acknowledged possibility of a loss of principal in exchange for a mere 1 or 2% of additional yearly income. If you are willing to assume some risk you should be certain that you can realize a really substantial gain in principal value if things go well. Hence a second-grade 5.5 or 6% bond *selling at par* is almost always a bad purchase. The same issue at 70 might make more sense—and if you are patient you will probably be able to buy it at that level.

Second-grade bonds and preferred stocks possess two contradictory attributes which the intelligent investor must bear clearly in mind. Nearly all suffer severe sinking spells in bad markets. On the other hand, a large proportion recover their position when favorable conditions return, and these ultimately "work out all right." This is true even of (cumulative) preferred stocks that fail to pay dividends for many years. There were a number of such issues in the early 1940s, as a consequence of the long depression of the 1930s. During the postwar boom period of 1945–1947 many of these large accumulations were paid off either in cash or in new securities, and the principal was often discharged as well. As a result, large profits were made by people who, a few years previously, had bought these issues when they were friendless and sold at low prices.[2]

It may well be true that, in an overall accounting, the higher yields obtainable on second-grade senior issues will prove to have offset those principal losses that were irrecoverable. In other words, an investor who bought all such issues at their offering prices might conceivably fare as well, *in the long run*, as one who limited himself to first-quality securities; or even somewhat better.[3]

But for practical purposes the question is largely irrelevant. Regardless of the outcome, the buyer of second-grade issues at full prices will be worried and discommoded when their price declines precipitately. Furthermore, he cannot buy enough issues to assure an "average" result, nor is he in a position to set aside a portion of his larger income to offset or "amortize" those principal losses which prove to be permanent. Finally, it is mere common sense to abstain from buying securities at around 100 if long experience indicates that they can probably be bought at 70 or less in the next weak market.

Foreign Government Bonds

All investors with even small experience know that foreign bonds, as a whole, have had a bad investment history since 1914. This was inevitable in the light of two world wars and an intervening world depression of unexampled depth. Yet every few years market conditions are sufficiently favorable to permit the sale of some new foreign issues at a price of about par. This phenomenon tells us a good deal about the working of the average investor's mind—and not only in the field of bonds.

We have no *concrete reason* to be concerned about the future history of well-regarded foreign bonds such as those of Australia or Norway. But we do know that, if and when trouble should come, the owner of foreign obligations has no legal or other means of enforcing his claim. Those who bought Republic of Cuba 4½s as high as 117 in 1953 saw them default their interest and then sell as low as 20 cents on the dollar in 1963. The New York Stock Exchange bond list in that year also included Belgian Congo 5¼s at 36, Greek 7s at 30, and various issues of Poland as low as 7. How many readers have any idea of the repeated vicissitudes of the 8% bonds of Czechoslovakia, since they were first offered in this country in 1922 at 96½? They advanced to 112 in 1928, declined to 67¾ in 1932, recovered to 106 in 1936, collapsed to 6 in 1939, recovered (unbelievably) to 117 in 1946, fell promptly to 35 in 1948, and sold as low as 8 in 1970!

Years ago an argument of sorts was made for the purchase of foreign bonds here on the grounds that a rich creditor nation such as ours was under moral obligation to lend abroad. Time, which brings so many revenges, now finds us dealing with an intractable balance-of-payments problem of our own, part of which is ascribable to the large-scale purchase of foreign bonds by American investors seeking a small advantage in yield. For many years past we have questioned the inherent attractiveness of such investments from the standpoint of the buyer; perhaps we should add now that the latter would benefit both his country and himself if he declined these opportunities.

New Issues Generally

It might seem ill-advised to attempt any broad statements about new issues as a class, since they cover the widest possible range of quality and attractiveness. Certainly there will be exceptions to any suggested rule. Our one recommendation is that all investors should be *wary* of new issues—which means, simply, that these should be subjected to careful examination and unusually severe tests before they are purchased.

There are two reasons for this double caveat. The first is that new issues have special salesmanship behind them, which calls therefore for a special degree of sales resistance.* The second is that most new issues are sold under "favorable market conditions"—which means favorable for the seller and consequently less favorable for the buyer.†

The effect of these considerations becomes steadily more important as we go down the scale from the highest-quality bonds through second-grade senior issues to common-stock flotations at the bottom. A tremendous amount of financing, consisting of the repayment of existing bonds at call price and their replacement by new issues with lower coupons, was done in the past. Most of this was in the category of high-grade bonds and preferred stocks. The buyers were largely financial institutions, amply qualified to protect their interests. Hence these offerings were carefully priced to

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* New issues of common stock–initial public offerings or IPOs–normally are sold with an "underwriting discount" (a built-in commission) of 7%. By contrast, the buyer's commission on older shares of common stock typically ranges below 4%. Whenever Wall Street makes roughly twice as much for selling something new as it does for selling something old, the new will get the harder sell.

† Recently, finance professors Owen Lamont of the University of Chicago and Paul Schultz of the University of Notre Dame have shown that corporations choose to offer new shares to the public when the stock market is near a peak. For technical discussion of these issues, see Lamont's "Evaluating Value Weighting: Corporate Events and Market Timing" and Schultz's "Pseudo Market Timing and the Long-Run Performance of IPOs" at http://papers.ssrn.com.

meet the going rate for comparable issues, and high-powered salesmanship had little effect on the outcome. As interest rates fell lower and lower the buyers finally came to pay too high a price for these issues, and many of them later declined appreciably in the market. This is one aspect of the general tendency to sell new securities of all types when conditions are most favorable to the issuer; but in the case of first-quality issues the ill effects to the purchaser are likely to be unpleasant rather than serious.

