
by Benjamin Graham

The Future Of Common Stocks

The following article is taken, with slight revisions, from a paper prepared for delivery before a group of corporate pension executives in June 1974. The last half of the article aims to answer specific questions raised in connection with the address.

Before I came down to Wall Street in 1914 the future of the stock market had already been forecast—once for all—in the famous dictum of J.P. Morgan the elder: "It will fluctuate." It is a safe prediction for me to make that, in future years as in the past, common stocks will advance too far and decline too far, and that investors, like speculators—and institutions, like individuals—will have their periods of enchantment and disenchantment with equities.

To support this prediction let me cite two "watershed episodes"—as I shall call them—that occurred within my own financial experience. The first goes back just 50 years, to 1924; it was the publication of E.L. Smith's little book entitled, *Common Stocks as Long-Term Investments*. His study showed that, contrary to prevalent beliefs, equities as a whole had proved much better purchases than bonds during the preceding half-century. It is generally held that these findings provided the theoretical and psychological justification for the ensuing bull market of the 1920's. The Dow Jones Industrial Average (DJIA), which

stood at 90 in mid-1924, advanced to 381 by September 1929, from which high estate it collapsed—as I remember only too well—to an ignominious low of 41 in 1932.

On that date the market's level was the lowest it had registered for more than 30 years. For both General Electric and for the Dow, the highpoint of 1929 was not to be regained for 25 years.

Here was a striking example of the calamity that can ensue when reasoning that is entirely sound when applied to past conditions is blindly followed long after the relevant conditions have changed. What was true of the attractiveness of equity investments when the Dow stood at 90 was doubtful when the level had advanced to 200 and was completely untrue at 300 or higher.

The second episode—historical in my thinking—occurred towards the end of the market's long recovery from the 1929 to 1932 debacle. It was the report of the Federal Reserve in 1948 on the public's attitude toward common stocks. In that year the Dow sold as low as 165 or seven times earnings, while AAA bonds returned only 2.82 per cent. Nevertheless, over 90 per cent of those canvassed were opposed to buying equities—about half because they thought them too risky and half because of unfamiliarity. Of course this was just the moment before common stocks were to begin the greatest upward movement in market history—which was to carry the Dow from 165 to 1050 last year. What better illustration can one wish of the age-old truth that the public's attitudes in matters of finance are completely untrustworthy as guides to investment policy? This may easily prove as true in 1974 as it was in 1948.

Benjamin Graham, senior author of Security Analysis, first edition of which appeared in 1934, needs no introduction to the readers of this magazine.

I think the future of equities will be roughly the same as their past; in particular, common-stock purchases will prove satisfactory when made at appropriate price levels. It may be objected that is far too cursory and superficial a conclusion; that it fails to take into account the new factors and problems that have entered the economic picture in recent years—especially those of inflation, unprecedentedly high interest rates, the energy crisis, the ecology-pollution mess and even the movement towards less consumption and zero growth. Perhaps I should add to my list the widespread public mistrust of Wall Street as a whole, engendered by its well-nigh scandalous behavior during recent years in the areas of ethics, financial practices of all sorts and plain business sense.

Of course these elements—mainly unfavorable to the future values of common stocks—should be taken into account in the formulation of today's investments policies. But it is absurd to conclude from them that from now on common stocks will be undesirable investments no matter how low their price level may fall. The real question is the same as it has always been in the past, namely: Is this a desirable time or price level to make equity purchases? We should divide that question, I think, into the following: a) Is this a desirable level to buy stocks in general, as represented by the DJIA or Standard and Poor's 500 (S&P 500)? b) Even if the averages may not be at an attractive level, can investors expect satisfactory results by choosing individual issues that are undoubtedly worth at least what they are selling for? The distinction I have just made is clearly relevant to the present situation because of the recent advent of the "two-tiered market," resulting from the massive preference of insitutions for large, high-growth companies. This in turn has brought about disparities in the P/E ratios for issues of investment character—differences as high as ten to one—that have been unexampled in all my experience, except perhaps at the height of the 1929 madness with its celebrated "blue-chip" issues.

My own answer to the double question just posed is as follows: As to the present level of the averages—say, 850 for the Dow and 93 for the S&P 500—the factor most directly affecting current security values and prices is most assuredly the high rate of interest now established for the entire spectrum of bond and note issues. One of the glaring defects of institutional attitudes has been that as recently as early 1973—when they supported the record price level of the averages—they

failed to take into account that AAA bonds were then yielding 7.3 per cent and had been above 8.5 per cent not long before. (As it happened they were destined to surpass the 8.5 per cent rate in 1974.) In 1964 the AAA rate averaged 4.4 per cent. It seems logical to me that the earning/price ratio of stocks generally should bear a relationship to bond-interest rates. If this thesis is accepted in its simplest form we must conclude: If one dollar of Dow earnings were worth \$17 when bond yields were 4.4 per cent, that one dollar is now worth only 52 per cent of \$17, or \$8.80, with AAA bonds at 8.5 per cent. This in turn would suggest a currently justified multiplier of, say, nine for the normal current earnings of the Dow. If you place those earnings at the record 1973 figure of \$86, you arrive at a current valuation of only 775 for the DJIA. You may quarrel with this figure on various grounds. One may be your expectation that bond rates will fall in the future. But that prospect is far from certain, while the present 8-1/2 per cent rate is a fact. Also, if bond yields go down appreciably, then bond prices—especially of the low-coupon, large-discount issues—will advance as well as stocks. Hence such bonds could still work out better than the Dow if and when interest rates decline.

Viewing the matter from another angle, I should want the Dow or Standard and Poor's to return an earnings yield of at least four-thirds that on AAA bonds to give them competitive attractiveness with bond investments. This would mean an earnings yield of 11 per cent, and it brings us smack back to the valuation of about 775 for the Dow that we found by comparing the early 1974 situation with that ten years before.

