than by individuals. The poorer-quality ones almost always fluctuate over a wide range, percentagewise, not too differently from common stocks. We can offer no other useful remark about them. Table 16-2 below, p. 406, gives some information on the price changes of lower-grade nonconvertible preferreds between December 1968 and December 1970. The average decline was 17%, against 11.3% for the S & P composite index of common stocks.

COMMENTARY ON CHAPTER 8

> The happiness of those who want to be popular depends on others; the happiness of those who seek pleasure fluctuates with moods outside their control; but the happiness of the wise grows out of their own free acts.
>
> —*Marcus Aurelius*

DR. JEKYLL AND MR. MARKET

Most of the time, the market is mostly accurate in pricing most stocks. Millions of buyers and sellers haggling over price do a remarkably good job of valuing companies—on average. But sometimes, the price is not right; occasionally, it is very wrong indeed. And at such times, you need to understand Graham's image of Mr. Market, probably the most brilliant metaphor ever created for explaining how stocks can become mispriced.[1] The manic-depressive Mr. Market does not always price stocks the way an appraiser or a private buyer would value a business. Instead, when stocks are going up, he happily pays more than their objective value; and, when they are going down, he is desperate to dump them for less than their true worth.

Is Mr. Market still around? Is he still bipolar? You bet he is.

On March 17, 2000, the stock of Inktomi Corp. hit a new high of $231.625. Since they first came on the market in June 1998, shares in the Internet-searching software company had gained roughly 1,900%. Just in the few weeks since December 1999, the stock had nearly tripled.

What was going on at Inktomi the business that could make Inktomi the stock so valuable? The answer seems obvious: phenomenally fast

---

[1] See Graham's text, pp. 204–205.

growth. In the three months ending in December 1999, Inktomi sold $36 million in products and services, more than it had in the entire year ending in December 1998. If Inktomi could sustain its growth rate of the previous 12 months for just five more years, its revenues would explode from $36 million a quarter to $5 billion a month. With such growth in sight, the faster the stock went up, the farther up it seemed certain to go.

But in his wild love affair with Inktomi's stock, Mr. Market was overlooking something about its business. The company was losing money–lots of it. It had lost $6 million in the most recent quarter, $24 million in the 12 months before that, and $24 million in the year before that. In its entire corporate lifetime, Inktomi had never made a dime in profits. Yet, on March 17, 2000, Mr. Market valued this tiny business at a total of $25 billion. (Yes, that's *billion,* with a *B.*)

And then Mr. Market went into a sudden, nightmarish depression. On September 30, 2002, just two and a half years after hitting $231.625 per share, Inktomi's stock closed at 25 cents–collapsing from a total market value of $25 billion to less than $40 million. Had Inktomi's business dried up? Not at all; over the previous 12 months, the company had generated $113 million in revenues. So what had changed? Only Mr. Market's mood: In early 2000, investors were so wild about the Internet that they priced Inktomi's shares at 250 times the company's revenues. Now, however, they would pay only 0.35 times its revenues. Mr. Market had morphed from Dr. Jekyll to Mr. Hyde and was ferociously trashing every stock that had made a fool out of him.

But Mr. Market was no more justified in his midnight rage than he had been in his manic euphoria. On December 23, 2002, Yahoo! Inc. announced that it would buy Inktomi for $1.65 per share. That was nearly seven times Inktomi's stock price on September 30. History will probably show that Yahoo! got a bargain. When Mr. Market makes stocks so cheap, it's no wonder that entire companies get bought right out from under him.[2]

---

[2] As Graham noted in a classic series of articles in 1932, the Great Depression caused the shares of dozens of companies to drop below the value of their cash and other liquid assets, making them "worth more dead than alive."

THINK FOR YOURSELF

Would you willingly allow a certifiable lunatic to come by at least five times a week to tell you that you should feel exactly the way he feels? Would you ever agree to be euphoric just because he is—or miserable just because he thinks you should be? Of course not. You'd insist on your right to take control of your own emotional life, based on your experiences and your beliefs. But, when it comes to their financial lives, millions of people let Mr. Market tell them how to feel and what to do—despite the obvious fact that, from time to time, he can get nuttier than a fruitcake.

In 1999, when Mr. Market was squealing with delight, American employees directed an average of 8.6% of their paychecks into their 401(k) retirement plans. By 2002, after Mr. Market had spent three years stuffing stocks into black garbage bags, the average contribution rate had dropped by nearly one-quarter, to just 7%.[3] The cheaper stocks got, the less eager people became to buy them—because they were imitating Mr. Market, instead of thinking for themselves.

The intelligent investor shouldn't ignore Mr. Market entirely. Instead, you should do business with him—but only to the extent that it serves your interests. Mr. Market's job is to provide you with prices; your job is to decide whether it is to your advantage to act on them. *You do not have to trade with him just because he constantly begs you to.*

By refusing to let Mr. Market be your master, you transform him into your servant. After all, even when he seems to be destroying values, he is creating them elsewhere. In 1999, the Wilshire 5000 index—the broadest measure of U.S. stock performance—gained 23.8%, powered by technology and telecommunications stocks. But 3,743 of the 7,234 stocks in the Wilshire index went down in value even as the average was rising. While those high-tech and telecom stocks were hotter than the hood of a race car on an August afternoon, thousands of "Old Economy" shares were frozen in the mud—getting cheaper and cheaper.