The situation proves somewhat different when we study the lower-grade bonds and preferred stocks sold during the 1945–46 and 1960–61 periods. Here the effect of the selling effort is more apparent, because most of these issues were probably placed with individual and inexpert investors. It was characteristic of these offerings that they did not make an adequate showing when judged by the performance of the companies over a sufficient number of years. They did look safe enough, for the most part, if it could be assumed that the recent earnings would continue without a serious setback. The investment bankers who brought out these issues presumably accepted this assumption, and their salesmen had little difficulty in persuading themselves and their customers to a like effect. Nevertheless it was an unsound approach to investment, and one likely to prove costly.

Bull-market periods are usually characterized by the transformation of a large number of privately owned businesses into companies with quoted shares. This was the case in 1945–46 and again beginning in 1960. The process then reached extraordinary proportions until brought to a catastrophic close in May 1962. After the usual "swearing-off" period of several years the whole tragicomedy was repeated, step by step, in 1967–1969.*

* In the two years from June 1960, through May 1962, more than 850 companies sold their stock to the public for the first time—an average of more than one per day. In late 1967 the IPO market heated up again; in 1969 an astonishing 781 new stocks were born. That oversupply helped create the bear markets of 1969 and 1973–1974. In 1974 the IPO market was so dead that only nine new stocks were created all year; 1975 saw only 14 stocks born. That undersupply, in turn, helped feed the bull market of the 1980s, when roughly 4,000 new stocks flooded the market—helping to trigger the over-

New Common-Stock Offerings

The following paragraphs are reproduced unchanged from the 1959 edition, with comment added:

> Common-stock financing takes two different forms. In the case of companies already listed, additional shares are offered pro rata to the existing stockholders. The subscription price is set below the current market, and the "rights" to subscribe have an initial money value.* The sale of the new shares is almost always underwritten by one or more investment banking houses, but it is the general hope and expectation that all the new shares will be taken by the exercise of the subscription rights. Thus the sale of additional common stock of listed companies does not ordinarily call for active selling effort on the part of distributing firms.
>
> The second type is the placement with the public of common stock of what were formerly privately owned enterprises. Most of this stock is sold for the account of the controlling interests to enable them to cash in on a favorable market and to diversify their

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enthusiasm that led to the 1987 crash. Then the cycle swung the other way again as IPOs dried up in 1988–1990. That shortage contributed to the bull market of the 1990s—and, right on cue, Wall Street got back into the business of creating new stocks, cranking out nearly 5,000 IPOs. Then, after the bubble burst in 2000, only 88 IPOs were issued in 2001—the lowest annual total since 1979. In every case, the public has gotten burned on IPOs, has stayed away for at least two years, but has always returned for another scalding. For as long as stock markets have existed, investors have gone through this manic-depressive cycle. In America's first great IPO boom, back in 1825, a man was said to have been squeezed to death in the stampede of speculators trying to buy shares in the new Bank of Southwark; the wealthiest buyers hired thugs to punch their way to the front of the line. Sure enough, by 1829, stocks had lost roughly 25% of their value.

* Here Graham is describing rights offerings, in which investors who already own a stock are asked to pony up even more money to maintain the same proportional interest in the company. This form of financing, still widespread in Europe, has become rare in the United States, except among closed-end funds.

own finances. (When new money is raised for the business it comes often via the sale of preferred stock, as previously noted.) This activity follows a well-defined pattern, which by the nature of the security markets must bring many losses and disappointments to the public. The dangers arise both from the character of the businesses that are thus financed and from the market conditions that make the financing possible.

In the early part of the century a large proportion of our leading companies were introduced to public trading. As time went on, the number of enterprises of first rank that remained closely held steadily diminished; hence original common-stock flotations have tended to be concentrated more and more on relatively small concerns. By an unfortunate correlation, during the same period the stock-buying public has been developing an ingrained preference for the major companies and a similar prejudice against the minor ones. This prejudice, like many others, tends to become weaker as bull markets are built up; the large and quick profits shown by common stocks as a whole are sufficient to dull the public's critical faculty, just as they sharpen its acquisitive instinct. During these periods, also, quite a number of privately owned concerns can be found that are enjoying excellent results—although most of these would not present too impressive a record if the figures were carried back, say, ten years or more.

When these factors are put together the following consequences emerge: Somewhere in the middle of the bull market the first common-stock flotations make their appearance. These are priced not unattractively, and some large profits are made by the buyers of the early issues. As the market rise continues, this brand of financing grows more frequent; the quality of the companies becomes steadily poorer; the prices asked and obtained verge on the exorbitant. One fairly dependable sign of the approaching end of a bull swing is the fact that new common stocks of small and nondescript companies are offered at prices somewhat higher than the current level for many medium-sized companies with a long market history. (It should be added that very little of this common-stock financing is ordinarily done by banking houses of prime size and reputation.)*

* In Graham's day, the most prestigious investment banks generally steered clear of the IPO business, which was regarded as an undignified exploita-

