

# Common Sense Investing: The Papers of Benjamin Graham



Written by

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# **PART I**

## **THE INVESTOR AND THE MARKET**

## **Investment vs. Speculation**

One of the disastrous consequences of the New Era madness in Wall Street has been the disappearance of the former clean-cut distinctions between investment and speculation in common stocks. Old-time investment, with its emphasis on book value and the past record, was shortsighted and naive, but it possessed the supreme virtue of moderation. Present-day "investment," as practiced by investment trusts and everyone else, is not much more than an undisciplined wagering upon the future and as such logically indistinguishable from speculation.

Common stocks have one important characteristics and one important speculative characteristic. Their investment value and average market price tend to increase irregularly but persistently over the decades, as their net worth builds up through the reinvestment of undistributed earnings-- incidentally, with no clear-cut plus or minus response to inflation. However, most of the time common stocks are subject to irrational and excessive price fluctuations in both directions, as the consequence of the ingrained tendency of most people to speculate or gamble--i.e., to give way to hope, fear and greed.

In the easy language of Wall Street, everyone who buys or sells a security has become an investor, regardless of what he buys, or for what purpose, or at what price, or whether for cash or on margin. Compare this with the attitude of the public toward common stocks in 1948, when over 90 percent of those queried expressed themselves as opposed to the purchase of common stocks. About half gave as their reason "not safe, a gamble," and about half, the reason "not familiar with."

It is indeed ironical (though not surprising) that common-stock purchases of all kinds were quite generally regarded as highly speculative or risky at a time when they were selling on a most attractive basis, and due soon to begin their greatest advance in history; conversely the very fact they had advanced to what were undoubtedly dangerous levels as judged by past experience later transformed them into "investments" and the entire stock-buying public into "investors."

We must recognize that the situation existing today is not typical of all bear markets. Broadly speaking, it is new and unprecedented. It is a strange, ironical aftermath of the "new era" madness. It reflects the extraordinary results of profound but little understood changes in the financial attitude of the people, and the financial fabric of the country.

Two plausible and seemingly innocent ideas, the first that good stocks are good investments; the second, that values depend on earning power--were distorted and exploited into a frenzied financial gospel which ended by converting all our investors into speculators, by making our corporations rich and their stockholders poor, by reversing the relative importance of commercial loans and Wall Street loans, by producing topsy-turvy accounting policies and wholly irrational

standards of value--and in no small measure was responsible for the paradoxical depression in which we find ourselves submerged.

Behind the simple fact that a great many stocks are selling for much less than their working capital lies a complex of causes, results and implications. The remainder of this article will deal with the causes of the present unique situation, while other ramified aspects will be developed in succeeding articles. The current contrast between market prices and liquid assets is accounted for in large measure by the huge flood of new cash which stockholders in recent years have poured into the treasuries of their corporations by the exercise of subscription rights. This phenomenon, which was one of the distinguishing features of the 1928-1929 bull market, had two quite opposite consequences. On the one hand the additional funds received greatly improved the companies' cash and their working capital position; on the other hand the additional shares issued greatly increased the supply of stocks, weakened their technical position, and intensified their market decline. The same circumstance, therefore, served both to improve the values behind a stock and to depress the price.

It is doubtful, however, that the declines would have gone to the current extraordinary lengths if during the last decade investors had not lost the habit of looking at balance sheets. Much of the past year's selling of stocks has been due to fear rather than necessity. If these timid holders were thoroughly aware that they were selling out at only a fraction of the liquid assets behind their shares, many of them might have acted differently. But since value has come to be associated exclusively with earning power, the stockholder no longer pays any attention to what his company owns--not even its money in the bank.

It is undoubtedly true that the old-time investor laid too much stress upon book values and too little upon what the property could earn. It was a salutary step to ignore the figures at which the plants were carried on the books, unless they showed a commensurate earning power. But like most sound ideas in Wall Street, this one was carried too far. It resulted in excessive emphasis being laid on the reported earnings--which might only be temporary or even deceptive--and in a complete eclipse of what had always been regarded as a vital factor in security values, namely the company's working capital position.

Businesses have come to be valued in Wall Street on an entirely different basis from that applied to private enterprise. In good times the prices paid on the Stock Exchange were fantastically high, judged by ordinary business standards; and now, by the law of compensation, the assets of these same companies are suffering an equally fantastic undervaluation. A third reason that stocks now sell below their liquid asset value is the fear of future operating losses. Many readers will assert that this is the overshadowing cause of the present low market level. These quotations reflect not only the absence of earning power, but the existence of "losing power" which threatened to dissipate the working capital behind the shares today.

Being against speculation is almost like being against sin. But speculation really is a sin to the untrained member of the public. The ordinary man is more apt to get poorer by speculating on the market. A man can earn some money by taking a sensible attitude toward investment, but I don't see how a man can earn money by being an untrained speculator. He just doesn't put enough into it to justify the hopes of getting something out of it.

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Equally important and dangerous, in my eyes, is the ready acceptance by security analysts of the going market levels and earnings-multipliers as the proper standard of value and of comparison for any issue under study. The new analytical concepts of growth-stock valuation, of "cash flow," of the desirability of tax-free dividends from companies which are triumphantly able to report earnings deficits – all have enough plausibility and lack of inner discipline to lead both investors and speculators far astray. In sum, the new investment theories and techniques remind me very much of 1928-29, and the outpouring of common-stock issues of secondary and lower-degree enterprises reminds me equally of 1919.

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There is at least superficial similarity between the prices offered in takeovers and those formerly ruling in the market for the first-tier issues, as represented by "the favorite fifty". The large institutions have acted somewhat in the role of conglomerates extending their empires by extravagant acquisitions. The P/E ratio of Avon Products averaged 55 in 1972, and reached 65 at the high of \$140 per share. This multiplier could not have been justified by any conservative valuation formulae such as those we have been discussing. It was not made by speculators in a runaway bull market: it had the active or passive support of the institutions that have been large holders of Avon.

As I see it, institutions were persuaded to pay outlandish multipliers for shares of the Avon type by a combination of three influences: First, the huge amounts of money they have to administer, most of which they decided to place in equities. Second, the comparatively small number of issues to which their operations were confined, in part because they had to choose multi-million-share companies for their block transactions, and partly by their insistence on high-growth prospects. The third influence was the cult of performance, especially in pension-fund management. The arithmetic here is deceptively simple. If a company's earnings will increase 15 percent this year, and if the P/E ratio remains unchanged, the presto! The "investment" shows a 15 percent performance, plus the small dividend. If the P/E ratio advances – as it did for Avon in almost every year – the performance becomes that much better. These results are entirely independent of the price levels at which these issues are bought. Of course, in this fantasia the

institutions were pulling themselves up by their own bootstraps – something not hard to do in Wall Street, but impossible to maintain forever.

These institutional policies raise two implications of importance to financial analysts. First, what should a conservative analyst have done in the heady area and era of high-growth, high-multiplier companies? I must say mournfully that he would have to do the near impossible – namely, turn his back on them and let them alone. The institutions themselves had gradually transformed these investment-type companies into speculative stocks. I repeat that the ordinary analyst cannot expect long-term satisfactory results in the field of speculative issues, whether they are speculative by the company's circumstances or by the high price levels at which they habitually sell.

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#### *A Warning of Speculative Excesses*

Records show that stock market declines have tended to be proportional to their previous advance. Thus, the 6 largest advances averaging 63% of the high level reached were followed by declines averaging 46% while the other following 6 advances, averaging 38% at the peak produced declines averaging 37%.

Another measure is based on the principle that the higher the market advances above a computed normal, the further it is likely to decline below such normal. If this principle were to hold in the future as in the past, then further rises of present market levels will actually carry with it an intensified future penalty. The almost universal optimism that accompanies those great advances in stock market precludes even the most conservative observer from imagining an equally drastic decline.

Past experience suggests that optimism and confidence have always accompanied bull markets; they have grown as the bull market advances, otherwise the bull markets could not have continued to their dizzy levels – and they have been replaced by distrust and pessimism once the bull markets collapse.

As may be expected, the previous period of greatest enthusiasm about the economic prospects of the US coincided with the tumultuous bull market of the 1920's. Then, almost everyone was convinced that we had entered a "New Era" of continued and dynamic prosperity which made all past market experience worse than useless. The phrase "New Era" became almost the official description of the American economy of 1928-1929. It is a bit ironical to note that today, nearly everyone is again convinced that we have entered into a new era of sustained and dynamic

prosperity, but also that everyone is careful not to use the convenient word “New Era” because they would remind us too uncomfortably of what happened in and after 1929.

In the 1920’s, also, the new idea that good common stocks are intrinsically sounder than bonds gained ground rapidly. The financial services explained away the apparent dangers of stock yields below bond yield on the ground that the growth factor would eventually more than repay the stock buyer for his present sacrifice of income sacrifice.

I arrive finally at a “law” about human nature that cannot be repealed and it is unlikely to be modified to any great extent. This law says that people without experience or superior abilities may make a lot of money fast in the stock market, but most cannot keep what they make, and most of them will end up as net losers. (This is true even though the long-term trend of stock prices has been definitely upward.)

This is a particular application of a much wider natural law which may be stated simply as: “There is no such thing as a free lunch,” for those too young to remember, was offered in the good old days to patrons of the corner saloon.

The stock market has undoubtedly reached a stage where there are many people interested in free lunches. The extraordinary price levels of stock of rather new companies in the electronics and similar fields, the spate of new common-stock offerings of small enterprises at prices twenty five or more times their average earnings and three times their net worth (with immediate price advances upon issuance), the completely unwarranted price discrepancies indicate reckless elements in the present stock market picture which foretell serious trouble ahead, if past experience means anything at all.

Let me conclude with one of my favorite clichés – the French saying: “The more it changes the more it’s the same thing.” I have always thought this motto applied to the stock market better than anywhere else. Now the really important part of this proverb is the phrase “the more it changes.” The economic world has changed radically and it will change even more. Most people think now that the essential nature of the stock market has been undergoing a corresponding change. But if my cliché is sound – and a cliché’s only excuse, I suppose, is that it is sound – then the stock market will continue to be essentially what it always was in the past – a place where a big bull market is inevitably followed by a big bear market. In other words, a place where today’s free lunches are paid for doubly tomorrow. In the light of experience, I think the present level of the stock market is an extremely dangerous one.

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A growth company is one which (a) will be expanding its business and it profits at more than average rate, and (b) will in the course thereof be investing a large part of its profits back in the business. It's hard to tell how good your knowledge is in these companies because growth stocks lead to the future, and you don't really ever have any knowledge of the future. You may have a more expert guess than others, but it's still a guess. And many mistakes have been made in buying growth stocks on the theory that the future will duplicate the past.

The risk is basically related to paying a higher price for a security in terms of its past and current earnings and dividends than you would for a non-growth security, and there is always a possibility of disappointment. The company would have to be better than the average company to justify the price you pay for it. Maybe it won't be, but you think it will.

The speculative risks attached to high-growth stocks have been brought home dramatically in the past 18 months by the price declines in many of these favorites.

### **The Unsound Logic of Wall Street**

Suppose you were the owner of a large manufacturing business. Like many others, you lost money in 1931; the immediate prospects are not encouraging; you feel pessimistic and willing to sell out--cheap. A prospective purchaser asks you for your statement. You show him a very healthy balance sheet, indeed. It shapes up something like this:

Cash and U.S. Gov. Bonds	\$8,500,000
Receivables and Merchandise	\$15,000,000
Factories, Real Estate, etc	\$14,000,000
Total	\$37,500,000
Less owing for current accts	\$1,300,000
Net Worth	\$36,200,000

The purchaser looks it over casually, and then makes you a bid of \$5,000,000 for your business--the cash, Liberty Bonds and everything else included. Would you sell? The question seems like a joke, we admit. No one in his right mind would exchange 8 1-2 millions in cash for five million dollars, to say nothing of the 28 millions more in other assets. But preposterous as such a transaction sounds, the many owners of White Motors stock who sold out between \$7 and \$8 per share did that very thing--or as close to it as they could come.

The figures given above represent White Motors condition on December 31st last. At \$7 3/8 per share, the low price, the company's 650,000 shares were selling for \$4,800,000--about 60 per cent of the cash and equivalent alone, and only one-fifth of the net quick assets. There were no

capital obligations ahead of the common stock, and the only liabilities were those shown above for current accounts payable.

The spectacle of a large and old established company selling in the market for such a small fraction of its quick assets is undoubtedly a startling one. But the picture becomes more impressive when we observe that there are literally dozens of other companies which also have a quoted value less than their cash in bank. And more significant still is the fact that an amazingly large percentage of all industrial companies are selling for less than their quick assets alone--leaving out their plant and other fixed assets entirely.

This means that a great number of American businesses are quoted in liquidating value; that in the best recent judgment of Wall Street, these businesses are worth more dead than alive.

For most industrial companies should bring, in orderly liquidation, at least as much as their quick assets alone. Admitting that the factories, real estate, etc. could not fetch anywhere near their carrying price, they should still realize enough to make up the shrinkage in the proceeds of the receivables and merchandise below book figures. If this is not a reasonable assumption there must be something radically wrong about the accounting methods of our large corporations.

A study made at the Columbia University School of Business under the writer's direction, covering some 600 industrial companies listed on the New York Stock Exchange, disclosed that over 200 of them--or fully one out of three--have been selling at less than their net quick assets. Over fifty of them have sold for less than their cash and marketable securities alone. In the appended table is given a partial list, comprising the more representative companies in the latter category.

What is the meaning of this situation? The experienced financier is likely to answer that stocks always sell at unduly low prices after a boom collapses. As the president of the New York Stock Exchange testified, "in times like these frightened people give the United States of ours away." Or stated differently, it happens because those with enterprise haven't the money, and those with money haven't the enterprise, to buy stocks when they are cheap. Should we not find the same phenomenon existing in previous bear markets--for example, in 1921?

The facts are quite otherwise, however. Stocks sold at low prices in the severe post-war depression, but very few of them could be bought on the Stock Exchange for less than quick assets, and not one for less than the company's available cash.

The comparative figures for both periods, covering representative companies, are little short of astounding, especially when it is noted that they showed no materially poorer operating results in 1931 than in 1921. Today, these companies are selling in the aggregate for half their working

capital; ten years ago working capital was only half the bottom prices. With respect to cash assets alone, present prices are relatively six times lower than in 1921.

We must recognize, therefore, that the situation existing today is not typical of all bear markets. Broadly speaking, it is new and unprecedented. It is a strange, ironical aftermath of the "new era" madness of 1921-1929. It reflects the extraordinary results of profound but little understood changes in the financial attitude of the people, and the financial fabric of the country.

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But since value has come to be associated exclusively with earning power, the stockholder no longer pays any attention to which his company owns--not even its money in the bank. It is undoubtedly true that the old-time investor laid too much stress upon book values and too little upon what the property could earn. It was a salutary step to ignore the figures at which the plants were carried on the books, unless they showed a commensurate earning power.

But like most sound ideas in Wall Street, this one was carried too far. It resulted in excessive emphasis being laid on the reported earnings--which might only be temporary or even deceptive--and in a complete eclipse of what had always been regarded as a vital factor in security values, namely the company's working capital position. Businesses have come to be valued in Wall Street on an entirely different basis from that applied to private enterprise. In good times the prices paid on the Stock Exchange were fantastically high, judged by ordinary business standards; and now, by the law of compensation, the assets of these same companies are suffering an equally fantastic undervaluation.

A third reason that stocks now sell below their liquid asset value is the fear of future operating losses. Many readers will assert that this is the overshadowing cause of the present low market level. These quotations reflect not only the absence of earning power, but the existence of "losing power" which threatened to dissipate the working capital behind the shares today.

Is it true that one out of three American businesses is destined to continue losing money until the stockholders have no equity remaining? This is what the stock market says in no uncertain terms. In all probability it is wrong, as it always has been wrong in its major judgments of the future.

The logic of Wall Street is proverbially weak. It is hardly consistent, for example, to despair of the railroads because the trucks are going to take most of their business, and at the same time to be so despondent over the truck industry as to give away shares in its largest units for a small fraction of their liquid capital alone.

But since even in prosperous times many undertakings fall by the wayside, it is certain that the number of such ill--starred ventures must now be greatly increased. The weakly situated business will find it difficult, perhaps impossible, to survive. Hence in a number of individual cases the market's prophecy of extinction will be borne out. Nevertheless, there must still be a basic error in this wholesale dumping of shares at a small fraction of liquidating value.

If a business is doomed to lose money, why continue it? If its future is so hopeless that it is worth much less as a going concern than if it were wound up, why not wind it up? Surely the owners of a business have a better alternative than to give its present cash away, for fear that it is later going to be dissipated. We are back to the contrast between the White Motors stockholder and the individual factory owner, with which we started our article.

The issue is merely one of simple logic. Either White Motors is worth more as a going concern than its cash in bank, or it is not. If it is worth more, the stockholder is foolish to sell out for much less than this cash, unless he is compelled to do so. If it isn't the business should be liquidated and each stockholder paid out his share of the cash plus whatever the other assets will bring.

Evidently stockholders have forgotten more than to look at balance sheets. They have forgotten also that they are owners of a business and not merely owners of a quotation on the stock ticker. It is time, and high time, that the millions of American shareholders turned their eyes from the daily market reports long enough to give some attention to the enterprises themselves of which they are the proprietors, and which exist for their benefit and at their pleasure.

The supervision of these businesses must, of course, be delegated to directors and their operation to paid officials. But whether the owners' money should be dissipated by operating losses, and whether it should be tied up unproductively in excessive cash balances while they themselves are in dire need of funds, are questions of major policy which each stockholder must ponder and decide for himself.

These are not management problems; these are ownership problems. On these questions the management's opinion may be weighty but it is not controlling.

What stockholders need to-day is not alone to become "balance sheet conscious," but more than that, to become "ownership conscious." If they realized their rights as business owners, we would not have before us the insane spectacle of treasuries bloated with cash and their proprietors in a wild scramble to give away their interests on any terms they can get. Perhaps the corporation itself buys back the shares they throw out of irony; we see the stockholders' pitifully inadequate payment made to them with their own cash.

The waggish barber of the legend painted on his sign:  
What, do you think -- We shave you for nothing and give you a drink!

That, without the saving comma, might well be blazoned as the motto of the stock seller of to-day, who hands over his share in inventories and receivables for less than nothing, and throws in real estate, buildings, machinery and what-not as a lagniappe or trading stamp.

The humor of the situation could be exploited further, but the need is not for witticism but for a straightforward presentation of the vitally important issues that face stockholders, managements, and bankers. These will be dealt with in succeeding articles.

### **The Individual Investor and the Market**

There are two requirements for success in Wall Street. One, you have to think correctly; and secondly, you have to think independently. Most of the stockbrokers, financial analysts, investment advisers, etc., are above average in intelligence, business honesty and sincerity. But they lack adequate experience with all types of security markets and an overall understanding of

common stocks--of what I call "the nature of the beast." They tend to take the market and themselves too seriously. They spend a large part of their time trying, valiantly and ineffectively, to forecast short- and long-term changes in the economy, and in the price level of common stocks, to select the most promising industry groups and individual issues--generally for the near-term future.

My advice would be to study the past record of the stock market, study your own capabilities, and find out whether you can identify an approach to investment you feel would be satisfactory in your own case. And if you have done that, pursue that without any reference to what other people do or think or say. Stick to your own methods. That's what we did with our own business. We never followed the crowd, and I think that's favorable for the young analyst.

If you read *The Intelligent Investor*, which I feel would be more useful than *Security Analysis* of the two books--and select from what we say some approach which you think would be profitable, then I say that you should do this and stick to it. I had a nephew who started in Wall Street a number of years ago and came to me for some advice. I said to him, "Dick, I have some practical advice to give you which is this. You can buy closed-end investment companies at 15 percent discounts on an average. Get your friends to put "x" amount of dollars a month in these closed-end companies at discounts and you will start ahead of the game and you will make out all right." Well, he did that. He had no great difficulty in starting his business on that basis. It did work out all right and then the big bull market came along and, of course, he moved over to other fields and did an enormous amount of speculative business later. But at least he started, I think, on a sound basis. And if you start on a sound basis, you are half-way along.

The simplest advice I can give is to value companies as a private businesses. If you can look at a company and say that at this price for the stock the whole enterprise is selling at a figure which is clearly less than it would be worth to me if it were my business, if I owned it -- you can divide the figures by 10 or 100 to make them comparable to the kind of business you are familiar with in private practice. If that test shows that the price is quite low, then it's generally a reasonably good guide to your evaluation of the stock itself. In some cases, the very fact that the company is selling considerably under the working capital alone, with no value given to all the fixed assets, is a prima facie indication that the price is too low.

If you select good stocks, determine and specify that the price is within a range of fair value. If you select a growth stock, determine and specify the round amount which the buyer at the current price is already paying for the growth factor as compared with its reasonable price if the growth prospects were only average.

All investors want good results from their investments, and are entitled to them to the extent that they are actually obtainable. I see no reason why they should be content with results inferior to those of an indexed fund or pay standard fees for such inferior results.

The typical investor has a great advantage over the large institutions chiefly because these institutions have a relatively small field of common stocks to choose from--say 300 to 400 huge corporations--and they are constrained more or less to concentrate their research and decisions on this much over-analyzed group. By contrast, most individuals can choose at any time among some 3000 issues listed in the Standard & Poor's Monthly Stock Guide. Following a wide variety of approaches and preferences, the individual investor should at all times be able to locate at least one per cent of the total list--say, 30 issues or more--that offer attractive buying opportunities.

A suggestion I can make is that if you were sure that you could follow a dollar-averaging program, you could start [investing] right away. Dollar averaging is a method of investment under which you set aside regularly a fixed amount of money and invest it in common stocks generally, either in a single common stock or preferably in a group investment through investment-company shares. By investing the same amount of money at regular intervals – say, every three months, you get two advantages. One is that over the years your investment reflects the average market price rather than the high market levels – which is where you are likely to buy if you follow the crowd.

Secondly, the arithmetic of dollar averaging gives you more shares at the lower prices than at the higher prices, so that your average cost is lower than the arithmetic average. If you are putting \$1,000 in one kind of stock and the price is \$10, you'd get 100 shares. If later it's \$20, you'd get 50 shares. You bought more stock at the \$10 basis than at \$20. Consequently your average price would be less than \$15.

Let me suggest three rules for individual investor regarding investment policy: (1) The individual investor should act consistently as an investor and not as a speculator. This means, in sum, that he should be able to justify every purchase he makes and each price he pays by impersonal, objective reasoning that satisfies him that he is getting more than his money's worth for his purchase--in other words, that he has a margin of safety, in value terms, to protect his commitment. (2) The investor should have a definite selling policy for all his common stock commitments, corresponding to his buying techniques. Typically, he should set a reasonable profit objective on each purchase--say 50 to 100 per cent--and a maximum holding period for this objective to be realized--say, two to three years. Purchases not realizing the gain objective at the end of the holding period should be sold out at the market. (3) Finally, the investor should always have a minimum percentage of his total portfolio in common stocks and a minimum percentage in bond equivalents. I recommend at least 25 per cent of the total at all times in each category. A good case can be made for a consistent 50-50 division here, with adjustments for

changes in the market level. This means the investor would switch some of his stocks into bonds on significant rises of the market level, and vice-versa when the market declines. I would suggest, in general, an average seven- or eight-year maturity for his bond holdings.

I am no longer an advocate of elaborate techniques of security analysis in order to find superior value opportunities. This was a rewarding activity years ago when our textbook "Graham and Dodd" was first published; but the situation has changed a great deal since then. In the old days any well-trained security analyst could do a good professional job of selecting undervalued issues through detailed studies; but in the light of the enormous amount of research now being carried on, I doubt whether in most cases such extensive efforts will generate sufficiently superior selections to justify their cost. To that very limited extent I'm on the side of the "efficient market" school of thought now generally accepted by the professors.

I will also like to suggest that the average member of the public, who does not make a business of buying and selling securities, makes an error in buying securities on margin – most of the time. It would only be under exceptional circumstances that he would be justified in doing so.

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My second inference is a positive one for the investing public and for the analyst who may advise a non-institutional clientele. We have many complaints that institutional dominance of the stock market has put "the small investor at a disadvantage because he can't compete with the trust companies' huge resources, etc. The facts are quite the opposite. It may be that the institutions are better equipped than the individual to speculate in the market; I'm not competent to pass on that. But I am convinced that an individual *investor* with sound principles, and soundly advised, can do distinctly better over the long pull than a large institution. Where the trust company may have to confine its operations to 300 concerns or less, the individual has up to 3000 issues for his investigations and choice. Most true bargains are not available in large blocks; by this very fact the institutions are well-nigh eliminated as competitors of the bargain hunter.