Furthermore, my calculations of growth rates over the past 25 years give an annual figure for the Dow of only 4-1/2 per cent. If this rate were to continue in the future, the expectable combination of growth plus dividends would produce less than a ten per cent overall return, consisting of four and one-half per cent growth plus a compounded dividend yield of, say, five per cent. This second calculation would make my current 775 valuation for the Dow appear over generous. Incidentally, a corresponding approach to the S&P 500 Index gives a somewhat less favorable result than for the Dow at current levels. The S&P 425 and 500 Indexes have both grown at about a five per cent rate over the past 25 years. But this advantage appears to be offset by their higher P/E ratios compared with the DJIA. *(continued next page)*

Selecting Individual Common Stocks

When we come to valuing individual stocks I should like to divide them into three classes, as I find them in the NYSE list. Group I is the growth issues selling at more than 20 times their last 12 months' earnings. Group II is the relatively unpopular stocks selling for less than seven times recent earnings—i.e., at 15 per cent earnings yield or better. Group III has multipliers between seven and twenty.

In my count of 1530 NYSE issues there were 63, or four per cent of the total, selling above 20 times earnings, of which 24 passed the 30 times mark. By contrast, more than 500—over a third—sold below seven times earnings, and of these about 150—say, ten per cent of the total—were quoted under five times the last 12 months' profits.

If the earnings on which these multipliers are based can be counted on, more or less, in the future—without any special requirements as to growth—it is evident that many NYSE issues can now compete in attractiveness with bonds at 8-1/2 per cent. In this large area of choice there are many that would be suitable for pension-fund investment; many indeed that may be regarded as definitely undervalued. These are especially suited for longer-term commitments as distinguished from short-term speculative purchase. Among the under seven-times-earnings list are huge concerns like Firestone (with \$3 billion of sales) and intermediate-sized enterprises like Emhart, which has paid dividends for 72 years and recently sold under its net-current-asset value.

The Book-Value Approach

The developments that have produced these extraordinarily low multipliers for so many NYSE (and other) issues now present us with another phenomenon—namely the reestablishment of book value, or net worth, as a point of departure and possible guide to the selection of common stocks. In a large area of the present stock market we could return to a very old-fashioned but nonetheless useful criterion for equity investment—namely the value of the company as a private enterprise to a private owner, irrespective of market quotations for the shares. If the business has been prosperous, and is at least reasonably promising for the future, it should be worth its net asset value; hence an opportunity to buy an interest therein at a substantial discount from net worth could be considered attractive.

As it happens, about half the NYSE companies

were selling last month at less than book value, and about one-quarter, or about 400 issues, at less than two-thirds of net worth. What is equally interesting is that about one-third of all common stocks actually sold both *above* and *below* their net worth in the past 12 months. Certainly more than half fluctuated around this figure in the last five years. For the most part, these issues selling below book are also in the low-multiplier group.

I may be so bold as to suggest that this situation makes possible a quite simple approach to equity investment that is open to almost everyone from the small investor to the quite large pension fund manager. This is the idea of buying *selected* common stocks—those meeting additional criteria of financial strength, etc.—obtainable at two-thirds or less of book value, and holding them for sale at their net asset value—to show a non-spectacular but quite satisfactory 50 per cent profit. We cannot predict with assurance how this apparently too-simple investment program will work out in the future. But I can say that my studies covering the period 1961 to 1974 show the presence of sufficient opportunities of this kind in most years, and also excellent overall results from the assumed operations.

Since I spoke of three groupings of the NYSE list, I should now give my views of Groups I and III. Those selling at intermediate multipliers may present individual opportunities, but they have no special interest for me as a category. But the first-tier, high-growth issues present a real challenge to past experience. Obviously they would be wonderful private or market-type investments if obtainable at book value or even twice that figure. The trouble is, of course, that most of them sell at more than five times book value—and some more than ten times. Last year the ratios were a good deal higher than that. At these levels, they take on a *speculative character* which is due entirely to their price level, and in no sense to any weakness of the companies themselves. (I made this point as long ago as 1958 in an address before the Financial Analysts Federation; it is reproduced as an Appendix to *The Intelligent Investor*.) The speculative risks attached to high-growth stocks have been brought home dramatically in the past 18 months by the price declines in many of these favorites. (I need not give examples.)

However, I do want to use an instance here in connection with a brief discussion of a recently launched academic theory about the stock market, which could have great practical importance if it

coincided with reality. This is the hypothesis of "the efficient market." In its extreme form it makes two declarations: 1) The price of nearly every stock at nearly all times reflects whatever is knowable about the company's affairs; hence no consistent profits can be made by seeking out and using additional information, including that held by "insiders." 2) Because the market has complete or at least adequate information about each issue, the prices it registers are therefore "correct," "reasonable" or "appropriate." This would imply that it is fruitless, or at least insufficiently rewarding, for security analysts to look for discrepancies between price and value.

I have no particular quarrel with declaration one, though assuredly there are times when a researcher may unearth significant information about a stock, not generally known and reflected in the price. But I deny emphatically that because the market has all the information it needs to establish a correct price the prices it actually registers are in fact correct. Take as my example a fine company such as Avon Products. How can it make sense to say that its price of 140 was "correct" in 1973 and that its price of 32 was also "correct" in 1974? Could anything have happened—outside of stock-market psychology—to reduce the value of that enterprise by 77 per cent or nearly six billion dollars? The market may have had all the information it needed about Avon; what it has lacked is the right kind of judgment in evaluating its knowledge.

Descartes summed up the matter more than three centuries ago, when he wrote in his "Discours de la Méthode": "Ce n'est pas assez d'avoir l'esprit bon, mais le principal est de l'appliquer bien." In English: "It is not enough to have a good intelligence"—and I add, "enough information"—"the principal thing is to apply it well."

I can assure the reader that among the 500-odd NYSE issues selling below seven times earnings today, there are plenty to be found for which the prices are not "correct" ones, in any meaningful sense of the term. They are clearly worth more than their current selling prices, and any security analyst worth his salt should be able to make up an attractive portfolio out of this "universe."

Inflation and Investment Policy

Let us turn now to inflation. Do the prospects of continued inflation make equity purchases undesirable at present market prices or indeed at any conceivable level? It is passing strange that this

question should even suggest itself. It seems only yesterday that everyone was saying that stocks, even at high prices, were definitely preferable to bonds because equities carried an important measure of protection against future inflation.

