chapter 1

investment versus speculation results to

be expected by the intelligent investor

this chapter will outline the viewpoints that will be set forth in

the remainder of the book in particular we wish to develop at the

outset our concept of appropriate portfolio policy for the individual

nonprofessional investor

investment versus speculation

what do we mean by investor throughout this book the

term will be used in contradistinction to speculator as far back

as 1934 in our textbook security analysis 1 we attempted a precise

formulation of the difference between the two as follows an

investment operation is one which upon thorough analysis promises

safety of principal and an adequate return operations not

meeting these requirements are speculative

while we have clung tenaciously to this definition over the

ensuing 38 years it is worthwhile noting the radical changes that

have occurred in the use of the term investor during this period

after the great market decline of 19291932 all common stocks

were widely regarded as speculative by nature a leading authority

stated flatly that only bonds could be bought for investment2

thus we had then to defend our definition against the charge that

it gave too wide scope to the concept of investment

now our concern is of the opposite sort we must prevent our

readers from accepting the common jargon which applies the term

investor to anybody and everybody in the stock market in our

last edition we cited the following headline of a frontpage article

of our leading financial journal in june 1962

small investors bearish they are selling oddlots short

in october 1970 the same journal had an editorial critical of what it

called reckless investors who this time were rushing in on the

buying side

these quotations well illustrate the confusion that has been

dominant for many years in the use of the words investment and

speculation think of our suggested definition of investment given

above and compare it with the sale of a few shares of stock by an

inexperienced member of the public who does not even own what

he is selling and has some largely emotional conviction that he

will be able to buy them back at a much lower price it is not irrelevant

to point out that when the 1962 article appeared the market

had already experienced a decline of major size and was now getting

ready for an even greater upswing it was about as poor a time

as possible for selling short in a more general sense the laterused

phrase reckless investors could be regarded as a laughable contradiction

in termssomething like spendthrift miserswere

this misuse of language not so mischievous

the newspaper employed the word investor in these

instances because in the easy language of wall street everyone

who buys or sells a security has become an investor regardless of

what he buys or for what purpose or at what price or whether for

cash or on margin compare this with the attitude of the public

toward common stocks in 1948 when over 90 of those queried

expressed themselves as opposed to the purchase of common

stocks3 about half gave as their reason not safe a gamble and

about half the reason not familiar with it is indeed ironical

though not surprising that commonstock purchases of all kinds

were quite generally regarded as highly speculative or risky at a

time when they were selling on a most attractive basis and due

soon to begin their greatest advance in history conversely the very

fact they had advanced to what were undoubtedly dangerous levels

as judged by past experience later transformed them into investments

and the entire stockbuying public into investors

the distinction between investment and speculation in common

stocks has always been a useful one and its disappearance is a

cause for concern we have often said that wall street as an institution

would be well advised to reinstate this distinction and to

emphasize it in all its dealings with the public otherwise the stock

exchanges may some day be blamed for heavy speculative losses

which those who suffered them had not been properly warned

against ironically once more much of the recent financial embarrassment

of some stockexchange firms seems to have come from

the inclusion of speculative common stocks in their own capital

funds we trust that the reader of this book will gain a reasonably

clear idea of the risks that are inherent in commonstock commitments

risks which are inseparable from the opportunities of

profit that they offer and both of which must be allowed for in the

investors calculations

what we have just said indicates that there may no longer be

such a thing as a simonpure investment policy comprising representative

common stocksin the sense that one can always wait to

buy them at a price that involves no risk of a market or quotational

loss large enough to be disquieting in most periods the

investor must recognize the existence of a speculative factor in his

commonstock holdings it is his task to keep this component

within minor limits and to be prepared financially and psychologically

for adverse results that may be of short or long duration

two paragraphs should be added about stock speculation per

se as distinguished from the speculative component now inherent

in most representative common stocks outright speculation is

neither illegal immoral nor for most people fattening to the

pocketbook more than that some speculation is necessary and

unavoidable for in many commonstock situations there are substantial

possibilities of both profit and loss and the risks therein

must be assumed by someone there is intelligent speculation as

there is intelligent investing but there are many ways in which

speculation may be unintelligent of these the foremost are 1

speculating when you think you are investing 2 speculating seriously

instead of as a pastime when you lack proper knowledge

and skill for it and 3 risking more money in speculation than you

can afford to lose

in our conservative view every nonprofessional who operates

on margin+ should recognize that he is ipso facto speculating and it

is his brokers duty so to advise him and everyone who buys a

socalled hot commonstock issue or makes a purchase in any