Assuming all this is true we must recur to the question we raised at the outset. How many financial analysts can earn a good living by locating undervalued issues and recommending them to individual investors? In all honesty I cannot say that there is room for 14,000 analysts, or a large proportion thereof, in this area of activity. But I can assert that the influx of analysts into the undervalued sphere in the past has never been so great as to cut down its profit possibilities through that kind of over-cultivation and over-competition. (The value analyst was more likely to suffer from loneliness.) True, bargain issues have repeatedly become scarce in bull markets, but that was not because all the analysts became value-conscious, but because of the general



upswing in prices. (Perhaps one could even have determined whether the market level was getting too high or too low by counting the number of issues selling below working capital value. When such opportunities have virtually disappeared, past experience indicates that investors should have themselves out of the stock market and plunged up to their necks in U.S. Treasury bills.)

### **Portfolio Management Approach**

I favor a highly simplified approach that applies a single criteria or perhaps two criteria to the price to assure that full value is present and that relies for its results on the performance of the portfolio as a whole--i.e., on the group results--rather than on the expectations for individual issues. I can give two examples of my suggested approach. One appears severely limited in its application, but we found it almost unfailingly dependable and satisfactory in 30-odd years of managing moderate-sized investment funds. The second represents a great deal of new thinking and research on our part in recent years. It is much wider in its application than the first one, but it combines the three virtues of sound logic, simplicity of application, and an extraordinarily good performance record.

My first, more limited, technique confines itself to the purchase of common stocks at less than their working-capital value, or net-current-asset value, giving no weight to the plant and other fixed assets, and deducting all liabilities in full from the current assets. We used this approach extensively in managing investment funds, and over a 30-odd year period we must have earned an average of some 20 per cent per year from this source. For a while, however, after the mid-1950's, this brand of buying opportunity became very scarce because of the pervasive bull market. But it has returned in quantity since the 1973-74 decline. In January 1976 we counted over 300 such issues in the Standard & Poor's Stock Guide--about 10 per cent of the total. I consider it a foolproof method of systematic investment--once again, not on the basis of individual results but in terms of the expectable group outcome.

The second approach is similar to the first in its underlying philosophy. It consists of buying groups of stocks at less than their current or intrinsic value as indicated by one or more simple criteria. The criterion I prefer is seven times the reported earnings for the past 12 months. You can use others--such as a current dividend return above seven per cent or book value more than 120 percent of price, etc. We are just finishing a performance study of these approaches over the past half-century--1925-1975. They consistently show results of 15 per cent or better per annum, or twice the record of the DJIA for this long period. I have every confidence in the threefold merit of this general method based on (a) sound logic, (b) simplicity of application, and (c) an excellent supporting record. At bottom it is a technique by which true investors can exploit the recurrent excessive optimism and excessive apprehension of the speculative public.

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At this point let me consider briefly an approach with which we were closely identified when managing the Graham-Newman fund. This was the purchase of shares at less than their working capital value. That gave such good results for us over a forty-year period of decision making that we eventually renounced all other common-stock choices based on the usual valuation procedures, and concentrated on these “sub-asset stocks”. The “renaissance of value”, which we are talking about today involves the reappearance of this kind of investment opportunity. A Value-Line publication last month listed 100 such issues in the non-financial category. Their compilation suggests that there must be at least twice as many sub-working capital choices in the Standard & Poor’s Monthly Stock Guide. (However, don’t waste \$25 in sending for an advertised list of “1000 Stocks Priced at Less Than Working Capital”. Those responsible inexcusably omitted to deduct the debt and preferred stock liabilities from the working capital in arriving at the amount available for the common.)

It seems no more than ordinary sense to conclude that if one can make up, say a 30-stock portfolio of issues obtainable at less than working capital, and if these issues meet other value criteria including the analysts’ belief that the enterprise has reasonably good long-term prospects, why not limit one’s selection to such issues and forget the more standard valuation methods and choices we have previously discussed? I think the question is a logical one, but it raises various practical issues: How long will such “fire sale stocks” – as Value Line called them – continue to be given away; what would be the consequences if a large number of decision-makers began as of tomorrow to concentrate on that group; what should the analyst do when these are no longer available?

Such questions are actually related to broader aspects of the value approach involving the availability of attractive investment opportunities if and when most investors and their advisers followed this doctrine. I shall return to that problem later.

### **The Past and Future of Common Stocks**

Before I came down to Wall Street in 1914 the future of the stock market had already been forecast—once for all—in the famous dictum of JP. Morgan the elder: "It will fluctuate." It is a safe prediction for me to make that, in future years as in the past, common stocks will advance too far and decline too far, and that investors, like speculators—and institutions, like individuals— will have their periods of enchantment and disenchantment with equities. To support this prediction let me cite two "watershed episodes"—as I shall call them—that occurred within my own financial experience. The first goes back just 50 years, to 1924; it was the publication of E.I. Smith's book entitled *Common Stocks as Long-Term Investments*. His study showed that, contrary to prevalent beliefs, equities as a whole had proved much better

purchases than bonds during the preceding half-century. It is generally held that these findings provided the theoretical and psychological justification for the ensuing bull market of the 1920's.

The Dow Jones Industrial Average (DJIA), which stood at 90 in mid-1924, advanced to 381 by September 1929, from which high estate it collapsed— as I remember only too well—to an ignominious low of 41 in 1932. On that date the market's level was the lowest it had registered for more than 30 years. For both General Electric and for the Dow, the highpoint of 1929 was not to be regained for 25 years. Here was a striking example of the calamity that can ensue when reasoning that is entirely sound when applied to past conditions is blindly followed long after the relevant conditions have changed. What was true of the attractiveness of equity investments when the Dow stood at 90 was doubtful when the level had advanced to 200 and was completely untrue at 300 or higher. The second episode—historical in my thinking— occurred towards the end of the market's long recovery from the 1929 to 1932 debacle. It was the report of the Federal Reserve in 1948 on the public's attitude toward common stocks. In that year the Dow sold as low as 165 or seven times earnings, while AAA bonds returned only 2.82 per cent. Nevertheless, over 90 per cent of those canvassed were opposed to buying equities—about half because they thought them too risky and half because of unfamiliarity. Of course this was just the moment before common stocks were to begin the greatest upward movement in market history—which was to carry the Dow from 165 to 1050 last year. What better illustrations can one wish of the age-old truth that the public's attitudes in matters of finance are completely untrustworthy as guides to investment policy? This may easily prove as true in 1974 as it was in 1948.

I think the future of equities will be roughly the same as their past; in particular, common-stock purchases will prove satisfactory when made at appropriate price levels. It may be objected that is far too cursory and superficial a conclusion; that it fails to take into account the new factors and problems that have entered the economic picture in recent years—especially those of inflation, unprecedentedly high interest rates, the energy crisis, the ecology-pollution mess and even the movement towards less consumption and zero growth. Perhaps I should add to my list the widespread public mistrust of Wall Street as a whole, engendered by its well-nigh scandalous behavior during recent years in the areas of ethics, financial practices of all sorts and plain business sense.

Of course these elements—mainly unfavorable to the future values of common stocks—should be taken into account in the formulation of today's investments policies. But it is absurd to conclude from them that from now on common stocks will be undesirable investments no matter how low their price level may fall. The real question is the same as it has always been in the past, namely: Is this a desirable time or price level to make equity purchases? We should divide that question, I think, into the following: a) Is this a desirable level to buy stocks in general, as represented by the DJIA or Standard and Poor's 500 (S&P 500)? b) Even if the averages may not be at an attractive level, can investors expect satisfactory results by choosing individual issues

that are undoubtedly worth at least what they are selling for? The distinction I have just made is clearly relevant to the present situation because of the recent advent of the "two tiered market," resulting from the massive preference of institutions for large, high-growth companies. This in turn has brought about disparities in the P/E ratios for issues of investment character—differences as high as ten to one—that have been unexampled in all my experience, except perhaps at the height of the 1929 madness with its celebrated "blue-chip" issues.

My own answer to the double question just posed is as follows: As to the present level of the averages—say, 850 for the Dow and 93 for the S&P 500—the factor most directly affecting current security values and prices is most assuredly the high rate of interest now established for the entire spectrum of bond and note issues. One of the glaring defects of institutional attitudes has been that as recently as early 1973—when they supported the record price level of the averages—they failed to take into account that AAA bonds were then yielding 7.3 per cent and had been above 8.5 per cent not long before. (As it happened they were destined to surpass the 8.5 per cent rate in 1974.) In 1964 the AAA rate averaged 4.4 per cent. It seems logical to me that the earning/price ratio of stocks generally should bear a relationship to bond-interest rates. If this thesis is accepted in its simplest form we must conclude: If one dollar of Dow earnings were worth \$17 when bond yields were 4.4 per cent, that one dollar is now worth only 52 per cent of \$17, or \$8.80, with AAA bonds at 8.5 per cent. This in turn would suggest a currently justified multiplier of, say, nine for the normal current earnings of the Dow. If you place those earnings at the record 1973 figure of \$86, you arrive at a current valuation of only 775 for the DJIA. You may quarrel with this figure on various grounds. One may be your expectation that bond rates will fall in the future. But that prospect is far from certain, while the present 8-1/2 per cent rate is a fact. Also, if bond yields go down appreciably, then bond prices will advance as well as stocks. Hence such bonds could still work out better than the Dow if and when interest rates decline. Viewing the matter from another angle, I should want the Dow or Standard and Poor's to return an earnings yield of at least four-thirds that on AAA bonds to give them competitive attractiveness with bond investments. This would mean an earnings yield of 11 per cent, and it brings us smack back to the valuation of about 775 for the Dow that we found by comparing the early 1974 situation with that ten years before.

Furthermore, my calculations of growth rates over the past 25 years give an annual figure for the Dow of only 4-1/2 per cent. If this rate were to continue in the future, the expectable combination of growth plus dividends would produce less than a ten percent overall return, consisting of four and one-half per cent growth plus a compounded dividend yield of, say, five percent. This second calculation would make my current 775 valuation for the Dow appear over generous. Incidentally, a corresponding approach to the S&P 500 Index gives a somewhat less favorable result than for the Dow at current levels. The S&P 425 and 500 Indexes have both grown at about a five per cent rate over the past 25 years. But this advantage appears to be offset by their higher P/E ratios compared with the DJIA.

It is now the function of real old-timers like myself to caution against taking on an unjustified bias *against* stocks at low price levels. What will be the effect on performance of having, say, \$200 billion of institutional money in equities, plus, say 11,000 working security analysts, all trying to "beat the averages?" The reader will pardon a reference here to a couplet by Heinrich Heine a propos of the appointment of 45 German professors to some commission of inquiry 150 years ago. He wrote:

"Funf-und-vierzig Professoren—Vaterland, du bist verloren!"  
(Forty-five Professors—Fatherland, you're ruined!)

If only 45 professors can present such a menace, how about 11,000 analysts? Seriously, the effect of large-scale participation by institutions in the equity market, and the work of innumerable financial analysts striving to establish proper valuation for all sorts, should be to stabilize stock-market movements, i.e., in theory at least, to dampen the unjustified fluctuation in stock prices. I must confess, however, that I have seen no such result flowing from the preponderant position of the institutions in market activity.

The amplitude of price fluctuations has, if anything, been wider than before the institutions came into the market on a grand scale. What can be the reason? The only one I can give is that the institutions and their financial analysts have not shown any more prudence and vision than the general public; they seem to have succumbed to the same siren songs—expressed chiefly in the cult of "performance." They, too, have largely put aside the once vital distinction between investment and speculation. (This leads me to ask whether someday soon we shall see some legal problems for certain banking institutions growing out of their accountability for the results of *trust* investments made from 1968 to 1973 that failed to meet the strict judicial requirements of the prudent man rule).

A modification of my "fixed fund" suggestion would leave more leeway for the work of financial analysts. This modification would base equity portfolios initially on an actual or presumed imitation of the S&P Index, or—more simply—the DJIA. The operating manager or decision maker would be permitted to make substitutions in this list, but only on a persuasive showing that the issues substituted had distinctly more intrinsic value per dollar of price than the ones to be dropped. Combined with fairly heavy accountability for the results of such departures from the original list, such a program might well improve the actual performance. In any case it would give the financial analysts' profession something to do. There has indeed been a strong intimation in this article that the DJIA and the S&P Indexes are now selling too high in relation to many issues now purchasable at low P/E ratios.

If this view is correct any competent analyst has an excellent present opportunity to earn his pay by recommending desirable substitutes for certain companies in these averages. Please bear in mind that while I have been making a case for equity investment now—despite, or perhaps because of, institutional disillusionment with them—I am not proposing a 100 per cent stock position for any investor. On the contrary, I think that everyone's total portfolio should always have a minimum component of 25 per cent in bonds, along with a complementary minimum holding of 25 per cent in equities. The remaining half of the funds may be divided between the two, either on a standard 50-50 basis (adjusted to reflect changes caused by significant price movements) or in accordance with some consistent and conservative policy of increasing the bond proportion above 50 per cent when bonds appear more attractive than equities, and vice versa when equities appear more attractive than bonds.

Do equities win by default because there is no assumed liquidity in other alternatives? There are various answers to this query. The first is, of course, that the alternative of putting funds into short- or longer-term debt obligations does not diminish the liquidity factor. Secondly, I could argue that liquidity is itself a minor desideratum in a true investment program, and that too many value considerations have been sacrificed to an assumed need for quick marketability. But thirdly, I could not say to what extent the liquidity factor should enter into consideration of non-income producing objects—such as paintings, commodities, etc.—as alternatives to common stocks. My hunch is that the absence of income—as against 8-1/2 per cent annually on bonds—should be more important here for your investment decisions than the liquidity factor.

### **A Lesson from the Past**

Let us attempt an enumeration of the major differences and resemblances between the current market and that of the 1920's, as they appear to this observer. The two major internal differences relate to financial manipulation of various sorts and to excessive borrowing for speculation. The bull-market heights of 1929 were made possible by a huge wave of buying on thinner margins than are now permitted. Brokers' loans rose from \$2.769 million in 1926 to \$8.549 million in 1929, at which time they constituted about half of total member-bank loans.

By contrast, the corresponding rise to date has been relatively much smaller. (Borrowings on smaller margins through other sources are no doubt significant at present but not sufficiently so to change the broad picture.) In the field of financial practices, the major abuses of the 1920's consisted of crass manipulation of stock prices by speculative pools and of corporate pyramiding through successive tiers of holding companies of various types. Both stock-market manipulation and corporate-structure manipulation have been greatly restricted by the SEC legislation and by tighter stock-exchange supervision. The amount that escapes detection is comparatively small, in my view. Although the various investigations now under way produce some startling exposes,

whatever abuses now exist will not be found to have permeated the whole fabric of finance as was the case 30 years ago.

An exception to the above reassuring statement may have to be made in the field of new offerings of common stocks. Here I think a set of at least semi-manipulative practices has developed in handling so-called "hot issues." The number of such offerings has been increasing steadily in the last 2 years, and their quality has been retrogressing at an equal rate. It is in this speculative area that I sense the closest parallel between the internal market conditions of the late 1920's (and particularly of 1919) and those of today. Whether the new-issue financing of dubious merit will prove to be so heavy in aggregate dollars as ultimately to turn the market scales definitely downward, I shall not venture to guess. It is not impossible.

The widespread belief that we are in a new stock-market era, differing in its essential character from the bull-and-bear sequences of the past, rests on a number of claimed differences between then and now. These go well beyond the reforms in stock trading and in corporate financial practices. The case to justify the present unprecedented level of stock prices and earnings multipliers is essentially that which would justify the concept of a permanently changed character and future for the stock market. The safety and attractiveness of common-stock investment today is thought to be solidly grounded on a complex of favorable factors. Among them are (a) assured growth of population and GNP; (b) a rate of expansion more rapid than formerly, created by technological progress and the rivalry with Russia; (c) an assurance against major depressions provided by the government's new responsibility to prevent or quickly terminate them; (d) the public's recognition that common-stock investment is a necessary protection against continued inflation; and (e) the emergence of mutual funds, pension trusts, and other institutional investors as the chief source of demand and continuous support for common stocks.

Those who study the record of the 1920's will find that reasons similar to most, but not all, of the above were advanced to justify the ill-fated market rise of those years. The doctrine of "Common Stocks as (the Best) Long-Term Investments" emerged in 1924 and was made the cornerstone of the market's philosophy and its excesses. There was the same optimism about the future growth of the country and perhaps a better-founded confidence in the share of common-stock earnings in that growth. (The rate of return on invested capital was better maintained between 1922 and 1929 than between 1950 and 1961.) Old standards of value-particularly the once normal relationship between bond yields and common-stock yields-were thrown aside then as now, on the grounds that they had no relevance to the new economic climate. There was great confidence, also, in the future stability of business and its immunity from severe depressions. This was founded on the idea that scientific management, careful control of inventories, the absence of inflation, and other factors would help our business leaders avoid the costly mistakes of the past.

In my view, there are three major differences between the economic realities of the 1920's and the present. The first relates to the inflation factor, the second to the Cold War, and the third to the role of government in business. The bull market of the 1920's ran its course without the aid of commodity-price inflation; the market rise since 1949 has been accompanied by an irregular, but virtually continuous, advance in wholesale and consumer prices. It is difficult to say whether the investor's current emphasis on future inflation possibilities should be considered primarily as recognition on his part of objective fact or rather as a strong subjective reaction to an element that is by no means new to the financial scene. We had more inflation in wholesale prices from 1900 to 1910 than from 1950 to 1960; the rise from 1900 to 1920 also exceeded that from 1940 to 1960 (the equivalent of from 36 to 100 versus from 51 to 120). Most of us believe that inflation is the path of least resistance for governments, labor leaders, and business heads and that hence it will be followed. But the record of the past will not help us much to determine what the amount of inflation will be over future decades, whether its course will be regular or interspersed with sharp deflations, as in 1921 and 1932, and whether investors will remain as inflation-conscious in the future as they are today. The reaction to inflation, like almost every other investment and speculative attitude, seems to be more the result of the stock market's behavior than the cause of it.

My view of the effects of the Cold War on common-stock values is quite a personal one, not shared by many, I am sure. In the first place, I think that it has contributed a good deal to the business expansion and relative stability of the past decade. But, in a contrary sense, I cannot see how the kind of Cold War we are now living through can continue throughout "our lifetime and that of our children." Sometime within the present decade, a way will have to be found to terminate the Cold War, or it will be transformed into large-scale hostilities, with all their nuclear implications. If our prosperity since 1949 has, in fact, rested rather heavily on our defense expenditures and if, in truth, we must fairly soon have either no war or nuclear war in place of Cold War, then today's international situation cannot be termed more favorable for common stocks than the cloudless one of 1929.

The government's commitment to prevent large-scale unemployment and serious depressions is both a new factor and one of major importance. The most logical reason for expecting a different kind of stock-market cycle in the future than in the long-term past would appear to be by analogy with the business cycle. The record since 1949 strongly supports this thesis. The new material on "Business Cycle Developments," now available monthly, shows four periods of business contraction since 1948—in 1949, 1953-54, 1957-58, and 1960. All these were very moderate, as compared with the sharp recession of 1937-38 and the major depressions after 1919 and 1929. The three declines of about 20 per cent each in the stock averages since 1950 appear to correspond fairly well to the three setbacks of about 10 per cent in the index of industrial production. If we have now entered a new era that excludes old-time business depressions, it



seems reasonable to deduce that we are also in a new era that precludes old-fashioned bear markets.

Both my analysis and my instinct warn me that there may be a catch in this plausible and reassuring parallel. If the recent picture had been one of the stock market's advancing in step with the national product and in close proportion with it also, then the observer might conclude—somewhat to his amazement—that not only has the economy been reformed but human nature as well. But here the facts part company with the hypothesis. The stock-market level has not been governed primarily by the level of business but rather by the development of new investment theories and attitudes and by a typical growth of speculative interest and activity. Some of the old financial abuses that characterized former bull markets have, indeed, been virtually eliminated. But some have again raised their heads, and some new ones have appeared and are spreading apace. These are in the areas of corporate reporting, corporate financing, the quality of the enterprises offered for public sale, and the ways in which new issues of common stocks are offered and subsequently traded.

If the relative stability of general business and corporate profits produces an unlimited enthusiasm and demand for common stocks, then it must eventually produce instability in stock prices. We have already seen the working of this paradox in the area of growth stocks. The price of a successful and promising concern such as Texas Instruments can be driven up so high by speculative emphasis on its prospects that the ensuing reaction has cut the price in half—with no change in the underlying worth of the business. Examples of this sort are now numerous. Conceivably, this behavior of issues in the growth-stock class may give us a preview of the ultimate behavior of the general market—as represented by comprehensive averages—if common-stock investment becomes essentially identical with common-stock speculation. In that case the stock market will have a life-cycle of its own, quite independent of the business cycle. The market cycle will once more prove to be the human-nature cycle; its economic background will have changed but not its basic character or the consequences of its character.

These arguments against a new character for the stock market are not necessarily arguments that the present levels are too high, although they certainly would be adjudged so by older standards. Conceivably and even probably, new factors in the economic figure have moved upward the central value of the average dollar of corporate earnings and justify a more favorable relationship than heretofore between stock yields and bond yields. This would certainly be true if the general business picture can be counted on to continue indefinitely the relative immunity to depression it has shown since as far back as 1941. What we are concerned with here is not the future central value of the stock market but rather the amplitude and the consequences of possible future variations around this value.

To soften a possible charge of old fogysm and prejudice against new standards of value, may I take this paragraph to show how the recent record level of stock prices may be justified by some not implausible calculations. Let us assume that the investor wants an over-all return of 7.5 percent annually, as a composite of dividend income and average market appreciation. (This 7.5 percent target is itself taken from the long-term record of dividend yields and price advances; it seems reasonable as a guide to the future.) Assume, next, that earnings and dividends will grow in the indefinite future at the annual rate of 4.5 per cent, which appears to be the projection for this decade. Then the investor should be satisfied with a 3 percent dividend return. This would justify a current level of 65 for the S&P Composite, only 10 percent below the recent high. A small adjustment here or there would put us over the top.

It is by no means impossible to assume a permanent growth rate of 4.5 percent; we have been told that we must increase our GNP faster than this or lose out in the race with Russia. The basic objection is that it is only an assumption, that the experience of the longer past puts the figure rather at 2.5 percent and that the difference between 4.5 and 2.5 percent in this calculation means the difference between 65 and 39 for the value of the S&P Composite. My experience leads me to predict that the action of the market will govern the investor's choice as to probable future growth rates rather than vice versa.

If the market since 1949 foreshadows the stock markets of the future, the investment aspects of equity accumulation are unbelievably favorable. All that will be needed will be the funds to buy a representative assortment of common stocks and a little patience to sit through periods of mild reaction.

## **Security Analysis as a Science**

### *The Scientific Method*

The scientific method includes among its factors the wide observation and recording of events, the construction of rational and plausible theories or formulas, and their validation through the medium of reasonably dependable predictions. There are many varieties of scientific or quasi-scientific disciplines, and the character of the predictions based on them will vary greatly from one to another.

At one extreme take the microphone. An electrical engineer, having rigged it up carefully, can predict that a word spoken into it will be immediately amplified. The prediction is precise; the verification prompt and unquestionable. At the other extreme let us take psychoanalysis---a discipline sometimes compared with our own security analysis. Here prediction and verification are less definite. A layman who finances psychoanalytical treatment for one of his family is apt to be slightly in the dark about such details as the nature of the illness, the method and duration

of the treatment, and the extent of the cure, if any. About the only thing he can predict with certainty is how much it will cost per hour. Between these two extremes lies actuarial science, which to my mind is more relevant than the others to the scientific possibilities of security analysis. The life insurance actuary makes predictions concerning mortality rates, the rate of earnings on invested reserves, and factors of expense and profit--in all instances based largely on carefully analyzed past experience, with allowance for trends and new factors. Out of these predictions, with the aid of mathematical techniques, he fashions suitable premium schedules for various types of insurance. What is most important for us about his work and his conclusions is that he deals not with individual cases but with the probable *aggregate result* of a large number of similar cases. Diversification is of the essence in actuarial science.

Thus our first practical question about "scientific security analysis" is whether it is actuarial in character, and has diversification as its essential ingredient. One plausible answer may be that diversification is essential for certain types and objectives of security analysis but not for others. Let us classify the things that security analysis tries to do and see how the element of diversification applies to each. At the same time we may raise other questions concerning the scientific methods and predictions operating in each of the classes. I suggest that the end product of our work falls into four different categories, as follows:

1. The selection of safe securities, of the bond type.
2. The selection of undervalued securities.
3. The selection of growth securities, that is, common stocks that are expected to increase their earning power at considerably better than the average rate.
4. The selection of "near-term opportunities," that is, common stocks that have better-than-average prospects of price advance, within, say, the next 12 months.