But it should be admitted that not only recently, but for many years and perhaps decades past, equities as a whole have failed to provide the protection against inflation that was expected from them. I refer to the natural surmise that a higher general price level would produce a higher value for business assets and hence correspondingly higher profit rates in relation to original costs. This has not been borne out by the statistics. The rate of return on book equities as a whole—much understated as they must be in terms of reproduction costs—has at best held constant at around the 10 to 12 level. If anything, it has declined from the 1948 to 1953 period when the Dow was selling at only seven times earnings.

It is true of course that the earnings on the DJIA and the S&P 425 Industrials have tripled from 1947-1951 to 1969-1973. But in the same period the book value of both indexes has quadrupled. Hence we may say that all the increase in post-war earnings may be ascribed to the simple building up of net worth by the reinvestment of undistributed profits, and none of it to the more than doubling of the general price level in those 28 years. In other words, inflation as such has not helped common-stock earnings.

This is a good reason—and there are others—not to be enthusiastic about equities at every market level. This caution is part of my long-held investment philosophy. But what about the current situation? Should inflation prospects dissuade an investor from buying strong companies on a 15 per cent earnings return? My answer would be "no."

What are the investors' real choices—whether as an institution or as an individual? He can elect to keep his money in short-term obligations, at a good yield, expecting that future inflation will eventually produce lower market levels for all kinds of stocks, including those with low multipliers. This choice would be justified when the investor is convinced that stocks are selling above their true value, but otherwise it is only a kind of bet on future market movements. Or he may conceivably decide on an entirely new sort of investment policy—namely, to move from stocks or bonds into things: real estate, gold, commodities, valuable pictures and the like. Let me make three observations here.

The first is that it is impossible for any really

large sums of money—say billions of dollars—to be invested in such tangibles, other than real property, without creating a huge advance in the price level, thus creating a typical speculative cycle ending in the inevitable crash. Secondly, this very type of hazard is already manifest to us in the real estate field, where numerous new ventures, financed through a combination of borrowing and quoted common-stock issues, have encountered problems of all sorts, including large stock-market losses for their investors.

My third observation is on the positive side. I think all investors should recognize the possibility—though not necessarily the probability—of future inflation at the recent 11 per cent rate, or even higher, and should introduce what I shall call a "concrete-object factor" in their overall financial approach. By this I mean that they should not be content to have an overwhelming proportion of their wealth represented by paper money and its equivalents, such as bank deposits, bonds and receivables of all sorts. For the shorter or longer pull—who can really tell?—it may turn out to be wiser to have at least an indirect interest—via the common-stock portfolio—in such tangibles as land, buildings, machinery and inventories. This is relatively easy to accomplish in the execution of an ordinary common-stock investment policy. My point is only that it would be worthwhile to introduce the concept as a specific and measured criterion in analyzing one's resources. That idea is as readily applicable to pension funds as to other portfolios.

It should be obvious from my overall approach to the future of equities that I do not consider such much-publicized problems as the energy crisis, environmental pressures, foreign exchange instability, etc. as central determinations of financial policy. They enter into the value versus price equation in the same general fashion as would any such other adverse factors as 1) a tendency towards lower profit margins and 2) the higher debt burden and the higher interest rate thereon. Their weight for the future may be assessed by economists and security analysts, presumably with the same accuracy, or lack of it, as has characterized such predictive work in the past.

Institutional Dominance, Efficient Markets, and the Prospects for Security Analysis

Is there an equity bias among money managers? My answer is that there has undoubtedly been such a bias in the past decade, and that it was a powerful force in establishing price levels for the stock

market generally that were out of line with bond yields. It may well have contributed to these high yields themselves, for it deprived the bond market of billions of dollars that went instead into buying shares from former holders at advancing P/E rates. Since concern is now expressed about institutional disenchantment with equities, it may well be that the bias of recent years is not only rapidly disappearing but is being reversed and that it is now the function of real oldtimers like myself to caution against taking on an equally unjustified bias *against* stocks at low price levels.

What will be the effect on performance of having, say, \$200 billion of institutional money in equities, plus, say 11,000 working security analysts, all trying to "beat the averages?" The reader will pardon a reference here to a couplet by Heinrich Heine à propos of the appointment of 45 German professors to some commission of inquiry 150 years ago. He wrote:

"Funf-und-vierzig Professoren—
Vaterland, du bist verloren!"
(Forty-five Professors—
Fatherland, you're ruined!)

If only 45 professors can present such a menace, how about 11,000 analysts?

Seriously, the effect of large-scale participation by institutions in the equity market, and the work of innumerable financial analysts striving to establish proper valuation for all sorts, should be to stabilize stock-market movements, i.e., in theory at least, to dampen the unjustified fluctuation in stock prices. I must confess, however, that I have seen no such result flowing from the preponderant position of the institutions in market activity. The amplitude of price fluctuations has, if anything, been wider than before the institutions came into the market on a grand scale. What can be the reason? The only one I can give is that the institutions and their financial analysts have not shown any more prudence and vision than the general public; they seem to have succumbed to the same siren songs—expressed chiefly in the cult of "performance." They, too, have largely put aside the once vital distinction between investment and speculation. (This leads me to ask whether some day soon we shall see some legal problems for certain banking institutions growing out of their accountability for the results of *trust* investments made from 1968 to 1973 that failed to meet the strict judicial requirements of the prudent man rule).

Let me give a concrete example of my statement

that institutional investment does not appear to have contributed either stability or rationality to stock prices—American Airlines. The Standard and Poor's Monthly Stock Guide shows the holdings of this and other concerns by about 2000 insurance companies and investment funds, though not by banks and their trust departments. In 1970, the canvassed institutions owned 4.3 million shares of American Airlines, or 22 per cent of the total. The company reported a deficit of \$1.30 per share in 1970, then earnings of 13 cents in 1971 and a magnificent 20 cents in 1972. In response, our so-called efficient stock market advanced the price from a 1970 low of 13 to a new all-time high of 49-7/8 in 1972. This was 250 times that year's profits. Now what did our financial institutions do to hold down this insane speculative binge in the shares? Did they sell out their holdings somewhere along the line, to cash in a profit and rid their portfolios of a clearly overvalued issue? On the contrary. The Guide showed that during this period they actually *increased* their ownership to 6.7 million shares, or by a full 50 per cent, held by 143 companies. And the latest figures, in 1974, show that 117 funds etc. still owned 5.7 million shares or 20 per cent of the total. (In the meantime the company reported a record deficit of \$48 million in 1973, and the price collapsed from 50 in 1972 to 7-1/2 in 1974.)

