

Successful Investing Methods (Empire Club of Canada address)

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AN ADDRESS BY John M. Templeton, PRESIDENT, TEMPLETON GROWTH FUND, LTD.

CHAIRMAN The President, John A. MacNaughton

MR. MACNAUGHTON:

Ladies and gentlemen of The Empire Club of Canada: In the application form for membership in the Empire Club it is stated that our organization is a forum for “prominent people, speaking with authority on the issues of the day.” When the topic is “Successful Investing Methods” there are many speakers who might pretend to the mantle of authority, but there are few whose claim would have any legitimacy. One of those whose would is John M. Templeton, President of Templeton Growth Fund, Ltd., a man who is respected internationally for the magnitude and the consistency of his investment management performance record.

One modest measure of the esteem for John Templeton and of the respect for his achievements has been the demand for seats at this luncheon. The competition outside these doors prior to this meeting was intense, and I wish to compliment the staff of The Royal York Hotel in responding to the overflow attendance. All this excitement has served to underline the observation made in The Financial Post on July 28 of this year that the presence in Toronto of John Templeton is “a North American investment event.” And a happy event it is for those of us who were able to gain access to the inner sanctum.

The reason for this enthusiasm, of course, is the desire on the part of our members to benefit from the lessons of Mr. Templeton’s accomplishments during a lifetime of managing investment funds. Our guest of honour was recognized as a success many years ago, but the performance of Templeton Growth Fund, which celebrated its twenty-fifth anniversary in April of this year, has confirmed his place in the annals of the greats of the investment management world.

Anyone wise enough to have entrusted their funds to Mr. Templeton’s stewardship in April 1954 would have seen a \$10,000 investment, with dividends reinvested, appreciate to \$243,881 in April 1979—outperforming the Dow Jones Industrial Average by fifteen times in the process and leaving other supposed growth funds in the distance.

Templeton Growth Fund shareholders have not only prospered over the years, but they have also been secure in the knowledge that by investing their assets with Mr. Templeton’s fund they had achieved, in one stroke, the four investment goals of diversification of securities, diversification of

geography of investments, diversification of time horizons and pursuit of peace of mind; all goals that were first articulated by William Shakespeare's Antonio who said in *The Merchant of Venice*:

I thank my Fortune for it, my ventures are not in one bottom trusted, nor to one place, nor is my whole estate upon the Fortune of the present year. Therefore my merchandise makes me not sad.

In explaining his investment success John Templeton told the annual meeting of his shareholders in Toronto last year that "We don't have any formulas; we don't have any magic; we're not really that smart. What we try to do is to apply common sense to selecting investments."

It sounds easy, ladies and gentlemen, but as we all know, it is not. But for an individual who is perfectly mated to a task—whether Guy Lafleur to scoring goals, Isaac Stern to making music, John Fowles to writing fiction or Yousuf Karsh to taking photographs—genius is the ability to reduce the complicated to the simple. In the investment management world, John Templeton is unquestionably possessed of that kind of genius.

He is also very much a man of other parts. He is the Founder of the Templeton Foundation Program of Prizes for Progress in Religion. These prizes of £80,000 are awarded each year by Prince Philip to the person who has made an important contribution to increasing man's love of God, or man's understanding of God. Mr. Templeton is President of the Board of Trustees of Princeton Theological Seminary and is a Fellow of the International Academy of Religious Sciences.

Winston Churchill, who addressed this club in 1929 when he was Chancellor of the Exchequer in Great Britain, once observed "The farther backward you can look, the farther forward you are likely to see." It is our good fortune to have with us today an individual whose life's work enables him to look backward over forty years of experience and whose responsibilities during those forty years have required him always to look to the future, to understand it and to position his shareholders to benefit from its arrival.

Ladies and gentlemen, it is my pleasure to present to you now, John M. Templeton, President of Templeton Growth Fund, Ltd., who will address us on the topic "Successful Investing Methods."

MR. TEMPLETON:

Thank you, Mr. Chairman, and thank you all for coming today. It's a great joy for me to be in Toronto. I have been coming here four or five times a year now for twenty-five years and have always enjoyed tremendously being in your city. Also I have bought a cottage on Georgian Bay and an apple orchard at the south end of the Bay in the Peebles River Valley so as you can see I really enjoy Ontario.

