NEW HORIZONS IN INVESTMENT

by

Benjamin Graham

The word "horizon" presupposes something rather far in the distance. My emphasis, therefore, will be on the long-term future rather than on the immediate situation in securities. My topic can be divided in five parts. First, the future economic background for security investment; second, the indicated long-term investment policy that would be based on such a background; third, opportunities and hazards of such a policy; fourth, the future impact of tax considerations on investment policies; and finally, some future developments in stockholder-management relations.

With regard to the future economic climate, I start with the necessary assumption that there will be no atomic war. This is about the same as saying that the heavens will not fall. But what was once a humorous cliche, in our childhood, has now become, I'm afraid, almost an act of faith.

My second postulate I accept more willingly and not perforce. It is that we shall have a dynamic America, with Gross National Product growing quite steadily through increasing productivity, and supported by government commitments to maintain nearly full employment. I think there is more possibility of large-scale inflation in the future than there is of large-scale unemployment and deep depression.

As a third guidepost to the future, we might use the projections of the Congressional Joint Committee on the Economic Report. These describe the economic patterns that may prevail in 1965, assuming reasonably full employment. They are of course not intended to be a prediction - merely an indication of potential performance, based on carefully chosen assumptions. These projections are, among other things, very encouraging for corporate profits. Here are a few of the relevant figures:

The projected growth in Gross National Product from 1954 to 1965 is 47 percent - to $535 billion. A breakdown of the components, which includes corporate profits before and after taxes, shows that before taxes corporate profits of $56 billion are projected for 1965, against $59.5 billion in 1953 - an increase of 42 percent. A projection of after-tax profits shows $30 billion in 1965 as against $18.3 billion in 1954, or a 64 percent increase. Dividends show an increase of 90 percent - $18 billion as against $9.4 billion. However, I shall have a caution later on the matter of the dividend factor which, if I am correct, may change that particular figure, or at least the way dividends are handled.
In this analysis, the corporate picture as a whole shows a
greater projected rate of growth than that of the other parts of
the economy. The larger percentages indicate, to my mind, the in-
dispensable role of capitalism and of corporate profits in further-
ing the expansion of the United States economy. In spite of the
political weakness of American business, it has forged ahead since
1933, and I believe it will continue to do so in the future because
the country needs it.

II.

What future investment policy is called for by these optimistic
projections? Essentially, it is very much like the policy that
has been formulated by most authorities in recent years. Briefly,
it can be condensed into a statement that:

The average representative investor will divide his funds some-
where between one-third in government bonds or tax-exempt securi-
ties and two-thirds in equity securities, at one extreme; or two-
thirds in government securities or cash equivalents and one-third
in equities, at the other extreme.

What the actual proportion of equity investment may be will
depend on a number of individual judgments, among them expectations
concerning the future inflationary potential. It is quite obvious
that the people who failed to include common stocks in their port-
folios in recent years were very remiss - they did not read the
signs of the times, they did not read the convincing evidence of
past experience. These speak very strongly for every investor's
having a basic common stock component in his portfolio.

On the other hand, you can also go too far in this respect.
The possibility of inflation in the future does not mean that what
used to be regarded as very definitely excessive levels of the
stock market will no longer be excessive levels. I want to stress
this point, though it is based more on experience than anything
else. When you have security price levels which in the light of
the past are very high, there are always "good" reasons for them.
One reason readily given as the motivation behind the present bull
market, for example, is the inflation factor, and the fact of full
employment threatening more inflation. But there is a danger in
accepting this explanation one hundred percent, because the time
comes when that factor, though it may still be just as true as it
ever was, no longer controls stock prices to the same extent that
it did. Something else comes in - namely, higher interest rates,
or some temporary business setback, or some reappraisal of the
situation, and that will cause a break in stock prices.

As far as common stock holdings are concerned, future invest-
ments may be viewed as starting from a typical current investment-
fund portfolio. Usually, such a portfolio has a selection of
securities such as appear in the Dow-Jones industrial list; an
assortment of public utilities - which are, of course, more
homogeneous than the industrial list; a relatively few leading
railroads; and a fairly wide choice among banks and insurance
companies, to the extent that the investor wants to have that
type of security in his overall portfolio.

There are obviously many departures from this standard pat-
tern - there must be, since there are thousands of companies not
included there, all of which have to be owned by some people.
But those departures will require special reasons - not only
special reasons but a special equipment in the form of training
and skill by the investor. I want to amplify that just a little.
I have in mind particularly two types of departure from standard
policy. On the one hand, there is the emphasis that might be
placed on growth or quality stocks, which are higher-priced in
relation to earnings than the typical or representative security.
On the other hand, you may have emphasis on secondary or bargain
issues, which are relatively low-priced. In either event, invest-
ment in those areas should be motivated only by careful thought
and adequate equipment.