This list does not include stock market analysis and predictions based thereon. Let me comment briefly on this point. If security analysis is to be scientific, it will have to be so in its own right and not by depending on market techniques. It is easy to dismiss this point completely by saying that, if market analysis is good, it doesn't need security analysis; and, if it isn't good, security analysis doesn't want it. But this may be too cavalier an attitude toward an area of activity that engages the interest of a host of reputable security analysts. That stock market analysis and security analysis combined may be able to do a better job than security analysis by itself is at least a conceivable proposition and perhaps a plausible one. But the burden is on those who would establish this thesis to demonstrate it to the rest of us in unequivocal and convincing fashion. Certainly the published record is far too meager, as yet, to warrant conceding a scientific standing to a combination of the two analyses.

#### *Four Categories*

To return to our four categories of security analysis, choosing safe bonds and preferred stocks is certainly the most respectable if not the most exciting occupation of our guild. Not only has it major importance of its own, but also it can offer useful analogies and insights for other branches of our work. The emphasis of bond analysis is on past performance, tempered by a conservative view of future changes and dangers. Its chief reliance is on a margin of safety that grows out of a small ratio of debt to total real value of the enterprise. It requires broad diversification to assure a representative or average over-all result. These viewpoints have made bond investment, as practiced by our financial institutions, a soundly scientific procedure. In fact, bond investment now appears to be almost a branch of actuarial science. There are interesting similarities (as well as differences) between insuring a man's life for \$1,000 against a premium of \$34 per year, and lending \$1,000 on a long-term bond also paying \$35 per year. The calculated mortality rate for men aged 35 is about 4 out of 1,000, or 4/10% per year. A comparable "mortality rate" might be applied to corporate enterprises in the best financial and operating health, to estimate the risk attaching to high-grade bond investment. Such a figure, say 1/2%, might then properly measure the risk and yield differential between the strongest corporate bonds and U. S. Government obligations.

#### *Bond Investment: A Scientific Procedure*

Bond investment should take on more of the character of a scientific procedure when the monumental corporate bond study, carried on by the National Bureau of Economic Research and other agencies, is finally completed and the mass of statistical data and findings is made available to security analysts. The greatest weakness of our profession, I have long believed, is our failure to provide really comprehensive records of the results of investments initiated or carried on by us under various principles and techniques. We have asked for unlimited statistics from others covering the results of their operations, but we have been more than backward in compiling fair and adequate statistics relating to the results of our own work. I shall have a suggestion to make on that point a little later.

#### *Selection of Undervalued Securities*

The selection of undervalued securities appears next on my list because of its logical relationship to investment in safe bonds or preferred stocks. The margin-of-safety concept is the dominant one in both groups. A common stock is undervalued, typically, if the analyst can soundly establish that the enterprise as a whole is worth well above the market price of all its securities.

There is a close analogy here with bond selection, which also requires an enterprise value well in excess of the debt. But the rewards for establishing that a common stock is undervalued are, of course, incomparably greater; for in the average case all or a good part of the margin of safety should eventually be realized as a profit to the buyer of a truly undervalued issue.

In this connection I want to throw out a broad and challenging idea – that from a scientific standpoint common stocks *as a whole* may be regarded as an essentially undervalued *security form*. This point grows out of the basic difference between individual risk and overall or group risk. People insist on a substantially higher dividend return and a still larger excess in earnings yield for common stocks than for bonds, because the risk of loss in the average *single* common stock issue is undoubtedly greater than in the average *single* bond. But the comparison has not been true historically of a *diversified group* of common stocks, since common stocks as a whole have had a well-defined upward bias or long-term upward movement. This in turn is readily explicable in terms of the country's growth, plus the steady reinvestment of undistributed profits, plus the strong net inflationary trend since the turn of the century.

### *Fire and Casualty Rates*

The analogy here is with fire and casualty insurance rates. People pay about twice as much for fire insurance as their own actuarially determined exposure would indicate--because they cannot soundly afford to carry the individual risk themselves. For similar reasons the overall return on common stocks appears to have been at least twice as much as their true overall risk has required. An interesting relationship at this point appears from the Keystone chart showing the trend of the Dow-Jones industrial average since 1899. Both the upper and lower lines happen to rise at the rate of one third every ten years. You will recognize this as the 2.90% rate of compound interest realized on U. S. Savings Bonds, Series E. What this means is the consistent Dow-Jones investor has obtained the same increase in *principal value* as the savings bonds offer in lieu of interest; and in addition the Dow-Jones stock investor has obtained all the annual dividends from his holdings as a bonus above the Government bond interest rate.

The reasoning I have just indulged in is, I believe, both scientifically valid and psychologically dangerous. Its validity depends on the maintenance in the stock market of the substantial disparity between bond yields and the price-earnings ratios on stocks. If as happened in the 1920s--this very thesis is twisted into the slogan that common stocks are attractive investments, regardless of how high they sell, then we would find ourselves beginning as scientists and ending as heedless and ill-starred gamblers. It may be a fair generalization to assert that the top levels of most "normal" bull markets are characterized by a tendency to equate stock risks with bond risks. These high valuations may indeed have some justification in pure theory, but the important thing for us to bear in mind as practicing analysts is that, when you pay full value for common stocks, you are in great danger of later appearing to have paid too much.

### *Individual Undervaluations*

Turning now to the field of *individual* undervaluations, we find ourselves on more familiar ground. Our work with this group readily admits of the scientific processes of wide observation and the testing out of predictions or hypotheses by their sequels. The theory of undervalued issues must necessarily require an explanation of their origin. The explanations are in truth quite varied and taken together form what may be called a “pathology of market prices.” They range from obvious causes, such as an unduly low dividend or a temporary setback in earnings, to more subtle and special conditions such as too much common stock in the capital structure or even too much cash in the bank. In between lie numerous other causes such as the presence of important litigation, or the combination of two dissimilar businesses, or the use of the now discredited holding company setup.

### *Origins of Undervaluation Understood*

The origins of undervaluation are pretty well understood by now and could no doubt be set forth in an acceptably scientific study. We do not know as much about the cure of undervaluations. In what proportion of cases is the discrepancy corrected? How or why does the correction occur? How long does the process take? These questions remind us somewhat of those we raised about psychoanalysis at the outset. But one thing of importance we do know, and that is that the purchase of undervalued issues on a diversified basis does produce consistently profitable results. Thus we have a worthwhile field for more scientific cultivation. Here inductive studies carried on intelligently and systematically over a period of years are almost certain to be rewarding.

### *Selection of Growth Stocks*

The third objective of security analysis is the selection of growth stocks. How scientific a procedure is this now, and how scientific can it be made to be? Here I enter difficult waters. Most growth companies are themselves tied in closely with technological progress; by choosing their shares the security analyst latches on, as it were, to the coattails of science. In the 40 or more plant inspections that are on your scheduled field trips for this convention week, no doubt your chief emphasis will be placed on new products and new process developments; and these in turn will strongly influence your conclusions about the long-pull prospects of the various companies. But in most instances this is primarily a *qualitative* approach. Can your work in this field be truly scientific unless it is solidly based on dependable *measurements*, that is, specific or minimum projections of future earnings, and a capitalization of such projected profits at a rate or multiplier that can be called reasonably conservative in the light of past experience? Can a definite *price* be put on future growth---below which the stock is a sound purchase, above which it is dear, or in any event speculative? What is the risk that the expected growth will fail to materialize? What is the risk of an important downward change in the market's evaluation of

favorable prospects? A great deal of systematic study in this field is necessary before dependable answers to such questions will be forthcoming.

### *Stock Investment in Pre-Scientific Stage*

In the meantime I cannot help but feel that growth stock investment is still in the pre-scientific stage. It is at the same time more fascinating and less precise than the selection of safe bonds or undervalued securities. In the growth stock field, the concept of margin of safety loses the clarity and the primacy it enjoys in those other two classes of security analysis. True, there is safety in growth, and some of us will go so far as to declare that there can be no real safety except in growth. But these sound to me more like slogans than scientifically formulated and verified propositions. Again, in the growth field the element of selectivity is so prominent as to place diversification in a secondary and perhaps dubious position. A case can be made for putting all your growth eggs in the one best or a relatively few best baskets. Thus in this branch of security analysis the actuarial element may be missing, and that circumstance undoubtedly militates against truly scientific procedures and results.

### *Inverted Relationship*

There is undoubtedly an organic but inverted relationship between the growth stock concept and the theory of undervalued securities. The attraction of growth is like a tidal pull which causes high tides in one area, the assumed growth companies, and low tides in another area, the assumed non-growth companies. We can measure, in a sense, scientifically the distorting effect of this influence by using as our standard the *minimum business value* of enterprises in the non-favored group. By way of illustration let us apply that thought to three California concerns. The shares of Roos Brothers, a local retail enterprise, will in the nature of things tend to sell below their analytically determined value for basically the same reasons that are bound to produce overvaluations in the shares of Superior Oil or Kern County Land.

I come finally to the standard occupation of brokerage house analysts and advisory services, namely, the selection of issues favorably situated for a near-term market advance. The usual assumption here is that, if the earnings will improve or the dividend will be raised, then the price will improve. Thus the process consists essentially of locating and recommending those companies that are likely to increase their earnings or dividends in the near term. You all know the three basic hazards encountered in this work: that the expected improvement will not take place, that it is already discounted in the current price, that for some other reason or for no known reason the price will not move the way it should.

It may be that despite these hazards it is possible to obtain worthwhile results on the average from competent short-term analyses and predictions. Who of us can say whether or not this is

true? In view of the importance of this analytical work, in terms of time, energy, and money cost, it might not be a bad idea to subject it to a thoroughgoing evaluation.

### *Searching Self-Examination*

This brings me to my conclusion and my one concrete proposal. Security analysis has now reached the stage where it is ready for a continuous and searching self-examination by the use of established statistical tools. We should collect the studies and recommendations of numerous analysts, classify them in accordance with their objectives (perhaps in the four groups suggested in this paper), and then do our best to evaluate their accuracy and success. The purpose of such a record would not be to show who is a good security analyst and who is a poor one, but rather to show what methods and approaches are sound and fruitful and which ones fail to meet the test of experience.

This suggestion was originally made in the articles published under the pseudonym of *Cogitator* in *The Analysts Journal*. At that time I wrote: "It is unlikely that security analysis could develop professional stature in the absence of reasonably definite and plausible tests of the soundness of individual and group recommendations.' The New York Society is now taking the first positive steps to establish a quasi-professional rating or title for security analysts who meet specified requirements. It is virtually certain that this movement will develop ultimately in full-fledged professional status for our calling. The time may well be ripe for the Federation and its constituent Societies to begin a systematic accumulation of case histories, which should make possible the transmission of a continuous, ever-growing body of knowledge and technique from the analysts of the past to those of the future.

When this work is well under way security analysis may begin--modesty, but hopefully—to refer to itself as a scientific discipline.

### **The Fallacy of Efficient Markets**

I am sure that [proponents of efficient markets] are all very hardworking and serious. But it's hard for me to find a good connection between what they do and practical investment results. In fact, they say that the market is efficient in the sense that there is no particular point in getting more information than people already have. That might be true, but the idea of saying that the fact that the information is so widely spread that the resulting prices are logical prices—that is all wrong. I don't see how you can say that the prices made in Wall Street are the right prices in any intelligent definition of what right prices would be.

[Proponents] would claim that if they are correct in their basic contentions about the efficient market, the thing for people to do is to try to study the behavior of stock prices and try to profit



from these interpretations. To me, that is not a very encouraging conclusion because if I have noticed anything over these 60 years on Wall Street, it is that people do not succeed in forecasting what's going to happen to the stock market.

In particular, the hypothesis of "efficient markets," in its extreme form, makes two declarations: 1) The price of nearly every stock at nearly all times reflects whatever is knowable about the company's affairs; hence no consistent profits can be made by seeking out and using additional information, including that held by "insiders." 2) Because the market has complete or at least adequate information about each issue, the prices it registers are therefore "correct," "reasonable" or "appropriate." This would imply that it is fruitless, or at least insufficiently rewarding, for security analysts to look for discrepancies between price and value.

I have no particular quarrel with declaration one, though assuredly there are times when a researcher may unearth significant information about a stock, not generally known and reflected in the price. But I deny emphatically that because the market has all the information it needs to establish a correct price the prices it actually registers are in fact correct. Take as my example a fine company such as Avon Products. How can it make sense to say that its price of 140 was "correct" in 1973 and that its price of 32 was also "correct" in 1974? Could anything have happened—outside of stock market psychology—to reduce the value of that enterprise by 77 per cent or nearly six billion dollars? The market may have had all the information it needed about Avon; what it has lacked is the right kind of judgment in evaluating its knowledge. Descartes summed up the matter more than three centuries ago, when he wrote in his "Discours de la Methode":

"Ce n'est pas assez d'avoir l'esprit bon, mais le principal est de l'appliquer bien."

In English: "It is not enough to have a good intelligence"—and I add, "enough information" — "the principal thing is to apply it well." I can assure the reader that among the 500-odd NYSE issues selling below seven times earnings today, there are plenty to be found for which the prices are not "correct" ones, in any meaningful sense of the term. They are clearly worth more than their current selling prices, and any security analyst worth his salt should be able to make up an attractive portfolio out of this "universe."

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Let me pass now to the doctrine of the efficient market. I am particularly interested in this because of its negative implications for the work of security analysts generally. The subject is dealt with briefly in my current article in the Financial Analysts Journal, but it has such potential importance for this audience that I shall try another crack at it here.

Let me shorten slightly the definition of an efficient market that appears on p. 97 of *The Stock Market* by Lorie and Hamilton: “an efficient market is one in which a large number of buyers and sellers cause the prices to reflect fully what is knowable about the prospects for the companies dealt in.” The key phrase for me is “reflect fully.” Let us assume first that it means only that the market has and uses all knowable information about every company’s prospects, and hence that there is no point for analysts to spend their time trying to obtain additional information. I dissent from that statement to the extent that it would render meaningless the current controversy and concern on the use of “material information”, particularly as obtained by security analysts from managements. If in all cases the market already knows and reflects all that is knowable about each enterprise then there should be no such thing as “material inside information.”

But that is not my chief quarrel with the concept of the “efficient market.” There is a strong implication in the Lorie and Hamilton book that because the market reflects fully all the knowable facts it thereby establishes correct or reasonably correct prices for common stocks. Hence, only the superior security analyst can successfully select the stocks that should be bought or sold. These exceptional people – in the authors’ words – “have a quicker and more profound understanding of the economic consequences to individual firms of changes in the economic environment or changes within the firm itself.” They have “a rare and valuable talent.” I disagree completely with the viewpoint. To establish the right price for a stock the market must have adequate information, but it by no means follows that if the market has this information it will thereupon establish the right price. The market’s evaluation of the same data can vary over a wide range, dependent on bullish enthusiasm, concentrated speculative interest and similar influences, or bearish disillusionment. Knowledge is only one ingredient on arriving at a stock’s proper price. The other ingredient, fully as important as information, is sound judgment. Take Avon Products, which sold at \$140 per share early last year, or \$8 billion for the company and under \$20 – or a mere \$1.2 billion – last month. Was the market for Avon “efficient” on both these dates, in the sense that the price reflected “fully and properly” (the latter my addition to the Lorie and Hamilton phrase) the knowable facts. Were the changes in the short period in the environment or the company’s prospects sufficient to cut 85 percent from the true value of this highly profitable, well-managed, and strongly-financed enterprise?

Take at the other extreme the larger group of stocks selling for less than their working capital. Is the market “efficient” in maintaining these ‘fire-sale’ price levels? Surely it does not lack the essential information about companies. What it does lack is judgment courage, and patience. In situations of this kind lie the best opportunities for financial analysts to prove their mettle.

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Let me give a concrete example of my statement that institutional investment does not appear to have contributed either stability or rationality to stock prices—American Airlines. The Standard and Poor's Monthly Stock Guide shows the holdings of this and other concerns by about 2000 insurance companies and investment funds, though not by banks and their trust departments.

In 1970, the canvassed institutions owned 4.3 million shares of American Airlines, or 22 per cent of the total. The company reported a deficit of \$1.30 per share in 1970, then earnings of 13 cents in 1971 and a magnificent 20 cents in 1972. In response, our so called efficient stock market advanced the price from a 1970 low of 13 to a new all-time high of 49-7/8 in 1972. This was 250 times that year's profits. Now what did our financial institutions do to hold down this insane speculative binge in the shares? Did they sell out their holdings somewhere along the line, to cash in a profit and rid their portfolios of a clearly overvalued issue? On the contrary. The Guide showed that during this period they actually *increased their* ownership to 6.7 million shares, or by a full 50 per cent, held by 143 companies. And the latest figures, in 1974, show that 117 funds etc. still owned 5.7 million shares or 20 per cent of the total. (In the meantime the company reported a record deficit of \$48 million in 1973, and the price collapsed from 50 in 1972 to 7-1/2 in 1974.)

This story hardly suggests that the institutions have been valiant contributors to "efficient markets" and correct stock prices. More and more institutions are likely to realize that they cannot expect better than market-average results from their equity portfolios unless they have the advantage of better-than-average financial and security analysts. Logically this should move some of the institutions towards accepting the S&P 500 results as the norm for expectable performance. In turn this might lead to using the S&P 500 or 425 lists as actual portfolios. If this proves true, clients may then find themselves questioning the standard fees most of them are paying financial institutions to handle these investments. (Incidentally, if my half-serious prophecy of a movement towards actual S&P Index portfolios is realized we should have an ironical return to a form of investment in equities that existed here 50 years ago. The first investment funds were actual "trusts," and "fixed trusts" at that. The portfolios were set up, on a once-for-all basis, from the very beginning. Changes could be made only under compulsory conditions.)

## **PART II**

# **THE INVESTOR AND THE BUSINESS**

## Common Stock Categories

When we come to valuing individual stocks I should like to divide them into three classes, as I find them in the NYSE list. Group I is the growth issues selling at more than 20 times their last 12 months' earnings. Group II is the relatively unpopular stocks selling for less than seven times recent earnings—i.e., at 15 per cent earnings yield or better. Group III has multipliers between seven and twenty. In my count of 1530 NYSE issues there were 63, or four per cent of the total, selling above 20 times earnings, of which 24 passed the 30 times mark. By contrast, more than 500—over a third—sold below seven times earnings and of these about 150— say, ten per cent of the total—were quoted under five times the last 12 months' profits. If the earnings on which these multipliers are based can be counted on, more or less, in the future—without any special requirements as to growth—it is evident that many NYSE issues can now compete in attractiveness with bonds at 8-1/2 per cent. In this large area of choice there are many that would be suitable for pension-fund investment; many indeed that may be regarded as definitely undervalued. These are especially suited for longer-term commitments as distinguished from short-term speculative purchase.

Among the under seven-times-earnings list are huge concerns like Firestone (with \$3 billion of sales) and intermediate- sized enterprises like Emhart, which has paid dividends for 72 years and recently sold under its net-current-asset value.

The developments that have produced these extraordinarily low multipliers for so many NYSE (and other) issues now present us with another phenomenon—namely the reestablishment of book value, or net worth, as a point of departure and possible guide to the selection of common stocks. In a large area of the present stock market we could return to a very old-fashioned but nonetheless useful criterion for equity investment—namely the value of the company as a private enterprise to a private owner, irrespective of market quotations for the shares. If the business has been prosperous, and is at least reasonably promising for the future, it should be worth its net asset value; hence an opportunity to buy an interest therein at a substantial discount from net worth could be considered attractive. As it happens, about half the NYSE companies were selling last month at less than book value, and about one-quarter, or about 400 issues, at less than two-thirds of net worth.

What is equally interesting is that about one-third of all common stocks actually sold both *above* and *below* their net worth in the past 12 months. Certainly more than half fluctuated around this figure in the last five years. For the most part, these issues selling below book are also in the low-multiplier group. I may be so bold as to suggest that this situation makes possible a quite simple approach to equity investment that is open to almost everyone from the small investor to the quite large pension fund manager. This is the idea of buying selected common stocks—those meeting additional criteria of financial strength, etc.—obtainable at two-thirds or less of book

value, and holding them for sale at their net asset value—to show a non-spectacular but quite satisfactory 50 per cent profit. We cannot predict with assurance how this apparently too simple investment program will work out in the future. But I can say that my studies covering the period 1961 to 1974 show the presence of sufficient opportunities of this kind in most years, and also excellent overall results from the assumed operations.

Since I spoke of three groupings of the NYSE list, I should now give my views of Groups I and III. Those selling at intermediate multipliers may present individual opportunities, but they have no special interest for me as a category. But the first-tier, high-growth issues present a real challenge to past experience. Obviously they would be wonderful private or market-type investments if obtainable at book value or even twice that figure. The trouble is, of course, that most of them sell at more than five times book value—and some more than ten times. Last year the ratios were a good deal higher than that. At these levels, they take on a *speculative character* which is due entirely to their price level, and in no sense to any weakness of the companies themselves. (I made this point as long ago as 1958 in an address before the Financial Analysts Federation; it is reproduced as an Appendix to *The Intelligent Investor*.)

### **Analysis of Financial Statements**

Our view of financial statements, when we act as security analysts, is similar to that of the credit man in some cases, but in most practical instances it is quite different. In the exceptional case we may find ourselves asking the same detailed questions as the credit man does – that is, in cases where the soundness of the company's financial condition is the main question at issue. In the typical situation which the financial analyst examines a sound credit position is found without very much analysis, and unsound credit is also found to exist here and there without the need for detailed study. Consequently, the security analyst tends to devote his chief attention to other things.

He looks at earnings power, for example, with a very careful eye, realizing that it is the most important factor in the typical analysis.

The analyst is also interested in working capital as a factor of asset value. He tends to give more importance to it than the fixed or capital assets. But asset value as a whole is usually a minor element in security analysis, subject to some striking exceptions.

The man analyzing securities may devote the bulk of his attention to the figures he finds in the company's financial report; or else he may direct more of his attention to the industrial background of the company – and also the foreground, in the sense of its prospects. Prospective earnings are, basically, the most important thing that the analyst must consider in a typical case.

Strictly speaking, therefore, security analysis should divide itself into two parts. The financial analyst should do a considerable amount of work and bring his analysis up to a certain point. He should then turn it over to the industrial analyst and say “This is what the figures mean; it is from you to go on from here and determine what the corporation, with this financial position and record, is likely to do in the future.” But in practice this division of functions does not take place very often; the so-called financial analyst acts also as an industrial analyst.

Another distinction is that between current analysis and long-term analysis. There is a tendency in part of Wall Street people to pay excessive attention to the most recent figures and the present financial picture. They rarely give much time and thought to a long-term historical analysis, which I think is insufficiently appreciated by the typical security analyst.

As standard procedure we must often add to a financial statement certain things that don't appear there, so as to obtain a better picture of what actually happened; and we must also correct the statement in certain details which, from the analyst's standpoint, are not fairly representative of the company's position or its performance.

The corrections I am referring to, and I make a number of them, do not imply that the results are falsely presented. They do imply that there is frequently a significant difference between what the accountant indicates is the performance of the business and what the analyst, after his study, is ready to say is the performance of the corporation.

A word or two about asset component on earning power valuation. I will not like to stress the following too much as it is not customarily used and we have I have no particular reason for believing I am right, but would the earning power value exceed the asset value then some reduction should be made. I would suggest a reduction of a quarter of the difference between the two. In cases where assets exceed earning power we do not value the company upward, as we not very much impressed by assets with no earnings power, with only one exception: in cases where working capital alone exceeds earnings power. In this case, we are inclined to add half the difference to the earning power value to allow for the excess working capital which in some way or other tends to trickle down to stockholders over the years. This effect can take place as a distribution, sale of property, company policy changes, etc.

The next important part of analysis is simplification. An analysis is not very valuable unless you can bring it down to clear and manageable terms. That requires, most of all, that you divert your attention away from the things that are less important and toward the things that are most important. Here we find the main difference between the accountant and the security analyst. My experience with the accountant is that for him everything has equal importance. He is like the Lord in the Bible, where it is written that “a thousand years are in His sight as yesterday” when is past – except that it is just the other way around with the accountant: ten cents in his balance

sheet is just as important as a million dollars. The main thing for him is that every figure should be correct. With the security analyst perhaps the most valuable faculty is to know what items to look at and study carefully, and what items to forget about.

Finally, you have the division of interpretation, comparison, and appraisal. That is where the analyst takes the picture after he has first extended and corrected it, boiled it down, and proceeds to what the figures signify to the investor.

### **Valuation of Common Stocks**

Of the various approaches to common stock valuation, the most widely accepted is that which estimates the average earnings and dividends for a period of years in the future and capitalizes these elements at an appropriate rate. This statement is reasonably definite in form, but its application permits the widest range of techniques and assumptions, including plain guesswork. The analyst has first a broad choice as to the future period he will consider; then the earnings and dividends for the period must be estimated, and finally a capitalization rate selected in accordance with his judgment or his prejudices. We may observe here that since there is no a priori rule governing the number of years to which the value should look forward in the future, it is almost inevitable that in bull markets investors and analysts will tend to see far and hopefully ahead, whereas at other times they will not be so disposed to "heed the rumble of a distant drum." Hence arises a high degree of built-in instability in the market valuation of growth stocks, so much so that one might assert with some justice that the more dynamic the company the more inherently speculative and fluctuating may be the market history of its shares.

