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Will Market Grow to Sky? —Some Problems Ahead

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Doubting the widely assumed continuation of the market's past 12-year rise, interrupted only by three 20% setbacks, Mr. Graham now expects a pattern of wide "pendulum swings." Citing the "human nature element" in the stock market, he maintains the proportion of unintelligent speculation will increase further as the market advances, setting the stage for drastic losses. Notes disparity between market's recent action and economic factors. Suggests tax-exempt bonds for wealthy investors.

My study of history will not lead me to make any definite forecasts involving numbers and dates. That may be a disappointment to some, but it certainly is a great relief to me. The applicability of history almost always appears after the event. When it is all over, we can quote chapter and verse to demonstrate why what happened was bound to happen because it had happened before. This is not really very helpful. The Danish philosopher, Kirkegaard, made the statement that life can only be judged backwards, but it must be lived forward. That certainly is true with respect to our experiences in the stock market.

Benjamin Graham

Yet, I think that a knowledge of history — general history, financial history, stock market history—will be found useful for a broad perspective in planning one's course, even though it may create uncertainty and humility rather than cocksureness with respect to the immediate future. In any case, to start with a historical gesture of a sort, I shall refer to my previous address delivered before a New School audience almost exactly six years ago, in a series entitled "New Horizons in Business," and to which my own contribution was entitled "New Horizons in Investment."

It is chastening to consult one's former errors in preparation for committing new ones. So let me cite two paragraphs only from that April 1955 talk. One of them

is a summary of what I said, and the other is the only piece of specific advice which I gave to the audience.

The summary is as follows:

"To sum up, barring atomic warfare, I see a generally favorable future for long-term investments, particularly investments 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 a bull and bear market in the future as in the past and that for every 10% of overvaluation in the bull market, we are still likely as before to see a corresponding 10% of undervaluation in the succeeding decline.

"I predict a gradual but decisive change in corporate practices and 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."

Let me add to that my other paragraph containing investment advices, as follows:

"I do not believe that the field of growth stocks, attractive as it is, is practical for the average investor to operate in continuously over the years. However, a separate case may 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 gives 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 perhaps only average. But the stability factor will probably be greater. One could easily justify a determination to concentrate one's equity proportion of the portfolio in the public utility field under present market conditions."

That was said in April 1955.

My Errors

Now, most of the things that I talked about six years ago have not come to pass. We have not had a full-scale bull-and-bear-market sequence similar to older experience, but rather a persistent advance punctuated only by three declines each on the order of some 20%.

The adaptation of corporate dividends and investment policies to our modern tax structure is taking place very slowly. The effective check by stockholders on the stewardship of corporate management is also developing quite deliberately and in a roundabout way, chiefly through purchases of controlling stock by new interests.

My warning against continuous operation in the field of growth stocks by the average investor may or may not be judged to have been a useful one, in the light of the widely varying experience of amateurs in this area of investment. But I am rather proud of my one piece of concrete and positive advice given in 1955, which favored concentration of common stock purchases in the public utility field. Since then the net rise in the utility averages has been fully as great as that in the industrials. (Of course, I checked on this before referring to the subject.) And they have had no intervening market decline of any importance.

Today's "Agenda"

In my paper of today I want to cover four matters: (1) The causes of the market's great advance since 1949; (2) a closer look at some of these causal developments; (3) my opinion as to the general character of the stock market of the future, and (4) a concrete suggestion for investment policies under present conditions.

A number of reasons can be adduced to explain the great rise of the stock market from a low of 161 for the Dow-Jones Ind. average in 1959 to a high of 685 at the beginning of 1960, which is almost the current figure. In

terms of Standard & Poor's 500-stock composite average, the rise was from 13.55 in 1949 to a recent new high of over 64. Interestingly enough, that advance was larger than the one in the more popular Dow-Jones Industrial average during the same period.

Now, one simple explanation of the rise may be based on the pendulum-swing concept. For a period of nearly nine years, from October 1946 to March 1955, the Stock Market had held continuously **below** its normal value as judged even by old investment standards. One of these is my own "Central Value" calculation, which is based upon an average of ten years earnings divided by twice the current interest rate on high-grade bonds. The same thing was true of the valuations reached by several other methods. They all, incidentally, gave a figure of somewhere around 400 early in 1955, which was equivalent to the stock market level at the time. Prior thereto stock market prices for many years had been **below** the values calculated by these now rather old-fashioned methods.

This period of nine years—1946-1955—was no doubt an all-time record for continued stock market restraint. Conceivably we are in the midst of stock market over-valuation which is not nearly nine years old as yet. But let me add with emphasis that only a very rash person would take this simple calculation of dates as a reliable clue to the duration of the present bull market.

Bases of the Rise

More seriously, the market rise has been based on an increase in the earnings and dividends of common stocks generally. As everyone knows, that increase has been much less than the accompanying advance in stock prices. The disproportionate rise, in turn, has engendered a great growth of confidence in the future of common stocks, most significantly on the part of institutional investors —such as pension funds, universities and others.

Common stocks are expected to increase their earnings at least as rapidly as in former decades. Furthermore, these earnings are expected to have smaller downward fluctuations, — i.e., more stability—because of the government's new duty to prevent or cure depressions. Share earnings are expected to be increased as in the past by more or less continuous inflation. This inflation consciousness acts as a double incentive to common stock buying, since it not only makes them appear more attractive for the future but also makes cash and bond holdings appear unattractive alternatives.

That these developments and new attitudes have justified a substantial advance in the stock market is beyond question. But the careful investor cannot let it go at that. He must ask: "How much of a rise is justified by these considerations? Could the market's response to them be excessive, either presently or at some future date? How can I determine whether and when such an excessive price level has been reached, and how could I make sure neither to over-stay a dangerous bull market nor to get out much too soon?"

These are more than $64,000 questions. And I don't pretend to know the answer to them. In my observation there are two kinds of stock market experts, whom I call Grade A and Grade B. The Grade A expert knows all the right questions. I have always considered myself strictly a Grade B expert.

However, it might assist those endeavoring to formulate answers to these questions for themselves if I considered in a little more detail some of the factors previously enumerated on which the bull market has been founded.

First let's look at the business expansion which has occurred since 1949, gave the last decade its Wall Street sobriquet of the "Fabulous Fifties," and also led to the advance description of the

present decade as the "Soaring Sixties."

Herodotus on the "Soaring Sixties"

When I first read these confident references to the "Soaring Sixties" toward the end of 1959, I was forcibly reminded of a famous tale told by Herodotus in that earliest of histories. It was about King Croesus, the richest man in the world. He engaged unwisely in a war, lost it, and was about to be burned to death on the funeral pyre by his conqueror. On the pyre he recalled a statement made to him long before by Solon, a very wise Greek, who said that "no man's life should be counted happy until it was over." And it seemed to me that perhaps it would be more advisable to delay the appellation for a decade until it is over. In any event, wait until it is well on its way, before you characterize it.

The Economic Record

Strangely enough, the economic expansion of the fifties shows up statistically as nothing to boast about. In constant dollars it was next to the lowest of the six decades of this century, but approximately the same as two others. It was much less than the expansion of Gross National Product in the forties. The figure was a 56% increase in constant dollars in the forties and only 32% in the 1950's (See accompanying Table).

In deference to Dr. Julius Hirsch I would like to say that the figures for GNP are open to some question as all global figures are. It is quite possible that certain important items are omitted in each decade and that they would have a differential effect if they were put back into them. It is possible that the increase in the 1950's was larger than the figures indicate. I don't think, however, that it was large enough to change the complexion of the economic history of that decade as compared with previous decades. On the whole, it would seem that the decade's rate of growth in constant terms was more or less an average kind of performance and nothing fabulous.

Now, of course, we must next allow for the effect of the price inflation. There we find that the rise in Gross National Product is reported as 87%, which is certainly an impressive figure. However, in the preceding ten years the rise was 182%. That was a period in which the stock market had only a small advance. Between 1910 and 1919, the rise was 162%. Between 1899 and 1909 the rise in Gross National Product was 82%—just about what it was in the 1950's. We had two smaller periods of rise, one of only 22% in the 1920's and a decline of 12% in the 1930's, produced by the fall of the price level.

However, when we look at the 22% rise in GNP in the 1920's and of 87% in the 1950's, it is rather curious to observe that both the great bull market of our financial history have occurred in decades in which the actual economic expansion was a little below average, and in which the expansion in dollars was really no better than average.

Increases in Certain Economic Indices at Ten-Year Intervals
1899 - 1959

	GNP (Constant $)	GNP (Current $)	Common-Stock Earnings per Sh.*	Common-Stock Prices per Sh.*
1899-1909	+57%	+ 82%	+ 73%	+ 52%
1909-1919	+37	+163	+ 21	— 10
1919-1929	+34	+ 23	+ 57	+170
1929-1939	+ 4	— 12	— 38	— 43
1939-1949	+56	+182	+196	+ 34
1949-1959	+32	+ 87	+ 42	+270

*Cowles Commission figures 1899-1929; Standard Poor's 500—Stock Composite Index figures 1929-1959.

Share Earnings Unimpressive

The figures on common-stock earnings, which are more important than the gross national product to the investor, are even less impressive. The earnings of Standard & Poor's 500 stocks, as comprehensive an index as we have, increased only 42% from 1949 to 1959. That was less than half of the increase in GNP. The Dow-Jones Industrial figures are a little better, but the difference is not really worth discussing. The contrast with the 1940's is especially striking here. In the 1940's, earnings per share on the larger average increased by 196%, or practically tripled, but prices rose only by a third. In the 1950's earnings rose by about 50%, quite a modest figure, but the market level advanced by 270%. In other words, it went up to nearly four times its 1949 average. Thus, the relationship between price change and earnings change was just about reversed between the 1940's and the 1950's.

