of the Federal Reserve in increasing margin requirements as speculative activity increases.

I feel in general speculation on margin is expensive to the public, and is sound only when it is practiced by people who have a great deal of experience and a great deal of ability.

I also have an idea with respect to temporary modifications of the capital-gains tax if it appears desirable to increase the supply of stocks for a temporary period of time.

I would rather answer questions from this point on instead of going into more detail about my statement.

The CHAIRMAN. Thank you very much, Mr. Graham. In connection with your own company, does it invest in a representative sample of the best stocks in the market, or does it use some other guide for investment?

Mr. GRAHAM. No. We have not been purchasing the market leaders. Our business has been something of a specialty business. We have emphasized the purchase of securities selling under intrinsic value, and have gone to what is generally known as a special situation.

The CHAIRMAN. Would you describe that for us—for our information. You understand you are talking to a committee—at least the members who you notice are present now—who know very little about this. Would you tell us what specialty situations are and how you approach it? How do you determine whether a special situation is undervalued or not?

Mr. GRAHAM. There is a slight distinction between an overvalued security as such, and a special situation. I shall try to make that distinction clear.

In the first place, with respect to a special situation as it is known in Wall Street. That is a security which upon study is believed to have a probability of increasing in value for reasons not related to the movement of stock prices in general, but related to some development in the company's affairs. That would be particularly a matter such as recapitalization and reorganization, merger and so forth.

For example, the typical example of the special situation is a company in trusteeship undergoing reorganization. Because of the fact that it is in trusteeship, the securities tend to sell at less than their intrinsic value. When the reorganization is completed, the proper value is established and there will normally be a profit in the purchase of such securities. There are other examples of that kind. The public utility breakups were a very interesting generic group of securities, because we had an underlying situation in which these holding companies, being in ill favor in general with the investing public, tended to sell at less than the value of their constituent companies, and when they were broken up the value of the constituent companies in the market greatly exceeded the value of the holding company shares.

With respect to undervalued securities in general, not special situations, that would be based upon a process of security analysis, which shows by a study of the company's balance sheet and income account that it is selling for considerably less than its intrinsic value, which

in general can be defined as considerably less than the value of the company to a private owner.

The CHAIRMAN. How do you evaluate management?

Mr. GRAHAM. Management is one of the most important factors in the evaluation of a leading company and it has a great effect upon the market price of secondary companies. It does not necessarily control the value of the secondary companies for the long pull because if the management is comparatively poor there are forces at work which tend to improve the management and thereby improve the value of the company.

The CHAIRMAN. When you go into special situations and buy large blocks, do you usually try to get control of the company?

Mr. GRAHAM. No; that is very exceptional. I would say out of about 400 companies that we may have invested in in the last few years, there would not be more than 3 or 4 in which we would have had any interest in acquiring control.

The CHAIRMAN. You would have if you thought the management was bad, would you not? I mean that would be one of the principal elements in that case?

Mr. GRAHAM. That could be a reason for our seeking control, hoping to improve the management situation.

The CHAIRMAN. How do you go about acquiring large blocks without disturbing the market too much? Do you do it in your own name, or what is the procedure?

Mr. GRAHAM. Well, there are two procedures. One is to acquire shares in the open market over a period of time. The other is by making a bid for a specified or unspecified number of shares, which is made public and which all stockholders have an opportunity to accept.

The CHAIRMAN. What I mean is, I assume that you specialize in special situations. You analyze it and after considerable work, I take it, you decide that it is undervalued and it is a good special situation. You start buying in the market, and you reveal your interest and everyone knows what you are doing. I wondered how you proceed.

Mr. GRAHAM. That could happen, but very often it does not. May I give you an example of that, Senator. In a book I wrote, *The Intelligent Investor*, I gave an example of an undervalued security, the Northern Pacific Railroad stock, which at the time of my first analysis sold at 20 and later went down to 14. We decided to buy a fair amount of stock. I should say that after reading the book once or twice I convinced myself the shares should be bought. We went ahead and acquired about 50,000 shares of that stock in the market with comparatively little effect upon the price.

The CHAIRMAN. Were there a lot of shares of that?

Mr. GRAHAM. There were about 21½ million shares altogether.

The CHAIRMAN. That is a pretty big company?

Mr. GRAHAM. Yes, indeed, but that was a large investment for us. But there are other instances in which where companies are smaller it is not equally feasible to acquire shares in the open market, and it might be desirable to make a bid or offer, as it is generally called, to acquire shares in some public way.

The CHAIRMAN. You make no effort to conceal your interest in a special situation or to deal through trust companies or other accounts?

Mr. GRAHAM. Well, in most of our purchases, the vast majority of

them, we purchase shares the same way as anyone else would through brokerage houses, who act for us, and there is no concealment.

The CHAIRMAN. To your knowledge are there many instances of concealment of the purchaser in acquisition of stock?

Mr. GRAHAM. Well, you might say that virtually all of the companies that are acquired in the open market—I mean where control is acquired in the open market, in virtually all these cases there is some degree of concealment. That is to say, nobody publishes the fact that he and his group are acquiring control in the open market. It would obviously be unwise from a business point of view. Sometimes the news gets around, but it is generally unofficial. There have been a few instances, comparatively few, in which efforts are made to acquire control of a company generally through a reputable bank or trust company where the name of the purchaser is not revealed; in other cases it is revealed.

The CHAIRMAN. We have had suggestions that this is done, and I was wondering what the process is and whether or not you do it or have done it. I wonder if you could describe for us the way you can acquire control without revealing your identity, not applicable to yourself necessarily. How would anyone do it?

Mr. GRAHAM. Well, outside of the method of acquiring control in the open market, which as I said before is the more customary way, the other method would be to ask a bank or trust company to communicate to the stockholders an offer to buy the shares, generally at a price above the market, and state that the acquisition is being made for clients of the trust company, without giving their names.

The CHAIRMAN. There is no requirement if a trust company purchases stock on the exchange to reveal the beneficial owner; is that right? They do not have to say, "We are buying this for Mr. Jones or Mr. Smith"?

Mr. GRAHAM. No, obviously not, sir.

The CHAIRMAN. So that that would be the usual way, simply to use an established firm which is in and out of the market, for your agent to purchase for you?

Mr. GRAHAM. Yes. That would not be a trust company. Normally that would be a brokerage firm.

The CHAIRMAN. Does a broker have to reveal who his principal is?

Mr. GRAHAM. No. On the contrary, it is one of the basic principles of Wall Street that the relationship between the broker and the client is confidential and the name should not be revealed except to authorities who have a legitimate reason to ask for the information.

The CHAIRMAN. Well, that is an important exception. What about a trust company? If the Chase National Bank purchases shares and they are asked by the president of the exchange whom they are buying for, do they tell him? Is it same as the broker?

Mr. GRAHAM. The president of the New York Stock Exchange has no authority over anyone except members of the New York Stock Exchange.

The CHAIRMAN. Well, then, there is a difference. As to the brokers, he has access to the beneficial owner, but he does not have as to the trust company. Is that right?

Mr. GRAHAM. That would be true with respect to the president of the stock exchange, yes.

The CHAIRMAN. Who would have control, the SEC?

Mr. GRAHAM. As a reservation, I am not certain the constitution of the stock exchange gives the president the power to ask the brokers for the names of their clients or their dealings, but I assume that in the investigations that the stock exchange makes into its own dealings, including such things as manipulation and so forth, such information is asked for and given.

The CHAIRMAN. I understood that with regard to the members for disciplinary purposes they have the right to inquire, but I would not be too certain about that.

Mr. GRAHAM. I believe that is so, but I am not sure.

The CHAIRMAN. When there is a battle for control of a company, the stockholders who intend to remain with the company would want to know whether they should participate in the battle or should sell out, and the identity of the purchaser would be important to them in such circumstances, would it not?

Mr. GRAHAM. Well, if you are speaking of a battle for control in terms of a proxy battle, of course, the identity of the people who are endeavoring to obtain a majority of the votes by proxy solicitation is absolutely vital, and the proxy rules require that complete disclosure be made of the identity of such persons. With respect to purchases of shares, however, that is an entirely different matter, and the theory of the stock market is that people are allowed to purchase shares anonymously. It will be a little embarrassing for many people if each time they bought or sold shares their identity would have to be revealed.

The CHAIRMAN. Of course, it is not done customarily, but it is subject to being revealed in an investigation at any time, is it not?

Mr. GRAHAM. As far as I know, the revelations of purchasers of shares have been limited pretty much to criminal activities. I do not recall cases in which the names of buyers have been revealed, even though they may be known to the authorities, merely because these people happen to have bought stock.

The CHAIRMAN. Do you recall the Lawrence Portland Cement Co.? Did you make an attempt to gain control of that company?

Mr. GRAHAM. Yes; in association with other people, who at that time, I believe, were either the largest or second-largest holders, we made a bid for a specified number of shares.

The CHAIRMAN. How did that work out?

Mr. GRAHAM. It did not succeed. The price advanced above our bid price, and consequently we did not get any quantity of stock.

The CHAIRMAN. Do you think that was an instance of their having known that you were interested and having great respect for your judgment, and it went up before you could get control?

Mr. GRAHAM. No. On the contrary, what happened was that the company itself went into the market and forced the price up above our bid price.

The CHAIRMAN. Well, I do not know how it could have been otherwise. You could not have purchased that amount in open market, could you?

Mr. GRAHAM. No, but we made a blanket offer to the stockholders to turn in their stock to us at a given price, which was above the market at the time the offer was made.

The CHAIRMAN. What was your offer?

Mr. GRAHAM. I think it was \$26 a share.

The CHAIRMAN. When was that?

Mr. GRAHAM. Four years ago, perhaps.

The CHAIRMAN. What is it selling for now?

Mr. GRAHAM. I do not know.

The CHAIRMAN. Has it been split?

Mr. GRAHAM. It has advanced, and the name has been changed.

The CHAIRMAN. What is the name of it now?

Mr. GRAHAM. Dragon Portland Cement.

The CHAIRMAN. I am told that, allowing for the split, it is now selling for \$130 a share. That vindicates your judgment, does it not?

Mr. GRAHAM. I wish we had been able to buy it; yes.

The CHAIRMAN. Was it true that in that case you got no stock at all?

Mr. GRAHAM. No; because our offer was a contingent offer. We made an offer to the stockholders to buy their shares at a price above the then market, provided a sufficient number of shares would be deposited. What happened then was, as I said before, that the officers of the company, not wishing this bid to succeed, went into the market and pushed the price of the stock above our price. As a result, people did not turn in any number of shares to speak of, and we dropped the whole thing.

The CHAIRMAN. I am not sure—do you wish to discuss these individual cases or not?

Mr. GRAHAM. Well, I have no strong feeling on the matter. I do not know to what extent it would be useful to the committee. If it is useful to the committee, I have no objection.

The CHAIRMAN. I do not wish to embarrass you about it. I had understood that it was quite all right. The only purpose is that we have had a number of people here who have discussed general principles. None of them, I believe, were what we call active traders. I suppose that is what you are, is it not?

Mr. GRAHAM. Well, we do not consider ourselves as traders in the ordinary sense. Technically you might call us that.

The CHAIRMAN. What I was trying to do was to illustrate procedures that are followed by people actually in the market. If you do not care to be questioned about individual cases, I would not want to press the matter.

Mr. GRAHAM. I have no sensitiveness on the subject at all. We are very proud of our achievements in our company.

The CHAIRMAN. I thought maybe you were a little reluctant in the case of the Dragon Cement to discuss the details.

Mr. GRAHAM. I am not a reluctant dragon, Senator, except I do not remember the details too well. I was not active personally in the matter.

The CHAIRMAN. Can you think offhand of other similar examples of the intent to gain control?

Mr. GRAHAM. You mean examples similar to the one made in Lawrence?

The CHAIRMAN. Yes.

Mr. GRAHAM. Well, there was one recently.

The CHAIRMAN. What is that?

Mr. GRAHAM. I am trying to remember the name. I remember that a trust company in Boston—

The CHAIRMAN. The Atlantic Gulf and West Indies Steamship Co.?

Mr. GRAHAM. No, that was a different situation. You are referring now to our own experience. The Atlantic Gulf and West Indies was quite a different situation. At that time we made an arrangement with the chief stockholder of that company to purchase, I think, the greater part of his holdings, and made a corresponding bid to everybody else to buy their shares at the same price, which was considerably above the market at the time we began our negotiations.

The CHAIRMAN. Was that a negotiated sale you were trying to effect off the exchange, or was it a listed stock?

Mr. GRAHAM. Yes, it was a listed stock. The negotiation was done with the large stockholder, and the rest was an offer extended to all the stockholders on the same terms.

The CHAIRMAN. Was that negotiation directly with the stockholder?

Mr. GRAHAM. That is correct.

The CHAIRMAN. Did it succeed?

Mr. GRAHAM. Yes, it did.

The CHAIRMAN. You did not use an intermediary in that case?

Mr. GRAHAM. No, that offer went over our name, I believe. The difference was this: At that time we had already arranged to buy a large amount of this stock, and we felt that, for one thing, that should be a matter of record and was made a matter of record.

The CHAIRMAN. So that is an illustration of the successful way to purchase control of a company?

Mr. GRAHAM. Yes. It is much more desirable to buy it by negotiation to begin with.

The CHAIRMAN. Do you think there is any serious problem from the public's point of view with regard to the anonymous purchase of stock, especially with regard to gaining control of a company?

Mr. GRAHAM. Senator, I have observed this thing for the last 40 years. I cannot think of a single instance in which the public has been hurt by offers to buy control whether the names were revealed or not revealed. In every such instance the public has been helped because they have been able to get a higher price for their shares than they would have been able to get if no such bid had been made.

The CHAIRMAN. You see nothing wrong with that procedure? I am not arguing with you. I am only asking you.

Mr. GRAHAM. I have had occasion to think about that matter for a long time, Senator, and it seems to me that the true arguments are all, from the public's standpoint, in favor of not preventing bids being made to the public at higher than the prices previously ruling.

The CHAIRMAN. Is your company an open-end or closed-end company?

Mr. GRAHAM. We are technically an open-end company, and practically a closed-end company. Let me explain that.

The CHAIRMAN. I will be very happy for you to.

Mr. GRAHAM. We are registered under the Investment Company Act of 1940 as an open-end company, which means that we are contractually obligated to repurchase shares at any time at the net asset value when presented to us. However, no such shares have been presented to us for a great many years. Our shares have sold consistently at well over their net asset value. Furthermore, we have not sold any shares of stock to the public at any time and have not increased our capitalization for many years, so that we operate actually as a closed-end company, namely, with a fixed capitalization.

The CHAIRMAN. What is the capital? Are these trade secrets or not?

Mr. GRAHAM. Not at all. They would not be a secret in any case, Senator, but as it happens our figures are made public. They are filed with the Securities and Exchange Commission. We have 5,000 shares of stock with a present asset value on the order of \$1,100 a share and with a market price rather considerably above that.

The CHAIRMAN. A market price above that?

Mr. GRAHAM. That is right.

The CHAIRMAN. But the shares sell very seldom, I understand?

Mr. GRAHAM. That is true. There are very infrequent sales. Nonetheless, there are quite a number of them in the course of a year or two.

The CHAIRMAN. When was your company started?

Mr. GRAHAM. The company was incorporated in 1936, but it was a continuation of a business which was set up in 1926.

The CHAIRMAN. To what do you attribute your great success in this business?

Mr. GRAHAM. Well, Senator, that is assuming that we have made a great success.

The CHAIRMAN. Would you not consider it a success?

Mr. GRAHAM. I will admit that we think it is, but I did not want to be in the position of passing over your question as taking for granted that we have made a great success.

The CHAIRMAN. I will take responsibility for saying you obviously have made a success.

Mr. GRAHAM. I think our success is due to our having established sound principles of purchase and sale of securities, and having followed them consistently through all kinds of markets.

The CHAIRMAN. I take it that ordinary members of the public cannot buy your shares; is that right?

Mr. GRAHAM. Well, they cannot buy them in unlimited amounts, but they can buy them over the counter in small amounts.

The CHAIRMAN. Are they quoted over the counter?

Mr. GRAHAM. They are quoted over the counter; yes, sir.

The CHAIRMAN. At what, \$1,100?

Mr. GRAHAM. I would say probably around \$1,250 or \$1,300 a share now.

The CHAIRMAN. Above the asset value?

Mr. GRAHAM. That is correct, sir.

The CHAIRMAN. Is it customary for open-end companies to be selling above their asset value?

Mr. GRAHAM. Well, it is unusual for any investment company to sell above its asset value, but there are a number of instances. The best-known instance is the Lehman Corp., which for a good part of the time sells above its asset value. That, however, is a closed-end company. It is impossible for an open-end company to sell at more than the selling premium over its asset value as long as it offers shares of stock to the public. That is obvious. In some instances a company like State Street Investment has followed a policy like ours and has not offered shares generally to the public, and the shares have sold at a premium.

The CHAIRMAN. Do you personally control your company?

Mr. GRAHAM. No; I am a comparatively small stockholder.

The CHAIRMAN. You are?

Mr. GRAHAM. Yes, sir.

The CHAIRMAN. Does your family control it?

Mr. GRAHAM. No. We have a comparatively small number of shares.

The CHAIRMAN. Does any one family or person control it, or is it distributed rather evenly?

Mr. GRAHAM. The shares are distributed fairly evenly. I would say there is a family with whom we have no relationship that represents the largest stockholding at the present time.

The CHAIRMAN. If someone wishes to sell their shares, they still can demand what from you?

Mr. GRAHAM. They can demand the net asset value.

The CHAIRMAN. Which, of course, they do not do, because they can get more?

Mr. GRAHAM. That is correct. We have not taken in any shares for many years.

The CHAIRMAN. What inspired you to form an investment company? You did start this investment company; did you not?

Mr. GRAHAM. Yes. May I say that I entered the brokerage business in 1914 and became a junior member of a stock-exchange firm, and in 1923 I believed that sound investing principles would be successful, and I started a private fund in 1923, which was changed around in 1926.

The CHAIRMAN. What is a private fund?

Mr. GRAHAM. A private fund would be one in which no offering was made to the general public through advertisements, circulars, or any other way, but merely to friends who were permitted or asked to contribute.

The CHAIRMAN. How large was that company?

Mr. GRAHAM. It was about a half million dollars at the beginning.

The CHAIRMAN. Just you and your friends?

Mr. GRAHAM. That is correct, sir. My own participation was very small. I had very little money.

The CHAIRMAN. You started buying stock; is that right?

Mr. GRAHAM. Stocks and bonds; yes.

The CHAIRMAN. I would be interested, if you do not mind telling us, to have the history of this development.

Mr. GRAHAM. Well, Senator, if you feel there is any value in this.

The CHAIRMAN. There is, because we like to get some feel of how these trust companies develop. However, I do not wish to embarrass you. If you think it puts you at a disadvantage with competitors or anyone else, you do not have to.

Mr. GRAHAM. No, Senator. I have been accused of telling all my secrets. I have written a number of books, and I reveal them all in these books.

The CHAIRMAN. I was particularly interested to know what happened to you in 1932.

Mr. GRAHAM. We had rough going.

The CHAIRMAN. You first started at the beginning with a half million dollars. What happened then up until 1929?

Mr. GRAHAM. We were quite successful, and the fund grew to \$21½ million at the beginning of 1929.

The CHAIRMAN. In stocks, I take it?

Mr. GRAHAM. In stocks and bonds.

The CHAIRMAN. What did you do in 1929?

Mr. GRAHAM. In 1929 we lost money.

The CHAIRMAN. Well, a lot? Did you go down with the market or see it coming or what?

Mr. GRAHAM. We did pretty well in 1929 alone, but the real difficulty we experienced in 1930 and 1931 when the market went much further downward than we had anticipated. We had pretty well anticipated the 1929 decline. And so our resources were shrunk pretty much. I do not think they shrank as much as General Woods' pension fund did, which he mentioned before, but they went down fairly low, and it was not until 1936 that a person who had been with us in 1929 and had held on would find himself even, but by 1936 he was even in our business.

The CHAIRMAN. You said you changed. When did it become a registered investment company?

Mr. GRAHAM. It became a registered investment company in 1941 after the passage of the Investment Company Act.

The CHAIRMAN. What happened in 1936? Did not some change occur?

Mr. GRAHAM. We incorporated, for a very peculiar reason. We had originally operated as a joint account, and the individual members reported on a partnership basis.

The CHAIRMAN. Each participant in the fund?

Mr. GRAHAM. That is correct, reported his share of the results. But before 1936 the Treasury claimed that we were an association taxable as a corporation, and we had considerable problems as to where we stood, whether we were or were not a corporation. So our counsel said, "You had better incorporate and settle this matter once and for all, because the Treasury will get you either way."

The CHAIRMAN. This was the original group of friends; is that right?

Mr. GRAHAM. That is correct.

The CHAIRMAN. That is all that were in it in 1936?

Mr. GRAHAM. There were accretions on a private basis. I had more friends in 1936 than I had in 1923.

The CHAIRMAN. When did you make them, during the depression?

Mr. GRAHAM. Not so many as afterward.

The CHAIRMAN. Go ahead. You incorporated in 1936 and in 1941 you registered. When did you sell any stock to the public, or did you ever sell any? You have 5,000 shares, you say?

Mr. GRAHAM. Yes. May I say that we originally had more shares, that is, we sold stock up to 50,000 shares with a nominal par value and stated value of \$100 a share.

The CHAIRMAN. When did you do that?

