taxed substantially as partnerships. Thus if they make long-term security profits they can distribute these as "capital-gain dividends," which are reported by their shareholders in the same way as long-term gains. These carry a lower tax rate than ordinary dividends. Alternatively, such a company may elect to pay the 25% tax for the account of its shareholders and then retain the balance of the capital gains without distributing them as capital-gain dividends.

3. The Basics of Investment Taxation (Updated as of 2003)

Interest and Dividends

Interest and dividends are taxed at your ordinary-income tax rate except (a) interest received from municipal bonds, which is free from Federal income tax but may be subject to state tax, (b) dividends representing a return of capital, and (c) long-term capital-gain distributions paid by mutual funds (see below). Private-activity municipal bonds, even within a mutual fund, may subject you to the Federal alternative minimum tax.

Capital Gains and Losses

Short-term capital gains and losses are merged to obtain net short-term capital gain or loss. Long-term capital gains and losses are merged to determine your net long-term capital gain or loss. If your net short-term capital gain exceeds the net long-term capital loss, that excess is counted as ordinary income. If there is a net long-term capital gain, it is taxed at the favorable capital gains rate, generally 20%—which will fall to 18% for investments purchased after December 31, 2000, and held for more than five years.

A net capital loss is deductible from ordinary income to a maximum of $3,000 in the current year. Any capital losses in excess of $3,000 may be applied in later tax years to offset future capital gains.

Mutual Funds

As "regulated investment companies," nearly all mutual funds take advantage of special provisions of the tax law that exempt them from

corporate income tax. After selling long-term holdings, mutual funds can distribute the profits as "capital-gain dividends," which their shareholders treat as long-term gains. These are taxed at a lower rate (generally 20%) than ordinary dividends (up to 39%). You should generally avoid making large new investments during the fourth quarter of each year, when these capital-gain distributions are usually distributed; otherwise you will incur tax for a gain earned by the fund before you even owned it.

4. The New Speculation in Common Stocks[1]

What I shall have to say will reflect the spending of many years in Wall Street, with their attendant varieties of experience. This has included the recurrent advent of new conditions, or a new atmosphere, which challenge the value of experience itself. It is true that one of the elements that distinguish economics, finance, and security analysis from other practical disciplines is the uncertain validity of past phenomena as a guide to the present and future. Yet we have no right to reject the lessons of the past until we have at least studied and understood them. My address today is an effort toward such understanding in a limited field—in particular, an endeavor to point out some contrasting relationships between the present and the past in our underlying attitudes toward investment and speculation in common stocks.

Let me start with a summary of my thesis. In the past the speculative elements of a common stock resided almost exclusively in the company itself; they were due to uncertainties, or fluctuating elements, or downright weaknesses in the industry, or the corporation's individual setup. These elements of speculation still exist, of course; but it may be said that they have been sensibly diminished by a number of long-term developments to which I shall refer. But in revenge a new and major element of speculation has been introduced into the common-stock arena from *outside* the companies. It comes from the attitude and viewpoint of the stock-buying public and their advisers—chiefly us security analysts. This attitude may be described in a phrase: primary emphasis upon future expectations.

Nothing will appear more logical and natural to this audience than the idea that a common stock should be valued and priced

primarily on the basis of the company's expected future performance. Yet this simple-appearing concept carries with it a number of paradoxes and pitfalls. For one thing, it obliterates a good part of the older, well-established distinctions between investment and speculation. The dictionary says that "speculate" comes from the Latin "specula," a lookout. Thus it was the speculator who looked out and saw future developments coming before other people did. But today, if the investor is shrewd or well advised, he too must have his lookout on the future, or rather he mounts into a common lookout where he rubs elbows with the speculator.

Secondly, we find that, for the most part, companies with the best investment characteristics—i.e., the best credit rating—are the ones which are likely to attract the largest speculative interest in their common stocks, since everyone assumes they are guaranteed a brilliant future. Thirdly, the concept of future prospects, and particularly of continued growth in the future, invites the application of formulas out of higher mathematics to establish the present value of the favored issues. But the combination of precise formulas with highly imprecise assumptions can be used to establish, or rather to justify, practically any value one wishes, however high, for a really outstanding issue. But, paradoxically, that very fact on close examination will be seen to imply that no one value, or reasonably narrow range of values, can be counted on to establish and maintain itself for a given growth company; hence at times the market may conceivably value the growth component at a strikingly *low* figure.

Returning to my distinction between the older and newer speculative elements in common stock, we might characterize them by two outlandish but convenient words, viz.: endogenous and exogenous. Let me illustrate briefly the old-time speculative common stock, as distinguished from an investment stock, by some data relating to American Can and Pennsylvania Railroad in 1911–1913. (These appear in Benjamin Graham and David L. Dodd, *Security Analysis,* McGraw-Hill, 1940, pp. 2–3.)

In those three years the price range of "Pennsy" moved only between 53 and 65, or between 12.2 and 15 times its average earnings for the period. It showed steady profits, was paying a reliable $3 dividend, and investors were sure that it was backed by well over its par of $50 in tangible assets. By contrast, the price of Amer-

ican Can ranged between 9 and 47; its earnings between 7 cents and $8.86; the ratio of price to the three-year average earnings moved between 1.9 times and 10 times; it paid no dividend at all; and sophisticated investors were well aware that the $100 par value of the common represented nothing but undisclosed "water," since the preferred issue exceeded the tangible assets available for it. Thus American Can common was a representative speculative issue, because American Can Company was then a speculatively capitalized enterprise in a fluctuating and uncertain industry. Actually, American Can had a far more brilliant long-term future than Pennsylvania Railroad; but not only was this fact not suspected by investors or speculators in those days, but even if it had been it would probably have been put aside by the investors as basically irrelevant to investment policies and programs in the years 1911–1913.