So far in the 1960's both the general economic picture and the corporate earnings picture have been poorer than at the end of the 1950's. The strength of the stock market in these current months is to me very reminiscent of the stock market behavior of 1949, because it is exactly the opposite. In those days I recall, I think fairly accurately, a remark to the effect that the stock market in the late months of 1949 resembled the Island of Laputa in Gulliver's Travels by Swift. This was an island located somewhere up in the sky, and what happened there was completely independent of anything that occurred on earth.

Now we have the situation in which for a period of more than a year we have had relatively disappointing developments in the economic sphere and in earnings on common stocks; but the stock market has acted entirely on its own in response to elements which I am inclined to term basically speculative. This has caused a price behavior quite the opposite of what one might have expected.

The Inflation Impact

Since past and prospective inflation plays a dominant role in the thinking of investors, it is worth looking at the figures in this area for a moment. In the past nine years, since the Korean War, the Consumers Price Index (cost of living) has advanced about 12%, an inflation of a truly creeping sort. By contrast, in the two years 1947-1948, which was definitely a bear-market period, the price level advanced 23%—about twice as much as it did in the past nine years. Inflation has been with us most of the time during the century and generally at a more rapid rate than in recent years. Its influence on the stock market in the past has been most erratic. When investors were bullish, they were inflation conscious; and when they lost their enthusiasm for stocks, they seemed to lose their sensitiveness to inflation.

Government Support

Now, to go to another subject, there appears to be solid merit in the argument and conviction that the economic climate has had a major change for the better because of the enlarged role of the government in countering depressions. I believe that this has added to the underlying stability of the common stocks, has made them more suitable for general investment than they formerly were, and justifies a higher value than heretofore for a dollar of current or expected earnings.

However, it may be worth recalling that the business community was almost solidly opposed to that new government policy as embodied in the Employment Act of 1946. Here I am going to indulge in a little bit of vanity. I like to call to mind that as a member of the New York State Chamber of Commerce 15 years ago I was the only one who spoke out against the Chamber resolution roundly condemning the 1946

act, and one of the very few who voted "No" on this resolution of condemnation.

I refer to this incident to indicate what a remarkable change has come over investor's attitudes affecting stock valuation and stock prices. The increased valuation of common stocks can be traced in good part to three considerations now considered as very favorable and bullish, but which not so long ago would have filled an investor's heart with apprehension.

The first, already mentioned, is the increased government intervention in the economic picture, generically known as New Dealism and quite unpopular with businessmen in the past.

The second is the entrenched power of labor unions, which is expected to lead to successful demands for ever larger wages. In turn these are expected to push up the price level continuously, thus increasing the value of common stocks. To say the least, that is a novel investor reaction to the increased power of labor.

The Russian Challenge

Finally, we have the belief that the economy must expand at a faster rate than formerly to meet the challenge of Russian progress and Russian arms. Along with this is considerable reliance on government defense spending to stimulate business generally and especially to increase the profits of the electronic and other technological enterprises which play so prominent a part in the growth stock field. On the surface this reasoning appears justified. But as soon as one considers how closely connected are these economic considerations with the threat of an annihilating war, one can only marvel at the complete disappearance of the celebrated timidity of investors in the face of harrowing international uncertainties.

It seems to me that sobering considerations of the kind discussed in this section of my paper should enter into the thinking process of the investors and affect in some way their decisions as to their common stock portfolio. How important these considerations are, to what extent they are offset by countervailing arguments, must be left for the individual to figure out for himself.

Future Stock Markets

The next part of this discussion relates to the general character of future stock markets. The almost universally accepted optimism on this score at present is predicated on the following beliefs: First, the stock market will value earnings and dividends more liberally in the future than it did before 1950. Second, the normal or central value of shares as a whole will advance at an attractive rate—say at least 5% per annum—to reflect corresponding expansion of the economy plus inflation. Third, just as business will not be subject to the great depressions of the past because of the government's commitment against them, so the stock market of the future will not have the recurring large declines on the order of 40% to as high as 90% which were its essential characteristics for at least 70 years, covered by the Cowles Commisison's Common Stock Indexes — that is, for the period from 1871 to the last serious decline ending in 1942.

My thinking leads me to agree with the first part of this view as to a higher basic value for stocks than formerly; it leads me to a neutral position as to the expected 5%-and-more growth rate; and it leads me to essential disagreement with the opinion that the very satisfactory market pattern since 1949 will be continued indefinitely in the years to come.

New Era Talk Again

If this view of the stock market of the future is accurate, then we have indeed entered on a new era of finance. It is not inappropriate, therefore, that the main address at the Stock Market Luncheon of the forthcoming annual convention of the National Federation of Financial Analysts Societies in Richmond on May 1 next, bears the title, "The Beginning of a New Era." Some of us have lived through the "New Era" of the late 1920s. Its scars have healed, but the experience is not entirely forgotten. Today's analysts and investors would no doubt assert that the New Era which was only a mirage in 1928 and 1929 has now become a wholesome reality 30 years later.

I have two somewhat philosophical reasons for doubting whether things will work out in Wall Street as comfortably as now anticipated. The first relates to the determination of the new level of normal values, which I expect will be more liberal than before 1950.

Determining "Central Value"

However, there is neither a dependable statistical formula available nor a basis in long experience by which students of securities can determine just what this new central value should properly be. Consequently it will have to be worked out in the stock market itself, and in all probability by wide pendulum swings above and below what will ultimately be established as the new basis of normal value. When that has happened we will know perfectly and precisely why it had to be at that figure and not at some other figure.

Such eventual wide swings of the market pendulum are to be expected, I think, for a more fundamental reason, namely, the human nature factor as it shows itself in speculation. Participation in the stock market is not limited to the experienced, the conservative, nor even the intelligent. It is a game at which any number of people may play. And as the market level rises, the quantity of players grows rapidly and their quality diminishes somewhat in proportion.

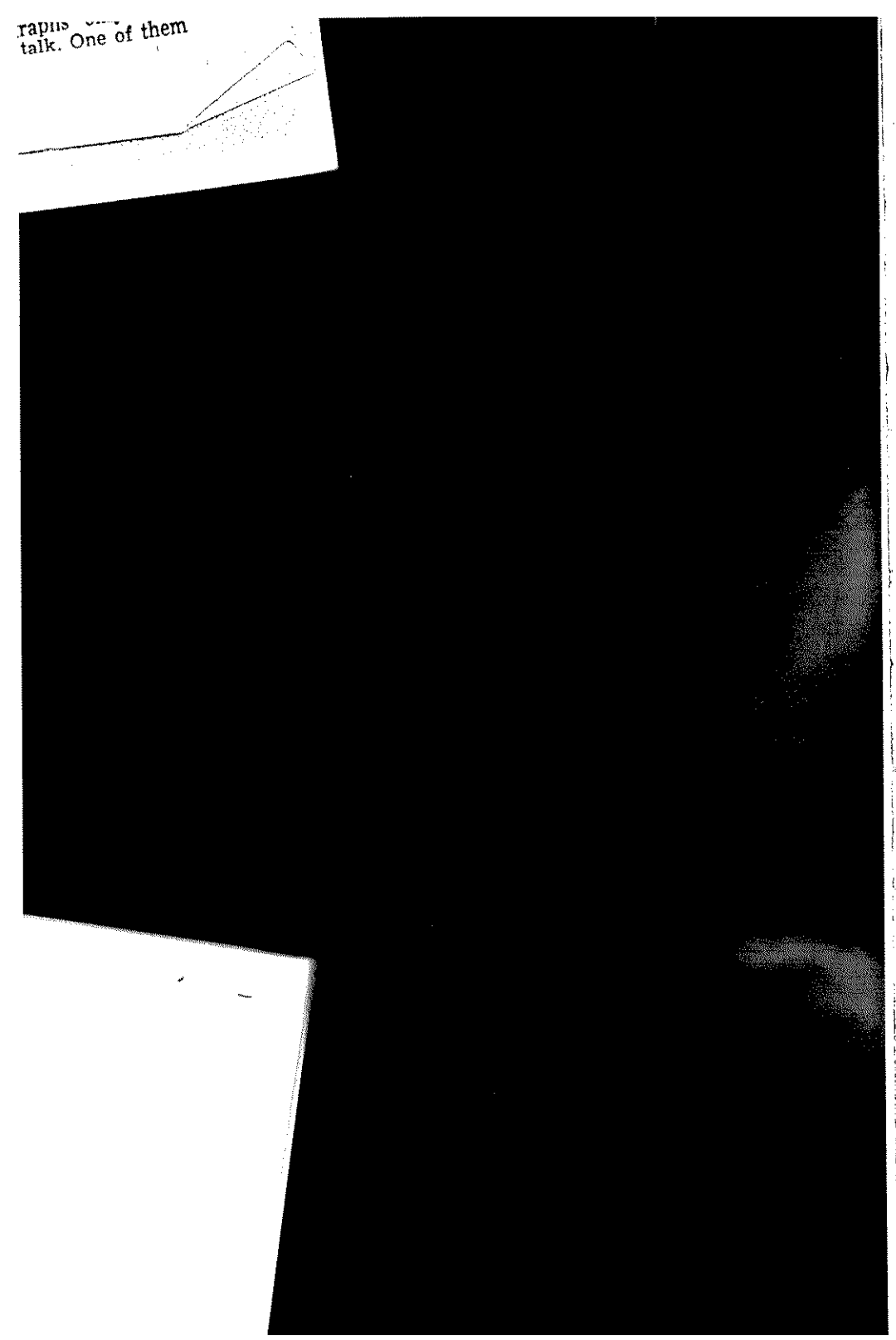
For contrast, consider the situation in 1948. Let me recall that the Dow-Jones average was then selling at about seven times its current earnings, against over 20 times at the present time. At that very low level a Federal Reserve survey showed that 12 out of 13 people consulted were opposed to common stock investments; about half of them gave as their reason that they were not safe and about half gave the reason that they were not familiar with stocks. Just recently the New York Stock Exchange proudly announced that the number of stockholders had grown to a new high of 15 million, a tremendous increase from the figures of 1948.