When it comes to estimating future earnings few analysts are willing to venture forth, Columbus-like, on completely uncharted seas. They prefer to start with known quantities--e.g., current or past earnings--and process these in some fashion to reach an estimate for the future. As a consequence, in security analysis the past is always being thrown out of the window of theory and coming in again through the back door of practice. It would be a sorry joke on our profession if all the elaborate data on past operations, so industriously collected and so minutely analyzed, should prove in the end to be quite unrelated to the real determinants of the value--the earnings and dividends of the future.

Undoubtedly there are situations, not few perhaps, where this proves to be the rueful fact. But in most cases the relationship between past and future proves significant enough to justify the analyst's preoccupation with the statistical record. In fact the daily work of our practitioner consists largely of an effort to construct a plausible picture of a company's future from his study of its past performance, the latter phrase inevitably suggesting similar intensive studies carried on by devotees of a very different discipline. The better the analyst he is, the less he confines



himself to the published figures and the more he adds to these from his special study of the company's management, its policies, and its possibilities.

The student of security analysis, in the classroom or at home, tends to have a special preoccupation with the past record as distinct from an independent judgment of the company's future. He can be taught and can learn to analyze the former, but he lacks a suitable equipment to attempt the latter. What he seeks, typically, is some persuasive method by which a company's earnings record--including such aspects as the average, the trend or growth, stability, etc--plus some examination of the current balance sheet, can be transmuted first into a projection of future earnings and dividends, and secondly into a valuation based on such projection.

A closer look at this desired process will reveal immediately that the future earnings and dividends need not be computed separately to produce the final value. Take the simplest presentation:

- (1) Past earnings times X equal future earnings.
- (2) Future earnings times Y equal present value.

This operation immediately foreshortens to:

- (3) Past earnings times XY equal present value.

It is the XY factor, or multiplier of past earnings, that my students would dearly love to learn about and to calculate. When I tell them that there is no dependable method of finding this multiplier they tend to be incredulous or to ask, "What good is security analysis then?" They feel that if the right weight is given to all the relevant factors in the past record, at least a reasonably good present valuation of a common stock can be produced, one that will take probable future earnings into account and can be used as a guide to determine the attractiveness or the reverse of the issue at its current market price.

In this article, I propose to explain two approaches of this kind which have been developed in a seminar on common-stock valuation. I believe the first will illustrate reasonably well how formula operations of this kind may be worked out and applied. Ours is an endeavor to establish a comparative value in 1957 for each of the 30 stocks in the Dow-Tones Industrial Average, related to a base valuation of 400 and 500, respectively, for the composite or group. (The 400 figure represented the approximate "Central Value" of the Dow-Jones Average, as found separately by a whole series of formula methods derived from historical relationships. The 500 figure represented about the average market level for the preceding twelve months.)

As will be seen, the valuations of each component issue take into account the four "quality elements" of profitability, growth, stability and dividend pay-out, applying them as multipliers to

the average earnings for 1947-1956. In addition, and entirely separately, a weight of 20% is given to the net asset value.

The second approach is essentially the reverse of that just described. Whereas the first method attempts to derive an independent value to be compared with the market price, the second starts with the market price and calculates there from the rate of future growth expected by the market. From that figure we readily derive the earnings expected for the future period, in our case 1957-1966, and hence the multiplier for such future earnings implicit in the current market price.

The place for detailed comment on these calculations is after they have been developed and presented. But it may be well to express the gist of my conclusions at this point, viz.:

(1) Our own "formula valuations" for the individual stocks, and probably any others of the same general type, have little if any utility in themselves. It would be silly to assert that Stock A is "worth" only half its market price, or Stock B twice its market price, because these figures result from our valuation formula.

(2) On the other hand, they may be suggestive and useful as composite reflections of the past record, taken by itself. They may even be said to represent what the value would be, assuming that the future were merely a continuation of past performances.

(3) The analyst is thus presented with a "discrepancy" of definite magnitude, between formula "value" and the price, which it becomes his task to deal with in terms of his superior knowledge and judgment. The actual size of these discrepancies, and the attitude that may possibly be taken respecting them, are discussed below.

Similarly, the approach which starts from the market price, and derives an implied "growth factor" and an implied multiplier therefrom, may have utility in concentrating the analyst's attention on just what the market seems to be expecting from each stock in the future, in comparison or contrast with what it actually accomplished in the past. Here again his knowledge and judgment are called upon either to accept or reject the apparent assumptions of the market place.

The first method consists of a formula valuation based solely on past performance in relation to the Dow-Jones Industrial Average as a group. The assumptions underlying this method are the following:

(1) Each component issue of the Dow-Jones Industrial Average may be valued in relation to a base value of the average as a whole by a comparison of the statistical records.

(2) The data to be considered are the following:

(a) Profitability--as measured by the rate of return on invested capital. (For convenience this was computed only for the year 1956.)

(b) Growth of per-share earnings--as shown by two measurements: 1947-56 earnings vs. 1947 earnings, and 1956 earnings vs. 1947-56 earnings.

(It would have been more logical to have used the 1954-56 average instead of the single year 1956, but the change would have little effect on the final valuations.)

(c) Stability--as measured by the greatest shrinkage of profits in the periods 1937-1938 and 1947-1956.

(The calculation is based on the percentage of earnings retained in the period of maximum shrinkage.)

(d) Payout--as measured by the ratio of 1956 dividends to 1956 earnings. In the few cases where the 1956 earnings were below the 1947-56 average we substituted the latter or the former, to get a more realistic figure of current payout.

These criteria demonstrate the quality of the company's earnings (and dividend policy) and thus may control the multiplier to be applied to the earnings. The figure found under each heading is divided by the corresponding figure for the Dow-Jones group as a whole, to give the company's relative performance. The four relatives were then combined on the basis of equal weights to give a final "quality index" of the company as against the overall quality of the group.

The rate of earnings on invested capital is perhaps the most logical measure of the success and quality of an enterprise. It tells how productive are the dollars invested in the business. In studies made in the relatively "normal" market of 1953 I found a surprisingly good correlation between the profitability rate and the price-earnings ratio, after introducing a major adjustment for the dividend payout and a minor (moderating) adjustment for net asset value.

It is not necessary to emphasize the importance of the growth factor to stock-market people. They are likely to ask rather why we have not taken it as the major determinant of quality and multipliers. There is little doubt that the expected future growth is in fact the major influence upon current price-earnings ratios, and this truth is fully recognized in our second approach, which deals with growth expectations as reflected in market prices. But the correlation between market multipliers and past growth is by no means close.

The companies with high multipliers may not have had the best growth in 1948-55, but most of them had greater than average stability of earnings over the past two decades.

These considerations led us to adopt the simple arithmetical course of assigning equal weight to past growth, past stability, and current profitability in working out the quality coefficient for each company. The dividend payout is not strictly a measure of quality of earning power, though in the typical case investors probably regard it in some such fashion. Its importance in most instances is undeniable, and it is both convenient and plausible to give it equal weight and similar treatment with each of the other factors just discussed.

Finally we depart from the usual Wall Street attitude and assign a weight of 20% in the final valuation to the net assets per share. It is true that in the typical case the asset value has no perceptible influence on current market price. But it may have some long-run effect on future market price, and thus it has a claim to be considered seriously in any independent valuation of a company. As is well known, asset values invariably play some part, sometimes a fairly important one, in the many varieties of legal valuations of common stocks, which grow out of tax cases, merger litigation, and the like. The basic justification for considering asset value in this process, even though it may be ignored in the current market price, lies in the possibility of its showing its weight later, through competitive developments, changes in management or its policies, merger or sale eventuality, etc.

The above discussion will explain, perhaps not very satisfactorily, why the four factors entering into the quality rating and the fifth factor of asset value were finally assigned equal weight of 20% each.

In Table I we supply the "valuation" reached by this method for each of the 30 stocks in the Dow Jones Industrial Average. Our table includes the various quality factors, the average earnings, and the asset values used to arrive at our final figures.

**Table I**  
**Formula Valuations of Dow-Jones Industrial Issues**

Company	Quality Factors				Av. Factor	Earns. 1947-1956	Book Value	Indicated Value		Price Aug. 5 1957
	Profit-ability	Growth	Stability	Payout				D.J. 400 Basis	D.J. 500	
Allied Ch.	91	46	94	100	84	4.50	40	55	69	89
Am. Can.	81	70	137	107	99	2.61	28	39	48	44
Am. S. & Ref.	101	39	100	81	80	5.43	51	65	85	54
Am. T. & T.	54	40	163	130	97	9.90	150	151	185	173
Am. Tob.	98	27	111	104	85	6.58	59	82	102	72
Beth. St.	95	138	0	97	83	2.88	31	36	45	49
Chrysler	*91	0	38	51	45	8.15	74	66	80	77
Corn. Prod.	100	65	114	98	94	1.96	40	31	37	31
Du Pont	154	198	100	109	140	5.60	41	107	136	199
East. Kod.	136	100	148	85	117	3.49	28	57	63	104
Gen. Elec.	139	129	84	127	120	1.87	14	31	39	68
Gen. Foods	138	99	141	79	114	2.42	20	39	49	49
Gen. Motors	160	119	95	104	120	2.48	20	42	53	45
Goodyear T.	108	207	129	83	132	4.18	43	78	98	76
Int. Harv.	*58	0	91	98	62	3.70	49	39	47	35
Int. Nickel	164	263	119	90	159	3.86	31	83	105	92
Int. Paper	100	46	0	101	62	6.40	55	61	76	101
Johns Man.	93	96	44	100	83	3.07	29	38	47	45
Nat. Dist.	*73	0	62	118	63	2.47	26	25	31	26
Nat. Steel	95	96	101	88	95	5.71	68	79	99	75
Proc. & Gam.	110	46	105	103	91	2.61	21	34	42	49
Sears Roe.	112	56	144	84	99	1.82	15	26	32	28
S. O. Cal.	124	113	134	65	109	3.09	24	47	59	58
S. O. N. J.	130	166	97	80	118	2.85	24	47	59	67
Texas Corp.	126	171	81	66	111	3.48	34	56	70	74
Un. C. & C.	138	92	108	100	110	3.73	27	53	67	117
Un. Airer.	158	361	181	66	192	3.65	35	96	121	62
U. S. Steel	99	239	0	67	101	3.51	47	54	67	69
Westinghouse	*65	0	0	83	37	3.79	43	27	32	64
Woolworth	*69	0	116	109	74	3.58	40	41	51	42
D.J. Ind. Av.	(13.0)	(56)	(52.3)	(64.3)	100	27.50	275	400	500	500

\*Based on 1947-56 Av. Earns. vs. 1956 Book Value plus adj.

In about half the cases these "valuations" differ quite widely from the prices ruling on August 5 last, on which date the D. J. Average actually sold at 500. Seven issues were selling at 20% or more above their formula value, and an equal number at 20% or more below such value. At the extremes we find Westinghouse selling at a 100% "premium," and United Aircraft at about a 50% "discount." The extent of these disparities naturally suggests that our method is technically a poor one, and that more plausible valuations could be reached--i.e., ones more congruous with market prices--if a better choice were made of the factors and weights entering into the method.

A number of tests were applied to our results to see if they could be "improved" by some plausible changes in the technique. To give these in any detail would prolong this report unnecessarily. Suffice it to say that they were unproductive. If the asset-value factor had been excluded, a very slight change would have resulted in favor of the issues which were selling at the highest premium over their formula value. On the other hand, if major emphasis had been placed on the factor of past growth, some of our apparently undervalued issues would have been

given still larger formula values; for Table I shows that more of the spectacular growth percentages occur in this group than in the other--e.g., United Aircraft, International Nickel, and Goodyear.

It is quite evident from Table I that the stock market fixes its valuation of a given common stock on the basis not of its past statistical performance but rather of its expected future performance, which may differ significantly from its past behavior. The market is, of course, fully justified in seeking to make this independent appraisal of the future, and for that reason any automatic rejection of the market's verdict because it differs from a formula valuation would be the height of folly. We cannot avoid the observation, however, that the independent appraisals made in the stock market are themselves far from infallible, as is shown in part by the rapid changes to which they are subject. It is possible, in fact, that they may be on the whole a no more dependable guide to what the future will produce than the "values" reached by our mechanical processing of past data, with all the latter's obvious shortcomings.

Let us turn now to our second mathematical approach, which concerns itself with future growth, or future earnings, as they appear to be predicted by the market price itself. We start with the theory that the market price of a representative stock, such as anyone in the Dow-Jones group, reflects the earnings to be expected in a future period, times a multiplier which is in turn based on the percentage of future growth. Thus an issue for which more than average growth is expected will have this fact shown to a double degree, or "squared," in its market price--first in the higher figure taken for future earnings, and second in the higher multiplier applied to those higher earnings.

We shall measure growth by comparing the expected 1957-66 earnings with the actual figures for 1947-56. Our basic formula says, somewhat arbitrarily, that where no growth is expected the current price will be 8 times both 1947-56 earnings and the expected 1957-66 earnings. If growth  $G$  is expected, expressed as the ratio of 1957-66 to 1947-56 earnings, then the price reflects such next decade earnings multiplied by 8 times  $G$ .

From these assumptions we obtain the simple formula:

Price equals  $(E \times G) \times (8 \times G)$ , or  $8G^2 \times E$ , where  $E$  is the per-share earnings for 1947-56.

To find  $G$ , the expected rate of future growth, we have only to divide the current price by 8 times 1947-56 earnings, and take the square root.

When this is done for the Dow-Jones Average as a whole, using its August 5, 1957, price of 500, we get a value of 1.5 for  $G$ --indicating an expected growth of 50% for 1957-66 earnings vs. the 1947-56 actuality. This anticipates an average of \$41 in the next decade, as against \$27.50 for the previous ten years and about \$36 in 1956. This estimate appears reasonable to the writer in

relation to the 500 level. (In fact he started with this estimate and worked back from it to get the basic multiplier of 8 to be applied to issues with no expected growth.) The price of 500 for the D. J. Average would represent in turn a multiplier of  $8 \times 1.5$ , or 12, to be applied to the expected future earnings of \$41. (Incidentally, on these assumptions the average current formula value of about 400 for the Dow-Jones Average would reflect expectations of a decade-to-decade growth of 35%, average earnings of \$37.1 for 1957-66, and a current multiplier of 10.8 for such future earnings.)

In Table II we set forth the results of applying this second approach to the 30 Dow-Jones issues (The figures for Am. Tel. & Tel. might well be ignored, since utility issues should take a different basic formula.) The main interest in the table lies in the disparities it indicates between the expected future growth, implicit in the market prices, and the actual growth during the past decade.

**Table II**  
**Formula Calculations of Expected Growth of Earnings of Dow-Jones Ind. Issues,**  
**as Indicated by August 5, 1957 Price**

Company	Price 8/5/57	Average Earnings 1947-56	Expected Growth 1957-66 vs. 47-56	Indicated Earnings 1957-66	Indicated Multiplier*	Earnings 1956	Expected Increase 57-66 vs. 1956	Actual Increase 56 vs. 47-56
Allied Ch.	89	\$4.50	+58%	\$ 7.22	12.6	\$4.74	+52%	+ 6 %
Am. Can	44	2.61	46	3.83	11.6	2.92	33	12
Am. S. & R.	54	5.43	12	6.10	9.0	6.67	(-8)	23
Am. T. & T.**	173	9.90	47	14.70	11.8	10.74	36	14
Am. Tob.	72	6.58	18	7.80	9.4	7.51	4	14
Beth. St.	49	2.88	44	4.15	11.5	3.83	8	33
Chrysler	77	8.95	4	9.28	8.3	2.29	(large)	(-76)
Corn Prod.	31	1.96	41	2.76	11.4	2.36	18	12
Du Pont	199	5.60	112	11.85	17.0	8.20	45	47
East. Kod.	104	3.49	93	6.62	15.4	4.89	36	37
Gen. Elec.	68	1.87	113	4.00	17.0	2.45	62	31
Gen. Foods	49	2.42	59	3.86	12.7	3.56	9	45
Gen. Motors	45	2.48	51	3.74	12.1	3.02	24	22
Goodyear T.	76	4.18	42	5.96	11.4	6.03	(-1)	47
Int. Harv.	35	3.70	8	4.02	8.6	3.14	29	(-15)
Int. Nickel	92	3.86	62	6.30	13.0	6.50	(-3)	68
Int. Paper	101	6.40	40	9.03	11.2	7.05	28	11
Johns Man.	45	3.07	36	4.21	10.9	3.50	20	14
Nat. Dist.	26	2.47	15	2.86	9.2	2.11	36	(-15)
Nat. Steel	75	5.71	28	7.32	10.2	7.09	3	25
Proc. & Gam.	49	2.61	53	3.99	12.2	3.05	30	20
Sears Roebuck	28	1.82	38	2.53	11.0	2.20	16	18
S. O. Cal.	58	3.09	55	4.78	12.4	4.24	12	39
S. O. N. J.	67	2.85	72	4.99	13.8	4.11	21	44
Texas Corp.	74	3.48	62	5.66	13.0	5.51	3	59
Un. C. & C.	117	3.73	99	7.43	15.9	4.86	53	32
Un. Air.	62	3.65	45	5.31	11.6	7.66	(-32)	93
U. S. Steel	69	3.51	57	5.55	12.6	6.01	(- 8)	73
Westinghouse	64	3.79	45	5.53	11.6	.10	(large)	(-97)
Woolworth	42	3.58	22	4.39	9.8	3.57	23	0
D.J. Ind. Av.	500	\$27.50	50	\$41.25	12.0	\$35.80	15	30

\*Dec. 1956 price ÷ Indic. 1957-1966 Earns.

\*\*The basic formula is less applicable to A. T. & T. than to industrial issues.

Ten of the companies (plus AT&T) sold at prices anticipating at least twice the Dow-ones Average rate of growth, comparing 1957-66 with 1956. Of these only two, Du Pont and General Electric, had actually shown distinctly better than average growth in the last ten years.

Conversely, eight of the companies were indicating less than half the average expected rate of growth, including five for which actual declines from 1956 levels were apparently predicted. Yet of these eight companies, no less than five had actually shown far greater than average growth in the past decade.

This leads us to our final observations, which tie our two tables together. The ten companies previously mentioned, for which unusually rapid growth is anticipated, include seven of those



shown in Table I as selling significantly above their formula valuation. Again, the eight for which subnormal or no growth is expected include six which were selling substantially below their formula valuations.

We conclude that a large part of the discrepancies between carefully calculated formula values and the market prices can be traced to the growth factor, not because the formulas underplay its importance, but rather because the market often has concepts of future earnings changes which cannot be derived from the companies' past performance. The reasons for the market's breaking with the past are often abundantly clear. Investors do not believe, for example, that United Aircraft will duplicate its brilliant record of 1947-56, because they consider that a company with the United States Department of Defense as its chief customer is inherently vulnerable. They have the opposite view with regard to Westinghouse. They feel its relatively mediocre showing in recent years was the result of temporary factors, and that the electric manufacturing industry is inherently so growth-assured that a major supplier such as Westinghouse is bound to prosper in the future.

These cases are clear cut enough, but other divergences shown in our table are not so easy to understand or to accept. There is a difference between these two verbs. The market may be right in its general feeling about a company's future, but the price tag it sets on that future may be quite unreasonable in either direction.

It is here that many analysts will find their challenge. They may not be satisfied merely to find out what the market is doing and thinking, and then to explain it to everyone's satisfaction. They may prefer to exercise an independent judgment--one not controlled by the daily verdict of the market place, but ready at times to take definite issue with it. For this kind of activity one or more valuation processes, of the general type we have been illustrating, may serve a useful purpose.

They give a concrete and elaborated picture of the past record, which the analyst may use as a point of departure for his individual exploration and discoveries in the field of investment values.

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### *The Renaissance of Value*

The titled of this section implies that the concept of value had previously been in eclipse in Wall Street. This eclipse may be identical with the disappearance of the once-established distinctions between investment and speculation. In the last decade, everyone became an investor – including buyers of stock options and odd-lot short sellers. In my own thinking the concept of value, along with that of margin of safety, has always lain at the heart of true investment, while price expectations have been at the center of speculation.

Let me list some questions relating to the value approach that confront the financial analyst now in light of the 1965-1974 experience:

1. Is the value approach a useful one in terms of:
  - a) what it can accomplish on its own, and
  - b) by comparison of its results with those of other analytical methods and practices?
2. To what degree should the techniques of valuation as presented, say in Graham, Dodd, & Cottle, 1962 – be modified by more recent developments, including theoretical thinking?
3. What is the effect of institutional domination of the stock market on the valuation work of the security analyst and the decision-making procedures of the financial analyst?
4. To what extent does the sheer number of practicing analysts – some 14,000 F.A.F. members, including 3,800 CFAs and over 2,000 active CFA candidates – prevent the average or representative worker from achieving worthwhile results? This is indeed a delicate question.

The discussion that follows will not separate each of these questions from the others, but I will try to answer them as best I can. The value approach has been founded on the premise that in many – but by no means in all – cases a dependable range of valuation can be established for a common stock by analytical techniques; that often this range differs substantially from the current price; and that such differences offer rewarding opportunities for investment operations. The phrase “rewarding opportunities” implies that the stock market itself will vindicate the value-based operation, after an interval that averages not too long for human patience – say, three years or less.

Typically, the midpoint range of the value range has been found by applying an appropriate multiplier to estimated future earnings. My present view is that this is not the best technique. Instead, the earnings figure taken should be what we call “normal current earnings”, and all the future prospects – favorable or unfavorable, specific or general – should enter into the multiplier. This procedural change obviates the necessity of establishing a future value and then discounting same to its present worth.

Such a procedure would carry us very far from the method first suggested in 1938 in Dr. John Burr Williams’ seminal book “The Theory of Investment Value”. His technique required an estimate of the stream of dividends to be received over a very long future period, and the summation of the discounted worth of each dividend to arrive at present value. The various mathematical methods later developed for valuing growth stocks represent a sort of compromise between the Williams approach and what I now suggest. For they stop the estimated stream of

dividends at a terminal year – say ten years hence – and the value the stock, usually on a conservative basis, in that terminal year. The resulting figures of dividends and terminal value would then be discounted at a uniform chosen rate to arrive at present value.

Those of you who have studied *Security Analysis* may recall that we tried to simplify the mathematical methods of several writers by suggesting a formula that employs a single variable G, representing the expected growth rate over the next seven to ten years. It read:

Value = current normal earnings times the sum of 8.5 plus 2G.

This valuation formula – like those it purported to approximate – had the great defect of failing to allow for changes in the basic rate of interest. But one development in the past decade that has had the greatest influence on stock values – and, somewhat belatedly, on stock prices – has been the phenomenal advance in interest rates. For the three years preceding the publication of our text the yield on AAA bonds averaged 4.4 percent, and that was also the figure just ten years ago. But for the three years 1971-1973 the average was 7.5 percent, and most recently 9.5 percent.

It would seem logical to me to make common stock valuations vary inversely with representative current interest rates corresponding to the analyst's use of representative current earnings. Suppose we restated our 1972 formula with that objective making it reflect the then going AAA rate of 4.4 percent. The expression would then read:

Value = Earnings time the sum of 37.5 plus 8.8G, divided by the AAA rate.

Since analysts have a weakness for figures, you might like to hear two or three results based on this revised formula. For the DJIA, taking G as its historic 4.5 percent and the AAA rate of its 3-year average of 7.5 percent, we get a multiplier of 10.2. Applying this to the 1971-73 average earnings of the Dow, its central value would be about 750. If instead of 3-year average figures you took the recent bond rate of 9.5 percent and the most recent inflation-aided annual earnings of about \$93 the indicated central value would be the same 750. (The higher earnings are offset by the higher interest divisor.)

These calculations, for what they are worth, suggest that the Dow at its recent low level of 627 was undervalued by about 15 percent. Whether this would presage a near or delayed end of the current bear market I leave to wiser or bolder heads than mine. However, this same method when applied to individual issues would indicate that many have been more significantly underpriced in the present market. Take Firestone as an example. Its earnings have grown at a better rate in the past decade than those of the Dow. The figures for 1971-73 show a 116 percent increase from 1961-61 for Firestone versus 66 percent for the DJIA. If we assume the same future G of 4.5 percent for Firestone as for the Dow, and hence the same multiplier of 10.2 times 1971-73

earnings, our valuation would be 254 for the tire company shares, fully 90 percent above their 1974 low. Incidentally, this would just about equal the current book value of Firestone – a previously minor detail in the investment picture but one to which I am inclined to ascribe major importance under today's new conditions. Firestone is, of course, only one example of the discrepancy between the current level of the Dow – which includes several first-tier institutional favorites – and that of the current run-of-the-mine good sized company.

