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Investment Policy in 1950

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Expert states investment will weather second half of century as it has the first half, and in any event, capital has no place to hide. In contrast to 50 years ago, common stocks constitute essential part of any investment portfolio. Bars individuals' investment in corporate senior securities. Sees stock purchases warranted at today's levels, with inclusion of numerous undervalued "secondary" issues.

I am intrigued by my topic, particularly because of the emphasis on 1950. That naturally invites comparison with beginning of the century, and since I have a vague and childish recollection of that early year I began to do some comparing of these exciting times of 1950 with the more languid days of 1900. We have made a great deal of progress since 1900. Our wealth and our production has grown enormously, so has our standard of living, so has our wage-scale, so have the prices of stocks. In addition to that, our national debt has succeeded in growing from $1 billion to over $250 billion, our annual budget from $500 million to $40 billion, and other things in proportion.

Benjamin Graham

If I may digress for a moment, I might recall to you that famous vaudeville skit about the suitor who was going to an important meeting with the girl's father. He brought along his best friend and told him: "I've got to be modest at this meeting, but you don't have to be modest; you make everything I say sound big." When the old man asked him "How about your business?" he answered, "Oh, I got a nice little business," but his friend exclaimed, "A nice little business? Why he's the biggest maker of buttonhole linings in the country." "How about your home?" "Nice little home," said the suitor.

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"Nonsense," said the friend, "he's got the best duplex apartment in Columbus Avenue." As this went on, the suitor began to cough a little and the old man said suspiciously, "How about your health?" "Oh, I've got a little cold," said the suitor. "A little cold—nothing," cried the friend; "he's got galloping consumption!"

Similarly, despite all the wonderful things in this country, many people believe that we are galloping down the road to statism, national bankruptcy, and many affiliated ills.

The International Picture

When we turn to the international picture, the picture ranges from the alarming to the appalling. It looks as if we are in the midst of a century of revolution. But, instead of revolution toward liberty, equality and fraternity, it seems to be a revolution toward the "iron curtain," toward the slave state and general misery. We have fought and won two world wars only to find ourselves in the middle of World War 2½. The hydrogen bomb is knocking at today's headlines and at the doors of the world.

Now, in the light of that unnerving situation, if you were to face the investment problems of 1950 in the traditional way, you would think in terms of storm cellars, in terms of hiding and hoarding. Yet this is far from the actual investment climate in 1950, and I believe there is a very good reason for it. The reason may be found in the history of investment itself over the last half century. The picture of the investment markets in no way reflects the world-shaking events that have transpired over the last 50 years. You will not see World War I and World War II prominently reflected in the stock market charts. You will see an extraordinary phenomenon there between 1927 and 1933. But that apparently had nothing to do with world events; it was rather an internally generated South Sea Bubble.

One might well say that if investment had been able to weather the storms of the first half of the century, there is reason to believe that it can weather the storms of the second half. One thing is sure—that investors will have to act from here out as if that is so, as if the rules of investment that proved sound in the first half of the century must be adhered to, because there is available no other alternative. There is no place to hide either for capitalists or for capital.

The Impact of Inflation

We do find, however, one important development in the first half of the century that should have a real effect upon investment attitudes and that is the impact of inflation upon investment results. There is no question but that the conception of bond investment as the full answer to the conservative requirements of the investor is no longer sound. Bond investments may have worked out reasonably well in terms of cash repayment, but they have not worked well in terms of value of the capital that has been put into the bonds. By contrast, common stocks, which have been subject to wide fluctuations in value from year to year, have over the last 50 years (and over the preceding 50 years) shown not only the ability to conserve their money value on the whole, but also to give a reasonable amount of protection against the over-riding factor of inflation. For that reason, authorities on investments are now almost unanimously agreed that common stocks are an essential part of any substantial investment portfolio today. Certainly, that was not the opinion 50 years ago.