Today's Market Participants

If numbers of participants establish the future of the stock market, we are on very safe ground. But as always before under similar conditions, many people in today's bull market are interested only in the price movements of stocks and have scarcely the most shadowy notion of the values behind the issues they buy. Even serious minded security analysts, lacking a guide to normal values, feel themselves compelled to take their measure of value from the level of the stock market itself, instead of judging the market level by their own independent value standards.

The motto of nearly every one active in common stock today could be taken from Goethe's Iphigenie, who said in German: "Ich untersuche nicht, ich fuhle nur" (I do not investigate; I only feel).

With these attitudes of people in the stock market, with their inherent tendency to buy more eagerly as the price level rises, it would be most extraordinary for the stock market to follow a disciplined behavior pattern. So by a law of human nature, which I consider more fundamental than the Employment Act of 1946 or other legislation, the excesses on the upside are bound to be followed by similar excesses on the downside—in other words, by an old-fashioned bear market of major proportions. When that occurs, the present unlimited confidence in the future growth and rela-



tively stable character of common stock prices will be replaced by serious doubts and pessimism.

In this connection, and again in a literary vein, permit me to quote a contemporary of Goethe from France, Chateaubriand. In his memoirs he describes the rapid changes of loyalties that took place between Napoleon and the Bourbons as the fortune of war fluctuated in 1814 and 1815. And then he made the succinct remark, "Events make more traitors than do opinions."

Disloyalty to Investment Principles

For the followers of the stock market, there is no such thing as loyalty to investment principles. It is not their convictions but the action of the market which determines how they will act and therefore what they will believe. In a bull market, they are for Napoleon; in a bear market, they will be for the Bourbons.

It will be observed that in this rather disquieting picture of the stock market of the future which I have drawn, I have been careful not to supply any dates or specific price levels. I don't think that the situation admits of making that type of prediction with any high degree of reliability—this is a point on which A. Wilfred May would agree with me—and therefore I have no worthwhile opinion on the subject.

Investment for the Wealthy

But I do have an opinion on investment policy for wealthy people at this juncture, a record number of whom must have been created by the stock market advances of the past decade. I present this suggestion now with even more conviction than my suggestion made six years ago, that the investor could find both stability and growth of values in the field of public-utility common stocks. My advice is as follows: Divide your portfolio between common stocks and tax-free bonds in such proportion that you can be sure in advance of not being hurt by any future developments. The chief practical advantage of having a large net worth under today's conditions lies precisely in the opportunity it affords to protect one's self in both financial and psychological terms against any vicissitudes to come.

Bad Advice

Not long ago I was told of a counsel being given by a large Wall Street banking firm to the effect that an investor is foolish to own any bonds at all, since all he can expect from them is a decrease in their value by reason of inflation. This may seem like good advice to those familiar only with the history of the past 12 years, but to one like myself, who has experienced personally the ups and downs of the past 47 years and has studied those of many decades previously, this counsel seems to be short-sighted and rash.

My motto would be taken from my favorite poet, Virgil. It has only three words: "In utrumque paratus" — "Ready for either event"

Own common stocks, if you wish, in order to protect yourself against serious further erosion of the dollar and in order to participate in the excitement of our spectacular bull market. But be sure you own enough bonds to safeguard both your financial strength and your peace of mind against the inevitable day of reckoning for the now happy breed of stock market speculators.

***An address by Mr. Graham at Round Table for Busir.ess Executives on "New Horizons in Business," conducted by the Business Administration Center of the New School, New York City, March 23, 1961.**

OUR BALANCE OF PAYMENTS

The 'Conspiracy of Silence'

by Benjamin Graham

THE PROBLEM, in relation to our balance of payments, is a highly paradoxical one. On the one hand there has been a real threat in the international position of the dollar; on the other, this threat arose from reasons which are in no sense basic and which differ completely from the standard causes of foreign-exchange difficulties.

In this paper I shall refer to more recent developments, and inquire further into a question which I have found most intriguing: Why have the innumerable commentators on the problem—from President Kennedy at one end of the spectrum to U. S. Steel's Robert Tyson at the other—failed to mention (except in completely inadequate fashion) the underlying cause of our "dollar crisis?" It is this virtually unanimous ignoring of the most important fact in the case that has invited the phrase "conspiracy of silence" used in our title.

This paper will be written in an uncompromising style and will be highly critical of other people's statements. It will surely hurt the feelings of some and will strike many as intemperate and even arrogant. My excuse (for what it is worth) is that the strength of the dollar, a primary interest of the United States, may well depend on a proper understanding of a much misunderstood situation. To bring that about, a forthright utterance may be essential.

RISE AND "DISAPPEARANCE" OF THE DOLLAR CRISIS

Our balance-of-payments problem began in 1958. In 1951-57 we had experienced an overall adverse balance averaging about $1 billion a year. This was regarded as a favorable development for international stability, since it permitted other nations to acquire gold and dollars to build up their sorely needed monetary reserves. But in the next three years our adverse balance averaged $3.7 billion, and in 1961 it was about $2.5 billion. This four-year loss of some $13½ billion in international "liquidity" transformed our net position from a credit balance of $6.7 billion to a debit balance of about the same amount (*Table I*). It became evident that we could not long continue a liquidity drain at this rate and maintain the international value of the dollar. Hence the "dollar crisis," and the widespread view that it would soon have to be devalued in terms of gold.

Our government steadfastly denied any such necessity or intention. It stated its expectation that various steps would place our foreign accounts in balance by the end of 1963. Figures for the second quarter of this year showed improvement—the adverse balance falling to an annual rate under $1 billion; and the anticipated deficit for 1962 was placed at about $1½ billion.

At the September convention of the World Bank and the IMF in Washington, central bankers from many countries "hailed the end of the dollar crisis" and "dismissed devaluation" as no longer a threat. In fact, they began to express worry at what would happen to their own trade balances and international liquidity when our own deficits had ceased. (Whether our balance-of-payments problem is indeed under full control is a separate question, to be dealt with later).

An observer might well suspect that the threat to the dollar could not have been a fundamental one if it could be dispelled by a change in the figures of a single quarter together with some reassuring official statements. This brings us to our thesis: The loss of liquidity by the United States since 1957 can be traced directly and exclusively *to the increase in the annual rate of our net foreign investments.* A development of this kind is not basic to a country's foreign-exchange position; it has never compelled a devaluation in the past, and need never be permitted to bring on an unwanted devaluation in the future.

The true situation was summed up epigramatically by

Table I

U. S. Liquid Position and U. S. Equity Position 1949-1961
(in billions)

	Dec. 1949	Dec. 1957	Dec. 1961*
Gold	$24.6	$22.8	$16.9
Less Due Foreigners on Short-term	7.0	16.1	23.8
Primary Liquidity	17.6	6.7	def. 6.9
Add:			
U. S. Private Investment			
Short-term (gross)	1.3	3.2	6.0
Long-term (net)	8.4	20.8	30.2
U. S. (Private) Equity	27.3	30.7	29.3
Add:			
U. S. Government Advances	11.0	17.3	17.0
Total Equity	38.3	48.2	17.0

*Partly estimated from balance-of-payments figures.

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Table II

Our Balance of Payments in Long-Term Perspective

(Annual averages in millions)

Period	Group A All Private Accounts (Excl. Capital)	Group B All Gov't Accounts (Incl. Capital)	A + B Current Balance (Equity Change)	Group C Private Investment (Net)*	A + B + C Final Balance (Change in Liquidity)
	cr	dr			
1929-41	$ 650	$ 100	cr $ 550	cr $ 570	cr $1,120
1942-45	.....	.....	dr 1,530	dr 170	dr 1,700
1946-49	7,942	5,928	cr 2,020	dr 100	cr 1,920
1950-57	4,537	4,877	dr 340	dr 940	dr 1,200
1958-1961	5,016	5,326	dr 310	dr 3,130	dr 3,440

*Excl. foreign short-term investment here.

Aggregate Balances for Two Periods

	21 Years 1929-1949	12 Years 1950-1961
Current Balance (Change in Equity)	cr $ 9,100	dr $ 4,000**
Our Foreign Investments (net)	cr 6,300*	dr 20,000
Final "Balance" (Change in Liquidity)	cr $15,400	dr $24,000

*Disinvestment—i.e., excess of foreign investment here

**Our equity in unremitted earnings would exceed this debit balance.

a delegate to the recent world bankers' convention as follows: "The United States has not been living beyond its international means, but it has been investing beyond its international means."

The correctness of this diagnosis will be demonstrated by the comparative data which follow. We shall then deal with certain contentions that seek to absolve our foreign-investment rate from responsibility for the dollar crisis. Later we shall ask why the facts in the matter have been all but universally ignored. Finally we shall indicate how in our opinion the origin of our difficulty itself suggests the best way of dealing with it.

Our Balance of Payments
In Longer Perspective

In *Table II* we summarize our foreign accounts for the long period 1929-1961 in a revised form intended to bring out the true significance of the figures, and in particular the extraordinary change in our foreign-investment operations in recent years as against all previous periods. The accounts are combined here into only three basic groups:

A. All private transactions, net, except private capital accounts.

B. All government transactions, net, including capital accounts.

C. Private capital accounts, net, (excluding foreign *short-term* capital) plus "unrecorded transactions (errors and omissions)."

Group A includes imports and exports, various services, transferred income from foreign investments, and our private remittances abroad. It excludes government services and "military transactions," which the official classification lists among "exports and imports of goods and services." We add these items—important since 1940—to other government receipts and payments in Group B.