The stock of CMGI, an "incubator" or holding company for Internet

---

[3] News release, The Spectrem Group, "Plan Sponsors Are Losing the Battle to Prevent Declining Participation and Deferrals into Defined Contribution Plans," October 25, 2002.

FIGURE 8-1 From Stinkers to Stars

Company	Business	Total Return 1999	2000	2001	2002	Final value of $1,000 invested 1/1/1999
Angelica	industrial uniforms	–43.7	1.8	19.3	94.1	1,328
Ball Corp.	metal & plastic packaging	–12.7	19.2	55.3	46.0	2,359
Checkers Drive-In Restaurants	fast food	–45.5	63.9	66.2	2.1	1,517
Family Dollar Stores	discount retailer	–25.1	33.0	41.1	5.0	1,476
International Game Technology	gambling equipment	–16.3	136.1	42.3	11.2	3,127
J B Hunt Transportation	trucking	–39.1	21.9	38.0	26.3	1,294
Jos. A. Bank Clothiers	apparel	–62.5	50.0	57.1	201.6	2,665
Lockheed Martin	defense & aerospace	–46.9	58.0	39.0	24.7	1,453
Pier 1 Imports	home furnishings	–33.2	63.9	70.5	10.3	2,059
UST Inc.	snuff tobacco	–23.5	21.6	32.2	1.0	1,241
Wilshire Internet Index		139.1	–55.5	–46.2	–45.0	315
Wilshire 5000 index (total stock market)		23.8	–10.9	–11.0	–20.8	778

Sources: Aronson + Johnson + Ortiz, L.P.; www.wilshire.com start-up firms, went up an astonishing 939.9% in 1999. Meanwhile, Berkshire Hathaway—the holding company through which Graham's greatest disciple, Warren Buffett, owns such Old Economy stalwarts as Coca-Cola, Gillette, and the Washington Post Co.—dropped by 24.9%.[4]

But then, as it so often does, the market had a sudden mood swing. Figure 8-1 offers a sampling of how the stinkers of 1999 became the stars of 2000 through 2002.

As for those two holding companies, CMGI went on to lose 96% in 2000, another 70.9% in 2001, and still 39.8% more in 2002—a cumulative loss of 99.3%. Berkshire Hathaway went up 26.6% in 2000 and 6.5% in 2001, then had a slight 3.8% loss in 2002—a cumulative gain of 30%.

CAN YOU BEAT THE PROS AT THEIR OWN GAME?

One of Graham's most powerful insights is this: "The investor who permits himself to be stampeded or unduly worried by unjustified market declines in his holdings is perversely transforming his basic advantage into a basic disadvantage."

What does Graham mean by those words "basic advantage"? He means that the intelligent individual investor has the full freedom to choose whether or not to follow Mr. Market. You have the luxury of being able to think for yourself.[5]

---

[4] A few months later, on March 10, 2000—the very day that NASDAQ hit its all-time high—online trading pundit James J. Cramer wrote that he had "repeatedly" been tempted in recent days to sell Berkshire Hathaway short, a bet that Buffett's stock had farther to fall. With a vulgar thrust of his rhetorical pelvis, Cramer even declared that Berkshire's shares were "ripe for the banging." That same day, market strategist Ralph Acampora of Prudential Securities asked, "Norfolk Southern or Cisco Systems: Where do you want to be in the future?" Cisco, a key to tomorrow's Internet superhighway, seemed to have it all over Norfolk Southern, part of yesterday's railroad system. (Over the next year, Norfolk Southern gained 35%, while Cisco lost 70%.)

[5] When asked what keeps most individual investors from succeeding, Graham had a concise answer: "The primary cause of failure is that they pay too much attention to what the stock market is doing currently." See "Benjamin Graham: Thoughts on Security Analysis" [transcript of lecture at Northeast Missouri State University Business School, March, 1972], *Financial History* magazine, no. 42, March, 1991, p. 8.

The typical money manager, however, has no choice but to mimic Mr. Market's every move—buying high, selling low, marching almost mindlessly in his erratic footsteps. Here are some of the handicaps mutual-fund managers and other professional investors are saddled with:

- With billions of dollars under management, they must gravitate toward the biggest stocks—the only ones they can buy in the multimillion-dollar quantities they need to fill their portfolios. Thus many funds end up owning the same few overpriced giants.
- Investors tend to pour more money into funds as the market rises. The managers use that new cash to buy more of the stocks they already own, driving prices to even more dangerous heights.
- If fund investors ask for their money back when the market drops, the managers may need to sell stocks to cash them out. Just as the funds are forced to buy stocks at inflated prices in a rising market, they become forced sellers as stocks get cheap again.
- Many portfolio managers get bonuses for beating the market, so they obsessively measure their returns against benchmarks like the S & P 500 index. If a company gets added to an index, hundreds of funds compulsively buy it. (If they don't, and that stock then does well, the managers look foolish; on the other hand, if they buy it and it does poorly, no one will blame them.)
- Increasingly, fund managers are expected to specialize. Just as in medicine the general practitioner has given way to the pediatric allergist and the geriatric otolaryngologist, fund managers must buy only "small growth" stocks, or only "mid-sized value" stocks, or nothing but "large blend" stocks.[6] If a company gets too big, or too small, or too cheap, or an itty bit too expensive, the fund has to sell it—even if the manager loves the stock.