> The heedlessness of the public and the willingness of selling organizations to sell whatever may be profitably sold can have only one result—price collapse. In many cases the new issues lose 75% and more of their offering price. The situation is worsened by the aforementioned fact that, at bottom, the public has a real aversion to the very kind of small issue that it bought so readily in its careless moments. Many of these issues fall, proportionately, as much below their true value as they formerly sold above it.
>
> An elementary requirement for the intelligent investor is an ability to resist the blandishments of salesmen offering new common-stock issues during bull markets. Even if one or two can be found that can pass severe tests of quality and value, it is probably bad policy to get mixed up in this sort of business. Of course the salesman will point to many such issues which have had good-sized market advances—including some that go up spectacularly the very day they are sold. But all this is part of the speculative atmosphere. It is easy money. For every dollar you make in this way you will be lucky if you end up by losing only two.
>
> Some of these issues may prove excellent buys—a few years later, when nobody wants them and they can be had at a small fraction of their true worth.

In the 1965 edition we continued our discussion of this subject as follows:

> While the broader aspects of the stock market's behavior since 1949 have not lent themselves well to analysis based on long experience, the development of new common-stock flotations proceeded exactly in accordance with ancient prescription. It is doubtful whether we ever before had so many new issues offered, of such low quality, and with such extreme price collapses, as we

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tion of naïve investors. By the peak of the IPO boom in late 1999 and early 2000, however, Wall Street's biggest investment banks had jumped in with both feet. Venerable firms cast off their traditional prudence and behaved like drunken mud wrestlers, scrambling to foist ludicrously overvalued stocks on a desperately eager public. Graham's description of how the IPO process works is a classic that should be required reading in investment-banking ethics classes, if there are any.

> experienced in 1960–1962.[4] The ability of the stock market as a whole to disengage itself rapidly from that disaster is indeed an extraordinary phenomenon, bringing back long-buried memories of the similar invulnerability it showed to the great Florida real-estate collapse in 1925.
>
> Must there be a return of the new-stock-offering madness before the present bull market can come to its definitive close? Who knows? But we do know that an intelligent investor will not forget what happened in 1962 and will let others make the next batch of quick profits in this area and experience the consequent harrowing losses.

We followed these paragraphs in the 1965 edition by citing "A Horrible Example," namely, the sale of stock of Aetna Maintenance Co. at $9 in November 1961. In typical fashion the shares promptly advanced to $15; the next year they fell to 2⅜, and in 1964 to ⅞. The later history of this company was on the extraordinary side, and illustrates some of the strange metamorphoses that have taken place in American business, great and small, in recent years. The curious reader will find the older and newer history of this enterprise in Appendix 5.

It is by no means difficult to provide even more harrowing examples taken from the more recent version of "the same old story," which covered the years 1967–1970. Nothing could be more pat to our purpose than the case of AAA Enterprises, which happens to be the first company then listed in Standard & Poor's *Stock Guide.* The shares were sold to the public at $14 in 1968, promptly advanced to 28, but in early 1971 were quoted at a dismal 25¢. (Even this price represented a gross overvaluation of the enterprise, since it had just entered the bankruptcy court in a hopeless condition.) There is so much to be learned, and such important warnings to be gleaned, from the story of this flotation that we have reserved it for detailed treatment below, in Chapter 17.

COMMENTARY ON CHAPTER 6

The punches you miss are the ones that wear you out.

—Boxing trainer Angelo Dundee

For the aggressive as well as the defensive investor, what you don't do is as important to your success as what you do. In this chapter, Graham lists his "don'ts" for aggressive investors. Here is a list for today.

JUNKYARD DOGS?

High-yield bonds—which Graham calls "second-grade" or "lower-grade" and today are called "junk bonds"—get a brisk thumbs-down from Graham. In his day, it was too costly and cumbersome for an individual investor to diversify away the risks of default.[1] (To learn how bad a default can be, and how carelessly even "sophisticated" professional bond investors can buy into one, see the sidebar on p. 146.) Today, however, more than 130 mutual funds specialize in junk bonds. These funds buy junk by the cartload; they hold dozens of different bonds. That mitigates Graham's complaints about the difficulty of diversifying. (However, his bias against high-yield preferred stock remains valid, since there remains no cheap and widely available way to spread their risks.)

Since 1978, an annual average of 4.4% of the junk-bond market has gone into default—but, even after those defaults, junk bonds have

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[1] In the early 1970s, when Graham wrote, there were fewer than a dozen junk-bond funds, nearly all of which charged sales commissions of up to 8.5%; some even made investors pay a fee for the privilege of reinvesting their monthly dividends back into the fund.

A WORLD OF HURT FOR WORLDCOM BONDS

Buying a bond only for its yield is like getting married only for the sex. If the thing that attracted you in the first place dries up, you'll find yourself asking, "What else is there?" When the answer is "Nothing," spouses and bondholders alike end up with broken hearts.

On May 9, 2001, WorldCom, Inc. sold the biggest offering of bonds in U.S. corporate history—$11.9 billion worth. Among the eager beavers attracted by the yields of up to 8.3% were the California Public Employees' Retirement System, one of the world's largest pension funds; Retirement Systems of Alabama, whose managers later explained that "the higher yields" were "very attractive to us at the time they were purchased"; and the Strong Corporate Bond Fund, whose comanager was so fond of WorldCom's fat yield that he boasted, "we're getting paid more than enough extra income for the risk."[1]

But even a 30-second glance at WorldCom's bond prospectus would have shown that these bonds had nothing to offer *but* their yield—and everything to lose. In two of the previous five years WorldCom's pretax income (the company's profits before it paid its dues to the IRS) fell short of covering its fixed charges (the costs of paying interest to its bondholders) by a stupendous $4.1 billion. WorldCom could cover those bond payments only by borrowing more money from banks. And now, with this mountainous new helping of bonds, WorldCom was fattening its interest costs by another $900 million per year![2] Like Mr. Creosote in *Monty Python's The Meaning of Life,* WorldCom was gorging itself to the bursting point.