The "unrecorded transactions" are included with our capital accounts, in Group C, since it is generally understood that most of these items represent transfers of capital into or out of this country which move "outside channels normally covered by our reporting network." Foreign short-term capital movements are excluded from Group C, because they are treated as a balancing item similar to gold movements. (Our own private and governmental short-term balances abroad are not considered offsets against the foreign balances here, mainly because our government cannot use them at will to meet demands on our gold.)

It is instructive to divide our foreign account developments since 1929 into five periods: (1) Pre-war—1929-41; (2) World War II—1941-45; (3) Post-war—1946-49; (4) Korea-Suez—1950-57; and (5) Dollar crisis—1958-61. Our true "balance of trade" in each period is found by combining Groups A and B, and excluding our net private capital transactions. This balance may be considered as our "net profit or loss" in dealing with the rest of the world, or as our "balance on current account," or as our "net change in foreign equity."

Here we see varying results between 1929 and 1949, followed by a very moderate average adverse balance in the past 12 years. Actually, the adverse balance disappears when our unremitted gains on investments are taken into account. Thus, our overall "equity" position has increased somewhat since 1949 and since 1957, without counting any part of our government advances, some of which are being currently collected.

The important point to note is that the small "current loss" was slightly lower in the dollar-crisis years than in the "contented period" of 1950-57. Not only that, in 1961—at the very height of the dollar scare—we were

Table III

What Is Responsible for the Change in Liquidity Balance Between 1949 and 1961?
(in millions)

	(Merchandise Balance Only)	Group A All Private Excl. Capital	Group B All Government	A + B Current Balance	Group C Private Investment, Net	A + B + C Final Balance
1949	($5,424)	cr $6,140	dr $6,270	dr $ 130	cr $ 341	cr $ 211
1961	(5,340)	cr 6,815	dr 5,327	cr 1,488	dr 3,949	dr 2,461
Change	(dr 84)	cr 675	cr 943	cr 1,618	dr 4,290	dr 2,677

reporting one of the largest favorable *current* balances in our history (exceeded only in 1946-47), even after deducting over $5 billion net of government expenditures abroad.

The chief figures to observe in *Table II* are those of our net foreign investments (Group C). From 1929 through 1949 we actually had a net *dis*-investment—excess of foreign purchases here over ours abroad—aggregating over $7 billion.

For the 1950-7 period our net private investments averaged somewhat under $1 billion.

We started that period in an extremely liquid position, with too much of the world's gold, and it was logical for us to exchange excess liquidity (earning no return) for profitable foreign long-term investments. But later our behavior resembled that of investor-speculators in our own bull market.

As our liquidity decreased—i.e., our capacity for making foreign investments without monetary strain—we stepped up enormously the *annual rate* of such investments. Excluding offsets by other investors here, our capital transfers rose from $600 million in 1949 to $1.3 billion in 1955 and then to $4.6 billion in 1961. (Unrecorded transactions of $600 million are included in the latter figure). We have indeed been investing beyond our international means.

CHALLENGES TO OUR THESIS

My emphasis on the rise in the rate of foreign investment as the basic cause of the dollar crisis has been challenged on various accounts. Consideration of these objections should help clarify the picture. The first argument is that there is no valid reason for singling out the investment item for blame, since our adverse balance is the resultant of many factors—including, on the debit side, notably our huge outlays for foreign aid and military expense abroad. One aspect of this general viewpoint was stated by one who certainly should know the subject, Walter Lederer, Chief of the Balance of Payments Division of the United States Department of Commerce. He says: "However, as long as the offsetting relationship between capital movements and changes in other transactions continues, both have to be considered in an evaluation of the balance of payments, and one cannot view some types of transactions as more 'basic' than the others."

The implication here seems to be that each year's foreign investments may have generated offsetting credit items of corresponding magnitude, and thus this category may not be usefully analyzed by itself as a causal factor in our difficulties.

But what are facts and figures? Let us look first at *Table III,* which compares the results for 1961 with those for 1949. In 1949 we had a small adverse balance on current account, but our investments abroad were then *less* than foreigners' here (treating unrecorded transactions as investments). Hence we ended 1949 with a slight increase in liquidity. In 1961 we had almost a $1½ billion favorable balance on current account, but net investments abroad of nearly $4 billion changed this figure into a very embarrassing final adverse balance of some $2½ billion.

Should the blame for this spectacular *change* be spread about indiscriminately between our trade accounts, our government expenditures and our foreign investments? Does the primary cause of the trouble defy identification? How can we ascribe the deficit to lagging exports—to "being priced out of the market," as so many have done—when our favorable merchandise balance in 1961 ($5.3 billion) was about equal to that of 1949, in spite of the trade advantages we enjoyed in the post-war years of European reconstruction?

Furthermore, our combined credit balance for goods and services (non-governmental) was actually $675 million *better* than in 1949. Yes, say some, but the real culprit is obviously our government's program of foreign aid and military support. Are these experts aware that we spent $940 million *less* for these purposes in 1961 than in 1949? By what logic can one blame an element that shows *improvement* for a great deterioration in the overall picture? Since foreign investments are the only group that shows a significant adverse change, and since this change is of extraordinary magnitude, its role as architect of our embarrassment should be obvious to anyone who looks at the figures.

Objections Cited

But, again say the objectors, these investments generate large offsetting credits, and so they do our liquidity no overall damage. Chief of these is our income therefrom. In 1961 this income received from abroad totaled $3,645 million and was not much less than the $3,951 million we added to our investments (excluding here the unrecorded transfers). It is widely held that the closeness of these items of income and outgo prove that our annual foreign investments have been responsible for

only a small part of our recent balance-of-payments deficits.

Plausible as this contention may sound, it is entirely fallacious. It fails to consider that nearly all the income from investments received in, say, 1960 and 1961, would still have been received even if we had not added a single dollar to our $45 billion of capital abroad at the end of 1959.

A reasonably accurate calculation on this point, covering 1958-1961, appears in *Table IV*. It shows that the $14 billion of private capital sent out of this country in the last four years produced at most about $1.2 billion of *additional* remitted income—an offset of less than 10% against our outlay. The entire "deficit" of 1960 and 1961—the period of maximum dollar crisis —would probably have been obviated had we reduced our gross capital outflow to, say, $1 billion each year instead of about $4.5 billion. (The current loss of investment income from this reduction would have been quite minor).

Defenders of our huge capital commitments argue further, in this context, that they produce other important balancing credits in the form of additional exports of capital goods, which presumably would not have been made had we not increased our foreign plant accounts. Hence there is no way of determining the overall effect of these outflows on our final balance of payments.

In the narrow sense of complete accuracy this is of course true. But we have some data which throw light on the approximate magnitude of the claimed offsets. (These appear in an elaborate study of "U. S. Business Investments in Foreign Countries," published in 1960 by the United States Department of Commerce). The figures indicate that our foreign interests in 1957 bought about $1 billion of capital goods from the U. S., as against a total of $4.9 billion they spent that year on plant account. Our total outflow for foreign investments in 1957 was $3.2 billion, of which $2 billion was for these "direct investment enterprises."

There is an indication from these figures that our foreign investments in any year may generate about 30% in offsetting capital exports. On the other hand, our direct investment enterprises exported over $3.7 billion of goods to this country in 1957, a figure which apparently well exceeded their total purchases of goods from us. (The "incomplete total" of the latter, as compiled by the study, was $2.6 billion). The text of the study emphasizes the dollar-saving advantages to the countries in which our investments are made. The implication is quite clear that, apart from remittances of income (already discussed), we lose rather than gain in the net effects of such investments on our balance of payments.

THE CONSPIRACY OF SILENCE

The data presented in our four tables should show clearly that the greatly enlarged rate of our investments abroad has the primary responsibility for the recent dollar crisis. Has any of my readers seen this aspect of

Table IV

Effect of 1958-1961 Foreign Investment on Our Income from Abroad

(in millions)

Investment income as at Dec. 1957	$ 2,900
Expectable income 1958-1961 without new investments (Four times the Dec. 1957 rate)	11,600
Actual investment income 1958-1961	12,815
Gain in income as a result of 1958-1961 investments	1,215
Our capital outflow 1958-1961 (about)*	14,700
Net loss in liquidity: 1958-1961 capital outflow less gain in income	13,500

*Includes unrecorded transactions aggregating about $1,200 million net.

the problem recognized, or the problem discussed in any detail, in the numerous pronouncements of the subject from nearly every authoritative source? I have not —before last September, at least. Let me now deal with the way the subject has been handled and the possible reason therefor.

There has been no recognition of the essential difference between the loss of liquidity from an unfavorable trade balance and one occasioned by investments. The January 1962 discussion by the Council of Economic Advisers combines both groups of transactions into what they term the "basic accounts."

Could the plant investment made by a business be "basic" in the same sense as its profit or loss from operations? By contrast the official Canadian analyses carefully distinguish between what they call the "Current Account Balance" and the "Net Capital Movement." A comparison between the highly unfavorable current balance of Canada since 1955 and the approximately break-even results of the United States in that period would have brought home the fact that Canada was to experience a true foreign-exchange crisis, while ours could be only a superficial or artificial one.

President Kennedy, in his February 1961 Special Message on the Balance of Payments, stated: "The surplus of our exports over imports, while substantial, has not been large enough to cover our expenditures for military establishments abroad, for capital invested abroad by private American business, and for government economic assistance and loan programs."

Note that our foreign investments are *sandwiched between* military expenditures and government aid—as if they were all of essentially the same character. This burying of capital items in the middle of expense items became the general treatment—*and a most misleading one.*

In his May 1962 speech to the U. S. Chamber of Commerce the President further stated: "It costs the United States $3 billion a year to maintain our troops and our defense establishment and security commitments abroad. If the balance of trade is not sufficiently in our favor to finance this burden, we have two alternatives: one, to lose gold, as we have been doing; and two, to begin to withdraw our security commitments."