The Investment Approach

Now, what about common stocks in terms of the investment approach? You gentlemen are perhaps more accustomed to think of them in terms of trading and speculation. Marshall Lyautey once said about the climate of North Africa, "People think North Africa is a hot country. It is not; it's a cold country with a hot sun." Most people think of common stocks as speculative media. They are not, in my opinion. Good common stocks are investment media which are subject to speculative influences. The speculative influences are not in the common stocks; they are in the minds of the people who buy and sell them. The problem of *investment* in common stocks is either to insulate yourselves from the speculative influences, or else to adjust your investment policy so that you can take advantage of the speculative fluctuations that are imposed upon the basic investment quality of common stocks. I need not remind you that the underlying quality of common stocks has improved tremendously since 1900. Not only do we have a great deal more dependable information about them, but the corporate structures upon which common stocks depend have been greatly improved in terms of conservatism, in terms of real and realizable value behind the shares. For these reasons I think the main conclusion that we can draw about sound investment in 1950 is that it must turn to a substantial degree upon the intelligent purchase of common stocks.

"Artistic-Scientific" Methods

Now, what would be the "artistic" or "scientific" methods that an investor should employ in connection with a program involving common stock investment? In the first place, the question is how far should the concept of common stocks as a component of a portfolio be carried. We all know that the conservative investor will not be psychologically inclined to go too far in the common stock field. As a practical matter the limits of apportionment seem to run between a 75% bond portfolio with 25% in stocks, and the other proportion of 75% in stocks and 25% in bonds. When we ask about the make-up of the bond type of portfolio, we find one very basic fact confronting us: *Corporation bonds*, which were the central and almost the only component of individual investment a generation ago no longer appear to be appropriate to any extent for purchase by individuals. It is easy to show that investment in Series E Savings Bonds or Series G Savings Bonds and in tax-free municipal and state securities is a much sounder and appropriate medium for fixed-value investment than any corporation bond or corporation preferred stock.

The reasoning here goes something like this: If you buy a corporation security of the highest grade you do not get any better return than you can in Government bonds; and, if you are in the high bracket your net return is much less than you would get in tax-free securities. On the other hand, if you buy a corporation bond or preferred stock of medium grade in order to "sweeten the yield" somewhat, you are assuming a risk which much more than compensates for the additional yield which you may obtain. That reasoning is undoubtedly sound with respect to individual investment in 1950. It may not be true in 1955; **but as long as the present relationship of corporate yields and government yields is maintained I think we should rule out individual investment in corporation senior securities.**

Institutional Investment

As far as institutional investment is concerned, that is another

that type of research, and a good deal of it is valuable. Unfortunately, the difficulty is to distinguish between the research which is going to be valuable and the research which is going to prove deceptive. When you place your emphasis mainly on the future the first thing you must realize is that you cannot control the future, and therefore you cannot control your material or your results. My observation in that area has been that the basing of investment primarily upon changes to be expected in the future will on the whole not yield satisfactory results, when you take a census of operations over many years and including many companies. (One criticism that I have to offer of the Wall Street approach—which applies to security analysts, investment companies, and everybody else—is that so little effort is made to keep track of what has happened in the large number of analyses that have been made year after year—how they actually worked out.)

The emphasis upon future prospects can turn out to be very deceptive indeed. I was impressed by reading yesterday of the passing of dividend by Heyden Chemical Co., as an example of what disappointment can occur in a field which is supposed to be almost fool-proof. The contrast between the behavior of the airline stocks, so far as their earnings are concerned since 1940, and the behavior of the coal stocks in that period is an extraordinary example of the divergence between expected action and actual action when you are forecasting the future. Therefore my point of view with respect to investment in 1950 tends to concentrate as far as possible upon the establishment of values which are grounded in the company's own performance up to date and in its own balance sheet.

The Balance Sheet Approach

Now let me put in a word for an approach which is almost forgotten in Wall Street, and that is the balance sheet approach. A prime weakness in the point of view that is generally expressed down here is the divergence between the valuation of businesses as they are considered in Wall Street and the valuation of the same kind of businesses that would be made by a private owner of that business. You all know that if you own a business yourself you start to find out what it is worth by looking at the balance sheet figures, and you either increase or decrease them, depending upon your view of the quality of the enterprise. To my mind that is the soundest approach to every kind of business and to every kind of stock, whether it is dealt in actively in Wall Street or not. By no means do I suggest that every business is worth its book value, but I do feel that the greatest mistakes in the Street will be avoided if you start in the same way that businessmen always start, by looking at the balance sheet and making your changes from there. I would like to suggest, as a practical approach toward making money in Wall Street. the idea of trying to find a group of stocks which appear to be worth pretty much what their balance sheet shows. (That would not be every stock by a long shot, but it might be a third of the total.) You would then observe how over the years the price of these shares tends to fluctuate below and above the book value—indicating that you have a recurrent opportunity to buy them when Wall Street is valuing them too low as against Main Street, and you have another opportunity to sell them recurrently when Wall Street is valuing them too high in relation to Main Street. I might say, if you want to be a little cautious in your approach it is not necessary