No yield could ever be high enough to compensate an investor for risking that kind of explosion. The WorldCom bonds did produce fat yields of up to 8% for a few months. Then, as Graham would have predicted, the yield suddenly offered no shelter:

- WorldCom filed bankruptcy in July 2002.
- WorldCom admitted in August 2002 that it had overstated its earnings by more than $7 billion.[3]

- WorldCom's bonds defaulted when the company could no longer cover their interest charges; the bonds lost more than 80% of their original value.

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[1] See www.calpers.ca.gov/whatshap/hottopic/worldcom_faqs.htm and www.calpers.ca.gov/whatsnew/press/2002/0716a.htm; Retirement Systems of Alabama Quarterly Investment Report for May 31, 2001, at www.rsa.state.al.us/Investments/quarterly_report.htm; and John Bender, Strong Corporate Bond Fund comanager, quoted in www.businessweek.com/magazine/content/01_22/b3734118.htm.

[2] These numbers are all drawn from WorldCom's prospectus, or sales document, for the bond offering. Filed May 11, 2001, it can be viewed at www.sec.gov/edgar/searchedgar/companysearch.html (in "Company name" window, enter "WorldCom"). Even without today's 20/20 hindsight knowledge that WorldCom's earnings were fraudulently overstated, WorldCom's bond offering would have appalled Graham.

[3] For documentation on the collapse of WorldCom, see www.worldcom.com/infodesk.

still produced an annualized return of 10.5%, versus 8.6% for 10-year U.S. Treasury bonds.[2] Unfortunately, most junk-bond *funds* charge high fees and do a poor job of preserving the original principal amount of your investment. A junk fund could be appropriate if you are retired, are looking for extra monthly income to supplement your pension, and can tolerate temporary tumbles in value. If you work at a bank or other financial company, a sharp rise in interest rates could limit your raise or even threaten your job security—so a junk fund, which tends to outperform most other bond funds when interest rates rise, might make sense as a counterweight in your 401(k). A junk-bond fund, though, is only a minor option—not an obligation—for the intelligent investor.

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[2] Edward I. Altman and Gaurav Bana, "Defaults and Returns on High-Yield Bonds," research paper, Stern School of Business, New York University, 2002.

THE VODKA-AND-BURRITO PORTFOLIO

Graham considered foreign bonds no better a bet than junk bonds.[3] Today, however, one variety of foreign bond may have some appeal for investors who can withstand plenty of risk. Roughly a dozen mutual funds specialize in bonds issued in emerging-market nations (or what used to be called "Third World countries") like Brazil, Mexico, Nigeria, Russia, and Venezuela. No sane investor would put more than 10% of a total bond portfolio in spicy holdings like these. But emerging-markets bond funds seldom move in synch with the U.S. stock market, so they are one of the rare investments that are unlikely to drop merely because the Dow is down. That can give you a small corner of comfort in your portfolio just when you may need it most.[4]

DYING A TRADER'S DEATH

As we've already seen in Chapter 1, day trading—holding stocks for a few hours at a time—is one of the best weapons ever invented for committing financial suicide. Some of your trades might make money, most of your trades will lose money, but your broker will always make money.

And your own eagerness to buy or sell a stock can lower your return. Someone who is desperate to buy a stock can easily end up having to bid 10 cents higher than the most recent share price before any sellers will be willing to part with it. That extra cost, called "market impact," never shows up on your brokerage statement, but it's real. If you're overeager to buy 1,000 shares of a stock and you drive its price

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[3] Graham did not criticize foreign bonds lightly, since he spent several years early in his career acting as a New York–based bond agent for borrowers in Japan.

[4] Two low-cost, well-run emerging-markets bond funds are Fidelity New Markets Income Fund and T. Rowe Price Emerging Markets Bond Fund; for more information, see www.fidelity.com, www.troweprice.com, and www.morningstar.com. Do not buy any emerging-markets bond fund with annual operating expenses higher than 1.25%, and be forewarned that some of these funds charge short-term redemption fees to discourage investors from holding them for less than three months.

up by just five cents, you've just cost yourself an invisible but very real $50. On the flip side, when panicky investors are frantic to sell a stock and they dump it for less than the most recent price, market impact hits home again.

The costs of trading wear away your returns like so many swipes of sandpaper. Buying or selling a hot little stock can cost 2% to 4% (or 4% to 8% for a "round-trip" buy-and-sell transaction).[5] If you put $1,000 into a stock, your trading costs could eat up roughly $40 before you even get started. Sell the stock, and you could fork over another 4% in trading expenses.

Oh, yes—there's one other thing. When you trade instead of invest, you turn long-term gains (taxed at a maximum capital-gains rate of 20%) into ordinary income (taxed at a maximum rate of 38.6%).