Now, to expose you to the development through time of the importance of long-term prospects for investments. I should like to use as my example our most spectacular giant industrial enterprise—none other than International Business Machines, which last year entered the small group of companies with $1 billion of sales. May I introduce one or two autobiographical notes here, in order to inject a little of the personal touch into what otherwise would be an excursion into cold figures? In 1912 I had left college for a term to take charge of a research project for U.S. Express Company. We set out to find the effect on revenues of a proposed revolutionary new system of computing express rates. For this purpose we used the so-called Hollerith machines, leased out by the then Computing-Tabulating-Recording Company. They comprised card punches, card sorters, and tabulators—tools almost unknown to businessmen, then, and having their chief application in the Census Bureau. I entered Wall Street in 1914, and the next year the bonds and common stock of C.-T.-R. Company were listed on the New York Stock Exchange. Well, I had a kind of sentimental interest in that enterprise, and besides I considered myself a sort of technological expert on their products, being one of the few financial people who had seen and used them. So early in 1916 I went to the head of my firm, known as Mr. A. N., and pointed out to him that C.-T.-R. stock was selling in the middle 40s (for 105,000 shares); that it had earned $6.50 in 1915; that its book value—

including, to be sure, some nonsegregated intangibles—was $130; that it had started a $3 dividend; and that I thought rather highly of the company's products and prospects. Mr. A. N. looked at me pityingly. "Ben," said he, "do not mention that company to me again. I would not touch it with a ten-foot pole. [His favorite expression.] Its 6 per cent bonds are selling in the low 80s and they are no good. So how can the stock be any good? Everybody knows there is nothing behind it but water." (Glossary: In those days that was the ultimate of condemnation. It meant that the asset account of the balance sheet was fictitious. Many industrial companies—notably U.S. Steel—despite their $100 par, represented nothing but water, concealed in a written-up plant account. Since they had "nothing" to back them but earning power and future prospects, no self-respecting investor would give them a second thought.)

I returned to my statistician's cubbyhole, a chastened young man. Mr. A. N. was not only experienced and successful, but extremely shrewd as well. So much was I impressed by his sweeping condemnation of Computing-Tabulating-Recording that I never bought a share of it in my life, not even after its name was changed to International Business Machines in 1926.

Now let us take a look at the same company with its new name in 1926, a year of pretty high stock markets. At that time it first revealed the good-will item in its balance sheet, in the rather large sum of $13.6 million. A. N. had been right. Practically every dollar of the so-called equity behind the common in 1915 had been nothing but water. However, since that time the company had made an impressive record under the direction of T. L. Watson, Sr. Its net had risen from $691,000 to $3.7 million—over fivefold—a greater percentage gain than it was to make in any subsequent eleven-year period. It had built up a nice tangible equity for the common, and had split it 3.6 for one. It had established a $3 dividend rate for the new stock, while earnings were $6.39 thereon. You might have expected the 1926 stock market to have been pretty enthusiastic about a company with such a growth history and so strong a trade position. Let us see. The price range for that year was 31 low, 59 high. At the average of 45 it was selling at the same 7-times multiplier of earnings and the same 6.7 per cent dividend yield as it had done in 1915. At its low of 31 it was not far in excess of its tangible book value, and in that respect was far more conservatively priced than eleven years earlier.

These data illustrate, as well as any can, the persistence of the old-time investment viewpoint until the culminating years of the bull market of the 1920s. What has happened since then can be summarized by using ten-year intervals in the history of IBM. In 1936 net expanded to twice the 1926 figures, and the average multiplier rose from 7 to 17½. From 1936 to 1946 the gain was 2½ times, but the average multiplier in 1946 remained at 17½. Then the pace accelerated. The 1956 net was nearly 4 times that of 1946, and the average multiplier rose to 32½. Last year, with a further gain in net, the multiplier rose again to an average of 42, if we do not count the unconsolidated equity in the foreign subsidiary.

When we examine these recent price figures with care we see some interesting analogies and contrasts with those of forty years earlier. The one-time scandalous water, so prevalent in the balance sheets of industrial companies, has all been squeezed out—first by disclosure and then by writeoffs. But a different kind of water has been put back into the valuation by the stock market—by investors and speculators themselves. When IBM now sells at 7 times its book value, instead of 7 times earnings, the effect is practically the same as if it had no book value at all. Or the small book-value portion can be considered as a sort of minor preferred-stock component of the price, the rest representing exactly the same sort of commitment as the old-time speculator made when he bought Woolworth or U.S. Steel common entirely for their earning power and future prospects.

It is worth remarking, in passing, that in the thirty years which saw IBM transformed from a 7-times earnings to a 40-times earnings enterprise, many of what I have called the endogenous speculative aspects of our large industrial companies have tended to disappear, or at least to diminish greatly. Their financial positions are firm, their capital structures conservative: they are managed far more expertly, and even more honestly, than before. Furthermore, the requirements of complete disclosure have removed one of the important speculative elements of years ago—that derived from ignorance and mystery.