to wait until Wall Street values these stocks much too high. If you sell them only at a reasonable price you will find that you will obtain a very nice profit on your investment because you have bought them so low.

The Margin of Safety

The concept of buying securities at less than their indicated value includes what I have always regarded as the most dependable assurance of success in every form of investment—whether it be bonds or stocks—and that is the concept of margin of safety. In bonds, as you are aware, you want to buy bonds which cover their interest charges with a goodly margin, because that indicates that even though things may not work out so well in the future, your bond will remain a sound bond. The same concept can be applied to common stock investment, and I think you will find if you study the subject, that it has stood up extremely well over the last 50 years. When you have such a margin on a common stock purchase, then if things do do not work out as well as you expect them you still have a cushion to absorb this disappointment. You can end up, if not with a profit, at least with no loss. But that can not be done when you are operating in the stock market either on the basis of anticipating what the market is going to do very soon, or on the basis of how the company is going to fare over the next few years. If you are wrong on either of these approaches then you are almost sure to lose money, because you have no margin of safety to fall back upon.

The "Grocery" Approach

I had the pleasure last week of talking to a group of ladies only for the first time in my career. Trying to bring this subject home to them by some analogy with a feminine quality, I pointed out to them that there were two ways of buying stocks: either on the basis that they buy groceries, or on the basis that we men buy perfume for them. When you buy stocks on the grocery basis you try to get adequate quality at a reasonable price. When you buy on the perfume basis you try to buy the stock which is most popular and which gives the most prestige; you pay comparatively little attention to price; in some respects, the more the price you pay the better you seem to like it. I suggested to the ladies that if they would take the grocery approach to the selection of securities they would probably do a very substantially better job in investments than we men do, because they are more likely to see, appreciate and take advantage of a true bargain whenever they see one.

Let me suggest to you as customers' brokers to include in your variety of approaches to security purchases the grocery approach. As a practical matter, I think the customers' broker should have at least two strings to his bow. No doubt he welcomes, or at least accepts, a speculative and trading attitude in his client; it is a very satisfactory source of income when things are going well. But I would suggest that the customers' broker should endeavor at the same time to cultivate a clientele which takes the grocery approach to stock investment, which is ready to buy securities after they have gone down, and which is ready to accept a further decline in the market price as an opportunity to buy more. You will find them a very comfortable kind of customer to have, and you will also find them coming in handy at the time you need them most. If you will encourage that point of view in your clientele,

story. The institutions have their own reasons for purchasing corporation securities at their present low yields, and it is not my purpose to examine into those reasons. I will say, however, that I think that trust departments which invest funds for individual beneficiaries are still too much governed by the traditional division of investments between corporation bonds, preferred stocks, and common stocks. They would be better advised to divide their portfolios solely between government bonds (or tax-free bonds) on the one hand, and common stocks on the other.

Market Forecasting Unsatisfactory

Now, with regard to the matter of investment in common stocks and the way of going about it in the year 1950. The main issue that confronts investors, and particularly confronts you as customers' brokers, is the question: To what extent shall we endeavor to anticipate what the stock market is going to do? My own views on this subject are pretty well known to all of you. I am not going to elaborate them. I believe that the endeavor to anticipate what the stock market is going to do is not on the whole a satisfactory activity. It is successful at times and it is unsuccessful at other times, but on balance it does not pay. I am an exponent of the philosophy that the main objective of common stock investment should be *pricing*, not *timing;* and by pricing I mean the endeavor to buy securities at prices which are attractive, letting timing take care of itself. It is obvious, of course, that when you buy securities at low prices—and if that happens to be a good time in relation to the future action of the market—your pricing and your timing coincide. There can be no objection to that combination. But from the viewpoint that I represent, the first and primary emphasis must be placed upon the endeavor to buy securities at the right *prices.* I believe that the decision to postpone buying at the right price, because of the thought that some future time may be more propitious, will on the whole turn out to be an unsatisfactory policy for the real investor. He may thus buy his shares sooner in relation to the rise that will finally come. But unless he acquires the stock at a considerably *lower price* than he previously considered, he has made no true gain whatever. (Certainly he has lost interest on his money.)