A multiplier based on expected growth and interest rates alone would imply that a company's financial structure and debt position do not enter into the valuation process. This might be the case if the formula were applied – as originally intended – only to high-growth companies, whose prospects are considered so good that they are assumed to face no financial problems. But if we seek to generalize our formula to apply to average –growth companies, we must recognize that many of these may be in unsatisfactory financial condition, caused in part by inflation pressures and in good part also by the over-expansion of corporate debt in the past decade. (I consider the total figures for corporate debt since 1968, published in the June 1974 issue of the *Society of Current Business*, to be most disquieting. They show an overall increase of 74 percent in only five years, with more to come in 1974.)

I see no satisfactory way of reducing the multiplier to allow for a below-par debt position. My advice to analysts would be rather to avoid attempting a formal valuation of such companies. In other words, limit your appraisals to enterprises of investment quality, excluding from that category such as do not meet specific criteria of financial strength. This statement brings me back to our old position that speculative companies cannot be dealt with at all by the analyst with satisfactory overall results. By my own rather strict quantitative criteria, Firestone would pass the financial strength test by a modest margin. Such tests might well exclude up to half of the NYSE list today from investment consideration, but there would remain enough qualifying issues to give the analysts and the investor an ample selection. It should be clear that I have faith in the valuation process as a guide to investment choices, but that I would limit this technique rather strictly to companies that meet criteria of financial soundness. Also, I should require that the buy decisions based on this approach involve a margin of safety factor. This might well be a purchase price not over two-thirds of the central appraised value.

How would such policy have worked out during the past decade? Several times the market price of Firestone fell below our formula value, but not by the one-third margin. (The indicated buying level in 1970 was 16 against its low of 17.5, followed by the next year's high of 28.5) Other studies have led me to believe that a computer-type valuation job of this kind would have found a considerable number of cases where shares of sound companies could have been obtained for less than two-thirds of their formula value. On the whole one would have done quite well over this period by buying on this basis and selling at a 50 percent profit when obtainable. I see no

reason to think that a similar policy could not be followed with satisfactory results in the future. (It should be unnecessary for me to add that these results are not guaranteed.)

There are, of course, many other approaches of the valuation type, and different analysts may favor different formulas with different parameters than the two I have been using. I have myself been intrigued by the idea of choosing stocks among those that are obtainable at not more than one-half their former high quotation, provided that they meet criteria of value independent of the price record. A technique of this sort would have worked fine, according to my studies, up to and including the post-1970 market recovery. Under more recent conditions it would merely have added a price decline criterion to the determination of buy points based on the valuation approach. For practically all issues of the Firestone type an acquisition price at two-thirds of analysts' valuation would be at less than half of the previous market high.

Let me pass on to a factor in the valuation process that I my thinking has taken on considerable importance under present conditions. This is the book value figure, to be viewed either as a point of departure for more refined calculations or as a practically usable measure of a common stock's value. For years we have all pretty well disregarded asset values, except for financial enterprises and some special cases. But in recent markets a large number – perhaps a majority – of NYSE, commons have actually fluctuate in price both above and below their asset values. Even Polaroid was recently obtainable at less than book value! This fact would seem to establish a realistic relationship in many cases between net worth and intrinsic or analysts' value. One might well speak today of “The Renaissance of Book Value.”

You are all intelligent enough to appreciate that I am not now saying that Avon Products is only worth its book figure of \$7.70 per share, or that Chicago Milwaukee common is to be valued at the \$149 per share shown on the balance sheet. In a substantial percentage of issues the book value figures have no worthwhile connection with the investment value of their shares. But the analyst has today perhaps a thousand stocks or more to choose from in which the asset value may actually fall within his range of appraised value. In many of these cases he could then settle for the net worth as his preferred specific figure of value, and base his buy-and-sell points on his convenient measure.

This approach can put the choice of marketable common stocks on a basis corresponding to that of investment in a private non-quoted enterprise. If the commitment would be attractive as an ordinary business venture it should be even more attractive as part of a publicly-held enterprise, with the added advantages of diversification and ready marketability.

However, in my experience marketability has proved of dubious overall advantage. It has led investors astray at least as much as it has helped them. It has made them stock-market minded instead of value-minded. I have a puritanic vision of the true investor as someone who is entirely

disinterested in what the stock market does except on two sorts of occasions that meet his convenience. The first occasion is when the market obingly permits him to buy a group of common stocks at less than their indicated value; the second is when with equal courtesy it permits him to sell at not more than one-half their former high quotation those that are of no importance to him. True, he may sometimes dispose of an investment at a loss. But that should not be because the market price went down; it should be because things went badly for the company and the true value of the shares declined below the price he paid for them. (Of course the investor may also use the stock market to switch out of issues he owns into others that offer more value at ruling prices.)

(You are now hearing some of the “old-time religion”. You may not be converted, but it shouldn’t do you any harm.)

Some interesting questions relating to intrinsic value vs. market price are raised by the take-over bids that are now part of our daily financial fare. The most spectacular such event occurred a few weeks ago, when two large companies actively competed to buy a third, with the result that within a single month the price of ESB Inc. advanced from 17.5 to over 41. We have always considered the value of the business to a private owner as a significant element of appraising a stock issue. We now have a parallel figure for security analysts to think about: the price that might be offered for a given company by a would-be acquirer. In that respect the ESB transaction and the Marcor one that followed it offer much encouragement to those who believe that the real value of most common stocks is well above their present market level.

### **Alternative Investments**

The value approach has always been more dependable when applied to senior issues than to common stocks. Its particular purpose in bond analysis is to determine whether the enterprise has a fair value so comfortably in excess of its debt as to provide an adequate margin of safety. The standard calculation of interest coverage has much the same function. There is much work of truly professional caliber that analysts can do in the vast area of bonds and preferred stocks – and to some degree also in that of convertible issues. The field has become an increasingly important one, especially since all well-rounded portfolios should have their bond component.

Any security analyst worth his salt should be able to decide whether a given senior issue has enough statistically based protection to warrant its consideration for investment. This job has been neglected at times in the past ten years – most glaringly in the case of the Penn Central debt structure. It is an unforgivable blot on the record of our profession that the Penn Central bonds were allowed to sell in 1968 at the same prices as good public-utility issues. An examination of that system’s record in previous years – noting inter alia its peculiar accounting and the fact that

it paid virtually no income taxes – would have clearly called for moving out of the bonds, to say nothing of the stock even at prices well below its high of \$86. We now have a situation in which all bonds sell at high yields, but many companies have an over-extended debt position. Also, many of them do not seem to have sufficiently strong protective provision in their bond indentures to prevent them from offering new debt in exchange for their own common stock. (A striking example is the current bond for stock operation of Caesar’s World.) These widespread present maneuvers seem to me to be so many daggers thrust in the soft bodies of the poor creditors. Bondholders can and should take steps, legal if necessary, to protect their interests against such forms of invasion.

Thus security analysts could well advise a host of worthwhile switching in the bond field. Even in the Federal debt structure – where safety is not an issue – the multiplicity of indirect U.S. Government obligations of all sorts, including some tax exempts, suggest many opportunities for investors to improve their yields. Similarly, we have seen many convertible issues selling at close to parity price with the common; in the typical case the senior issue has offered a higher yield than the junior shares. Thus a switch from the common stocks into the senior issue in these cases would be a plain matter of common sense. (Examples: Studebaker-Worthington and Engelhard Mineral preferred vs. common.)

## **Special Situations**

The period 1939-1942 was a heyday for operators in special situations and under-valued securities. During these years the trend was unfavorable to those owning standard issues, and the brokerage business also was on the quiet side. By contrast, many bargain industrial stocks scored substantial advances – especially since the early war years brought proportionately greater business improvement to the secondary companies than to the leaders. In addition, quite a number of railroad and utility reorganizations were taking shape, and developing good profits for those who had brought their issues at unpopular times and consequently at basement prices.

By 1942 many in Wall Street had come to believe that the only real and dependable income was to be made in special situations. As usually happens, this generalization proved wide of the mark. In the ensuing four years there have been good profits in almost everything, and the spectacular returns have lately been shown in essentially speculative, as distinct from “special” operations. But perhaps enough interest remains in the latter type of activity to warrant this section.

### *The Meaning of Special Situations*

First, just what is meant by a “special situation”? Convention has not jelled sufficiently to permit a clear-cut and final definition. In the broader sense, a special situation is one in which a particular development is counted upon to yield a satisfactory profit in the security even though

the general market does not advance. In the narrow sense, you do not have a real “special situation” unless the particular development is already under way.

This distinction is readily apparent by reference to the wide fields of bankrupt corporations and preferred stocks with large back dividends. In the former case, the “particular development” would be reorganization; in the latter, it would be discharge of the arrears, usually by a recapitalization. Many practitioners will say that a company in trusteeship does not constitute a special situation until a reorganization plan has actually been submitted; similarly, there must be a definite plan on foot for taking care of dividend accumulations.

There is a logical and important reason for favoring this narrower definition of a special situation. By doing so we are able to conceive of these commitments in terms of an expected annual return on the investment. As will be seen, such a calculation involves quite a number of estimates in each case, and thus the final figure bears little resemblance to the bond yields taken out of a basis book. Nevertheless, this technique is a valuable as a guide to the operator in special situations, and it gives him an entirely different attitude toward his holdings than that of the trader, speculator, or ordinary investor.

In one respect, however, the calculation goes beyond the lore of the yield book. If we are willing to make the necessary assumptions, the attractiveness of any given special situation can be expressed as an indicated annual return in per cent with allowance for the risk factor. Here is the general formula:

Let G be the expected gain in points in the event of success’

L be the expected loss in points in the event of failure;

C be the expected chance of success, expressed as a percentage;

Y be the expected time of holdings, in years;

P be the current price of the security.

Then

$$\text{Indicated annual return} = \frac{G C - L(100\% - C)}{Y P}$$

We may take as a current example the Metropolitan West Side Elevated 5s selling at 23. It is proposed to sell the property to the City of Chicago on terms expected to yield in cash about 35 for the bonds. For illustrative purposes, let us assume (a) that if the plan fails the bonds will be worth 16; (b) that the chances of success are two out of three – i.e., 67%; (c) that the holding period will average one year. Then by the formula:



$$\text{Indicated annual return} = \frac{12 \times 67\% - 7 \times 33\%}{1 \times 23} = 24.7\%$$

Note that the formula allows for the chance and the amount of possible loss. If only possible gain were considered the indicated return would be 34.5%.

### *Classes of Special Situations*

Let us turn now to a condensed description and discussion of the various types of special situations. These could be divided into two main categories: (I) Security exchanges or distributions, (II) Cash pay-outs. Only in a rare case does a special situation, as we use the term, work itself out in a higher market without a cash or security distribution occurring somewhere in the picture. However, a more conventional classification may better serve our present purpose.

#### *Class A. Standard Arbitrages, Based on a Reorganization, Recapitalization, or Merger Plan*

In bankruptcy reorganizations, particularly those of railroads, the operation consists of buying old and selling “when-issued” securities. Railroad arbitrage has had a curious history in the past five years. In more than half of the cases the plans have been consummated and the expected profit realized – although almost always after a longer time lag than was originally anticipated. In the remainder the plans have been changed or dropped and the when-issued trades cancelled; or else such cancellation is now expected, chiefly as a result of the Wheeler Bill. Nevertheless, large profits were made by many arbitragers, even in the unsuccessful plans, because the old securities advanced greatly above the price they paid, in spite of the plan’s failure. Thus, what was intended to be an old-fashioned arbitrage turned into a successful bond speculation.

This experience illustrates one pleasing aspect of the special situation operation, which is that if your deal works out pleasing aspect of the special situation operation, which is that if your deal works out you are sure to make a profit, but if it doesn’t, you may still make a profit. The hazards of arbitraging increase as the general market level rises, because your chances of loss in the event of the plan’s failure become correspondingly greater. To this important extent many types of special situation are tied with general market conditions; but it is still true in the average or representative case the result depends upon corporate and not on market price developments.

Arbitrages in industrials generally grow out of mergers or recapitalizations and involve the sale of existing rather than when-issued securities. In the recent Raytheon-Submarine Signal merger, one could buy Submarine Signal and sell Raytheon on announcement at an indicated spread of about 18%. That arbitrage was successfully consummated within sixty days. Similarly, when the General Cable Recapitalization Plan announced, one could buy a share of A stock at 52 and sell four shares of common for 5 – a spread of about 13% - with consummation in 45 days. However,

such operations have as a pre-requisite the ability to borrow the stock for the duration of the arbitrage. Under present conditions of no margin trading, such borrowing is so difficult as to prevent many (though not all) of these deals.

In the utility field, somewhat similar arbitrages have been available as a result of exchange offers made by holding companies for their preferred stocks. Recent examples are United Corporation and American Superpower.

There are, of course, various hazards involved in all these arbitrages. They include possible rejection by stockholders; possible legal action by minority holders; possible disapproval by the SEC, etc. The experienced operator does not ignore these hazards, but attempts to measure them carefully in the particular circumstances of each case.

It will be noted that the industrial, utility and rail arbitrages fall respectively into three distinct classes with regard to the time element. One might almost say that the first is usually a matter of weeks, the second of months, and the third of years.

An exception to this rule was the United Light & Power arbitrage. Here one bought a share of old preferred and sold five shares of new common "when issued" against it, at an initial spread of about 10% net. Because of litigation that reached the Supreme Court, this utility recapitalization took fully two years between proposal and consummation. Though it yielded the expected profit in dollars, the time element made the outcome far from brilliant.

#### *Class B. Cash Payouts in Recapitalizations or Mergers*

A recent example of this type is Central and Southwestern Utilities 2<sup>nd</sup> preferred. Under a recapitalization and merger plan, presented to the SEC on Feb 5, 1946, the holders were given the option of taking the full redemption value in cash or the equivalent in new common stock at the syndicate offering price. The current redemption value was \$220 per share, against the market price of 185. Thus the expected profit would be 19%, plus interest at about 3% per annum for the duration of the operation. The hurdles to be surmounted here include (a) SEC approval; (b) court approval; (c) ability to secure an underwriting of new common stock at a specified minimum price; (d) miscellaneous delays, most frequently caused by litigation. If the plan should fail, the buyer risks a fall in the price of his shares; but contrariwise in the typical preferred stock or bond pay-out, there is virtually no chance of getting more than the redemption value accorded under the plan. We must recognize here an inherent weakness in this type of operation. [Sequel: The plan was carried out, and the preferred holders who asked for cash received \$223 in February 1947.]

The experienced analyst knows that the chance of ultimate loss diminishes to the extent that the preferred stock is cushioned by the presence of proportionally large common stock equity. Thus he should feel differently as regards Cities Service 1<sup>st</sup> Preferred selling at 132, with total claim of 181 (or 193 call price), as compared with American Power and Light \$6 Preferred selling at 117 with a total claim of 145 (or 160 at call price). The maximum indicated gain for Cities Service Preferred is backed by \$1.20 in market value of common stock; while each dollar paid American P. & L. plan, the purchaser of Cities Service Preferred will undoubtedly fare the better of the two. [Sequel: The pending plan for paying off the American Power & Light Preferred was withdrawn, and the \$6 issue sold at 91 at the end of 1947. Conversely, a plan was proposed and carried out for paying off the Cities Service Preferred issues. As a consequence the First preferred was exchanged for bonds, making it worth \$157 per share at the end of 1947.]

### *Class C. Cash Payments on Sale or Liquidation*

In most cases where a company sells out its business to another or merely liquidates its assets piecemeal, the ultimate amount received by the security holder exceeds the market price at the time the sale or liquidation is proposed. (This condition grows out of the nature of the price making factors in the security market). In the case of a sale for cash on a going concern basis, the large profits are most often to be made by those who buy before the negotiations are begun or completed. But even after the terms are announced, there is often an interesting spread to be realized if the sale is consummated.

Quite a number of such sales have recently taken place in the textile-mill field. At this time the most recent example is a bid of \$365 per share for stock of the Luther Mfg. Co., contingent on acceptance by not less than 95% of the stock. A week before the purchase offer was made public the stock was quoted at \$150 bid. [Sequel: The purchase at \$365 was consummated.] Most of these purchase offers, even though contingent on acceptance by a large majority, have become effective; and those which failed generally did so because a still higher bid was forthcoming from other quarters.

A vote to liquidate assets by piecemeal sale is rather infrequent, except that we have had a number of such liquidations of public utility holding companies under statutory pressure. In such cases the amount of cash to be realized for the assets, less the corporate liabilities and expenses, is subject to estimation and consequent error. Where estimates are made by the management, they are customarily on the conservative side. In most instances, the market price at the time of the vote to liquidate proves to be appreciably less than the amount recovered. A protracted liquidation of this kind has been under way in Ogden Corp., showing a very good percentage profit for those who bought at an early stage. Brewster Corp. is an example in the

industrial field. At this writing the tax liabilities of Brewster have not been determined. As against a stated book value of 5 and a market price of about 4.25, the current “expert” estimate of ultimate realization ranges between 5.5 and 6. [Sequel: The stockholders have since received \$5.75 per share in cash, and are expected to realize something additional.]

#### *Class D. Litigated Matters*

These are fairly numerous cases in which the value of a security depends largely on the put come of litigation. This may involve a damage or subordination suit, disputed income tax liability, and an appeal from reorganization plan wiping out stock issues. In general, the market undervalues a litigated claim as an asset and overvalues it as a liability. Hence the students of these situations often have an opportunity to buy into them at less than their true value, and to realize attractive profits – on the average – when the litigation is disposed of.

#### *Class E. Public Utility Breakups*

These have been a very important group of special situations in recent years. They are an essentially temporary phenomenon in that they will pass out of the picture when compliance with Section 11 of the Public Utility Holding Company Act has been completed for the industry.

Their unique feature is that the profit in them depends upon the principle that a holding company is worth more dead than alive – i.e., that its separate assets, net, will sell for more than the parent company securities. This has brought about the paradoxical situation that the stocks of holding companies bitterly fighting dissolution – presumably for the sake of their owners, the shareholders – have been depressed in price by this valiant battle and have advanced when they lost their fight.

The technical quality which sets these situations apart from others is the fact that they usually depend upon an estimate or forecast of the market value of securities which are to be distributed and are not now traded in. In some cases there is a marrow market for existing minority shares, but it may not be too informing in relation to conditions after the majority shares come on the market. (An example of this is Philadelphia Co., which is the central factor in the valuation of Standard Gas and Electric Preferred issues. The curb-market price for the 3.2% minority interest may or may not be representative of the value of the entire issue.)

Improvement in the art of utility analysis, favored by the relative infrequency of unlooked for developments in the field, makes it possible to calculate fairly dependably what any operating company stock is likely to sell at under current market conditions. Thus the hazard in exploiting these breakup situations grows largely out of the uncertain time element, with the attendant possibility of an unfavorable change in market conditions before the distributions are received.

### *Class F. Miscellaneous Special Situations*

This catch-all category includes everything we have not already classified. There is no point in trying to make our descriptions comprehensive since a good deal depends on one's personal definition of "special situation." We may suggest two additional varieties by way of example only. A peculiar one would be the rather major field of hedging operations – most characteristically the sale of a common stock against ownership of a convertible bond or preferred stock. (Here the security-exchange feature operates to protect against loss rather than to create the profit.) Another, more limited, would be the purchase of a guaranteed security on the expectation that it will later be made exchangeable into a bond on attractive terms, in order to save heavy corporate income tax. (This occurred in the case of Delaware Hudson and D.L. & W. leased-line stocks.)

### *Conclusion*

At the outset of this section, we grouped special situations and undervalued securities together. The reader will have noticed that we do not consider these terms as synonymous – although it may be held that special situations constitute a major sub-division of undervalued securities. The essence of a special situation is an expected corporate (not market) development, within a time period estimable in the light of past experience. Thus here, as almost everywhere else in finance, wide experience is a major factor in lasting success; it must be supplemented by careful study of each situation and the possession of sound though somewhat specialized judgment.

Special situations, as we define them, appeal mightily to one class of temperament for the very reason that they leave other people cold. They lack industrial glamour, speculative dynamite, or more sober growth prospects. But they do afford the analyst an opportunity to deal with security values very much as the merchant deals with his inventory, calculating in advance his average profits and his average holding period. In this sense they occupy an interesting middle ground between security purchases for ordinary speculation or investment and security purchases for resale in syndicate or dealership operations.

### **Common Stocks and Inflation**

Let us turn now to inflation. Do the prospects of continued inflation make equity purchases undesirable at present market prices or indeed at any conceivable level? It is passing strange that this question should even suggest itself. It seems only yesterday that everyone was saying that stocks, even at high prices, were definitely preferable to bonds because equities carried an important measure of protection against future inflation.

But it should be admitted that not only recently, but for many years and perhaps decades past, equities as a whole have failed to provide the protection against inflation that was expected from them. I refer to the natural surmise that a higher general price level would produce a higher value for business assets and hence correspondingly higher profit rates in relation to original costs. This has not been borne out by the statistics. The rate of return on book equities as a whole—much understated as they must be in terms of reproduction costs—has at best held constant at around the 10 to 12 level. If anything, it has declined from the 1948 to 1953 period when the Dow was selling at only seven times earnings.

It is true of course that the earnings on the DJIA and the S&P 425 Industrials have tripled from 1947-1951 to 1969-1973. But in the same period the book value of both indexes has quadrupled. Hence we may say that all the increase in post-war earnings may be ascribed to the simple building up of net worth by the reinvestment of undistributed profits, and none of it to the more than doubling of the general price level in those 28 years. In other words, inflation as such has not helped common stock earnings.

This is a good reason—and there are others—not to be enthusiastic about equities at every market level. This caution is part of my long-held investment philosophy. But what about the current situation? Should inflation prospects dissuade an investor from buying strong companies on a 15 percent earnings return? My answer would be "no." What are the investors' real choices—whether as an institution or as an individual? He can elect to keep his money in short-term obligations, at a good yield, expecting that future inflation will eventually produce lower market levels for all kinds of stocks, including those with low multipliers. This choice would be justified when the investor is convinced that stocks are selling above their true value, but otherwise it is only a kind of bet on future market movements. Or he may conceivably decide on an entirely new sort of investment policy—namely, to move from stocks or bonds into things: real estate, gold, commodities, valuable pictures and the like.

Let me make three observations here. The first is that it is impossible for any really large sums of money—say billions of dollars—to be invested in such tangibles, other than real property, without creating a huge advance in the price level, thus creating a typical speculative cycle ending in the inevitable crash. Secondly, this very type of hazard is already manifest to us in the real estate field, where numerous new ventures, financed through a combination of borrowing and quoted common-stock issues, have encountered problems of all sorts, including large stock-market losses for their investors. My third observation is on the positive side. I think all investors should recognize the possibility—though not necessarily the probability—of future inflation at the recent 11 per cent rate, or even higher, and should introduce what I shall call a "concrete-object factor" in their overall financial approach. By this I mean that they should not be content to have an overwhelming proportion of their wealth represented by paper money and its equivalents, such as bank deposits, bonds and receivables of all sorts. For the shorter or longer

pull—who can really tell?—it may turn out to be wiser to have at least an indirect interest—via the common-stock portfolio—in such tangibles as land, buildings, machinery and inventories. This is relatively easy to accomplish in the execution of an ordinary common-stock investment policy. My point is only that it would be worthwhile to introduce the concept as a specific and measured criterion in analyzing one's resources. That idea is as readily applicable to pension funds as to other portfolios.

It should be obvious from my overall approach to the future of equities that I do not consider such much-publicized problems as the energy crisis, environmental pressures, foreign exchange instability, etc. as central determinations of financial policy. They enter into the value versus price equation in the same general fashion as would any such other adverse factors as 1) a tendency towards lower profit margins and 2) the higher debt burden and the higher interest rate thereon. Their weight for the future may be assessed by economists and security analysts, presumably with the same accuracy, or lack of it, as has characterized such predictive work in the past.

### **The Beta Coefficient**

So far I have been talking about the virtues of the value approach as if I had never heard of such newer discoveries as “the random walk”, “the efficient market”, “efficient portfolios”, the Beta coefficient, and others such. I have heard about them, and I want to talk first for a moment about Beta. This is a more or less useful measure of past stock price fluctuations of common stocks. What bothers me is that authorities now equate the Beta idea with the concept of “risk”. Price variability yes; risk no. Real investment risk is measured not by the percent that a stock may decline in price in relation to the general market in a given period, but by the danger of a loss of quality and earning power through economic changes or deterioration in management. In the five editions of *The Intelligent Investor* I have used the example of A & P shares in 1936-1939 to illustrate the basic difference between fluctuations in price and changes in value. By contrast, in the last decade, the price of A & P shares from 43 to 8 paralleled pretty well a corresponding loss of trade position profitability, and intrinsic value. The idea of measuring investment risks by price fluctuations is repugnant to me, for the very reason that it confuses what the stock market says with what actually happens to the owners' stake in the business.