way similar thereto is either speculating or gambling speculation

is always fascinating and it can be a lot of fun while you are ahead

of the game if you want to try your luck at it put aside a portion

the smaller the betterof your capital in a separate fund for this

purpose never add more money to this account just because the

market has gone up and profits are rolling in thats the time to

think of taking money out of your speculative fund never mingle

your speculative and investment operations in the same account

nor in any part of your thinking

results to be expected by the defensive investor

we have already defined the defensive investor as one interested

chiefly in safety plus freedom from bother in general what

course should he follow and what return can he expect under

average normal conditionsif such conditions really exist to

answer these questions we shall consider first what we wrote on

the subject seven years ago next what significant changes have

occurred since then in the underlying factors governing the

investors expectable return and finally what he should do and

what he should expect under presentday early 1972 conditions

1 what we said six years ago

we recommended that the investor divide his holdings between

highgrade bonds and leading common stocks that the proportion

held in bonds be never less than 25 or more than 75 with the

converse being necessarily true for the commonstock component

that his simplest choice would be to maintain a 5050 proportion

between the two with adjustments to restore the equality when

market developments had disturbed it by as much as say 5 as

an alternative policy he might choose to reduce his commonstock

component to 25 if he felt the market was dangerously high

and conversely to advance it toward the maximum of 75 if he

felt that a decline in stock prices was making them increasingly

attractive

in 1965 the investor could obtain about 412 on highgrade taxable

bonds and 314 on good taxfree bonds the dividend return

on leading common stocks with the djia at 892 was only about

32 this fact and others suggested caution we implied that at

normal levels of the market the investor should be able to obtain

an initial dividend return of between 312 and 412 on his stock

purchases to which should be added a steady increase in underlying

value and in the normal market price of a representative

stock list of about the same amount giving a return from dividends

and appreciation combined of about 712 per year the half

and half division between bonds and stocks would yield about 6

before income tax we added that the stock component should

carry a fair degree of protection against a loss of purchasing power

caused by largescale inflation

it should be pointed out that the above arithmetic indicated

expectation of a much lower rate of advance in the stock market

than had been realized between 1949 and 1964 that rate had averaged

a good deal better than 10 for listed stocks as a whole and it

was quite generally regarded as a sort of guarantee that similarly

satisfactory results could be counted on in the future few people

were willing to consider seriously the possibility that the high rate

of advance in the past means that stock prices are now too high

and hence that the wonderful results since 1949 would imply not

very good but bad results for the future4

2 what has happened since 1964

the major change since 1964 has been the rise in interest rates on

firstgrade bonds to record high levels although there has since

been a considerable recovery from the lowest prices of 1970 the

obtainable return on good corporate issues is now about 712 and

even more against 412 in 1964 in the meantime the dividend

return on djiatype stocks had a fair advance also during the market

decline of 196970 but as we write with the dow at 900 it is

less than 35 against 32 at the end of 1964 the change in going

interest rates produced a maximum decline of about 38 in the

market price of mediumterm say 20year bonds during this

period

there is a paradoxical aspect to these developments in 1964 we

discussed at length the possibility that the price of stocks might be

too high and subject ultimately to a serious decline but we did not

consider specifically the possibility that the same might happen to

the price of highgrade bonds neither did anyone else that we

know of we did warn on p 90 that a longterm bond may vary

widely in price in response to changes in interest rates in the light

of what has since happened we think that this warningwith

attendant exampleswas insufficiently stressed for the fact is that

he would have had a small profit thereon in late 1971

even at the lowest level 631 in 1970 his indicated loss would have

been less than that shown on good longterm bonds on the other

hand if he had confined his bondtype investments to us savings

bonds shortterm corporate issues or savings accounts he would

have had no loss in market value of his principal during this period

and he would have enjoyed a higher income return than was

offered by good stocks it turned out therefore that true cash

equivalents proved to be better investments in 1964 than common

stocksin spite of the inflation experience that in theory should

have favored stocks over cash the decline in quoted principal

value of good longerterm bonds was due to developments in the

money market an abstruse area which ordinarily does not have an

important bearing on the investment policy of individuals

this is just another of an endless series of experiences over time

that have demonstrated that the future of security prices is never

predictable almost always bonds have fluctuated much less than

stock prices and investors generally could buy good bonds of any

maturity without having to worry about changes in their market

value there were a few exceptions to this rule and the period after

1964 proved to be one of them we shall have more to say about

change in bond prices in a later chapter

3 expectations and policy in late 1971 and early 1972

toward the end of 1971 it was possible to obtain 8 taxable

interest on good mediumterm corporate bonds and 57 taxfree

on good state or municipal securities in the shorterterm field the

