The Stock Market Situation

By BENJAMIN GRAHAM*
Chairman of Graham-Newman Corporation
(a registered investment company)
Adjunct Professor of Finance,
Graduate School of Business, Columbia University

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

This statement will address itself mainly to three points:

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

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

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

(A)

The Present Level of Stock Prices

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

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

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

10 years ending in 19 obtain average earnin include any period c pression. In a sense the soundness of this Central Value is bou our ability to escape s ness depression in th we have in the rece is probably fair to s market is not too hi we have really mana the business cycle.

Although such a c would involve a r break with the past prepared to deny its There is some reasc cluding that in the fu depressions will be p not by the natural American business, tl ernmental interventic sible inflationary n above analysis is by unfavorable to the p of stock prices. E reaching my over-al on the subject, I am

All of t

NOT NEW I

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

Benjamin Graham

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

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

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

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

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

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

A Reassuring Measure

This mechanical method applied to the situation in the beginning of 1955 yields a Central Value for the Dow-Jones Industrials of 396, or only slightly under their present value. Such a figure, if reliable, would have to be regarded as rather reassuring. It would indicate that the market in terms of value is no higher now than it was in early 1926, or in early 1936, or late 1945. However, the validity of this Central Value figure may be open to question if we observe that the

Frozen-Food Deliveries, ...

Avenue.

uation

ration
y)

University

ck prices based d causes of the rolling excessive not as high as ious quantitative is holdings. As- ise since Septem- idence, with pub- rather than risks of possible aboli- l, suggests Presi- in effective rate,

-Jones Industrials are lower ratio to their nings in the past than at their highs in 1929, 46. The same applies to ectric as an individual clear that the issues —which may be con- reasonably representa- larger Industrials as a ve a considerable way ore reaching the ratios their former tops. It pointed out also that e interest rates are now lower than in previous kets except for 1946. asic interest rates pre- justify a higher value for ar of dividends or earn-

has been made of these hips as indicating that the is still on safe ground. such comparisons fail

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

Although such a development would involve a revolutionary break with the past, I am not prepared to deny its possibility. There is some reason for concluding that in the future serious depressions will be prevented, if not by the natural vitality of American business, then by governmental intervention and possible inflationary moves. The above analysis is by no means unfavorable to the present level of stock prices. However, in reaching my over-all conclusion on the subject, I am inclined to hark back to the analysis I made of the stock market in October, 1954, at a time when the Dow-Jones Average stood at 185. (This was published in "The Commercial and Financial Chronicle," Oct. 18, 1945.) I should like to quote intact the Summary appearing at the end of that article and state that it expresses my view with respect to the stock market today.

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

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

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

Continued on page 22

All of these Shares having been sold, this advertisement appears as a matter of record only.

March 25, 1955

NOT NEW ISSUES

27,000 Shares

Amerada Petroleum Corporation

Common Stock

(No Par Value)

20,000 Shares