Mr. GRAHAM. Well, we did that in series by offering rights primarily to our older stockholders, and that built our capital up to \$5 million, consisting of 50,000 shares worth about \$100 a share. But we discovered—this may interest you, Senator—that we were beginning to get a great many one-share stockholders, people we had never heard of who came in and invested a hundred-odd dollars and then got our reports and found out what we were doing and imitated it. So to deal with that situation we perpetrated a reverse split-up in which we issued 1 share for 10, increased the unit value in the market

to about \$1,200 or \$1,300 a share, and from that time on we did not get quite so many 1-share stockholders.

The CHAIRMAN. What do you charge for managing the investment company? You are the manager of the company; is that right?

Mr. GRAHAM. I am 1 of 3 managers. The other two managers are Mr. Jerome A. Newman, who has been a partner of mine since 1927, and his son, Mr. Howard A. Newman.

The CHAIRMAN. Is it public knowledge what you charge?

Mr. GRAHAM. Yes. We charge a great deal. We pay ourselves salaries on the order of \$25,000 and \$15,000, and we also have a profit-sharing plan under which after a \$40-a-share dividend is earned and paid in any year the management as a whole receives 20 percent of the additional amount earned and paid.

The CHAIRMAN. Are your earnings largely capital gains?

Mr. GRAHAM. Yes; very largely capital gain. As a matter of fact, you might say they are almost exclusively so.

The CHAIRMAN. I hope it is clear that if you do not wish to say, if it is a matter that you do not wish to discuss, particularly your own compensation, I am not trying to fish. That is just illustrative of what I assume is a typically successful man, and if you do not care to answer, I hope you will feel free to say so.

Mr. GRAHAM. I would just like to make two remarks about that. In the first place, I have no hesitation whatever in telling you things that the investors in my fund know, obviously; but, secondly, I think it is a misconception to consider that we are typical managers of a successful firm. Our arrangement is very unusual.

The CHAIRMAN. I want to clear up the misconception. That is exactly why you are here. Why is it not typical? I would like you to describe what is a typical situation.

Mr. GRAHAM. The difference is first, that our compensation arrangement is much more liberal than that received by other investment funds. This 20 percent which we receive on excess earnings is a very large percentage.

The CHAIRMAN. But that depends on what you pay. You said \$40 a share, which struck me as a rather liberal dividend.

Mr. GRAHAM. That is just the base dividend. We paid \$340 a share last year.

The CHAIRMAN. That is still better than General Motors paid.

Mr. GRAHAM. Yes. I just want to make two things clear, sir. One is that our compensation arrangement is much more liberal in its terms than the standard arrangement. Secondly, we believe, and I think our stockholders believe, that we earn our compensation because our results to them after deducting compensation have been good.

The CHAIRMAN. I assumed that or you would not be there. I was trying to get a picture of this business. You are helping us a great deal, I may say. Can you put it in a little different terms so that we can compare your situation with the managers of some of the well-known firms? I would appreciate it if you would put that in the record so that we will have it.

Mr. GRAHAM. Oh, yes. The difference is tremendous between our own situation and that of a typical investment fund. Let us take the largest one, Massachusetts Investors Trust.

The CHAIRMAN. Yes.

Mr. GRAHAM. Their capital may be a hundred times ours. Their expenses are much less than a hundred times ours. Their expense burden is very little, percentagewise, as compared with ours. The trustees receive compensation on the order of maybe one-fourth of 1 percent on capital.

The CHAIRMAN. Wait a minute. Of earnings or capital?

Mr. GRAHAM. This would be capital.

The CHAIRMAN. Per year? One-quarter of 1 percent?

Mr. GRAHAM. No, I think I have overstated it. It might have been that much at one time. I think it is less now. As the capital grows, the percentage of compensation to the trustees has diminished. Frankly speaking, I should not be talking about this because I do not know it well enough, but I do know in general that their rate of compensation is very conservative in relation to the funds that they handle.

The CHAIRMAN. What percentage of the capital invested in your fund is represented by the compensation to management? Can you express it in terms that would be comparable? Would it be 1 percent?

Mr. GRAHAM. Well, let us put it this way: Over a period of years we have tended to earn about 20 percent on capital per year before compensation and about 3 percent of that has been paid to management as compensation, leaving 17 percent to the stockholders.

The CHAIRMAN. Three percent of the earnings?

Mr. GRAHAM. No; 3 percent on capital out of the 20 percent earned on capital.

The CHAIRMAN. I do not follow you there. You earn 20 percent on the invested capital per year; is that right?

Mr. GRAHAM. That is roughly true on an average.

The CHAIRMAN. What percentage of that 20 did you get as management?

Mr. GRAHAM. We got about 15 percent, the reason being that there is a 4 percent deduction first.

The CHAIRMAN. Fifteen percent of the 20 percent earned?

Mr. GRAHAM. That is right.

The CHAIRMAN. I see.

Mr. GRAHAM. Not 15 percent out of 20, leaving 5; but 15 percent of 20—

The CHAIRMAN. Leaving 85 percent for the stockholders of the 20?

Mr. GRAHAM. That is right.

The CHAIRMAN. I understand that. Maybe this is a silly question and you never do it, but is it ever translated into a percentage of the capital invested per year?

Mr. GRAHAM. Well, these figures I am giving you start with the percentage of capital invested.

The CHAIRMAN. No, that is earnings.

Mr. GRAHAM. Well, we earn 20 percent on capital. May I summarize once again. Taking that as a typical result on capital, the stockholders have gotten 17 percent on their capital and we have gotten an amount equivalent to 3 percent on their capital.

The CHAIRMAN. I see, whereas the normal or average investment company, I take it, is less than 1 percent; is that right?

Mr. GRAHAM. Yes, that is certainly true.

The CHAIRMAN. You get three times as much as the average, or better?

Mr. GRAHAM. That is true.

The CHAIRMAN. Well, I take it you are worth it. You manage it more effectively than they do. Is that not correct?

Mr. GRAHAM. Well, naturally we have to believe that, and our stockholders believe that.

The CHAIRMAN. I take it you approach this whole business in quite a different way. Those big funds do not look for special situations. They go into the market and just buy the run of the mine, do they not—the blue chips and the bonds, and so on. Is that not correct?

Mr. GRAHAM. Well, that is correct in a general way, but not completely. Some of the bigger funds, particularly like the Lehman Corp., which is a large fund, has always had a rather keen interest in special situations, and a certain amount of their capital—by no means the major amount—has gone into special situations.

The CHAIRMAN. When you say "large," how large is Lehman?

Mr. GRAHAM. Lehman would be over \$100 million.

The CHAIRMAN. Of invested capital?

Mr. GRAHAM. At present market values.

The CHAIRMAN. As compared to yours?

Mr. GRAHAM. Ours is on the order of 6½ million.

The CHAIRMAN. On market value. That is not the original investment. That is the capital as now valued on the market; is that correct?

Mr. GRAHAM. That is right. We have paid back to our stockholders virtually all the earnings that have been made, so that in a sense our present value is very similar to the amount of money paid in.

The CHAIRMAN. You do not seek to increase the invested capital, I take it. Any particular reason for that?

Mr. GRAHAM. The basic reason, Senator, has been that we have not believed that we could get the same satisfactory results on very large capital as we can get on a moderate amount of capital.

The CHAIRMAN. Why is that?

Mr. GRAHAM. Because if you deal with special situations and undervalued securities, the markets in those for the most part are not very large. It is not possible to acquire an unlimited amount without affecting the market price, and if we had 10 times as much capital it would be very difficult for us to invest it the same way as our present capital.

The CHAIRMAN. I know some who have undervalued stocks down in Arkansas in my hometown who might talk to you about it.

Mr. GRAHAM. We are always open to suggestions, Senator.

The CHAIRMAN. There is no market for them. I believe you said in your statement that as far as whether the market is too high or too low right now, you could not say it is too high or too low. I take it that you think it is a period that requires caution, and you do not believe in jumping in and purchasing stocks?

Mr. GRAHAM. Well, let us put it this way, Senator: Quantitatively the market seems to be about right, but qualitatively I consider it to be on the high side and getting into a dangerous situation.

The CHAIRMAN. Well, that is, I think, a very understandable statement. That ought to be plain to anyone. If it is about right, that means it is not likely to go up or down? It is about on dead center?

Mr. GRAHAM. On the contrary, Senator, it may be about right, but that is likely to be accidental. A year from now—pardon me, sir.

The CHAIRMAN. I take it you meant the relationship between prices and earnings and income is at a figure that is not clearly undervalued or overvalued; is that right?

Mr. GRAHAM. I would say that is true for the most representative stocks as a whole.

The CHAIRMAN. There will always be exceptions both ways?

Mr. GRAHAM. Yes, indeed.

The CHAIRMAN. I am not trying to tell you, you understand. I am rephrasing it only for the purpose of trying to understand what you said. I haven't any idea about whether it is high or low. I am trying to put in language so I could understand what I thought you said.

Did you notice the testimony of Mr. Galbraith the other day regarding the tendency of the market and speculators losing their relationship to reality, that the market generates enthusiasm all its own for capital gains? Did you notice that testimony?

Mr. GRAHAM. Yes, indeed, sir.

The CHAIRMAN. Would you agree with it?

Mr. GRAHAM. Yes; I would agree with it in general terms.

The CHAIRMAN. That is interesting, because he is purely an academic figure and you are a practical one, and yet this is one point upon which you agree.

Mr. GRAHAM. I should say, Senator, that I am something of an academic man myself.

The CHAIRMAN. I did not know that.

Mr. GRAHAM. I have the title of adjunct professor of finance at Columbia University, and I give a course in the evaluation of common stocks.

The CHAIRMAN. I saw you on television in an Ed Murrow show, but I did not understand that you were a professor. I thought they had brought you in as a practical operator to tell them how it was done. I misunderstood.

Mr. GRAHAM. They made me a professor because I am a practical operator.

The CHAIRMAN. That is very unusual, is it not?

Mr. GRAHAM. Yes. The Columbia School of Business has about 4 or 5 such practicing professors.

The CHAIRMAN. I see. I think that it is interesting that you agree that it is a dangerous element when the market becomes too over-enthusiastic and loses, as Professor Galbraith says, contact with reality. You think there is a tendency to that at the present time?

Mr. GRAHAM. Yes, there are some tendencies, undoubtedly.

The CHAIRMAN. Then you would say, as he put it, I believe, that there is too much speculative activity in the market?

Mr. GRAHAM. Well, "too much" is a difficult phrase to define. I think if the market continued pretty much as it has been doing now in regard to the total amount of speculative activity, I would not be too concerned about the outcome. I am afraid of the cumulative effect of more and more speculative activity.

The CHAIRMAN. I am not sure that is different from the way he put it. I think he was careful to say he did not think the level of prices was too high, but that during the past year there had been too rapid a rise. That there had not been any developments in the business world, productivity or all the other things that would justify that rapid rise. It was the rapidity of the rise and the tendency to

generate a sentiment, as he put it, of overenthusiasm that disturbed him. He recommended, as you know, an increase in the margin requirements. Would you recommend an increase in margin requirements?

Mr. GRAHAM. I would like to duck the responsibility to this extent: I said in my statement that I feel the Federal Reserve should have no hesitation about increasing margin requirements further if it became increasingly concerned over the extent of speculation. I do not think it is necessary for me to make the decision for my friend Bill Martin, but I think the Federal Reserve has as good judgment as anyone in that connection.

The CHAIRMAN. That is a proper answer. I see nothing wrong with that. It is not your responsibility. Some, though, have taken the position that it would be discriminatory and a bad thing to increase the margin requirements to 100 percent.

Do you think if the capital gains tax were eliminated and there was no tax upon capital gains that that would increase the attractiveness of speculation or decrease it?

Mr. GRAHAM. On the whole it would increase the attractiveness of speculation.

The CHAIRMAN. If it did, that would tend to increase the level of prices; would it not?

Mr. GRAHAM. That is my best judgment. It is true that there would be some unfreezing of shares now held by long-time owners, but my own feeling is that very likely the net result would be an increase in speculative enthusiasm.

The CHAIRMAN. Is it fair to ask you now whether your own company—and you do not have to answer if you do not want to—is buying or selling stocks? You can be perfectly free to say you do not care to answer.

Mr. GRAHAM. We have been selling on balance from our general portfolio of undervalued securities and endeavoring to put our money into special situations which are not at the risk of the market.

The CHAIRMAN. Has it happened that in the past year or two you have made any particular study of any industry which is primarily dependent upon defense contracts for its business?

Mr. GRAHAM. No: we have had no occasion to study them in any detail. We just have a general knowledge of the picture.

The CHAIRMAN. Would you care to elaborate at all about your knowledge of the defense industry picture?

Mr. GRAHAM. Well, it is common knowledge, of course, that the aircraft-manufacturing companies are largely dependent on the defense program.

The CHAIRMAN. Would the fact that a company which is wholly dependent upon a defense contract had profits which increased in the last 6 months of 400 or 500 percent over the preceding year or similar period mean anything to you at all with regard to the Government's contracts with that company?

Mr. GRAHAM. Senator, I did not state in my statement that I was chairman of the research committee of the War Contracts Price Adjustment Board during the war. That is the renegotiation board, and we had to consider principles of renegotiation, including the profits of aircraft-manufacturing concerns. The mere increase in

profits as such is not an indication that the contracts are improvident, but there is a prima facie suggestion that they be examined into.

The CHAIRMAN. Do you not think that 400 or 500 percent is a rather unusual increase in profits in the course of 12 months?

Mr. GRAHAM. I do not recall any particular instances in which that ratio existed, but if it should exist I am sure the renegotiation people will study that with care.

The CHAIRMAN. Do you think the Renegotiation Act ought to be reenacted? It expired, you know, at the end of December.

Mr. GRAHAM. I am convinced that it should be, or something similar.

The CHAIRMAN. The administration has not requested it, has it?

Mr. GRAHAM. I am not part of the administration, Senator.

The CHAIRMAN. I understand they did last weekend; yes. It was also in the state of the Union message. I had forgotten that. If nothing else happens in these hearings, maybe that is worthwhile. But you are in favor of the reenactment of that?

Mr. GRAHAM. Yes, indeed.

The CHAIRMAN. Would you mind commenting upon the situation which I notice recurs in many instances—there was a notable one this morning in the case of Du Pont, one of our big companies, and the same thing is true with General Motors—where so many of them have shown during 1954 a substantial increase in profits on a decreased volume. In some instances, of course, as we saw in the figures of General Motors, it was the difference in excess-profits tax, but I believe in many cases that plays a relatively minor part. What do you think is going on in our big industries that accounts for that?

Mr. GRAHAM. Well, of course, the first point is what you have mentioned—that the good showing for 1954 earnings in the large companies (approximately equal to the 1953 earnings in the aggregate) is due to a considerable degree to the repeal of the excess-profits tax. To some extent it is also due to the fact that corporations, both large and small, have been getting somewhat better control over their costs in recent years. That I would say is more true actually in the case of the small companies than it is in the big ones, because the small companies suffered most from the costs getting out of hand.

The CHAIRMAN. Would such a circumstance indicate a lack of competition?

Mr. GRAHAM. I do not think so, because for one thing the margin of profit in and of itself is no larger now than it was in previous years. In the case of General Motors, for example, their profit margin last year, I think, after taxes was about 8.2 percent. I imagine that in 1936 it was probably around 14 to 15 percent after smaller taxes, but before taxes I would say the profit margin is approximately the same, maybe somewhat less now than it was in 1936.

The CHAIRMAN. You do not see anything to criticize about General Motors carrying all of the reductions in taxes in profit rather than decreasing the prices?

Mr. GRAHAM. My own views on that may seem peculiar to you, Senator, but I think that General Motors does not care to reduce its prices substantially because the effect on the competitive situation would be disastrous, and they would—

The CHAIRMAN. Why?

Mr. GRAHAM. Well, the point is this: General Motors has to make a very good profit in order that other automobile companies can exist at all. If it made a small profit, some of the other automobile companies would go out of business completely.

The CHAIRMAN. Why do you want to subsidize these other automobile companies at the expense of the poor farmer, who is struggling along on a starvation diet now?

Mr. GRAHAM. Senator, I did not suggest that.

The CHAIRMAN. The prices for these Chevrolets are enormous. If they could cut them \$800, it would help a lot.

Mr. GRAHAM. I would like to make my point of view clear again. I am not expressing my own opinion as to what should or should not be done. I am only telling you what I think is General Motors' policy, and that General Motors itself cannot dare in the present state of the economy and the political sentiment to reduce its prices to a point where other companies were forced out of business and General Motors had almost a monopoly of the business.

The CHAIRMAN. Well, in another way you are saying there is no competition in the automobile business; are you not?

Mr. GRAHAM. No, sir, that is not true either, because in the first place the competition between General Motors and Ford is very keen, and the competition between General Motors and Chrysler used to be very keen and is now again becoming keen.

The CHAIRMAN. To show you how innocent I am, I do not understand it at all. I always thought price happened to be the principal element in competition, that you could not have competition if you did not care what the price was, and that all the rest was shadowboxing and just make-believe. If you were really competitive and your desired to have the market, I had thought one of the first things to do was sell cheaper. That used to be the orthodox doctrine. This idea that the competition is just in advertising, to keep the price up, makes no sense to an old-fashioned man. It sounds exactly like the cartel system in Germany—"We split up the market and all take our part, and then we advertise and make people believe we are competing"—and there is no real competition. If General Motors really is competing and is desirous of obtaining the market, she would get it, would she not, by cutting the prices?

Mr. GRAHAM. Well, Senator, my view of this thing may be wrong, but it differs quite a bit from yours. I think the competition that existed between General Motors and Chrysler, for example, was very intense, and its effect on Chrysler was almost disastrous. Chrysler lost virtually all its earning power last year, and although its business remained high in terms of dollars, it lost out on sales of cars to a point where the earnings almost disappeared and tremendous effort was necessary by Chrysler to improve its cars and to improve its selling practice. Now, that, as far as I can see, is more or less a classical example of the actual working of competition.

The CHAIRMAN. I am afraid I gave a false impression. I am not now at least trying to express an opinion for or against it. I am trying to develop whether or not there is competition in the automobile field. I am unable to see that there is, in view of your statement that all General Motors needs to do to put them all out of business is lower the prices to where it could still get along and it would not go broke but it could break its competitors. In orthodox competitive

business that is what happens, is it not? In the old days that is what happened, was it not?

Mr. GRAHAM. Well—

The CHAIRMAN. I do not say I disagree with you that that would be a bad thing socially, and politically it is dangerous. That is a different thing from saying that it is really competitive. Do you really feel that it is competition or do you feel that it would be inadvisable to permit competitive forces to have their full sway?

Mr. GRAHAM. Could I try to summarize my view by saying that I believe there is a great deal of competition in the automobile industry today, but it is not competition carried to its final conclusion, which would mean the destruction of the weaker companies.

The CHAIRMAN. It is sort of superficial competition?

Mr. GRAHAM. It is a limited-objective competition.

The CHAIRMAN. Some of the bureaucrats, or somebody, developed a term called "administered prices." Is that not what it is? They kind of get together and decide if you go below a certain amount you will destroy Chrysler, and it is not wise to destroy Chrysler?

Mr. GRAHAM. As long as you are speaking of economic principle, you must remember there is such a thing as the optimum or maximization of profits, and it is quite possible that General Motors by cutting its prices could do more business but at the same time earn less money. There is no reason in the world why General Motors as an ordinary business should not charge such prices as will give it maximum profits.

The CHAIRMAN. If it ran them all out with a monopoly, they could charge what they like?

Mr. GRAHAM. No, sir. The United States would interfere.

The CHAIRMAN. That is what I am talking about. You are getting into a different field and leaving old-fashioned competition when you talk about interference by the Government and what the social and political effects may be. I am not saying it is a good or bad thing. I have heard it said before and I was interested that you confirmed that General Motors could make a reasonable profit—I think that is the language—and still destroy all its competition because of the way it is set up and its efficiency, if you like that term, or at least its distribution and volume. I would gather you would agree with that?

Mr. GRAHAM. I do not know the situation intimately, but I feel that probably that is so.

The CHAIRMAN. I think it is important simply because as your economy changes these different aspects arise which do involve things beyond the immediate profits of a company. I think it would be a great catastrophe if all the other companies were put out of business. I would agree with you on that, but at the same time I do not like to kid myself that they are out there fighting for the business because they are not. General Motors could get it if it thought it wise to do it and still not really injure itself. Of course, its own personal advantage or disadvantage regardless of the Nation would be another matter.

Mr. Graham, if you do not mind, our staff director would like to ask you a few questions.

Mr. WALLACE. Mr. Graham, in buying a company do you confer with management and obtain information about the company which is not generally available?

Mr. GRAHAM. Well, where the purchase was made by agreement with large stockholders who are part of the management, we would ordinarily get, say, a copy of the audit report and material of that kind which is not published, largely, I think, because it is just a matter of inconvenience to publish it. But I should add, in order to avoid a misconception, that I can think of no instance in which we have gotten any information of importance which had any effect on our judgment, which information was not given to the stockholders in connection with the offer to buy.

Mr. WALLACE. To the degree that reports are published quarterly, you might get a report on earnings in between these reports, for example, which was not published?

Mr. GRAHAM. Well, that is conceivable, a monthly report; but it would be very unusual if it had any effect. I might give you an example of that. When we made our offer to purchase the Atlantic Gulf and West Indies stock—and, incidentally, I might say the offer was made through the Manufacturers Trust Co.—we published, and, I think, at the suggestion of the Securities and Exchange Commission, with whom we had discussed the matter before, a semiannual balance sheet which had been supplied to us by management and had not been made public. It did not give any particular information of value, but it was published as a matter of general policy.