So there's no reason you can't do as well as the pros. What you cannot do (despite all the pundits who say you can) is to "beat the pros at their own game." *The pros can't even win their own game!* Why should you want to play it at all? If you follow their rules, you will lose—since you will end up as much a slave to Mr. Market as the professionals are.

---

[6] Never mind what these terms mean, or are supposed to mean. While in public these classifications are treated with the utmost respect, in private most people in the investment business regard them with the contempt normally reserved for jokes that aren't funny.

Instead, recognize that investing intelligently is about controlling the controllable. You can't control whether the stocks or funds you buy will outperform the market today, next week, this month, or this year; in the short run, your returns will always be hostage to Mr. Market and his whims. But you *can* control:

- **your brokerage costs,** by trading rarely, patiently, and cheaply
- **your ownership costs,** by refusing to buy mutual funds with excessive annual expenses
- **your expectations,** by using realism, not fantasy, to forecast your returns[7]
- **your risk,** by deciding how much of your total assets to put at hazard in the stock market, by diversifying, and by rebalancing
- **your tax bills,** by holding stocks for at least one year and, whenever possible, for at least five years, to lower your capital-gains liability
- and, most of all, **your own behavior.**

If you listen to financial TV, or read most market columnists, you'd think that investing is some kind of sport, or a war, or a struggle for survival in a hostile wilderness. *But investing isn't about beating others at their game. It's about controlling yourself at your own game.* The challenge for the intelligent investor is not to find the stocks that will go up the most and down the least, but rather to prevent yourself from being your own worst enemy—from buying high just because Mr. Market says "Buy!" and from selling low just because Mr. Market says "Sell!"

If you investment horizon is long—at least 25 or 30 years—there is only one sensible approach: Buy every month, automatically, and whenever else you can spare some money. The single best choice for this lifelong holding is a total stock-market index fund. Sell only when you need the cash (for a psychological boost, clip out and sign your "Investment Owner's Contract"—which you can find on p. 225).

To be an intelligent investor, you must also refuse to judge your financial success by how a bunch of total strangers are doing. You're not one penny poorer if someone in Dubuque or Dallas or Denver

---

[7] See the brilliant column by Walter Updegrave, "Keep It Real," *Money,* February, 2002, pp. 53–56.

beats the S & P 500 and you don't. No one's gravestone reads "HE BEAT THE MARKET."

I once interviewed a group of retirees in Boca Raton, one of Florida's wealthiest retirement communities. I asked these people—mostly in their seventies—if they had beaten the market over their investing lifetimes. Some said yes, some said no; most weren't sure. Then one man said, "Who cares? All I know is, my investments earned enough for me to end up in Boca."

Could there be a more perfect answer? After all, the whole point of investing is not to earn more money than average, but to earn enough money to meet your own needs. The best way to measure your investing success is not by whether you're beating the market but by whether you've put in place a financial plan and a behavioral discipline that are likely to get you where you want to go. In the end, what matters isn't crossing the finish line before anybody else but just making sure that you do cross it.[8]

YOUR MONEY AND YOUR BRAIN

Why, then, do investors find Mr. Market so seductive? It turns out that our brains are hardwired to get us into investing trouble; humans are pattern-seeking animals. Psychologists have shown that if you present people with a random sequence—and tell them that it's unpredictable—they will nevertheless insist on trying to guess what's coming next. Likewise, we "know" that the next roll of the dice will be a seven, that a baseball player is due for a base hit, that the next winning number in the Powerball lottery will definitely be 4-27-9-16-42-10—and that this hot little stock is the next Microsoft.

Groundbreaking new research in neuroscience shows that our brains are designed to perceive trends even where they might not exist. After an event occurs just two or three times in a row, regions of the human brain called the anterior cingulate and nucleus accumbens automatically anticipate that it will happen again. If it does repeat, a natural chemical called dopamine is released, flooding your brain with a soft euphoria. Thus, if a stock goes up a few times in a row, you reflexively expect it to keep going—and your brain chemistry changes

---

[8] See Jason Zweig, "Did You Beat the Market?" *Money,* January, 2000, pp. 55–58.

as the stock rises, giving you a "natural high." You effectively become addicted to your own predictions.

But when stocks drop, that financial loss fires up your amygdala—the part of the brain that processes fear and anxiety and generates the famous "fight or flight" response that is common to all cornered animals. Just as you can't keep your heart rate from rising if a fire alarm goes off, just as you can't avoid flinching if a rattlesnake slithers onto your hiking path, you can't help feeling fearful when stock prices are plunging.[9]

In fact, the brilliant psychologists Daniel Kahneman and Amos Tversky have shown that the pain of financial loss is more than twice as intense as the pleasure of an equivalent gain. Making $1,000 on a stock feels great—but a $1,000 loss wields an emotional wallop more than twice as powerful. Losing money is so painful that many people, terrified at the prospect of any further loss, sell out near the bottom or refuse to buy more.

That helps explain why we fixate on the raw magnitude of a market decline and forget to put the loss in proportion. So, if a TV reporter hollers, "The market is *plunging*—the Dow is down *100 points!*" most people instinctively shudder. But, at the Dow's recent level of 8,000, that's a drop of just 1.2%. Now think how ridiculous it would sound if, on a day when it's 81 degrees outside, the TV weatherman shrieked, "The temperature is *plunging*—it's dropped from *81 degrees* to *80 degrees!*" That, too, is a 1.2% drop. When you forget to view changing market prices in percentage terms, it's all too easy to panic over minor vibrations. (If you have decades of investing ahead of you, there's a better way to visualize the financial news broadcasts; see the sidebar on p. 222.)