investor could realize about 6 on us government issues due in

five years in the latter case the buyer need not be concerned about

a possible loss in market value since he is sure of full repayment

including the 6 interest return at the end of a comparatively

short holding period the djia at its recurrent price level of 900 in

1971 yields only 35

let us assume that now as in the past the basic policy decision

to be made is how to divide the fund between highgrade bonds

or other socalled cash equivalents and leading djiatype

stocks what course should the investor follow under present conditions

if we have no strong reason to predict either a significant

upward or a significant downward movement for some time in the

future first let us point out that if there is no serious adverse

change the defensive investor should be able to count on the current

35 dividend return on his stocks and also on an average

annual appreciation of about 4 as we shall explain later this

appreciation is based essentially on the reinvestment by the various

companies of a corresponding amount annually out of undistributed

profits on a beforetax basis the combined return of his

stocks would then average say 75 somewhat less than his interest

on highgrade bonds on an aftertax basis the average return

on stocks would work out at some 535 this would be about the

same as is now obtainable on good taxfree mediumterm bonds

these expectations are much less favorable for stocks against

bonds than they were in our 1964 analysis that conclusion follows

inevitably from the basic fact that bond yields have gone up

much more than stock yields since 1964 we must never lose sight

of the fact that the interest and principal payments on good bonds

are much better protected and therefore more certain than the dividends

and price appreciation on stocks consequently we are

forced to the conclusion that now toward the end of 1971 bond

investment appears clearly preferable to stock investment if we

could be sure that this conclusion is right we would have to advise

the defensive investor to put all his money in bonds and none in

common stocks until the current yield relationship changes significantly

in favor of stocks

but of course we cannot be certain that bonds will work out better

than stocks from todays levels the reader will immediately

think of the inflation factor as a potent reason on the other side in

the next chapter we shall argue that our considerable experience

with inflation in the united states during this century would not

support the choice of stocks against bonds at present differentials

in yield but there is always the possibilitythough we consider it

remoteof an accelerating inflation which in one way or another

would have to make stock equities preferable to bonds payable in a

fixed amount of dollars there is the alternative possibility

which we also consider highly unlikelythat american business

will become so profitable without steppedup inflation as to justify

a large increase in commonstock values in the next few years

finally there is the more familiar possibility that we shall witness

another great speculative rise in the stock market without a real

justification in the underlying values any of these reasons and

perhaps others we havent thought of might cause the investor to

regret a 100 concentration on bonds even at their more favorable

yield levels

hence after this foreshortened discussion of the major considerations

we once again enunciate the same basic compromise policy

for defensive investorsnamely that at all times they have a significant

part of their funds in bondtype holdings and a significant

part also in equities it is still true that they may choose between

maintaining a simple 5050 division between the two components

or a ratio dependent on their judgment varying between a minimum

of 25 and a maximum of 75 of either we shall give our

more detailed view of these alternative policies in a later chapter

since at present the overall return envisaged from common stocks

is nearly the same as that from bonds the presently expectable

return including growth of stock values for the investor would

change little regardless of how he divides his fund between the

two components as calculated above the aggregate return from

both parts should be about 78 before taxes or 55 on a taxfree

or estimated taxpaid basis a return of this order is appreciably

higher than that realized by the typical conservative investor over

most of the longterm past it may not seem attractive in relation to

the 14 or so return shown by common stocks during the 20

years of the predominantly bull market after 1949 but it should be

remembered that between 1949 and 1969 the price of the djia had

advanced more than fivefold while its earnings and dividends had

about doubled hence the greater part of the impressive market

record for that period was based on a change in investors and

speculators attitudes rather than in underlying corporate values

to that extent it might well be called a bootstrap operation

in discussing the commonstock portfolio of the defensive

investor we have spoken only of leading issues of the type

included in the 30 components of the dow jones industrial average

we have done this for convenience and not to imply that these

30 issues alone are suitable for purchase by him actually there are

many other companies of quality equal to or excelling the average

of the dow jones list these would include a host of public utilities

which have a separate dow jones average to represent them but

the major point here is that the defensive investors overall results

are not likely to be decisively different from one diversified or representative

list than from another ormore accuratelythat neither

he nor his advisers could predict with certainty whatever

differences would ultimately develop it is true that the art of skillful

or shrewd investment is supposed to lie particularly in the

selection of issues that will give better results than the general market

for reasons to be developed elsewhere we are skeptical of the

ability of defensive investors generally to get better than average