Mr. WALLACE. In general, when you buy a block of stock, do the people from whom you buy the stock have the same information that you have?

Mr. GRAHAM. As far as any important pieces of information are concerned, I would say "Yes."

Mr. WALLACE. But if you were to buy stock on the open market on the basis of information that you had gotten in conferring with management, would this be considered trading on the basis of inside information?

Mr. GRAHAM. No, sir; because, as I understand the interpretation of the rules, trading on inside information applies only to those who have a fiduciary relationship toward the stockholders, namely, officers, directors, and major stockholders.

Mr. WALLACE. Is it not illegal for an officer of a corporation to divulge to you any inside information which is not available to the public?

Mr. GRAHAM. I would like to clear that point up a little, because I am on both sides of that fence. I am an officer and director of a number of corporations, and I think it is worthwhile for the Senators to get a realistic view of the way corporate affairs actually operate. A good deal of information from day to day and month to month naturally comes to the attention of directors and officers. It is not at all feasible to publish every day a report on the progress of the company in the newspapers or send out letters to the stockholders. On the other hand, as a practical matter, there is no oath of secrecy imposed upon the officers or directors so that they cannot say anything about information that may come to their attention from week to week. The basic point involved is that where there is a matter of major importance it is generally felt that prompt disclosure should be made to all the stockholders so that nobody would get a substantial advantage in knowing that. But there are all degrees of importance, and it is very difficult to determine exactly what kind of infor-

mation should or must be published and what kind should just go the usual grapevine route.

Mr. WALLACE. Of course, the SEC act itself makes it illegal for an officer of a corporation to trade on the basis of inside information himself. At least, if he does trade on the basis of inside information the corporation or stockholders may sue to get his profits back?

Mr. GRAHAM. Yes. That is defined in the law in relation to 6-months' trades, and I imagine that there is a general idea of the law that it applies to any other kind of trade.

Mr. WALLACE. Am I to understand that an officer of a corporation can reveal inside information which would enable a person to trade in stocks on the basis of such information which is not available to the public?

Mr. GRAHAM. I believe you are right about that, Mr. Wallace, and it is an interesting area for consideration. It has given me a great deal of thought.

Mr. WALLACE. I was going to ask you what your opinion was of the adequacy of the present law. As I understand it, in talking with Mr. Wood when he was here, of the National Association of Securities Dealers, he said that it was not illegal for a director of a corporation whose stock is not listed to do all the trading he wants on the basis of inside information. The question I am raising with you in the case of listed stock is trading on the basis of inside information, not by the director himself but by the director divulging information to someone else. For example, if there is consideration of a merger that is not generally known about, but the officer knows about it and he can tell whether the merger may come off, or on earnings reports he may be in a position to know the dividend will be higher than it was originally thought, or a stock dividend or a stock split, the officer is in a position to have inside information. He is prohibited from trading on a 6-months' basis himself, but I would like to ask your opinion if you think the law should be tightened up with respect to his divulging information so that others may trade on the basis of inside information which is not available to the public generally.

Mr. GRAHAM. Well, if a feasible method of tightening the law could be devised which would get that objective without countervailing disadvantages of many sorts, I would be for it. But my experience in these things makes me hesitate to endorse the idea because of gradations of knowledge between the mere beginning of a possibility of something and its finalization. That would be particularly true with respect to a merger. When a merger is only a gleam in a person's eye, it is undesirable, of course, to make any public statement of it. On the other hand, it is very difficult for people to be so discreet that not a word can leak out from anybody when somebody has sat down with somebody else, and from that earliest idea to the later point the gradations are so numerous that it seems very difficult to me to control the passing out of information by officers to other people.

Mr. WALLACE. There are how many stockholders of publicly held corporations—between 6½ and 7½ million?

Mr. GRAHAM. That seemed to be the figure published by the stock exchange in its study.

Mr. WALLACE. Is it your opinion that these 6½ or 7½ million stockholders realize and understand that it is possible to trade on the basis of inside information which they do not have?

Mr. GRAHAM. Some do and some do not. I think that the average experienced person would assume that some people are bound to know more about the company than he would, and possibly trade on the additional knowledge.

Mr. WALLACE. Now, Mr. Graham, just for the record. You are an expert in this field. Could you explain some terms to us? Could you tell us what is meant by the term "profit-taking"?

Mr. GRAHAM. Well, profit-taking is very simple. It means that people who have a paper profit in their shares realize on their paper profit by selling, and the general inference is that there is some pressure on prices as a result of that which puts the market down when that happens. There is some profit-taking going on all the time.

Mr. WALLACE. Profit-taking would have in general an effect of depressing the market slightly for a temporary period?

Mr. GRAHAM. Well, profit-taking as it is used in markets means there is enough profit-taking to depress prices, because there is profit-taking all the time in the market even while it is going up.

Mr. WALLACE. Is that similar to a sell-off?

Mr. GRAHAM. Well, a sell-off is simply a decline, presumably temporary, in the market, for any number of reasons. Profit-taking may be the reason advanced, or a war scare, or something that happens in this committee room or anything else.

Mr. WALLACE. Or a technical adjustment is another term?

Mr. GRAHAM. The technical adjustment is very likely related to profit-taking.

The CHAIRMAN. You do not think anything we have been doing here has accounted for any fluctuations in the stock market, do you?

Mr. GRAHAM. Yes, sir.

The CHAIRMAN. You do?

Mr. GRAHAM. I do, yes. I think that the market, being at a rather sensitive level, is subject to a vast number of influences which might put the market down or up, and among those influences are these hearings.

Mr. WALLACE. Mr. Graham, one of the reasons I was discussing these questions is that the market reached a pretty high level on Friday last, did it not? The total market was pretty strong last Friday?

Mr. GRAHAM. Yes.

Mr. WALLACE. Over the weekend the President announced he was going to extend the Renegotiation Act, did he not?

Mr. GRAHAM. Yes.

Mr. WALLACE. The foreign picture was in the news considerably, was it not?

Mr. GRAHAM. Well, I saw rather minor reference to it in the news.

Mr. WALLACE. Then you have this tendency for profit-taking, sell-offs, technical adjustments, following on a relatively high market, do you not?

Mr. GRAHAM. Yes.

Mr. WALLACE. So that would you not say that all these factors entered into what happened to the market on Monday and Tuesday—all these factors had some bearing and you cannot really decide which one had the most bearing. But there are many, many factors influencing the market, including the feeling of the stockholder and whether his ulcers are acting up?

MR. GRAHAM. I agree with that, and I tried to convey that impression in my previous answer.

MR. WALLACE. This study then, has some effect on the market only one of a great, great many factors?

MR. GRAHAM. I might leave out one of the "greats," but it is one of a number of factors.

MR. WALLACE. Thank you.

THE CHAIRMAN. I am impressed that they are taking notice that we are interested in and concerned with what goes on in the market. I do not see any reason why the study should necessarily put the market down. That is what everybody is blaming the committee for, or at least when I say "everybody" we received quite a large number of telegrams the other day—I guess 15 or 20—complaining bitterly that we were putting the market down, rocking the boat, and all that. You would not agree to that, would you?

MR. GRAHAM. No. I think I can say something that would be reassuring to you, Senator, and put it this way: If the study actually does put the market down, then the market was due to go down and should go down.

THE CHAIRMAN. That is a very fair observation, it seems to me. It is a mighty weak market that this hearing could put down, is it not?

MR. GRAHAM. I would agree on that.

THE CHAIRMAN. Now one or two things that have occurred to me. Did you notice Mr. Eccles' proposal yesterday on capital-gains tax? Was it brought to your attention?

MR. GRAHAM. I read it in this morning's paper.

THE CHAIRMAN. Does it appeal to you at all?

MR. GRAHAM. Yes. I had a proposal of my own. I guess all of us have proposals on this thing. I think Mr. Baruch will make one when he appears. We all have proposals. Mr. Eccles' proposal basically is, I think, a sound one, to differentiate more than the law now differentiates between various holding periods.

THE CHAIRMAN. Your proposal, I thought, was simply a temporary device and then, I assumed, a return to what we have?

MR. GRAHAM. Yes; that would be true.

THE CHAIRMAN. Which is certainly worthy of consideration.

The effect is that if you hold it really a long time, beyond, say, 5 years—he was not dogmatic about the precise ending of it—that there would be no capital gains. Does that appeal to you?

MR. GRAHAM. On the whole it does, Senator. You may recall that a number of years ago we had a capital-gains tax of that type, and that the amount of the tax went down to about 10 percent, I think, on holdings between 5 and 10 years, and zero I think after 10 years. So these gradations are largely a matter of judgment, but I think the principle is sound. The theoretical objection to the capital-gains taxes is that it is taxing something which does not appear anywhere in the national income or the gross national product, and so on. This theoretical objection could be met in part by this gradation.

THE CHAIRMAN. This is a rather technical question, but perhaps you can help us. While I realize it is difficult to generalize, would you give us your best estimate as to how much the market value of a dollar of retained earnings in comparison to a dollar of dividends paid—how much market value in dollars?

Mr. GRAHAM. That takes a few sentences to answer. In the first place, I have made studies on that subject and have written on the subject, and in the past it was possible to show that a dollar of paid-out earnings had four times the value of a dollar of retained earnings in their effect on the market for the average stock, the exception being stocks that were bought mainly for their long-term prospects and were treated in the market in a separate category. I have a feeling, however, that we are now going through a transition period on the question of the weighting of dividends as against retained earnings. I think the transition is going on fairly rapidly. I cannot tell you just where we stand at this minute, but I will predict that in a few years from now the weight of retained earnings will be better, considerably better, than it had been as against distributed earnings.

The CHAIRMAN. Is that not very largely influenced by the tax structure—the difference between capital gains and normal and sur-tax rates?

Mr. GRAHAM. Well, no, sir; it has not been influenced in the past. On the contrary, the behavior of investors and speculators has been very illogical. In theory they should have preferred retained earnings by successful companies, because those earnings were subject to only one tax to begin with and ultimately only to a capital-gains tax in addition, whereas the distributed earnings were subject to two large taxes immediately. However, the ingrained desire of investors for dividends was so great that it has not yet adjusted itself to the facts of life in the tax structure. It is only beginning now to do so.

The CHAIRMAN. I see. What you mean is they will slowly catch up?

Mr. GRAHAM. They have been extremely slow, and I think extremely unintelligent.

The CHAIRMAN. That is a very understandable statement.

Incidentally, do you think that stock options are largely motivated by the desire to compensate directors by capital gains rather than salaries?

Mr. GRAHAM. Well, sir, it is the desire to compensate officers by capital gains. There is no doubt about that at all. That is the admitted purpose of stock options.

The CHAIRMAN. No, it is not admitted by some of the people that we have had on the stand. They say, "Oh, it is just to inspire loyalty. It has nothing to do with the retaining of earnings." You do not subscribe to that?

Mr. GRAHAM. I do not, sir.

The CHAIRMAN. I agree with your views quite often.

Mr. GRAHAM. Senator, I have no intention of shaping my views with the expectation of your agreement.

The CHAIRMAN. I did not accuse you of that. I was only impressed with your wisdom.

Mr. GRAHAM. Thank you, Senator.

The CHAIRMAN. I used to be a professor. Maybe that is my weakness.

You noticed this morning that Sears, Roebuck has found a way to compensate the ordinary employees by capital gains, which I never realized before. Is that not the effect of that pension plan?

Mr. GRAHAM. It is provided you have got a Sears, Roebuck type of company. If you had the ordinary company—let me add this,

Because this is very important. If you took the ordinary company at random on the New York Stock Exchange and tried to put in a Sears, Roebuck type of plan, not only would it be true that in the long run the returns would be comparatively small as against Sears, Roebuck, but I think it would be impossible to maintain such a plan because of the variations in results and in stock prices from year to year. The people just would not have the guts to keep up a plan of that kind in the ordinary company.

THE CHAIRMAN. Well, a company like General Motors could do it, could it not?

MR. GRAHAM. I think so, yes.

THE CHAIRMAN. Do you know whether other funds have this system of paying into a pension fund as much as 10 percent of their income before taxes as a compensation really to their employees, without paying the normal tax rate?

MR. GRAHAM. Well, the only difference is the 10-percent figure that you are mentioning. Ten percent is a fairly high figure, but it is by no means unexampled. I wish I could think of the other companies, but there have been instances I know of of more than 10 percent of the earnings going to a combination of executive and run-of-the-mine employee compensation.

THE CHAIRMAN. I do not believe the compensation to the executives was included in this morning's testimony.

MR. GRAHAM. The executives are part of this, but they are limited to this \$500-a-year figure or whatever the maximum is.

THE CHAIRMAN. I meant in addition to that they have bonuses and stock options, which is in addition to the participation in the pension fund.

MR. GRAHAM. That is correct, sir.

THE CHAIRMAN. Which may result in an overall figure beyond 10 percent.

MR. GRAHAM. Yes.

THE CHAIRMAN. What do you think of that?

MR. GRAHAM. There are two parts to it. In the first place, I think it is a remarkably good device for establishing the proper relationship between the business and its employees and a fair treatment of profits. As I said at the beginning, we have a similar approach in our Government employees insurance company, and it has worked out very well for us and our employees. The tax status, of course, is another matter. It is a very favorable tax status in these plans that the Congress adopted, and I am sure knowing full well what the consequences would be with the intention of encouraging this kind of development in corporate business and in the position of corporate employees. I think personally even at the cost of some loss of revenue to the Treasury it would be very desirable to encourage this development of medium-size capitalist or, in any event, happy and prosperous employees at the end of their working career.

THE CHAIRMAN. I agree with you as far as you go. It is a fine thing if you look only at that. What do you say about these people who have no way of adjusting their income to capital gains and have to pay the straight tax? What is your answer to them? Do you say, "Well, it is too bad," or how do you justify one set of employees receiving compensation and paying only capital-gains rates and

another set doing almost the same thing paying the other rate? If you were in my place and they blamed you for all governmental policies, what would you say to them?

Mr. GRAHAM. I would say that what we are talking about is a marginal part of the total compensation of employees. The Sears, Roebuck case, of course, is not so marginal, because you have had this extraordinary success of the corporation itself. But if you take a typical corporation, which sets aside 10 percent of its earnings for this purpose, the amount of additional gains and income to the employees would represent not an inconsiderable part of their earnings, but at least a minor part of their earnings, and the tax advantage I should think should be accepted philosophically because of the desirable consequences that flow from it.

The CHAIRMAN. Supposing they devoted 50 percent? Supposing they reduced everybody's wages and transferred that to a 50-percent payment into the fund. If you accept the principle, why could you not pay them all on a capital-gains basis?

Mr. GRAHAM. No; the principle cannot be accepted to an unlimited application, and the present act, if I understand it correctly, imposes a limitation on that. The amounts which can be put to the benefit of employees in pension funds and profit-sharing funds I believe are limited to 15 percent of the compensation in each year.

The CHAIRMAN. I wonder if you would give us your views in a broad sense about the economic future of the next few years. Do you see any culmination of a business cycle, or do you subscribe to this view that I read the other day of one of your colleagues in the investment field in New York that a final blowout is necessary?

Mr. GRAHAM. Is not necessary?

The CHAIRMAN. I read into the record an opinion that it always must come, that we have to have this final orgy of buying. I wonder if you would give us an idea of your views for the next few years. How has your mind been working?

Mr. GRAHAM. I will do it with the proviso that these views should not be taken too seriously.

The CHAIRMAN. I do not believe you are infallible.

Mr. GRAHAM. As a matter of fact, I have never specialized in economic forecasting or market forecasting either. My own business has been largely based on the principle that if you can make your results independent of any views as to the future you are that much better off. Nevertheless, as an economist of a sort I have studied this question, and I will be glad to give you my view on the matter.

I think that in all probability we would have some economic recession of an appreciable amount, not necessarily a very serious amount, in the natural course of events, which means such things as the inventory situation, the consumer credit situation, the housing situation, capital goods situation, all of which tend on the whole to operate in cycles, and which on the whole could not be continued, in my opinion, indefinitely at the rate at which we see them developing right now. And of course I am now expressing merely the view of an experienced, conservative economist who expects history to repeat itself or the pattern of history to repeat itself.

You have an unknown factor, which is Government intervention. The Government, it seems to me, is committed now through both parties to intervene perhaps nationally to prevent any serious decline in

the business activity which is accompanied by substantial unemployment. I might say that you could have substantial unemployment with an increase in the gross national product and with apparent prosperity, merely because of the development of productivity. And we are approaching an interesting period, in which, I believe, the intentions of the Government vis-a-vis employment will be tested out. Last year we expected that it would be tested out, but it was not. We were all very pleasantly surprised. I think in the next 5 years such a test will take place, and I think you will see, in all probability, the Government taking action of an important kind to prevent large-scale unemployment.

The CHAIRMAN. You think the Government should add an element of stability to the normally fluctuating economy?

Mr. GRAHAM. The Government will try.

The CHAIRMAN. It will depend upon the wisdom of the Government's policy?

Mr. GRAHAM. Yes; I guess if you judge wisdom in terms of results.

The CHAIRMAN. How do you judge wisdom?

Mr. GRAHAM. I have an a priori test of wisdom in most cases, but I think in economics it is very difficult to tell what is wise until you have been through it.

The CHAIRMAN. I suppose I should not ask you to look back and see what happened in the twenties to see who was wise in administration of government; should I?

Mr. GRAHAM. I think not.

The CHAIRMAN. What is your commodity reserve plan? I understand you have one.

Mr. GRAHAM. I can put it in a very few words. It is related to your question as to the future of our economic system. In the last 20 years I have been identified with a concept of stabilizing the economy by stabilizing the price level of raw materials taken as a whole and not in individual commodities. The objective has been to permit individual commodities to fluctuate but to establish a narrow range of fluctuation and virtual stability for the value of a market basket of the important commodities. I have added to it the very important factor, quite radical, that those commodities would represent a sound backing for our money, because they represent the things that we need and use, and by so doing they would become commodity reserves and would be self-financing in the same way our gold reserves are self-financing. The consequence would be that by stabilizing pretty well the general level of raw materials prices you would add a very important degree of stability to the general economy.

The CHAIRMAN. I do not think I quite understood what the limitation of the commodities involved would be?

Mr. GRAHAM. These are major storable commodities for the most part, those dealt in on commodity exchanges, but not absolutely.

The CHAIRMAN. What agricultural commodities, if any, would it include?

Mr. GRAHAM. They would include such products as wheat, corn, cotton, sugar, and rubber.

The CHAIRMAN. Rubber and cotton would be storable indefinitely?

Mr. GRAHAM. They would be storable indefinitely through rotation.

The CHAIRMAN. I forgot to mention one thing. With regard to Government policy and interference, do you regard tax policy as of major importance in this element of interference in the economic system?

Mr. GRAHAM. It could be. That is to say that one of the means by which the Government could intervene to an important degree in the economy would be through a tax-reduction plan. Another method would be through an increase of its expenditures.

The CHAIRMAN. Did you hear Mr. Eccles yesterday? I am not using him as a model, but simply to save the time of describing the situation, because it does take time. Do you remember his proposal yesterday on taxes?

Mr. GRAHAM. I have forgotten it.

The CHAIRMAN. Well, it does not matter. One other question and I will desist. When you find a special situation and you decide, just for illustration, that you can buy for 10 and it is worth 30, and you take a position, and then you cannot realize it until a lot of other people decide it is worth 30, how is that process brought about—by advertising, or what happens?

Mr. GRAHAM. That is one of the mysteries of our business, and it is a mystery to me as well as to everybody else. We know from experience that eventually the market catches up with value. It realizes it in one way or another.

The CHAIRMAN. But do you do anything to help that? Do you advertise, or what do you do?

Mr. GRAHAM. On the contrary, we try, as a matter of fact, to keep our operations as confidential as we can.

The CHAIRMAN. Even after you buy?

Mr. GRAHAM. Even after we have acquired our shares.

The CHAIRMAN. Why?

Mr. GRAHAM. Basically for the reason that we just are not interested in other people knowing about our business, and we have no interest in endeavoring to persuade people to buy stocks in which we have an ownership. We have never done it and we never will do it.

The CHAIRMAN. That is rather unusual. Since you make your capital gains, a lot of people have got to decide it is worth 30.

Mr. GRAHAM. We have been very fortunate in our experience by finding that people decide that that stock that you mention is worth 30 without the necessity of our doing anything about it on the advertising side. We might conceivably at times intervene in a managerial policy. We might suggest some change in the procedure, but that of course is merely because we are substantial stockholders.

The CHAIRMAN. I think that is about all. There are many other things we could ask you about, I am sure. However, you have other things to do, and the hour is late.

I would like to express the appreciation of the committee for your having taken your time to come down here and volunteer this information. I am sure it is not very pleasant for you to have to talk about these things, but I know no other way we can learn about them. I do appreciate the contribution you have made to our knowledge of the market.

Mr. GRAHAM. If I have made a contribution, I do not mind the discomfort.

The CHAIRMAN. If you have any further suggestions that occur to you which you think we ought to know about we will welcome your writing them to us. Thank you very much for coming.

(Mr. Graham's full prepared statement is as follows:)

STATEMENT OF BENJAMIN GRAHAM, CHAIRMAN OF GRAHAM-NEWMAN CORP.

My name is Benjamin Graham. I live in Scarsdale, N. Y. I am chairman of Graham-Newman Corp., a registered investment company or investment fund. I am also adjunct professor of finance at the Graduate School of Business, Columbia University.

This statement will address itself mainly to three points;

(a) The present level of stock prices from the standpoint of the relationship between price and value.

