

STOCK MARKET STUDY

2975
HEARINGS
BEFORE THE
COMMITTEE ON BANKING AND CURRENCY
UNITED STATES SENATE
EIGHTY-FOURTH CONGRESS
FIRST SESSION

ON
FACTORS AFFECTING THE BUYING AND SELLING OF
EQUITY SECURITIES

MARCH 3, 4, 7, 8, 9, 10, 11, 14, 15, 16, 17, 18, 21,
22, AND 23, 1955

Printed for the use of the Committee on Banking and Currency



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General Wood. I think it is very good. You put your finger, as I expected you would, on the one potential weakness, which is that if somebody gets control of these big funds for selfish purposes, it would be bad.

The CHAIRMAN. That is right.

General Wood. All I can say is I think I have indoctrinated my associates and directors and officers pretty well, so that I know nothing will be done in the next 10 years. After that time I cannot answer for it.

Senator BRICKER. May I express a word of appreciation to General Wood for coming here and the information he has brought to us. It is an example of one of the great American industries.

The CHAIRMAN. Thank you very much, General. The next witness is Mr. Benjamin Graham, chairman and president of Graham-Newman Corp., of New York. Mr. Graham, we are very happy to have you this morning and are looking forward to your testimony.

~~World for service~~

STATEMENT OF BENJAMIN GRAHAM, CHAIRMAN OF THE BOARD,
GRAHAM-NEWMAN CORP., NEW YORK

Mr. GRAHAM. I would prefer to summarize it if I may.

The CHAIRMAN. Fine.

Mr. GRAHAM. But in the first place may I make a correction?

The CHAIRMAN. Yes.

element of danger because a change of sentiment for the better may be followed by a change in sentiment for the worse.

Finally, in regard to the feasible methods of controlling excessive speculation in the future, I am in sympathy with the action of the Federal Reserve in increasing margin requirements as speculative activity increases.

I feel in general speculation on margin is expensive to the public, and is sound only when it is practiced by people who have a great deal of experience and a great deal of ability.

I also have an idea with respect to temporary modifications of the capital-gains tax if it appears desirable to increase the supply of stocks for a temporary period of time.

I would rather answer questions from this point on instead of going into more detail about my statement.

The CHAIRMAN. Thank you very much, Mr. Graham. In connection with your own company, does it invest in a representative sample of the best stocks in the market, or does it use some other guide for investment?

Mr. GRAHAM. No. We have not been purchasing the market leaders. Our business has been something of a specialty business. We have emphasized the purchase of securities selling under intrinsic value, and have gone to what is generally known as a special situation.

The CHAIRMAN. Would you describe that for us—for our information. You understand you are talking to a committee—at least the members who you notice are present now—who know very little about this. Would you tell us what specialty situations are and how you approach it? How do you determine whether a special situation is undervalued or not?

Mr. GRAHAM. There is a slight distinction between an overvalued security as such, and a special situation. I shall try to make that distinction clear.

In the first place, with respect to a special situation as it is known in Wall Street. That is a security which upon study is believed to have a probability of increasing in value for reasons not related to the movement of stock prices in general, but related to some development in the company's affairs. That would be particularly a matter such as recapitalization and reorganization, merger and so forth.

For example, the typical example of the special situation is a company in trusteeship undergoing reorganization. Because of the fact that it is in trusteeship, the securities tend to sell at less than their intrinsic value. When the reorganization is completed, the proper value is established and there will normally be a profit in the purchase of such securities. There are other examples of that kind. The public utility breakups were a very interesting generic group of securities, because we had an underlying situation in which these holding companies, being in ill favor in general with the investing public, tended to sell at less than the value of their constituent companies, and when they were broken up the value of the constituent companies in the market greatly exceeded the value of the holding company shares.

With respect to undervalued securities in general, not special situations, that would be based upon a process of security analysis, which shows by a study of the company's balance sheet and income account that it is selling for considerably less than its intrinsic value, which

in general can be defined as considerably less than the value of the company to a private owner.

The CHAIRMAN. How do you evaluate management?

Mr. GRAHAM. Management is one of the most important factors in the evaluation of a leading company and it has a great effect upon the market price of secondary companies. It does not necessarily control the value of the secondary companies for the long pull because if the management is comparatively poor there are forces at work which tend to improve the management and thereby improve the value of the company.

The CHAIRMAN. When you go into special situations and buy large blocks, do you usually try to get control of the company?

Mr. GRAHAM. No; that is very exceptional. I would say out of about 400 companies that we may have invested in in the last few years, there would not be more than 3 or 4 in which we would have had any interest in acquiring control.

The CHAIRMAN. You would have if you thought the management was bad, would you not? I mean that would be one of the principal elements in that case?

Mr. GRAHAM. That could be a reason for our seeking control, hoping to improve the management situation.

The CHAIRMAN. How do you go about acquiring large blocks without disturbing the market too much? Do you do it in your own name, or what is the procedure?

Mr. GRAHAM. Well, there are two procedures. One is to acquire shares in the open market over a period of time. The other is by making a bid for a specified or unspecified number of shares, which is made public and which all stockholders have an opportunity to accept.

The CHAIRMAN. What I mean is, I assume that you specialize in special situations. You analyze it and after considerable work, I take it, you decide that it is undervalued and it is a good special situation. You start buying in the market, and you reveal your interest and everyone knows what you are doing. I wondered how you proceed.