In the late 1990s, many people came to feel that they were in the dark unless they checked the prices of their stocks several times a day. But, as Graham puts it, the typical investor "would be better off if his stocks had no market quotation at all, for he would then be spared the mental anguish caused him by *other persons'* mistakes of judg-

---

[9] The neuroscience of investing is explored in Jason Zweig, "Are You Wired for Wealth?" *Money,* October, 2002, pp. 74–83, also available at http://money.cnn.com/2002/09/25/pf/investing/agenda_brain _short/index.htm. See also Jason Zweig, "The Trouble with Humans," *Money,* November, 2000, pp. 67–70.

NEWS YOU COULD USE

Stocks are crashing, so you turn on the television to catch the latest market news. But instead of CNBC or CNN, imagine that you can tune in to the Benjamin Graham Financial Network. On BGFN, the audio doesn't capture that famous sour clang of the market's closing bell; the video doesn't home in on brokers scurrying across the floor of the stock exchange like angry rodents. Nor does BGFN run any footage of investors gasping on frozen sidewalks as red arrows whiz overhead on electronic stock tickers.

Instead, the image that fills your TV screen is the facade of the New York Stock Exchange, festooned with a huge banner reading: "SALE! 50% OFF!" As intro music, Bachman-Turner Overdrive can be heard blaring a few bars of their old barn-burner, "You Ain't Seen Nothin' Yet." Then the anchorman announces brightly, "Stocks became more attractive *yet again* today, as the Dow dropped *another* 2.5% on heavy volume—the *fourth day in a row* that stocks have gotten *cheaper.* Tech investors fared *even better,* as leading companies like Microsoft *lost nearly 5% on the day,* making them *even more affordable.* That comes on *top* of the *good* news of the past year, in which stocks have *already* lost *50%,* putting them at *bargain* levels not seen in *years.* And *some* prominent analysts are *optimistic* that prices may drop *still further* in the weeks and months to come."

The newscast cuts over to market strategist Ignatz Anderson of the Wall Street firm of Ketchum & Skinner, who says, "My forecast is for stocks to lose *another 15%* by June. I'm cautiously *optimistic* that if *everything goes well,* stocks could lose *25%,* maybe *more.*"

"Let's hope Ignatz Anderson is *right,*" the anchor says cheerily. "*Falling* stock prices would be *fabulous* news for *any* investor with a very long *horizon.* And now over to *Wally Wood* for our *exclusive* AccuWeather forecast."

ment." If, after checking the value of your stock portfolio at 1:24 P.M., you feel compelled to check it all over again at 1:37 P.M., ask yourself these questions:

- Did I call a real-estate agent to check the market price of my house at 1:24 P.M.? Did I call back at 1:37 P.M.?
- If I had, would the price have changed? If it did, would I have rushed to sell my house?
- By not checking, or even knowing, the market price of my house from minute to minute, do I prevent its value from rising over time?[10]

The only possible answer to these questions is *of course not!* And you should view your portfolio the same way. Over a 10- or 20- or 30-year investment horizon, Mr. Market's daily dipsy-doodles simply do not matter. In any case, for anyone who will be investing for years to come, falling stock prices are good news, not bad, since they enable you to buy more for less money. The longer and further stocks fall, and the more steadily you keep buying as they drop, the more money you will make in the end—*if* you remain steadfast until the end. Instead of fearing a bear market, you should embrace it. The intelligent investor should be perfectly comfortable owning a stock or mutual fund even if the stock market stopped supplying daily prices for the next 10 years.[11]

Paradoxically, "you will be much more in control," explains neuroscientist Antonio Damasio, "if you realize how much you are not in control." By acknowledging your biological tendency to buy high and sell low, you can admit the need to dollar-cost average, rebalance, and sign an investment contract. By putting much of your portfolio on permanent autopilot, you can fight the prediction addiction, focus on your long-term financial goals, and tune out Mr. Market's mood swings.

---

[10] It's also worth asking whether you could enjoy living in your house if its market price was reported to the last penny every day in the newspapers and on TV.

[11] In a series of remarkable experiments in the late 1980s, a psychologist at Columbia and Harvard, Paul Andreassen, showed that investors who received frequent news updates on their stocks earned half the returns of investors who got no news at all. See Jason Zweig, "Here's How to Use the News and Tune Out the Noise," *Money,* July, 1998, pp. 63–64.

WHEN MR. MARKET GIVES YOU LEMONS, MAKE LEMONADE

Although Graham teaches that you should buy when Mr. Market is yelling "sell," there's one exception the intelligent investor needs to understand. Selling into a bear market can make sense if it creates a tax windfall. The U.S. Internal Revenue Code allows you to use your realized losses (any declines in value that you lock in by selling your shares) to offset up to $3,000 in ordinary income.[12] Let's say you bought 200 shares of Coca-Cola stock in January 2000 for $60 a share—a total investment of $12,000. By year-end 2002, the stock was down to $44 a share, or $8,800 for your lot—a loss of $3,200.

You could have done what most people do—either whine about your loss, or sweep it under the rug and pretend it never happened. Or you could have taken control. Before 2002 ended, you could have sold all your Coke shares, locking in the $3,200 loss. Then, after waiting 31 days to comply with IRS rules, you would buy 200 shares of Coke all over again. The result: You would be able to reduce your taxable income by $3,000 in 2002, and you could use the remaining $200 loss to offset your income in 2003. And better yet, you would still own a company whose future you believe in—but now you would own it for almost one-third less than you paid the first time.[13]

With Uncle Sam subsidizing your losses, it can make sense to sell and lock in a loss. If Uncle Sam wants to make Mr. Market look logical by comparison, who are we to complain?

