

MEMORANDUM

FROM: Ted Aronson
 DATE: May 22, 2015
 RE: **GRAHAM + ZWEIG**

Today, investors face three grave threats:

- *threat of war*
- *threat of inflation*
- *threat of severe market fluctuations*

These are the very same threats Benjamin Graham discussed — fifty years ago!

Jason Zweig unveiled the attached speech on his website, saying: *Here is the original typewritten text of a speech Benjamin Graham gave in San Francisco one week before John F. Kennedy was assassinated. In this brilliant presentation, Graham explores how an investor should go about determining whether the market is overvalued, how to tell what asset allocation is right for you, and how to pick stocks wisely. This speech is a rare opportunity to see the workings of Graham's mind in the raw.*

Graham begins with a play on words in his speech's title, playing off "SECURITY" and "SECURITIES," and continues with a wonderful recollection about the first Financial Analysts Journal . . .

. . . when the New York Society of Security Analysts established a journal in 1946 we gave it the simple title "The Analysts Journal." But then we got so many subscriptions from psychoanalysts that we were forced in self-defense to change the name to the present title "The Financial Analysts Journal."



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Jason, responsible for many things Ben Graham, continues in his introduction:

*I am grateful to Richard A. Rigg of San Francisco, who was in the audience that day, for providing me with this copy of Graham's speech, which to the best of my knowledge had previously been undiscovered. After I sent a copy to Warren Buffett, he told me that he hadn't been aware of it but regarded it as one of the best of Graham's speeches. I first posted it online in 2010 and am re-posting it now because 1) I discovered it too late to include in the anthology **Benjamin Graham: Building a Profession** and 2) several people have told me they have been unable to find it since I redesigned my website last year.*

I hope you will agree that Graham's words are at least as timely as they were more than a half-century ago.

For all things Jason, his redesigned website is wonderful — and wonderfully free of conflicts (oops, I mean "agency issues") — a safe haven indeed.



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SECURITIES IN AN INSECURE WORLD

A LECTURE *by*
BENJAMIN GRAHAM

delivered at
TOWN HALL
St. Francis Hotel

November 15-1963

50¢ per copy

SECURITY IN AN INSECURE WORLD

A LECTURE BY

BENJAMIN GRAHAM

Doctor Rappaport has chosen a very intriguing title for my talk, "SECURITY IN AN INSECURE WORLD." I hope that not many of you came under the mistaken impression that I am going to talk about security in general. I am going to talk only about financial security, not about physical security, mental security, matrimonial security, or other types. Even as far as financial security is concerned, I am going to address myself only to investment policy in stocks and bonds. The title of this talk might better have been SECURITIES IN AN INSECURE WORLD, because securities are my field. I am not going to talk about savings and budget policy, life insurance, home ownership, pension plans and other matters of that kind. The reason is that I don't consider myself an expert in those areas, and I would rather talk to you about things I hope I know more about than you do.

This reminds me of the fact that when the New York Society of Security Analysts established a journal in 1946 we gave it the simple title "The Analysts Journal." But then we got so many inquiries and even subscriptions from psychoanalysts that we were forced in self-defense to change the name to the present title "The Financial Analysts Journal."

In the field of financial security, as limited to the problems of investment policy, I would say there are three kinds of threats or dangers that investors should recognize as possibly existing at the present time. One of them would be the threat from atomic war; the second would be the threat from inflation; and the third would be the threat from severe market fluctuations up and down, and of course primarily down. Now, I have no prescription for financial security or for portfolio policy that could deal with the possibility of atomic war. I don't think anyone else has; we prefer to sweep that problem under the rug and go forward to things that we can deal with more effectively. The second danger I mentioned was inflation. Inflation has been a big factor in investors financial experience going back as far as 1900. Not many people realize that we had more inflation in the first thirty years of this century than in the second thirty years, as measured by the usual indices.

The continuation of some degree of inflation is certainly probable in the future, and that is the chief reason why most intelligent investors now recognize that some common stocks must be included in their portfolio. However, that is only part of the question of the effect of inflation on investment policy. The fact is that both the extent of inflation and the investor's reaction to it have varied greatly over the years. It is by no means a straight-line matter. A good example is the most recent one. We have had a small inflation in recent years accompanied by a very large increase in stock-market prices, which seem to be geared not to the inflation experienced but rather to the expectation of greater inflation in the future. You probably know there has been no increase in the wholesale-price average since 1958. There has indeed been a rise of $6\frac{1}{2}$ per cent in the cost of living in the last five years, which of course is not negligible, but it could scarcely in itself be a sound basis for a 100 per cent rise in stock prices. Conversely, during the years 1945-1949 we did have a rather explosive kind of inflation--the consumer price index, (that is, the "cost of living") advanced over 33 per cent--but during that period stock prices actually had a small decline.