Mr. MacNaughton has spoken about the performance of Templeton Growth Fund, and I think the reason I was invited to speak here is because of the performance of that mutual fund. I'd like to point out that it's too much to expect that it can always be good. No mutual fund has ever had top

performance every year. We have endeavoured to stay somewhere near the top and over a long period of years we may have averaged out on top. On a ten-year basis, we have had the best performance as far as we've been able to find out in Canada and the United States and every other nation. We searched in Britain, Germany and Japan and we found no other fund that performed as well if you are looking at the ten-year basis. The same thing is true on a fifteen-year comparison, or a twenty-year comparison but not necessarily for one year or even for five years.

The difficulty of producing a superior investment performance is so great that no one can do it all the time. In twenty-five years of trying hard there have only been three years when our performance was the tops of any fund in the United States. There have been six years out of those twenty-five when our performance ranked behind the average of all the United States funds, although we've had none of those years in the last ten. We've had ten fortunate years in which we ranked near the top but I predict that in the next twenty-five years there will be at least six in which we lag behind other mutual funds. That's inevitable.

When you are selecting a stock for purchase or sale the chances of being right are not so great as they are in other businesses. If you ask twelve engineers how to build a bridge and they agree, chances are that's the way to build it. But if you get the same answer from twelve security analysts about which stock to buy you can be pretty sure it's the wrong stock. That's because if everybody is optimistic about a stock then that has already been reflected in the market price. That's the nature of the work and I can assure you that in all my life I have never been right more than two-thirds of the time. In one-third of the decisions I make—to sell one stock and buy another—a year later I wish I hadn't done it.

Now through those twenty-five years there have been only four things that we are doing that I think you might be interested in. That's the heart of what I am saying. We really are not any smarter than other people. We don't have any formulae. We don't have any magic. We are not geniuses. What we try to do is use common sense and we do it in four ways.

We search for bargains. It seems to be common sense that if you buy a share for a small fraction of what you think it's worth then, in the long run, most times it will turn out better than if you bought stocks for more than they are worth. So we search for those stocks that have the lowest possible price in relation to what we think they are worth.

Now there's no magic and no secret in that. In deciding what a company is worth and therefore what its shares are worth we use standard methods. It is called security analysis. In the United States alone there are 20,000 security analysts. There are roughly a thousand chartered financial analysts. They are all familiar with the methods of appraising corporations. They are available to you in textbooks such as *Security Analysis* by Graham and Dodd. We use standard security analysis to decide the value of each stock. Then we compare the market price with that estimate of its value and we buy those stocks that have the lowest price in relation to what we think or somebody thinks they

are worth. That to me seems only common sense. For forty years it has amazed me that more of you don't go about it that way.

The second point is that it seems to be common sense that if you are going to search for these unusually good bargains you wouldn't search just in Canada. If you search just in Canada you will find some, or if you 'search just in the United States you will find some.

But why not search everywhere? That's what we've been doing for forty years. We search anywhere in the world to see which stock is available at the lowest possible price in relation to its estimated value.

If you search world-wide there is less risk. One of the first principles of investment portfolio management is to diversify and most people should not put all their money in one stock or even in one industry. I recommend to them they don't even put it all in one nation. If you diversify in many nations you will be less subject to the declines in the stock markets. The Canadian market sometimes has years of performing badly; so does the New York market. If you are only in those markets, then you suffer in those years. But if you have diversified, you don't suffer as much as the people who put all their eggs in one basket. So the world-wide viewpoint is a safety factor. It also helps you to find better bargains and, of course, bargain money is also a safety factor. If you buy something for a half or a quarter of what you think it is worth, the risk that it might go bad on you is smaller than if you bought something for all its worth or more than its worth. So, searching for bargains and searching world-wide gives you better bargains and less risk.

The third point is that we are flexible. We are properly called the flexible investment mutual fund. Now what does that mean? The majority of funds in North America are specialized. There will be a fund that specializes in high income stocks and another fund that specializes in high quality stocks and another that specializes in technology stocks or growth stocks, or whatever. Those are specialized funds and in certain types of stock market conditions they produce a record much better than ours. But they do that only occasionally.