Here our foreign investments are not even mentioned. The fact is that our *balance of trade*—with investments excluded—has been sufficiently in our favor to finance virtually all our government outlays abroad.

The President, in ignoring the role of enlarged investment may be plausibly ascribed to his strong desires in two directions: first to prevent wage and price increases here; and second, to persuade our prosperous allies to assume a larger share of our overseas burdens. For one purpose it is useful to assert that our exports must be substantially increased; for the other, to imply that the dollar's position is really precarious and in need of aid from our allies.

Finance Chairman Tyson of U. S. Steel, last March, put the case in stronger language—and in my view, with even greater inaccuracy. Said he: "There is only one real solution of the problem of unfavorable balances of payment: it is the development or restoration of greater ability to compete in international markets." The purpose of that statement is clear from the next sentence: "That means, in turn, I think, that Americans must find the fortitude to bring to an end the era of flat wage inflation."

Most of us would agree that wage inflation should be halted. But some of us would disapprove basing that demand on an alleged impairment of our ability to compete in foreign markets—when the trade figures had just shown for both 1960 and 1961 two of our largest favorable merchandise balances in peacetime history, considerably exceeding the 1950-57 average.

The Silence Continues

The Wall Street Journal, always pursuing its own *bete noire,* summarized the situation thus in an editorial last July: "Though a lot of confusion has developed about the payments deficit, the essential facts are perfectly plain. U. S. business enjoys a large export surplus; it is primarily the Government's policies at home and abroad that have created the deficit." *Business Week,* more judicious in tone but hardly more respectful of the facts, expressed a similar view at the same time in this fashion: "The plain—if disagreeable—fact is that the U. S. has committed itself to a considerably larger program of overseas military operations and foreign aid than it can finance within the present structure of international trade." Neither publication as much as mentions our stepped-up rate of investment, without which there would have been no dollar crisis. (Presumably, had we been investing $8 billion instead of $4 billion a year, and running a $7 billion final deficit, our government policies and commitments would still be responsible for all of it).

These inaccurate characterizations have influenced other periodicals to even more exaggerated comments. Typical, perhaps, would be one from my own newspaper, one of the country's largest: "International bankruptcy is the theoretical disaster facing the U. S. if the bad news about the puzzling imbalance of payments problem continues. . . . We owe more in world markets than other countries owe us. Our liabilities exceed our assets. . . . U. S. liabilities include imports, military expenditures overseas, investments in foreign enterprises, and foreign aid."

Note here the listing of foreign investments in the midst of our "liabilities," with the concomitant suggestion that we are on the verge of international bankruptcy. No wonder people have expected a cut in the gold value of the dollar, and some have transferred huge sums to Switzerland and elsewhere.

It took the British Chancellor of the Exchequer to set the situation in almost its proper perspective last September, by stating: "The nature of this deficit is a very special one. On current commercial transactions the U. S. has a massive surplus and the problem has arisen because of the enormous amounts spent abroad on aid, defense, and investment. It could be said that the problem is less one of a balance of payments than a balance of generosity." These words imply that our huge foreign investments are part of our "generosity" which is scarcely true; but they *resemble* generous deeds in that their continuance is purely voluntary.

I have been chiefly concerned by the failure of our leading economists to take the trouble to look the facts in the face and to pay adequate attention to the key role of foreign investment in bringing about our dollar crisis. Relevant quotations are too numerous to be feasible. Suffice to say that an authoritative volume, issued last year containing 13 essays on the subject by as many leading economists, devotes so little and so unilluminating discussion to the investment component to put the entire picture completely out of proper focus.

I am at a loss to explain what I consider a failure of professional competence. One explanation—which undoubtedly will seem plausible to many readers—is that my own diagnosis is completely incorrect. In self defense may I ask only that they go back over my data and my arguments, and consider them carefully before deciding who is right and who is wrong in this matter of transcendent importance.

FUTURE DANGERS AND POSSIBLE REMEDIES

Even though our problem may have arisen from a "balance of generosity," plus overseas investment, it did pose a real threat to the international position of the dollar. The improvement shown in the first half of 1962 does not in itself carry assurance that it will continue to the point needed to put the dollar out of danger. (I should place that point at an annual loss of liquidity of not more than, say, $1 billion).

Our foreign trade balance, so satisfactory for many months, may take a turn for the worse, and our military expenditures may have to be greatly increased. These appear more than outside possibilities in the atmosphere of real international crisis in which these words were written (October 28, 1962).

Assume that our liquidity loss is not sufficiently stemmed in the months to come, and assume that our foreign investments persist at their recent embarrassing rates; what steps can and should be taken to deal with the situation? It is obvious that we cannot rapidly step

up our merchandise exports sufficiently, by means of the plant modernization expected to follow the recent granting of tax incentives. The reliance on his procedure for a *quick* solution, constantly expressed by highly-placed officials, had overtones of absurdity.

A deep cut in our overseas expenditures by the government is not out of the question, but involves a basic change of policy at a time when world events seem strongly against it. A rise in interest rates to attract or retain *short-term* capital from abroad is already under way; but this cannot change our overall liquidity position—it only prevents conversion of our short-term liabilities into gold withdrawals.

Whether much *long-term* capital could be brought in by higher interest rates appears uncertain; in any event there is strong opposition to moving up radically our entire domestic interest-rate structure for this or any other purpose. Let us discuss three other possibilities.

The first is devaluation of the dollar. Whether that would really solve the problem is a matter of controversy. But how could we possibly justify such an "act of bankruptcy" if it is brought on by our persistence in investing huge sums abroad? Has any nation, corporation or individual ever gone bankrupt for such a fantastically inadequate reason?

The second possibility is obvious and logical. Let us cut our coat to our cloth—in other words, let us cut down our annual *new* foreign investments, net, to the amounts available for this purpose from all our other transactions. This would correspond to the normal behavior of an individual, who invests each year his surplus earnings above living expenses, taxes, and contributions.

The most appealing place to start such a policy would be in the area of foreign bond and stock flotations in this country. These have always been large, and appear to be larger than ever in 1962—reaching a rate of $1 billion or more.

Secretary Dillon has already indicated that, should the necessity arise, some steps to restrict that outflow of dollars will be taken. On the other hand, the compulsory reduction of our private investment abroad is opposed to our objectives of financial freedom. All of us would be reluctant to see such controls imposed—even though there is ample precedent therefor in the fiscal history of Great Britain.

To my mind the least objectionable way of dealing with the problem would be by means of *long-term* borrowings abroad made by our corporations and/or the U. S. Government. Our difficulty grows essentially out of our incurring short-term liabilities to foreigners to finance long-term investments made in their countries. The evident solution would be to finance long-term foreign investments, to the extent required, by long-term foreign borrowings. These do not reduce our liquidity balance, for the year, or in total, as do short-term debts.

Such a program would entail the payment of appreciably higher interest rates than on borrowings floated in the U. S. But if our new investments are sufficiently profitable we can afford to pay these larger borrowing costs against them. If they are not, we should not make them.

It is claimed that such borrowing is "impossible" because foreign capital markets are not well-enough organized. However, investors in the prosperous European countries are lending large sums to their own enterprises; some of our corporations have already borrowed abroad; securities payable at the lenders' option either in their own currency or in U. S. dollars would be especially attractive.

The question surely is not "Can we borrow abroad on long term?" but rather "How much will it cost us?" To balance this extra cost against the position of the dollar as the world's key currency, it is well to consider the relative magnitudes involved. One billion dollars worth of foreign borrowing at an extra interest cost of 1½% would involve an annual expense of $15 million. Place this amount in the context of our annual foreign accounts exceeding $30 billion on each side, and our Gross National Product of some $550 billion. If future threats to the dollar could be dispelled by expenditures in annual units of $15 million, the price paid would be a small one.

Comments by Ben Graham at luncheon on 11/21/62

In new edition of Security Analysis, Graham comes up with a valuation of 550. He asked our opinions.

Bert felt the averages wouldn't go below 550
I said Ididn't ~~kx~~ try to figure intrinsic value of Dow Jones but instead tried to buy undervalued stocks.
Ed. Laufer agrred with me and Larry Kessel had no opinion.

Ben told us of his relationship with IDS. He was asked to make suggestions on improving methods of analysis. He charged $10,000 for a preliminary study. His conclusions were that Analysts started out favoring a stock and then went out and talked to management which confirmed their ideas. They went for growth stocks justifying their recommendations on the fact that comparable companies were selling at even higher multiples.

Ben has changed his ideas on multiples of companies. Thinks stocks will sell at higher multiples in the future. Thinks 15 times past earnings and 13½ times future earnings.

I indicated that investors are more sophisticated than in the past possibly because they have read B.G.'s books. (105,000 copies of S.A. have been sold according to Charles Tatham).
A lot of wealthy investors who will put some money in Tax Exempts but will now buy large quantities of an oil producer and then force See.
D.G. Pin./ ~~Bell didn~~'t think there was much change in the ability of avg. investors altho he conceded there was more money around to buy things.

Larry felt opening of Common Market would cause great agony and competition for many American Companies and European Companies would penetrate American markets with lower profit margin than they were willing to accept in Europe. B.G. felt the Common Mkt gave us some protection as we would all be in the same boat. The Common Market would tend to operate the way our tariff barriers had in the past.

Ben is going to Washington to talk to Cary and Milton Cohen. Thinks S.E.C. can require several ~~xx~~ new things. 1. Require companies to file annual reports that correspond to reports co's make to S.E.C. (I.C.C.requires this). 2. Make O.T.C. co's file reports to S.E.C. or give stockholders similar ~~xxx~~ info to Listed Companies

Are We Too Confident About Invulnerability of Stocks?