---

[12] Federal tax law is subject to constant change. The example of Coca-Cola stock given here is valid under the provisions of the U.S. tax code as it stood in early 2003.

[13] This example assumes that the investor had no realized capital gains in 2002 and did not reinvest any Coke dividends. Tax swaps are not to be undertaken lightly, since they can be mishandled easily. Before doing a tax swap, read IRS Publication 550 (www.irs.gov/pub/irspdf/p550.pdf). A good guide to managing your investment taxes is Robert N. Gordon with Jan M. Rosen, *Wall Street Secrets for Tax-Efficient Investing* (Bloomberg Press, Princeton, New Jersey, 2001). Finally, before you pull the trigger, consult a professional tax adviser.

INVESTMENT OWNER'S CONTRACT

I, ______________ ____________________, hereby state that I am an investor who is seeking to accumulate wealth for many years into the future.

I know that there will be many times when I will be tempted to invest in stocks or bonds because they have gone (or "are going") up in price, and other times when I will be tempted to sell my investments because they have gone (or "are going") down.

I hereby declare my refusal to let a herd of strangers make my financial decisions for me. I further make a solemn commitment never to invest because the stock market has gone up, and never to sell because it has gone down. Instead, I will invest $______.00 per month, every month, through an automatic investment plan or "dollar-cost averaging program," into the following mutual fund(s) or diversified portfolio(s):

___________________________________,

___________________________________,

___________________________________.

I will also invest additional amounts whenever I can afford to spare the cash (and can afford to lose it in the short run).

I hereby declare that I will hold each of these investments continually through at least the following date (which must be a minimum of 10 years after the date of this contact): __________________ _____, 20__. The only exceptions allowed under the terms of this contract are a sudden, pressing need for cash, like a health-care emergency or the loss of my job, or a planned expenditure like a housing down payment or a tuition bill.

I am, by signing below, stating my intention not only to abide by the terms of this contract, but to re-read this document whenever I am tempted to sell any of my investments.

This contract is valid only when signed by at least one witness, and must be kept in a safe place that is easily accessible for future reference.

Signed: Date:

______________ ____________________ ________________ ____, 20__

Witnesses:

______________ ____________________

______________ ____________________

CHAPTER 9

Investing in Investment Funds

One course open to the defensive investor is to put his money into investment-company shares. Those that are redeemable on demand by the holder, at net asset value, are commonly known as "mutual funds" (or "open-end funds"). Most of these are actively selling additional shares through a corps of salesmen. Those with nonredeemable shares are called "closed-end" companies or funds; the number of their shares remains relatively constant. All of the funds of any importance are registered with the Securities & Exchange Commission (SEC), and are subject to its regulations and controls.*

The industry is a very large one. At the end of 1970 there were 383 funds registered with the SEC, having assets totaling $54.6 billions. Of these 356 companies, with $50.6 billions, were mutual funds, and 27 companies with $4.0 billions, were closed-end.†

There are different ways of classifying the funds. One is by the broad division of their portfolio; they are "balanced funds" if they have a significant (generally about one-third) component of bonds, or "stock-funds" if their holdings are nearly all common stocks. (There are some other varieties here, such as "bond funds," "hedge

---

* It is a violation of Federal law for an open-end mutual fund, a closed-end fund, or an exchange-traded fund to sell shares to the public unless it has "registered" (or made mandatory financial filings) with the SEC.

† The fund industry has gone from "very large" to immense. At year-end 2002, there were 8,279 mutual funds holding $6.56 trillion; 514 closed-end funds with $149.6 billion in assets; and 116 exchange-trade funds or ETFs with $109.7 billion. These figures exclude such fund-like investments as variable annuities and unit investment trusts.

funds," "letter-stock funds," etc.)* Another is by their objectives, as their primary aim is for income, price stability, or capital appreciation ("growth"). Another distinction is by their method of sale. "Load funds" add a selling charge (generally about 9% of asset value on minimum purchases) to the value before charge.[1] Others, known as "no-load" funds, make no such charge; the managements are content with the usual investment-counsel fees for handling the capital. Since they cannot pay salesmen's commissions, the size of the no-load funds tends to be on the low side.† The buying and selling prices of the *closed-end* funds are not fixed by the companies, but fluctuate in the open market as does the ordinary corporate stock.

Most of the companies operate under special provisions of the income-tax law, designed to relieve the shareholders from double taxation on their earnings. In effect, the funds must pay out virtually all their ordinary income—i.e., dividends and interest received, less expenses. In addition they can pay out their realized long-term profits on sales of investments—in the form of "capital-gains dividends"—which are treated by the shareholder as if they were his own security profits. (There is another option here, which we omit to avoid clutter.)‡ Nearly all the funds have but one class

---

* Lists of the major types of mutual funds can be found at www.ici.org/pdf/g2understanding.pdf and http://news.morningstar.com/fundReturns/CategoryReturns.html. Letter-stock funds no longer exist, while hedge funds are generally banned by SEC rules from selling shares to any investor whose annual income is below $200,000 or whose net worth is below $1 million.