Add it all up, and a stock trader needs to gain at least 10% *just to break even* on buying and selling a stock.[6] Anyone can do that once, by luck alone. To do it often enough to justify the obsessive attention it requires—plus the nightmarish stress it generates—is impossible.

Thousands of people have tried, and the evidence is clear: The more you trade, the less you keep.

Finance professors Brad Barber and Terrance Odean of the University of California examined the trading records of more than 66,000 customers of a major discount brokerage firm. From 1991 through 1996, these clients made more than 1.9 million trades. Before the costs of trading sandpapered away at their returns, the people in the study actually outperformed the market by an average of at least half a percentage point per year. But after trading costs, the most active of these traders—who shifted more than 20% of their stock holdings per

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[5] The definitive source on brokerage costs is the Plexus Group of Santa Monica, California, and its website, www.plexusgroup.com. Plexus argues persuasively that, just as most of the mass of an iceberg lies below the ocean surface, the bulk of brokerage costs are invisible—misleading investors into believing that their trading costs are insignificant if commission costs are low. The costs of trading NASDAQ stocks are considerably higher for individuals than the costs of trading NYSE-listed stocks (see p. 128, footnote 5).

[6] Real-world conditions are still more harsh, since we are ignoring state income taxes in this example.

month—went from beating the market to underperforming it by an abysmal 6.4 percentage points per year. The most patient investors, however—who traded a minuscule 0.2% of their total holdings in an average month—managed to outperform the market by a whisker, even after their trading costs. Instead of giving a huge hunk of their gains away to their brokers and the IRS, they got to keep almost everything.[7] For a look at these results, see Figure 6-1.

The lesson is clear: Don't just do something, stand there. It's time for everyone to acknowledge that the term "long-term investor" is redundant. A long-term investor is the only kind of investor there is. Someone who can't hold on to stocks for more than a few months at a time is doomed to end up not as a victor but as a victim.

THE EARLY BIRD GETS WORMED

Among the get-rich-quick toxins that poisoned the mind of the investing public in the 1990s, one of the most lethal was the idea that you can build wealth by buying IPOs. An IPO is an "initial public offering," or the first sale of a company's stock to the public. At first blush, investing in IPOs sounds like a great idea—after all, if you'd bought 100 shares of Microsoft when it went public on March 13, 1986, your $2,100 investment would have grown to $720,000 by early 2003.[8] And finance professors Jay Ritter and William Schwert have shown that if you had spread a total of only $1,000 across every IPO in January 1960, at its offering price, sold out at the end of that month, then invested anew in each successive month's crop of IPOs, your portfolio would have been worth more than $533 decillion by year-end 2001.

(On the printed page, that looks like this:
$533,000,000,000,000,000,000,000,000,000,000,000.)

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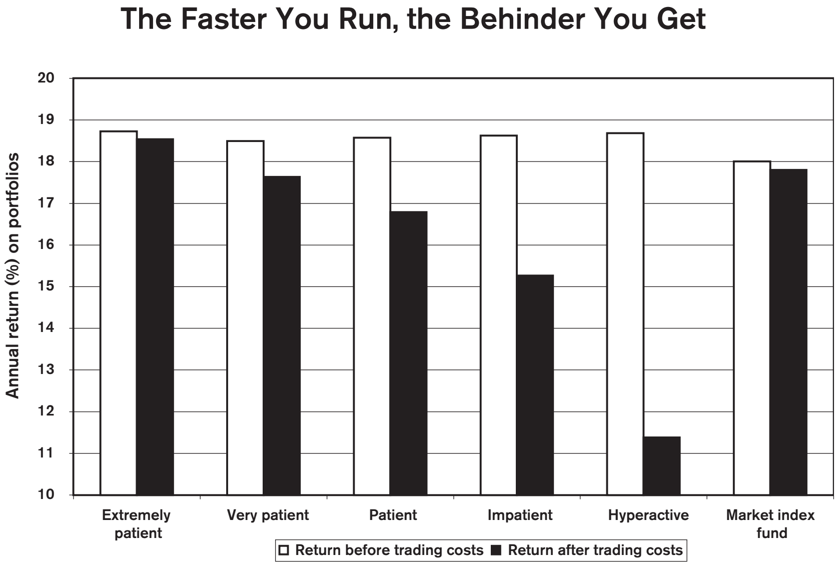
[7] Barber and Odean's findings are available at http://faculty.haas.berkeley.edu/odean/Current%20Research.htm and http://faculty.gsm.ucdavis.edu/~bmbarber/research/default.html. Numerous studies, incidentally, have found virtually identical results among professional money managers—so this is not a problem limited to "naïve" individuals.

[8] See www.microsoft.com/msft/stock.htm, "IPO investment results."

FIGURE 6-1



Researchers Brad Barber and Terrance Odean divided thousands of traders into five tiers based on how often they turned over their holdings. Those who traded the least (at the left) kept most of their gains. But the impatient and hyperactive traders made their brokers rich, not themselves. (The bars at the far right show a market index fund for comparison.)