Another personal digression here. In my early years in the Street one of the favorite mystery stocks was Consolidated Gas of New York, now Consolidated Edison. It owned as a subsidiary the profitable New York Edison Company, but it reported only dividends received from this source, not its full earnings. The unreported Edi-

son earnings supplied the mystery and the "hidden value." To my surprise I discovered that these hush-hush figures were actually on file each year with the Public Service Commission of the state. It was a simple matter to consult the records and to present the true earnings of Consolidated Gas in a magazine article. (Incidentally, the addition to profits was not spectacular.) One of my older friends said to me then: "Ben, you may think you are a great guy to supply those missing figures, but Wall Street is going to thank you for nothing. Consolidated Gas with the mystery is both more interesting and more valuable than ex-mystery. You youngsters who want to stick your noses into everything are going to ruin Wall Street."

It is true that the three M's which then supplied so much fuel to the speculative fires have now all but disappeared. These were Mystery, Manipulation, and (thin) Margins. But we security analysts have ourselves been creating valuation approaches which are so speculative in themselves as to pretty well take the place of those older speculative factors. Do we not have our own "3M's" now—none other than Minnesota Mining and Manufacturing Company—and does not this common stock illustrate perfectly the new speculation as contrasted with the old? Consider a few figures. When M. M. & M. common sold at 101 last year the market was valuing it at 44 times 1956 earnings, which happened to show no increase to speak of in 1957. The enterprise itself was valued at $1.7 billion, of which $200 million was covered by net assets, and a cool $1½ billion represented the market's appraisal of "good will." We do not know the process of calculation by which that valuation of good will was arrived at; we do know that a few months later the market revised this appraisal downward by some $450 million, or about 30 per cent. Obviously it is impossible to calculate accurately the intangible component of a splendid company such as this. It follows as a kind of mathematical law that the more important the good will or future earning-power factor the more uncertain becomes the true value of the enterprise, and therefore the more speculative inherently the common stock.

It may be well to recognize a vital difference that has developed in the valuation of these intangible factors, when we compare earlier times with today. A generation or more ago it was the standard rule, recognized both in average stock prices and in formal or legal

valuations, that intangibles were to be appraised on a more conservative basis than tangibles. A good industrial company might be required to earn between 6 per cent and 8 per cent on its tangible assets, represented typically by bonds and preferred stock; but its excess earnings, or the intangible assets they gave rise to, would be valued on, say, a 15 per cent basis. (You will find approximately these ratios in the initial offering of Woolworth preferred and common stock in 1911, and in numerous others.) But what has happened since the 1920s? Essentially the exact reverse of these relationships may now be seen. A company must now typically earn about 10 per cent on its common equity to have it sell in the average market at full book value. But its excess earnings, above 10 per cent on capital, are usually valued more liberally, or at a higher multiplier, than the base earnings required to support the book value in the market. Thus a company earning 15 per cent on the equity may well sell at 13½ times earnings, or twice its net assets. This would mean that the first 10 per cent earned on capital is valued at only 10 times, but the next 5 per cent—what used to be called the "excess"—is actually valued at 20 times.

Now there is a logical reason for this reversal in valuation procedure, which is related to the newer emphasis on growth expectations. Companies that earn a high return on capital are given these liberal appraisals not only because of the good profitability itself, and the relative stability associated with it, but perhaps even more cogently because high earnings on capital generally go hand in hand with a good growth record and prospects. Thus what is really paid for nowadays in the case of highly profitable companies is not the good will in the old and restricted sense of an established name and a profitable business, but rather their assumed superior expectations of increased profits in the future.

This brings me to one or two additional mathematical aspects of the new attitude toward common-stock valuations, which I shall touch on merely in the form of brief suggestions. If, as many tests show, the earnings multiplier tends to increase with profitability—i.e., as the rate of return on book value increases—then the arithmetical consequence of this feature is that value tends to increase directly as the square of the earnings, but *inversely* the book value. Thus in an important and very real sense tangible assets have become a drag on average market value rather than a source

thereof. Take a far from extreme illustration. If Company A earns $4 a share on a $20 book value, and Company B also $4 a share on $100 book value, Company A is almost certain to sell at a higher multiplier, and hence at higher price than Company B—say $60 for Company A shares and $35 for Company B shares. Thus it would not be inexact to declare that the $80 per share of greater assets for Company B are responsible for the $25 per share lower market price, since the earnings per share are assumed to be equal.

But more important than the foregoing is the general relationship between mathematics and the new approach to stock values. Given the three ingredients of (a) optimistic assumptions as to the rate of earnings growth, (b) a sufficiently long projection of this growth into the future, and (c) the miraculous workings of compound interest—lo! the security analyst is supplied with a new kind of philosopher's stone which can produce or justify any desired valuation for a really "good stock." I have commented in a recent article in the *Analysts' Journal* on the vogue of higher mathematics in bull markets, and quoted David Durand's exposition of the striking analogy between value calculations of growth stocks and the famous Petersburg Paradox, which has challenged and confused mathematicians for more than two hundred years. The point I want to make here is that there is a special paradox in the relationship between mathematics and investment attitudes on common stocks, which is this: Mathematics is ordinarily considered as producing precise and dependable results; but in the stock market the more elaborate and abstruse the mathematics the more uncertain and speculative are the conclusions we draw therefrom. In forty-four years of Wall Street experience and study I have never seen dependable calculations made about common-stock values, or related investment policies, that went beyond simple arithmetic or the most elementary algebra. Whenever calculus is brought in, or higher algebra, you could take it as a warning signal that the operator was trying to substitute theory for experience, and usually also to give to speculation the deceptive guise of investment.