resultswhich in fact would mean to beat their own overall performance

our skepticism extends to the management of large

funds by experts

let us illustrate our point by an example that at first may seem

to prove the opposite between december 1960 and december 1970

the djia advanced from 616 to 839 or 36 but in the same period

the much larger standard poors weighted index of 500 stocks

rose from 5811 to 9215 or 58 obviously the second group had

proved a better buy than the first but who would have been so

rash as to predict in 1960 that what seemed like a miscellaneous

assortment of all sorts of common stocks would definitely outperform

the aristocratic thirty tyrants of the dow all this proves

we insist that only rarely can one make dependable predictions

about price changes absolute or relative

we shall repeat here without apologyfor the warning cannot

be given too oftenthat the investor cannot hope for better than

average results by buying new offerings or hot issues of any

sort meaning thereby those recommended for a quick profit+ the

contrary is almost certain to be true in the long run the defensive

investor must confine himself to the shares of important companies

with a long record of profitable operations and in strong financial

condition any security analyst worth his salt could make up such

a list aggressive investors may buy other types of common

stocks but they should be on a definitely attractive basis as established

by intelligent analysis

to conclude this section let us mention briefly three supplementary

concepts or practices for the defensive investor the first is the

purchase of the shares of wellestablished investment funds as an

alternative to creating his own commonstock portfolio he might

also utilize one of the common trust funds or commingled

funds operated by trust companies and banks in many states or

if his funds are substantial use the services of a recognized investment

counsel firm this will give him professional administration

of his investment program along standard lines the third is the

device of dollarcost averaging which means simply that the

practitioner invests in common stocks the same number of dollars

each month or each quarter in this way he buys more shares when

the market is low than when it is high and he is likely to end up

with a satisfactory overall price for all his holdings strictly speaking

this method is an application of a broader approach known as

formula investing the latter was already alluded to in our suggestion

that the investor may vary his holdings of common stocks

between the 25 minimum and the 75 maximum in inverse relationship

to the action of the market these ideas have merit for the

defensive investor and they will be discussed more amply in later

chapters

results to be expected by the aggressive investor

our enterprising security buyer of course will desire and

expect to attain better overall results than his defensive or passive

companion but first he must make sure that his results will not be

worse it is no difficult trick to bring a great deal of energy study

and native ability into wall street and to end up with losses instead

of profits these virtues if channeled in the wrong directions

become indistinguishable from handicaps thus it is most essential

that the enterprising investor start with a clear conception as to

which courses of action offer reasonable chances of success and

which do not

first let us consider several ways in which investors and speculators

generally have endeavored to obtain better than average

results these include

1 trading in the market this usually means buying stocks

when the market has been advancing and selling them after it has

turned downward the stocks selected are likely to be among those

which have been behaving better than the market average a

small number of professionals frequently engage in short selling

here they will sell issues they do not own but borrow through the

established mechanism of the stock exchanges their object is to

benefit from a subsequent decline in the price of these issues by

buying them back at a price lower than they sold them for as our

quotation from the wall street journal on p 19 indicates even

small investorsperish the termsometimes try their unskilled

hand at short selling

2 shortterm selectivity this means buying stocks of companies

which are reporting or expected to report increased earnings

or for which some other favorable development is anticipated

3 longterm selectivity here the usual emphasis is on an

excellent record of past growth which is considered likely to continue

in the future in some cases also the investor may choose

companies which have not yet shown impressive results but are

expected to establish a high earning power later such companies

belong frequently in some technological areaeg computers

drugs electronicsand they often are developing new processes

or products that are deemed to be especially promising

we have already expressed a negative view about the investors

overall chances of success in these areas of activity the first we

have ruled out on both theoretical and realistic grounds from the

domain of investment stock trading is not an operation which on

thorough analysis offers safety of principal and a satisfactory

return more will be said on stock trading in a later chapter

or the longer future the investor faces obstacles of two

kindsthe first stemming from human fallibility and the second

from the nature of his competition he may be wrong in his estimate

of the future or even if he is right the current market price

may already fully reflect what he is anticipating in the area of

nearterm selectivity the current years results of the company are

generally common property on wall street next years results to

the extent they are predictable are already being carefully considered

hence the investor who selects issues chiefly on the basis of

this years superior results or on what he is told he may expect for

next year is likely to find that others have done the same thing for

the same reason

in choosing stocks for their longterm prospects the investors

handicaps are basically the same the possibility of outright error