This story hardly suggests that the institutions have been valiant contributors to "efficient markets" and correct stock prices.

More and more institutions are likely to realize that they cannot expect better than market-average results from their equity portfolios unless they have the advantage of better-than-average financial and security analysts. Logically this should move some of the institutions towards accepting the S&P 500 results as the norm for expectable performance. In turn this might lead to using the S&P 500 or 425 lists as actual portfolios. If this proves true, clients may then find themselves questioning the standard fees most of them are paying financial institutions to handle these investments. (Incidentally, if my half-serious prophecy of a movement towards actual S&P Index portfolios is realized we should have an ironical return to a form of investment in equities that existed here 50 years ago. The first investment funds were actual "trusts," and "fixed trusts" at that. The portfolios were set up, on a once-for-all basis, from the very beginning. Changes could be made only under compulsory conditions.)

A modification of my "fixed fund" suggestion would leave more leeway for the work of financial analysts. This modification would base equity portfolios initially on an actual or presumed imitation of the S&P Index, or—more simply—the DJIA. The operating manager or decision maker would be permitted to make substitutions in this list, but only on a persuasive showing that the issues substituted had distinctly more intrinsic value per dollar of price than the ones to be dropped. Combined with fairly heavy accountability for the results of such departures from the original list, such a program might well improve the actual performance. In any case it would give the financial analysts' profession something to do.

There has indeed been a strong intimation in this article that the DJIA and the S&P Indexes are now selling too high in relation to many issues now purchasable at low P/E ratios. If this view is correct any competent analyst has an excellent present opportunity to earn his pay by recommending desirable substitutes for certain companies in these averages.

Please bear in mind that while I have been making a case for equity investment now—despite, or perhaps because of, institutional disillusionment with them—I am not proposing a 100 per cent stock position for any investor. On the contrary, I think that everyone's total portfolio should always have a minimum component of 25 per cent in bonds, along with a complementary minimum holding of 25 per cent in equities. The remaining half of the funds may be divided between the two, either on a standard 50-50 basis (adjusted to reflect changes caused by significant price movements) or in accordance with some consistent and conservative policy of increasing the bond proportion above 50 per cent when bonds appear more attractive than equities, and vice versa when equities appear more attractive than bonds.

Do equities win by default because there is no assumed liquidity in other alternatives? There are various answers to this query. The first is, of course, that the alternative of putting funds into short- or longer-term debt obligations does not diminish the liquidity factor. Secondly, I could argue that liquidity is itself a minor desideratum in a true investment program, and that too many value considerations have been sacrificed to an assumed need for quick marketability. But thirdly, I could not say to what extent the liquidity factor should enter into consideration of non-income-producing objects—such as paintings, com-

modities, etc.—as alternatives to common stocks. My hunch is that the absence of income—as against 8-1/2 per cent annually on bonds—should be more important here for your investment decisions than the liquidity factor.

An Indexed Economy and a Managed Economy

What are the implications of an "indexed economy"? I have already stated views of inflation's effect on equities. I feel that an indexed economy—in the full sense of Milton Friedman's recent proposal—is too impractical and remote to warrant serious discussion here. We have it in part in cost-of-living adjustments in union contracts, including to some degree pension plans. There was once an indexed bond issue, put out by Remington-Rand Corporation at the instance of Irving Fisher (then a director), which varied the coupon payments with the cost-of-living index. Conceivably—though not probably—that idea may be revived. However, we have a growing number of debt obligations that vary the coupon rates with changes in current bond yields or bank lending rates. The floodgates seem to be opening here with the offering of \$650 million of Citicorp Floating Rate Notes due in 1989.

We have all become so familiar with a more or less managed economy since the Roosevelt era beginning 40 years ago, that we should be quite inured to its effect on everything including equities. Basically, the intervention of government in the economy has had two opposite effects on common stock values. It has benefited them greatly through its virtual guarantee against the money panics and large-scale depressions of the pre-1935 decades. But it was hurt profits through the maze of restrictions and the numerous other burdens it has imposed on business operations. Up to now the net effect seems to have been favorable to equity values—or at least to their prices. This can be seen at first glance by comparing the Dow or S&P Index lines on a chart before and after 1949. In such comparisons the price declines in 1969 to 70 and 1973 to 74 appear like minor downturns in a massive upward sweep.

Experience suggests therefore that the various threats to equities implied in the last question are not very different from other obstacles that common stocks have faced and surmounted in the past. My prediction is that stocks will surmount them in the future.

But I cannot leave my subject without alluding to another menace to equity values not touched on in my terms of reference. This is the loss of public

confidence in the financial community growing out of its own conduct in recent years. I insist that more damage has been done to stock values and to the future of equities from inside Wall Street than from outside Wall Street. Edward Gibbon and Oliver Goldsmith both wrote that, "History is little more than a register of the crimes, the follies and the misfortunes of mankind." This phrase applies to Wall Street history in the 1968 to 73 period, but with more emphasis to be given to its crimes and follies than to its misfortunes. I have not time even to list all the glaring categories of imprudent and inefficient business practice, of shabby and shoddy ethics perpetrated by financial houses and individuals, without the excuse of poverty or ignorance to palliate their misdemeanors. Just one incredible example: Did anyone ever hear of a whole industry almost going bankrupt because it was accepting more business than it could handle? That is what happened to our proud NYSE community in 1969, with their back-office mix ups, missing securities, etc. The abuses in the financial practices of many corporations during the same period paint the same melancholy picture.