By Benjamin Graham,* *Visiting Professor, University of California, Los Angeles; Author: "The Intelligent Investor", and of "Security Analysis" (with D. L. Dodd)*

Equities as the preferable investment medium for the future are analyzed in terms of their performance in the broad sweep of the past with particular inquiry raised as to the predictive significance of the 1871-1961, 1920's and 1949-61 periods. Skeptical about the invulnerability of stocks as a whole, and the success of dollar-cost-averaging and mutual funds, Mr. Graham advises accumulators of equities to have an equal stake in bonds in case we return to the old standard of values or until we redevelop a new level of sounder values. His current view of the market is one cut adrift from old standards of value without replacement of dependable new standards.

The terms of reference for this paper relate to systematic plans for saving or accumulation through common stocks. Such plans might include (a) a pension plan concentrating on equities, such as the CREF arrangement for college professors, (b) the very similar mechanics of the newly-developing variable annuities, (c) systematic purchases of mutual-fund or closed-end investment company shares, (d) an individual dollar-averaging plan, such as the monthly-purchase program of the New York Stock Exchange.

Benjamin Graham

I was asked to consider investment aspects of such plans in longer perspective, and to give my views on the following questions: What results can be expected from them in the future as compared with the results either of the shorter-term past—i.e., since 1949—or of the longer-term past, going back into the last century and farther? How good will common stocks be as an inflation hedge in the future? Can dollar-averaging be counted on infallibly to produce satisfactory results? More specifically, can the much better performance of common stocks as against bonds be counted on to repeat itself in the next 15 years?

These are difficult questions to answer authoritatively or even with an acceptable degree of professional expertise. We have not only to make a hazardous choice between the shorter-term and the longer-term past as our guide to the future, but also to face the possibility that the future may be much different than either. The major determining factor that controls the welfare of the investor as of everyone else is the factor of nuclear war. It is customary to dispose of this overshadowing possibility by some simple phrase such as "nuclear war excluded" or "ex-nuclear war." At first blush this attitude under today's conditions—something like staging "Hamlet" without the melancholy Dane. But perhaps we are all forced to this recourse for want of a better. It is indeed difficult to consider rationally the effect of a nuclear war on investment values. Can the investor construct a fall-out shelter for his portfolio? Somehow the question seems too unimportant in relation to larger values to take up seriously; even if we did, we have little ground for believing that bonds will necessarily be better than stocks, or vice-versa, if the dies irae comes upon us.

Hence, like other "investment experts" I too shall leave the chances and the effects of atomic war out of the following discussion, except for some observations regarding the indefinite continuance of the Cold War.

Which Period Will Stocks Resemble?

This brings us, too quickly perhaps, to the other major question confronting investors. Which of the two past periods will the future stock market resemble more closely—that of 1949-1961, or that of, say, 1871-1961?

The latter comprises the 90 years for which we have common stock indexes of earnings, dividends and prices, as compiled first by the Cowles Commission and then continued by Standard & Poor's. In discussing equity experience in terms of the future behavior of these indexes we are assuming that the various equity-accumulation plans within our purview are likely to show results in the aggregate approximating those of the S-P Composite or 500-Stock Index. It would seem easy enough to equal these average results; all that is needed is a representative diversification "across the board," and without that selectivity which is a watchword of today. But, paradoxically, if it is easy to equal the averages it seems almost impossible for the average skilled investor to beat them.

We have very full information regarding the operations and achievements of the investment funds. For the 1949-1960 period, as in the earlier years, they have not managed as a group to outperform the S-P 500 Stock Composite. (Based on the performance for 1951-1960 of the 58 investment companies included in the ten-year table appearing in Moody's Financial Manual for 1961.) It may be that professionally managed funds are too large a part of the total picture to be able to outperform the market as a whole; it

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corporations with no real business purpose or function; unrealistic sales or purchase prices; and artificial salaries, rents, royalties and allocations of expenses. We have discovered that these devices are used by all types of taxpayers, regardless of size or reputation, and many cases involving large corporations now are under active audit in the field.

Our biggest problem right now is the development of adequate information to deal with the situation. Recent legislation requiring reporting should be of great assistance. In addition, the National Office is working very closely with our field offices on cases with international aspects. We already have received some 1,170 reports concerning some 6,000 foreign subsidiaries in a controlled audit program we are conducting, and we expect to improve our enforcement procedures with the data obtained from this survey. Recently, our Chief Counsel set up an International Operations Branch, which should prove of value in coordinating our studies in this complex field.

We also are expanding our operations abroad to increase our scope of operation and to develop more effective audit procedures. We now have five permanent posts in London, Paris, Manila, Ottawa and SaoPaulo, and we are in the process of increasing both overseas posts and personnel. Any new legislation in the foreign field will obviously heighten this expansion program.

Enforcement of our tax laws must necessarily be on a worldwide basis. The American businessman and American taxpayer must be assured that these foreign transactions with U. S. connections are bearing their proper tax burden.

A very large part of the operations of the Internal Revenue Service goes far beyond enforcement alone; rather it is aimed at assisting businessmen to understand the tax laws and fostering greater respect for our tax system.

In the last analysis, we are doing everything reasonably possible to encourage more effective voluntary compliance with the tax laws. For only in this manner will we be able to raise the revenue needed by our government for all its important programs — defense, national and international.

Although the relationships between the Service and the business community have been emphasized here, a strong workable tax system is the property of all Americans. To carry out the grave burden of administering our highly complex tax laws, the Commissioner and the entire Revenue Service must have the active cooperation and strong support of every American, and this is sometimes said to be a painful course to pursue willingly.

By administering the laws given us in the fairest and most equitable manner, we shall at least persuade the vast majority of Americans that their interests are being guarded to the best of our abilities. This is one of the most effective ways we can build confidence and compliance in the Federal tax system.

To do this, of course, we need the understanding and help of every business, every farmer, every professional man, every citizen of our country. We cannot promise to please everyone, but we can promise to carry out our function honestly and fairly.

In this context we ask for the cooperation of every American taxpayer. In this manner, we all can be proud that we have met our responsibilities as free citizens in a democratic society—and that we are making full contribution to the strength of our government in a crucial period of its history.

*From an address by Mr. Caulin before the Federal Tax Forum, New York City.

Are We Too Confident About Invulnerability of Stocks?

Continued from page 3

may also be true, as I suspect, that certain weaknesses in their basic principles of stock selection tend to offset the superior training, intelligence and effort that they bring to this task. But our main point is to establish that what happens to the stock market in general is going to happen to the typical or average accumulator of equities by any plan or under any auspices.

Analyzes Two Periods

Let us attempt to summarize briefly the chief characteristics of the two market periods to which we are turning for clues to the future, and among which we may have to choose. Table I gives some data covering the three salient factors of earnings, dividends and price behavior. We bring down the 1949-1961 period into two six-year halves. The longer span can be handled in a variety of ways; we have decided to supply average computations for each of the nine decades between 1871 and 1961.

A cursory study of our Table shows a number of striking differences between the exhibits of the two periods. Molodovsky has demonstrated that the overall gain to investors for the 88 years 1871-1959 has averaged about 5% per annum in dividend return and 2½% per annum in price appreciation—both taken against annual market prices. The 2½% annual increase, compounded, in market price was closely paralleled by the annual rate of growth in both earnings and dividends.[1]

But between 1947-49 and 1959-61 the growth rates for the various components have been quite diverse, and they have also varied sharply between the first and the second half of the period. Thus we get very different indications of recent performance if we consider earnings rather than market price, and if we consider the last six years rather than the last 12.

The behavior of the stock market itself has been significantly different in the past 12 years than in any previous period of equal length covered by our records. We have experienced what appears to be a single bull market, beginning at 13.55 for the composite index and rising to a current high of 72. The advance has been interrupted by three recessions, each on the order of some 20%. Under the usual terminology these would be characterized as corrections or setbacks within a bull market.

Cyclical Stock Gyrations

As is well known, the long-term history of the stock market has been completely different. The picture, shown in Table II, is one of a succession of bull and bear markets of varying duration and amplitude. Between 1899 and 1949 there were 10 such well-defined cycles, thus averaging five years in length. (The longest period between peaks was 10 years, from 1919 to 1929, and the shortest was two years, from 1899 to 1901 and from 1937 to 1939.) Most of the declines in the industrial averages were in the range of 40% to 50%; in the earlier years the composite average had somewhat smaller losses. The largest, of course, was the shocking fall of the Composite Index from 31.92 in 1929 to a low of only 4.40 in 1932, a loss of 86%. About the same decline was shown by the Dow-Jones Industrial Average.

It should be pointed out also that the gyrations of past stock markets may not properly be viewed as taking place around a well-defined and persistent upward trend line, sloped at 2½% per annum. Both the price record and the earnings record disclose an irregular rather than a regular trend line. This should be evident from an inspection of our successive 10-year average figures between 1871 and 1950, and the Molodovsky growth rates appended thereto.

The price-earnings ratio has also shown wide fluctuations. Since earnings have been even more unstable than prices—because of the recurrent business cycles—there has been a clear-cut tendency for the highest earnings multipliers to be established in years of depression when profits tended towards the vanishing point. Our average figures by decades smooth out this type of variation; but they do not show the upward trend in price-earnings ratios that we might have expected to accompany improvement in the underlying strength of our corporations and in the dependability of published earnings figures. Actually the ratio of 6.2 times for 1949-50, at the beginning of the present bull market, was the lowest for any two-year period in our 90-year history of stock prices and earnings. A devotee of the pendulum-swing theory of economic phenomena might well explain the current record high multiplier as a reaction to the opposite extreme from the 1949-1950 depreciation of the earnings dollar.