My conclusion here is that investors' feelings and reactions regarding inflation are probably more the result of the stock-market action that they have recently experienced than the cause of it. Consequently there is great danger of investors giving inflation too much weight when the market advances and ignoring it entirely, as they did in 1945-9, when the market declines. This has actually been the history of inflation and stock market behavior ever since 1900.

The problem of price fluctuations, or market fluctuations, is a very real one for investors as well as speculators, although there has been a tendency in Wall Street to deny that for a number of years in the past and even currently. Actually, the real problem is not whether price fluctuations are important to the investor; it is rather the opposite, that is to find some good workable distinction between the investor and the speculator in common stocks. As will be pointed out later that distinction has almost vanished from Wall Street, a fact which has caused a great deal of trouble in the past and will cause a great deal of trouble in the future.

Yet only last year, although it seems a long time ago--market fluctuations, as evidenced by a decline in the Dow Jones Average from 735 to 535, did loom as extremely important to investors and speculators alike. This fall of about 27% in the Dow Jones Average was accompanied by declines of between 50 and 90 per cent or more in most of the new securities that had been issued in the preceding two years and had played such a spectacular part in the stock market activity of that period. At that time then, in May 1962, the concept of a one-way market, which could go only upwards with very small reactions, seemed to be abandoned for good. However, Wall Street has a very short memory, and now the majority of financial authorities seem to be slipping back to the concepts of 1960 and 1961.

They are returning to the idea that for the smart investor the question of stock market fluctuations does not have to be considered to any great extent. There is a two-fold emphasis here, which slurs over the reality of stock market fluctuations. The first is the general conviction that the market can be counted on to advance so emphatically through the years that whatever declines take place are comparatively unimportant; hence if you have the true investor's attitude you don't have to concern yourself with them. The second claim is a denial that the "stock market" exists at all, meaning thereby that what the market averages do is of no real importance to the intelligent, well-advised investor or speculator. It seems to be a ruling tenet of Wall Street that if you practice the proper kind of selectivity in investments you don't have to worry about what the stock market does as a whole, as shown by the averages, for at all times the good stocks will be going up and the bad ones will be going down and all you need to do is pick the good stocks and forget about the stock-market averages.

How valid are these two arguments? The first one-- the argument that common stocks are and always will be attractive, including the present time, because of their excellent record since 1949-- involves in those terms a very fundamental and important fallacy. This is the idea that the better the past record of the stock market as such the more certain it is that common stocks are sound investments for the future. Now we all know that if a corporation has had a very good record over the past years that is a fair indication (but no guarantee) that its record is likely to be good in the future, because it has certain business advantages which in most cases ought to continue. But you cannot say that the fact that the stock market has risen continuously (or slightly irregularly) over a long period in the past is a guarantee that it will continue to act in the same way in the future. As I see it, the real truth is exactly the opposite, for the higher the stock market advances the more reason there is to mistrust its future action if you are going to consider only the market's internal behavior. We all know that

for many decades the typical history of the stock market has been a succession of large rises, in good part speculative, followed inevitably by substantial falls. Consequently, the substantial upsweeps of the past have always carried with them warning signals of unhappy consequences to come. It does not necessarily follow that a large rise in the price of a individual stock or in the market averages must be followed by a decline; but the only reason to view with confidence the future price of a security that has already advanced substantially in the presence of external reasons, other than the actual price movement itself, which would justify such confidence. Hence a large advance in the stock market is basically a sign for caution and not a reason for confidence.

Let us discuss the market's possibilities from present levels in terms first of theoretical reasoning and then in terms of some practical considerations. I would like to present three possibilities; undoubtedly there are a great many more. One possibility, which is a very popular one in present thought, is that the rise that has taken place since 1949-- from about 163 in the Dow Jones Average, to 750 at the present time-- reflects a new and a marvelously improved character of common stocks, and therefore can be expected to continue more or less at the same rate in the future. Only such a point of view can make sense out of the prevalent practice of calculating the gains that investors could have made in mutual-fund shares or in similar purchases over the last 14 years as a basis for trying to persuade them to buy such securities at their present advanced prices. As you know, this kind of calculation is done all the time by mutual-fund salesmen to impress investors. The SEC requires it to be accompanied by a perfunctory statement that the calculation carries no warranty for the future, but I don't think very much emphasis is placed upon that qualification.

The second possibility is that a good part of the rise I spoke of was an adjustment from an undervalued level in 1949 to a proper level on some new basis of valuation. If that is so, a good part of the 1949-1963 rise could not be expected to be repeated from a level which is now a corrected one. However, we could have a satisfactory advance on the average, say $4\frac{1}{2}\%$ per annum, from whatever level turns out to be about right for today. If 750 is about the right present level then the investor might possibly expect a more or less standard $4\frac{1}{2}\%$ advance from this level, year by year, subject to moderate downward fluctuations.