### **Pitfalls of Discounted Cash Flows**

We are badly in need of a technique of common-stock investment which will be at once forward-looking and quantitatively restrained. Mr. Williams' book seeks to give us just this-and more, because it deals also with bond investment. As applied to stocks, the underlying idea is simple enough. The investment value of a stock is the present worth of all future dividends. If we can fairly estimate these dividends and can select a suitable discount rate, the calculation of present

value becomes merely a problem in higher algebra. A good part of the book is devoted to working out the formulas applicable to a variety of hypotheses, the treatment here being similar to, but far more elaborate than, the mathematical part of G. A. D. Preinreich's *The Nature of Dividends*. Many of these formulas are later employed in "case studies" to determine the investment value of General Motors, United States Steel, and Phoenix Insurance in 1937, and four public utility issues as of 1930. Mr. Williams gives us also an elaborate study of United States government bonds, aiming at a forecast of future interest rates and an appraisal of the outlook for inflation.

A vast amount of original thought, comprehensive research, and laborious mathematical study has gone into this impressive work. The task of evaluating it is no easy one, for it is crammed with new ideas, critical judgments of the past and both bold and tentative prediction. At the least we have here an interesting combination of economic and mathematical theory. The author claims much more for it—namely, that he has given investment analysts "the proper methods of evaluation" and of translating "prospects into prices", so that there is now no excuse for another excessive boom. But on this point there may be room for skepticism. If we examine the case studies critically we may find that the sound conclusions are not really dependent on the new technique, while the latter's distinctive results are either inconsequential or unconvincing.

I was especially interested in the study of Phoenix Insurance to see how Mr. Williams deals with the vexing problem of evaluating an expected long-term upward trend in earnings. The result was rather surprising. The value "assuming growth completed" was set at \$105, by what amounts to the quite conventional method of multiplying expected normal earnings by 20. The method of discounting future growth (consuming seven pages and requiring much mathematics) added only \$5.00 to this value, because in fine the author arbitrarily limited his consideration to a very minor net gain from an expansion lasting only a few years. The case study of American Telephone in 1930 yields even stranger results. Assuming an annual rate of growth of 10 per cent for ten years, the author finds an investment value of \$200 per share. But had he assumed no growth at all and valued the 1929 earnings on the same basis as he used for the average earning power of Phoenix Insurance, the value of American Telephone would have been  $20 \times \$14$ , or \$280.

Clearly, Mr. Williams' method stands or falls not on his formulas (which are unimpeachable) but on his assumptions with respect to their numerous variables—e.g., the rates of growth, of distribution of profits, and of interest; and the "terminal value" when growth ceases. One wonders whether there may not be too great a discrepancy between the necessarily hit-or-miss character of these assumptions and the highly refined mathematical treatment to which they are subjected.

A word must be added with respect to the elaborate study of factors affecting the future interest yield of government bonds. The reviewer cannot refrain from expressing strong disagreement



with the reasoning which leads Mr. Williams to assert that common-stock prices should not reflect anticipated inflation, while bond yields should adjust themselves mathematically to expected future changes in the cost of living. If this last were so, bonds could sell at a minus yield to discount a substantial fall in prices.

These criticisms, if justified, are serious. Nevertheless there remains much of solid value in the work. The case studies of United States Steel and Phoenix Insurance are models of thoroughgoing security and industry analysis. The emphasis on the primacy of dividends, and the insistence that the value of reinvested earnings is to be found only in increased dividends, are a much-needed warning to Wall Street. In many other respects, too, Mr. Williams is to be commended for his conservative approach toward stock values. This conservatism is not really implicit in the author's formulas; but if the investor can be persuaded by higher algebra to take a sane attitude toward common-stock prices, I will cast a loud vote for higher algebra.

## **Dividends and Tax Matters**

### *Tax Advantages*

Given an expanding economy, which needs to add substantially to its equity capital, both at the management and the stockholders face a dilemma in the matter of dividend policy. If the dividend is held down below a reasonable return on the fair value of the enterprise, the rank and file of the stockholders lose twice – first, by inadequate income, and second, by an unduly low market price for the shares.

On the other hand, if the company follows what used to be considered the preferable policy – namely, to pay a fully adequate dividend, but then to build up its equity capital by selling additional shares – the result makes no sense at all from the income-tax angle. For in that case the stockholders receive a good dividend, pay a high average personal tax thereon, and concurrently are called upon to put the same money, tax diminished, back into the business.

The simple solution of this dilemma lies in the use of *non-taxable stock dividends* to represent that part of the earnings which ordinarily would be paid out in cash, but are now required by the company for purposes of expansion. However, in the present state of investors' thinking on the matter of dividends, the stock-dividend solution is unattractive. A recent incident will illustrate this point.

The Caterpillar Tractor Co. is a strong and successful enterprise which has paid dividends continuously since 1914. In June, 1953, it cut its quarterly cash dividend from 75 cents to 50 cents, but at the same time paid a stock dividend of 4%. In the accompanying statement the management explained that it needed to conserve cash for the building of a large additional plant.

It added that the stockholders would be better off with a \$2 annual rate in cash, plus a 4% stock dividend, than they were with the straight \$3 cash disbursement, since those who wish to can realize more than \$1 difference by the sale of their stock dividends.

Apparently, the stockholders did not accept this reassurance at face value; however, for immediately following the announcement (in a generally weak market) the shares declined a full 10%. It would appear from this incident, and from others like it, that investors do not regard a stock dividend as a desirable substitute for a cash payment, even though their former may have a higher value taken at market. Under present conditions of taxation and corporate expansion needs, a stock dividend policy *of the right kind* is in many cases more logical and more advantageous than a cash dividend policy. It is not too difficult, we think, to demonstrate that this is true. But it will be much more difficult to change the thinking and the traditional reactions of the financial community in the matter of dividends.

There are several factors that now make cash dividends less desirable than they used to be, and have enhanced the usefulness of systematic stock dividends. The first of these factors is the above-mentioned double taxation of distributed earnings, at heavy rates. The second is the continuous need for corporate expansion on a huge scale to support the full-employment principle to which both government and business are now committed. These same conditions give rise to a third factor, namely the sharpening of an inherent conflict of desire, re dividends, between the average or outside stockholder and controlling interests. Finally, we might assert that the cash dividend rate and dividend record are no longer, as once they were, the most convincing indication available of the success and the quality of a common stock investment.

Today's situation can be illustrated by almost any public utility company of the typical kind. It has satisfactory earnings; it pays a "normal" cash dividend; it is expanding at a rapid rate, and financing that expansion by the sale of bonds, preferred stock and also by offering subscription rights for new common stock to its shareholders, or directly to the public. If you examine what took place over the past seven years – the postwar period – you will find that the common stockholders as a class have given back to the company for new stock all or a large part of the cash dividends paid out to them. If you can trace the matter further you will find that the stockholders in the aggregate (other than corporations) lost in income taxes about 50% of the dividend received. This tax – piled on top of a 52% levy on the utility's net profits – was paid merely for the privilege of letting the dividend money pass into the stockholders' bank accounts and then out again in payment for the additional shares purchased.

Could the payment of this heavy dividend tax have been avoided, with the same results otherwise to both the company and its stockholders? Yes, by the use of periodic stock dividends to take the place of that part of the quarterly cash payment that is taken back by the sale of new shares. Those stockholders who in the past have not exercised their subscription rights could obtain the

same overall cash result by selling their stock dividends as received. Those stockholders – the majority, no doubt – who subscribed to the new stock would obtain the same overall result by merely keeping their stock dividends. The latter group would have no income tax at all to pay on these transactions. The former group would pay very small income taxes, on a capital gains basis, as the stock dividends as sold.

According to the Edison Electric Institute, about \$4 billion is to be spent by the industry in 1953 and at least an additional \$8 billion will be spent in 1954-56. Without question, utility stockholders will be called upon to purchase at least \$1 of the new stock for each \$1 of cash dividends received. But to the extent that stock dividends are substituted for cash the sale of new stock would be correspondingly diminished – and at the same time the income tax burden on the equity owners would be reduced.

The case for adopting this kind of policy can perhaps be dramatized by taking an extreme example – that of the American Telephone & Telegraph Co. In 1946-52 A.T. & T. paid out \$1,800 million in cash dividends at its traditional \$9 rate. During the same seven years it received from its stockholders (and their transferees) nearly \$2,700 million, paid in the first instance for convertible bonds and in the second as additional cash consideration (premiums) for the exchange of the bonds into stock. By the end of 1952 most of the bonds – as well as some previously existing – had been converted, so that the stock and premium accounts alone showed a growth of \$2,600 million.

It is clear from these figures that in the past seven years A.T. & T. stockholders have effectively paid over to the company a good deal more money than they have received in dividends. To the extent that non-stockholders bought rights or convertible bonds, they were in the same position as if they had bought stock from existing owners. Had the shareholders received the new stock directly from the company in the form of stock dividends – instead of via the combination of cash dividends with convertible bond subscriptions and exchanges – they would have been saved at least a half billion dollars in personal income taxes.

The mechanism of a stock dividend policy by A. T. & T. is much simpler than one would imagine. The declarations would continue to fix a payment of \$9 annually, but the medium of payment would be in stock valued at \$150 per share. The same kind of dividend checks would be issued as now; but instead of calling for so many times \$2.25 in cash it would call for that many times 3/200ths of a share. The owner could either hold these dividend checks, to add to his stock interest, or else he could cash them by depositing them with any broker or even his bank. The company would presumably set up an agency to cash in or round out stock fractions for its shareholders, at no cost to them.

The cost of administering such a plan – covering the equivalent of over \$90 million in cash dividends every three months – should be a good deal less than the present elaborate financial operations entail. Stock issued via the stock-dividend route would supersede the following series of steps: (a) Payment of cash dividends; (b) issuance of subscription rights for convertible bonds; (c) transferring such rights when sold; (d) issuing the new convertible bonds; (e) paying interest on and otherwise administering the convertible bonds; and (f) taking in the convertibles and the related cash premiums and issuing new stock in exchange – the same stock that would have been issued in the first place had a stock dividend policy been followed.

The idea proposed for A. T. & T. is indeed a revolutionary one. In view of the almost sacred character of this company's quarterly dividend of \$2.25 – a fixture since 1920 – a change might appear unthinkable. This may be true. Nevertheless, it makes better sense than the present enormously expensive shuttling back and forth of hundreds of millions of dollars annually. And if not applicable to A. T. & T. the idea would certainly fit a large number of utilities that are not bound by a particular dividend tradition. Citizens Utilities Co., a small but highly successful enterprise, has followed a combined cash and stock dividend policy with excellent results since 1946. The advantages of the policy have been fully explained to the shareholders.

The stock-dividend concept has a wider application, however, than the “subscription right” cases we have been considering. Stock dividends should be used also, in a systematic fashion, to supplement a present low cash payout in relation to earnings. In the industrial and railroad fields most companies have met their need for more equity capital by holding down their cash dividend rates, rather than by paying full dividends and selling additional common stock. The overall situation in this respect is indicated by the following ratios covering the 200 stocks reported on by Moody's. In 1935-39 the payout averaged 81% of earnings; in 1945-49 the payout was only 51%. (For rails alone in 1948-52 the payout rate was 37%.)

It is clear from these figures that a large number of companies have been paying out well under half of their earnings. Such a policy may be justified from the standpoint of corporate needs, but it has been unnecessarily hard upon the income and market position of the stockholders. A properly conceived and executed stock dividend policy can conserve cash earnings for the company's requirements and at the same time give adequate recognition to the stockholders' desire for liberal distributions.

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### *Major Obstacles*

In our previous section we have indicated some of the obvious tax advantages that might accrue to the investor if more corporations paid dividends in stock instead or as well as in cash,

provided that this policy were thoroughly explained to the public and accepted as normal by the financial community.

Corporations which need large sums for capital developments, as most do today, are caught on the horns of a dilemma with respect to dividends. If they conserve cash, and make small dividend payments, the investor obviously suffers as regards to return. If, on the other hand, they pay generous cash dividends, and then come back into the market for capital the shareholder may be scarcely better off. He will pay a high income tax on the dividend received, and if he then subscribes to the new capital issue he will be just where he was before, *minus* the tax. In the case of many utilities, and in the dramatic case of A. T. & T. in particular, we showed that this needless shuffling of funds back and forth between company and shareholder has been enormously expensive over the years.

There is, therefore, a *prima facie* case for the use of stock dividends which avoid giving this unnecessary hostage to the Federal Treasury. But, if this practice is to spread, it will have to receive much more general public acceptance than is the case today. In this section, we will examine some of the obstacles to stock dividend policy, first from the point of view of the law and, secondly, from the point of view of the corporations and its owners.

As to the law, it is well-known that dividends paid in stock (on a basis which does not change the relative position of each shareholder) are not subject to income tax. This was the ruling of the U.S. Supreme Court in the famous case of *Eisner vs. Macomber* in 1920. The Court found that an ordinary stock dividend is not income within the meaning of the Constitution as amended; because it neither gives to the shareholders anything that they did not already have nor takes anything from the corporation. It merely re-divides stockholders' equity into more parts than before, in the same manner as is done by a reduction in par value or other stock splits.

The non-taxability of the ordinary stock dividend is thus firmly established in law, logic, and practice. However, one may properly ask whether a program of stock dividends adopted in place of a previous combination of cash dividends, plus stock offerings, would be regarded as a device to avoid the second or personal tax on corporate earnings. When the philosophy of the present tax law is examined the answer is found to run quite the other way. The present practice of paying cash dividends and then selling stock is in fact a device to subject earnings to double taxation when they should be taxed only once.

The present scheme of taxation – good or bad – imposes three kinds of taxes on corporate profits:

1. Corporate earnings are first subject to the corporate income tax.
2. Earnings paid out to stockholders are then subject to the personal income tax.

3. Earnings improperly accumulated – i.e. retained by the corporation for the purpose of evading the payment of personal income tax by shareholders – are subject to a penalty tax under Section 102 of the Internal Revenue Code.

The purpose of these provisions should be clear. Earnings properly retainable by a corporation, and so retained, are subject only to corporate tax; earnings not properly retainable by a corporation are subject to a double tax, whether or not actually paid out in dividends. The courts have held that earnings are properly retainable if they are used to expand the business.

It is an evasion of the tax law to retain earnings not needed in the business in order that stockholders may be spared personal income tax thereon. But, conversely, the purpose and provisions of the tax law are complied with then earnings are retained for expansion. If an expanding business pays out cash dividends and then takes the equivalent money back from its stockholders for new stock, it is going out of its way to subject the profits to double taxation. Furthermore, it is thereby reducing its own ability and that of the American economy to finance the expansion needed to maintain full employment. Thus we are led to conclude that one of the most vital tax reforms from the standpoint of encouraging business expansion does not require governmental action or change in the tax laws, but can be initiated by business itself by a change in its dividend and financing policies.

Turning from government to management we find that the latter should clearly favor the payment of stock dividends rather than cash dividends when their corporate financing needs are large. The problem of paying adequate dividends and financing plant expansion has become increasingly serious, in view of the sharp increase in the sum total of corporate indebtedness and the accompanying rise in the cost of borrowing. Moreover, as we indicated in our previous article, a regular stock dividend policy is certainly no more burdensome to administer than the policy of cash dividends, plus regular offerings of subscription rights.

Management, of course, plays the key role in establishing a successful stock dividend program. The plan should call for systematic distributions representing current or recently accumulated earnings. As a corollary to the above, the market value of the stock should be taken into account when declaring a stock dividend. In the twenties, when stock dividends were popular, distributions tended to be much too high relative to earnings. (In 1929, for example, the regular quarterly stock dividends of 2.5% paid by North American Co. had an aggregate market value of \$12.70 per share, while the year's earnings were on \$5.03 per share.) Excessive liberality discredited the stock dividend concept in the past and must be avoided in the future. Finally, large stock dividends, purporting to represent the "distribution" of accumulated surplus, have no sound place in financial practice. An increase in the number of shares and the reduction and the reduction of their market level should be accomplished by split-ups having no connotation of a dividend.

Above all, however, management must be clear as to what they are doing and explain matters thoroughly to their shareholders. For as investors view the matter today a stock dividend is not an adequate substitute for cash dividends. They are willing enough to take a stock dividend in addition to the regular cash payment, but in most cases the typical 5% extra declared in stock has much less of an effect on the market – i.e., on stockholders' thinking – than is produced by a more modest increase in the regular rate of distribution.

The chief reason for this is that stock dividends are not recognized by the market as part of the dividend yield. The example of Caterpillar Tractor Co., examined in our previous article, clearly illustrates this point. When Caterpillar Tractor sold at \$60 and paid \$3 in cash, its dividend yield was universally figured at 5%. When the rate was changed to \$2 in cash, plus 4% in stock, the financial community had no adequate method of recognizing and evaluating the new policy. The newspapers and services cut the stated dividend rate down from \$3 to \$2, with a buried footnote reference to a stock supplement. In the yield calculations, which are part of nearly all statistical presentations, only the cash rate is taken into account and the stock payment is also relegated to a footnote reference. Thus at its June 30 price of 52.5 the yield on Caterpillar Tractor is given in Standard & Poor's Stock Guide at 3.8%, with the ambiguous addition of "also stock." Since the May 31 yield was stated at 5% on a price of 60, the change in dividend policy *appears* highly unfavorable.

There is here a paradoxical conflict between the views of investors as a whole – i.e., "the market" – regarding cash dividends and the personal interest and arithmetic of the individual investor. Recent surveys show clearly that most dividends are received by people who do not need the cash itself for living expenses, who pay a high rate of tax thereon, and who would much prefer capital gains to dividend income. A Harvard study published this year ("Effects on Taxation – Investments by Individuals," by Butters, Thompson and Bollinger) calculates that 75% of the stock held by private owners belongs to the top 3% of the spending units, and that 65% of all stock is owned by spending units with net worth in excess of \$250,000.

It states further that the top 5% of the income receivers is responsible for over 55% of the total annual savings. In other words, they do not have to spend their dividends, in spite of their heavy tax load. Complementing this study is that made by the New York Stock Exchange of stock transactions on March 18 and March 25, 1953. Information was assembled on the reasons for buying shares. The figures show, in substance, that only 16% of purchases are made for income return, about 33% for quick or short-term gain, and 51% for ultimate long-term gain.

These analyses suggest quite clearly that the typical investor wants cash dividends, not for the sake of dependable income, but rather "for the sake of his stocks." He knows that market prices are governed to a great extent by the cash dividend rate, and that the surest way to realize his coveted capital gain is by having the cash dividend raised. Conversely, he realizes that stock

dividends are not a popular substitute for cash in the view of the market; and consequently he is himself opposed to such a substitution because it will hurt the price of his shares. Thus, we see that the representative investor wants his shares to pay taxable cash dividends rather than non-taxable stock dividends because that is what other investors want. The thinking of each individual is here shaped by the market – which is none other than the aggregate of these very individuals. This is a kind of vicious circle which operates as a formidable barrier to the introduction of newer and sounder thinking in the matter of dividend policy. This barrier could, however, be partially overcome were corporations more explicit in their dividend declarations.

We are far from asserting, however, that all that is needed to gain proper acceptance for a stock-dividend policy is the right kind of statement by the corporation at the time dividends are declared. The problem of educating stockholders, their advisers, investment services, and other significant agencies, to a proper evaluation of systematic stock dividends is one of major importance. We do not believe that a company could today successfully substitute stock dividends even for cash dividends plus repeated stock offerings. The matter would first have to be widely discussed in the financial community, and a general acknowledgement secured of the logic and advantage of the new approach. The second step would be taken by individual companies in advising stockholders of their intention to adopt a systematic stock dividend policy at a specified future date. The lapse of a fair amount of time, and the right sort of educational campaign in the interim, should together achieve adequate acceptance of the new policy by stockholders.

An important additional area for education and change of practice lies in the legal, accounting, and “journalistic” treatment of systematic stock dividends. The financial community as a whole must be persuaded to treat stock dividends as the equivalent of a specified amount of cash, to the extent that they are so denominated by the declaring corporation. Thus, in our Caterpillar Tractor example, if the “new” dividend were specified as being at the annual rate of \$4.30, payable \$2 in cash and \$2.30 in stock, then the newspapers and the financial services should designate the dividend in the same fashion. The basic difference would be that instead of calling the rate \$2, with a footnote addition “plus stock” – as they do now – they would call the rate \$4.30 with the footnote addition “partly in stock.” The dividend yield should be calculated on the basis of \$4.30, instead of \$2, as at present.

If a stock dividend policy is to become more widespread, there would of course have to be a change in the accounting practices affecting all administered funds, and probably in the legal provisions governing trust funds. In the latter category it is the standard rule that stock dividends, even if regularly received and regularly disposed of for cash, do not constitute distributable income. Income beneficiaries from such funds would therefore suffer unless present practice, and probably present law, were changed. In the case of other administered portfolios – such as mutual trust funds, insurance company holdings, and funds managed by investment advisors –



there is at present no standard procedure for handling stock dividends in calculating normal income or yield from the fund. This situation, however, could be changed if paying corporations clearly designate their stock dividends as equivalent to a specified amount of cash distribution.

An innovation of this basic nature may seem too heavy an assignment for the financial world to cope with. Maybe it is. But the question is well worth thinking over and arguing about, because there is something obviously foolish in paying out cash dividends subject to personal tax, and taking back the same money in payment for new stock. Hundreds of millions of stockholders' money can be saved annually by adjusting dividend policies to present-day realities. No less important, a well defined cash and stock dividend policy might contribute powerfully to reconciling the real interests of the modern corporation with the interests and desires of its shareholders.

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Congress has been concerned for many years with the question of the distribution or retention of corporation profits, insofar as such corporate policies affect the tax revenue. Five Internal Revenue Acts of the Civil War period taxed as income to the stockholder his share of corporate gains, whether divided or not.<sup>2</sup> After a lapse of forty years the Revenue Act of 1913 sought to apply the same principle as a punitive measure in the case of corporations which accumulated surplus "beyond the reasonable needs of the business" for the purpose of preventing the imposition of surtax on their shareholders. Similar provisions appear in the 1916 and 1918 tax legislation. In 1917 a special tax of 10% was imposed on corporate profits remaining undistributed six months after the close of the fiscal year and not actually employed in the business, or "retained for employment in the reasonable requirements of the business", or invested in War Loans. Beginning with the Revenue Act of 1921, a penalty surtax of 25% was levied on the entire net income of corporations "formed or availed of for the purpose of preventing the imposition of surtax upon its share-holders through the medium of permitting earnings or profits to accumulate instead of being divided or distributed".

The principle of this tax has been maintained in subsequent revenue acts. In 1924 the rate was raised to 50%; but in 1934 it was reduced to 25% on the first \$100,000 and 35% on the remainder of net income minus dividends paid. For a considerable period this penalty tax seems to have been very much of a dead letter, although it may have exerted a substantial deterrent influence. In more recent years the Treasury Department has had some success in collecting surtaxes under this provision. But even if it were possible to prevent by this means all "improper" accumulations of surplus-as clearly it was not-there remained a substantial tax advantage to the wealthy stockholders of corporations which could find legitimate ways of reinvesting all or most of their current profits. In the 1936 Revenue Act Congress extended the

idea of the penalty tax to apply to all undistributed earnings regardless of the motive of their retention.

The new Surtax on Undistributed Profits is imposed on all domestic corporations, except banks, insurance companies, concerns in receivership, and two other minor groups. The tax is levied in brackets, beginning with 7% of the undistributed profits up to 10% of the "adjusted net income" and ending with 27% on all undistributed profits above 60% of the adjusted net income. If no part of the earnings is distributed the total "pressure" or "penalty" tax will amount to 20.5% of the income after the 8% to 15% normal tax, and (in the case of a large corporation) the two taxes together will take about one-third of the income. Corporations subject to the new Surtax on Undistributed Profits may also be subject to the old "Surtax on Corporations Improperly Accumulating Surplus", but at reduced rates, or they may be subject also to the "Surtax on Personal Holding Companies" at rates ranging from 8% to 48% of the undistributed adjusted net income. It evidently was the purpose, and it undoubtedly will be the effect, of the Revenue Act of 1936 to induce corporations generally to pay out in dividends a larger proportion of their profits than heretofore. If this new fiscal idea is not abandoned as the result of the election, it is bound to have significant effects upon the financial policies of corporations, and upon the welfare of their stockholders, and possibly of their creditors. It is intended in this paper to consider some of the theoretical and practical implications of the new Surtax on Undistributed Profits, as they bear upon the related fields of corporation and investment finance.

### *Tax Burden on Corporate Profits*

From the tax standpoint, the Revenue Act of 1936 unquestionably imposes a heavy additional burden upon stockholders. As conceived by the President and as passed by the House, the Bill originally aimed to tax corporation earnings on exactly the same basis as partnership earnings.

