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Very interesting — is he right? Wait

Will Market Grow to Sky? —Some Problems Ahead

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

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

Benjamin Graham

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

It is chastening to consult one's former errors in preparation for committing new ones. So let me cite two paragraphs only from that April 1955 talk. One of them is a summary of what I said, and the other is the only piece of specific advice which I gave to the audience.

The summary is as follows:

"To sum up, barring atomic warfare, I see a generally favorable future for long-term investments, particularly investments in common stocks, which is now about the only interesting part of the whole field. My one unfavorable prognosis is that we shall continue to have a bull and bear market in the future as in the past and that for every 10% of overvaluation in the bull market, we are still likely as before to see a corresponding 10% of undervaluation in the succeeding decline.

"I predict a gradual but decisive change in corporate practices and investment policies to adapt both of them to the realities of our tax structure. I foresee also an important movement in the direction of a more effective check by stockholders on the stewardship of corporate management."

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

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

That was said in April 1955.

My Errors

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

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

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

Today's "Agenda"

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

A number of reasons can be adduced to explain the great rise of the stock market from a low of 161 for the Dow-Jones Ind. average in 1959 to a high of 685 at the beginning of 1960, which is almost the current figure. In terms of Standard & Poor's 500-stock composite average, the rise was from 13.55 in 1949 to a recent new high of over 64. Interestingly enough, that advance was larger than the one in the more popular Dow-Jones Industrial average during the same period.

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

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

Bases of the Rise

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

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

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

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

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

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

Herodotus on the "Soaring Sixties"

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

The Economic Record

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

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

Now, of course, we must next allow for the effect of the price inflation. There we find that the rise in Gross National Product is reported as 87%, which is certainly an impressive figure. However, in the preceding ten years the rise was 182%. That was a period in which the stock market had only a small advance. Between 1910 and 1919, the rise was 163%. Between 1899 and 1909 the rise in Gross National Product was 82%—just about what it was in the 1950's. We had two smaller periods of rise, one of only 22% in the 1920's and a decline of 12% in the 1930's, produced by the fall of the price level.

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

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

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

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

Share Earnings Unimpressive

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

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

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

The Inflation Impact

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

Government Support

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

However, it may be worth recalling that the business community was almost solidly opposed to that new government policy as embodied in the Employment Act of 1946. Here I am going to indulge in a little bit of vanity. I like to call to mind that as a member of the New York State Chamber of Commerce 15 years ago I was the only one who spoke out against the Chamber resolution roundly condemning the 1946 act, and one of the very few who voted "No" on this resolution of condemnation.

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

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

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

The Russian Challenge

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

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

Future Stock Markets

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

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

New Era Talk Again

If this view of the stock market of the future is accurate, then we have indeed entered on a new era of finance. It is not inappropriate, therefore, that the main address at the Stock Market Luncheon of the forthcoming annual con-

vention of the National Federation of Financial Analysts Societies in Richmond on May 1 next, bears the title, "The Beginning of a New Era." Some of us have lived through the "New Era" of the late 1920s. Its scars have healed, but the experience is not entirely forgotten. Today's analysts and investors would no doubt assert that the New Era which was only a mirage in 1928 and 1929 has now become a wholesome reality 30 years later.

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

Determining "Central Value"

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

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

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

Today's Market Participants

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

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

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

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

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

Disloyalty to Investment Principles

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

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

Investment for the Wealthy

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

Bad Advice

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

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

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

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