But the third possibility is that the nature of the market has not changed from its earliest times, as shown in our records that go back at least to the South Seas Bubble in 1720, practically 200 years. WE have also very detailed data on stock prices in the United States since 1871, which were incorporated in the Cowles and the Standard and Poor's records. It may well be that we shall still have the all-too-familiar alter nations of excessive optimism and excessive pessimism. The most recent example of excessive pessimism is the very period which was a starting one for this market. During 1949-50 the market had the lowest peace-time price-earnings ratio in its history. Stocks sold at only about 7 times their earnings, in the market averages I am talking about, as compared with about 20 times at the present time. The implication here is that just as stocks were evidently undervalued at seven times their earnings they might very well be overvalued at twenty times earnings or at some higher multiplier that will be established later in this market and will represent a level of excessive optimism.

My own opinion about these three choices is that the first possibility is really out of the question. It is not in the nature of economic reality to permit net gains at the shown rates from 1949 to 63-- something like 14% per annum including the dividend returns-- to continue indefinitely in the future. We just don't have a financial and economic system that can operate on that basis. If that were true nobody would have to work for a living. I remember very well the

number of people in the late 1920's who got a corresponding view of the stock market, gave up their jobs and plunged into Wall Street to take advantage of its wonderful future. The second possibility--which is that the market will advance pretty steadily from approximately the present level, but will not have the advantage of starting from a very low level-- is admissible in theory. But the great problem, one that I will talk about later, is how can you determine the proper new basis for common stocks valuations and therefore how can you determine the more or less proper level for now? I discussed this question in a paper read to the American Finance Ass'n. in December 1961, and said then that the market was really adrift on a sea of unsettled standards. The old standards of value, which had been well established for decades and perhaps generations, no longer seem to be tenable, as much too conservative; but the proper new standards of value could certainly not be worked out either by somebody's inner-consciousness or by mathematical calculations. We shall have to wait, probably for a considerable length of time before we can determine dependable new standards. In the mean time it seemed to me that the stock market will have to carry on its calculations by a process of trial and error, which could lead to large fluctuations around what in the end will turn out to be the new central value. I think what happened since December 1961 bears out this interpretation to some degree. Certainly the big decline in 1962 represented a sharp fluctuation of one kind, and the impressive recovery since June 1962 may represent a fluctuation of the other kind.

No doubt you would be interested to know what I mean by the terms "old and new standards of value" as applied to the stock market level. The old standards of value--which were pretty well accepted up to say 1955 were reached by a number of different approaches based on reasoning or experience. The one I like best of course was my own, which has been known as the "Graham." It was derived from the Central Value average earnings of the 30 stocks in the Dow Jones Industrial Average for ten years past, capitalized at twice the interest rate on high grade bonds. For example at the present time the average earnings for the last ten years are about \$33 on the Dow Jones unit and the present rate on high grade bonds is 4.3 per cent. If you capitalize \$33 at 8.6%-- which is a multiplier of about 12 you would get a Central Value on the old basis of about 380, as compared with the present price of about 750.

In early 1955 when I testified before the Fulbright Committee the stock market was then about 400, my central value was also around 400 and the valuations of other "experts" using other methods all seemed to come to about that level. The action of the stock market since then would appear to demonstrate that these methods of valuations are ultra-conservative and much too low, although they did work out extremely well through the stock market fluctuations from 1871 to about 1954, which is an exceptionally long period of time for a test. Unfortunately in this kind of work, where you are trying to determine relationships based upon past behavior, the almost invariable experience is that by the time you have had a long enough period to give you sufficient confidence in your form of measurement just then new conditions supersede and the measurement is no longer dependable for the future.

We had to deal with this problem in the fourth edition of "Security Analysis" published last year, and to recognize the probability that stocks should be valued more liberally now than in the past, our chief reason for that, incidentally is not because the government's commitment to prevent large scale depressions has changed the climate of corporate earnings from what it was prior to the Employment Act of 1946. We think this new insurance against a very severe falling off in the earnings of corporations generally would justify a higher valuation of these earnings than in former years. Hence we have added an arbitrary 50 per cent to the valuation based upon our old method. That would give us now a value of about

570 for the Dow Jones Average, and a corresponding value of about 56 for the Standard Poors 500-stock average. Let me point out that the two averages stand so close together on a ten-to-one basis in their price level, dividends and earnings, that you can use the two figures almost interchangeably for purposes of description or analysis.