† Today, the maximum sales load on a stock fund tends to be around 5.75%. If you invest $10,000 in a fund with a flat 5.75% sales load, $575 will go to the person (and brokerage firm) that sold it to you, leaving you with an initial net investment of $9,425. The $575 sales charge is actually 6.1% of that amount, which is why Graham calls the standard way of calculating the charge a "sales gimmick." Since the 1980s, no-load funds have become popular, and they no longer tend to be smaller than load funds.

‡ Nearly every mutual fund today is taxed as a "regulated investment company," or RIC, which is exempt from corporate income tax so long as it pays out essentially all of its income to its shareholders. In the "option" that

of security outstanding. A new wrinkle, introduced in 1967, divides the capitalization into a preferred issue, which will receive all the ordinary income, and a capital issue, or common stock, which will receive all the profits on security sales. (These are called "dual-purpose funds.")*

Many of the companies that state their primary aim is for capital gains concentrate on the purchase of the so-called "growth stocks," and they often have the word "growth" in their name. Some specialize in a designated area such as chemicals, aviation, overseas investments; this is usually indicated in their titles.

The investor who wants to make an intelligent commitment in fund shares has thus a large and somewhat bewildering variety of choices before him—not too different from those offered in direct investment. In this chapter we shall deal with some major questions, viz:

1. Is there any way by which the investor can assure himself of better than average results by choosing the right funds? (Subquestion: What about the "performance funds"?)†

2. If not, how can he avoid choosing funds that will give him worse than average results?

3. Can he make intelligent choices between different types of funds—e.g., balanced versus all-stock, open-end versus closed-end, load versus no-load?

Graham omits "to avoid clutter," a fund can ask the SEC for special permission to distribute one of its holdings directly to the fund's shareholders—as his Graham-Newman Corp. did in 1948, parceling out shares in GEICO to Graham-Newman's own investors. This sort of distribution is extraordinarily rare.

* Dual-purpose funds, popular in the late 1980s, have essentially disappeared from the marketplace—a shame, since they offered investors a more flexible way to take advantage of the skills of great stock pickers like John Neff. Perhaps the recent bear market will lead to a renaissance of this attractive investment vehicle.

† "Performance funds" were all the rage in the late 1960s. They were equivalent to the aggressive growth funds of the late 1990s, and served their investors no better.

Investment-Fund Performance as a Whole

Before trying to answer these questions we should say something about the performance of the fund industry as a whole. Has it done a good job for its shareholders? In the most general way, how have fund investors fared as against those who made their investments directly? We are quite certain that the funds in the aggregate have served a useful purpose. They have promoted good habits of savings and investment; they have protected countless individuals against costly mistakes in the stock market; they have brought their participants income and profits commensurate with the overall returns from common stocks. On a comparative basis we would hazard the guess that the average individual who put his money exclusively in investment-fund shares in the past ten years has fared better than the average person who made his common-stock purchases directly.

The last point is probably true even though the actual performance of the funds seems to have been no better than that of common stocks as a whole, and even though the cost of investing in mutual funds may have been greater than that of direct purchases. The real choice of the average individual has not been between constructing and acquiring a well-balanced common-stock portfolio or doing the same thing, a bit more expensively, by buying into the funds. More likely his choice has been between succumbing to the wiles of the doorbell-ringing mutual-fund salesman on the one hand, as against succumbing to the even wilier and much more dangerous peddlers of second- and third-rate new offerings. We cannot help thinking, too, that the average individual who opens a brokerage account with the idea of making conservative common-stock investments is likely to find himself beset by untoward influences in the direction of speculation and speculative losses; these temptations should be much less for the mutual-fund buyer.

But how have the investment funds performed as against the general market? This is a somewhat controversial subject, but we shall try to deal with it in simple but adequate fashion. Table 9-1 gives some calculated results for 1961–1970 of our ten largest stock funds at the end of 1970, but choosing only the largest one from each management group. It summarizes the overall return of each of these funds for 1961–1965, 1966–1970, and for the single years

TABLE 9-1 Management Results of Ten Large Mutual Funds[a]

	(Indicated) 5 years, 1961–1965 (all +)	*5 years, 1966–1970*	*10 years, 1961–1970 (all +)*	*1969*	*1970*	*Net Assets, December 1970 (millions)*
Affiliated Fund	71%	+19.7%	105.3%	–14.3%	+2.2%	$1,600
Dreyfus	97	+18.7	135.4	–11.9	–6.4	2,232
Fidelity Fund	79	+31.8	137.1	–7.4	+2.2	819
Fundamental Inv.	79	+ 1.0	81.3	–12.7	–5.8	1,054
Invest. Co. of Am.	82	+37.9	152.2	–10.6	+2.3	1,168
Investors Stock Fund	54	+ 5.6	63.5	–80.0	–7.2	2,227
Mass. Inv. Trust	18	+16.2	44.2	– 4.0	+0.6	1,956
National Investors	61	+31.7	112.2	+ 4.0	–9.1	747
Putnam Growth	62	+22.3	104.0	–13.3	–3.8	684
United Accum.	74	– 2.0	72.7	–10.3	–2.9	1,141
Average	72	18.3	105.8	– 8.9	–2.2	$13,628 (total)
Standard & Poor's composite index	77	+16.1	104.7	– 8.3	+3.5	
DJIA	78	+ 2.9	83.0	–11.6	+8.7	

[a] These are the stock funds with the largest net assets at the end of 1970, but using only one fund from each management group. Data supplied by Wiesenberger Financial Services.