It may take many years—and new legislation—for public confidence in Wall Street to be restored, and in the meantime stock prices may languish. But I should think the true investor would be pleased, rather than discouraged, at the prospect of investing his new savings on very satisfactory terms. To pension-fund managers, especially with large and annual increments to invest, the prospects are especially inviting. Could they have imagined five years ago that they would be able to buy AAA bonds on an eight to nine per cent basis, and the shares of sound companies on a 15 per cent or better earnings yield? The opportunities available today afford a more promising investment approach than the recent absurd idea of aiming at, say, 25 per cent market appreciation by shifting equities among institutions at constantly higher price levels—a bootstrap operation if there ever was one.

Let me close with a quotation from Virgil, my favorite poet. It is inscribed beneath a large picture panel at the head of the grand staircase of the Department of Agriculture building in Washington. It reads:

"O fortunati nimium... (etc.) Agricolaе!"

Virgil addressed this apostrophe to the Roman farmers of his day, but I shall direct it at the common-stock buyers of this and future years:

"O enviably fortunate Investors, if only you realized your current advantages!" ■

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Benjamin Graham

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David G. Watterson, C.F.A., President
The Financial Analysts Research Foundation

The title of this seminar—"The Renaissance of Value"—implies that the concept of value had previously been in eclipse in Wall Street. This eclipse may be identified with the virtual disappearance of the once well-established distinction between investment and speculation. In the last decade everyone became an investor—including buyers of stock options and odd-lot short-sellers. In my own thinking the concept of value, along with that of margin of safety, has always lain at the heart of true investment, while price expectations have been at the center of speculation.

Let me list some of the questions relating to the value approach that confront the financial analyst now in the light of the 1965-1974 experience:

1. Is the value approach a useful one in terms of
 - (a) what it can accomplish on its own, and
 - (b) by comparison of its results with those of other analytical methods and practices?
2. To what degree should the techniques of valuation as presented, say, in Graham, Dodd and Cottle, 1962—be modified by more recent developments, including theoretical thinking?
3. What is the effect of institutional domination of the stock market on the valuation work of the security analyst and the decision-making procedures of the financial analyst?
4. To what extent does the sheer number of practicing analysts—some 14,000 F.A.F. members, including 3,800 C.F.A.s and over 2,000 active C.F.A. candidates—prevent the average or representative worker from achieving worthwhile results? This is indeed a delicate question.

The discussion that follows will not separate each of these questions from the others, but I will try to answer them as best I can.

The value approach has been founded on the premise that in many—but by no means in all—cases a dependable range of valuation can be established for a common stock by analytical techniques; that often this range differs substantially from the current price; and that

such differences offer rewarding opportunities for investment operations. The phrase "rewarding opportunities" implies that the stock market itself will vindicate the value-based operation, after an interval that averages not too long for human patience—say, three years or less.

Typically, the midpoint of the value range has been found by applying an appropriate multiplier to estimated future earnings. My present view is that this is not the best technique. Instead, the earnings figure taken should be what we call "normal current earnings", and all the future prospects—favorable or unfavorable, specific or general—should enter into the multiplier. This procedural change obviates the necessity of establishing a future value and then discounting same to its present worth.

Such a procedure would carry us very far from the method first suggested in 1938 in Dr. John Burr Williams' seminal book "The Theory of Investment Value". His technique required an estimate of the stream of dividends to be received over a very long future period, and the summation of the discounted worth of each dividend to arrive at present value. The various mathematical methods later developed for valuing growth stocks represent a sort of compromise between the Williams approach and what I now suggest. For they stop the estimated stream of dividends at a terminal year—say ten years hence—and then value the stock, usually on a conservative basis, in that terminal year. The resulting figures of dividends and terminal value would then be discounted at a uniform chosen rate to arrive at present value.

Those of you who have studied *Security Analysis* may recall that we tried to simplify the mathematical methods of several writers by suggesting a formula that employs a single variable G , representing the expected growth rate over the next seven to ten years. It read (at bottom of p. 537):

Value = current normal earnings times the sum of $8\frac{1}{2}$ plus $2G$.

This valuation formula—like those it purported to approximate—had the great defect of failing to allow for changes in the basic rate of interest. But the one development in the past decade that has had the greatest influence on stock values—and, somewhat belatedly, on stock prices—has been the phenomenal advance in interest rates. For the three years preceding the publication of our text the yield on AAA bonds averaged 4.4 percent, and that was also the figure just ten years ago. But for the three years 1971-1973 the average was 7.5 percent, and most recently 9½ percent.

It would seem logical to me to make common-stock valuations vary inversely with representative current interest rates corresponding to the analyst's use of representative current earnings. Suppose we restated our 1972 formula with that objective, making it reflect the then going AAA rate of 4.4 percent. The expression would then read:

Value = Earnings times the sum of $37\frac{1}{2}$ plus $8.8 G$, divided by the AAA rate.

Since analysts have a weakness for figures, you might like to hear two or three results based on this revised formula. For the DJIA, taking G as its historic 4½ percent and the AAA rate of its 3-year average of 7½ percent, we get a multiplier of 10.2. Applying this to the 1971-73 average earnings of the Dow, its central value would be about 750. If instead of three-year average figures you took the recent bond rate of 9½ percent and the most recent inflation-aided annual earnings of about \$93 the indicated central value would be the same 750. (The higher earnings are offset by the higher interest divisor.)

These calculations, for what they are worth, suggest that the Dow at its recent low level of 627 was undervalued by about 15 percent. Whether this would presage a near or delayed end of the current bear market I leave to wiser or bolder heads than mine. However, this same method when applied to individual issues would indicate that many have been more significantly under-priced in the present market. Take Firestone as an example. Its earnings have grown at a better rate in the past decade than those of the Dow; the figures for 1971-73 show a 116 percent increase from 1961-63 for Firestone versus 66 percent for the DJIA. If we assume the same future G of 4½ percent for Firestone as for the Dow, and hence the same multiplier of $10.2 \times 1971-73$ earnings, our valuation would be 24 for the tire company shares, fully 90 percent above their 1974 low. Incidentally, this would just about equal the current book value of Firestone—a previously minor detail in the investment picture but one to which I am inclined to ascribe major importance under today's new conditions. Firestone is, of course, only one example of the discrepancy between the current level of the Dow—which includes several first-tier institutional favorites—and that of the current run-of-the-mine good sized company.