(b) Causes of the rise in the market since September 1953.

(c) Feasible methods of controlling excessive speculation in the future.

With regard to the present level of stock prices, common stocks look high and are high, but they are not as high as they look. The market level of industrial stock is far above the 1929 high as shown by the Standard & Poor's index of 420 industrials. The present figure is above 300 as compared with the 1929 high of 195. The Dow-Jones industrials average at about 410 is now only moderately above its 1929 high of 382, but the difference would be much larger except for the substitutions made in the average. However, the railroad and utility issues as a whole are well below their 1929 highs.

The true measure of common stock values, of course, is not found by reference to price movements alone, but by price in relation to earnings, dividends, future prospects and, to a small extent, asset values.

Present concepts of common stock valuation turn largely on estimating average future earnings and dividends and applying thereto a suitable capitalization rate or multiplier. Since these elements are all matters of prediction or judgment, there is room for a wide difference of informed opinion as to the proper value for a single stock or group of stocks at any time. Uninformed or speculative opinion will, of course, cover an even wider range as the market swings from the depth of pessimism to the heights of optimism.

As a guide to identifying the present level of stock prices in the light of past experience, I have made 2 sets of comparisons—1 relating to the Dow-Jones industrial average, the other to General Electric, a component of that average and an outstanding blue chip issue. I have related the present prices and the high prices in 1929, 1937, and 1946 to earnings of the preceding year, the preceding 5 years and the preceding 10 years. This information, together with certain other data, appears on the appended table.

The Dow-Jones industrials are now at a lower ratio to their average earnings in the past than they were at their highs in 1929, 1937, and 1946. The same applies to General Electric as an individual stock. It is clear that the issues referred to—which may be considered as reasonably representative of the larger industrials as a whole—have a considerable way to go before reaching the ratios shown at their former tops. It should be pointed out also that high-grade interest rates are now definitely lower than in previous bull markets except for 1946. Lower basic interest rates presumably justify a higher value for each dollar of dividends or earnings.

Much has been made of these relationships as indicating that the market is still on safe ground. However, such comparisons fail to take into account the extent of the subsequent declines from past bull market highs. Since the Dow-Jones average lost 90 percent of its price from 1929 to 1932, it is evident not only that 381 was much too high in 1929, but that the market had entered dangerous ground at a point far below that figure.

I have found it useful to estimate the central value of the Dow-Jones industrial average by the simple method of capitalizing 10-year average earnings at twice the interest rate for high-grade bonds. This technique presupposes that the average past earnings of a group of stocks presents a fair basis for estimating future earnings, but with a conservative bias on the low side. It also assumes that by doubling the capitalization rate presented by high-grade bonds, we allow properly for the differential in imputed risk between good bonds and good stocks. Although this method is open to serious theoretical objections, it has in fact given a reasonably accurate reflection of the central value of industrial common stock averages since 1881. It may be interesting to note that the central value

found by this method in 1929 was 120, which happens to be about the geometric mean between the high of 381 and the subsequent 1932 low of 41. Similarly, the central value in 1936 was 138, higher than in 1938, and this proved to be about the mean between the 1937 high of 194 and the low of 99 in 1938.

This mechanical method applied to the situation in the beginning of 1955 yields a central value for the Dow-Jones industrials of 396, or only slightly under their present value. Such a figure, if reliable, would have to be regarded as rather reassuring. It would indicate that the market in terms of value is no higher now than it was in early 1926, or in early 1936, or late 1945. However, the validity of this central value figure may be open to question if we observe that the 10 years ending in 1954, used to obtain average earnings, did not include any period of real depression. In a sense, therefore, the soundness of this appraisal of central value is bound up with our ability to escape serious business depression in the future as we have in the recent past. It is probably fair to say that the market is not too high today if we have really managed to lick the business cycle.

Although such a development would involve a revolutionary break with the past, I am not prepared to deny its possibility. There is some reason for concluding that in the future serious depressions will be prevented, if not by the natural vitality of American business, then by governmental intervention and possible inflationary moves. The above analysis is by no means unfavorable to the present level of stock prices. However, in reaching my overall conclusion on the subject, I am inclined to hark back to the analysis I made of the stock market in October 1945 at a time when the Dow-Jones average stood at 185. This was published in *The Commercial and Financial Chronicle*, October 18, 1945. I should like to quote intact the summary appearing at the end of that article and state that it expresses my view with respect to the stock market today.

"The three different approaches used in judging the present level of stock prices have yielded diverse indications. From the first, or historical, approach the market appears distinctly on the high side and vulnerable to a substantial setback. Contrariwise, our second category—that of appraisal based on figures and formula—about supports the present level, and suggests that the familiar bull-market enthusiasm might well carry prices considerably higher. Our third approach, through guesses and projections as to future developments, supplies plenty of material but no definite verdict.

"What is the net significance of this analysis for the speculator and the prudent stock investor? Let us define the speculator as one who seeks to profit from market movements, without primary regard to intrinsic values; the prudent stock-investor as one who (a) buys only at prices amply supported by underlying value, and (b) who determinedly reduces his stock holdings when the market enters the speculative phase of a sustained advance.

"This speculative stage, we are convinced, is now at hand. Hence, the principles of the prudent investor will require him to lighten significantly his holdings of common stocks—the precise selling policy to depend, of course, on his individual position and methods. For the stock speculator we can say little that is helpful. We think he has a 50-50 chance—or perhaps a little better—of seeing the market attain substantially higher than present heights, subject to the probability of intervening reactions. But his chance of eventually holding on to the profits he makes beyond the current level, we should term no better than in former bull markets—and that is none too good."

As to reasons for the market rise since September 1953, in general I agree with the answers by President Funston, of the New York Stock Exchange, to question 1 of the committee's questionnaire. However, I should like to emphasize more than he did the role of investment and speculative sentiment in determining the wide variations in stock market prices.

In my view, the fundamental reason for the rise was the swing from doubt to confidence—from emphasis on the risks in common stocks to the emphasis on the opportunities in common stocks.

There has been no change of importance in the earnings of the Dow-Jones industrial average since 1949. Actually, however, earnings of most secondary companies fell a great deal in 1953-54 from the levels of the previous 5 years. But prior to 1954, the public was expecting a substantial setback and was braced for a large falling off in earnings when business turned down after the middle of 1953. It was the mildness of the shrinkage—especially in gross national product and disposable incomes—that reversed the tide of sentiment and gave currency to the view that we no longer have to fear deep depressions.

This change in sentiment produced a change in the public's valuation of stocks, especially in what it considered suitable multipliers of current earnings. In

effect, the multiplier advanced from about 8 for the Dow-Jones industrials in 1948-50 to 10 in 1953, and to a current 14, which is slightly less than the 1936-40 average.

My studies have led to the conclusion that sentiment alone, not supported by any visible change in value, will produce a swing on the order of 100 to 250 or 100 to 300 in price. It is interesting to note that while American Telephone & Telegraph has paid a uniform dividend of \$9 since 1922, and while its earnings have fluctuated comparatively little, its price advanced from 115 in 1922 to 310 in 1929, declined to 70 in 1932, and since then it has fluctuated between lows of about 110 and highs of about 200.

Among the secondary companies, the present situation is more complicated. Prices were very low as against earnings prior to 1953, but many of these companies had poor earnings results in 1953-54. The price behavior of this large group lagged behind the blue-chip advance until July 1954. Recently the rise in secondary issues has more than kept pace with that of the leaders. Bargains are fast disappearing and there are numerous instances of overspeculation in this field. On the whole, however, the typical second-grade stock appears less overvalued today than it was in early 1946.

Regarding feasible ways of controlling undue speculation in the future, I believe the committee should consider carefully and cautiously whether any plan of control is feasible. Speculation has not gone too far as yet, but there may be a grave danger that it will do so. Assuming that measures could be found that are useful and feasible, it would be wise to agree to such measures in advance of the necessity for their use—rather than to begin discussing them while the fire is raging.

It should be recognized that any form of intervention by Washington in the stock market is risky and controversial. You cannot be sure that what you are doing is the right thing and won't cause more harm than good. In this respect your problem corresponds to the public's own quandary in deciding whether to buy or sell or sit tight in the present market. Yet, despite the hazards of any intervention, a certain responsibility is there. It is actually being assumed—for example, by the Federal Reserve in varying margin requirements to correspond somewhat with the state of speculation.

On balance, I am inclined to favor strict controls for margin trading and a fairly rapid advance to the 100-percent-margin limit—that is, no borrowing at all—as the Federal Reserve becomes increasingly concerned about the extent of speculation. My reason is that it is basically unsound for nonprofessionals to borrow money to speculate in stocks—or in anything else. It is unsound for them and for the economy as a whole. Responsibility should also be placed upon our commercial banks to avoid, in general, the direct lending of money to the public for the purpose of speculating in stocks.

Much has been made of the capital gains tax as a deterrent to the selling of stocks. It is urged that this tax be abolished or cut in two, in order to increase the supply of stocks by unfreezing holdings showing large profits. There is some merit in this contention, and I shall have a suggestion to make along these very lines. But I regret that the issue has usually been presented by Wall Street—of which I am proud to consider myself a part—in an incomplete and rather one-sided fashion.

Taxes on capital gains have been imposed since the modern income tax began in 1913. Thus the problem of their impact on speculative markets is by no means a new one. The evidence hardly suggests that the capital gains tax has by itself produced unduly high prices or unduly wide fluctuations. Impressive arguments may be made against capital gains taxes as inequitable in theory and unsound in practice. But there are also impressive arguments against permitting capital gains to go untaxed while imposing high rates on other forms of profit. Although I believe the present capital gains tax system is open to improvement, I would not consider it basically inequitable in relation to our tax burden as a whole. Finally, while a lightening of the tax might well increase the supply of common stocks by persuading holders to take large profits, it might at the same time stimulate further speculative buying, attracted by the new tax advantage. The net result of such a move cannot be foretold.

The objections to reducing the capital gains tax would be overcome, in my opinion, if such a policy were adopted for a limited period of time only and for the specific purpose of dealing with a dangerous stock market situation. For example, the tax might well be reduced from the present 25 percent maximum to a 12½ percent maximum on securities owned at least 2 years, such reduction to be effective for a specified period only—say 6 months. I believe such an

arrangement would have the desired effect of increasing the supply of common stocks at a time when such increase is deemed necessary. From the standpoint of the Treasury, the result might well be that a larger revenue would be realized, in spite of the reduced tax rate, because of the inducement to sell locked-up shares. Whatever its effect on the level of stock prices, bona fide investors could not be harmed by such a concession, even if it ran for a limited period.

My proposal would require legislation by Congress, as would any other change in the capital gains tax. Perhaps the best method would be to give the President the power to make changes in the effective rate, within specified limits, upon advice from the Board of Governors of the Federal Reserve System. We have precedents for such powers in our tariff laws.

In conclusion, may I say that while Congress should not ordinarily meddle with the stock market, there are times when it deserves attention from Congress. We are probably in such a time at present.

CERTAIN PRICE-EARNINGS RATIOS FOR THE DOW-JONES INDUSTRIAL AVERAGE AND FOR GENERAL ELECTRIC COMMON STOCK

TABLE A.—Dow-Jones industrial average

Date	Price	Ratio to earnings for the preceding—			Yield on AAA bonds (Moody's)	Subsequent low price of average
		1 year	5 years	10 years		
1955 (March).....	414	15X	15X	18X	Percent 2.95	
1946 high.....	212	20	21	22	2.46	(1946) 163
1937 high.....	194	19½	43	21½	3.42	(1938) 99
1929 high.....	381	25	28½	34	4.69	(1932) 41
1927 high.....	202	14½	16	16	4.58	

TABLE B.—General Electric common stock

	Price	Ratio to average earnings for the preceding—			Subsequent low price
		1 year	5 years	10 years	
1955 (February).....	¹ 167	23	28	38	
1946 high.....	52	26½	30	31	
1937 high.....	65	42	84	51	33 (1946)
1929 high.....	² 101	45	60	85	27¼ (1938)
1927 high.....	² 36	23	29	34	8 (1932)

¹ Multiplied by 3 to reflect 1954 split.

² Divided by 4 to reflect 1930 split.

The CHAIRMAN. The committee will recess until Monday, when Mr. Martin of the Federal Reserve will be with us.

(Whereupon, at 1:15 p. m., the hearing was recessed, to be reconvened at 10 a. m., Monday, March 14, 1955.)

HOW TO HANDLE YOUR MONEY

Never before have so many people had extra money out of income to save or invest.

Millions wonder where to put this money—for safety, return, rise in value.

Do U. S. savings bonds pay enough? Is common stock safe?

What advantages do municipal bonds offer? What about corporation bonds?

To get competent answers to these and

other questions now raised for so many, U. S. News & World Report consulted an authority.

Benjamin Graham, security analyst and widely read author on investments, was one of the experts invited by the Senate to testify at recent stock-market hearings.

Mr. Graham also is adjunct professor at Columbia University's School of Business, where he teaches investment analysis.

Q Do you recommend, Mr. Graham, that a man of moderate means include, as a general rule, some common stock when he invests his savings for the long term?

A My answer would be definitely "Yes," under normal conditions.

Q Why?

A Because common stocks have the advantage, in the first instance, of representing sound, growing investments in the American economy, with a higher return than you would get on bonds, and, secondly, because they do carry some measure of protection against inflation—against further inflation of the kind we've lived through as a result of the last two wars.

Q Would you say there is some risk in not including some common stocks in long-term savings?

A Yes. The experience of my lifetime has shown it is a very definite risk to have your investment only in bonds.

Q Will you detail that a bit for us?

A Yes. Since 1913, the price level has approximately tripled, and, at the same time, interest rates have gone down a good deal. The old bonds with high coupon rates have been pretty well called, no longer exist. The result is that the man whose investments were solely in bonds has suffered both a reduction in income return on a percentage basis and a large reduction in the purchasing power of whatever income or principal he had.

Q Will you give us the other side of that now? What would have happened to the same man if he had bought some stocks?

A Well, if he would have diversified his holdings among representative common stocks in 1913, or in most other periods since 1913, he would have had an advance in value and in income which would have at least kept pace with the rise in the cost of living.

Q Now a man with an income of, say, \$5,000 who has but little saved, and doesn't expect to accumulate much out of that kind of income—would you recommend any common stock for him?

A On the whole, I would say "No," largely because what he could gain by having a common-stock component in his savings isn't large enough to warrant the amount of intelligence and character needed to carry on an investment program in common stocks soundly.

Q He would be better off to buy something with a safe principal and a fixed return?

A I think so, even though it involved some risk of loss of purchasing power.

Q And in a situation like that, would you recommend, say, No. 1, insurance and, No. 2, Government bonds? Or what would you recommend?

A Yes. I think the usual combination of insurance and Government bonds is correct.

Q What is that combination—what proportion?

A Well, that's difficult to say, because I think the insurance depends almost entirely on his protection requirements. I don't believe that the amount of insurance should be related to his savings program particularly. The savings are important in insurance, but they are incidental.

Perhaps I should correct my previous statement a little bit by saying that it is possible for the small man, the \$5,000-a-year man, who wishes to build up an interest in common stocks out of his rather modest savings, to do so reasonably well by following one of these accumulation programs in the investment-fund area—

Q Investment companies?

A Yes, investment companies. Yes, he could do it, and I think on balance it would probably be better for him to do it if he wants to do so rather than not to do it. There are some risks involved in that program, but there are also some advantages, too.

Q If he goes into that, you would recommend three elements, then: whatever insurance his family needs for protection, some savings bonds, and some investment-company purchases?

A That is right, yes.

Who Should Buy Common Stocks . . . Ways to Offset Wide Price Swings . . . Investing at Different Income Levels

Q When you speak of Government bonds, you mean savings bonds?

A Oh, yes. I see no reason whatever for the small man to invest in Government securities other than the very attractive savings bonds which he now can buy.

Q You think they are a good buy for the average man?

A A very good buy in terms of fixed-interest investments.

Q You are talking primarily about the E bond?

A The H bond and the E bond. Actually, the E bond is better than the H bond because a man who is saving doesn't need to get current interest and reinvest it. It's better to have it compounded for him automatically.

Q This \$5,000 man we were talking about—

A Actually, I should like to say this about the \$5,000-a-year man. The original question assumed that his \$5,000 was pretty well fixed. But that may be rather unrealistic. Most \$5,000-a-year men are expecting to earn more than that as they go along, in one way or another.

The young man who has reached \$5,000 in his career naturally expects to do better, and it wouldn't hurt him at all to start out in some common-stock program and get an education in common stocks, in part, by practice.

Q He would get mostly education, wouldn't he? Because he wouldn't have enough surplus income to invest much—

A No, but I mean he could start with the small amount that he has in his savings to do something in the common-stocks field more advantageously for his future program than in connection with anything he may accomplish now. For example, if he's going to make mistakes, it's better that he make them with the small amount of money that he has than with a larger amount of money that he might have later.

Q Would you say there are many men in the \$10,000 and \$20,000 group who should be buying stocks but who are not?

A I'd put it this way: There are thousands who should have been buying stocks and who didn't.

Q But with the market level aside—

A Market level aside, I would say that \$10,000 to \$20,000 men would be well advised, as a whole, to have a systematic investment program in common stocks.

Q How should their investments be divided, roughly?

A On the whole, they can go higher in the common-stocks spectrum than the persons who don't have earnings independent of capital. They could get into the two-thirds-common-stocks area very soundly.

Q Why?

A I think mainly because of the fact that they can take the risks involved in changes in the economic situation from year

to year with more equanimity than those whose sole financial support is their capital funds.

Q You mean they are less likely to face a time when they have to sell their stocks whether they want to or not because they find that the price has gone down—is that it?

A That's the way it's usually expressed, but my experience has been that it's not the outer compulsion that governs it so much as the inner compulsion, drive, the inner apprehension. Most people sell stocks at low prices not because they have to but because they are scared.

Q They won't hold on long enough?

A They won't see the situation through. Let's take a widow who has all her money in common stocks, or nearly all, and is doing pretty well with it for a while. Then the market has one of its old lashings, it collapses, and she finds her principal value greatly reduced. She is likely to get so panicky that she might sell out at the bottom, or near the bottom, and have a harrowing experience as a result of that.

A businessman or a man with a career earning a good deal of money may do the same thing, but he's not as likely to do it, particularly if he has educated himself to know and be familiar with the normal vicissitudes of the stock market.

Q You were talking about putting two thirds of savings for the long term in common stocks. Which man is that—which man should do that?

A That would be the \$10,000 to \$20,000-a-year earner who feels he may go further than that in the future.

Q As we go on up higher, as we get into \$25,000 and \$30,000, would you recommend a higher proportion in common stocks?

A I don't believe so, because, when you get beyond that range, you get to a different question where it's not so essential to try to get the maximum results out of your investment, but it becomes important to feel that you are protected against any eventuality.

One of the advantages of having a lot of money is that nothing should be able to hurt you. If you have a fair amount of your money in the Government-bond area and another fair amount in common stocks, you're in an ideal position.

Q Do you recommend corporate bonds for the man making \$20,000?

A No. I don't see any reason under conditions today, and those we've seen for many years past, why a man should buy corporation bonds.

Q Why?

A The yields of the good bonds are only slightly in excess of what he could get on U. S. savings bonds. On the second—

(Continued on next page)



—Greystone Studio

BENJAMIN GRAHAM

... "Investing a few thousand—you can't do it casually, by tips"

grade bonds, the risk element offsets, approximately at least, the additional income. There is, of course, the question of tax-exempt bonds, which is a separate factor; a \$20,000-a-year unmarried man might find the tax-exempts interesting, whereas the married man with \$20,000 income probably wouldn't.

Q We've been talking up to now, by implication at least, only about investing money to get income. Is there a stage at which investments become logical for long-term appreciation—that is, where profit can be made by an advance in the market value of a security?

A Oh, yes. I think in the early part of one's career, in business or the professions, if you have considerable interest in financial matters, as many people have, and want to educate yourself as far as you can in finance, there, if you wish to get the full advantage out of your education, the advantage would be in investment for appreciation. The rewards are greater, of course, in appreciation than they are in income, and there's no reason why a person shouldn't aim at those things.

Q Even at a relatively low income level?

A He could do that, too, as a matter of fact, and get more interest out of life, being a skillful investor for appreciation on a small scale, than he would if he just did it to get a few dollars a year income.

Q You think the average person is capable of doing this?

A Well, taking everything into account, I would say "No." I mean, if you took a person at random and gave him the ideal surroundings and education and counsel, and so on, you might turn him into a person capable of doing this. But, under the circumstances in which he lives, he probably would not do a good job.

Q Who would, then?

A It would be good for a person who has considerable native intelligence and ability and who has a real interest in financial matters and is willing to devote the amount of time and energy to it.

Q And who has time for it—the time is important?

A Well, everybody has enough time for it. It's really the determination that counts. I mean, investing a few thousand dollars is not a full-time job. But it is a job that you can't do casually, by tips, and so forth.

Q Where can the average man get his information? How does he go about it?

A You mean his education. Information is one thing and education is another, a more fundamental thing in connection with investment. Naturally, the way he can do that is by pursuing some of the avenues of instruction that are open. He can take courses, as many do. Those who are in New York, of course, have a better opportunity than those who are in small towns.

Q Around the country, though, many can't get such instruction, can they?

A Well, the average man won't do it. But I wouldn't be willing to admit that he can't do it. A person who is really determined to prepare himself to be an intelligent investor can do it. For example, he can take a correspondence course. You learn the job just the way you learn to play the piano.