As far as the high-priced issues are concerned, I feel as a
practical matter that it is dangerous for the individual investor
to take the stand that if he likes Company A he should buy it
regardless of its price. And since he cannot take that stand, it
seems very difficult to me to decide just how big a premium he
should pay over normal multipliers in order to get a good company.
In other words, I do not believe that the field of growth stocks,
attractive as it is, is a very practical field for the average
investor to operate in continuously over the years.

However, a separate case might 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 combines 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 even
perhaps only average. But the stability factor will probably be
greater. One could very easily justify a determination to con-
centrate one's equity proportion of the portfolio in the public
utility field under present market conditions.

I see no justification, at least in the near-term future, for
individual investors to buy corporate bonds and preferred stocks,
rather than U.S. savings bonds and tax-exempt securities. The
reason is this: The higher yields that might be obtained are not
sufficiently attractive to compensate either for the risk incurred -
partly a true risk and partly a risk of market fluctuation - or the amount of skill that is needed in order to get the higher yield without undergoing the greater risk.

As far as investment in foreign enterprises is concerned, I am perhaps a very bad man to speak about it, because I have been down in Wall Street for forty years and the experience of investors in foreign countries in those forty years has, on the whole, been a bad one. It might be argued that it hasn't been so bad financially. But certainly it has been bad psychologically, as a whole. I think we will probably see growing foreign investment, nonetheless. But whether it will turn out to be sound, whether the investors will be happy about it in the future - I am inclined to be somewhat skeptical.

III

My third topic concerns the stock market of the future. What kind of behavior might be expected of it? Can we expect it to parallel fairly closely the performance expected from business? That would mean that it would advance fairly steadily and would experience at worst only minor setbacks.

This is a charming prospect. I think there is a current tendency to embrace it, among people in the stock market. But, personally, I do not believe in it. I think that it is perfectly true that the general rate of growth of American business profits will undoubtedly control the future rate of growth of representative common stocks, their earnings, dividends, and prices. But the fluctuations of the stock market will not be governed solely, or even perhaps predominantly, by the fluctuations of business.

There is a large component of stock market fluctuations that will continue to come from the attitudes of investors and speculators, from the subjective element in stock prices. The excesses of optimism and pessimism will, I am sure, continue to produce the excesses of over-valuation and under-valuation in the market to which we have long been accustomed. The market cycle of the future may prove to be surprisingly independent of the business cycle, and it may even exist if there is no business cycle - which is in itself quite an assumption, but not an entire impossibility. I am not yet ready to give up what has long been my favorite description of Wall Street - "plus ca change" - the more it changes, the more it's the same thing.

Let me try to throw some light - and one or two paradoxical sidelights - on common stock price fluctuations. This subject is actually more interesting and more complicated than any of the problems I have covered up to now.
What we call the excessive price levels reached in bull markets are excessive primarily in the light of experience. They are not excessive by a priori logic or reasoning. It is easy to prove, to any professor's satisfaction, that dividend yields should properly be no higher than bond yields - the phenomenon that you find at the top of bull markets. You could well argue that a representative stock investor, at those prices, receives not only the same income he would get from bonds, but in addition gets the benefit of reinvested earnings, a participation in the growth of the country, and a protection against inflation. And it is easy to argue, therefore, that if you have a good stock that yields you the same amount as a bond, you have a better investment than you have in a bond.

Undoubtedly, reasoning of this kind is implicit in the recurrent willingness, not only of speculators, who may be called the heedless type, but also of fairly conservative and experienced investors, to buy and hold stocks at the top of each successive bull market. This gospel of "the good stock", because it has a good deal of persuasiveness, almost conviction, to it, finds ready acceptance in bull market periods.

Past experience, on the other hand, shows clearly that the "normal" or "average" price of common stocks tends to be well below this theoretical long-term value. The reason for it is easy to understand. There is an element of "insurance premium" that enters into the common stock picture. In normal times the investor insists on being paid something extra above value for assuming the psychological hazards of a stock program - hazards associated, first, with temporary market shrinkages in securities as a whole, and secondly, with the possibility of a permanent or semi-permanent loss of value in some of his individual commitments. The market pays the investor a special premium for such risk-taking - a very substantial premium above the actuarial exposure to risk.

There is an interesting and very close analogy here to the field of casualty and fire insurance rates. Fire insurance companies receive premiums equal to about twice their actual loss experience or exposure (exclusive of operating expenses). You pay that extra premium - the word premium itself is an interesting word, it really means an amount paid in excess of calculated risk - you pay this premium willingly to be relieved of the psychological hazards involved in having an uninsured house, or automobile.