1969 and 1970. We also give average results based on the sum of one share of each of the ten funds. These companies had combined assets of over $15 billion at the end of 1969, or about one-third of all the common-stock funds. Thus they should be fairly representative of the industry as a whole. (In theory, there should be a bias in this list on the side of better than industry performance, since these better companies should have been entitled to more rapid expansion than the others; but this may not be the case in practice.)

Some interesting facts can be gathered from this table. First, we find that the overall results of these ten funds for 1961–1970 were not appreciably different from those of the Standard & Poor's 500-stock composite average (or the S & P 425-industrial stock average). But they were definitely better than those of the DJIA. (This raises the intriguing question as to why the 30 giants in the DJIA did worse than the much more numerous and apparently rather miscellaneous list used by Standard & Poor's.)* A second point is that the funds' aggregate performance as against the S & P index has improved somewhat in the last five years, compared with the preceding five. The funds' gain ran a little lower than S & P's in 1961–1965 and a little higher than S & P's in 1966–1970. The third point is that a wide difference exists between the results of the individual funds.

We do not think the mutual-fund industry can be criticized for doing no better than the market as a whole. Their managers and their professional competitors administer so large a portion of all marketable common stocks that what happens to the market as a whole must necessarily happen (approximately) to the sum of their funds. (Note that the trust assets of insured commercial banks included $181 billion of common stocks at the end of 1969; if we add to this the common stocks in accounts handled by investment advisers, plus the $56 billion of mutual and similar funds, we must conclude that the combined decisions of these professionals pretty well determine the movements of the stock averages, and that the

* For periods as long as 10 years, the returns of the Dow and the S & P 500 can diverge by fairly wide margins. Over the course of the typical investing lifetime, however—say 25 to 50 years—their returns have tended to converge quite closely.

movement of the stock averages pretty well determines the funds' aggregate results.)

Are there better than average funds and can the investor select these so as to obtain superior results for himself? Obviously all investors could not do this, since in that case we would soon be back where we started, with no one doing better than anyone else. Let us consider the question first in a simplified fashion. Why shouldn't the investor find out what fund has made the best showing of the lot over a period of sufficient years in the past, assume from this that its management is the most capable and will therefore do better than average in the future, and put his money in that fund? This idea appears the more practicable because, in the case of the mutual funds, he could obtain this "most capable management" without paying any special premium for it as against the other funds. (By contrast, among noninvestment corporations the best-managed companies sell at correspondingly high prices in relation to their current earnings and assets.)

The evidence on this point has been conflicting over the years. But our Table 9-1 covering the ten largest funds indicates that the results shown by the top five performers of 1961–1965 carried over *on the whole* through 1966–1970, even though two of this set did not do as well as two of the other five. Our studies indicate that the investor in mutual-fund shares may properly consider comparative performance over a period of years in the past, say at least five, *provided* the data do not represent a large net upward movement of the market as a whole. In the latter case spectacularly favorable results may be achieved in unorthodox ways—as will be demonstrated in our following section on "performance" funds. Such results in themselves may indicate only that the fund managers are taking undue speculative risks, and getting away with same *for the time being.*

"Performance" Funds

One of the new phenomena of recent years was the appearance of the cult of "performance" in the management of investment funds (and even of many trust funds). We must start this section with the important disclaimer that it does not apply to the large majority of well-established funds, but only to a relatively small section of the industry which has attracted a disproportionate amount of attention. The story is simple enough. Some of those in charge set out to get much better than average (or DJIA) results. They succeeded in doing this for a while, garnering considerable publicity and additional funds to manage. The aim was legitimate enough; unfortunately, it appears that, in the context of investing really sizable funds, the aim cannot be accomplished without incurring sizable risks. And in a comparatively short time the risks came home to roost.

Several of the circumstances surrounding the "performance" phenomenon caused ominous headshaking by those of us whose experience went far back—even to the 1920s—and whose views, for that very reason, were considered old-fashioned and irrelevant to this (second) "New Era." In the first place, and on this very point, nearly all these brilliant performers were young men—in their thirties and forties—whose direct financial experience was limited to the all but continuous bull market of 1948–1968. Secondly, they often acted as if the definition of a "sound investment" was a stock that was likely to have a good rise in the market in the next few months. This led to large commitments in newer ventures at prices completely disproportionate to their assets or recorded earnings. They could be "justified" only by a combination of naïve hope in the future accomplishments of these enterprises with an apparent shrewdness in exploiting the speculative enthusiasms of the uninformed and greedy public.

This section will not mention people's names. But we have every reason to give concrete examples of companies. The "performance fund" most in the public's eye was undoubtedly Manhattan Fund, Inc., organized at the end of 1965. Its first offering was of 27 million shares at $9.25 to $10 per share. The company started out with $247 million of capital. Its emphasis was, of course, on capital gains. Most of its funds were invested in issues selling at high multipliers of current earnings, paying no dividends (or very small ones), with a large speculative following and spectacular price movements. The fund showed an overall gain of 38.6% in 1967, against 11% for the S & P composite index. But thereafter its performance left much to be desired, as is shown in Table 9-2.