To bring this about, it provided for the complete elimination of both the normal corporation tax and the capital stock tax (with its appended excess profits tax provision). On the other hand it subjected dividends to normal individual tax, in the same way that partnership profits are taxed, and it imposed a tax on undistributed earnings de-signed either to induce the payment of dividends or to collect from the corporation a penalty substantially equal to the personal taxes which the stockholders might save through the non-receipt of dividends. As finally passed, however, the effect of the Revenue Act is to tax corporate earnings upon both a corporation and a partnership basis. If all earnings are distributed in dividends the profits will first bear the regular corporation tax of between 8% and 15% and also the capital stock-excess profits combination tax, amounting to not less than 1% of income and certainly averaging nearer 2% of income.

The balance will then be subject to full normal tax and surtax in the hands of the individual stockholders. The penalty imposed on retained earnings will prevent any substantial escape from

this double taxation. It cannot be fairly said that the new law removes the inequalities in tax status as between stockholders and members of partnerships. It has indeed very largely eliminated the tax advantage formerly enjoyed by wealthy stock-holders, but it has placed all other stockholders at a great tax disadvantage as compared with partners. The smaller the stockholder the greater proportionately is this additional handicap. This outcome, so disconcerting to stockholders generally, is not without its ironical aspects. The House Bill, which did substantially equalize the tax status of corporations and partnerships, was subjected to violent attack by the business world. The measure was harshly criticized, and with justice, as being complicated, confusing, and full of technical faults.

But the chief assault centered on the theory of the Undistributed Profits Tax. This was excoriated as running counter to all sound concepts of corporate policy, as encouraging improvidence, penalizing prudence, and making impossible the necessary accumulation of rainy-day reserves. With what may be regarded as an excess of zeal, the critics insisted both that the new tax would cripple corporations and that it would bring in disappointingly small revenue. Hence they argued the Government could not afford to give up the time-tried corporation tax for this new experiment. Congress, being impressed by the latter argument, compromised by retaining the old taxes, imposing the new one as well, and abolishing the time-honored exemption of dividends from normal tax. In this case business seems to have talked itself into a higher tax bill.

There is further irony in the fact that what was a punitive provision in the 1918 War Revenue Act reappears in the 1936 Act as a concession or privilege grudgingly granted a very limited group of enterprises called "Mutual Investment Companies". In the 1918 legislation the penalty for the improper accumulation of surplus was merely to tax the enterprise on a partnership basis—that is, waiving the corporation in-come tax, but taxing each stockholder on his full pro rata share of the profits.<sup>14</sup> Under the present scheme of taxation such "punishment" would prove a boon. This boon is in fact graciously accorded to certain "mutual investment companies", provided they meet one general and eight specific conditions. With the progress of taxation, the horrors of war become the blessings of peace.

#### *Alternatives to Cash Dividends*

The criticisms of the undistributed profits tax have for the most part taken it for granted that corporations now have but two alternatives: either to denude themselves of substantially all their earnings or else pay a crushing penalty tax. If this were so, it would undoubtedly work great hardship, although needed additional capital might still be raised in most cases by the private or public sale of securities. But the new law supplies an important third alternative, namely that corporations may retain but capitalize any de-sired portion of their earnings.

Such capitalization of retained earnings may be effected in at least four different ways, namely:

- (1) By the payment of taxable stock dividends;
- (2) By the declaration of optional dividends, payable either in cash or stock, so arranged as to result in the payment of stock only;
- (3) By the declaration of cash dividends accompanied by an attractive right to purchase stock therewith;
- (4) By the use of part-paid shares, and the calling of payments thereon coincident with the declaration of cash dividends.

Under the recent ruling of the United States Supreme Court in the *Koshland case*, dividends upon common stock paid in stock of some other class may be taxable to the stockholder. Apparently dividends on preferred stock paid in stock of either the same or a different class would be similarly taxable. The 1936 Revenue Act provides that such stock dividends shall be valued for taxation at their fair market value at the time of payment and shall create a corresponding "dividends paid credit" for the benefit of the corporation. A corporation may presumably adopt the device of declaring a taxable dividend payable in preferred stock which in turn is convertible for a brief period into the common stock on attractive terms. The result will be the prompt conversion of the stock dividend into additional common, with a final set-up equivalent to that produced by an ordinary (common) stock dividend. Such taxable dividends may also be paid in obligations of the company, including income bonds and other new-fangled forms of pseudo-debt.

The second of our four methods is provided for specifically in Section 115 (f) (2) of the new Revenue Act. This states that if a dividend may be taken either in cash or stock at any stockholder's option, it shall constitute a taxable dividend in the hands of all stockholders receiving it, regardless of the medium in which it is paid. Such optional dividends were paid in the past by a number of companies, for example, North American Company in the earlier years of its stock dividend policy. Hence, literally construed, Section 115 (f) (2) presents an extremely simple way of enabling corporations to pay ordinary stock dividends which will be "deductible" for the corporation and taxable to the stockholders. It can declare such a dividend accompanied by an option to take an entirely negligible amount of cash. Of course, no shareholder will exercise that nugatory "option". Concretely, a company could declare a dividend payable either in common stock worth \$5 or at the rate of 1 cent in cash. It may be doubted, however, whether on such a state of facts the courts would hold that the ruling in *Eisner v. Macomber* had been successfully circumvented and that the dividend was in essence anything other than a "true stock dividend made lawfully and in good faith", such as is not taxable under the rule of that case.

A further literal construction of this sub-section would permit the option to take cash to be given to a single stockholder, thus making an ordinary stock dividend taxable to all the stockholders. Whether the courts will uphold such a peculiar method of making taxable stock dividends that are otherwise non-taxable, also remains to be seen. A conflict of interest is likely to develop between corporations and certain of their stockholders on the question whether a given stock dividend is or is not taxable.

The method of offering subscription rights simultaneously with the payment of a cash dividend, and involving the same amount, has also been used not infrequently in the past. By making the subscription price of the additional stock appreciably lower than its market value, the company can make sure that the rights will be exercised and the cash dividend returned to its treasury. In its practical effects this device differs in one respect from that discussed just previously. In the latter case, the taxable and "deductible" value of the dividend would be the market value of the stock on the date received; under this third method such value is restricted to the cash dividend declared, which is presumably less than the market value of the stock ultimately received.

The combination of cash dividends and subscription rights is merely a special manner of selling additional shares to stockholders. If it chooses, a corporation can offer these shares at other times and raise amounts either greater or less than the cash dividends paid. The prohibition against selling stock at less than par formerly constituted a technical obstacle in the way of such stock offerings. With the present vogue of no-par and artificially low par shares, this no longer presents a serious difficulty.

The application of cash dividends to the paying up of part-paid shares is a device perhaps unknown to this country, but not unusual abroad where part-paid shares are far more prevalent than they are here. Theoretically it should be possible to issue such partially paid shares with a charter provision to the effect that demands for further payments thereon may only be made coincidentally with the declaration of an equivalent cash dividend. Under this arrangement a "dividend distribution" will mean merely the transfer of certain dollar amounts from surplus to capital, with no change in the number of shares outstanding, but with an increase in the nominal or paid-in value of each share. Evidently such a payment will be no more than a bookkeeping device to relieve the corporation of the penalty tax by making its income taxable to the individual stockholders. Such a device would seem, however, to be quite legitimate and feasible.

We have dwelt at such length upon these possible media of capitalizing retained earnings because they seem to have been largely over-looked in the early heated discussions of the new pressure tax. The writer is convinced that they will be widely availed of, so as to permit many corporations to retain pretty much the same proportion of earnings as heretofore without incurring the surtax. Dividend actions taken by publicly-owned corporations from the passage of the 1936 Revenue Act to date would not seem to bear out this prediction, since these devices

have not yet been used to any great extent. There has, however, been a pronounced expansion in cash dividend payments, for which both the new law and increased earnings have been responsible. It may take some little time for corporations generally to familiarize themselves with the lines of procedure just discussed. Many companies are undoubtedly delaying action of this sort pending the outcome of the election, which may promise the repeal of the Surtax on Undistributed Profits.

### *Effect upon Corporate Policies*

So much for the burden of taxation under the new Revenue Act. Let us now address ourselves to its effect upon the dividend policies of corporations. Will it result in a substantial increase in the percentage of earnings paid out in cash dividends? If so, will this be a bad thing, or possibly a good thing for stockholders generally? Are corporations likely to adopt devices by which they may avoid both the payment of cash dividends and the imposition of the penalty tax? What are these devices, and what will be their effects upon the corporate structure and upon the corporate picture in good times and bad?

Since our inquiry may appear to take a number of devious turns, it might be helpful if at this point we summarized the conclusions to which we are proceeding. We shall conclude that the new law will result in the distribution of nearly all the current earnings of publicly-owned corporations, but that such distribution will be divided between cash and taxable stock dividends as the managements see fit. On the whole, cash dividends are likely to be somewhat larger than has been the practice previously, particularly in the case of companies which have a limited field of profitable expansion. As regards other corporations, however, there is not likely to be a striking change in the proportion of current earnings which is reinvested in the business.

If these predictions are well founded, the new penalty tax will not have a profoundly disturbing effect upon significant corporate policies, as distinguished from matters of bookkeeping. But numerous exceptions are likely to occur in the case of companies which are unable or unwilling to adopt the flexible capitalization policies that will be now required. Moreover, there are serious technical defects in the new law which subject to tax, and impel the distribution of amounts that may not be true earnings at all. These inequities may be highly injurious to some corporations, and, of course, to their stockholders.

As far as the interests of shareholders generally are concerned, the greater liberality of dividend payments is likely to redound to their advantage, especially through curtailing the extent of uneconomic corporate expansion. A more specific responsibility will be placed upon management to justify the "plowing back" of earnings in the property. The advantages frequently gained by insiders through manipulating the dividend policy are likely to be less prominent. While it is possible that dividend rates may be more variable than heretofore, they will be kept

closely in line with annual earnings. In view of the greater emphasis now given by the stock market to earnings as against the dividend rate, the equalizing of the latter with the former may not create much additional instability of stock prices.

From the standpoint of corporate accounting, the penalty tax will in all probability accentuate the recent blurring of the distinction between capital and surplus, in order to offset the apparent interdiction against building up an earned surplus available for the maintenance of dividends during poor years. Reductions in par value and other transfers from book capital to book surplus, already familiar phenomena; will become even more widespread.

### *Effect upon the Stockholder's Interests*

There is reason to believe that stock prices generally will benefit from a more liberal dividend policy in relation to earnings. Wall Street may pay lip-service to the idea that withholding of earnings is beneficial to stockholders, but it pays higher prices for the shares of companies which pay out their earnings. Of two substantially similar concerns with the same earnings per share, the one paying the larger dividend will nearly always sell at the higher figure. This preference for dividends rather than for increased book values seems justified by the investor's experience. Where a large proportion of the profits has been retained and reinvested in the business over a period of years it frequently happens that the earning power and the stock price fail to show a proportionate increase, particularly if allowance be made for compound interest on the amounts retained.

Broadly speaking, it may be said that if additional capital can be profitably employed in the business, the management can always get it from old and new stockholders. As a practical matter, financing in the market is not difficult if the company has been prosperous in the past and has paid liberal dividends. The advantage of retaining earnings rather than selling new stock seems to accrue to the management rather than to the stockholders, in that there does not seem to be the same responsibility for earning an adequate return upon surplus as upon capital funds. This point is illustrated by a remark made some years ago by Judge Gary at an annual meeting of the United States Steel Corporation. To a stockholder arguing for an increased dividend, the Chairman replied that the current \$7 rate was a liberal return on any common stock. But adding the undistributed profits to the common stock issue at par, the dividend figured out at barely 4% on the stockholder's equity.

When the reinvested earnings are represented by a proportionate increase in stated capital, the underlying nature of the financial operation is made clearer to both the stockholders and the management. A more definite responsibility is laid upon the latter to justify the expansion of the business capital by showing a corresponding increase in the earnings and by maintaining the basic cash dividend rate on the additional number of shares. Where there may be good reason to

doubt whether the rein-vested earnings will be duly productive, this more specific challenge to the management may impel it to decide against such reinvestment and in favor of a cash disbursement. Under the circumstances stated, this would be decidedly in the stockholders' interest.

Summarizing the foregoing argument, we conclude that the Undistributed Profits tax, if continued, will lead to larger cash disbursements by companies with limited opportunities of profitable expansion, and to the issuance of additional stock generally to represent reinvested earnings.<sup>29</sup> As far as those particular effects are concerned, we consider them favorable to the stockholders and not inimical to the financial soundness of corporations.

Certain collateral problems and objections in this connection present themselves. First, how will stockholders find the money to pay income taxes on dividends received in the form of stock? If the enterprise is a close corporation they may not be able to sell their stock at all; in other cases sales to raise money for taxes may seriously depress the market price.

When carefully considered, this question is seen to be part of the general problem of obtaining the cash to pay individual taxes on business earnings. If an individual owner or members of a partnership wish to leave substantially all the profits in the business, they must still pay their taxes thereon and must find the money from some other source. The stockholders of a private corporation are in exactly the same position as a partnership in this respect-except, as we pointed out at the beginning, that the aggregate tax burden on their earnings is substantially greater. In either case a distribution policy will be adopted which seems best suited to the needs of the owners (including their tax bill) on the one hand, and the requirements of the business on the other. In the case of some corporations the owners may decide that the new penalty tax is still less burdensome than their individual surtaxes would be, and retain part of the earnings with this tax saving in view.

In a publicly owned corporation the tax status of the individual share-holders may or may not exert an influence upon the distribution policy. If there are wealthy stockholders who own a controlling interest, their preference as between cash payments, stock payments, and no payments, will no doubt carry due weight with the directors. In most cases the cash distributions will be at least sufficient to take care of the stockholders' tax bill for both the cash and stock dividends combined. It may well be that part of the stock dividends will be sold to meet taxes imposed there-on, but such sales are not likely to be a more serious matter market-wise than sales of such dividends for any other purpose.

The second question relates to the building up of reserves for the purpose of maintaining cash dividends and meeting losses in bad years. This is somewhat different than the matter of finding money for expanding the business. It is argued that surpluses constitute a necessary rainy-day



reserve, and that the new tax, by virtually prohibiting the accumulation of a substantial surplus, will make it impossible for corporations generally and new enterprises in particular to meet the challenge of hard times.

This contention is not so plausible as it sounds, because there is really no close connection between a balance-sheet surplus and surplus cash. A company may have a large accumulated surplus and yet be short of cash -the surplus earnings having gone into other assets or to pay liabilities. For opposite reasons an enterprise may have a very small surplus, or even a profit and loss deficit, and have far more cash than it needs. This condition did in fact exist in many important companies at the height of the depression in 1931-1933. On the whole it does not appear to have been a well-defined policy of leading corporations to build up a substantial cash reserve out of the profits of prosperous years. The large cash holdings that have been characteristic of recent years, in the case of industrial companies, were in good part the result of additional stock financing before the crash.

Whether or not this is in fact true, the use of taxable stock dividends will enable corporations to build up their cash holdings almost as freely under the new surtax as previously. The question of maintaining an established cash dividend in depression years involves an additional consideration; for, if there is no accumulated book surplus, the state laws would prohibit dividend payments in excess of current earnings, even though cash holdings were ample for the purpose. On this point two observations suggest themselves. The first is that accumulated surpluses could not be relied upon in the recent depression to assure the continuance of dividends. By the end of 1931 United States Steel had accumulated Undistributed Net Income of about \$1,200,000,000 (of which \$500 million had been appropriated to write off intangibles). Yet it passed the dividend on its common stock in April 1932, and reduced the dividend on its preferred from \$7 to \$2 in January, 1933. The record of the Atchison Topeka & Santa Fe Railroad is very similar.

The second observation is that under the new accounting techniques the payment of stock dividends representing all the earnings above cash dividends may still permit the accumulation of a substantial book surplus. Hence both a cash fund and a statutory surplus may be available to continue cash dividends even when there are no earnings. To illustrate: Company A may have common stock selling at \$100 per share, with a stated value (no par) of \$5, or with an artificially low par of \$5. It earns \$8, pays \$3 in cash, and by one of the devices described previously pays a taxable dividend of 5% in common stock, worth \$5 per share. On its books this 5% stock dividend is transferred from surplus to capital at a valuation of only 25 cents per old share outstanding-that is, 5% of \$5 par or stated value. There remains \$4.75 per share in surplus, available to continue the \$3 cash dividend even if there are no earnings next year.

On the whole, therefore, the Undistributed Profits Tax need not change substantially the aggregate of cash dividends paid by any given corporation over a cycle of good and bad years. If the cash dividend is kept low in the prosperous years, the balance of earnings being "paid out" in stock, it may still be possible to maintain the cash rate in an ensuing depression. If all the earnings are paid out in cash, and there is no previously accumulated surplus, it will of course be impossible to continue dividends when there are losses. Such a policy might well be improvident; but there is no reason why the typical company need follow it, in view of the other alternatives at its command.

### *Effect upon Creditors*

There remains the question of the effect of the new tax upon creditors, particularly bondholders. If the penalty tax will make for improvident corporate policies, creditors as well as stock-holders would of course be harmed thereby. Since we have concluded that most corporations will be able to utilize their cash earnings very much as in the past, we do not anticipate any serious impairment of the position of bondholders because of the new pressure to pay dividends. It may be added that the safety of bond investments in general is not measured by or predicated upon the expectation of a substantial rein-vestment of future profits in the business. Bonds are bought on the basis of the past earnings record, the present financial status, and the general view as to future prospects. Protection against untoward developments is provided in indentures by various stipulations, affirmatively, by requiring sinking-fund payments and the maintenance of a certain working capital position; negatively, by prohibiting sales of additional bonds or dividends unless stated conditions are met. Only when bonds are issued under conditions of considerable corporate weakness do we find a specific agreement to build up surplus to a certain point before paying dividends.

The new law may seem to interfere with proper sinking fund arrangements for future bond issues, since such sinking fund payments may not be deducted from earnings subject to the pressure tax. Sinking funds of reasonable size are highly desirable features of bond issues; hence the imposition of an extra tax burden on resources used for that purpose would run counter to sound financial principles and be fairly subject to severe criticism. It should be pointed out, however, that the typical bond sinking fund represents the application of sums reserved for depreciation and deducted from earnings before calculating the income subject to tax. From an accounting standpoint moreover, the sinking fund payment it-self is not a deduction from earnings at all, since the company's funded debt is decreased in virtually the same amount as the cash expenditure.

Depreciation charges are frequently offset, and even exceeded, by current expenditures for additions and replacements, and hence there may not be cash available from that source for sinking fund payments. But in theory such expenditures are no different from any other new

investments in the business, and they may just as properly be capitalized by selling new bonds, paying stock dividends, etc. Whether or not this is true in practice is not necessarily relevant to the question of a special allowance for sinking fund payments, but rather to the more basic issue of whether all sums retained and added to surplus may be considered the equivalent of new capital in their effect upon future earning power. This problem exists, of course, regardless of whether or not there are bond issues with sinking fund provisions. It may be pointed out that the heavier weight of taxes requires an offsetting liberalization of the deductions allowed from income to reflect the very real element of obsolescence, which up to now has been taken care of to a considerable extent in the surplus account.

The pressure tax should produce certain changes in the wording of protective covenants in bond indentures. The new law gives corporations an exemption from surtax with respect to earnings withheld in accordance with a written contract not to pay dividends, if executed prior to May 1, 1936. If a future bond issue carries such a provision, compliance therewith may subject the company to a heavy penalty tax. To meet this situation such protective prohibitions should apply to cash dividends only, leaving free the payment of dividends in stock; they might even allow the declaration of a cash dividend provided a corresponding amount of cash has been or is to be returned to the treasury through the sale or acceptance of stock. It should be evident that creditors' interests are not adversely affected by the payment of stock dividends. In fact, to the extent that such dividends earmark past earnings as additional capital, they may be said to benefit the creditors.

A conspicuous weakness in most bond indentures is their failure to insist on the maintenance of a minimum amount of stockholders' "junior investment". Theoretically, the typical company with funded debt might, with the approval of stockholders only, reduce its capital to \$1, distribute all of the stockholders' equity in the form of a return of capital, and leave the bondholders without any of that margin of resources over debt on which the purchase of the bonds was largely based. Some of the more recent indentures remedy this weakness by prohibiting or restricting distributions to shareholders through the medium of a return of capital. A provision of this kind should be standard practice; but here again the Undistributed Profits Tax should be kept in mind, and a suitable degree of flexibility retained. Transfers from capital to surplus and payments of stock dividends out of the capital so transferred should be permitted, since they will not injure the creditors and may prove to be necessary in order to avoid the penalty surtax.

The effect of the Undistributed Profits Tax on corporate accounting would seem to be concentrated in the area of capital and surplus items. Corporations will desire (a) to retain a flexible cash dividend policy; (b) to escape the penalty tax on undistributed earnings; and (c) to comply with state law. As already indicated, this three-fold objective will be conducive to arbitrarily low par values for both preferred and common stocks (already expedient from the standpoint of transfer taxes, etc.), a low stated value for the issued capital, and hence to liberal

transfers from capital to special surplus accounts. Such transfers will be especially necessary to eliminate accumulated deficits on the balance sheet, which in some states prevent payment of dividends out of current earnings.

The huge write-offs and write-downs occasioned by the depression have already been responsible for widespread transfers from capital to surplus. Hence the manipulations induced by the pressure tax will merely intensify an already pronounced trend. The effect of all this may be misleading to unwary investors. Ultimately we shall grow accustomed to ignore par values, stated values, etc.; renounce the idea that the Profit and Loss Surplus in the balance sheet has a separate historical value; and treat the capital and surplus accounts together as an indivisible entity for purposes of analysis.

The chief result of the undistributed profits tax will not be the disruption of American business policies but rather the imposition of considerably higher aggregate taxes upon corporations and their stock-holders. Shareholders of publicly owned companies will get partial compensation in higher dividends, which will come largely in the form of additional stock. The effect upon stockholder-management relationships is likely to be rather salutary; upon the position of bondholders and other creditors, unfavorable but not disastrously so. The objectionable features of the Revenue Act of 1936 do not reside in the principle of the undistributed profits tax but in numerous unfair details of its application.

### **Threats to Equity Values**

We have all become so familiar with a more or less managed economy since the Roosevelt era beginning 40 years ago, that we should be quite inured to its effect on everything including equities. Basically, the intervention of government in the economy has had two opposite effects on common stock values. It has benefited them greatly through its virtual guarantee against the money panics and large-scale depressions of the pre-1935 decades. But it has hurt profits through the maze of restrictions and the numerous other burdens it has imposed on business operations. Up to now the net effect seems to have been favorable to equity values—or at least to their prices. This can be seen at first glance by comparing the Dow or S&P Index lines on a chart before and after 1949. In such comparisons the price declines in 1969 to 70 and 1973 to 74 appear like minor downturns in a massive upward sweep.

Experience suggests therefore that the various threats to equities implied in the last question are not very different from other obstacles that common stocks have faced and surmounted in the past. My prediction is that stocks will surmount them in the future.

But I cannot leave my subject without alluding to another menace to equity values not touched on in my terms of reference. This is the loss of public confidence in the financial community

growing out of its own conduct in recent years. I insist that more damage has been done to stock values and to the future of equities from inside Wall Street than from outside Wall Street. Edward Gibbon and Oliver Goldsmith both wrote that, "History is little more than a register of the crimes, the follies and the misfortunes of mankind." This phrase applies to Wall Street history in the 1968 to 73 period, but with more emphasis to be given to its crimes and follies than to its misfortunes. I have not time even to list all the glaring categories of imprudent and inefficient business practice, of shabby and shoddy ethics perpetrated by financial houses and individuals, without the excuse of poverty or ignorance to palliate their misdemeanors. Just one incredible example: Did anyone ever hear of a whole industry almost going bankrupt because it was accepting more business than it could handle? That is what happened to our proud NYSE community in 1969, with their back-office mix ups, missing securities, etc. The abuses in the financial practices of many corporations during the same period paint the same melancholy picture.

It may take many years—and new legislation—for public confidence in Wall Street to be restored and in the meantime stock prices may languish. But I should think the true investor would be pleased, rather than discouraged, at the prospect of investing his new savings on very satisfactory terms. To pension-fund managers, especially with large and annual increments to invest, the prospects are especially inviting. Could they have imagined five years ago that they would be able to buy AAA bonds on an eight to nine per cent basis, and the shares of sound companies on a 15 per cent or better earnings yield? The opportunities available today afford a more promising investment approach than the recent absurd idea of aiming at, say, 25 per cent market appreciation by shifting equities among institutions at constantly higher price levels—a bootstrap operation if there ever was one.