Source: Profs. Brad Barber, University of California at Davis, and Terrance Odean, University of California at Berkeley

Unfortunately, for every IPO like Microsoft that turns out to be a big winner, there are thousands of losers. The psychologists Daniel Kahnerman and Amos Tversky have shown when humans estimate the likelihood or frequency of an event, we make that judgment based not on how often the event has actually occurred, but on how vivid the past examples are. We all want to buy "the next Microsoft"—precisely because we know we missed buying the first Microsoft. But we conveniently overlook the fact that most other IPOs were terrible investments. You could have earned that $533 decillion gain only if you never missed a single one of the IPO market's rare winners—a practical impossibility. Finally, most of the high returns on IPOs are captured by members of an exclusive private club—the big investment banks and fund houses that get shares at the initial (or "underwriting") price, before the stock begins public trading. The biggest "run-ups" often occur in stocks so small that even many big investors can't get any shares; there just aren't enough to go around.

If, like nearly every investor, you can get access to IPOs only *after* their shares have rocketed above the exclusive initial price, your results will be terrible. From 1980 through 2001, if you had bought the average IPO at its first public closing price and held on for three years, you would have underperformed the market by more than 23 percentage points annually.[9]

Perhaps no stock personifies the pipe dream of getting rich from IPOs better than VA Linux. "LNUX THE NEXT MSFT," exulted an early owner; "BUY NOW, AND RETIRE IN FIVE YEARS FROM NOW."[10] On December 9, 1999, the stock was placed at an initial public offering price of $30. But demand for the shares was so ferocious that when NASDAQ opened that morning, none of the initial owners of VA Linux would let go of any shares until the price hit $299. The stock peaked at $320 and closed at $239.25, a gain of 697.5% *in a single day.* But that gain was earned by only a handful of institutional traders; individual investors were almost entirely frozen out.

More important, buying IPOs is a bad idea because it flagrantly violates one of Graham's most fundamental rules: No matter how many other people want to buy a stock, you should buy only if the stock is a cheap way to own a desirable business. At the peak price on day one, investors were valuing VA Linux's shares at a total of $12.7 billion. What was the company's business worth? Less than five years old, VA Linux had sold a cumulative total of $44 million worth of its software and services—but had lost $25 million in the process. In its most recent fiscal quarter, VA Linux had generated $15 million in sales but

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[9] Jay R. Ritter and Ivo Welch, "A Review of IPO Activity, Pricing, and Allocations," *Journal of Finance,* August, 2002, p. 1797. Ritter's website, at http://bear.cba.ufl.edu/ritter/, and Welch's home page, at http://welch.som.yale.edu/, are gold mines of data for anyone interested in IPOs.

[10] Message no. 9, posted by "GoldFingers69," on the VA Linux (LNUX) message board at messages.yahoo.com, dated December 16, 1999. MSFT is the ticker symbol for Microsoft Corp.

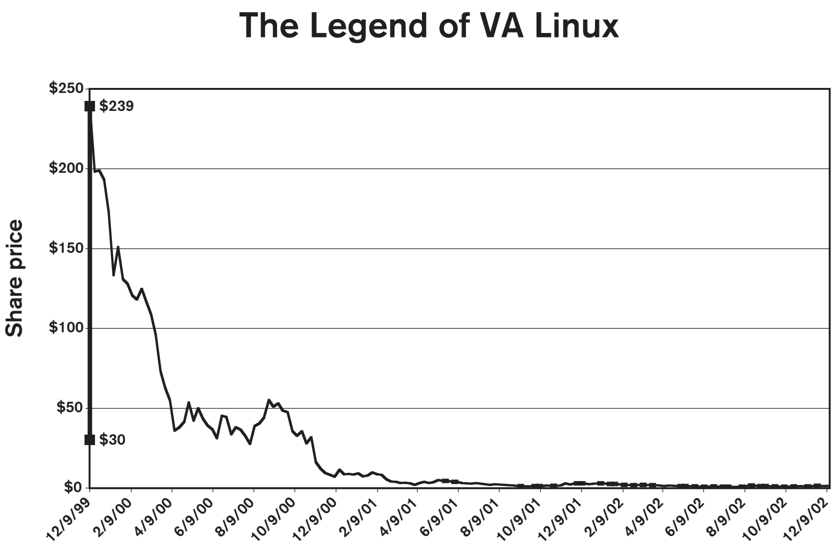
had lost $10 million on them. This business, then, was losing almost 70 cents on every dollar it took in. VA Linux's accumulated deficit (the amount by which its total expenses had exceeded its income) was $30 million.

If VA Linux were a private company owned by the guy who lives next door, and he leaned over the picket fence and asked you how much you would pay to take his struggling little business off his hands, would you answer, "Oh, $12.7 billion sounds about right to me"? Or would you, instead, smile politely, turn back to your barbecue grill, and wonder what on earth your neighbor had been smoking? Relying exclusively on our own judgment, none of us would be caught dead agreeing to pay nearly $13 billion for a money-loser that was already $30 million in the hole.

But when we're in public instead of in private, when valuation suddenly becomes a popularity contest, the price of a stock seems more important than the value of the business it represents. As long as someone else will pay even more than you did for a stock, why does it matter what the business is worth?

This chart shows why it matters.

FIGURE 6-2



Sources: VA Linux Systems Inc.; www.morningstar.com

After going up like a bottle rocket on that first day of trading, VA Linux came down like a buttered brick. By December 9, 2002, three years to the day after the stock was at $239.50, VA Linux closed at $1.19 per share.

Weighing the evidence objectively, the intelligent investor should conclude that IPO does not stand only for "initial public offering." More accurately, it is also shorthand for:

It's Probably Overpriced,
Imaginary Profits Only,
Insiders' Private Opportunity, or
Idiotic, Preposterous, and Outrageous.