The older ideas of common-stock investment may seem quite naïve to the sophisticated security analyst of today. The great emphasis was always on what we now call the defensive aspects of the company or issue—mainly the assurance that it would continue its dividend unreduced in bad times. Thus the strong rail-

roads, which constituted the standard investment commons of fifty years ago, were actually regarded in very much the same way as the public-utility commons in recent years. If the past record indicated stability, the chief requirement was met; not too much effort was made to anticipate adverse changes of an underlying character in the future. But, conversely, especially favorable future prospects were regarded by shrewd investors as something to look for but not to pay for.

In effect this meant that the investor did not have to pay anything substantial for superior long-term prospects. He got these, virtually without extra cost, as a reward for his own superior intelligence and judgment in picking the best rather than the merely good companies. For common stocks with the same financial strength, past earnings record, and dividend stability all sold at about the same dividend yield.

This was indeed a shortsighted point of view, but it had the great advantage of making common-stock investment in the old days not only simple but also basically sound and highly profitable. Let me return for the last time to a personal note. Somewhere around 1920 our firm distributed a series of little pamphlets entitled *Lessons for Investors.* Of course it took a brash analyst in his middle twenties like myself to hit on so smug and presumptuous a title. But in one of the papers I made the casual statement that "if a common stock is a good investment it is also a good speculation." For, reasoned I, if a common stock was so sound that it carried very little risk of loss it must ordinarily be so good as to possess excellent chances for future gains. Now this was a perfectly true and even valuable discovery, but it was true only because nobody paid any attention to it. Some years later, when the public woke up to the historical merits of common stocks as long-term investments, they soon ceased to have any such merit, because the public's enthusiasm created price levels which deprived them of their built-in margin of safety, and thus drove them out of the investment class. Then, of course, the pendulum swung to the other extreme, and we soon saw one of the most respected authorities declaring (in 1931) that no common stock could *ever* be an investment.

When we view this long-range experience in perspective we find another set of paradoxes in the investor's changing attitude toward capital gains as contrasted with income. It seems a truism

to say that the old-time common-stock investor was not much interested in capital gains. He bought almost entirely for safety and income, and let the speculator concern himself with price appreciation. Today we are likely to say that the more experienced and shrewd the investor, the less attention he pays to dividend returns, and the more heavily his interest centers on long-term appreciation. Yet one might argue, perversely, that precisely because the old-time investor did not concentrate on future capital appreciation he was virtually guaranteeing to himself that he would have it, at least in the field of industrial stocks. And, conversely, today's investor is so concerned with anticipating the future that he is already paying handsomely for it in advance. Thus what he has projected with so much study and care may actually happen and still not bring him any profit. If it should fail to materialize to the degree expected he may in fact be faced with a serious temporary and perhaps even permanent loss.

What *lessons*—again using the pretentious title of my 1920 pamphlet—can the analyst of 1958 learn from this linking of past with current attitudes? Not much of value, one is inclined to say. We can look back nostalgically to the good old days when we paid only for the present and could get the future for nothing—an "all this and Heaven too" combination. Shaking our heads sadly we mutter, "Those days are gone forever." Have not investors and security analysts eaten of the tree of knowledge of good and evil prospects? By so doing have they not permanently expelled themselves from that Eden where promising common stocks at reasonable prices could be plucked off the bushes? Are we doomed always to run the risk either of paying unreasonably high prices for good quality and prospects, or of getting poor quality and prospects when we pay what seems a reasonable price?

It certainly looks that way. Yet one cannot be sure even of that pessimistic dilemma. Recently, I did a little research in the long-term history of that towering enterprise, General Electric—stimulated by the arresting chart of fifty-nine years of earnings and dividends appearing in their recently published 1957 Report. These figures are not without their surprises for the knowledgeable analyst. For one thing they show that prior to 1947 the growth of G. E. was fairly modest and quite irregular. The 1946 earnings, per share adjusted, were only 30 per cent higher than in 1902—52 cents ver-

sus 40 cents—and in no year of this period were the 1902 earnings as much as doubled. Yet the price-earnings ratio rose from 9 times in 1910 and 1916 to 29 times in 1936 and again in 1946. One might say, of course, that the 1946 multiplier at least showed the well-known prescience of shrewd investors. We analysts were able to foresee then the really brilliant period of growth that was looming ahead in the next decade. Maybe so. But some of you remember that the next year, 1947, which established an impressive new high for G.E.'s per-share earnings, was marked also by an extraordinary fall in the price-earnings ratio. At its low of 32 (before the 3-for-1 split) G.E. actually sold again at only 9 times its current earnings and its average price for the year was only about 10 times earnings. Our crystal ball certainly clouded over in the short space of twelve months.

This striking reversal took place only eleven years ago. It casts some little doubt in my mind as to the complete dependability of the popular belief among analysts that prominent and promising companies will now always sell at high price-earnings ratios—that this is a fundamental fact of life for investors and they may as well accept and like it. I have no desire at all to be dogmatic on this point. All I can say is that it is not settled in my mind, and each of you must seek to settle it for yourself.

But in my concluding remarks I can say something definite about the structure of the market for various types of common stocks, in terms of their investment and speculative characteristics. In the old days the investment character of a common stock was more or less the same as, or proportionate with, that of the enterprise itself, as measured quite well by its credit rating. The lower the yield on its bonds or preferred, the more likely was the common to meet all the criteria for a satisfactory investment, and the smaller the element of speculation involved in its purchase. This relationship, between the speculative ranking of the common and the investment rating of the company, could be graphically expressed pretty much as a straight line descending from left to right. But nowadays I would describe the graph as U-shaped. At the left, where the company itself is speculative and its credit low, the common stock is of course highly speculative, just as it has always been in the past. At the right extremity, however, where the company has the highest credit rating because both its past record

and future prospects are most impressive, we find that the stock market tends more or less continuously to introduce a highly speculative element into the common shares through the simple means of a price so high as to carry a fair degree of risk.