Let me close with a quotation from Virgil, my favorite poet. It is inscribed beneath a large picture panel at the head of the grand staircase of the Department of Agriculture building in Washington. It reads:

“O fortunati nimium.. .(etc.) Agricolae!”

Virgil addressed this apostrophe to the Roman farmers of his day, but I shall direct it at the common-stock buyers of this and future years:

“O enviably fortunate Investors, if only you realized your current advantages!”

### **Shareholders and Management**

If gold dollars without any strings attached could actually be purchased for 50 cents, plenty of publicity and plenty of buying power would quickly be marshaled to take advantage of the

bargain. Corporate gold dollars are now available in quantity at 50 cents and less--but they do have strings attached. Although they belong to the stockholder, he doesn't control them. He may have to sit back and watch them dwindle and disappear as operating losses take their toll. For that reason the public refuses to accept even the cash holdings of corporations at their face value.

In fact, the hardhearted reader may well ask impatiently: "Why all this talk about liquidating values, when companies are not going to liquidate? As far as the stockholders are concerned, their interest in the corporation's cash account is just as theoretical as their interest in the plant account. If the business were wound up, the stockholders would get the cash; if the enterprise were profitable, the plants would be worth their book value. "If we had some ham, etc., etc."

This criticism has force, but there is an answer to it. The stockholders do not have it in their power to make a business profitable, but they do have it in their power to liquidate it. At bottom is not a theoretical question at all; the issue is both very practical and very pressing. It is also a highly controversial one. It includes an undoubted conflict of judgment between corporate managements and the stock market, and a probable conflict of interest between corporate managements and their stockholders.

In its simplest terms the question comes down to this: Are these managements wrong or is the market wrong? Are these low prices merely the product of unreasoning fear, or do they convey a stern warning to liquidate while there is yet time? To-day stockholders are leaving the answer to this problem, as to all other corporate problems, in the hands of their management. But when the latter's judgment is violently challenged by the verdict of the open market, it seems childish to let the management decide whether itself or the market is right. This is especially true when the issue involves a strong conflict of interest between the officials who draw salaries from the business and the owners whose capital is at stake. If you owned a grocery store that was doing badly, you wouldn't leave it to the paid manager to decide whether to keep it going or to shut up shop.

The innate helplessness of the public in the face of this critical problem is aggravated by its acceptance of two pernicious doctrines in the field of corporate administration. The first is that directors have no responsibility for, or interest in, the market price of their securities. The second is that outside stockholders know nothing about the business, and hence their views deserve no consideration unless sponsored by the management. By virtue of dictum number one, directors succeed in evading all issues based upon the market price of their stock. Principle number two is invoked to excellent advantage in order to squelch any stockholder (not in control) who has the temerity to suggest that those in charge may not be proceeding wisely or in the best interests of their employers. The two together afford management's perfect protection against the necessity of justifying to their stockholders the continuance of the business when the weight of sound opinion points to better results for the owners through liquidation.

The accepted notion that directors have no concern with the market price of their stock is as fallacious as it is hypocritical. Needless to say, managements are not responsible for market fluctuations, but they should take cognizance of excessively high or unduly low price levels for the shares. They have a duty to protect their stockholders against avoidable depreciation in market value--as far as is reasonable in their power--equal to the duty to protect them against avoidable losses of earnings or assets.

If this duty were admitted and insisted upon, the present absurd relationship between quoted prices and liquidating values would never have come into existence. Directors and stockholders both would recognize that the true value of their stock should under no circumstances be less than the realizable value of the business, which amount in turn would ordinarily be not less than the net quick assets.

They would recognize further that if the business is not worth its realizable value as a going concern it should be wound up. Finally, directors would acknowledge their responsibility to conserve the realizable value of the business against shrinkage and to prevent, as far as is reasonably possible, the establishment of a price level continuously and substantially below the reasonable value.

Hence, instead of viewing with philosophic indifference the collapse of their stock to abysmally low levels, directors would take these declines as a challenge to constructive action. In the first place, they would make every effort to maintain a dividend at least commensurate with the minimum real value of the stock. For this purpose they would draw freely on accumulated surplus, provided the company's financial position remained unimpaired. Secondly, they would not hesitate to direct the stockholders' attention to the existence of minimum liquidating values in excess of the market price, and to assert their confidence in the reality of these values. In the third place, wherever possible, they would aid the stock-holders by returning to them surplus cash capital through retirement of shares pro rata at a fair price.

Finally, they would study carefully the company's situation and outlook, to make sure that the realizable value of the shares is not likely to suffer a substantial shrinkage. If they find there is danger of serious future loss, they would give earnest and fair-minded consideration to the question whether the stockholders' interest might not best be served by sale or liquidation. However forcibly the stock market may be asserting the desirability of liquidation, there are no signs that managements are giving serious consideration to the issue. In fact, the infrequency of voluntary dissolution by companies with diversified ownership may well be a subject of wonder, or of cynicism. In the case of privately owned enterprises, withdrawing from business is an everyday occurrence. But with companies whose stock is widely held, it is the rarest of corporate developments.

Liquidation after insolvency is, of course, more frequent, but the idea of shutting up shop before the sheriff steps in seems repugnant to the canons of Wall Street. One thing can be said for our corporate managements--they are not quitters. Like Josh Billings, who in patriotic zeal stood ready to sacrifice all his wife's relations on the altar of his county, officials are willing to sacrifice their stockholders' last dollar to kept he business going.

But is it not true that the paid officials are subject to the decisions of the board of directors, who represent the stockholders, and whose duty it is to champion the owners' interests--if necessary, against the interests of the operating management? In theory this cannot be gain-said, but it doesn't work out in practice.

The reasons will appear from a study of any typical directorate. Here we find: (a) The paid officials themselves, who are interested in their jobs first and the stockholders second; (b) Investment bankers, whose first interest is in underwriting profits; (c) Commercial bankers, whose first interest is in making and protecting loans; (d) Individuals who do business of various kinds with the company; and finally--and almost always in a scant minority--(e) Directors who are interested only in the welfare of the stockholders.

Even the latter are usually bound by ties of friendship to the officers (that is how they came to be nominated), so that the whole atmosphere of a board meeting is not conducive to any assertion of stockholders' rights against the desires of the operating management. Directors are not dishonest, but they are human. The writer, being himself a member of several boards, knows something of this subject from personal experience.

The conclusion stands out that liquidation is peculiarly an issue for the stockholders. Not only must it be decided by their independent judgment and preference, but in most cases the initiative and pressure to effect liquidation must emanate from stockholders not on the board of directors. In this connection we believe that the recognition of the following principle would be exceedingly helpful: The fact that a company's shares sell persistently below their liquidating value should fairly raise the question whether liquidation is advisable. Please note we do not suggest that the low price proves the desirability of liquidation. It merely justifies any stockholder in raising the issue, and entitles his views to respectful attention. It means that stockholders should consider the issue with an open mind, and decide it on the basis of the facts presented and in accordance with their best individual judgment. No doubt in many of these cases--perhaps a majority--a fair minded study would show liquidation to be unjustified. The going concern value under normal conditions would be found so large, as compared with the sum realizable in liquidation, as to warrant seeing the depression through, despite current operating losses.

However, it is conceivable that under present difficult conditions the owners of a great many businesses might conclude that they would fare better by winding them up rather than continuing



them. What would be the significance of such a movement to the economic situation as a whole? Would it mean further deflation, further unemployment, and further reduction of purchasing power? Would stockholders be harming the county while helping themselves? Superficially it might seem so, but powerful arguments can be advanced to the opposite effect.

The operation of unsoundly situated enterprises may be called a detriment, instead of an advantage, to the nation. We suffer not only from over-capacity, but still more from the disruptive competition of companies which have no chance to survive, but continue to exist none the less, to the loss of their stockholders and the unsettlement of their industry. Without making any profits for themselves, they destroy the profit possibilities of other enterprises. Their removal might permit a better adjustment of supply to demand, and a larger output with consequent lower costs to the stronger companies which remain. An endeavor is now being made to accomplish this result in the cotton goods industry.

From the standpoint of employment, the demand for the product is not reduced by closing down unprofitable units. Hence, production is transferred elsewhere and employment in the aggregate may not be diminished. That great individual hardship would be involved cannot be denied, nor should it be minimized, but in any case the conditions for employment in a fundamentally unsound enterprise must be precarious in the extreme. Admitting that the employees must be given sympathetic consideration, it is only just to point out that our economic principles do not include the destruction of stockholders' capital for the sole purpose of providing employment. We have not yet found any way to prevent depression from throttling us in the midst of our superabundance. But unquestioningly there are ways to relieve the plight of the stockholders who to-day own so much and can realize so little. A fresh viewpoint on these matters might work wonders for the sadly demoralized army of American stockholders.

Another aspect of the current maladjustment between corporations and their stockholders is the question of possible liquidation. Many stocks sell for less than their cash value because the market judges that future operating losses will dissipate this cash. If that is the case, then should not the stockholder demand liquidation before his cash is used up?

The management says "no,--naturally. But the stock market says "Yes,"--emphatically.

If a business is doomed to lose money, why continue it? If its future is so hopeless that it is worth much less as a going concern than if it were wound up, why not wind it up? Surely the owners of a business have a better alternative than to give its present cash away for fear that it is later going to be dissipated. Either the business is worth more as a going concern than its cash in bank, or it is not. If it is worth more, the stockholder is foolish to sell out for much less than this cash, unless he is compelled to do so. If it isn't the business should be liquidated and each stockholder paid out his share of the cash plus whatever the other assets will bring.

The supervision of these businesses must, of course, be delegated to directors and their operation to paid officials. But whether the owners' money should be dissipated by operating losses, and whether it should be tied up unproductively in excessive cash balances while they themselves are in dire need of funds, are questions of major policy which each stockholder must ponder and decide for himself. These are not management problems; these are ownership problems.

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There is another aspect of takeovers that I want to bring up here, on a somewhat personal basis, because it relates to an old and losing battle that I have long fought to make stockholders less sheep-like vis-à-vis their managements. You will recall that the first bid of INCO was termed a “hostile act” by the ESB management, who vowed to fight it tooth and nail. Several managements have recently asked stockholders to vote charter changes that would make such acquisitions more difficult to accomplish against their opposition; in other words, make it more difficult to deprive present officers of their jobs and more difficult for stockholders to obtain an attractive price for their shares.

The stockholders, still sheep-like, generally approve such proposals. If this movement becomes widespread it could really harm investors; interests. I hope financial analysts will form a sound judgment about what is involved here and do what they can to dissuade stockholders from cutting their own throats in such a foolish and reckless fashion. This might well be a subject for the FAF to discuss and take an official stand on.

### **U.S. Steel Case Study**

This is not a hand-picked instance in which I can give you a neat solution and say “Look! The public thinks this stock is worth \$10, but I can prove by my analytical technique that it is worth \$30.” I can do something like that from time to time, but obviously those are exceptional cases.

The problem of the U.S. Steel Corporation is typical in its nature. In other words, it has no definite conclusive solution. The security analyst can only give you certain hints as to what the solution is likely to be, certain indications of a range of value rather than a specific figure, and perhaps a different suggestion as to where within this range he believes the probabilities of the future will lie. Those things, inconclusive as they are, may be found not without practical utility even in a typical, perplexing case such as U.S. Steel common.

The analysis goes along in a certain logical sequence. The first question we shall study is “What did the company earn most recently?” That is the thing on which most emphasis is placed by the ordinary investor, and it is also the starting point – if not the most important factor for the analyst.

An income account published under today’s conditions is subject to a series of corrections which we need to go over one by one. In Table A we have the income of U.S. Steel as reported – namely, \$35.6 million for the common, or \$4.09 a share.

Table A.

**Condensed Financial Analysis of U. S. Steel Co.  
(end of 1944)  
Corrections of the Current Income Account (1944)**

	(in Millions)	Per Share
<b>Income for Common Stock</b>		
As Reported .....	\$35.6	\$4.09
Corrections for Renegotiation .....	—	—
Contingency Reserves .....	21.5 (net)	2.47
Tax Liability .....	—	—
Depreciation, etc. ....	—	—
Other .....	—	—
<b>Corrected Earnings .....</b>	<b>\$57.1</b>	<b>\$6.56</b>

That is far from a large figure of earnings for the Steel Corporation, especially when you consider that it did a business of over \$2 billion dollars, which was fully twice its normal volume. These earnings, under war conditions of capacity operation, would undoubtedly be regarded as very disappointing if they fairly reflect what the Steel Corporation had accomplished in 1944. However, as we look over the report with care, we see that at least one correction needs to be made which will increase the indicated profits. Let us take up the corrections in their order.

The first is that for renegotiation, which represents a current rather than a recurrent problem. All the corporations engaged in war work to any extent are subject to renegotiation contingency. In their annual reports they make estimates of current renegotiation liability, and they also tell you what has happened with respect to the renegotiation liability for previous years. As it happens, the U.S. Steel Corporation clearly has no serious problem with renegotiation. In 1943 they paid over a very little amount of money, and in all probability they will not have to pay back anything for 1944.

In the 1943 report, Steel Corporation speaks about adding \$25 million dollars to expenses in each of the past three years “for additional costs applicable to the period caused by the war.” If that was all they said, it would clearly indicate that they had actually incurred these additional costs. But the report adds:

“Such costs include deferred maintenance and repairs, reconverting and reallocating facilities from wartime to peacetime use, costs resulting from reemployment of servicemen, loss on raw materials and supplies not needed in the post-war period, and other similar costs.”

I think it is obvious to anyone who analyzes that statement that they do not really mean *additional costs applicable to the period caused by the war*” but rather “additional costs that *may*

*later be incurred* because of the war.” Such costs are of an indefinite character; they do not represent any true loss or liability, except insofar as you can measure the actual amount of deferred maintenance and repairs; in a general way they represent the post-war contingency reserves which most corporations have been setting up for general purposes.

An analyst, for the purpose of making his presentation of the company’s earnings, would add back these contingency reserves to the company’s earnings, and say they have earnings of over \$6.50 in the year 1944, instead of \$4.09 as reported.

The next item that we look at is that of liability for Federal income and excess profit taxes. The U.S. Steel Corporation reserves an amount for taxes of \$65 million for this purpose. It is rather clear from their report that they paid no excess profit tax for the last year, and it is also clear that they have provided for their full tax liability.

The next item is that of depreciation. The Corporation’s depreciation charges have been quite large. They were \$129 million in 1944, which is the record figure, and that included about \$56 million for amortization of emergency facilities which are being written off on the basis of only a five-year tax life. From the standpoint of the true life of the property, the facilities do not require so rapid an amortization. On the other hand, it is true that the rate of production shown last year requires rather liberal depreciation.

I don’t believe the analyst would go so far as to make correction for excessive depreciation for 1944, even though the total figure is very high. He would content himself with saying that the actual amortization and the maintenance charges are on the liberal side, and that perhaps there is some extra or concealed earnings power, because of the high depreciation charges.

The ten-year analysis, given in tabular outline below, pretty well speaks for itself. Let me call attention to two points. One is the final result of the ten-year analysis. This shows that, while the reported earnings averaged \$3.92 per share, there were additional earnings due to surplus adjustments (including contingency reserves) averaging about \$1.90. Hence, the true earnings were about 50% more than those reported for the ten-year period. The second point is that, since the depreciation reserves charged in the ten-year period were considerably greater than the expenditures on the plant, the company’s financial position increased another \$1.28 per share annually. Hence, the total “cash flow” in the past decade averaged about \$7 per share annually.

There is room for much argument, of course, as to the true significance of the amount of cash which is accruing for the common stock from sources other than the corrected earnings. If we were only going to look at the working capital as a measure of asset value for stocks, then we would say that amounts turned back from plant account into current assets should be regarded as equivalent to additional earnings. Obviously one should not go so far as that. My own rule-of-

thumb is to say that 50% of the net reduction of the plant account over a period of time might be considered as equivalent to additional earnings for the common stock. On that basis we should have “constructive earnings” of somewhere around \$6.25 a share for the stock over a ten-year period.

Table B.

<b>Ten Year Analysis</b>			
<b>I. Comparative Balance Sheet</b>			
(in millions)			
	Dec. 31, 1934***	Dec. 31, 1944 (approx.)	Change in 10 yrs.
Net Current Assets.....	\$ 365	\$ 748	+ \$383
Other Assets Net.....	1,098	987	— 111
	<u>\$1,463</u>	<u>\$1,735</u>	+ \$272
Senior Claims* .....	517	456	— 61
Common Stock Equity**.....	946	1,279	+ 333
	<u>\$1,463</u>	<u>\$1,735</u>	+ \$272

\* Includes small minority interest.

\*\* Includes contingent reserve.

\*\*\* Adjusted for write-off of \$530,000,000 in 1935 and 1938.

**II. Statement of Corrected Earnings and  
Current-Assets Flow for Common**  
(in millions)

	1935-9	1940-44	1935-44	10 yr. Ave. Per Share- per year
Earnings Reported .....	\$54	\$288	\$342	\$3.92
Additional Earnings .....	31	131	162	1.86
	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>
Corrected Earnings .....	\$85	\$419	\$504	\$5.78
Change in Plant Acct., etc.....	dr. 74	cr. 185	cr. 111	1.28
	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>
Current Assets Flow for Common.....	\$11	\$604	\$615	\$7.06

We turn next to our long-term historical survey. That task is greatly facilitated by the unusual practice of U.S. Steel in giving us much annual data from 1902 on each report. We have telescoped this 40-year study by selecting only the first, the middle, and the last years of the period.

What stands out in any long-term study is that the company’s financial position has been revolutionized in the direction of improvement while its earning power has been revolutionized in the direction of deterioration. I think that is a sensational and challenging situation. It requires a great deal of pondering before you can get to the bottom of its significance.

You will notice that the figures for 1902 show a deficit of \$163 million for the common stock equity. Of course, that isn’t what the balance sheet stated at the time; it claimed a plus equity of \$550 million. This figure was later written off by successive charges, so that we now know that the company really started off with less than nothing for the common stock in terms of tangible assets. Nevertheless it was able to earn \$54 million that year. Forty-two years later, it had built up equity of \$1,270 million – \$1,433 more than in 1902 – but was able to earn only \$56 million for the common stock after counting in the \$21 million in reserves that have been challenged

here. If you do not include that \$21 million, the company would have earned only \$35 million, or much less than in 1902 – despite the additional common stock investment of nearly \$1.5 billion, and despite a level of war production which must be regarded as extremely favorable to the steel industry.

The analysis of the income account for 1902 and 1944, broken down as to various items of expense, will show you in what manner profit margin of the company has retrogressed. The proportion of labor expenditures has gone up from 28% to 46% – a most adverse development. The purchase exchange hasn't changed, but the tax percentage has expanded a great deal. Interest charges and preferred dividends, on the other hand, show a very substantial decrease.

Table C.

**Special Historical Survey of U. S. Steel**  
(by use of selected years)

**I. Balance Sheet**

	*1902	*1923	1944
	(In Millions)		(Approx.)
Net Current Assets.....	\$167	\$ 568	\$ 748
Other Assets Net.....	560	1,287	987
<b>Total for Capitalization.....</b>	<b>\$727</b>	<b>\$1,855</b>	<b>\$1,735</b>
Senior Claims** .....	890	918	456
Common Stock Equity.....	def. 163	937	1,279
Net Current Assets for Common Stock.....	def. 723	def. 350	292

\*Adjusted for write-down of \$768 million of intangibles.

\*\*Includes small minority interest.

**II. Production and Prices**

Tons Ingots Produced.....	10.9 mill.	22.8 mill.	31.0 mill.
% of Capacity Operated.....	94.3%	88.7%	95%
% of Nation's Steel Produced.....	65%	45%	35%
Composite Steel Price Per Ton.....	Abt. \$40	\$59	\$53
"Equated" Production—Tons .....	10.6 mill.	19 mill.	39 mill.

**III. Income Account**

	(Millions)	Per Equated Ton	(Millions)	Per Equated Ton	(Millions)	Per Equated Ton
Net Sales .....	\$423	\$40	\$1097	\$59	\$2082	\$53
Labor Expense .....	121	(28.6%)	471	(43.0%)	957	(46.0%)
Purchases, etc. ....	161		377		793	
Taxes (excl. Fed. Inc.).....	2		est. 35		41	
Depreciation, etc. ....	28		57		139	
<b>Balance .....</b>	<b>111</b>	<b>10.5</b>	<b>157</b>	<b>8.3</b>	<b>152</b>	<b>3.9</b>
Fed. Inc. Tax.....	—		est. 20	1.1	65	1.7
Int. & Pfd. Div.....	57	5.4	53	2.8	30	.8
<b>Bal. for Common.....</b>	<b>54</b>	<b>\$ 5.1</b>	<b>84</b>	<b>\$ 4.4</b>	<b>†57</b>	<b>\$1.4</b>
Per Share .....	*\$ 7.57		*\$ 11.73		\$ 6.56	

\* Adj. for 40% stock div.

† Before reserves of \$21.5 mill. net.

The net result is that the company has improved its financial position enormously, but it has not been able to do better than to retain about the same earning power for its common stock. You

will see in the bottom figure that it earned \$7.57 per share in 1902 after allowing for a later stock dividend, and only \$6.56 in 1944 before reserves.

Our concluding section will deal with the analyst's technique in appraising the future earning power of U.S. Steel. The kind of thing an analyst might do is shown in Table D, in which we make several hypotheses and derive corresponding figures for the earnings per share. The last favorable assumption is that Steel will go back to 1940 volume – which is by no means a bad volume, historically – and show a profit margin as low as that of 1944. If it did these two things it would earn only \$2.20 per share. Our most optimistic hypothesis is that Steel will do a business 25% greater than in 1940 and have the same profit margin as in that year. On that basis the common stock would earn \$10.40 a share.

Table D

	Prospective Earnings for U. S. Steel Common (on various assumptions)			
	(1)	(2)	(3)	(4)
	1940 Volume 1940 Profit Margin	1940 Volume 1944 Margin	1940 Volume +25% 1940 Margin	1940 Volume +25% 1944 Margin
	(In Millions)			
	\$1,100	\$1,100	\$1,400	\$1,400
Sales.....	\$1,100	\$1,100	\$1,400	\$1,400
Profit Margin.....	14%	7.2%	14%	7.2%
Operating Profit.....	154	79	196	101
Interest.....	5	5	5	5
Federal Tax at 40%.....	60	30	76	39
Preferred Dividends.....	25	25	25	25
Balance for Common.....	64	19	90	32
Per Share.....	\$7.30	\$2.20	\$10.40	\$3.70

Despite the range of figures it is by no means impossible that the true earning power of U.S. Steel could be either as low as \$2.20 or as high as \$10.40 s share. Neither extreme, however, appears probable. The likely area of variation would be more in the range between \$4 and \$8 a share and the valuation you would get from that range of earnings would probably run between a low of \$40 and a high of \$120 in value. This assumes that the multiplier may be as low as ten or as high as fifteen.

If this analyst were put on the spot and asked to make his best single estimate of the future earning power and value of U.S. Steel, he would be inclined to take middle points in the range given. Hence he would say that earnings of around \$6 a share would be his best guess for an average period of time for the future. His multiplier would be only 12.5, and he would thus arrive at an indicated value of \$75. That multiplier is undoubtedly low for an immense, financially strong concern such as U.S. Steel. Large enterprises are generally thought to be worth more than 12.5 times average earnings; but in my opinion Steel does not rate a high multiplier. This is because its history is one that is weak rather than a strong one with respect to earning power

developments, and also because there have been great elements of variation and instability in the company's picture in the past. You are likely to see those again in the future.

## **Prologue**

Let me close with a few words of counsel from an 80 year-old veteran of many a bull and many a bear market. Do those things as an analyst that you know you can do well, and only those things. If you can really beat the market by charts, by astrology, or by some rare and valuable gift of your own, then that's the row you should hoe. If you're really good at picking the stocks most likely to succeed in the next twelve months, base your work on the endeavor. If you can foretell the next important development in the economy, or in the technology, or in consumers' preferences, and gauge its consequences for various equity values, then concentrate on that particular activity. But in each case you must prove to yourself by honest, no-bluffing self-examination, and by continuous testing of performance, that you have what it takes to produce worthwhile results.

If you believe – as I have always believed – that the value approach is inherently sound, workable, and profitable, then devote yourself to that principle. Stick to it, and don't be led astray by Wall Street's fashions, its illusions, and its constant chase after the fast dollar. Let me emphasize that it does not take a genius or even a superior talent to be successful as a value analyst. What it needs is, first, reasonable good intelligence; second, sound principles of operation; third, and most important, firmness of character.

But whatever path you follow as financial analysts, hold on to your moral and intellectual integrity. Wall Street in the past decade fell far short of its once praiseworthy ethical standards, to the great detriment of the public it serves and of the financial community itself. When I was in elementary school, more than 70 years ago, we had to write various maxims in our copybooks. The first on the list was: "Honesty is the best policy." It is still the best policy.

Benjamin Graham – 1974