TABLE 9-2 A Performance-Fund Portfolio and Performance
(Larger Holdings of Manhattan Fund, December 31, 1969)

Shares Held (thousands)	*Issue*	*Price*	*Earned 1969*	*Dividend 1969*	*Market Value (millions)*
60	Teleprompter	99	$ .99	none	$ 6.0
190	Deltona	60½	2.32	none	11.5
280	Fedders	34	1.28	$ .35	9.5
105	Horizon Corp.	53½	2.68	none	5.6
150	Rouse Co.	34	.07	none	5.1
130	Mattel Inc.	64¼	1.11	.20	8.4
120	Polaroid	125	1.90	.32	15.0
244[a]	Nat'l Student Mkt'g	28½	.32	none	6.1
56	Telex Corp.	90½	.68	none	5.0
100	Bausch & Lomb	77¾	1.92	.80	7.8
190	Four Seasons Nursing	66	.80	none	12.3[b]
20	Int. Bus. Machines	365	8.21	3.60	7.3
41.5	Nat'l Cash Register	160	1.95	1.20	6.7
100	Saxon Ind.	109	3.81	none	10.9
105	Career Academy	50	.43	none	5.3
285	King Resources	28	.69	none	8.1
					$130.6
			Other common stocks		93.8
			Other holdings		19.6
			Total investments[c]		$244.0

[a] After 2-for-1 split.

[b] Also $1.1 million of affiliated stocks.

[c] Excluding cash equivalents.

Annual Performance Compared with S & P Composite Index

	1966	*1967*	*1968*	*1969*	*1970*	*1971*
Manhattan Fund	– 6 %	+38.6%	– 7.3%	–13.3%	–36.9%	+ 9.6%
S & P Composite	–10.1%	+23.0%	+10.4%	– 8.3%	+ 3.5%	+13.5%

The portfolio of Manhattan Fund at the end of 1969 was unorthodox to say the least. It is an extraordinary fact that two of its largest investments were in companies that filed for bankruptcy within six months thereafter, and a third faced creditors' actions in 1971. It is another extraordinary fact that shares of at least one of these doomed companies were bought not only by investment funds but by university endowment funds, the trust departments of large banking institutions, and the like.* A third extraordinary fact was that the founder-manager of Manhattan Fund sold his stock in a separately organized management company to another large concern for over $20 million in its stock; at that time the management company sold had less than $1 million in assets. This is undoubtedly one of the greatest disparities of all times between the results for the "manager" and the "managees."

A book published at the end of 1969[2] provided profiles of nineteen men "who are tops at the demanding game of managing billions of dollars of other people's money." The summary told us further that "they are young . . . some earn more than a million dollars a year . . . they are a new financial breed . . . they all have a total fascination with the market . . . and a spectacular knack for coming up with winners." A fairly good idea of the accomplishments of this top group can be obtained by examining the published results of the funds they manage. Such results are available for funds directed by twelve of the nineteen persons described in *The Money Managers.* Typically enough, they showed up well in 1966, and brilliantly in 1967. In 1968 their performance was still good in the aggregate, but mixed as to individual funds. In 1969 they all showed losses, with only one managing to do a bit better than the S & P composite index. In 1970 their comparative performance was even worse than in 1969.

---

* One of the "doomed companies" Graham refers to was National Student Marketing Corp., a con game masquerading as a stock, whose saga was told brilliantly in Andrew Tobias's *The Funny Money Game* (Playboy Press, New York, 1971). Among the supposedly sophisticated investors who were snookered by NSM's charismatic founder, Cort Randell, were the endowment funds of Cornell and Harvard and the trust departments at such prestigious banks as Morgan Guaranty and Bankers Trust.

We have presented this picture in order to point a moral, which perhaps can best be expressed by the old French proverb: *Plus ça change, plus c'est la même chose.* Bright, energetic people—usually quite young—have promised to perform miracles with "other people's money" since time immemorial. They have usually been able to do it for a while—or at least to appear to have done it—and they have inevitably brought losses to their public in the end.* About a half century ago the "miracles" were often accompanied by flagrant manipulation, misleading corporate reporting, outrageous capitalization structures, and other semifraudulent financial practices. All this brought on an elaborate system of financial controls by the SEC, as well as a cautious attitude toward common stocks on the part of the general public. The operations of the new "money managers" in 1965–1969 came a little more than one full generation after the shenanigans of 1926–1929.† The specific malpractices banned after the 1929 crash were no longer resorted to—they involved the risk of jail sentences. But in many corners of Wall Street they were replaced by newer gadgets and gimmicks that produced very similar results in the end. Outright manipulation of prices disappeared, but there were many other methods of drawing the gullible public's attention to the profit possibilities in "hot" issues. Blocks of "letter stock"[3] could be bought well below the quoted market price, subject to undisclosed restrictions on their sale; they could immediately be carried in the reports at their full market value, showing a lovely and illusory profit. And so on. It is

---

* As only the latest proof that "the more things change, the more they stay the same," consider that Ryan Jacob, a 29-year-old boy wonder, launched the Jacob Internet Fund at year-end 1999, after producing a 216% return at his previous dot-com fund. Investors poured nearly $300 million into Jacob's fund in the first few weeks of 2000. It then proceeded to lose 79.1% in 2000, 56.4% in 2001, and 13% in 2002–a cumulative collapse of 92%. That loss may have made Mr. Jacob's investors even older and wiser than it made him.

† Intriguingly, the disastrous boom and bust of 1999–2002 also came roughly 35 years after the previous cycle of insanity. Perhaps it takes about 35 years for the investors who remember the last "New Economy" craze to become less influential than those who do not. If this intuition is correct, the intelligent investor should be particularly vigilant around the year 2030.