At this point I cannot forbear introducing a surprisingly relevant, if quite exaggerated, quotation on the subject which I found recently in one of Shakespeare's sonnets. It reads:

> Have I not seen dwellers on form and favor
> Lose all and more by paying too much rent?

Returning to my imaginary graph, it would be the center area where the speculative element in common-stock purchases would tend to reach its minimum. In this area we could find many well-established and strong companies, with a record of past growth corresponding to that of the national economy and with future prospects apparently of the same character. Such common stocks could be bought at most times, except in the upper ranges of a bull market, at moderate prices in relation to their indicated intrinsic values. As a matter of fact, because of the present tendency of investors and speculators alike to concentrate on more glamorous issues, I should hazard the statement that these middle-ground stocks tend to sell on the whole rather below their independently determinable values. They thus have a margin-of-safety factor supplied by the same market preferences and prejudices which tend to destroy the margin of safety in the more promising issues. Furthermore, in this wide array of companies there is plenty of room for penetrating analysis of the past record and for discriminating choice in the area of future prospects, to which can be added the higher assurance of safety conferred by diversification.

When Phaëthon insisted on driving the chariot of the Sun, his father, the experienced operator, gave the neophyte some advice which the latter failed to follow—to his cost. Ovid summed up Phoebus Apollo's counsel in three words:

> *Medius tutissimus ibis*
> You will go safest in the middle course

I think this principle holds good for investors and their security analyst advisers.

5. A Case History: Aetna Maintenance Co.

The first part of this history is reproduced from our 1965 edition, where it appeared under the title "A Horrible Example." The second part summarizes the later metamorphosis of the enterprise.

We think it might have a salutary effect on our readers' future attitude toward new common-stock offerings if we cited one "horrible example" here in some detail. It is taken from the first page of Standard & Poor's *Stock Guide,* and illustrates in extreme fashion the glaring weaknesses of the 1960–1962 flotations, the extraordinary overvaluations given them in the market, and the subsequent collapse.

In November 1961, 154,000 shares of Aetna Maintenance Co. common were sold to public at $9 and the price promptly advanced to $15. Before the financing the net assets per share were about $1.20, but they were increased to slightly over $3 per share by the money received for the new shares.

The sales and earnings prior to the financing were:

Year Ended	*Sales*	*Net for Common*	*Earned Per Share*
June 1961	$3,615,000	$187,000	$0.69
(June 1960)*	(1,527,000)	(25,000)	(0.09)
December 1959	2,215,000	48,000	0.17
December 1958	1,389,000	16,000	0.06
December 1957	1,083,000	21,000	0.07
December 1956	1,003,000	2,000	0.01

* For six months.

The corresponding figures after the financing were:

June 1963	$4,681,000	*$ 42,000* (def.)	*$0.11* (def.)
June 1962	4,234,000	149,000	0.36

In 1962 the price fell to 2⅝, and in 1964 it sold as low as ⅞. No dividends were paid during this period.

COMMENT: This was much too small a business for public participation. The stock was sold—and bought—on the basis of *one good year;* the results previously had been derisory. There was nothing in

the nature of this highly competitive business to insure future stability. At the high price soon after issuance the heedless public was paying much more per dollar of earnings and assets than for most of our large and strong companies. This example is admittedly extreme, but it is far from unique; the instances of lesser, but inexcusable, overvaluations run into the hundreds.

Sequel 1965–1970

In 1965 new interests came into the company. The unprofitable building-maintenance business was sold out, and the company embarked in an entirely different venture: making electronic devices. The name was changed to Haydon Switch and Instrument Co. The earnings results have not been impressive. In the five years 1965–1969 the enterprise showed average earnings of only 8 cents per share of "old stock," with 34 cents earned in the best year, 1967. However, in true modern style, the company split the stock 2 for 1 in 1968. The market price also ran true to Wall Street form. It advanced from ⅞ in 1964 to the equivalent of 16½ in 1968 (after the split). The price now exceeded the record set in the enthusiastic days of 1961. This time the overvaluation was much worse than before. The stock was now selling at 52 times the earnings of its only good year, and some 200 times its average earnings. Also, the company was again to report a deficit in the very year that the new high price was established. The next year, 1969, the bid price fell to $1.

QUESTIONS: Did the idiots who paid $8+ for this stock in 1968 know anything at all about the company's previous history, its five-year earnings record, its asset value (very small)? Did they have any idea of how much—or rather how little—they were getting for their money? Did they care? Has anyone on Wall Street any responsibility at all for the regular recurrence of completely brainless, shockingly widespread, and inevitable catastrophic speculation in this kind of vehicle?

6. Tax Accounting for NVF's Acquisition of Sharon Steel Shares

1. NVF acquired 88% of Sharon stock in 1969, paying for each share $70 in NVF 5% bonds, due 1994, and warrants to buy 1½

shares of NVF at $22 per share. The initial market value of the bonds appears to have been only 43% of par, while the warrants were quoted at $10 per NVF share involved. This meant that the Sharon holders got only $30 worth of bonds but $15 worth of warrants for each share turned in, a total of $45 per share. (This was about the average price of Sharon in 1968, and also its closing price for the year.) The book value of Sharon was $60 per share. The difference between this book value and the market value of Sharon stock amounted to about $21 million on the 1,415,000 shares of Sharon acquired.