You must recognize that this level of 570, which is derived from an arbitrary mark up of 50% from the old level, has no special authority behind it. It was merely the best judgment that we could give on a situation which does not admit of any really dependable calculations. As a matter of fact if one is sufficiently optimistic and adroit it is quite possible to develop a method of valuation which sounds plausible enough and would justify the present level of 750 for the Dow Jones Average. Let me show you how that could be done. You say first that investors would like to get an over-all return of $7\frac{1}{2}\%$ on their money in future years. That's what common stocks have returned on the average- in dividends and price appreciation-ever since 1871, as shown by the Cowles and Molodorsky studies. Now if we can expect a rate of growth of earnings and dividends of $4\frac{1}{2}\%$ a year then all we need is a dividend return of 3% to make up the desired $7\frac{1}{2}\%$ total. Since the Dow Jones and Standard Poor's dividend return is just a little more than 3% right now on the market price, we could buy these at the present level with confidence, as we would then get a 3% return in dividends and a $4\frac{1}{2}\%$ annual return in growth. Many people might think that even less than an overall $7\frac{1}{2}\%$ should suffice. All that sounds fine but if you reflect that by some chance the future growth rate would be $3\frac{1}{2}\%$ instead of $4\frac{1}{2}\%$ - and $3\frac{1}{2}\%$ was about the actual annual growth in dividends in the last ten years-- then you get quite a difference. For if now you are expecting a $3\frac{1}{2}\%$ growth rate, you will need a 4% dividend return to make up the required $7\frac{1}{2}\%$. On that basis the Dow Jones Average is worth just about the 570 which we arbitrarily gave to it.

There is a lot of juggling with figures that can be done now as always; but none of these methods in itself gives a dependable result. To a great extent the figures selected are determined by the general attitude of the man who is selecting them, and that general attitude is very often determined in turn by what the stock market has been doing. When the stock market is at 750 you take an optimistic attitude and use some favorable figures; but if it should have a severe decline most people would jump back to the older and more conservative evaluation methods.

Let me now point out a striking area in which the uncertainty of the proper valuation of common stocks is brought to the fore. That is this very question of the relationship between dividend return on stocks and the interest rate on bonds. For fifty years or more it was a tenet in Wall Street that stocks should yield considerably more than bonds. In speculative markets stocks might rise until their yield became less than that of bonds. But this very development was a sure sign that you were in a dangerous market-- one heading for a bad fall. A friend of mine, head of an important brokerage house, was so enamored of that idea he used it constantly in his market letters. More than that he actually had the relationship between stock yields and bond yields printed in a nice chart-design on neckties imported from Paris, which he distributed to his friends including me. For awhile I wore this tie at some of my lectures, and said that this was the first time that anybody had analyzed the technical position of the stock market from his necktime. Well, since 1958 stocks have been yielding considerably less than bonds with no sign of a return to old relationships. Hence my broker friends found that this concept increasing hard to stick to. About two years ago, actually not very long before the big market break, in a huge newspaper advertisement he abandoned this concept completely, said it was all bosh to talk about stock yields as the basis of evaluation, claimed the main thing was the psychology and attitude of the public; and asserted this factor was strongly bullish and justified

confident buying of stocks. My chief reason for mentioning this incident is that I had just spent a lot of time studying the weekly analyses of the stock market by one of our oldest financial services which started in 1909 and I found the identical experience took place just 30 years before in this service (whose name I also won't mention.) For many years they talked about the standard relationship between stock yields and bond yields, and they used it to determine the probable top levels for the stock market advances. In the great bull market of the late 1920's this relationship proved to be very unreliable as a short-term market forecaster. So they too, in a spectacular statement using almost the same language, turned their back completely on the comparison of stock yields and bond yields and said that the market's psychology was the best basis for forecasting. That happened sometime in 1928, and they stick to this viewpoint to the great crash of 1929.

The present relationship gives considerably lower yields on stocks than on bonds. High grade bonds yield about 4.30 per cent while the stocks averages yield a little bit more than 3%. Because that relationship has existed for the past five years does it represent a permanent relationship for the future, or is it only an indication that the stock market has been clearly overvalued for five years, in the same way that it was clearly undervalued during the period 1949-1954? This is the many-billion-dollar question. You won't be able to get the answer to that by mathematics; you won't be able to get it from an expert such as me or anybody else; so you'll have to answer that question for yourself.

But the thought that the stock market may have been over-valued in the last five years, just as it was undervalued fifteen years ago, brings us to the third possibility which I enumerated, namely that we are still going to have wide fluctuations in the future. This I consider the most probable one, though it is far from certain. My reason for thinking that we shall have these wide fluctuations- of which we had a taste in 1962, in May particularly- is that I don't see any change in human natures vis-a-vis the stock market which is sufficient to establish more restraints in the public behavior than it showed over so many decades in the past. The actions of the public with respect to low-grade new issues during the 1960-61 extravaganza in that field are an indication of its inherent lack of restraint. You ought to remember also, that many of the highest grade common stock issues were forced up to excessive levels by a market enthusiasm which produced large subsequent declines. Let me give you some examples: The most impressive to my mind was that of International Business Machines which is undoubtedly the leading common stock in the entire market. Speculative enthusiasm pushed it up to 607 in December 1961, from which it declined to 300 in June 1962-- a fall of more than 50% in the short period of 6 months. General Electric, which is the oldest high grade investment common stock, declined from a high of 100 in 1960 to 54 in 1962. Dow Chemical, one of our best chemical companies, fell from a high of 101 to a low of 40, and U.S. Steel which is an old leader, shrank from 109 in 1959 to a low of 38 in 1962. These very wide swings underline the fact that the stock market is basically the same now as it always was, in the sense it is still subject to very substantial over-evaluation at sometimes and undoubtedly substantial under evaluations at others.