With these two quite diverse stock market pictures before us, let us now inquire what are the respective arguments for considering the 1949-1961 period as an integral continuation of the 1871-1949 span, or for recognizing it as a new dispensation which will determine the character of the markets of the future. It is not too difficult for the student to fit the pattern of the recent market into that of the longer past. True, both the duration and the etxent of its rise are already greater than any other's.[2] But that a pattern of many decades should establish new records at various kinds from time to time is only to be expected. A new record does not create a new pattern or character.

Are We Repeating the 1920's?

Is it possible then that we are living through a modified but not essentially different version of the experience of the 1920's? That there must be impressive differences goes without saying; for otherwise all of us would have been so struck by the incipient similarity as to make its continuation impossible. What may be more likely—speaking in abstract terms—is that the original differences have convinced us that the 1929 experience is irrelevant, but that the similarities have been developing later, gradually and so insidiously as to find us psychologically incapable of recognizing them. Let us attempt an enumeration of the major resemblances between the current market and that of the 1920's, as they appear to this observer.

The two major internal differences relate to financial manipulation of various sorts and to excessive borrowing for speculation. The bull-market heights of 1929 were made possible by a huge wave of buying on thinner margins than are now permitted. Brokers' loans rose from $2.769 million in 1926 to $8.549 million in 1929, at which time they constituted about half of total member-bank loans. By contrast, the corresponding rise to date has been relatively much smaller. (Borrowing on smaller margins through other sources are no doubt significant at present but not sufficiently so to change the broad picture.) In the field of financial practices, the major abuses of the 1920's consisted of crass manipulation of stock prices by speculative pools and of corporate pyramiding through successive tiers of holding companies of various types. Both stock-market manipulation and corporate-structure manipulation have been greatly restricted by the SEC legislation and by tighter stock-exchange supervision. The amount that escapes detection is comparatively small, in my view. Although the various investigations now under way produce some startling exposes, whatever abuses now exist will not be found to have permeated the whole fabric of finance as was the case 30 years ago.

Offerings Increase and Quality Decreases

An exception to the above reassuring statement may have to be made in the field of new offerings of common stocks. Here I think a set of at least semi-manipulative practices has developed in handling so-called "hot issues." The number of such offerings has been increasing steadily in the past two years, and their quality has been retrogressing at an equal rate. It is in this speculative area that I sense the closest parallel between internal market conditions of the late 1920's (and particularly of 1919) and today. Whether the new-issue financing of dubious merit will prove to be so heavy in aggregate dollars as ultimately to turn the market scales definitely downward, I shall not venture to guess. It is not impossible.

The widespread belief that we are in a new stock-market era, differing in its essential character from the bull-and-bear sequences of the past, rests on a number of claimed differences between then and now. These go well beyond the reforms in stock trading and in corporate financial practices. The case to justify the present unprecedented level of stock prices and earnings multipliers is essentially that which would justify the concept of a permanently changed character and future for the stock market.

The safety an dattractiveness of common-stock investment today is thought to be solidly grounded on a complex of favorable factors. Among them are (a) assured growth of population and GNP; (b) a rate of expansion more rapid than formerly, created by technological progress and the rivalry with Russia; (c) an assurance against major depression provided by the government's new responsibility to prevent or quickly terminate them; (d) the public's recognition that common-stock investment is a necessary protection against continued inflation; (e) the emergence of mutual-funds, pension trusts and other institutional investors as the chief source of demand and continuous support for common stocks.

Resurrection of the 1924 Doctrine

Those who study the record of the 1920's will find that reasons similar to most, but not all, of the above were advanced to justify the ill-fated market rise of those years. The doctrine of "Common Stocks as (the Best) Long-Term Investments" emerged in 1924 and was made the cornerstone of the market's philosophy and its excesses. There was the same optimism about the future growth of the country, and perhaps a better-founded confidence in the share of common-stock earnings in that growth. (The rate of return on invested capital was better maintained between 1922 and 1929 than between 1950 and 1961.)

Old standards of value—particularly the once normal relationship between bond yields and

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[1] (See N. Molodovsky "Stock Values and Stock Prices," *Financial Analysts Journal*, March 1960.)

TABLE I

A Picture of Stock Market Performance 1871-1960 and 1947-1961

Period	Average Price	Average Earns.	Average P/E Ratio	Average Div.	Average Yield	Average Payout	Annual Growth Rate Earns.	Annual Growth Rate Dividends
1871-80	3.58	0.32	11.3x	0.21	6.0%	67%		
1881-90	5.00	0.32	15.6	0.24	4.7	75	—0.64%	—0.66%
1891-1900	4.65	0.30	15.5	0.19	4.0	64	—1.04	—2.23
1901-10	8.32	0.63	13.1	0.35	4.2	58	+6.91	+5.33
1911-20	8.62	0.86	10.0	0.50	5.8	58	+3.85	+3.94
1921-30	13.89	1.05	13.3	0.71	5.1	68	+2.84	+2.29
1931-40	11.55	0.68	17.0	0.78	5.1	85	—2.15	—0.23
1941-50	13.90	1.46	9.5	0.87	6.3	60	+10.60	+3.25
1951-60	39.20	3.00	13.1	1.63	4.2	54	+6.74	+5.90
1951	22.34	2.45	9.1	1.41	6.3	58	+2.5	
1961 (Hi)	78.20	3.10	23.2	1.97	2.7	64	+2.5	+3.5
1947-49	15.71	2.18	7.1	0.97	6.4	45		
1953-55	31.64	3.02	10.1	1.51	4.8	50	+5.7	+7.8
1959-61	59.70	3.24	18.3	1.91	3.2	58	+3.5	+5.9

NOTE: The above data are based largely on figures appearing in N. Molodovsky's article: "Stock Values and Stock Prices," "Financial Analysts Journal," May, 1960. These, in turn, are taken from the Cowles Commission book, "Common Stock Indexes" for years before 1926 and from the spliced-on Standard Poor's 500-Stock Composite Index for 1926 to date.

The annual-growth-rate figures are Molodovsky compilations covering successive 21-year periods ending in 1890, 1900, etc. The lower growth-rate figures cover the ten years ended 1961, the six years ended 1953-55 and the 12 years ended 1959-61. The 1961 price is the high to Dec. 7.

TABLE II

Major Stock-Market Swings Between 1871 and 1949

Year	Cowles-Stand'd 500-Composite High	Low	% Decline	—Dow-Jones Indus. Average— High	Low	% Decline
1871		4.74				
1881	6.58					
1885		4.24	28			
1887	5.00					
1893		4.08	31			
1897				38.85		
1899				77.6		
1900					53.5	31
1901	8.50			78.3		
1903		6.26	26		43.2	45
1906	10.03			103		
1907		6.25	38		53	48
1909	10.30			100.5		
1914		7.35	29		53.2	47
1916	10.21			110.2		
1917/8		6.80	33		73.4	33
1919	9.51			119.6		
1921		6.45	32		63.9	47
1929	31.92			381.0		
1932		4.40	86		41.2	89
1937	18.68			197.4		
1938		8.50	55		99	50
1939	13.23			158		
1942		7.47	44		92.9	41
1946	19.25			212.5		
1949		13.55	30		161.2	24

[2] (These statements refer to the S-P Composite Index. The percentage rise in the industrials was somewhat larger from 1921 to 1929 than from 1949 to date, because it started from a relatively lower level.)

Are We Too Confident About Invulnerability of Stocks?

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common-stock yields — were thrown aside then as now, on the grounds that they had no relevance to the new economic climate. There was great confidence, also, in the future stability of business and its immunity from severe depressions. This was founded on the idea that scientific management, careful control of inventories, the absence of inflation, and other helpful factors would help our business leaders avoid the costly mistakes of the past.

Differences in 1920's and Today Compared

In my view there are three major differences between the economic realities of the 1920's and the present. The first relates to the inflation factor, the second to the Cold War, and the third to the role of government in business. The bull market of the 1920's ran its course without the aid of commodity-price inflation; the market rise since 1949 has been accompanied by an irregular, but virtually continuous, advance in wholesale and consumer prices. It is difficult to say whether the investor's current emphasis on future inflation possibilities should be considered primarily as a recognition on his part of objective fact, or rather as a strong subjective reaction to an element that is by no means new to the financial scene. We had more inflation in wholesale prices from 1900 to 1910 than from 1950 to 1960; the rise from 1900 to 1920 also exceeded that from 1940 to 1960 (the equivalent of from 36 to 100 vs. from 51 to 120).

Most of us believe that inflation is the path of least resistance for governments, labor leaders and business heads, and that hence it will be followed. But the record of the past will not help us much to determine what the amount of inflation will be over future decades, whether its course will be regular or interspersed with sharp deflations as in 1921 and 1932, and whether investors will remain as inflation-conscious in the future as they are today. The reaction to inflation, as almost every other investment and speculative attitude, seems to be more the result of the stock-market's behavior than the cause of it.

My view of the effects of the Cold War on common-stock values is quite a personal one, not shared by many I am sure. In the first place I think it has contributed a good deal to the business expansion and relative stability of the past decade. But, in a contrary sense, I cannot see how the kind of Cold War we are now living through can continue throughout "our lifetime and that of our children." Sometime within the present decade, a way will have to be found to terminate the Cold War, or it will be transformed into large-scale hostilities, with all their nuclear implications.

If our prosperity since 1949 has in fact rested rather heavily on our defense expenditures, and if in truth we must fairly soon have either no war or nuclear war in place of Cold War, then today's international situation cannot be termed more favorable for common stocks than the cloudless one of 1929.

The government's commitment to prevent large-scale unemployment and serious depressions is both a new factor and one of major importance. The most logical reason for expecting a different kind of stock-market cycle in the future than in the long-term past would appear to be by analogy with the business cycle. The record since 1949 strongly supports this thesis.