2. The accounting treatment was designed to accomplish three things: *(a)* To treat the issuance of the bonds as equivalent to a "sale" thereof at 43, giving the company an annual deduction from income for amortization of the huge bond discount of $54 million. (Actually it would be charging itself about 15% annual interest on the "proceeds" of the $99 million debenture issue.) *(b)* To offset this bond-discount charge by an approximately equal "profit," consisting of a credit to income of one-tenth of the difference between the cost price of 45 for the Sharon stock and its book value of 60. (This would correspond, in reverse fashion, to the required practice of *charging* income each year with a part of the price paid for acquisitions in *excess* of the book value of the assets acquired.) *(c)* The beauty of this arrangement would be that the company could save initially about $900,000 a year, or $1 per share, in income taxes from these two annual entries, because the amortization of bond discount could be deducted from taxable income but the amortization of "excess of equity over cost" did not have to be included in taxable income.

3. This accounting treatment is reflected in both the consolidated income account and the consolidated balance sheet of NVF for 1969, and pro forma for 1968. Since a good part of the cost of Sharon stock was to be treated as paid for by warrants, it was necessary to show the initial market value of the warrants as part of the common-stock capital figure. Thus in this case, as in no other that we know, the warrants were assigned a substantial value in the balance sheet, namely $22 million+ (but only in an explanatory note).

7. Technological Companies as Investments

In the Standard & Poor's services in mid-1971 there were listed about 200 companies with names beginning with Compu-, Data, Electro-, Scien-, Techno-. About half of these belonged to some part of the computer industry. All of them were traded in the market or had made applications to sell stock to the public.

A total of 46 such companies appeared in the S & P *Stock Guide* for September 1971. Of these, 26 were reporting deficits, only six were earning over $1 per share, and only five were paying dividends.

In the December 1968 *Stock Guide* there had appeared 45 companies with similar technological names. Tracing the sequel of this list, as shown in the September 1971 *Guide,* we find the following developments:

Total Companies	*Price Advanced*	*Price Declined Less Than Half*	*Price Declined More Than Half*	*Dropped from Stock Guide*
45	2	8	23	12

COMMENT: It is virtually certain that the many technological companies not included in the *Guide* in 1968 had a poorer subsequent record than those that were included; also that the 12 companies dropped from the list did worse than those that were retained. The harrowing results shown by these samples are no doubt reasonably indicative of the quality and price history of the entire group of "technology" issues. The phenomenal success of IBM and a few other companies was bound to produce a spate of public offerings of new issues in their fields, for which large losses were virtually guaranteed.

Endnotes

Introduction: What This Book Expects to Accomplish

1. "Letter stock" is stock not registered for sale with the Securities and Exchange Commission (SEC), and for which the buyer supplies a letter stating the purchase was for investment.
2. The foregoing are Moody's figures for AAA bonds and industrial stocks.

Chapter 1. Investment versus Speculation: Results to Be Expected by the Intelligent Investor

1. Benjamin Graham, David L. Dodd, Sidney Cottle, and Charles Tatham, McGraw-Hill, 4th. ed., 1962. A fascimile copy of the 1934 edition of *Security Analysis* was reissued in 1996 (McGraw-Hill).
2. This is quoted from *Investment and Speculation,* by Lawrence Chamberlain, published in 1931.
3. In a survey made by the Federal Reserve Board.
4. 1965 edition, p. 8.
5. We assume here a top tax bracket for the typical investor of 40% applicable to dividends and 20% applicable to capital gains.

Chapter 2. The Investor and Inflation

1. This was written before President Nixon's price-and-wage "freeze" in August 1971, followed by his "Phase 2" system of controls. These important developments would appear to confirm the views expressed above.
2. The rate earned on the Standard & Poor's index of 425 industrial stocks was about 11½% on asset value—due in part to the inclusion of the large and highly profitable IBM, which is not one of the DJIA 30 issues.

3. A chart issued by American Telephone & Telegraph in 1971 indicates that the rates charged for residential telephone services were somewhat less in 1970 than in 1960.
4. Reported in the *Wall Street Journal*, October, 1970.

Chapter 3. A Century of Stock-Market History: The Level of Stock Prices in Early 1972

1. Both Standard & Poor's and Dow Jones have separate averages for public utilities and transportation (chiefly railroad) companies. Since 1965 the New York Stock Exchange has computed an index representing the movement of all its listed common shares.
2. Made by the Center for Research in Security Prices of the University of Chicago, under a grant from the Charles E. Merrill Foundation.
3. This was first written in early 1971 with the DJIA at 940. The contrary view held generally on Wall Street was exemplified in a detailed study which reached a median valuation of 1520 for the DJIA in 1975. This would correspond to a discounted value of, say, 1200 in mid-1971. In March 1972 the DJIA was again at 940 after an intervening decline to 798. Again, Graham was right. The "detailed study" he mentions was too optimistic by an entire decade: The Dow Jones Industrial Average did not close above 1520 until December 13, 1985!

Chapter 4. General Portfolio Policy: The Defensive Investor

1. A higher tax-free yield, with sufficient safety, can be obtained from certain *Industrial Revenue Bonds*, a relative newcomer among financial inventions. They would be of interest particularly to the enterprising investor.

Chapter 5. The Defensive Investor and Common Stocks

1. *Practical Formulas for Successful Investing*, Wilfred Funk, Inc., 1953.
2. In current mathematical approaches to investment decisions, it has become standard practice to define "risk" in terms of average price variations or "volatility." See, for example, *An Introduction to Risk and Return*, by Richard A. Brealey, The M.I.T. Press, 1969. We find this use of the word "risk" more harmful than useful for sound investment decisions—because it places too much emphasis on market fluctuations.
3. All 30 companies in the DJIA met this standard in 1971.