My basic conclusion is that investors as well as speculators must be prepared in their thinking and in their policy for wide price movements in either direction. They should not be taken in by soothing statements that a real investor doesn't have to worry about the fluctuations of the stock market.

It is time now to say what little I can say about the probable course of the stock market from the present level. No doubt that is the point which would interest the audience most and on which I can be the least enlightening. In my view there is an important difference between the present stock market and the market at more or less the same level in December 1961. At that time I had no hesitation about predicting that then there would have to be a fairly near-term collapse of the new-issue market, which had passed all bounds in speculative excesses. And if that

collapsed it would surely effect in some serious way the general level of stock prices, it might possibly usher in the bear market which inwardly I have been expecting for some time past. The new issue collapse came per schedule and it did have a major adverse effect on the rest of the market. But a recovery began in a comparatively short time, and it has carried the market averages to new heights, which were contrary to my inward expectations but not to any specific predictions which I made. I would like to point out that the last time I made any stock market predictions was in the year 1914, when my firm judged me qualified to write their daily market letter, based on the fact that I had one month's experience in Wall Street. Since then I have given up making predictions.

The important point now is that the current high levels of the market are not accompanied by those excesses in the new-issue market and in some other directions which made it appear so vulnerable in 1961. It is the general view in Wall Street that such characteristic abuses must develop again before the stock market can have another collapse,--or before a true bear market can begin (if it isn't against the law to use the dirty words "bear market"). These abuses would include large public participation by small people who don't know what they are doing, high borrowings on margin, the renewal of the new-issues spree and so on. Now this contention sounds plausible enough based on experience, and so one might guess that the market could well continue generally upward for quite a while. But let me point out "for the record" that it is not impossible in theory that the market's high level alone could sooner or later precipitate a collapse without the necessity for these technical weaknesses to show themselves. The collapse might be triggered by some untoward economic or political development. But if things do happen that way it will be the first time in market history, I believe, that we would have the end of a bull market without the excesses and abuses of the sort I have mentioned. But there is always a first time for everything.

My opinion then regarding the present market level must be rather inconclusive, and I shall base my later prescription of policy on the assumption that investors cannot have a dependable view on the market's future action in the next year or so, but that a large and disturbing decline is likely to take place again sometime in the future, and that we should be prepared in thought and action for it, is a necessary assumption for investors to make, and for sensible speculators too if there are any such.

The second claim which is that there is no real "stock market" but only, as the Wall Street people like to say, only "a market of stocks"--deserves a moment or two of discussion. What they mean by saying this is that investment results depend only on what happens to individual securities, some of which will go up and others down, and that it is illusory to talk about what happens to the market as a whole as having a major bearing on how the investor fares. I disagree with that point of view on three grounds.

The first is that I doubt that the market is really so much different in this respect from what it always was in the past. I have some recollection of the market in 1928 and 1929, and I am sure that the disparity and diversity of stocks between those that acted well and those that acted poorly was almost as great then as we see now. But despite that fact it was essential for investors to be guided by a view as to the general level of the stock market. It is surprising to me that Wall Street people haven't taken the time to make a study of the spread in price movements between individual stocks in recent years as compared with what happened in former years. (I have a student at UCLA who is going to make this study and it may prove quite illuminatory).

The second reason is that there is actually a considerable underlying consistency in the stock market if you measure its movements by comparing two averages which seem to be quite different. One of them is the Dow Jones Industrial Average, which consists of only 30 stocks, and the other is the Standard & Poor's Composite Average which consists of 500 stocks. You might well assume that if there

is an underlying diversity of price movements than an average including only 30 stocks would certainly behave different from one embracing 500. But if you observe the fluctuations in both averages, now given by most newspapers you get virtually a ten-to-one change, which means a parity change, almost day by day and certainly month by month and year by year. In the past ten years the Dow Jones Average rose from a 275 mid-point in 1953 to 750, while the Standard Poor's index rose from 24.7 to 73.5. An interesting point is that the apparently miscellaneous group of 500 issues actually had a slightly better advance than the gilt-edge or blue-chip stocks in the Dow Jones Average. This indicates that you cannot tell a priority, what any group of stocks is going to do over the future years in comparison with any other.

