

STATEMENT OF BENJAMIN GRAHAM
BEFORE COMMITTEE ON BANKING AND CURRENCY
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Please Return

My name is Benjamin Graham. I live in Scarsdale, New York. I am Chairman of Graham-Newman Corporation, a registered investment company or "investment fund." I am also Adjunct Professor of Finance at the Graduate School of Business, Columbia University.

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 Industrials. (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.

The true measure of common stock 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 ten years. This information, together with certain other data, appears on the appended table.

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 of the subsequent declines from past bull market highs. Since the Dow-Jones Average lost 90 percent 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.

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 ten 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 1945 at a time when the Dow-Jones Average stood at 185. (This was published in The Commercial and Financial Chronicle, October 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. Contrarywise, 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 investor will require him to lighten significantly his holdings of common 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--or perhaps a little better--of seeing the market attain substantially higher than present heights, subject to the probability of intervening reactions. But his chance of eventually holding on to the profits he makes beyond the current level, we should term no better than in former bull markets--and that is none too good.

(B) Reasons for Market Rise Since September 1953

In general, I agree with the answers by President Funston of The New York Stock Exchange to Question 1 of the Committee's Questionnaire.

However, I should like to emphasize more than he did the role of investment and speculative sentiment in determining the wide variations in stock market prices.

In my view, the fundamental reason for the rise was the swing from doubt to confidence--from emphasis on the risks in common stocks to the emphasis on the opportunities in common stocks.

There has been no change of importance in the earnings of the Dow-Jones Industrial Average since 1949. (Actually, however, earnings of most secondary companies fell a great deal in 1953-1954 from the levels of the previous five years.) But prior to 1954, the public was expecting a substantial setback and was braced for a large falling off in earnings when business turned down after the middle of 1953. It was the mildness of the shrinkage--especially in Gross National Product and Disposable Incomes--that reversed the tide of sentiment and gave currency to the view that we no longer

have to fear deep depressions.

This change in sentiment produced a change in the public's valuation of stocks, especially in what it considered suitable multipliers of current earnings. In effect, the multiplier advanced from about 8 for the Dow-Jones Industrials in 1948-1950 to 10 in 1953, and to a current 14, which is slightly less than the 1936-1940 average.

My studies have led to the conclusion that sentiment alone, not supported by any visible change in value, will produce a swing on the order of 100 to 250 or 100 to 300 in price. It is interesting to note that while American Telephone and Telegraph has paid a uniform dividend of \$9 since 1922, and while its earnings have fluctuated comparatively little, its price advanced from 115 in 1922 to 310 in 1929, declined to 70 in 1932, and since then it has fluctuated between lows of about 110 and highs of about 200.

Among the secondary companies, the present situation is more complicated. Prices were very low as against earnings prior to 1953, but many of these companies had poor earnings results in 1953-1954. The price behavior of this large group lagged behind the blue-chip advance until July 1954. Recently the rise in secondary issues has more than kept pace with that of the leaders. Bargains are fast disappearing and there are numerous instances of over-speculation in this field. On the whole, however, the typical second-grade stock appears less over-valued today than it was in early 1946.

C. Feasible Ways of Controlling Undue Speculation in the Future

I believe the Committee should consider carefully and cautiously whether any plan of control is feasible. Speculation has not gone too far as yet, but there may be a grave danger that it will do so. Assuming that measures could be found that are useful and feasible, it would be wise to agree to such measures in advance of the necessity for their use--rather than to begin discussing them while the fire is raging.

It should be recognized that any form of intervention by Washington in the stock market is risky and controversial. You cannot be sure that what you are doing is the right thing and won't cause more harm than good. . . (In this respect your problem corresponds to the public's own quandary in deciding whether to buy or sell or sit tight in the present market.) Yet, despite the hazards of any intervention, a certain responsibility is there.

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On balance, I am inclined to favor strict controls for margin trading requirements to correspond somewhat with the state of speculation.

and a fairly rapid advance to the 100 percent margin limit--i.e., no borrowing at all--as the Federal Reserve becomes increasingly concerned about the extent of speculation. My reason is that it is basically unsound for nonprofessionals to borrow money to speculate in stocks--or in anything else. It is unsound for them and for the economy as a whole. Responsibility should also be placed upon our commercial banks to avoid, in general, the direct lending of money to the public for the purpose of speculating in stocks.

The Capital Gains Tax

Much has been made of the Capital Gains Tax as a deterrent to the selling of stocks. It is urged that this tax be abolished or cut in two, in order to increase the supply of stocks by "unfreezing" holdings showing large profits. There is some merit in this contention, and I shall have a suggestion to make along these very lines. But I regret that the issue has usually been presented by Wall Street--of which I am proud to consider myself a part--in an incomplete and rather one-sided fashion.

Taxes on capital gains have been imposed since the modern income tax began in 1913. Thus the problem of their impact on speculative markets is by no means a new one. The evidence hardly suggests that the Capital Gains Tax has by itself produced unduly high prices or unduly wide fluctuations. Impressive arguments may be made against Capital Gains Taxes as inequitable in theory and unsound in practice; but there are also impressive arguments against permitting capital gains to go untaxed while imposing high rates on other forms of profit. Although I believe the present Capital Gains Tax system is open to improvement, I would not consider it basically inequitable in relation to our tax burden as a whole. Finally, while a lightening of the tax might well increase the supply of common stocks by persuading holders to take large profits, it might at the same time stimulate further speculative buying, attracted by the new tax advantage. The net result of such a move cannot be foretold.

The objections to reducing the Capital Gains Tax would be overcome, in my opinion, if such a policy were adopted for a limited period of time only and for the specific purpose of dealing with a dangerous stock market situation. For example, the tax might well be reduced from the present 25 percent maximum