The new material on "Business Cycle Developments," now available monthly, shows four periods of business contraction since 1948 —in 1949, 1953-4, 1957-8, and 1960. All of these were very moderate as compared with the sharp recession of 1937-8 and the major depressions after 1919 and 1929. The three declines of about 20% each in the stock averages since 1950 appear to correspond fairly well the three setbacks of about 10% in the index of industrial production. If we have now entered a new era that excludes old-time business depressions, it seems reasonable to deduce that we are also in a new era that precludes old-fashioned bear markets.

Both my analysis and my instinct warn me that there may be a catch in this plausible and reassuring parallel. If the recent picture had been one of the stock market's advancing in step with the national product, and in close proportion with it also, then the observer might conclude—somewhat to his amazement—that not only has the economy been reformed but human nature as well. But here the facts part company with the hypothesis.

The stock market level has not been governed primarily by the level of business, but rather by the development of new investment theories and attitudes and by a typical growth of speculative interest and activity. Some of the old financial abuses that characterized former bull markets have indeed been virtually eliminated. But some have again raised their head, and some new ones have appeared and are spreading space. These are in the areas of corporate reporting, corporate financing, the quality of the enterprises offered for public sale, and the ways in which new issues of common stocks are offered and subsequently traded.

Questions Today's Investment Theories

Equally important and dangerous, in my eyes, is the ready acceptance by security analysts of the going market levels and earnings-multipliers as the proper standard of value and of comparison for any issue under study. The new analytical concepts of growth-stock valuation, of "cash flow," of the desirability of tax-free dividends from companies which are triumphantly able to report earnings deficits—all have enough plausibility and lack of inner discipline to lead both investors and speculators far astray. In sum, the new investment theories and techniques remind me very much of 1928-1929, and the outpouring of common-stock issues of secondary and lower-degree enterprises reminds me equally of 1919. If the relative stability of general business and corporate profits produces an unlimited enthusiasm and demand for common stocks, then it must eventually produce instability in stock prices.

We have already seen the working of this paradox in the area of growth stocks. The price of a successful and promising concern such as Texas Instruments can be driven up so high by speculative emphasis on its prospects that the ensuing reaction has cut the price in half—with no change in the underlying worth of the business. Examples of this sort are now numerous.

Conceivably this behavior of issues in the growth-stock class may give us a preview of the ultimate behavior of the general market—as represented by comprehensive averages—if common-stock investment becomes essentially identical with common-stock speculation. In that case the stock market will have a life cycle of its own quite independent of the business cycle. The market cycle will once more prove to be the human-nature cycle; its economic background will have changed, but not its basic character nor the consequences of its character.

These arguments against a new character for the stock market are not necessarily arguments that the present levels are too high, although they certainly would be adjudged so by older standards. Conceivably, and even probably, new factors in the economic figure have moved upward the central value of the average dollar of corporate earnings, and justify a more favorable relationship than heretofore between stock yields and bond yields. This would certainly be true if the general business picture can be counted on to continue indefinitely the relative immunity to depression it has shown since as far back as 1941. What we are concerned with here is not the future central value of the stock market but rather the amplitude and the consequences of possible future variations around this value.

To soften a possible charge of old-fogyism and prejudice against new standards of value, may I take this paragraph to show how the recent record level of stock prices may be justified by some not implausible calculations. Let us assume that the investor wants an overall return of 7½% annually, as a composite of dividend income and average market appreciation. (This 7½% target is itself taken from the long-term record of dividend yields and price advances; it seems reasonable as a guide to the future.) Assume next that earnings and dividends will grow in the indefinite future at the annual rate of 4½%, which appears to be the projection for this decade. Then the investor should be satisfied with a 3% dividend return. This would justify a current level of 65 for the S-P Composite, only 10% below the recent high. A small adjustment here or there would put us over the top. [**Ed. Note:** S-P industrial average reached 75.93 on Dec. 27, 1961, the day of Mr. Graham's address.]

It is by no means impossible to assume a permanent growth rate of 4½%; we have been told we must increase our GNP faster than this or lose out in the race with Russia. The basic objection is that it is only an assumption, that the experience of the longer past puts the figure rather at 2½%, and that the difference between 4½% and 2½% in this calculation means the difference between 65 and 39 for the value of the S-P Composite. My experience leads me to predict that the action of the market will govern the investor's choice as to probable future growth rates, rather than vice-versa.

Sees Ominous Portent

This completes my case for and against a new era and character for the stock market. If the market since 1949 foreshadows the stock markets of the future, the investment aspects of equity accumulation are unbelievably favorable. All that will be needed will be the funds to buy a representative assortment of common stocks and a little patience to sit through periods of mild reaction. The annually-compounded rate of overall return from the 500-Stock Composite has been about 13% —curiously enough, this has been about the same as the average from a selected list of growth stocks.[3]

A much lower annual rate, without severe interruptions, will prove amply rewarding.

But if, as I deem it more likely, the fundamental character of the stock market must be as unchanging as that of human nature, then the accumulator of equities who starts today is faced with quite a different prospect. The new appearance of the variable annuity suggests a broad analogy with the 1920's. It was during that bull market that investment trusts had their first important development in this country. Most of the arguments in their favor were the same as those now used for the sale of mutual-fund shares and for equity accumulation in general. The collapse of 1929 resulted in a severe and protracted setback for the investment-trust movement, as part of a widespread loss of faith in common stocks generally. It is true that many—although perhaps less than half—managed to survive the bitter subsequent experience and to re-establish themselves more firmly than before in public esteem. Furthermore, the principle of dollar-cost averaging—which is the most systematic of the equity-accumulation techniques—was able to vindicate itself in the end, after perhaps 20 years of unsatisfactory-to-mediocre results.[4]

Doubts Success of Dollar-Cost-Averaging

The computations made of theoretical dollar-averaging experience in the past embolden us to predict that such a policy will pay off ultimately regardless of when it is begun, **provided** it is adhered to conscientiously and courageously under all intervening conditions. This is by no means a minor proviso. It pre-supposes that the dollar-cost-averager will be a different sort of person from the rest of us, that he will not be subject to the alternations of exhilaration and deep gloom that have accompanied the gyrations of the stock market for generations past. This, I greatly doubt—particularly because most of the dollar-cost-averagers we are speaking of will be typical members of the public who have been persuaded to embark on an equity-accumulation program by the arts of salesmanship now so highly developed in the mutual-fund field.

Let me return once again to the problem of the proper perspective for viewing the character of the stock market and the investment aspects of equity accumulation. At the outset I presented a statistical comparison of the market's behavior over the past 12 years and over the past 90 years. But our knowledge of stock-market behavior goes back a good deal more than 90 years — a full two centuries and a half, in fact, to the inception of the South Sea Company in 1711.

In our first edition of **Security Analysts**, published in 1934, we characterized the stock-market madness of the 1920's as a repetition or rerun of the famous South Sea Bubble. By comparison the behavior of our present market appears more rational, dignified and reassuring. No one today, not even ingrained conservatives such as myself, expects consequences to this market and the economy even faintly resembling the catastrophe of 1929-1932. Yet I have a feeling that the financial world has become too complacent about the future, too confident of the invulnerability of common stocks as a whole to a drastic change in their fortunes.

Quotes Walter Bagehot

Fifty years ago, when I first read a bit of economic history, there were some lines by Walter Bagehot about stock-market speculation that every student was supposed to know almost by heart. These lines, not without their dry and wry humor, read as follows:

"Much has been written on panics and manias. But one thing is certain: That at particular times a great many stupid people have a great deal of stupid money. Several economists have plans for preventing improvident speculation—our scheme is not to allow any man to have a hundred pounds who cannot prove to the satisfaction of the Lord Chancellor that he knows what to do with a hundred pounds . . . At intervals . . . the money of these people—the blind capital (as we call it) of the country — is particularly large and craving; it seeks some one to devour it and there is plethora; it finds some one and there is speculation; it is devoured and there is panic."[5]

This paragraph was written nearly 150 years after the South Sea Bubble episode, and it seemed relevant to financial affairs for nearly another century to come. Interestingly enough, the South Sea Company itself had lasted almost 150 years after its disastrous beginning. I see in these dates an evidence of the persistence and the repetitions of history. A great corporation can withstand great vicissitudes; the same is true of great institutions, among which not the least important is common-stock investment and equity accumulation over a span of time. But a bull market has never become a financial institution, and I have great doubts whether this attractive development is an admissible possibility, when the frailty of human nature is taken into account.

My own inward picture of the present stock market is that of an institution cut adrift from old standards of value without having found dependable new standards. (In this respect present-day investment may be in somewhat the same position as present-day painting.) The market may either return to the old measures of central value, or—as is perhaps more probable—eventually establish a new and more liberal basis for evaluating equities. If the first happens, common stocks will prove highly disappointing over a long period for many accumulators of equities. If the newer and higher value levels are to be established on a sound basis, I envisage this working out by a process of trial and error, covering an unpredictable period of time and a number of pendulum swings of unforeseeable magnitude. I do not know whether bonds will do better than stocks over the next fifteen years, but I do know that the people behind College Retirement Equity Fund (CREF) are eminently wise in insisting that its beneficiaries have at least an equal dollar stake in bond as in stock investment.

*An address by Mr. Graham before the American Finance Association, New York City, Dec. 27, 1961.

3 See, for example, Table A in "The Growth Stock Philosophy," by J.F. Behmfalk, Jr., *The Financial Analysts Journal*, Nov. 1960.

4 For calculated results of dollar-cost-averaging results for 10-year periods ending from 1929 through 1952, see "Practice Formulas for Successful Investing," by Lucile Tomlinson, New York, 1953, Table 3, p. 82.

5 "Literary Studies—Edward Gibbon," 1858.

Joins Irving Lundborg

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SAN FRANCISCO, Calif.—Clarence J. Richardson is now affiliated with Irving Lundborg & Co., 310 Sansome Street, members of the New York and Pacific Coast Stock Exchange. He was formerly with Reynolds & Co.

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