In a somewhat converse but analogous way, in normal or average markets the stock investor obtains a similar extra premium or reward for his gumption, aggressiveness, and so on, in going into stocks, as against the bond investor. My theory is that this inherent over-estimation of common-stock risks will continue to be a feature of the stock market over the long pull.
To some degree it is the consequence of the very instability of investors' thinking - the very variation in investor confidence which leads them to view the picture through rosy glasses one year and through dark glasses the next year. This truly subjective element detracts from the objective or independent quality of common stocks as a whole, and creates what I like to call the "built-in discount factor" in common stock prices.

There is a second paradox related to the structure of common stock prices that I would like to point out. Under the modern attitude toward common stock valuations, the higher the quality of a company the more inescapable is the speculative component in its price, and the more subject it is to wide price variations.

The value of a common stock has come to be defined and accepted as being based upon the future earnings of the business capitalized at a rate appropriate to the quality of the company. When we are dealing with a very strong company we are dealing with a company in which there is the greatest confidence both as to the growth and stability of its future earnings. Hence the willingness exists to capitalize these earnings on an extremely liberal basis.

But both of these judgments are essentially subjective. There is no way in which anyone can tell precisely what those future earnings are going to be. Much less can you tell precisely what the correct capitalization rate is to apply to such earnings.

My own method for finding a "normal multiplier" is to take a group of securities like the Dow-Jones Industrials as a whole, which is a better than average group of stocks but does not consist of only the very best. A multiplier about equivalent to twice the long-term interest rate on high-grade bonds would yield a pretty good idea of the normal value of this group. That multiplier should be applied to ten-year average earnings rather than to single-year earnings, which cannot be accepted as the basis for sound valuation. This procedure would currently yield multipliers of between 15 and 17 for the Dow-Jones group.

One might say that securities of a better quality than this list as a whole would be entitled to a higher rate. But I have found from experience that when you get beyond a multiplier of 20 you are definitely moving over into the subjective or speculative area. You are beginning to rely a good deal on what investors are likely to think of your stock in the future. Conversely, of course, companies of poorer quality than the Dow-Jones list may be expected to have lower multipliers, going down to as low as 10 or 8.

You can also value good stocks not by taking past earnings and applying a high multiplier, but by taking estimated future earnings which are high and using a normal multiplier. Now what actually
happens - the way the stock market often does it - is to estimate high future earnings and to use a high multiplier in addition. There is then a tendency to count the same trick twice. As a result, you find that the larger part of the price of high-grade companies may reflect merely the subjective views of the investors, and the degree of confidence that they have at the moment in the future of these companies. That is the characteristic which is subject, inescapably, to a wide degree of variation. The psychological mood of people changes more drastically than anything else in finance. Human nature changes least of all. So what you have is a combination of great fluctuations in the mood of investors, and practically no change at all in their essential characteristics. That is the "built-in destabilizer" of the stock market - the factor that can make for market fluctuations irrespective of overall economic stability.

Let me add just one word as to the role of mutual funds in this picture. I think that on the whole they will be a strengthening element rather than a weakening element in the future, in comparison, at least, with the ownership of the same securities by individuals. The easiest way to talk about this is to compare the typical public owner of a mutual fund security with him as the direct owner of the same securities in the fund's portfolio. I think he is much more likely to sacrifice his direct security and act unwisely in relation to it than he is to act unwisely in relation to his mutual funds. An there are reasons for it - especially because it is much easier to be scared about one security that you own than it is to be scared about a hundred.

IV

We must turn now to a discussion of the impact of tax considerations on investment policies and corporate policies in the future. One of my primary reasons for cautioning against thinking that the stock market will be stable in the future because it looks as if the business scene will be stable, is the inexcusably slow reaction of both investors and corporate managements to the impact of tax developments over the past twenty years or more. My point is that if it is going to take more than thirty years for investors to realize what the new tax structure actually means for investment and corporate policies, it might take them another thirty years, or fifty years, before they realize that common stocks are really as good as we may feel they have already proved they are. We have to allow in our thinking for that long a time lag.

We are just beginning to realize that the basic 52 percent corporate tax rate, plus individual tax rates reaching 50 percent on a taxable income of $18,000 for single individuals - that those large rates require rethinking both as to corporate financial policy and investors' attitudes, in comparison with the habits of, say, 1925 or 1900.
Business is now developing some ways of escaping - legitimately, of course - the double tax on corporate earnings. To a small extent this escape may come from statutory relief such as under the 1954 tax bill, which received so much attention. That was a very minor amount of statutory relief. Yet it has already generated considerable political reaction against it, and it seems to me that not a great deal can be expected in that area.