Q What about the man who lives where such a course simply is not available? As a matter of fact, most people aren't willing to devote the time for such courses, anyway. What's the next best thing?

A The next best thing for him to do is to decide that he cannot expect to get optimum investment results without this

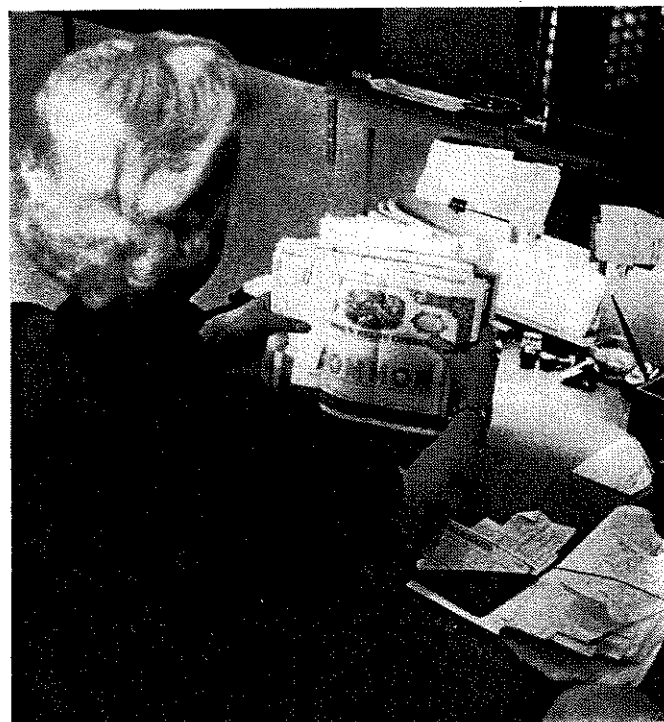
optimum preparation, and consequently he has to accept a more representative or average investment program. He can do that by deciding to follow a simple but very definite plan—first, dividing his money into the compartments we discussed before and, secondly, following a systematic and simple procedure with respect to the common-stock components.

For example, I suggest that he buy investment-company shares on a regular basis. That brings in the concept of dollar averaging, which has now become so familiar and popular. That would be a sound procedure. The main thing for him is not to go off suddenly on a tangent, believing that he had suddenly become an expert because the market has gone up and he has been making some money.

Q What do you mean by "dollar averaging"?

A Dollar averaging is a method of investment under which you set aside regularly a fixed amount of money and invest it in common stocks generally, either in a single common stock or preferably in a group investment through investment-company shares. By investing the same amount of money at regular intervals—say, every three months—you get two advantages. One is that over the years your investment reflects the average market price rather than the high market levels—which is where you are likely to buy if you follow the crowd.

Secondly, the arithmetic of dollar averaging gives you more shares at the lower prices than at the higher prices, so that your average cost is lower than the arithmetical average. If you are putting \$1,000 in one kind of stock and the price is \$10, you'd get 100 shares. If later it's \$20, you'd get 50 shares. You bought more stock at the \$10 basis than at \$20. Consequently your average price would be less than \$15.



COMMON STOCKS: "They do carry some measure of protection against inflation"

... "Dollar averaging—the soundest and most simple plan"

Q Do you think the dollar-averaging plan for an individual is sound?

A Yes, I think it's the soundest and most simple plan open to everybody that I know of.

Q About how long does it take for dollar averaging to produce results?

A Over past experience, it's generally felt that a seven-year period is a kind of minimum. A 10-year period is usually the one that is talked about.

Q That being the case, one could start at any time?

A Yes. The reason you talk about a 10-year period is that past analysis shows that had you started at any time, even at the top of the market in 1929, you would have done all right by 10 years later.

Q Then the man of moderate means has two alternatives in buying stocks: If he hasn't a lot of time and know-how, he is well advised to buy conservatively, either to buy investment shares or to buy well-known stocks when they are at reasonable prices. Or if he has a lot of time, then he can go into it with more detail, take more risks, buy lesser-known shares, and not be so conservative about it. Is that the sum of it?

A I would question, in a way, your expression. You mention the fact that he would take more risks, and that is the usual concept where one buys securities that are not so well known. But when you consider the matter carefully you'll see that the purchase of securities that are not so well known at low prices—which is what a man wants to use his particular skill for—does not really involve more risk. It involves less risk on the whole. It only appears to be riskier.

Q Still, the point is that, if he doesn't have the time to think

about it or the know-how, he's got to buy something like investment-company shares or the standard blue chips—isn't that right? He has no other choice, has he?

A Yes, that's true. And, when he departs from those procedures, the chances are that he will make mistakes, and perhaps very serious mistakes, by buying the kind of thing that's called to his attention by salesmen or others who operate by tips.

Q When a man is planning to use dollar averaging, the first thing he wants to do is to select a group of stocks that he's going to buy. Now, maybe he'd prefer to invest directly rather than through an investment company. What should he do? Should he go to his broker to seek advice?

A I don't want to disparage the service that brokers can render. I think they can render good services in many circumstances. But I don't believe that on the whole the service they can render for this particular man would turn out to be best. Because his limited objective is to buy sound securities over a period of years, and it's easier for him to follow that general principle than it is for him to get good specific advice.

The broker is likely to have his thoughts pretty much on what seems to be good at the moment, and that would not fit in too well with this long-term investment plan.

Q What would be the best plan for this long-term investor? He's going to try to select a group of investments that he is going to buy over a period of years and he does not feel confident in himself to sit down and figure out what those issues should be—

A It seems to me that the investment company is just made to order for that man.

(Continued on next page)



WATCHING THE PRICES IN A BROKER'S OFFICE

—USN&WR Photo

"A person who is really determined to prepare himself to be an intelligent investor can do it"

... At \$100,000, "half to two thirds in common stocks"

Q But aren't investment-company shares expensive to deal in?

A They are expensive on a short-term basis. They are not particularly expensive on a long-term basis. The commission rates run, let's say, 7.5 to 8 per cent. If a man were to hold his investment for a 10-year period, that would mean it cost him about three quarters of a per cent a year on his principal. He's also paying a certain amount, perhaps 6 or 7 per cent out of the income, for operating expenses. While that is not negligible at all, I don't believe it's prohibitive.

One thing you must remember is that if he bought his investments directly and then later sold them, he would have an aggregate commission that might be about one third to a half of what he would pay to buy into an open-end investment fund.

Q So that the investment fund is for the man who is making long-term investments, the man who is saving for the future?

A Yes, by all means. I don't think it makes sense for any proposed investment for less than a number of years.

Q And particularly for the man who hasn't great amounts to invest and not too much time to go into it?

A Well, it's not limited to him necessarily, but it's of greatest advantage for the man who wants to invest over a period of time in a simple manner.

AT \$50,000 OF INCOME—

Q What about higher up in the income scale? What about the man who is earning \$50,000 a year?

A He, naturally, would feel that he would like to look over the situation in investments at least and consider making decisions of his own in the kind of securities that he wants. The amount of money that he has would make it worth while to give it thought and considerable care. I'm not so sure that this man would necessarily do any better than he would do if he bought investment-fund shares; but it's more natural and more interesting for him to do other things.

You must never minimize the personal equation. Most men like to make their own decisions.

Q To go back to what a man can do—is it impractical for the average investor, for instance, to deal with an investment counselor?

A For the small man, yes. The investment counselor generally deals with a person with \$100,000 or more to invest in securities, particularly common stocks. It doesn't make much sense for a man to bring to an investment counselor a \$50,000 fixed-bond portfolio. He can invest that money in bonds without paying the charges of an investment counselor. You need to be fairly wealthy to do that.

Q What about the investment services that are published monthly or weekly?

A Frankly speaking, I don't know much about them. But it's obvious that the small man couldn't soundly pay money for a weekly investment service and try to follow their suggestions every week or month. That would imply that he is going to be active all the time in the market, and that is an entirely different thing from the kind of investment that we are talking about. If he's a speculator, that's another story.

Q For the man who is going to spend some time of his own, instead of buying the Dow-Jones list or investment shares—and you've already suggested that the broker can't

help him much—where does he get the factual information that he needs in order to exercise his own judgment?

A Now, I don't want to do an injustice to brokers here. I would say that the man who had a purely conventional program and wanted to select some issue for long-term, repeated investment probably wouldn't get much help from a broker. On the other hand, if he wants to do a continuous study of the financial and business situation, he could get advice from a broker.

Q What does he get from a broker?

A In the first place, he'd get the information he needs in convenient form—

Q The factual information?

A Yes. He doesn't have to subscribe to Moody's and Standard & Poor's, and so on. He can use the broker's facilities.

Q The broker will tell him about a company's financial condition, its record, dividends, and that sort of thing?

A That's right. He can get all of that data, which is, of course, essential if he wants to do any studying. He can get analyses from the broker—presenting the information in a little better way, perhaps, than he could get it himself by just reading the sources. And he can also get points of view, recommendations, and so on, which may be better, on the whole, than ones he would make up for himself.

Q What about a man with a \$100,000 income? Take a man with that much income and considerable savings laid aside—how should he divide his savings among various types of investments?

A I would say that under normal conditions, in the light of the experience of the last 50 years, he would likely aim at anywhere from one half to two thirds of his investment in common stocks as his objective.

Q And the rest?

A The rest could be in insurance savings, to some extent, though generally the insurance savings are not considered a part of your funds today. They do act as a protection. Any combination of Government bonds and tax-free bonds—municipal or State bonds—would do for the rest.

STOCKS FOR \$100,000 MAN—

Q What is the kind of stocks that this man should buy on a dollar-averaging basis? Is he going to buy the blue chips? Is he going to buy his stocks in terms of long-term growth?

A That man is probably not going to be such a dollar-averager, because the higher up you are on the income scale, the more variable generally, is the amount of money that you have available for investment. It's not so simple for him to adopt or pursue a dollar-averaging plan. Typically, he invests money as it becomes available. There his selection of stocks will, I suppose, depend on the amount of attention that he is able to give to the subject, his personal equipment, and so forth.

If he wanted to become something of an expert investor, then he would go over into the field of interesting situations, based upon his knowledge and study. They could include "growth" stocks, on the one hand, they could include bargain securities on the other, and special situations of various sorts. If you assume that he doesn't want to give the amount of attention to the business that it requires to do it properly, then actually there isn't too much point in his trying to be selective at all.

... "A widow with \$50,000—almost an insoluble problem"

That's where a broker can come in handy. He asks the broker from time to time to make up a list of good, representative securities, of the kind that are in the Dow-Jones industrial average, and he would probably do about as well with these as he would in trying to use a rather inexpert way of picking out the things that seem to be good to him from year to year or day to day.

You know, people say there's no point in comparing things with the averages because you don't buy the averages. And I've always added: Why not? There's no particular reason why a person couldn't buy 10 shares or 100 shares of all the stocks in the Dow-Jones averages and actually get their results. People don't do it, for one reason or another, but there's nothing impossible or unsound about it.

Q But for the average fellow who does not have an opportunity or inclination to become expert, to follow the situation very closely, you think that buying the blue chips would be about as good as anything that he could do?

A Yes. He should do that normally. But, as I've said often, he ought, however, to be reasonably sure that he's not paying excessive prices for them.

Q By definition, isn't the growth company one you think of as putting a large part of its profits back into growth instead of paying it out in dividends?

A That should be the idea of a growth company—

WHAT A "GROWTH" STOCK IS—

Q Unless you think of a uranium company—

A Well, that's another type of thing. But basically a growth company is one which (a) will be expanding its business and its profits at more than the average rate, and (b) will in the course thereof be investing a large part of its profits back in the business.

Q When you get into the growth stocks, you get into a situation where a man needs a good deal of knowledge?

A I think so. But even then it's hard to tell how good your knowledge is, because growth stocks lead to the future, and you don't really ever have any knowledge of the future. You may have a more expert guess than the other man, but it's still a guess. And many mistakes have been made in buying growth stocks on the theory that the future will duplicate the past.

Q In trying to buy something for long-term growth, you ordinarily have to recognize, one, that you are taking a chance and, two, you perhaps have to sacrifice income along the way in order to achieve a long-term growth. Isn't that ordinarily the case?

A Yes. The chance is basically related to the point that you pay a higher price for a security in terms of its past and current earnings and dividends than you would for nongrowth securities, and there is always a possibility of disappointment. The company would have to be better than the average company to justify the price you pay for it. Maybe it won't be, but you think it will.

You start with a sacrifice of income generally and you are apt to find it continuing for some years. But that is not particularly important to people if they are right in their estimate of the company's future expansion. The fact that the income is small is not a real sacrifice if you don't need the income to spend.

Q What about a widow who gets her husband's insurance of, say, \$50,000? How should she invest it? Or should she

leave it all in the insurance company, drawing monthly payments?

A Well, the widow would like, if possible, to earn enough income to pay her living expenses. Naturally there is a great aversion against using up capital. Yet, for most widows of whom we are talking, those particularly within the \$50,000-to-\$100,000 capital range, that's almost an insoluble problem.

Q You mean with those sums there isn't enough income to leave the capital alone?

A Not if she were dependent upon the income from that money—unless she were living in rather unusual conditions, a very small town, and so forth, where her wants were extremely limited. But the average widow wants to live somewhat in the style to which she was accustomed when her husband was accumulating \$100,000 in one way or another, including insurance, and she would find it very difficult to make it do. And that, as you probably know, is one of the most difficult problems that investment counsel have to deal with nowadays.

Q How is it usually resolved—by a compromise?

A Yes, it's usually resolved by a compromise. There's been a tendency through recent years to be bolder and bolder in advice to widows, suggesting that they consider getting up pretty high in the percentage of investments in common stocks on the twin grounds, first, that they do need the income badly and, secondly, that it's not unsound or risky for them to put their money in well-selected or representative common stocks. And that advice was really good advice at a time when one could say with conviction that the price level of common stocks was an attractive one.

Q That's for the widow with \$50,000. Now, for the widow drawing a smaller amount, \$10,000 or \$15,000, you would not suggest that she put any part of it into common stocks?

A I think not. I'm afraid that, when you take into account the psychological factors in that kind of thing, which can create real problems, and compare that with the monetary advantages of a small common-stock investment, the psychological dangers far outweigh the monetary advantages.

WHY PREFERRED STOCK—

Q What do you think of preferred stocks?

A Preferred stocks are a hybrid investment. Theoretically they are all wrong, but that doesn't prevent them from working out all right practically. I say they're all wrong because, for one thing, if they are really a good investment for the investor, they are not a good security for the corporation. The corporation should issue a bond and get the advantage of the income tax saving. If the corporation can't afford to issue a bond for that particular amount of capital, then they're not too good for the investor. That's the way it is in theory.

In practice, however, many corporations issue perfectly good preferred stocks—I think by a wrong policy on their part—and investors can buy them soundly. The history of preferred stocks is not quite as bad as you'd expect it to be. Nevertheless, it turns out that when the market is weak, preferred stocks generally behave quite badly, not nearly so well as bonds would behave if they were in the same general position.

Q What about mortgages as an investment for the individual?

A I've felt that the FHA guaranteed mortgages are per
(Continued on next page)

... "Ordinary man more apt to get poorer by speculating"

fectly sound. We've bought them for insurance companies that I am identified with, and I see no reason why the individual shouldn't buy them, except that they may be a little too much of a nuisance for him to handle. I am not experienced at all in the mortgage field for individual investors. But in principle I don't see why an investor couldn't do quite well with these guaranteed mortgages. I'm convinced that the Government's obligation there is perfectly dependable.

Q Actually, only in rare cases do individuals buy mortgages, corporation bonds and preferred stocks—isn't that generally true?

A Well, it used to be true that bonds and preferred stocks were a standard part of portfolios—and they're still a standard part of portfolios administered by banks for even average investor clients or trust funds. But now the tendency—and I think it's a sound one—is in the direction of dividing the individual portfolio into either Government bonds or tax-free securities on the one hand and common stocks on the other.

Q Going into this current stock market, you've indicated a couple of times that some of your answers would not apply to the market as it is today. Is that right?

A Well, it might not apply. What I meant was that, if one believes that the present market is definitely too high, it would not be sound for an investor to start out by putting a substantial part of his funds in it. There is some question whether he should start dollar averaging when the market is too high.

FOR THE NEW INVESTOR—

Q For the average man who has never invested in stocks, but who now discovers he has a surplus income and feels that he should start building up some equities—should he not start today at the current level of stock prices?

A The best suggestion I can make is that if he were sure that he could follow a dollar-averaging program, he could start today. If he has any doubts on that subject, either because of his financial situation or his psychological situation, I'd advise him to hold off. This is not the most satisfactory time to start in stocks.

Q Might it be better for him to wait anyway, even if he thinks he can keep his program going?

A Well, waiting is a difficult operation itself. While you're waiting, you're wondering how much you're missing, whether you'll ever have a chance to get back at a better time. When the chance does occur, you wonder when is the right moment to start coming in. All those things are difficult decisions to make. It's easier to do the thing mechanically than it is to do it by these judgments.

Q From what you say here and what you've written, you do not advise people to speculate—ordinary people, that is. Isn't that right?

A Well, being against speculation is almost like being against sin. But speculation really is a sin to the untrained member of the public.

Q So that the ordinary man is not going to get rich by speculating on the market?

A No, but more apt to get poorer. The main point is that a man can earn some money by taking a sensible attitude toward investment, but I don't see how a man can earn money by being an untrained speculator. He just doesn't put enough into it to justify his hopes of getting something out of it.

Q Do you have the feeling that we are at a point in history where, again, the market fever is hitting the little people and

that speculation with cash savings is possibly going to spread to rather dangerous levels?

A Yes, I'm quite apprehensive about it.

Q Do you think a good many issues are too high now?

A Yes. That is undoubtedly true.

Q This would indicate that there are a good many well-accepted issues which today would appear to be overpriced?

A I think that's so. I think they carry with them some dangers.

Q Do you also feel that there are issues in the market which are underpriced?

A Yes. I think there are considerable numbers of those issues. Actually, among the thousands of issues that are dealt in, quite a number of them are still selling at considerably under what I would consider to be their true value. However, I should add that nearly all of those securities tend most of the time to sell under their true value.

Q So that they would later as well as now?

A Yes. Except at more or less the top of the market.

Q How does one identify these issues?

A The simplest test that I've had is the value of the company as a private business. If you can look at a company and say that at this price for the stock the whole enterprise is selling at a figure which is clearly less than it would be worth to me if it were my business, if I owned it—you can divide the figures by 10 or 100 to make them comparable to the kind of business you are familiar with in private practice—if that test shows that the price is quite low, then it's generally a reasonably good guide to your evaluation of the stock itself. In some cases, the very fact that the company is selling considerably under the working capital alone, with no value given to all the fixed assets, is a prima facie indication that the price is too low.

BUYING ON MARGIN—

Q What is your opinion of an individual buying stocks on margin?

A I would say the average member of the public, who does not make a business of buying and selling securities, makes an error in buying securities on margin—most of the time. It would only be under exceptional circumstances that he would be justified in doing so.

Q Such as?

A Such as the conviction on his own part that the market level is unusually low.

Q Should the man who has considerable money to put into investments, and who has been doing so, should he perhaps compromise at this point and continue buying more carefully?

A No. I think if you take the man you are talking about—he's already been in the market and has a considerable stake in common stocks now—it would be sounder for him to start a selling policy at this stage. It could be on an upward scale, involving small amounts at present, or if he really feels apprehensive, he should sell larger amounts. Nobody can tell him how fast to sell.

Q What does he do when he sells—put his money into Government bonds until the market goes down?

A I imagine that's what he ought to do. He may wait a year, decide he was wrong, and then go back in the market on a dollar-averaging basis again. At least he could say he was wrong intelligently.

Two Illustrative Approaches to Formula Valuations of Common Stocks

BENJAMIN GRAHAM

OF THE VARIOUS BASIC APPROACHES to common-stock valuation, the most widely accepted is that which estimates the average earnings and dividends for a period of years in the future and capitalizes these elements at an appropriate rate. This statement is reasonably definite in form, but its application permits of the widest range of techniques and assumptions, including plain guesswork. The analyst has first a broad choice as to the future period he will consider; then the earnings and dividends for the period must be estimated, and finally a capitalization rate selected in accordance with his judgment or his prejudices. We may observe here that since there is no *a priori* rule governing the number of years to which the valuer should look forward in the future, it is almost inevitable that in bull markets investors and analysts will tend to see far and hopefully ahead, whereas at other times they will not be so disposed to "heed the rumble of a distant drum." Hence arises a high degree of built-in instability in the market valuation of growth stocks, so much so that one might assert with some justice that the more dynamic the company the more inherently speculative and fluctuating may be the market history of its shares.¹

When it comes to estimating future earnings few analysts are willing to venture forth, Columbus-like, on completely uncharted seas. They prefer to start with known quantities—e.g., current or past earnings—and process these in some fashion to reach an estimate for the future. As a consequence, in security analysis the past is always being thrown out of the window of theory and coming in again through the back door of practice. It would be a sorry joke on our profession if all the elaborate data on past operations, so industriously collected and so minutely analyzed, should prove in the end to be quite unrelated to the real determinants of the value—the earnings and dividends of the future.

Undoubtedly there are situations, not few perhaps, where this proves to be the rueful fact. But in most cases the relationship between past and future proves significant enough to justify the analyst's preoccupation with the statistical record. In fact the daily work of our practitioner consists largely of an effort to construct a plausible picture of a company's future from his study of its past performance, the latter phrase inevitably suggesting similar intensive studies carried on by devotees of a very different discipline. The better the analyst he is, the less he confines

1. On this point the philosophically inclined are referred to the recent article of David Durand on "Growth Stocks and the Petersburg Paradox", in the September 1957 issue of the *Journal of Finance*. His conclusion is "that the growth-stock problem offers no great hope of a satisfactory solution."

himself to the published figures and the more he adds to these from his special study of the company's management, its policies, and its possibilities.