CHAPTER 7

Portfolio Policy for the Enterprising Investor: The Positive Side

The enterprising investor, by definition, will devote a fair amount of his attention and efforts toward obtaining a better than run-of-the-mill investment result. In our discussion of general investment policy we have made some suggestions regarding *bond investments* that are addressed chiefly to the enterprising investor. He might be interested in special opportunities of the following kinds:

(1) Tax-free New Housing Authority bonds effectively guaranteed by the United States government.
(2) Taxable but high-yielding New Community bonds, also guaranteed by the United States government.
(3) Tax-free industrial bonds issued by municipalities, but serviced by lease payments made by strong corporations.

References have been made to these unusual types of bond issues in Chapter 4.*

At the other end of the spectrum there may be lower-quality bonds obtainable at such low prices as to constitute true bargain opportunities. But these would belong in the "special situation" area, where no true distinction exists between bonds and common stocks.†

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* As already noted (see p. 96, footnote †), the New Housing Authority and New Community bonds are no longer issued.

† Today these "lower-quality bonds" in the "special situation" area are known as distressed or defaulted bonds. When a company is in (or

Operations in Common Stocks

The activities specially characteristic of the enterprising investor in the common-stock field may be classified under four heads:

1. Buying in low markets and selling in high markets
2. Buying carefully chosen "growth stocks"
3. Buying bargain issues of various types
4. Buying into "special situations"

General Market Policy—Formula Timing

We reserve for the next chapter our discussion of the possibilities and limitations of a policy of entering the market when it is depressed and selling out in the advanced stages of a boom. For many years in the past this bright idea appeared both simple and feasible, at least from first inspection of a market chart covering its periodic fluctuations. We have already admitted ruefully that the market's action in the past 20 years has not lent itself to operations of this sort on any mathematical basis. The fluctuations that have taken place, while not inconsiderable in extent, would have required a special talent or "feel" for trading to take advantage of them. This is something quite different from the intelligence which we are assuming in our readers, and we must exclude operations based on such skill from our terms of reference.

The 50–50 plan, which we proposed to the defensive investor and described on p. 90, is about the best specific or automatic formula we can recommend to all investors under the conditions of 1972. But we have retained a broad leeway between the 25% mini-

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approaching) bankruptcy, its common stock becomes essentially worthless, since U.S. bankruptcy law entitles bondholders to a much stronger legal claim than shareholders. But if the company reorganizes successfully and comes out of bankruptcy, the bondholders often receive stock in the new firm, and the value of the bonds usually recovers once the company is able to pay interest again. Thus the bonds of a troubled company can perform almost as well as the common stock of a healthy company. In these special situations, as Graham puts it, "no true distinction exists between bonds and common stocks."

mum and the 75% maximum in common stocks, which we allow to those investors who have strong convictions about either the danger or the attractiveness of the general market level. Some 20 years ago it was possible to discuss in great detail a number of clear-cut formulas for varying the percentage held in common stocks, with confidence that these plans had practical utility.[1] The times seem to have passed such approaches by, and there would be little point in trying to determine new levels for buying and selling out of the market patterns since 1949. That is too short a period to furnish any reliable guide to the future.*

Growth-Stock Approach

Every investor would like to select the stocks of companies that will do better than the average over a period of years. A growth stock may be defined as one that has done this in the past and is expected to do so in the future.[2] Thus it seems only logical that the intelligent investor should concentrate upon the selection of growth stocks. Actually the matter is more complicated, as we shall try to show.

It is a mere statistical chore to identify companies that have "outperformed the averages" in the past. The investor can obtain a list of 50 or 100 such enterprises from his broker.† Why, then, should he not merely pick out the 15 or 20 most likely looking issues of this group and lo! he has a guaranteed-successful stock portfolio?

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* Note very carefully what Graham is saying here. Writing in 1972, he contends that the period since 1949—a stretch of more than 22 years—is too short a period from which to draw reliable conclusions! With his mastery of mathematics, Graham never forgets that objective conclusions require very long samples of large amounts of data. The charlatans who peddle "time-tested" stock-picking gimmicks almost always base their findings on smaller samples than Graham would ever accept. (Graham often used 50-year periods to analyze past data.)

† Today, the enterprising investor can assemble such a list over the Internet by visiting such websites as www.morningstar.com (try the Stock Quickrank tool), www.quicken.com/investments/stocks/search/full, and http://yahoo.marketguide.com.

There are two catches to this simple idea. The first is that common stocks with good records and apparently good prospects sell at correspondingly high prices. The investor may be right in his judgment of their prospects and still not fare particularly well, merely because he has paid in full (and perhaps overpaid) for the expected prosperity. The second is that his judgment as to the future may prove wrong. Unusually rapid growth cannot keep up forever; when a company has already registered a brilliant expansion, its very increase in size makes a repetition of its achievement more difficult. At some point the growth curve flattens out, and in many cases it turns downward.