I think the third and most important reason why the investor should not be led to emphasize his selection of individual stocks, and to neglect the general level of the stock market is the fact that there is no indication that the investor can do better than the market averages by making his own selections or by taking expert advice. The outstanding support for that pessimistic statement is found in the record of the investment funds, which represent a combination of about the best financial brains in the country, and a tremendous expenditure, of money, time, and carefully directed effort. The record shows that the funds have had great difficulty as a whole in equaling the performance of the 30 stocks in the Dow Jones Averages or the 500 Standard & Poor's Index. If an investor had been able, by some rough across-the-board diversification to make up a portfolio approximating these averages he would have had every reason to expect about as good results as were shown by the very intelligent and careful stock selections by the investment-fund managers. But the great justification for the mutual funds is that very few investors actually do follow such a sound and simple policy.

I must reluctantly express some skepticism about the general efficacy of economic forecasting, of stock market forecasting, and of expert selection of common stocks, in their relation to the investment and speculative profits which can be made therefrom. Let me give you my reasons: I say first that to the extent that an economic forecast appears dependable--and it is generally so only for the short term--its effect is likely to be already reflected in the market level, and there is no way to make money from it. For example, we cannot say because the forecast for 1964 is favorable that common stocks should be bought today. The price of common stocks today, as everybody should know reflects the general expectation of a good 1964. On the other hand, longer term business forecasts have proven unreliable on the whole.

Similarly, take the case where an individual stock is favored by one of my own fraternity of security analysis is because he is optimistic about its future earnings and general prospects. To the extent that investors generally agree that this company has good future prospects to that extent its prospects are also likely to be fully reflected and perhaps over-reflected in the market price. Sometimes you find the contrary case where a Wall Street man may say "Nobody likes this stock, nobody has confidence in it, but I have confidence in it and I know its results are going to be better in the future." That's an interesting and valuable conclusion if true. The trouble is that in most cases you can't rely on its dependability. The man may be right or he may be wrong in saying that some unpopular stock is going to have a very good future. That is the dilemma all investors face in trying to make money out of forecasts as to the future prospects of any individual security.

Now, with respect to stock market forecasting as such, as a separate occupation or amusement, I don't think there is any good evidence that a recognized and publicly used method of stock market forecasting can be relied upon to be pro-

fitable. Let me illustrate what I mean by reference to the famous "Dow Theory" which is the best known of the methods used for forecasting the stock market. I made some elaborate studies of the results of applying the mechanical concepts of the Dow Theory, in which you have well-defined signals to buy and sell stocks by the movement of the average through resistance points upward or downward. I found that when I studied the record from 1898 to 1933, a period of about 35 years--the results from following this mechanical method were remarkably good. About 1933, the time when the Dow Theory had shown itself a very useful method for dealing with the market action in the 1920's and early 1930's, the public's interest in the Theory increased enormously. Previously it had been a kind of esoteric prescription followed only by a few devoted adherents, and about which everybody else had been pretty skeptical. The Dow Theory became extremely popular after 1933. I studied the consequences of using exactly the same method in the market after 1933, and I found peculiarly enough that in no case in the next 25 years did one benefit through following the Dow signals mechanically. By this I mean that one was never able to buy his stocks back at a lower price than he sold them for.

As you know, the Dow Theory is still pursued by a number of practitioners and services. I think all of them will tell you that it is not a mechanical theory now, and that a large element of judgment has to enter in the interpretation of the signals. But once you introduce that element you don't have a true theory anymore, you just have a certain expertise which may or may not be dependable and useful.

Let me now make a general observation. For obvious reasons it is impossible for investors as a whole, and therefore for the average investor or speculator, to do better than the general market. The reason is that you are the general market and you can't do better than yourselves. I do believe it is possible for a minority of investors to get significantly better results than the average. Two conditions are necessary for that. One is that they must follow some sound principles of selection which are related to the value of the securities and not to their market price action. The other is that their method of operation must be basically different than that of the majority of security buyers. They have to cut themselves off from the general public and put themselves into a special category. I will touch more briefly on that point later.

Now, let me summarize up this stage. The investor needs common stocks in his portfolio; but these introduce hazards of wide fluctuations which he cannot expect to avoid more successfully than others unless perhaps he thinks independently from the crowd, that is unless he is constitutionally different from the average.

Now let me come to part two: what investment policy to follow under the conditions discussed? My views thereon are and definite and strong. In my nearly fifty years of experience in Wall Street I've found that I know less and less about what the stock market is going to do but I know more and more about what investors ought to do; and that's a pretty vital change in attitude. The first point is that the investor is required by the very insecurity ruling in the world of today to maintain at all times some division of his funds between bonds and stocks (cash and various types of interest-bearing deposits may be viewed as bond-equivalents.) My suggestion is that the minimum position of this portfolio held in common stocks should be 25% and the maximum should be 75%. Consequently the maximum holding of bonds would be 75% and the minimum 25%-- the figures being reversed. Any variations made in his portfolio mix should be held within these 25% and 75% figures. Any such variations should be clearly based on value considerations, which would lead him to own more common stocks when the market seems low in relation to value and less common stocks when the market seems high

most important
analysis

in relation to value.