The student of security analysis, in the classroom or at home, tends to have a special preoccupation with the past record as distinct from an independent judgment of the company's future. He can be taught and can learn to analyze the former, but he lacks a suitable equipment to attempt the latter. What he seeks, typically, is some persuasive method by which a company's earnings record—including such aspects as the average, the trend or growth, stability, etc.—plus some examination of the current balance sheet, can be transmuted first into a projection of future earnings and dividends, and secondly into a valuation based on such projection.

A closer look at this desired process will reveal immediately that the future earnings and dividends need not be computed separately to produce the final value. Take the simplest presentation:

- (1) Past earnings times X equal future earnings.
- (2) Future earnings times Y equal Present Value.

This operation immediately foreshortens to:

- (3) Past Earnings times XY equal Present Value.

It is the XY factor, or multiplier of past earnings, that my students would dearly love to learn about and to calculate. When I tell them that there is no dependable method of finding this multiplier they tend to be incredulous or to ask, "What good is security analysis then?" They feel that if the right weight is given to all the relevant factors in the past record, at least a reasonably good present valuation of a common stock can be produced, one that will take probable future earnings into account and can be used as a guide to determine the attractiveness or the reverse of the issue at its current market price.

In this article I propose to explain two approaches of this kind which have been developed in a Seminar on Common-Stock Valuation. I believe the first will illustrate reasonably well how formula operations of this kind may be worked out and applied. Ours is an endeavor to establish a comparative value in 1957 for each of the 30 stocks in the Dow-Jones Industrial Average, related to a base valuation of 400 and 500, respectively, for the composite or group. (The 400 figure represented the approximate "Central Value" of the Dow-Jones Average, as found separately by a whole series of formula methods derived from historical relationships. The 500 figure represented about the average market level for the preceding twelve months.)

As will be seen, the valuations of each component issue

take into account the four "quality elements" of profitability, growth, stability and dividend pay-out, applying them as multipliers to the average earnings for 1947-1956. In addition, and entirely separately, a weight of 20% is given to the net asset value.

The second approach is essentially the reverse of that just described. Whereas the first method attempts to derive an independent value to be compared with the market price, the second starts with the market price and calculates therefrom the rate of future growth expected by the market. From that figure we readily derive the earnings expected for the future period, in our case 1957-1966, and hence the multiplier for such future earnings implicit in the current market price.

The place for detailed comment on these calculations is after they have been developed and presented. But it may be well to express the gist of my conclusions at this point, viz.:

(1) Our own "formula valuations" for the individual stocks, and probably any others of the same general type, have little if any utility in themselves. It would be silly to assert that Stock A is "worth" only half its market price, or Stock B twice its market price, because these figures result from our valuation formula.

(2) On the other hand, they may be suggestive and useful as composite reflections of the past record, taken by itself. They may even be said to represent what the value would be, assuming that the future were merely a continuation of past performances.

(3) The analyst is thus presented with a "discrepancy" of definite magnitude, between formula "value" and the price, which it becomes his task to deal with in terms of his superior knowledge and judgment. The actual size of these discrepancies, and the attitude that may possibly be taken respecting them, are discussed below.

Similarly, the approach which starts from the market price, and derives an implied "growth factor" and an implied multiplier therefrom, may have utility in concentrating the analyst's attention on just what the market seems to be expecting from each stock in the future, in comparison or contrast with what it actually accomplished in the past. Here again his knowledge and judgment are called upon either to accept or reject the apparent assumptions of the market place.

Method 1. A Formula Valuation Based Solely on Past Performance in Relation to the Dow-Jones Industrial Average as a Group.

The assumptions underlying this method are the following:

(1) Each component issue of the Dow-Jones Industrial Average may be valued in relation to a base value of the average as a whole by a comparison of the statistical records.

(2) The data to be considered are the following:

(a) *Profitability*—as measured by the rate of return on invested capital. (For convenience this was computed only for the year 1956.)

(b) *Growth of per-share earnings*—as shown by two

measurements: 1947-56 earnings vs. 1947 earnings, and 1956 earnings vs. 1947-56 earnings.

(It would have been more logical to have used the 1954-56 average instead of the single year 1956, but the change would have little effect on the final valuations.)

(c) *Stability*—as measured by the greatest shrinkage of profits in the periods 1937-1938 and 1947-1956.

(The calculation is based on the percentage of earnings retained in the period of maximum shrinkage.)

(d) *Pay-out*—as measured by the ratio of 1956 dividends to 1956 earnings. In the few cases where the 1956 earnings were below the 1947-56 average we substituted the latter for the former, to get a more realistic figure of current pay-out.

These criteria demonstrate the quality of the company's earnings (and dividend policy) and thus may control the multiplier to be applied to the earnings. The figure found under each heading is divided by the corresponding figure for the Dow-Jones group as a whole, to give the company's relative performance. The four relatives were then combined on the basis of equal weights to give a final "quality index" of the company as against the over-all quality of the group.

The rate of earnings on invested capital is perhaps the most logical measure of the success and quality of an enterprise. It tells how productive are the dollars invested in the business. In studies made in the relatively "normal" market of 1953 I found a surprisingly good correlation between the profitability rate and the price-earnings ratio, after introducing a major adjustment for the dividend pay-out and a minor (moderating) adjustment for net asset value.

It is not necessary to emphasize the importance of the growth factor to stock-market people. They are likely to ask rather why we have not taken it as the major determinant of quality and multipliers. There is little doubt that the expected future growth is in fact the major influence upon current price-earnings ratios, and this truth is fully recognized in our second approach, which deals with growth expectations as reflected in market prices. But the correlation between market multipliers and past growth is by no means close.

Some interesting figures worked out by Ralph A. Bing show this clearly.² Dow Chemical, with per-share earnings growth of 31% (1955 vs. 1948) had in August 1956 a price-earnings ratio of 47.3 times 1955 earnings. Bethlehem Steel, with corresponding growth of 93%, had a multiplier of only 9.1. The spread between the two relationships is thus as wide as fourteen to one. Other ratios in Mr. Bing's table show similar wide disparities between past growth and current multipliers.

It is here that the stability factor asserts its importance. The companies with high multipliers may not have had the best growth in 1948-55, but most of them had greater than average stability of earnings over the past two decades.

These considerations led us to adopt the simple arith-

2. "Can We Improve Methods of Appraising Growth Stocks?" by R. A. Bing, *Commercial and Financial Chronicle*, Sept. 13, 1956. Table on p. 24.

metrical course of assigning equal weight to past growth, past stability, and current profitability in working out the quality coefficient for each company. The dividend payout is not strictly a measure of quality of earning power, though in the typical case investors probably regard it in some such fashion. Its importance in most instances is undeniable, and it is both convenient and plausible to give it equal weight and similar treatment with each of the other factors just discussed.

Finally we depart from the usual Wall Street attitude and assign a weight of 20% in the final valuation to the net assets per share. It is true that in the typical case the asset value has no perceptible influence on current market price. But it may have some long-run effect on future market price, and thus it has a claim to be considered seriously in any independent valuation of a company. As is well known, asset values invariably play some part, sometimes a fairly important one, in the many varieties of legal valuations of common stocks, which grow out of tax cases, merger litigation, and the like. The basic justification for considering asset value in this process, even though it may be ignored in the current market price, lies in the possibility of its showing its weight later, through competitive developments, changes in management or its policies, merger or sale eventuality, etc.

The above discussion will explain, perhaps not very satisfactorily, why the four factors entering into the quality rating and the fifth factor of asset value were finally assigned equal weight of 20% each.

The actual application of our illustrative method can now be explained by working through the figures for the first company in the group, Allied Chemical & Dye. Following are data used in computing the "value" of ACD relative to a 400 and a 500 valuation for the Dow-Jones Industrial Average:

	D. J. Ind. Av.	Allied C. & D.	"Quality" Factors: Ratio of ACD to D.J.
Earned per share 1956	\$36.00	\$ 4.74	
1947-56	27.50	4.50	
1947-49	21.80	3.73	
1938 (unadjusted)	6.01	5.92	
1937	11.49	11.19	
Dividends 1956	23.15	3.	
Net Asset Value 1956	275.	40.	
Profitability:			
1956 earnings/1956 net assets	13.0%	11.85%	91%
Growth-A: 1947-56 vs. 1947-9	26%	21%	
B: 1956 vs. 1947-56	30%	5%	
A plus B.	56%	26%	46%
Stability:			
1938 earnings/1937 earnings	52.3%	53%	101%
Pay-out:			
1956 dividend/1956 earnings	64.3%	64%	100%
Average of four Quality Factors			84%

Formula to produce value of 400 for D.J. Ind. Av.:

"Value" equals $1/5$ Net Assets plus $12.5 \times 1947-56$ earnings or 55 plus 12.5×27.50 or 400.

Corresponding "Valuation" of Allied Chem. & Dye, (including Quality Factor of 84%):

Value equals $1/5 \times 40$ plus $.84 \times 12.5 \times 4.50$ or 55.

Formula to produce value of 500 for D.J. Ind. Av.:

Value equals $1/5$ Net Assets plus $16.2 \times 1947-56$ earnings or 500.

Corresponding "Valuation" of Allied Chem. & Dye:

Value equals $1/5 \times 40$ plus $.84 \times 16.2 \times 4.50$ or 69.

In Table I we supply the "valuation" reached by this method for each of the 30 stocks in the Dow Jones Industrial Average. Our table includes the various quality factors, the average earnings, and the asset values used to arrive at our final figures.

In about half the cases these "valuations" differ quite widely from the prices ruling on August 5 last, on which date the D. J. Average actually sold at 500. Seven issues were selling at 20% or more above their formula value, and an equal number at 20% or more below such value. At the extremes we find Westinghouse selling at a 100% "premium," and United Aircraft at about a 50% "discount." The extent of these disparities naturally suggests that our method is technically a poor one, and that more plausible valuations could be reached—i.e., ones more congruous with market prices—if a better choice were made of the factors and weights entering into the method.

A number of tests were applied to our results to see if they could be "improved" by some plausible changes in the technique. To give these in any detail would prolong this report unnecessarily. Suffice it to say that they were unproductive. If the asset-value factor had been excluded, a very slight change would have resulted in favor of the issues which were selling at the highest premium over their formula value. On the other hand, if major emphasis had been placed on the factor of past growth, some of our apparently undervalued issues would have been given still larger formula values; for Table I shows that more of the spectacular growth percentages occur in this group than in the other—e.g., United Aircraft, International Nickel, and Goodyear.

It is quite evident from Table I that the stock market fixes its valuation of a given common stock on the basis not of its past statistical performance but rather of its expected future performance, which may differ significantly from its past behavior. The market is, of course, fully justified in seeking to make this independent appraisal of the future, and for that reason any automatic rejection of the market's verdict because it differs from a formula valuation would be the height of folly. We cannot avoid the observation, however, that the independent appraisals made in the stock market are themselves far from infallible, as is shown in part by the rapid changes to which they are subject. It is possible, in fact, that they may be on the whole a no more dependable guide to what the future will produce than the "values" reached by our mechanical processing of past data, with all the latter's obvious shortcomings.

Let us turn now to our second mathematical approach, which concerns itself with future growth, or future earnings, as they appear to be predicted by the market price itself. We start with the theory that the market price of a representative stock, such as any one in the Dow-Jones group,

reflects the earnings to be expected in a future period, times a multiplier which is in turn based on the percentage of future growth. Thus an issue for which more than average growth is expected will have this fact shown to a double degree, or "squared," in its market price—first in the higher figure taken for future earnings, and second in the higher multiplier applied to those higher earnings.

We shall measure growth by comparing the expected 1957-66 earnings with the actual figures for 1947-56. Our basic formula says, somewhat arbitrarily, that where no growth is expected the current price will be 8 times both 1947-56 earnings and the expected 1957-66 earnings. If growth G is expected, expressed as the ratio of 1957-66 to 1947-56 earnings, then the price reflects such next decade earnings multiplied by 8 times G .

From these assumptions we obtain the simple formula:

Price equals $(E \times G) \times (8 \times G)$, or $8G^2 \times E$,
where E is the per-share earnings for 1947-56.

To find G , the expected rate of future growth, we have only to divide the current price by 8 times 1947-56 earnings, and take the square root.

When this is done for the Dow-Jones Average as a whole, using its August 5, 1957, price of 500, we get a value of 1.5 for G —indicating an expected growth of 50% for 1957-66 earnings vs. the 1947-56 actuality. This

anticipates an average of \$41 in the next decade, as against \$27.50 for the previous ten years and about \$36 in 1956. This estimate appears reasonable to the writer in relation to the 500 level. (In fact he started with this estimate and worked back from it to get the basic multiplier of 8 to be applied to issues with no expected growth.) The price of 500 for the D. J. Average would represent in turn a multiplier of 8×1.5 , or 12, to be applied to the expected future earnings of \$41. (Incidentally, on these assumptions the average current formula value of about 400 for the Dow-Jones Average would reflect expectations of a decade-to-decade growth of 35%, average earnings of \$37.1 for 1957-66, and a current multiplier of 10.8 for such future earnings.)

In Table II we set forth the results of applying this second approach to the 30 Dow-Jones issues. (The figures for Am. Tel. & Tel. might well be ignored, since utility issues should take a different basic formula.) The main interest in the table lies in the disparities it indicates between the expected future growth, implicit in the market prices, and the actual growth during the past decade. Ten of the companies (plus ATT) sold at prices anticipating at least twice the Dow-Jones Average rate of growth, comparing 1957-66 with 1956. Of these only two, Du Pont and General Electric, had actually shown distinctly better than average growth in the last ten years. Conversely, eight of

Table I
Formula Valuations of Dow-Jones Industrial Issues

Company	Quality Factors				Av. Factor	Earns. 1947-1956	Book Value	Indicated Value		Price Aug. 5 1957
	Profitability	Growth	Stability	Payout				D.J. 400 Basis	D.J. 500	
Allied Ch.	91	46	94	100	84	4.50	40	55	69	89
Am. Can.	81	70	137	107	99	2.61	28	39	48	44
Am. S. & Ref.	101	39	100	81	80	5.43	51	65	85	54
Am. T. & T.	54	40	163	130	97	9.90	150	151	185	173
Am. Tob.	98	27	111	104	85	6.58	59	82	102	72
Beth. St.	95	138	0	97	83	2.88	31	36	45	49
Chrysler	*91	0	38	51	45	8.15	74	66	80	77
Corn. Prod.	100	65	114	98	94	1.96	40	31	37	31
Du Pont	154	198	100	109	140	5.60	41	107	136	199
East. Kod.	136	100	148	85	117	3.49	28	57	63	104
Gen. Elec.	139	129	84	127	120	1.87	14	31	39	68
Gen. Foods	138	99	141	79	114	2.42	20	39	49	49
Gen. Motors	160	119	95	104	120	2.48	20	42	53	45
Goodyear T.	108	207	129	83	132	4.18	43	78	98	76
Int. Harv.	*58	0	91	98	62	3.70	49	39	47	35
Int. Nickel	164	263	119	90	159	3.86	31	83	105	92
Int. Paper	100	46	0	101	62	6.40	55	61	76	101
Johns Man.	93	96	44	100	83	3.07	29	38	47	45
Nat. Dist.	*73	0	62	118	63	2.47	26	25	31	26
Nat. Steel	95	96	101	88	95	5.71	68	79	99	75
Proc. & Gam.	110	46	105	103	91	2.61	21	34	42	49
Sears Roe.	112	56	144	84	99	1.82	15	26	32	28
S. O. Cal.	124	113	134	65	109	3.09	24	47	59	58
S. O. N. J.	130	166	97	80	118	2.85	24	47	59	67
Texas Corp.	126	171	81	66	111	3.48	34	56	70	74
Un. C. & C.	138	92	108	100	110	3.73	27	53	67	117
Un. Aircr.	158	361	181	66	192	3.65	35	96	121	62
U. S. Steel	99	239	0	67	101	3.51	47	54	67	69
Westinghouse	*65	0	0	83	37	3.79	43	27	32	64
Woolworth	*69	0	116	109	74	3.58	40	41	51	42
D.J. Ind. Av.	(13.0)	(56)	(52.3)	(64.3)	100	27.50	275	400	500	500

*Based on 1947-56 Av. Earns. vs. 1956 Book Value plus adj.

Table II
Formula Calculations of Expected Growth of Earnings of Dow-Jones Ind. Issues,
as Indicated by August 5, 1957 Price

Company	Price 8/5/57	Average Earnings 1947-56	Expected Growth 1957-66 vs. 47-56	Indicated Earnings 1957-66	Indicated Multiplier*	Earnings 1956	Expected Increase 57-66 vs. 1956	Actual Increase 56 vs. 47-56
Allied Ch.	89	\$4.50	+58%	\$ 7.22	12.6	\$4.74	+52%	+ 6 %
Am. Can.	44	2.61	46	3.83	11.6	2.92	33	12
Am. S. & R.	54	5.43	12	6.10	9.0	6.67	(-8)	23
Am. T. & T.**	173	9.90	47	14.70	11.8	10.74	36	14
Am. Tob.	72	6.58	18	7.80	9.4	7.51	4	14
Beth. St.	49	2.88	44	4.15	11.5	3.83	8	33
Chrysler	77	8.95	4	9.28	8.3	2.29	(large)	(-76)
Corn Prod.	31	1.96	41	2.76	11.4	2.36	18	12
Du Pont	199	5.60	112	11.85	17.0	8.20	45	47
East. Kod.	104	3.49	93	6.62	15.4	4.89	36	37
Gen. Elec.	68	1.87	113	4.00	17.0	2.45	62	31
Gen. Foods	49	2.42	59	3.86	12.7	3.56	9	45
Gen. Motors	45	2.48	51	3.74	12.1	3.02	24	22
Goodyear T.	76	4.18	42	5.96	11.4	6.03	(-1)	47
Int. Harv.	35	3.70	8	4.02	8.6	3.14	29	(-15)
Int. Nickel	92	3.86	62	6.30	13.0	6.50	(-3)	68
Int. Paper	101	6.40	40	9.03	11.2	7.05	28	11
Johns Man.	45	3.07	36	4.21	10.9	3.50	20	14
Nat. Dist.	26	2.47	15	2.86	9.2	2.11	36	(-15)
Nat. Steel	75	5.71	28	7.32	10.2	7.09	3	25
Proc. & Gam.	49	2.61	53	3.99	12.2	3.05	30	20
Sears Roebuck	28	1.82	38	2.53	11.0	2.20	16	18
S. O. Cal.	58	3.09	55	4.78	12.4	4.24	12	39
S. O. N. J.	67	2.85	72	4.99	13.8	4.11	21	44
Texas Corp.	74	3.48	62	5.66	13.0	5.51	3	59
Un. C. & C.	117	3.73	99	7.43	15.9	4.86	53	32
Un. Air.	62	3.65	45	5.31	11.6	7.66	(-32)	93
U. S. Steel	69	3.51	57	5.55	12.6	6.01	(- 8)	73
Westinghouse	64	3.79	45	5.53	11.6	.10	(large)	(-97)
Woolworth	42	3.58	22	4.39	9.8	3.57	23	0
D.J. Ind. Av.	500	\$27.50	50	\$41.25	12.0	\$35.80	15	30

*Dec. 1956 price ÷ Indic. 1957-1966 Earnings.

**The basic formula is less applicable to A. T. & T. than to industrial issues.

the companies were indicating less than half the average expected rate of growth, including five for which actual declines from 1956 levels were apparently predicted. Yet of these eight companies, no less than five had actually shown far greater than average growth in the past decade.

This leads us to our final observations, which tie our two tables together. The ten companies previously mentioned, for which unusually rapid growth is anticipated, includes seven of those shown in Table I as selling significantly above their formula valuation. Again, the eight for which subnormal or no growth is expected include six which were selling substantially below their formula valuations.

We conclude that a large part of the discrepancies between carefully calculated formula values and the market prices can be traced to the growth factor, not because the formulas underplay its importance, but rather because the market often has concepts of future earnings changes which cannot be derived from the companies' past performance. The reasons for the market's breaking with the past are often abundantly clear. Investors do not believe, for example, that United Aircraft will duplicate its brilliant record of 1947-56, because they consider that a company with the United States Department of Defense as its chief cus-

tommer is inherently vulnerable. They have the opposite view with regard to Westinghouse. They feel its relatively mediocre showing in recent years was the result of temporary factors, and that the electric manufacturing industry is inherently so growth-assured that a major supplier such as Westinghouse is bound to prosper in the future.

These cases are clear cut enough, but other divergencies shown in our table are not so easy to understand or to accept. There is a difference between these two verbs. The market may be right in its general feeling about a company's future, but the price tag it sets on that future may be quite unreasonable in either direction.

It is here that many analysts will find their challenge. They may not be satisfied merely to find out what the market is doing and thinking, and then to explain it to everyone's satisfaction. They may prefer to exercise an independent judgment—one not controlled by the daily verdict of the market place, but ready at times to take definite issue with it. For this kind of activity one or more valuation processes, of the general type we have been illustrating, may serve a useful purpose. They give a concrete and elaborated picture of the past record, which the analyst may use as a point of departure for his individual exploration and discoveries in the field of investment values.