Chapter 6. Portfolio Policy for the Enterprising Investor: Negative Approach

1. In 1970 the Milwaukee road reported a large deficit. It suspended interest payments on its income bonds, and the price of the 5% issue fell to 10.
2. For example: Cities Service $6 first preferred, not paying dividends, sold at as low as 15 in 1937 and at 27 in 1943, when the accumulations had reached $60 per share. In 1947 it was retired by exchange for $196.50 of 3% debentures for each share, and it sold as high as 186.
3. An elaborate statistical study carried on under the direction of the National Bureau of Economic Research indicates that such has actually been the case. Graham is referring to W. Braddock Hickman, *Corporate Bond Quality and Investor Experience* (Princeton University Press, 1958). Hickman's book later inspired Michael Milken of Drexel Burnham Lambert to offer massive high-yield financing to companies with less than sterling credit ratings, helping to ignite the leveraged-buyout and hostile takeover craze of the late 1980s.
4. A representative sample of 41 such issues taken from Standard & Poor's *Stock Guide* shows that five lost 90% or more of their high price, 30 lost more than half, and the entire group about two-thirds. The many not listed in the *Stock Guide* undoubtedly had a larger shrinkage on the whole.

Chapter 7. Portfolio Policy for the Enterprising Investor: The Positive Side

1. See, for example, Lucile Tomlinson, *Practical Formulas for Successful Investing;* and Sidney Cottle and W. T. Whitman, *Investment Timing: The Formula Approach,* both published in 1953.
2. A company with an ordinary record cannot, without confusing the term, be called a growth company or a "growth stock" merely because its proponent expects it to do better than the average in the future. It is just a "promising company." Graham is making a subtle but important point: If the definition of a growth stock is a company that will thrive in the future, then that's not a definition at all, but wishful thinking. It's like calling a sports team "the champions" before the season is over. This wishful thinking persists today; among mutual funds, "growth" portfolios describe their holdings as companies with "above-average growth

potential" or "favorable prospects for earnings growth." A better definition might be companies whose net earnings per share have increased by an annual average of at least 15% for at least five years running. (Meeting this definition in the past does not ensure that a company will meet it in the future.)

3. See Table 7-1.
4. Here are two age-old Wall Street proverbs that counsel such sales: "No tree grows to Heaven" and "A bull may make money, a bear may make money, but a hog never makes money."
5. Two studies are available. The first, made by H. G. Schneider, one of our students, covers the years 1917–1950 and was published in June 1951 in the *Journal of Finance.* The second was made by Drexel Firestone, members of the New York Stock Exchange, and covers the years 1933–1969. The data are given here by their kind permission.
6. See pp. 393–395, for three examples of special situations existing in 1971.

Chapter 8. The Investor and Market Fluctuations

1. Except, perhaps, in dollar-cost averaging plans begun at a reasonable price level.
2. But according to Robert M. Ross, authority on the Dow theory, the last two buy signals, shown in December 1966 and December 1970, were well below the preceding selling points.
3. The top three ratings for bonds and preferred stocks are Aaa, Aa, and A, used by Moody's, and AAA, AA, A by Standard & Poor's. There are others, going down to D.
4. This idea has already had some adoptions in Europe—e.g., by the state-owned Italian electric-energy concern on its "guaranteed floating rate loan notes," due 1980. In June 1971 it advertised in New York that the annual rate of interest paid thereon for the next six months would be 8⅛%.

   One such flexible arrangement was incorporated in The Toronto-Dominion Bank's "7%–8% debentures," due 1991, offered in June 1971. The bonds pay 7% to July 1976 and 8% thereafter, but the holder has the option to receive his principal in July 1976.

Chapter 9. Investing in Investment Funds

1. The sales charge is universally stated as a percentage of the selling price, which includes the charge, making it appear lower than if applied to net asset value. We consider this a sales gimmick unworthy of this respectable industry.
2. *The Money Managers,* by G. E. Kaplan and C. Welles, Random House, 1969.
3. See definition of "letter stock" on p. 579.
4. Title of a book first published in 1852. The volume described the "South Sea Bubble," the tulip mania, and other speculative binges of the past. It was reprinted by Bernard M. Baruch, perhaps the only continuously successful speculator of recent times, in 1932. *Comment:* That was locking the stable door after the horse was stolen. Charles Mackay's *Extraordinary Popular Delusions and the Madness of Crowds* (Metro Books, New York, 2002) was first published in 1841. Neither a light read nor always strictly accurate, it is an extensive look at how large numbers of people often believe very silly things–for instance, that iron can be transmuted into gold, that demons most often show up on Friday evenings, and that it is possible to get rich quick in the stock market. For a more factual account, consult Edward Chancellor's *Devil Take the Hindmost* (Farrar, Straus & Giroux, New York, 1999); for a lighter take, try Robert Menschel's *Markets, Mobs, and Mayhem: A Modern Look at the Madness of Crowds* (John Wiley & Sons, New York, 2002).