Now while this is the classic language of investment authorities, it is amazing how many people think in exactly opposite terms. That was brought home to me shortly after the May 1962 break when a savings-and-loan company representative came to me with questions. The first question he asked me was "Don't you think that common stocks now are less safe than before because of the decline in the market?" That hit me between the eyes. Here were financial people who could seriously consider that stocks less safe because they have declined in price than they were after they had advanced in price. The policy I propose to have more common stocks when the market seems to be low and less when it seems to be high by value standards is obviously opposed to the psychology of investors generally and to that of speculators always. It is particularly true now because of the great confusion between investment and speculation which I shall refer to later. I suppose the idea of having more common stocks at low levels than at high levels is a "counsel of perfection" for most investors. But it could be followed by many investors to the extent of an inflexible rule that they should not increase the percentage of common stocks in their portfolio as the market advances, except of course through the rise in the market itself. However, a more sophisticated application, which would take advantage of a rise in the market level for sales, could be something like this. Use a fixed 50-50 division between bonds and stocks. When the market level of the stocks rises to a point where they constitute 55% of the total or maybe 60%, you would then sell out enough to bring your proportion back to 50%, putting the proceeds back into bonds or into savings banks. And conversely when the market went down so that your common stock proportion had fallen 45% or 40%, you would use some of your bond money to buy common stocks and bring it back to the 50%. That was the famous Yale University system, which was one of the earliest formula methods known. They used a 35% basis for common stocks, a percentage which at that time was regarded as pretty rash for an institution of learning. When a market rise brought it up to 40% they sold out one eighth of their holdings, to get back to 35%; when it went down to 30% they bought one sixth to bring the ratio up again to 35%. It was a good system until the market ran away on the upside, and then they decided they had too little in common stocks. Now they are up to a 50 to 55% ratio, like the other universities, I think, and they don't follow the formula anymore.

Another approach that is practicable, but from a different point of view, is the "Dollar Averaging" method, in which you put the same amount of money in common stocks year after year, or quarter after quarter. In that way you buy more shares of stocks when the market level is low and fewer shares when it's high. That method has worked out extremely well for those who have had (a) the money, (b) the time, and (c) the character necessary to pursue a consistent policy over the years regardless of whether the market has been going up or down. If you can do that you are guaranteed satisfactory success in your investments.

Let me add that there are countless variants of this type, which are called "formula plans." The main need here is for the investor to select some rule which seems to be suitable for his point of view, one which will keep him out of mis- chief, and one, I insist, which will always maintain some interest in common stocks regardless of how high the market level goes. For if you had followed one of these older formulas which took you out of common stocks entirely at some level of the market, your disappointment would have been so great because of the ensuing advance as probably to ruin you from the standpoint of intelligent investing for the rest of your life.

Now let me come to the problems of security selection. We have talked about a bond component (and/or a cash-equivalent component) and a common stock component. There's a wide choice in the bond component, but the decision is not of

too much importance in most cases. In the taxable list, you can put your money in U.S. Savings Bonds at $3\frac{1}{2}\%$; which you can redeem at will; you can buy long term U.S. Government Bonds at about 4.10% taxable; you can buy high grade, long-term corporate bonds at 4.30% , or $4\frac{1}{2}\%$ if you do a little selecting; you can have savings deposits in commercial banks which give you up to $4\frac{1}{4}\%$ if held for one year; you can buy savings-and loan shares (bear in mind that they are not deposits but shares) which now yield up to 5% in California. Another choice of great importance are tax-free state and municipal bonds, which yield up to about $3\frac{1}{2}\%$ for good quality and long maturity. For most investors who are in a tax bracket of more than 30% , tax-free bonds have been the most attractable for many years. They actually were in part a gift to the investor of which he didn't take advantage up to the extent he should have as against taxable bonds. That advantage has diminished, because tax free bonds have advanced relative to others, but it is still persuasive for people of substantial means. I would like to point out that in 1953 municipal bonds yielded 2.93% and U.S. Government taxable bonds 3.08% , nearly the same return despite the full tax on the governments. In October 63 the municipal average was 3.28% and that of U.S. Government bonds 4.06% , so you see the advantage that has accrued to the past holder of tax-free bonds as compared with U.S. government.

One question for the investor which I won't go into, and I am glad I haven't got the time to do it, is whether he should take advantage of the 5% rate offered by some of the savings and loan associations in California. Let me say that I am not an expert on savings- and loan associations, and I don't want to get drawn into the controversy that has now begun as to whether their methods are completely sound and their prospects are completely dependable. I just want to say in general terms that nobody can assume that he can get exactly the same degree of safety and dependability in a standard type of investment yielding 5% as in one yielding 4% .