The New Speculation in Common Stocks

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ASKED HARTLEY SMITH, in introducing me to you, to lay chief stress upon my advanced age. What I shall have to say will reflect the spending of many years in Wall Street, with their attendant varieties of experience. This has included the recurrent advent of new conditions, or a new atmosphere, which challenge the value of experience itself. It is true that one of the elements that distinguish economics, finance, and security analysis from other practical disciplines is the uncertain validity of past phenomena as a guide to the present and future. Yet we have no right to reject the lessons of the past until we have at least studied and understood them. My address today is an effort toward such understanding in a limited field—in particular, an endeavor to point out some contrasting relationships between the present and the past in our underlying attitudes towards investment and speculation in common stocks.

Let me start with a summary of my thesis. In the past the speculative elements of a common stock resided almost exclusively in the company itself; they were due to uncertainties, or fluctuating elements, or downright weaknesses in the industry, or the corporation's individual set-up. These elements of speculation still exist, of course; but it may be said that they have been sensibly diminished by a number of long-term developments to which I shall refer. But in revenge a new and major element of speculation has been introduced into the common-stock arena from *outside* the companies. It comes from the attitude and viewpoint of the stock-buying public and their advisers—chiefly us security analysts. This attitude may be described in a phrase: primary emphasis upon future expectations.

Nothing will appear more logical and natural to this audience than the idea that a common stock should be valued and priced primarily on the basis of the company's expected future performance. Yet this simple-appearing concept carries with it a number of paradoxes and pitfalls. For one thing, it obliterates a good part of the older, well-established distinctions between investment and speculation. The dictionary says that "speculate" comes from the Latin "specula", a look-out or watch-tower. Thus it was the speculator who looked out from his elevated watch-tower and saw future developments coming before other people did. But today, if the investor is shrewd or well-advised, he too must have his watch-tower looking out on the future, or

rather he mounts into a common watch-tower where he rubs elbows with the speculator.

Secondly, we find that, for the most part, companies with the best investment characteristics—i.e., the best credit rating—are the ones which are likely to attract the largest speculative interest in their common stocks, since everyone assumes they are guaranteed a brilliant future. Thirdly, the concept of future prospects, and particularly of continued growth in the future, invites the application of formulae out of higher mathematics to establish the present value of the favored issues. But the combination of precise formulae with highly imprecise assumptions can be used to establish, or rather to justify, practically any value one wishes, however high, for a really outstanding issue. But, paradoxically, that very fact on close examination will be seen to imply that no one value, or reasonably narrow range of values, can be counted on to establish and maintain itself for a given growth company; hence at times the market may conceivably value the growth component at a strikingly *low* figure.

Returning to my distinction between the older and newer speculative elements in common stock, we might characterize them by two outlandish but convenient words, viz: endogenous and exogenous. Let me illustrate briefly the old-time speculative common stock, as distinguished from an investment stock, by some data relating to American Can and Pennsylvania Railroad in 1911-13. (These appear in "Security Analysis", 1940 Edition, pp. 2-3.)

In those three years the price range of "Pennsy" moved only between 53 and 65, or between 12.2 and 15 times its average earnings for the period. It showed steady profits, was paying a reliable \$3 dividend, and investors were sure that it was backed by well over its par of \$50 in tangible assets. By contrast, the price of American Can ranged between 9 and 47; its earnings between 7c and \$8.86; the ratio of price to the average earnings moved between 1.9 times and 10 times; it paid no dividend at all; and sophisticated investors were well aware that the \$100 par value of the common represented nothing but undisclosed "water", since the preferred issue exceeded the tangible assets available for it. Thus American Can common was a representative speculative issue, because American Can Company was then a speculative-capitalized enterprise in a fluctuating and uncertain industry. Actually, American Can had a far more

brilliant long-term future than Pennsylvania Railroad; but not only was this fact not suspected by investors or speculators in those days, but even if it had been it would probably have been put aside by the investors as basically irrelevant to investment policies and programs in the years 1911-1913.

Now, to expose you to the development through time of the importance of long-term prospects for investments, I should like to use as my example our most spectacular giant industrial enterprise—none other than International Business Machines, which last year entered the small group of companies with \$1 billion of sales. May I introduce one or two autobiographical notes here, in order to inject a little of the personal touch into what otherwise would be an excursion into cold figures? In 1912 I had left college for a term to take charge of a research project for U. S. Express Co. We set out to find the effect on revenues of a proposed revolutionary new system of computing express rates. For this purpose we used the so-called Hollerith machines, leased out by the then Computing-Tabulating-Recording Co. They comprised card-punches, card-sorters, and tabulators—tools almost unknown to businessmen, then, and having their chief application in the Census Bureau. I entered Wall Street in 1914, and the next year the bonds and common stock of C.-T.-R. Co. were listed on the New York Stock Exchange. Well, I had a kind of sentimental interest in that enterprise, and besides I considered myself a sort of technological expert on their products, being one of the few financial people who had seen and used them. So early in 1916 I went to the head of my firm, known as Mr. A. N., and pointed out to him that C.-T.-R. stock was selling in the middle 40s (for 105,000 shares); that it had earned \$6.50 in 1915; that its book value—including, to be sure, some non-segregated intangibles—was \$130; that it had started a \$3 dividend; and that I thought rather highly of the company's products and prospects. Mr. A. N. looked at me pityingly. "Ben," said he, "Do not mention that company to me again. I would not touch it with a ten-foot pole. (His favorite expression.) Its 6% bonds are selling in the low 80s and they are no good. So how can the stock be any good. Everybody knows there is nothing behind it but water." (Glossary: In those days that was the ultimate of condemnation. It meant that the asset-account on the balance sheet was fictitious. Many industrial companies—notably U. S. Steel—despite their \$100 par, represented nothing but water, concealed in a written-up plant account. Since they had "nothing" to back them but earning power and future prospects, no self-respecting investor would give them a second thought.)

I returned to my statistician's cubby-hole, a chastened young man. Mr. A. N. was not only experienced and successful, but extremely shrewd as well. So much was I impressed by his sweeping condemnation of Computing-Tabulating-Recording that I never bought a share of it in my life, not even after its name was changed to IBM in 1926.

Now let us take a look at the same company with its new name in 1926, a year of pretty high stock markets. At that time it first revealed the good-will item in its balance-sheet, in the rather large sum of \$13.6 millions. A. N. had been right. Practically every dollar of the so-called equity

behind the common in 1915 had been nothing but water. However, since that time the company had made an impressive record under the direction of T. L. Watson, Sr. Its net had risen from \$691,000 to \$3.7 million—over five-fold—a greater percentage gain than it was to make in any subsequent 11-year period. It had built up a nice tangible equity for the common, and had split it 3.6 for one. It had established a \$3 dividend rate for the new stock, while earnings were \$6.39 thereon. You might have expected the 1926 stock market to have been pretty enthusiastic about a company with such a growth history and so strong a trade position. Let us see. The price range for that year was 31 low, 59 high. At the average of 45 it was selling at the same 7-times multiplier of earnings and the same 6.7% dividend yield as it had done in 1915. At its low of 31 it was not far in excess of its tangible book value, and in that respect was far more conservatively priced than 11 years earlier.

These data illustrate, as well as any can, the persistence of the old-time investment viewpoint until the culminating years of the bull market of the 1920s. What has happened since then can be summarized by using 10-year intervals in the history of IBM. In 1936 net expanded to twice the 1926 figures, and the average multiplier rose from 7 to 17½. From 1936 to 1946 the gain was 2½ times, but the average multiplier in 1946 remained at 17½. Then the pace accelerated. The 1956 net was nearly 4 times that of 1946, and the average multiplier rose to 32½. Last year, with a further gain in net, the multiplier rose again to an average of 42, if we do not count the unconsolidated equity in the foreign subsidiary.

When we examine these recent price figures with care we see some interesting analogies and contrasts with those of 40 years earlier. The one-time scandalous water, so prevalent in the balance-sheets of industrial companies, has all been squeezed out—first by disclosure and then by write-offs. But a different kind of water has been put back into the valuation by the stock market—by investors and speculators themselves. When IBM now sells at 7-times its book value, instead of 7-times earnings, the effect is practically the same as if it had no book value at all. Or the small book-value portion can be considered as a sort of minor preferred-stock component of the price, the rest representing exactly the same sort of commitment as the old-time speculator made when he bought Woolworth or U. S. Steel common entirely for their earning power and future prospects.

It is worth remarking, in passing, that in the 30 years which saw IBM transformed from a 7-times earnings to a 40-times earnings enterprise, many of what I have called the endogenous speculative aspects of our large industrial companies have tended to disappear, or at least to diminish greatly. Their financial positions are firm, their capital structures conservative; they are managed far more expertly, and even more honestly, than before. Furthermore, the requirements of complete disclosure have removed one of the important speculative elements of years ago—that derived from ignorance and mystery.

Another personal digression here. In my early years in the Street one of the favorite mystery stocks was Consoli-

dated Gas of New York, now Consolidated Edison. It owned as a subsidiary the profitable New York Edison Co., but it reported only dividends received from this source, not its full earnings. The unreported Edison earnings supplied the mystery and the "hidden value." To my surprise I discovered that these hush-hush figures were actually on file each year with the Public Service Commission of the state. It was a simple matter to consult the records and to present the true earnings of Consolidated Gas in a magazine article. (Incidentally, the addition to profits was not spectacular.) One of my older friends said to me then: "Ben, you may think you are a great guy to supply those missing figures, but Wall Street is going to thank you for nothing. Consolidated Gas with the mystery is both more interesting and more valuable than ex-mystery. You youngsters who want to stick your noses into everything are going to ruin Wall Street."

It is true that the three M's which then supplied so much fuel to the speculative fires have now all but disappeared. These were Mystery, Manipulation, and (thin) Margins. But we security analysts have ourselves been creating valuation approaches which are so speculative in themselves as to pretty well take the place of those older speculative factors. Do we not have our own "3 M's" now—none other than Minnesota Mining and Manufacturing Co.—and does not this common stock illustrate perfectly the new speculation as contrasted with the old? Consider a few figures. When M.M. & M. common sold at 101 last year the market was valuing it at 44 times 1956 earnings, which happened to show no increase to speak of in 1957. The enterprise itself was valued at \$1.7 billion, of which \$200 million was covered by net assets, and a cool \$1½ billion represented the market's appraisal of "good-will". We do not know the process of calculation by which that valuation of good-will was arrived at; we do know that a few months later the market revised this appraisal downward by some \$450 million, or about 30%. Obviously it is impossible to calculate accurately the intangible component of a splendid company such as this. It follows as a kind of mathematical law that the more important the good-will or future earning-power factor the more uncertain becomes the true value of the enterprise, and therefore the more speculative inherently the common stock.

It may be well to recognize a vital difference that has developed in the valuation of these intangible factors, when we compare earlier times with today. A generation or more ago it was the standard rule, recognized both in average stock prices and in formal or legal valuations, that intangibles were to be appraised on a more conservative basis than tangibles. A good industrial company might be required to earn between 6% and 8% on its tangible assets, represented typically by bonds and preferred stock; but its excess earnings, or the intangible assets they gave rise to, would be valued on, say, a 15% basis. (You will find approximately these ratios in the initial offering of Woolworth Preferred and Common stock in 1911, and in numerous others.) But what has happened since the 1920s? Essentially the exact reverse of these relationships may now be seen. A company must now typically earn about 10% on its common equity to have it sell in the average market at full book value. But

its excess earnings, above 10% on capital, are usually valued more liberally, or at a higher multiplier, than the base earnings required to support the book value in the market. Thus a company earning 15% on the equity may well sell at 13½ times earnings, or twice its net assets. This would mean that the first 10% earned on capital is valued at only 10 times, but the next 5%—what used to be called the excess—is actually valued at 20 times.

Now there is a logical reason for this reversal in valuation procedure, which is related to the newer emphasis on growth expectations. Companies that earn a high return on capital are given these liberal appraisals not only because of the good profitability itself, and the relative stability associated with it, but perhaps even more cogently because high earnings on capital generally go hand and hand with a good growth record and prospects. Thus what is really paying for nowadays in the case of highly profitable companies is not the good-will in the old and restricted sense of an established name and a profitable business, but rather for their assumed superior expectations of increased profits in the future.

This brings me to one or two additional mathematical aspects of the newer attitude toward common-stock valuations, which I shall touch on merely in the form of brief suggestions. If, as many tests show, the earnings multiplier tends to increase with profitability—i.e., as the rate of return on book value increases—then the arithmetical consequence of this feature is that value tends to increase directly as the square of the earnings, but *inversely* with book value. Thus in an important and very real sense tangible assets have become a drag on average market value rather than a source thereof. Take a far from extreme illustration. If Company A earns \$4 a share on a \$20 book value, and Company B also \$4 a share on \$100 of book value, Company A is almost certain to sell at a higher multiplier, and hence at higher price than Company B—say \$60 for Company A shares and \$35 for Company B shares. Thus it would not be inexact to declare that the \$80 per share of greater assets for Company B are responsible for the \$25 per share lower market price, since the earnings per share are assumed to be equal.

But more important than the foregoing is the general relationship between mathematics and the newer approach to stock values. Given the three ingredients of (a) optimistic assumptions as to the rate of earnings growth, (b) a sufficiently long projection of this growth into the future, and (c) the miraculous workings of compound interest—and the security analyst is supplied with a new kind of Philosopher's Stone which can produce or justify any desired valuation for a really "good stock." I have commented in a recent article in the *Analysts Journal* on the vogue of higher mathematics in bull markets, and quoted David Durand's exposition of the striking analogy between value calculations of growth stocks and the famous Petersburg Paradox, which has challenged and confused mathematicians for more than 200 years. The point I want to make here is that there is a special paradox in the relationship between mathematics and investment attitudes on common stocks, which is this: Mathematics is ordinarily considered as producing precise and dependable results; but in the stock market the

more elaborate and abstruse the mathematics the more uncertain and speculative are the conclusions we draw therefrom. In 44 years of Wall Street experience and study I have never seen dependable calculations made about common-stock values, or related investment policies, that went beyond simple arithmetic or the most elementary algebra. Whenever excalculus is brought in, or higher algebra, you could take it as a warning signal that the operator was trying to substitute theory for experience, and usually also to give to speculation the deceptive guise of investment.

The older ideas of common-stock investment may seem quite naive to the sophisticated security analyst of today. The great emphasis was always on what we now call the defensive aspects of the company or issue—mainly the assurance that it would continue its dividend unreduced in bad times. Thus the strong railroads, which constituted the standard investment commons of 50 years ago, were actually regarded in very much the same way as the public-utility commons in recent years. If the past record indicated stability, the chief requirement was met; not too much effort was made to anticipate adverse changes of an underlying character in the future. But, conversely, especially favorable future prospects were regarded by shrewd investors as something to look for but not to pay for.

In effect this meant that the investor did not have to pay anything substantial for superior long-term prospects. He got these, virtually without extra cost, as a reward for his own superior intelligence and judgment in picking the best rather than the merely good companies. For common stocks with the same financial strength, past earnings record, and dividend stability, all sold at about the same dividend yield.

This was indeed a short-sighted point of view, but it had the great advantage of making common-stock investment in the old days not only simple but also basically sound and highly profitable. Let me return for the last time to a personal note. Somewhere around 1920 our firm distributed a series of little pamphlets entitled "Lessons for Investors". Of course it took a brash analyst in his middle twenties like myself to hit on so smug and presumptuous a title. But in one of the papers I made the casual statement that "If a common stock is a good investment it is also a good speculation." For, reasoned I, if a common stock was so sound that it carried very little risk of loss it must ordinarily be so good as to possess excellent chances for future gains. Now this was a perfectly true and even valuable discovery, but it was true only because nobody paid any attention to it. Some years later, when the public woke up to the historical merits of common stocks as long-term investments, they soon ceased to have any such merit, because the public's enthusiasm created price levels which deprived them of their built-in margin of safety, and thus drove them out of the investment class. Then, of course, the pendulum swung to the other extreme, and we soon saw one of the most respected authorities declaring (in 1931) that no common stock could *ever* be an investment.

When we view this long-range experience in perspective we find another set of paradoxes in the investor's changing attitude towards capital gains as contrasted with income. It

seems a truism to say that the old-time common-stock investor was not much interested in capital gains. He bought almost entirely for safety and income, and let the speculator concern himself with price appreciation. Today we are likely to say that the more experienced and shrewd the investor, the less attention he pays to dividend returns, and the more heavily his interest centers on long-term appreciation. Yet one might argue, perversely, that precisely because the old-time investor did not concentrate on future capital appreciation he was virtually guaranteeing to himself that he would have it, at least in the field of industrial stocks. And, conversely, today's investor is so concerned with anticipating the future that he is already paying handsomely for it in advance. Thus what he has projected with so much study and care may actually happen and still not bring him any profit. If it should fail to materialize to the degree expected he may in fact be faced with a serious temporary and perhaps even permanent loss.

What *lessons*—again using the pretentious title of my 1920 pamphlets—can the analyst of 1958 learn from this linking of past with current attitudes? Not much of value, one is inclined to say. We can look back nostalgically to the good old days when we paid only for the present and could get the future for nothing—an "all this and Heaven too" combination. Shaking our heads sadly we mutter, "Those days are gone forever". Have not investors and security analysts eaten of the tree of knowledge of good and evil prospects? By so doing have they not permanently expelled themselves from that Eden where promising common stocks at reasonable prices could be plucked off the bushes? Are we not doomed always to run the risk either of paying unreasonably high prices for good quality and prospects, or of getting poor quality and prospects when we pay what seems a reasonable price?

It certainly looks that way. Yet one cannot be sure even of that pessimistic dilemma. Recently, I did a little research in the long-term history of that towering enterprise, General Electric—stimulated by the arresting chart of 59 years of earnings and dividends appearing in their recently published 1957 Report. These figures are not without their surprises for the knowledgeable analyst. For one thing they show that prior to 1947 the growth of G.E. was fairly modest and quite irregular. The 1946 earnings, per share adjusted, were only 30% higher than in 1902—52c vs. 40c—and in no year of this period were the 1902 earnings as much as doubled. Yet the price-earnings ratio rose from 9 times in 1910 and 1916 to 29 times in 1936 and again in 1946. One might say, of course, that the 1946 multiplier at least showed the well known prescience of shrewd investors. We analysts were able to foresee then the really brilliant period of growth that was looming ahead in the next decade. Maybe so. But some of you remember that the next year, 1947, which established an impressive new high for G.E.'s per share earnings, was marked also by an extraordinary fall in the price-earnings ratio. At its low of 32 (before the 3-for-1 split) G.E. actually sold again at only 9 times its current earnings, and its average price for the year was only about 10 times earnings. Our crystal ball certainly clouded over in the short space of twelve months.

• This striking reversal took place only eleven years ago. It casts some little doubt in my mind as to the complete dependability of the popular belief among analysts that prominent and promising companies will now always sell at high price-earnings ratios; that this is a fundamental fact of life for investors and they may as well accept and like it. I have no desire at all to be dogmatic on this point. All I can say is that it is not settled in my mind, and each of you must seek to settle it for yourself.

But in my concluding remarks I can say something definite about the structure of the market for various types of common stocks, in terms of their investment and speculative characteristics. In the old days the investment character of a common stock was more or less the same as, or proportionate with, that of the enterprise itself, as measured quite well by its credit rating. The lower the yield on its bonds or preferred, the more likely was the common to meet all the criteria for a satisfactory investment, and the smaller the element of speculation involved in its purchase. This relationship, between the speculative ranking of the common and the investment rating of the company, could be graphically expressed pretty much as a straight line descending from left to right. But nowadays I would describe the graph as U-shaped. At the left, where the company itself is speculative and its credit low, the common stock is of course highly speculative, just as it has always been in the past. At the right extremity, however, where the company has the highest credit rating because both its past record and future prospects are most impressive, we find that the stock market tends more or less continuously to introduce a highly speculative element into the common shares through the simple means of a price so high as to carry a fair degree of risk.

At this point I cannot forbear introducing a surprisingly relevant, if quite exaggerated, quotation on the subject

which I found recently in one of Shakespeare's sonnets. It reads:

"Have I not seen dwellers on form and favor
Lose all and more by paying too much rent?"

Returning to my imaginary graph, it would be the center area where the speculative element in common-stock purchases would tend to reach its minimum. In this area we could find many well-established and strong companies, with a record of past growth corresponding to that of the national economy and with future prospects apparently of the same character. Such common stocks could be bought at most times, except in the upper ranges of a bull market, at moderate prices in relation to their indicated intrinsic values. As a matter of fact, because of the present tendency of investors and speculators alike to concentrate on more glamorous issues, I should hazard the statements that these middle-ground stocks tend to sell on the whole rather below their independently determinable values. They thus have a margin-of-safety factor supplied by the same market preferences and prejudices which tend to destroy the margin of safety in the more promising issues. Furthermore, in this wide array of companies there is plenty of room for penetrating analysis of the past record and for discriminating choice in the area of future prospects, to which can be added the higher assurance of safety conferred by diversification.

When Phaethon insisted on driving the chariot of the Sun, his father, the experienced operator, gave the neophyte some advice which the latter failed to follow—to his cost. Ovid summed up Phoebus Apollo's counsel in three words:

"Medius tutissimus ibis"
"You will go safest in the middle course"

I think this principle holds good for investors and their security-analyst advisers.

STOCK MARKET WARNING: DANGER AHEAD!

Graham, Benjamin

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Stock Market Warning: Danger Ahead!*

BENJAMIN GRAHAM

Good business mixed with steady inflation has produced a powerful stock-market cocktail which the public is finding intoxicating and most agreeable. Will a hangover follow soon?