in the predictionwhich we illustrated by our airlines example on

p 6is no doubt greater than when dealing with nearterm earnings

because the experts frequently go astray in such forecasts it is

theoretically possible for an investor to benefit greatly by making

correct predictions when wall street as a whole is making incorrect

ones but that is only theoretical how many enterprising investors

could count on having the acumen or prophetic gift to beat the professional

analysts at their favorite game of estimating longterm

future earnings

we are thus led to the following logical if disconcerting conclusion

to enjoy a reasonable chance for continued better than average

results the investor must follow policies which are 1 inherently

sound and promising and 2 not popular on wall street

are there any such policies available for the enterprising

investor in theory once again the answer should be yes and there

are broad reasons to think that the answer should be affirmative in

practice as well everyone knows that speculative stock movements

are carried too far in both directions frequently in the general

market and at all times in at least some of the individual

issues furthermore a common stock may be undervalued because

of lack of interest or unjustified popular prejudice we can go further

and assert that in an astonishingly large proportion of the

trading in common stocks those engaged therein dont appear to

knowin polite termsone part of their anatomy from another in

this book we shall point out numerous examples of past dis

crepancies between price and value thus it seems that any intelligent

person with a good head for figures should have a veritable

picnic on wall street battening off other peoples foolishness so it

seems but somehow it doesnt work out that simply buying a neglected

and therefore undervalued issue for profit generally proves

a protracted and patiencetrying experience and selling short a

too popular and therefore overvalued issue is apt to be a test not

only of ones courage and stamina but also of the depth of ones

pocketbook the principle is sound its successful application is

not impossible but it is distinctly not an easy art to master

there is also a fairly wide group of special situations which

over many years could be counted on to bring a nice annual return

of 20 or better with a minimum of overall risk to those who knew

their way around in this field they include intersecurity arbitrages

payouts or workouts in liquidations protected hedges of

certain kinds the most typical case is a projected merger or acquisition

which offers a substantially higher value for certain shares

than their price on the date of the announcement the number of

such deals increased greatly in recent years and it should have

been a highly profitable period for the cognoscenti but with the

multiplication of merger announcements came a multiplication of

obstacles to mergers and of deals that didnt go through quite a

few individual losses were thus realized in these oncereliable

operations perhaps too the overall rate of profit was diminished

by too much competition

the lessened profitability of these special situations appears one

manifestation of a kind of selfdestructive processakin to the law

of diminishing returnswhich has developed during the lifetime

of this book in 1949 we could present a study of stockmarket fluctuations

over the preceding 75 years which supported a formula

based on earnings and current interest ratesfor determining a

level to buy the djia below its central or intrinsic value

and to sell out above such value it was an application of the governing

maxim of the rothschilds buy cheap and sell dear and

it had the advantage of running directly counter to the ingrained

and pernicious maxim of wall street that stocks should be bought

because they have gone up and sold because they have gone down

alas after 1949 this formula no longer worked a second illustration

is provided by the famous dow theory of stockmarket

movements in a comparison of its indicated splendid results for

18971933 and its much more questionable performance since

1934

a third and final example of the golden opportunities not

recently available a good part of our own operations on wall

street had been concentrated on the purchase of bargain issues easily

identified as such by the fact that they were selling at less than

their share in the net current assets working capital alone not

counting the plant account and other assets and after deducting all

liabilities ahead of the stock it is clear that these issues were selling

at a price well below the value of the enterprise as a private business

no proprietor or majority holder would think of selling what

he owned at so ridiculously low a figure strangely enough such

anomalies were not hard to find in 1957 a list was published showing

nearly 200 issues of this type available in the market in various

ways practically all these bargain issues turned out to be profitable

and the average annual result proved much more remunerative

than most other investments but they too virtually disappeared

from the stock market in the next decade and with them a dependable

area for shrewd and successful operation by the enterprising

investor however at the low prices of 1970 there again appeared a

considerable number of such subworkingcapital issues and

despite the strong recovery of the market enough of them

remained at the end of the year to make up a fullsized portfolio

the enterprising investor under todays conditions still has various

possibilities of achieving better than average results the huge

list of marketable securities must include a fair number that can be

identified as undervalued by logical and reasonably dependable

standards these should yield more satisfactory results on the

average than will the djia or any similarly representative list in

our view the search for these would not be worth the investors

effort unless he could hope to add say 5 before taxes to the average

annual return from the stock portion of his portfolio we shall

try to develop one or more such approaches to stock selection for

use by the active investor

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