With respect to preferred stocks the import point is that they do not belong in the individual investor's portfolio. The reason is they have a great tax advantage for corporate owners which they don't have for individual owners. Corporate owners save 85% of the tax on these dividends, individual owners save a very small amount, which may disappear pretty soon in the new law. It should be obvious that preferred stocks should be bought only by corporate investors just as tax-free bonds should be bought only by people who pay income tax. You may have noticed last week that one of the public utility companies offered a bond issue and a preferred-stock issue at practically the same yield, although hitherto preferred stocks have always yielded quite a bit more than the bonds to which they were junior. The great tax advantage of preferred stocks to corporate buyers is now belatedly showing its effect on relative yields.

We come finally to common-stock investment. My recommendation is that the investor choose either his own list of, say, 20 or 30 representative and leading companies, or else put his money in several of the well-established mutual funds. (There is usually an advantage for the shrewd investor in buying shares of the closed-end investment companies on the New York Stock Exchange, when obtainable at discounts from net asset value, rather than paying the premium added on to the price of most open-end shares.)

Many investors would think my prescription too simple. If they can get results equal to the averages in this easy way why shouldn't they try to get a substantially higher return by careful and competently-advised selection? My short answer has already been given: If the investment funds as a whole can't beat the averages, even pretty clever investors as a whole can't do it either. The underlying problem of selection is that the "good stocks--chiefly the growth stocks with better than average prospects--tend to be fully priced and

often overpriced." At the other extreme new stock offerings, when the craze is on, are likely to combine fourth-rate quality with absurdly high price-earnings ratios. There are better opportunities in between these extremes, but most investors don't look for them there.

As I see it, the fundamental problem in common stocks is the market's injection of a large speculative element into the strongest and best companies by establishing an untenably high price for them. (The rise of IBM or 607, soon followed by a fall to 300, is the best illustration of my point.) This has added greatly to the confusion between investment and speculation, because it is easy to tell oneself that the shares of a good company are always a sound investment, regardless of price. From this it was an easy step to calling everyone an investor who bought his shares outright, and finally to calling every Wall Street customer an investor--period.

My recent crusade has been to persuade Wall Street that it has made a mistake, and harmed itself, in suppressing the word "speculation" from its vocabulary. Speculation is not bad in itself; overspeculation is. It is important that the public should have a fairly good idea of the extent to which it is speculating, not only when it buys a "hot issue" at a completely silly price, but even when it buys into a wonderful concern such as IBM at 70 times its highest recorded earnings. To my mind the most valuable contribution that security analysts could make to the art of investing would be the determination of the investment and speculative components in the current price of any given common stock, so that the intending buyer might have some notion of the risks he is taking as well as what profit he might make. I have pointed out that my own conservative appraisal put the investment component in IBM's 1961 price at not more than \$200 per share --about \$6 billion for the entire enterprise--the remainder of the quotation representing a speculative valuation of the company's undoubtedly brilliant future. Conversely, I stated that at least 80% of the highest prices (55) of International Harvester in 1961 could be ascribed to its investment value. This did not prove that Harvester was a better buy than IBM--it was, as it turned out--but it did demonstrate that the risk factor involved was much smaller.

Let me raise a final question: Despite rather discouraging results from endeavors to predict market moves or to select the most attractive companies, can the intelligent investor follow any policies of common-stock selection that promise better than average results? I think it is possible for some strong-minded investors to do this, by buying value rather than prospects or popularity. Some examples of this approach: (1) Select stocks of important companies which sell on a no-glamour basis--e.g., International Harvester. Some extraordinary results could have been obtained since 1933 by buying each year the shares of the six companies in the Dow Jones Ind. Average which sold at the lowest multiplier of their recent earnings. (2) Buy definitely "bargain issues." Typically these would be shares that sold for less their value in working-capital alone, with nothing paid for fixed assets and goodwill. These were quite numerous up to as late as 1957, and were consistently profitable when diversification was observed. Few such opportunities remain; perhaps they have been supplanted by shares of smaller companies selling on a relatively depressed basis and likely to be taken over by a larger concern at a good advance in price. (3) Finally there is the wide field of "special situations"--reorganizations, mergers, take-overs, liquidations, etc. This is a professional area, but it is not impossible for intelligent investors to profit handsomely from it if they approach security operations as they would a commercial business.

CONCLUSION.

The investor must recognize that there are uncertain and hence speculative

elements inherent in any policy he follows--even an all-Government-bond program. He must deal with these uncertainties by a policy of continuous compromise between bonds and common stocks, and by adequate diversification. (Exception: He may put and keep most of his funds in shares of a promising business with which he is closely connected.) He must make a strong effort to have more money invested in common stocks at lower market levels (at least on the basis of cost) than at what he recognizes to be potentially high levels. Most important, he must maintain a philosophical attitude towards the inescapable variations in his financial position and the inevitable "mistakes" associated with these variations.

According to an old Wall Street story, when a certain broker was asked by a client to recommend issues to buy, he always asked in return, "What is your preference? Do you want to eat well or to sleep well?" I am optimist enough to believe that by following sound policies almost any investor--even in this insecure world--should be able to eat well enough without having to lose any sleep.