There are many funds that don't call themselves specialized but really are because of the psychology or the mental attitude of the people who manage them. For example, there are many people who just can't persuade themselves to buy a stock that isn't famous so they are specialists in famous companies. There are others who are prejudiced toward backing growth so they are always in growth stocks. The majority of mutual funds are specialized. We have tried very hard for forty years to avoid that by changing our type of security fairly often. My viewpoint is that if we've been successful, if we've been in the right kind of security for several years, then it's not going to be right in the future. There's always a temptation, when you've had unusually favourable performance, to be self-satisfied and to think that you have found the answer so you will just continue with it. But it's almost certain and it's only common sense to say that if you have invested in some kind of security or a nation or an industry or whatever for as long as five years and you've had a very superior performance, then that

is not going to be the right area for the next five years. So we try to go for something different. That's what we call our flexible policy.

Now in changing from one type of security to another we can't be right all the time. Sometimes we make a mistake. The way to decide which area to change into is to look around and ask, "Where are the cheapest stocks? Which stocks are the lowest price? Which industry? Which nation? Or what type of stocks? Is it income stocks or growth stocks?" Then we consider shifting from our successful area into the new one.

Now that brings me to the fourth and last method of investing, and that is that it is utterly impossible to buy a bargain if you buy what other people are buying. If you want to buy the same thing that is popular with your friends or popular with the investment security analysts you can't get a bargain. If you buy the same things they buy you will get the same performance they get. If you are going to have a superior performance you've got to buy what the other people are not buying or even what those people are selling. Therefore, we search for those areas that are unpopular and then we study them to see if that unpopularity is permanent.

Now, there are a few odd cases where something never comes back. Let's say you bought stocks in Cuba twenty years ago and Castro came in; the market never came back. But in most cases they do finally come back. So we search for nations or industries where the stock prices are extremely low and they are only extremely low when there are good reasons for it. Things don't get very low for no reason. They get low because other people are selling them. That's the only thing that puts the price down. So we search for those things that other people are selling and then if the problem or adverse outlook is temporary we buy them and hold them patiently for years until the public changes its mind.

Some of the ancestors of the Rothschilds in Europe were asked questions on this subject and they said something that might amuse you:

We always buy cheap and sell dear. We are philanthropists. Sometimes people are extremely anxious to sell things and are willing to try to find a buyer at any price and so we buy and accommodate them. And at other times people are extraordinarily anxious to buy something and bid it up to a high price, so we sell and accommodate them.

Now, naturally I would like to say that the outlook is very uncertain but I could have said that every day for the last forty years. It's always uncertain. We don't have the same uncertainties that we had in the past but we have some very serious uncertainties. Therefore, nobody can promise you that you are going to get good investment performance in anything, no matter what, including Templeton Growth Fund.

One of the great uncertainties is socialism. Throughout the world there is a tendency for government to interfere more and more with free enterprise, the free economic process of the competitive system, and that does lead to a lot of problems for investors. It burdens producers with a lot of

unnecessary work and expense. It raises the cost of almost everything. It reduces the growth rate. So in our investment work one of our major problems is to find out which stocks are not likely to be greatly hurt by socialism. And in order to do that we study all nations where information is available to see what happened where socialism has become serious. Did they nationalize the banks or the mines or the oil companies or the railways? Did they regulate rents so that they became uneconomic? We try to avoid those areas of risk. Now let me pass on to inflation. There has always been inflation and there always will be, but in our opinion it will be faster in the future so more than ever before we are searching for shares of companies that will not suffer much from inflation or maybe even would benefit from inflation. You are never sure in making these decisions. But, for instance, we bought shares of a Canadian company called Daon about five or six years ago because it had ninety per cent debt. Forty years ago we would have stayed away from it because any company that's got ninety per cent debt in its structure is risky. But we took the viewpoint that in the real estate field where Daon is, if ninety per cent of their capital was in the form of debt then the owners of the ten per cent would receive the total appreciation. That has been one of our fortunate selections—worth ten times what we paid for it five years ago.