A multiplier based on expected growth and interest rates alone would imply that a company's financial structure and debt position do not enter into the valuation process. This might be the case if the formula were applied—as originally intended—only to high-growth companies, whose prospects are considered so good that they are assumed to face no financial problems. But if we seek to generalize our formula to apply to average-growth companies, we must recognize that

many of these may be in unsatisfactory financial condition, caused in part by inflation pressures and in good part also by the over-expansion of corporate debt in the past decade. (I consider the total figures for corporate debt since 1968, published in the June 1974 issue of the *Survey of Current Business*, to be most disquieting. They show an overall increase of 74 percent in only five years, with more to come in 1974.)

I see no satisfactory way of reducing the multiplier to allow for a below-par debt position. My advice to analysts would be rather to avoid attempting a formal valuation of such companies. In other words, limit your appraisals to enterprises of investment quality, excluding from that category such as do not meet specific criteria of financial strength. This statement brings me back to our old position that speculative companies cannot be dealt with at all by the analyst with satisfactory overall results. By my own rather strict quantitative criteria, Firestone would pass the financial-strength test by a modest margin. Such tests might well exclude up to half of the NYSE list today from investment consideration, but there would remain enough qualifying issues to give the analysts and the investor an ample selection. It should be clear that I have faith in the valuation process as a guide to investment choices, but that I would limit this technique rather strictly to companies that meet criteria of financial soundness. Also, I should require that the buy-decisions based on this approach involve a margin-of-safety factor. This might well be a purchase price not over two-thirds of the central appraised value.

How would such a policy have worked out during the past decade? Several times the market price of Firestone fell below our formula value, but not by the one-third margin. (The indicated buying level in 1970 was 16 against its low of 17½, followed by the next year's high of 28½.) Other studies have led me to believe that a computer-type valuation job of this kind would have found a considerable number of cases where shares of sound companies could have been obtained for less than two-thirds of their formula-value. On the whole one would have done quite well over this period by buying on this basis and selling at a 50 percent profit when obtainable. I see no reason to think that a similar policy could not be followed with satisfactory results in the future. (It should be unnecessary for me to add that these results are not guaranteed.)

There are, of course, many other approaches of the valuation type, and different analysts may favor different formulas with different parameters than the two I have been using. I have myself been intrigued by the idea of choosing stocks among those that are obtainable at not more than one-half their former high quotation, provided that they

meet criteria of value independent of the price record. A technique of this sort would have worked fine, according to my studies, up to and including the post-1970 market recovery. Under more recent conditions it would merely have added a price-decline criterion to the determination of buy points based on the valuation approach. For practically all issues of the Firestone type an acquisition price at two-thirds of analysts' valuation would be at less than half of the previous market high.

Let me pass on to a factor in the valuation process that in my thinking has taken on considerable importance under present conditions. This is the book value figure, to be viewed either as a point of departure for more refined calculations or as a practically usable measure of a common stock's value. For years we have all pretty well disregarded asset values, except for financial enterprises and some special cases. But in recent markets a large number—perhaps a majority—of NYSE commons have actually fluctuated in price both above and below their asset values. Even Polaroid was recently obtainable at less than book value! This fact would seem to establish a realistic relationship in many cases between net worth and intrinsic or analysts' value. One might well speak today of "The Renaissance of Book Value."

You are all intelligent enough to appreciate that I am not now saying that Avon Products is only worth its book figure of \$7.70 per share or that Chicago Milwaukee common is to be valued at the \$149 per share shown on the balance sheet. In a substantial percentage of issues the book value figures have no worthwhile connection with the investment value of the shares. But the analyst has today perhaps a thousand stocks or more to choose from in which the asset value may actually fall within his range of appraised value. In many of these cases he could then settle for the net worth as his preferred specific figure of value, and base his buy-and-sell points on this convenient measure.

This approach can put the choice of marketable common stocks on a basis corresponding to that of investment in a private, non-quoted enterprise. If the commitment would be attractive as an ordinary business venture it should be even more attractive as part of a publicly-held enterprise, with the added advantages of diversification and ready marketability.

However, in my experience marketability has proved of dubious overall advantage. It has led investors astray at least as much as it has helped them. It has made them stock-market minded instead of value-minded. I have a puritanic vision of the true investor as someone who is entirely disinterested in what the stock market does except on two sorts of occasions that meet his convenience. The first occasion is when the market obligingly permits him to buy a group of common

stocks at less than their indicated value; the second is when with equal courtesy it permits him to sell at not more than one-half their former high quotation those that are of no importance to him. True, he may sometimes dispose of an investment at a loss. But that should not be because the market price went down; it should be because things went badly for the company and the true value of the shares declined below the price he paid for them. (Of course the investor may also use the stock market to switch out of issues he owns into others that offer more value at ruling prices.)

(You are now hearing some of the "old-time religion". You may not be converted, but it shouldn't do you any harm.)

At this point let me consider briefly an approach with which we were closely identified when managing the Graham-Newman fund. This was the purchase of shares at less than their working-capital value. That gave such good results for us over a forty-year period of decision-making that we eventually renounced all other common-stock choices based on the usual valuation procedures, and concentrated on these "sub-asset stocks". The "renaissance of value," which we are talking about today, involves the reappearance of this kind of investment opportunity. A ValueLine publication last month listed 100 such issues in the non-financial category. Their compilation suggests that there must be at least twice as many sub-working-capital choices in the Standard & Poor's Monthly Stock Guide. (However, don't waste \$25 in sending for an advertised list of "1000 Stocks Priced at Less Than Working Capital." Those responsible inexcusably omitted to deduct the debt and preferred stock liabilities from the working capital in arriving at the amount available for the common.)