The 200 Dow-Jones

In January, 1950, you have the problem whether a level of the Dow-Jones Average at about 200 represents a suitable price for the purchase of common stocks for investment. You also have a problem that concerns you individually very much, I am sure, whether January, 1950 represents a suitable *time* for purchase, in the light of what the market will do. In trying to answer that question I am reminded of an address I made in March, 1948, before the National Federation of Financial Analysts Societies, in which I considered the question of the purchase of General Motors at 52. I stated that, on the past record, there was danger that General Motors might well decline to 40, and a perhaps equal an opportunity for it to advance to 80. But from the investor's standpoint, if his appraisal of General Motors indicated some central value around 65, he would be intelligent to buy at 52, and ignore the risk of its declining temporarily to 40.

There is a fairly good analogy today in relation to stock prices generally. Unfortunately, you do not have as much of a margin of safety as you had in March, 1948, dealing with stocks like General Motors. As near as one is able to ascertain value, the Dow-Jones average is worth somewhat more

than 200 as a central figure. As near as one is able to project the probable range of fluctuation for the Dow-Jones average from here out, past history indicates that it would be somewhere between 140 at the bottom side and 280 at the top side—a plentifully wide range for anybody's imagination to traverse. I lunched yesterday with a Stock Exchange firm member who is sure that stocks are headed well below 140. I read an article in the "Financial Chronicle" this morning in which somebody was equally certain that stocks were heading up toward the 280 level. Unfortunately, or fortunately for me, I have no opinion on this subject whatever. I really and honestly believe that it is not impossible for stocks either to go down substantially in the next 12 months or to go up substantially or to repeat the relatively narrow fluctuations that we have been accustomed to since 1948. I think that the investor has to take into account that any one of these three diverse courses is a possibility.

Nevertheless, I believe the investor is justified in buying today on either of two alternative principles. One objective could be to buy representative common stocks at levels which are not too high, to hold them for income and for eventual capital appreciation. If that is his objective, he would be justified in investing his money at today's levels even though it is not a bargain level, and even though, as in most other times in the history of the stock market, it carries with it a risk of loss on market quotations in the same way that it carries a chance of gain.

A Below-Value Approach

The second approach is to emphasize the purchase of securities at considerably less than their indicated value—an area of activity in which, as you know, I have been interested for a great many years. Today's situation is quite different from that of 1946, even though the ostensible market level as shown by the Dow-Jones average is almost the same as the top in May, 1946. In May, 1946, there were virtually no securities that were demonstrably selling considerably under their true value. New stock offerings were being made at prices that were far beyond the realms of conservative valuation; secondary stocks were selling at prices which might conceivably be justified, but certainly could not be characterized as bargains. Now the picture is very different. Although the leading stocks are almost as high as they were in 1946 the secondary stocks are very much lower. A great many of them would appear to be distinctly undervalued by the ordinary tests of appraisal which have worked out very well for the investor over the last 50 years. That being the case, in 1950 the investor who wants to use a superior degree of enterprise and intelligence should be able to find a rather large selection of common stocks which are selling under their indicated value. I think he would be justified in buying and holding them regardless of the possibility of a decline of substantial proportions in the stock market. (He cannot be too sure that the optimistic market expectations of the majority will prove well founded.)

Predicting Future Hazardous

Now, talking about the expectations of the majority brings me to the type of selection of common stocks which represents the most customary form of security analysis in Wall Street. That is endeavoring to pick out securities and companies which have better than average prospects for the future. A great deal of very intelligent and careful work goes into

you will not only be increasing your own earning power and value—but what is equally important from my point of view—you will be contributing to the creation of a sound and stable viewpoint toward securities in Wall Street.