Now, I have touched much too briefly on areas of trouble. There is sure to be all kinds of trouble in the

world. But let me say that as far as I can see (and I have studied this continually) all the kinds of trouble in Canada and the United States or Europe or Asia are not going to lead to deflation. If you find anything that's going to lead to deflation, let me know! Whatever or how serious the troubles are, there may be chaos but not deflation.

If these things lead to inflation rather than deflation then you shouldn't have your money in cash and bonds because they are not going to protect you. Not that real estate will protect you, but at least you've got a chance. And so I would say to you that after you have finished worrying about all the world's problems, don't sell your stocks.

Where will common stock prices be eight years from now? First, let's look at where the gross national product will be. I believe, and almost every economist would agree with me, that the gross national product will double in the next eight years. That's largely because of inflation. The cost of living in the United States doubled in the last eleven years and at the last estimate it will double again in the next nine years, so that the cost of living alone will almost double the gross national product. When you add on increased population and increased output per person it is, I think, conservative to say that the gross national product of Europe or Canada or the United States will double in the next eight years. If the gross national product doubles, the sales volume of the corporations will double.

If sales volumes double, what will happen to profits? They will double too unless there's a change in the profit margin. There could be, and there sometimes are, temporary changes in profit margins but my guess is that profit margins eight years from now won't be any lower than that. There's a less

than even chance that they will be lower and a better than even chance that they will be higher. Therefore profits will double.

If profits double what will happen to share prices? Right now shares are selling on the Dow Jones Industrial Average in New York at only six times earnings. In Canada they are slightly higher than that but not much. If you exclude the oil and gas stocks, your industrial stocks are almost as cheap as they are in the United States. Now in the United States, over an eighty-year period, stocks sold at fourteen times earnings and for many reasons I think that sometime—six, seven, eight or nine years from now—stocks will again sell for at least average price/earnings ratios. If they do, that ratio is more than double where they are now in New York, and if earnings and the price/earnings ratios double, stock prices will have to quadruple. That's not a certainty but in my opinion there's a better than even chance that within eight years New York stock prices will quadruple.

Let me say that there are several reasons why I would say that this is not over-optimistic. One, that I have already mentioned, is that price/earnings ratios today are extraordinarily low. I have never seen a time in forty years when the ratio between the price and the earnings was below six for more than two or three months. Further, price/earnings ratios are low compared to what they are in other nations. In Japan the average price/earnings ratio was twenty times earnings. In most of the world price/earnings ratios are far higher than they are in Toronto or New York so I think that common stocks are cheap in relation to earnings.

The next point is that share prices are low in relation to book value. There have been very, very few times in the history of the United States when you could buy shares that hold all stocks on the exchange below their book value, the asset value. This is one of those few times. The asset value of the Dow Jones Industrial Average is about 900 and you can buy them now at 830. In addition to that, consider the replacement cost of those assets. I have spoken only of their original cost, but the replacement value is far higher than their book value. Never has there been a time when common stocks were so cheap in relation to their replacement value. Even five years ago, when the industrial average was 577 compared with 830 today, it was not as cheap as now in relation to replacement values. Even in the famous great depression, when common stocks got down to 190 in 1929, they were still not as cheap in relation to replacement values as they are today. The same sort of assurance is borne out by what people who know the companies are willing to pay for those shares. Companies are buying in their own shares more than they ever did in the past because the people who run them know that their stock is selling for a fraction of what it's worth. So they use their cash to buy in their own shares. Their competitors, other people in the industry, know how ridiculously low the prices are and so we have takeovers. We have never had so many. In take-overs the buyer will frequently pay fifty per cent or even a hundred per cent above the market price because the people who know these companies best know that they are bargains even at double the selling price. So that assures me that this is a period of bargain prices.

The last thing, and the most important of all, is that the stocks don't necessarily sell at a high price because of value. Value is only half of the equation. The other half of the equation is how much cash.

Most security analysts say ninety-nine per cent of the work done by security analysts is on value—what a company is worth. But what determines the buying price is partly value and partly what people are going to do with the cash and how much cash is available. And when you look at that, the picture is surprisingly optimistic. I have never known in my lifetime a period when there was so much cash in the banks, so much cash in the savings and loan associations, so much cash in the trust companies, so much cash in the pension funds or in the hands of the people. That's why the stock prices in Japan are twenty times earnings—there's so much cash.