To a much greater extent, I believe, this escape will develop out of a change in corporate and investor policies - a change which will not be interfered with by Congress or by the Treasury because Washington has a bad conscience on this matter of double taxation of corporate profits.

If either the corporate impost or the individual impost on earnings can be saved, the net result is typically a doubling of the effective income of the present stockholder. That is a very important objective, and I think that the inducement is so great that the people in Wall Street will finally be moved to do the correct things instead of the foolish things in corporate policy, in spite of their laziness in thinking and acting.

This escape will take one of two forms: either escaping the corporate tax on some of the earnings, or escaping the individual tax on those earnings. The saving in corporate taxes will be effected by the substitution of debt - primarily income debt - for preferred stocks and for guaranteed or preferred securities; and to some extent, I believe, by the substitution of a certain degree of debt for common stocks in present, all common-stock capitalization structures.

1. Corporations have been accustomed to use preferred stocks in place of income bonds because preferred stocks were not a contractual obligation for either interest or principal, and bonds were. It seemed to be, and of course it was, more prudent for corporations to issue preferred stocks if they could sell them at reasonable prices. There is now a penalty on this which did not exist thirty years ago, namely, that it costs the corporation twice as much for its money when it sells preferred stock as when it sells a bond with the same interest rate.

It's interesting to note, first, that most bonds carry lower interest rates than preferred stock, so that the actual ratio is even higher than two to one in cost. Secondly, the income bond that has been developed now virtually relieves the corporation from any important or serious obligation that is heavier than exists in a good preferred stock; because the interest has to be paid only if earned, the principal is due many years hence, and the income tax saving itself can be used to pay off the principal, so that by the time the maturity arrives you have nothing to pay off. The tax
saving on an income bond, if substituted for a preferred stock, will, if used as a sinking fund, retire the entire principal amount of the security within about a 22-year period in a typical case.

This combination of factors has, I think, very great advantages for a corporation. For the individual investor there are advantages too. He of course tends to have a somewhat better security in a typical income bond than in a typical preferred stock of the same kind of corporation. That does not mean that a preferred stock of a strong corporation is not as good as an income bond of a bad one. But in the same situation, the income bond is somewhat better because there is somewhat more assurance of regularity of interest payment even though the corporation may not absolutely have to pay it. And eventually I think you will see - and this won’t take very long - that income bonds will be appraised in terms of the actual financial position of the corporation issuing them instead of in terms of the prejudice against the income bond as a vehicle itself or as a form of security. The individual pays no higher tax on income bond interest than he does on preferred stock - except for the small credit allowed in the 1954 law - and the differences in yield are a pretty minor matter as it stands now. Corporations, of course, have a greater tax advantage in owning preferred stocks as against owning income bonds, but there are not many corporate owners of importance of preferred stocks.

The substitution of income debt for preferred stock (and of other debt for guaranteed stocks), is already in full swing in the railroad field. One of the astonishing things, to me, is the rapidity with which railroads have been substituting income bonds for preferred stock in the last year or two. I have had some personal contact with it because I am a director of the Western Pacific Railroad and we were the first railroad to retire our preferred stock and issue income bonds in place of it. I foresee the fairly rapid extension of this development to non-railroad companies. But it will require the abandonment by investors of their prejudice against income bonds, which they have generally felt are inferior in quality to preferred stock - a prejudice which grew out of the fortuitous circumstance that, in the past, income bonds were mainly the product of railroad reorganizations and therefore a product of financial troubles of the companies involved.

2. The other avenue of escape from double taxation for individuals is via the acceptance of stock dividends - or even no dividends - in place of cash dividends. In the dynamic parts of our corporate economy, notably in the public utilities field, the present practice of paying cash dividends and then taking the same money back from the same people through the sale of new common stock is really a very ingenious device for paying double taxes without any necessity or real excuse. It should be borne in mind that large-scale corporate expansion is an essential ingredient in any future
prosperity and employment, and consequently many corporations will need in the future, as they have in recent years, to continue to increase their equity capital regularly. I am sure that before too long they will devise practical and painless measures for substituting periodic stock dividends or perhaps some other device for the customary but quite irrational practice of paying cash dividends subject to personal income tax, and then selling the equivalent amount of stock to the same people who get the dividends.