It seems no more than ordinary sense to conclude that if one can make up, say a 30-stock portfolio of issues obtainable at less than working capital, and if these issues meet other value criteria including the analysts' belief that the enterprise has reasonably good long-term prospects, why not limit one's selection to such issues and forget the more standard valuation methods and choices we have previously discussed? I think the question is a logical one, but it raises various practical issues: How long will such "fire-sale stocks"—as Value Line called them—continue to be given away; what would be the consequences if a large number of decision-makers began, as of tomorrow to concentrate on that group; what should the analyst do when these are no longer available?

Such questions are actually related to broader aspects of the value approach, involving the availability of attractive investment opportunities if and when most investors and their advisers followed this doctrine. I shall return to that problem later.

Some interesting questions relating to intrinsic value vs. market price are raised by the take-over bids that are now part of our daily financial fare. The most spectacular such event occurred a few weeks ago, when two large companies actively competed to buy a third, with the result that within a single month the price of ESB Inc. advanced from 17½ to over 41. We have always considered the value of the business to a private owner as a significant element in appraising a stock issue. We now have a parallel figure for security analysts to think about: the price that might be offered for a given company by a would-be acquirer. In that respect the ESB transaction and the Marcor one that followed it offer much encouragement to those who believe that the real value of most common stocks is well above their present market level.

There is another aspect of take-overs that I want to bring up here, on a somewhat personal basis, because it relates to an old and losing battle that I have long fought to make stockholders less sheeplike vis-à-vis their managements. You will recall that the first bid of INCO was termed a "hostile act" by the ESB management, who vowed to fight it tooth and nail. Several managements have recently asked stockholders to vote charter changes that would make such acquisitions more difficult to accomplish against their opposition—in other words, make it more difficult to deprive present officers of their jobs and more difficult for stockholders to obtain an attractive price for their shares. The stockholders, still sheeplike, generally approve such proposals. If this movement becomes widespread it could really harm investors' interests. I hope that financial analysts will form a sound judgment about what is involved here and do what they can to dissuade stockholders from cutting their own throats in such a foolish and reckless fashion. This might well be a subject for the FAF to discuss and take an official stand on.

There is at least a superficial similarity between the prices offered in takeovers and those formerly ruling in the market for the first-tier issues, as represented by "the favorite fifty". The large institutions have acted somewhat in the role of conglomerates extending their empires by extravagant acquisitions. The P/E ratio of Avon Products averaged 55 in 1972, and reached 65 at the high of 140. This multiplier could not have been justified by any conservative valuation formulae such as those we have been discussing. It was not made by speculators in a runaway bull market; it had the active or passive support of the institutions that have been large holders of Avon.

As I see it, institutions were persuaded to pay outlandish multipliers for shares of the Avon type by a combination of three influences: First, the huge amounts of money they have to administer,

most of which they decided to place in equities. Second, the comparatively small number of issues to which their operations were confined, in part because they had to choose multi-million-share companies for their block transactions, and partly by their insistence on high-growth prospects. The third influence was the cult of performance, especially in pension-fund management. The arithmetic here is deceptively simple. If a company's earnings will increase 15 percent this year, and if the P/E ratio remains unchanged, then presto! the "investment" shows a 15 percent performance, plus the small dividend. If the P/E ratio advances—as it did for Avon in almost every year—the performance becomes that much better. These results are entirely independent of the price levels at which these issues are bought. Of course, in this fantasia the institutions were pulling themselves up by their own bootstraps—something not hard to do in Wall Street, but impossible to maintain forever.

These institutional policies raise two implications of importance for financial analysts. First, what should a conservative analyst have done in the heady area and era of high-growth, high-multiplier companies? I must say mournfully that he would have to do the near-impossible—namely, turn his back on them and let them alone. The institutions themselves had gradually transformed these investment-type companies into speculative stocks. I repeat that the ordinary analyst cannot expect long-term satisfactory results in the field of speculative issues, whether they are speculative by the company's circumstances or by the high price levels at which they habitually sell.

My second inference is a positive one for the investing public and for the analyst who may advise a non-institutional clientele. We have many complaints that institutional dominance of the stock market has put the small investor at a disadvantage because he can't compete with the trust companies' huge resources, etc. The facts are quite the opposite. It may be that the institutions are better equipped than the individual to speculate in the market; I'm not competent to pass on that. But I am convinced that an individual investor with sound principles, and soundly advised, can do distinctly better over the long pull than a large institution. Where the trust company may have to confine its operations to 300 concerns or less, the individual has up to 3000 issues for his investigations and choice. Most true bargains are not available in large blocks; by this very fact the institutions are well-nigh eliminated as competitors of the bargain hunter.

Assuming all this is true we must recur to the question we raised at the outset. How many financial analysts can earn a good living by locating undervalued issues and recommending them to individual

investors? In all honesty I cannot say that there is room for 14,000 analysts, or a large proportion thereof, in this area of activity. But I can assert that the influx of analysts into the undervalued sphere in the past has never been so great as to cut down its profit possibilities through that kind of over-cultivation and over-competition. (The value analyst was more likely to suffer from loneliness.) True, bargain issues have repeatedly become scarce in bull markets, but that was not because all the analysts became value-conscious, but because of the general upswing in prices. (Perhaps one could even have determined whether the market level was getting too high or too low by counting the number of issues selling below working-capital value. When such opportunities have virtually disappeared, past experience indicates that investors should have taken themselves out of the stock market and plunged up to their necks in U. S. Treasury bills.)

So far I have been talking about the virtues of the value approach as if I had never heard of such newer discoveries as "the random walk", "the efficient market", "efficient portfolios", the Beta coefficient, and others such. I have heard about them, and I want to talk first for a moment about Beta. This is a more or less useful measure of past price fluctuations of common stocks. What bothers me is that authorities now equate the Beta idea with the concept of "risk." Price variability yes; risk no. Real investment risk is measured not by the percent that a stock may decline in price in relation to the general market in a given period, but by the danger of a loss of quality and earning power through economic changes or deterioration in management. In the five editions of *The Intelligent Investor* I have used the example of A & P shares in 1936-1939 to illustrate the basic difference between fluctuations in price and changes in value. By contrast, in the last decade the price decline of A & P shares from 43 to 8 paralleled pretty well a corresponding loss of trade position profitability, and intrinsic value. The idea of measuring investment risks by price fluctuations is repugnant to me, for the very reason that it confuses what the stock market says with what actually happens to the owners' stake in the business.