The stock market has been advancing with only one significant setback throughout the decade of the 1950's. It has thus established a new record for the length of its rise, although it has not equaled the extent of the record advance of the 1920's: 325 percent in this market versus 450 percent from 1921-1929.

What does this phenomenal upward movement portend for investors and speculators in the future? There are various ways of approaching this question. To answer it, I shall divide the question into two parts. First, what indications are given us by past experience? Second, how relevant is past experience to the present situation and prospects?

As to the first part of my answer, I should be able to make some definite statements—which will be the reverse of encouraging. But as to the applicability of the record of the past to the present, I cannot express a categorical judgment. I shall present certain facts on the one side and certain expectations pointing the other way; I shall state my own opinion as to the probable answer; but in the end, each must resolve that part of the question for himself.

Indications from Past Experience

However, in order to judge today's market level, it is desirable—perhaps essential—to have a clear picture of its past behavior. Speculators often prosper through ignorance; it is a cliché that in a roaring bull market knowledge is superfluous and experience a

handicap. But the typical experience of the speculator is one of temporary profit and ultimate loss. If experience cannot help today's investor, then we must be logical and conclude that there is no such thing as investment in common stocks and that everyone interested in them should confess himself a speculator. This is just about what has actually happened in recent years—only in reverse. Everyone now calls himself an investor, including a huge horde of speculators.

This point is neatly illustrated by the opening lines of an article in a recent issue of *Business Week* describing the annual convention of Investment Clubs. The writer says: "Like all investors, large and small, they were mainly interested in which way the market—and particular stocks—would move next." If that sentence accurately describes a *bonafide* investor of 1960, then—to use a phrase made famous by a certain Mr. Krushchev—the shrimps have really begun to whistle on the mountaintops.

Bull Market or New Market?

The main issue before the investor may be expressed this way: Have we been in a bull market or in a new sort of market? If this is a bull market, then the term itself implies a bear market to follow it some day. What could be the probable extent of a decline in a traditional bear market? Here are some figures, which apply the experience of the 12 bear markets since 1874 to the recent high level of 685 for the Dow-Jones Industrial Average.

* This article is based on a talk delivered at the University of California, Los Angeles, on Dec. 17, 1959.

TABLE I
COMPARISON OF TWELVE BEAR-
MARKET DECLINES

TIME PERIOD	PERCENT DECLINE	EQUIVALENT LOW FROM 685
1874-77	36	435
1881-84	26	500
1889-97	40	410
1901-03	44	385
1906-07	45	375
1909-14	29	485
1916-17	36	435
1919-21	44	385
1929-32	85	115
1937-38	44	385
1939-42	39	415
1946-49	27	490

The average of these 12 declines (all taken from Cowles-Standard indexes) would indicate a market low of about 400, a fall of over 40 percent from the 685 high. Investors may consider themselves mentally prepared for a 40 percent shrinkage in stock prices, especially if they envisage such a drop as taking place from a level far above today's average. At this point, however, a second factor from past experience becomes relevant. The record shows that declines have tended to be roughly proportional to the previous advanced. Thus, the 6 largest advances averaging 63 percent of the high level reached were followed by declines averaging 46 percent while the other 6 advances averaging 38 percent of the high produced declines averaging 37 percent.

Experience gives us another measure of the possible bear-market decline. This measure is based on the principle that the higher the market advances above a computed normal, the further it is likely to decline below such normal. If this principle—enunciated long ago by Roger Babson—were to hold in the future as in the past, then a further rise of the market from these levels—in itself an alluring probability—would actually carry with it an intensified future penalty.

Let me illustrate this point of experience

by some horrifying assumptions—to present the worst of the picture. Let us assume that the market makes everyone happy by advancing fairly soon to that millennial level of 1,000 for the Dow-Jones Industrials, of which some predictions are already on file. Assume further that this is a speculative advance—very like that of the late 1920's—and that the Central Value of the D-J Average at the time is only 400. By applying the old Babson economic law of “action and reaction—equal and opposite,” the corrective downswing would carry the average as low as 160, a loss of 84 percent. Impossible, you say, and no doubt you are right. But a condition similar to the one I am assuming actually occurred in 1929, and the ensuing shrinkage in the D-J Average was not 86 percent but 89 percent—from 382 to 42.

There is a paradox in this economic law which makes it virtually impossible for it to find acceptance in practice. For the almost universal optimism that accompanies the great advances in the stock market precludes even the most conservative observer from imagining a decline so drastic as these figures illustrate.

Current Optimism

Let me turn now from this Cassandra-like utterance to the picture of the future stock market that is strongly etched in the minds of most investors and speculators and of their expert advisors. Past experience may not be entirely eliminated from this picture, but it enters in a very muted way. The keynote, of course, is optimism. We are enthusiastic about business prospects for the next decade. In fact, that period received its name in many quarters—the Fabulous Sixties—even before it had begun. Herodotus recounts a saying of Solon the Wise that rich King Croesus sadly recalled before his execution—namely that no man's life should be accounted a happy one until it is over. Perhaps the more prudent time to characterize the 1960's would be when they are over rather than when they have just begun.

Most people are equally optimistic about the stock market. One of my friends—a brilliant analyst—was quoted recently in the Wall Street Journal as saying that the bull market is about to enter its 19th year and soon will be able to vote. Translated, that means he is carrying the bull market both backward in time to include 1942—ignoring the 1946-49 setback and doldrums—and confidently forward in time to 1963.

The optimism about both business and the stock market is founded on a host of favorable facts and expectations, including as an important "favorable factor" the likelihood of continued price inflation. I shall discuss these a little later.

Investors accept in theory the premise that the stock market may have its recessions in the future. But these drops are envisaged in terms of the experience of the past 10 years when the maximum decline was only 19 percent—from 521 to 420 in 1957. The public is confident that such setbacks will be made up speedily, and hence that a small amount of patience and courage will bring great rewards in the form of a much higher price level soon thereafter.

Investors may think they are basing this view of the future on past experience, but in this they are surely mistaken. The experience of the 1949-59 market—or of all bull markets put together—reflects only the sunny side of investment. It is one thing to say airily that the market has always come back after

declines and made new highs; it is another to reflect on the fact that it took 25 years for the market to reach again the high level of 1929, or that the D-J Average sold at the same high point in 1919 as it did in 1942—23 years later.

The Present Bull Market in Relation to Past Ones

Up to now I have been talking only in terms of past fluctuations on the one hand, and present confidence and optimism on the other. It is time to fill in the picture with certain financial and economic data which will place the present stock market quantitatively in relation to past bull markets.

We have a number of authoritative measures of the factors of earnings, dividends, and asset values in relations to price, as applied to the market as a whole—with most emphasis placed on the industrial list. My data will apply to the industrials only. There are the figures for the 30 D-J issues published by Barrons; on 125 issues of Moody's; and the very comprehensive group of 425 industrials of Standard-Poors. Rather strangely, all three indexes give very much the same indications, both currently and over the last thirty years. At the high levels of 1959, the dividend yield on all three indices was just about 3 percent, and the ratio of price to earnings of the past 12 months was about 19 times. Let us compare these ratios with some figures for the high levels of past bull markets:

TABLE II

	Moody's 125 Industrials		Long-Term Bond Yield (Moody's AAA Corporates)	Standard-Poors 425 Industrials	
	Price-Earnings Ratio	Dividend Yield		Price-Earnings Ratio	Dividend Yield
1959 High.....	19.0x	3.06%	4.55%	18.2x	2.95%
1949 Low.....	(Av) 7.1	(Av) 6.82	2.65	5.6	7.50
1946 High.....	15.9	3.58	2.49	16.1	3.55
1937 High.....	17.3	4.15	2.27	17.6	4.08
1929 High.....	19.4	3.23	4.95	19.0	3.10

And now compare them with the situation just before this bull market started in 1949:

TABLE III

	Dow-Jones 30 Industrials			Standard-Poors 425 Industrials		
	Earnings	Dividends	Price	Earnings	Dividends	Price
Cal. Year 1949.....	23.54	12.79	Low 161	2.46	1.03	13.9
12 mos. Sept. 1959..	35.14	20.00	High 678	3.50	1.92	65.3
Percent Increase....	49	57	322	42	86	370

These figures illustrate two important points. The first is that the ratios of price to dividends and to earnings are just about where they were at the top of the markets in 1946, 1937, 1929, and about $2\frac{1}{2}$ times what these ratios were ten years ago. The second point is that the actual increase in earnings between 1949 and 1959 was very modest—only about 50 percent or less. During this period, the interest rate on highest-grade bonds advanced from 2.65 percent to 4.55 percent, or about 75 percent. This means that if the proper rate of capitalization of current earnings should vary with long-term interest rates—a not implausible theory—then common stocks would actually be worth less now than in 1949, although they are selling 4 times as high.

The value situation is not as bad as that, however. On the one hand, we find that dividends have increased more than earnings, and have nearly doubled in the ten years—at least for the Moody's and Standard indexes. Again, if we capitalize average earnings, say of the past ten years, rather than the last 12 months' earnings, we would find an increase of about 120 percent between the 1940-49 and 1950-59 decades. What is most important, perhaps, is that the 1947-49 price level was clearly too low. But even making allowance for these three factors, the actual figures would probably not produce an increase of more than 100 percent in value from the 1949 year-end figure of 200 for the D-J index.

If the rise of interest rates is not taken into account—and most of the valuation methods

applied to the D-J index do not do so—the various techniques will produce, for the most part, higher figures. These figures cover a wide range, but they all have one thing in common: they are appreciably lower than the present market price. Let me summarize a few of the valuations referred to in the 1959 edition of "The Intelligent Investor," which apply to the beginning of that year: Gerstein—383; Molodovsky—560; Value Line—471; Weston—600; Graham—365. Not all these methods have been applied consistently in the past—the high ones are definitely influenced by the new and more favorable attitude towards common stocks. I would estimate that the older valuation methods—i.e. those in use prior to 1955, let us say—would yield a current average figure of no more than 450, or one-third less than the present level.

Two of the large financial-counsel firms have made valuations applicable to the year 1963—four years ahead of their valuation date. One found a value for the D-J of 664, the other of 634. These were based on rather optimistic assumptions of earnings growth in the next four years. If we assume that their conclusions are sound, we then should have to observe that the stock market is already paying a full price for the much better earnings and dividends expected in 1963. (Note that these 1963 valuations cannot properly be said to derive from past experience, in the manner of the other figures presented.)

This ends my presentation of the direct implications of past experience as applied to the current market level. My conclusions are

not favorable. They would imply that the current bull market is repeating the excesses of past bull markets and is destined to pay a penalty correspondingly severe. But now I must approach the second part of my review, and raise the companion question: "How relevant and useful is past experience as applied to the present situation?"

New Economic Factors

Most investors, businessmen, and economists are convinced that the business world we find ourselves in now is radically different and more favorable than that of the past. The improvement is of two kinds: First, the positive drive towards an expanding economy. This is powered by rising population, more research, more sustained capital investment, broader consumer spending, etc.—in other words, by a confident and aggressive attitude in all the important sectors of the economy. Then we have new defenses against recession, which will guarantee us more stability than in the past. These include the Government's obligation to maintain high-level employment, assumed in the 1946 Act, and the automatic built-in stabilizers, such as unemployment benefits, social security, farm supports. Two other factors—not as respectable as those just described—are also counted on by many to help maintain and expand the economy. One is price inflation, considered as beneficial to business if not overdone. The other is the Cold War, with the huge defense spending that it entails.

This array of favorable factors is most imposing, and it has captured the imagination of many, perhaps most, experienced economists. The case for very good business in the 1960's is made energetically in a current book *New Forces in American Business* by Dexter Keezer and the McGraw-Hill economics staff.

The optimism about business is no doubt the chief factor in producing the present optimism about the stock market. But here the factor of inflation plays a stronger and almost separate role. People tell themselves,

on the one hand, that the inescapable inflation of the future guarantees ever-higher earnings and prices for common stocks—and, conversely, that if their funds are held in bonds or other cash equivalents their real value, in terms of purchasing power, will dwindle constantly. This combination of prospects for the 1960's—good business mixed with steady inflation—has produced a powerful stock-market cocktail which the public—young and old, experienced and inexperienced—is finding intoxicating and most agreeable.

The Rosy View of the Future

Now what can past experience tell us about the validity and dependability of this rosy view as to the future of business and common stocks? Its verdict cannot be conclusive, because no prediction—whether of a repetition of past patterns or of a complete break with past patterns—can be proved in advance to be right. Nevertheless, past experience does have some things to say that are at least relevant to our problem. The first is that optimism and confidence have always accompanied bull markets; they have grown as the bull markets advanced, and they had to grow, otherwise the bull markets could not have continued to their dizzy levels—and they have been replaced by distrust and pessimism when the bull markets of the past collapsed.

As might be expected, the previous period of greatest enthusiasm about the economic prospects of the U. S. coincided with the tumultuous bull market of the late 1920's. Then, as now, nearly everyone was convinced that we had entered a "New Era" of continued and dynamic prosperity which made all past market experience worse than useless. You all know that the phrase "New Era" became almost the official description of the American economy of 1928–29. It is a bit ironical to note that today nearly everyone is again convinced that we have entered into a new era of sustained and dynamic prosperity, but also that everyone is care-

ful not to use the convenient words "New Era," because they would remind us too uncomfortably of what happened in and after 1929.

In the 1920's, also, the new idea that good common stocks are intrinsically sounder than bonds gained ground rapidly. The financial services explained away the apparent dangers of stock yields below bond yields on the ground that the growth factor would eventually more than repay the stock buyer for his present sacrifice of income return.

Influence of Price Inflation

The factor of price inflation did not enter into the market of the 1920's, since the price level remained steady throughout. However, it did enter into the thinking of investors and speculators in 1936-37; for between the June 1932 low and the March 1937 high, wholesale prices advanced about 90 percent. (This may be compared with an advance of just 19 percent between the 1949 low and the recent 1959 high). You may be interested to know that between 1901 and 1910, wholesale prices advanced steadily to a total of 27% percent—quite a bit more than in the 1950's. Nevertheless, in that decade, the market experienced two declines of about 50 percent each, and the rise to March 1937 was also followed by a decline of nearly 50 percent.

Past experience shows us two things about commodity-price inflation as a stock market factor. First, inflation has existed most of the time in this century, and often at a much greater average rate than we have seen since 1949. But this has not prevented the stock market from falling disconcertingly after large advances. Secondly, the investor-speculator view as to the significance of inflation has varied greatly in this period. Paradoxically, three of the six *bear* markets since 1914 have been accompanied by *rising* wholesale prices—two of them very substantial. Arnold Bernhard in his recent book, *The Evaluation of Common Stocks*, points out that in the bear-market lows of 1949, many financial

experts were writing about inflation as an unfavorable factor for common stocks—this at a time when the price level had advanced nearly 40 percent in the three years 1946-49.

The past record shows clearly that inflation has been chiefly a *subjective* stockmarket factor. It has exerted an important bullish influence only when wholesale prices and the stock market happened to be rising at the same time. Investors seem to forget about inflation when stocks turn definitely downward.

An arithmetical aspect of the inflation element was brought to my attention recently by William Miller, Executive Secretary of Town Hall. At current levels, tax-exempt bonds returned fully twice as much to most investors as representative common stocks, after allowing for income tax on the latter. The investor in tax-free bonds could accordingly set aside about 2 percent per annum out of his bond interest as a fund to take care of future inflation, and still remain in as good a net-disposable-income position as he would with common stocks today.

There are some factors in our present economy which were not duplicated in previous bull markets. Most of you will think of the great advance in the popularity of common stocks—especially with pension funds and other institutional holders—as one of these new factors. There could be some doubt on this point; for the popularity of common stocks in 1929 may have been not very different from that of today. The New York Stock Exchange points to the approximate doubling of the number of shareholders—from 6 to 12 million—as an indication of the greatly improved standing of common stocks; this, too, is a phenomenon characteristic of a long bull market. No doubt the number of holders had scored a similar advance in the bull market running from 1921 to 1929. In fact, *simon-pure* experience suggests that the increase of small shareholders may be more of a danger than a strength for future stock markets.

Increased Stability

The factors I would recognize as new relate mainly to economic stability—as exemplified by the Government's commitment under the Employment Act of 1946, the institution of unemployment insurance, old-age pensions, and the like. There are few predictions I am willing to make—but one is that the intensity of future business recessions or depressions will be less than it has been in the past. And this is an important bullish factor. Another new factor in today's balance sheet is the Cold War—a really unparalleled phenomenon in former times. My view—not held by many authorities—is that the Cold War has contributed a good deal on balance to stimulating our economy during the 1950's. To what extent it will continue in the 1960's is a matter of opinion; it is also a matter of opinion as to whether or not the related military expenditures will carry the same weight in the total economy as in the last decade.

Possibilities of Decline

If the last two factors I have mentioned are both new and favorable to the business climate, it is proper to ask whether they also guarantee investors a favorable stock market experience indefinitely in the future—more specifically, whether they guarantee him against those market declines on the order of 40 percent or more which we have had so often in the past. To answer this question even tentatively requires me to depart to some extent from consideration of past experience and to indulge in some more abstract reasoning. If business is to have more stability in the future than before 1950—as seems likely—then common stock earning and dividends should also be more stable. This, in turn, should entitle them to be valued more liberally than in the past, which means that a higher normal or central value for common stocks generally may well be more justified than would be indicated solely by past experience. How much higher? If the D-J, judged solely by past experience, is

worth 450 today, would it be worth 670 or more in the light of these new stabilizing factors? I don't know—and I don't think anyone else knows. My own guess is that under the bull market conditions of today, most financial experts would be inclined to answer yes—thus justifying the present level. But if the market should decline to 450, the same experts will persuade themselves that the old valuation relationships are still valid and that the new ones were only a bull-market mirage.

In support of this rather cynical opinion, let me refer once more to conditions in 1949 just before our great bull market started. The Employment Act was three years old, but it was completely ignored as a stabilizing factor—indeed, organized business was violently opposed to it. What is more to the point is the fact that, as recently as ten years ago, the multipliers or valuation rate for stock earning were the *lowest* for any three-year period in history since the Cowles records began in 1871, except for the World War I years 1916–18, when everyone recognized the earnings to be temporary. Now let us see what one of the leading investment services said about the stock market in September 1949—just before the rise began—when confronted with the current price level of less than 6 times earnings. I summarize their remarks: "Historically the price-earnings ratio is extremely low. Stocks are intrinsically cheap. But the governing factor is public sentiment. Renewal of confidence is needed. Because of these problems, we have for some time recommended that a portion of investment funds be in the form of reserves." The last sentence is a professional way of expressing a generally bearish view on the stock market.

Now let us contrast this analysis of the record low price-earnings ratio of 1959 with the reaction of another leading service to the near-record-high multipliers in 1959. This service lists the variations in these ratios from 1929 to 1959, and points out that "stocks are now in the upper reaches of the

valuation scale." But then the report adds that business prospects are favorable for 1960, that earnings and dividends should rise further, and "they should support new market pushes." The service does suggest that during future periods of strength, the investor should move away from stocks to a more balanced position between stocks and bonds. This is a mildly cautionary view, and certainly not to be criticized. But the point I do want to make is how weak and equivocal was the reaction of one service to the record-low price-earnings ratios in 1949 and of the other service to the record-high multipliers of today. All my experience goes to show that most investment advisers take their opinions and measures of stock values from stock prices. In the stock market, value standards do not determine prices; prices determine value standards.

Let me return to the question of whether new economic conditions justify higher multipliers of earnings and dividends than in the past. Let us assume, as is likely, that the answer is yes. Would that fact assure the investor against a costly and discouraging bear-market experience? It seems to me that this is most improbable. The central level of values will be raised, but the fluctuations around these levels may well be just as wide as in the past; in fact one might expect even wider fluctuations. For since no one has any clear idea of just how the new central values are to be determined, it will be done by a process of trial and error in which speculative excesses on the upside and undue pessimism on the downside may play an even greater part than in most market cycles of former years.

Speculative Excesses in the Current Market

In this connection, I arrive finally at a "law" about human nature that cannot be repealed and is unlikely to be modified to any great extent. This law says that people without experience or superior abilities may make a lot of money fast in the stock market,

but they cannot keep what they make, and most of them will end up as net losers. (This is true even though the long-term trend of stock prices has been definitely upward.) This is a particular application of a much wider natural law which may be stated simply as: "There is no such thing as a free lunch." A "free lunch," for those too young to remember, was offered in the good old days to patrons of the corner saloon.

The stock market has undoubtedly reached the stage where there are many people interested in free lunches. The extraordinary price levels of stock of rather new companies in the electronics and similar fields, the spate of new common-stock offerings of small enterprises at prices twenty-five or more times their average earnings and three times their net worth (with immediate price advances upon issuance), the completely unwarranted price discrepancies such as those established by speculators between the three issues of Studebaker-Packard—all indicate reckless elements in the present stock-market picture which foretell serious trouble ahead, if past experience means anything at all.

Let me conclude with one of my favorite clichés—the French saying: "The more it changes the more it's the same thing." I have always thought this motto applied to the stock market better than anywhere else. Now the really important part of this proverb is the phrase, "the more it changes." The economic world has changed radically and will change even more. Most people think now that the essential nature of the stock market has been undergoing a corresponding change. But if my cliché is sound—and a cliché's only excuse, I suppose, is that it *is* sound—then the stock market will continue to be essentially what it always was in the past—a place where a big bull market is inevitably followed by a big bear market. In other words, a place where today's free lunches are paid for doubly tomorrow. In the light of experience, I think the present level of the stock market is an extremely dangerous one.