I am well aware that in the past investors had a very large preference for dividends, especially as compared with undistributed earnings. My studies show that in the past the ratio was as high as 4 to 1, for the value of a dollar of distributed earnings against undistributed earnings. But I think that this is changing. It may change very rapidly, and this development will be aided by the device of the periodic stock dividend, which is a very convenient way of letting the stockholder eat his cake and let the corporation have it too. I believe that this device, when its practical merits are understood, will eventually reach the stage where the stock dividend will be accepted as fully equal to a cash dividend.

To understand this point better, let us take public utility common stockholders as a whole. It should be quite obvious that they do not buy their stocks for income. While they may think they buy them for income, they do not do so in actual fact — that is, for income to live on — because practically all the utilities are constantly offering additional stock to their stockholders, and these are using their money — their dividend money, let us say, diminished by taxes — to buy the additional shares. The greater proportion of stockholders are doing that. In the case of Pacific Gas and Electric, for example, about 60 percent of their stockholders actually exercise these recurrent rights. That really means that these stockholders have to put up twice as much money, or more, for the new stock than they're getting in dividends. There are a number of individual cases, of course, where people do need dividend income for living purposes. But I think that if anyone took a census he would be surprised at how few there really are in relation to the total. These people could easily get the equivalent of their cash income, by selling their stock dividends currently; and not only would they get the same income but they would have to pay a very small tax indeed on the proceeds as against paying a larger tax on an equivalent amount of dividends.

As a sidelight on this issue, I might mention the recent successful sale of stock issues in Canadian investment funds, where the investor is told that he will not receive any dividends at all. Yet he is happy to buy on that basis, because all his profits will eventually be realized in the form of capital gains subject to a much lower tax. The amusing thing about it is that it all depends on the language used to sell and the consequent attitude of the
investors. For, if another company came along and said, "I have good news for you stockholders - we're not going to pay you dividends any more," the reaction would be completely different.

There is an additional important factor in the business picture which is in part related to the tax situation but mainly to other considerations. In the past few years new capital spending has been pretty well pegged at the enormous figure of some $25 to $28 billion annually, which is about five times the 1939, or pre-World War II level. This is beginning to have a consequence in the corporate field, and the field of investment security values, which some of us foresaw a number of years ago and which we were surprised to see so long delayed. That is a tendency, developing apace, for profitable, prosperous, expanding companies to acquire smaller and less profitable ones as a partial substitute for the construction of new facilities and other types of expansion. Most of these acquisitions have been possible at a price far below the present construction costs of new fixed assets. In addition to acquiring the assets themselves, not perhaps of an ideal character but nevertheless usable, at a low cost, the acquiring corporation obtains an established sales volume, experienced personnel, and other advantages.

This trend is important for the more sophisticated investors to watch. It represents, in effect, a partial offset to the contrary tendency for profitable companies to sell at increasing premiums in the stock market, while the less profitable companies tend to sell at increasing discounts - I refer to premiums or discounts from book value or from any other established norm of value.

To an important degree the tax factor also enters into this picture of corporate acquisitions. It is not only the operating losses of the past, but even losses in going-concern value as against cost or other income-tax-base values, which may be recouped to the extent of about 50 percent by various types of permissible inter-business deals. This factor tends to mitigate to some extent the shrinkage in value of unprofitable businesses. What I am really driving at is the fact that, in theory, any corporation which started out with dollars of value and now has only 50 percent in going-concern value can in one form or another recoup one-half of that loss through the proper arrangements with other corporations. That is very theoretical, but it has a number of practical implications which the experienced investor should watch rather carefully.
My final point is related directly to the subject of non-prosperous businesses. I see on the investment horizon a slow development of a commonsense attitude in the field of management-stockholder relations. The present flurry of proxy battles and endeavors to capture control of businesses are indications of something approaching a stockholders' revolution. The issues are easily confused by personal factors and by personal attacks of all sorts, but at the bottom they are quite simple. Stockholders have a right to ask for efficient management and for successful results within the limits imposed by the economics of their industry. If the results are not satisfactory, the least the management can do is to show convincingly that it is aware of the fact, and that it is making every effort to remedy the situation.

As I see the future - and this is quite a jump ahead to far horizons - we shall gradually develop some simple and workable criteria to determine whether or not a company is being properly run, and then certain standard procedures for remedying the situation where it needs to be remedied. For countless years past it has been customary for the disgusted stockholders of a badly managed company to part with their shares. In the future, the stockholders of such a company may decide instead to part with their management.

To sum up what I have had to say: Barring atomic war, I see a generally favorable future for long-term investment, particularly investment 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 bull and bear markets in the future as in the past, and that for every 10 percent of over-valuation in bull markets we are still likely, as before, to see a corresponding 10 percent of under-valuation in the succeeding decline. I predict a gradual but decisive change in corporate practices and in 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.