It is obvious that if one confines himself to a few chosen instances, based on hindsight, he could demonstrate that fortunes can readily be either made or lost in the growth-stock field. How can one judge fairly of the overall results obtainable here? We think that reasonably sound conclusions can be drawn from a study of the results achieved by the investment funds specializing in the growth-stock approach. The authoritative manual entitled *Investment Companies,* published annually by Arthur Wiesenberger & Company, members of the New York Stock Exchange, computes the annual performance of some 120 such "growth funds" over a period of years. Of these, 45 have records covering ten years or more. The average overall gain for these companies—unweighted for size of fund—works out at 108% for the decade 1961–1970, compared with 105% for the S & P composite and 83% for the DJIA.[3] In the two years 1969 and 1970 the majority of the 126 "growth funds" did worse than either index. Similar results were found in our earlier studies. The implication here is that no outstanding rewards came from diversified investment in growth companies as compared with that in common stocks generally.*

* Over the 10 years ending December 31, 2002, funds investing in large growth companies—today's equivalent of what Graham calls "growth funds"—earned an annual average of 5.6%, underperforming the overall stock market by an average of 3.7 percentage points per year. However, "large value" funds investing in more reasonably priced big companies also underperformed the market over the same period (by a full percentage point per year). Is the problem merely that growth funds cannot reliably select

There is no reason at all for thinking that the average intelligent investor, even with much devoted effort, can derive better results over the years from the purchase of growth stocks than the investment companies specializing in this area. Surely these organizations have more brains and better research facilities at their disposal than you do. Consequently we should advise against the usual type of growth-stock commitment for the enterprising investor.* This is one in which the excellent prospects are fully recognized in the market and already reflected in a current price-earnings ratio of, say, higher than 20. (For the defensive investor we suggested an upper limit of purchase price at 25 times average earnings of the past seven years. The two criteria would be about equivalent in most cases.)†

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stocks that will outperform the market in the future? Or is it that the high costs of running the average fund (whether it buys growth or "value" companies) exceed any extra return the managers can earn with their stock picks? To update fund performance by type, see www.morningstar.com, "Category Returns." For an enlightening reminder of how perishable the performance of different investment styles can be, see www.callan.com/resource/periodic_table/pertable.pdf.

* Graham makes this point to remind you that an "enterprising" investor is not one who takes more risk than average or who buys "aggressive growth" stocks; an enterprising investor is simply one who is willing to put in extra time and effort in researching his or her portfolio.

† Notice that Graham insists on calculating the price/earnings ratio based on a multiyear average of past earnings. That way, you lower the odds that you will overestimate a company's value based on a temporarily high burst of profitability. Imagine that a company earned $3 per share over the past 12 months, but an average of only 50 cents per share over the previous six years. Which number—the sudden $3 or the steady 50 cents—is more likely to represent a sustainable trend? At 25 times the $3 it earned in the most recent year, the stock would be priced at $75. But at 25 times the average earnings of the past seven years ($6 in total earnings, divided by seven, equals 85.7 cents per share in average annual earnings), the stock would be priced at only $21.43. Which number you pick makes a big difference. Finally, it's worth noting that the prevailing method on Wall Street today—basing price/earnings ratios primarily on "next year's earnings"—would be

The striking thing about growth stocks as a class is their tendency toward wide swings in market price. This is true of the largest and longest-established companies—such as General Electric and International Business Machines—and even more so of newer and smaller successful companies. They illustrate our thesis that the main characteristic of the stock market since 1949 has been the injection of a highly speculative element into the shares of companies which have scored the most brilliant successes, and which themselves would be entitled to a high investment rating. (Their credit standing is of the best, and they pay the lowest interest rates on their borrowings.) The investment caliber of such a *company* may not change over a long span of years, but the risk characteristics of its *stock* will depend on what happens to it in the stock market. The more enthusiastic the public grows about it, and the faster its advance as compared with the actual growth in its earnings, the riskier a proposition it becomes.*

But is it not true, the reader may ask, that the really big fortunes from common stocks have been garnered by those who made a substantial commitment in the early years of a company in whose future they had great confidence, and who held their original shares unwaveringly while they increased 100-fold or more in value? The answer is "Yes." But the big fortunes from single-company investments are almost always realized by persons who

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anathema to Graham. How can you value a company based on earnings it hasn't even generated yet? That's like setting house prices based on a rumor that Cinderella will be building her new castle right around the corner.

* Recent examples hammer Graham's point home. On September 21, 2000, Intel Corp., the maker of computer chips, announced that it expected its revenues to grow by up to 5% in the next quarter. At first blush, that sounds great; most big companies would be delighted to increase their sales by 5% in just three months. But in response, Intel's stock dropped 22%, a one-day loss of nearly $91 billion in total value. Why? Wall Street's analysts had expected Intel's revenue to rise by up to 10%. Similarly, on February 21, 2001, EMC Corp., a data-storage firm, announced that it expected its revenues to grow by at least 25% in 2001—but that a new caution among customers "may lead to longer selling cycles." On that whiff of hesitation, EMC's shares lost 12.8% of their value in a single day.

TABLE 7-1 Average Results of "Growth Funds," 1961–1970[a]

	1 year 1970	*5 years* 1966–1970	*10 years* 1961–1970	*1970* Dividend Return
17 large growth funds	– 7.5%	+23.2%	+121.1%	2.3%
106 smaller growth funds—group A	–17.7	+20.3	+102.1	1.6
38 smaller growth funds—group B	– 4.7	+23.2	+106.7	1.4
15 funds with "growth" in their name	–14.2	+13.8	+ 97.4	1.7
Standard & Poor's composite	+ 3.5%	+16.1	+104.7	3.4
Dow Jones Industrial Average	+ 8.7	+ 2.9	+ 83.0	3.7

[a] These figures are supplied by Wiesenberger Financial Services.