Take one particular instance. Let's say pension funds. There is in the United States about \$600 billion in pension funds and over the years about half of the new money going into pension funds was put into common stocks. When the managers were optimistic in 1971 and 1972 they put more than 100 per cent of each year's new money into common stocks. Last year they put in only nine per cent of their new money into common stocks. But the time will come when again they will be putting fifty per cent into common stocks. That's \$30 billion a year of new money going into common stocks and there are not that many common stocks to buy. If you make an arithmetic calculation with compound interest, you will find that if the pension fund managers in the United States put fifty per cent of their new money into common stocks and keep it there, within ten years they will own more common stocks than the total amount outstanding. The total amount outstanding in the United States is about \$900 billion worth of common stocks and the pension funds will own more than that in ten or eleven years if they put fifty per cent per year into common stocks.

It won't happen that way. They are not going to own more than all the stocks outstanding. But what will happen? They will start to bid against each other and that will get the prices up. So the risk on the down side, and there is a down-side risk that stock prices might go down next month or next year, is small compared to what can happen over the next seven or eight or nine years when the pension fund managers and the public gets excited about stocks again. When they get fearful about the value of their cash and the value of their bonds and try to shift into stocks, the prices at which common stocks can sell will be surprising. Certainly the potential on the up side is many times as great as the risk on the down side. If you go back in history in all nations you will find that the greatest way to preserve wealth is real estate. Throughout all history that has been a great way and it still is. But I am not buying much real estate now because the average stock on the U.S. stock exchange all lumped together are selling forty per cent lower than they were eleven years ago and I can find very few pieces of real estate that's forty per cent lower.

The second largest area of investment is bonds. The amount of money the world has invested in bonds is far greater than is invested in common stocks. But I own practically no bonds because I regard them as a guaranteed way to lose money. Right now we have the highest deals we have ever seen on bonds in the United States—ten per cent on the very highest Triple A top quality bonds.

But most bonds belong to fairly wealthy people who are probably in the sixty per cent tax bracket, so if they pay off sixty per cent on the bond income that leaves them only four per cent. With an inflation rate running at nine per cent a year they are losing five per cent a year purchasing power by

being in bonds. If they put it into city or state bonds in the United States where the interest is tax exempt they get a better deal but they still lose something every year.

Gold is an increasing favourite as a way to protect yourself against inflation and in the very long run gold has protected people all over the world against inflation. But I am not buying it now. I am not buying it because I am always looking for what is unpopular, and gold is not unpopular today. Also gold pays no dividend and has no intrinsic value. Its value depends on human psychology.

So I would not say that the best bargains in the world are in real estate, bonds, gold or collectables. The best rate of investment in the last ten years would have been in things like paintings or rare books or Chinese ceramics and all kinds of things like that. They have done far better than common stocks. But the fact they have done better in the last ten years means they are not cheap. This is not the time to go into collectables to protect yourself against inflation.

So what has happened? I like to look at the fundamentals. I like to ask, "What is the basic fact here?" Throughout the history of the world, ownership of your own home has almost always been a wise policy in every condition. No matter what happens owning your own home is something I would recommend to you. Another thing which we tend to forget in our modern sophisticated society is that throughout all the centuries, in fact, throughout all the millions of years in the past, having a lot of jewellery was your way to build up your wealth and it still is. But there's still a better way. And I am going to give you that in four quotations and then I'll sit down. These four quotations have more wisdom than all the security analysts I have ever met.

Firstly, life on earth is only a brief moment between two eternities.

Secondly, when you die all you can take with you is what you have given away.

Thirdly, store up your treasures in heaven where neither mould nor rust ever corrupt nor thieves break through and steal.

Lastly, we give Thee but thine own, dear Lord, what e'er our gifts may be, for all that we have, dear Lord, is but a trust from Thee.

The thanks of the club were expressed to Mr. Templeton by Donald H. Carlisle, a Director of The Empire Club of Canada.