Let me pass now to the doctrine of the efficient market. I am particularly interested in this because of its negative implications for the work of security analysts generally. The subject is dealt with briefly in my current article in the *Financial Analysts Journal*, but it has such potential importance for this audience that I shall try another crack at it here.

Let me shorten slightly the definition of an efficient market that appears on p. 97 of *The Stock Market* by Lorie and Hamilton. "An efficient market is one in which a large number of buyers and sellers cause the prices to reflect fully what is knowable about the prospects

for the companies dealt in." The key phrase for me is "reflect fully." Let us assume first that it means only that the market has and uses all knowable information about every company's prospects, and hence that there is no point for analysts to spend their time trying to obtain additional information. I dissent from that statement to the extent that it would render meaningless the current controversy and concern on the use of "material information", particularly as obtained by security analysts from managements. If in all cases the market already knows and reflects all that is knowable about each enterprise then there should be no such thing as "material inside information."

But that is not my chief quarrel with the concept of the "efficient market." There is a strong implication in the Lorie and Hamilton book that because the market reflects fully all the knowable facts it thereby establishes correct or reasonably correct prices for common stocks. Hence, only the superior security analyst can successfully select the stocks that should be bought or sold. These exceptional people—in the authors' words—"have a quicker and more profound understanding of the economic consequences to individual firms of changes in the economic environment or changes within the firm itself." They have "a rare and valuable talent." I disagree completely with this viewpoint. To establish the right price for a stock the market must have adequate information, but it by no means follows that if the market has this information it will thereupon establish the right price. The market's evaluation of the same data can vary over a wide range, dependent on bullish enthusiasm, concentrated speculative interest and similar influences, or bearish disillusionment. Knowledge is only one ingredient in arriving at a stock's proper price. The other ingredient, fully as important as information is sound judgment. Take Avon Products, which sold at 140 early last year, or \$8 billion for the company and under 20—or a mere \$1.2 billion—last month. Was the market for Avon "efficient" on both these dates, in the sense that the price reflected "fully and properly" (the latter my addition to the Lorie and Hamilton phrase) the knowable facts. Were the changes in the short period in the environment or the company's prospects sufficient to cut 85 percent from the true value of this highly profitable, well-managed, and strongly-financed enterprise?

Take at the other extreme the large group of stocks selling for less than their working capital. Is the market "efficient" in maintaining these "fire-sale" price levels? Surely it does not lack the essential information about companies. What it does lack is judgment, courage and patience. In situations of this kind lie the best opportunities for financial analysts to prove their mettle.

The value approach has always been more dependable when applied to senior issues than to common stocks. Its particular purpose in bond analysis is to determine whether the enterprise has a fair value so comfortably in excess of its debt as to provide an adequate margin of safety. The standard calculation of interest coverage has much the same function. There is much work of truly professional calibre that analysts can do in the vast area of bonds and preferred stocks—and, to some degree also, in that of convertible issues. The field has become an increasingly important one, especially since all well-rounded portfolios should have their bond component.

Any security analyst worth his salt should be able to decide whether a given senior issue has enough statistically-based protection to warrant its consideration for investment. This job has been neglected at times in the past ten years—most glaringly in the case of the Penn-Central debt structure. It is an unforgivable blot on the record of our profession that the Penn-Central bonds were allowed to sell in 1968 at the same prices as good public-utility issues. An examination of that system's record in previous years—noting inter alia, its peculiar accounting and the fact that it paid virtually no income taxes—would have clearly called for moving out of the bonds, to say nothing of the stock even at prices well below its high of 86. We now have a situation in which all bonds sell at high yields, but many companies have an overextended debt position. Also, many of them do not seem to have sufficiently strong protective provision in their bond indentures to prevent them from offering new debt in exchange for their own common stock. (A striking example is the current bond for stock operation of Caesar's World.) These widespread present maneuvers seem to me to be so many daggers thrust in the soft bodies of the poor creditors. Bondholders can and should take steps, legal if necessary, to protect their interests against such forms of invasion.

Thus security analysts could well advise a host of worthwhile switching in the bond field. Even in the Federal debt structure—where safety is not at issue—the multiplicity of indirect U. S. Government obligations of all sorts, including some tax exempts, suggest many opportunities for investors to improve their yields. Similarly, we have seen many convertible issues selling at close to a parity price with the common; in the typical case the senior issue has offered a higher yield than the junior shares. Thus a switch from the common stock into the senior issue in these cases would be a plain matter of common sense. (Examples: Studebaker-Worthington and Engelhard Mineral preferred vs. common.)

Let me close with a few words of counsel from an 80-year-old veteran of many a bull and many a bear market. Do those things as an

analyst that you know you can do well, and only those things. If you can really beat the market by charts, by astrology, or by some rare and valuable gift of your own, then that's the row you should hoe. If you're really good at picking the stocks most likely to succeed in the next twelve months, base your work on the endeavor. If you can foretell the next important development in the economy, or in technology, or in consumers' preferences, and gauge its consequences for various equity values, then concentrate on that particular activity. But in each case you must prove to yourself by honest, no-bluffing self-examination, and by continuous testing of performance, that you have what it takes to produce worthwhile results.

If you believe—as I have always believed—that the value approach is inherently sound, workable, and profitable, then devote yourself to that principle. Stick to it, and don't be led astray by Wall Street's fashions, its illusions, and its constant chase after the fast dollar. Let me emphasize that it does not take a genius or even a superior talent to be successful as a value analyst. What it needs is, first, reasonable good intelligence; second, sound principles of operation; third, and most important, firmness of character.

But whatever path you follow as financial analysts, hold on to your moral and intellectual integrity. Wall Street in the past decade fell far short of its once praiseworthy ethical standards, to the great detriment of the public it serves and of the financial community itself. When I was in elementary school in this city, more than 70 years ago, we had to write various maxims in our copybooks. The first on the list was: "Honesty is the best policy." It is still the best policy, as our new President reminded us last month.