Chapter 10. The Investor and His Advisers

1. The examinations are given by the Institute of Chartered Financial Analysts, which is an arm of the Financial Analysts Federation. The latter now embraces constituent societies with over 50,000 members.
2. The NYSE had imposed some drastic rules of valuation (known as "haircuts") designed to minimize this danger, but apparently they did not help sufficiently.
3. New offerings may now be sold only by means of a prospectus prepared under the rules of the Securities and Exchange Commission. This document must disclose all the pertinent facts about the issue and issuer, and it is fully adequate to inform the *prudent investor* as to the exact nature of the security offered him. But the very copiousness

of the data required usually makes the prospectus of prohibitive length. It is generally agreed that only a small percentage of *individuals* buying new issues read the prospectus with thoroughness. Thus they are still acting mainly not on their own judgment but on that of the house selling them the security or on the recommendation of the individual salesman or account executive.

Chapter 11. Security Analysis for the Lay Investor: General Approach

1. Our textbook, *Security Analysis* by Benjamin Graham, David L. Dodd, Sidney Cottle, and Charles Tatham (McGraw-Hill, 4th ed., 1962), retains the title originally chosen in 1934, but it covers much of the scope of financial analysis.
2. With Charles McGolrick, Harper & Row, 1964, reissued by Harper-Business, 1998.
3. These figures are from Salomon Bros., a large New York bond house.
4. At least not by the great body of security analysts and investors. Exceptional analysts, who can tell in advance what companies are likely to deserve intensive study and have the facilities and capability to make it, may have continued success with this work. For details of such an approach see Philip Fisher, *Common Stocks and Uncommon Profits,* Harper & Row, 1960.
5. On p. 295 we set forth a formula relating multipliers to the rate of expected growth.
6. Part of the fireworks in the price of Chrysler was undoubtedly inspired by two two-for-one stock splits taking place in the single year 1963—an unprecedented phenomenon for a major company. In the early 1980s, under Lee Iacocca, Chrysler did a three-peat, coming back from the brink of bankruptcy to become one of the best-performing stocks in America. However, identifying managers who can lead great corporate comebacks is not as easy as it seems. When Al Dunlap took over Sunbeam Corp. in 1996 after restructuring Scott Paper Co. (and driving its stock price up 225% in 18 months), Wall Street hailed him as little short of the Second Coming. Dunlap turned out to be a sham who used improper accounting and false financial statements to mislead Sunbeam's investors–including the revered money managers Michael Price and Michael Steinhardt, who had hired him. For a keen dissection of Dunlap's career, see John A. Byrne, *Chainsaw* (HarperCollins, New York, 1999).

7. Note that we do not suggest that this formula gives the "true value" of a growth stock, but only that it approximates the results of the more elaborate calculations in vogue.

Chapter 12. Things to Consider About Per-Share Earnings

1. Our recommended method of dealing with the warrant dilution is discussed below. We prefer to consider the market value of the warrants as an addition to the current market price of the common stock as a whole.

Chapter 13. A Comparison of Four Listed Companies

1. In March 1972, Emery sold at 64 times its 1971 earnings!

Chapter 14. Stock Selection for the Defensive Investor

1. Because of numerous stock splits, etc., through the years, the actual average price of the DJIA list was about $53 per share in early 1972.
2. In 1960 only two of the 29 industrial companies failed to show current assets equal to twice current liabilities, and only two failed to have net current assets exceeding their debt. By December 1970 the number in each category had grown from two to twelve.
3. But note that their combined market action from December 1970 to early 1972 was poorer than that of the DJIA. This demonstrates once again that no system or formula will guarantee superior market results. Our requirements "guarantee" only that the portfolio-buyer is getting his money's worth.
4. As a consequence we must exclude the majority of gas pipeline stocks, since these enterprises are heavily bonded. The justification for this setup is the underlying structure of purchase contracts which "guarantee" bond payments; but the considerations here may be too complicated for the needs of a defensive investor.

Chapter 15. Stock Selection for the Enterprising Investor

1. *Mutual Funds and Other Institutional Investors: A New Perspective,* I. Friend, M. Blume, and J. Crockett, McGraw-Hill, 1970. We should add that the 1966–1970 results of many of the funds we studied were

somewhat better than those of the Standard & Poor's 500-stock composite and considerably better than those of the DJIA.

2. Personal note: Many years before the stock-market pyrotechnics in that particular company the author was its "financial vice-president" at the princely salary of $3,000 per annum. It was then really in the fireworks business. In early 1929, Graham became a financial vice president of Unexcelled Manufacturing Co., the nation's largest producer of fireworks. Unexcelled later became a diversified chemical company and no longer exists in independent form.
3. The *Guide* does not show multipliers above 99. Most such would be mathematical oddities, caused by earnings just above the zero point.

Chapter 16. Convertible Issues and Warrants

1. This point is well illustrated by an offering of two issues of Ford Motor Finance Co. made simultaneously in November 1971. One was a 20-year nonconvertible bond, yielding 7½%. The other was a 25-year bond, subordinated to the first in order of claim and yielding only 4½%; but it was made convertible into Ford Motor stock, against its then price of 68½. To obtain the conversion privilege the buyer gave up 40% of income and accepted a junior-creditor position.
2. Note that in late 1971 Studebaker-Worthington common sold as low as 38 while the $5 preferred sold at or about 77. The spread had thus grown from 2 to 20 points during the year, illustrating once more the desirability of such switches and also the tendency of the stock market to neglect arithmetic. (Incidentally the small premium of the preferred over the common in December 1970 had already been made up by its higher dividend.)

Chapter 17. Four Extremely Instructive Case Histories

1. See, for example, the article "Six Flags at Half Mast," by Dr. A. J. Briloff, in *Barron's,* January 11, 1971.

Chapter 18. A Comparison of Eight Pairs of Companies

1. The reader will recall from p. 434 above that AAA Enterprises tried to enter this business, but quickly failed. Here Graham is making a pro-