Mr. GRAHAM. That could happen, but very often it does not. May I give you an example of that, Senator. In a book I wrote, *The Intelligent Investor*, I gave an example of an undervalued security, the Northern Pacific Railroad stock, which at the time of my first analysis sold at 20 and later went down to 14. We decided to buy a fair amount of stock. I should say that after reading the book once or twice I convinced myself the shares should be bought. We went ahead and acquired about 50,000 shares of that stock in the market with comparatively little effect upon the price.

The CHAIRMAN. Were there a lot of shares of that?

Mr. GRAHAM. There were about 21½ million shares altogether.

The CHAIRMAN. That is a pretty big company?

Mr. GRAHAM. Yes, indeed, but that was a large investment for us. But there are other instances in which where companies are smaller it is not equally feasible to acquire shares in the open market, and it might be desirable to make a bid or offer, as it is generally called, to acquire shares in some public way.

The CHAIRMAN. You make no effort to conceal your interest in a special situation or to deal through trust companies or other accounts?

Mr. GRAHAM. Well, in most of our purchases, the vast majority of

them, we purchase shares the same way as anyone else would through brokerage houses, who act for us, and there is no concealment.

The CHAIRMAN. To your knowledge are there many instances of concealment of the purchaser in acquisition of stock?

Mr. GRAHAM. Well, you might say that virtually all of the companies that are acquired in the open market—I mean where control is acquired in the open market, in virtually all these cases there is some degree of concealment. That is to say, nobody publishes the fact that he and his group are acquiring control in the open market. It would obviously be unwise from a business point of view. Sometimes the news gets around, but it is generally unofficial. There have been a few instances, comparatively few, in which efforts are made to acquire control of a company generally through a reputable bank or trust company where the name of the purchaser is not revealed; in other cases it is revealed.

The CHAIRMAN. We have had suggestions that this is done, and I was wondering what the process is and whether or not you do it or have done it. I wonder if you could describe for us the way you can acquire control without revealing your identity, not applicable to yourself necessarily. How would anyone do it?

Mr. GRAHAM. Well, outside of the method of acquiring control in the open market, which as I said before is the more customary way, the other method would be to ask a bank or trust company to communicate to the stockholders an offer to buy the shares, generally at a price above the market, and state that the acquisition is being made for clients of the trust company, without giving their names.

The CHAIRMAN. There is no requirement if a trust company purchases stock on the exchange to reveal the beneficial owner; is that right? They do not have to say, "We are buying this for Mr. Jones or Mr. Smith"?

Mr. GRAHAM. No, obviously not, sir.

The CHAIRMAN. So that that would be the usual way, simply to use an established firm which is in and out of the market, for your agent to purchase for you?

Mr. GRAHAM. Yes. That would not be a trust company. Normally that would be a brokerage firm.

The CHAIRMAN. Does a broker have to reveal who his principal is?

Mr. GRAHAM. No. On the contrary, it is one of the basic principles of Wall Street that the relationship between the broker and the client is confidential and the name should not be revealed except to authorities who have a legitimate reason to ask for the information.

The CHAIRMAN. Well, that is an important exception. What about a trust company? If the Chase National Bank purchases shares and they are asked by the president of the exchange whom they are buying for, do they tell him? Is it same as the broker?

Mr. GRAHAM. The president of the New York Stock Exchange has no authority over anyone except members of the New York Stock Exchange.

The CHAIRMAN. Well, then, there is a difference. As to the brokers, he has access to the beneficial owner, but he does not have as to the trust company. Is that right?

Mr. GRAHAM. That would be true with respect to the president of the stock exchange, yes.

The CHAIRMAN. Who would have control, the SEC?

Mr. GRAHAM. As a reservation, I am not certain the constitution of the stock exchange gives the president the power to ask the brokers for the names of their clients or their dealings, but I assume that in the investigations that the stock exchange makes into its own dealings, including such things as manipulation and so forth, such information is asked for and given.

The CHAIRMAN. I understood that with regard to the members for disciplinary purposes they have the right to inquire, but I would not be too certain about that.

Mr. GRAHAM. I believe that is so, but I am not sure.

The CHAIRMAN. When there is a battle for control of a company, the stockholders who intend to remain with the company would want to know whether they should participate in the battle or should sell out, and the identity of the purchaser would be important to them in such circumstances, would it not?

Mr. GRAHAM. Well, if you are speaking of a battle for control in terms of a proxy battle, of course, the identity of the people who are endeavoring to obtain a majority of the votes by proxy solicitation is absolutely vital, and the proxy rules require that complete disclosure be made of the identity of such persons. With respect to purchases of shares, however, that is an entirely different matter, and the theory of the stock market is that people are allowed to purchase shares anonymously. It will be a little embarrassing for many people if each time they bought or sold shares their identity would have to be revealed.

The CHAIRMAN. Of course, it is not done customarily, but it is subject to being revealed in an investigation at any time, is it not?

Mr. GRAHAM. As far as I know, the revelations of purchasers of shares have been limited pretty much to criminal activities. I do not recall cases in which the names of buyers have been revealed, even though they may be known to the authorities, merely because these people happen to have bought stock.

The CHAIRMAN. Do you recall the Lawrence Portland Cement Co.? Did you make an attempt to gain control of that company?

Mr. GRAHAM. Yes; in association with other people, who at that time, I believe, were either the largest or second-largest holders, we made a bid for a specified number of shares.

The CHAIRMAN. How did that work out?

Mr. GRAHAM. It did not succeed. The price advanced above our bid price, and consequently we did not get any quantity of stock.

The CHAIRMAN. Do you think that was an instance of their having known that you were interested and having great respect for your judgment, and it went up before you could get control?

Mr. GRAHAM. No. On the contrary, what happened was that the company itself went into the market and forced the price up above our bid price.

The CHAIRMAN. Well, I do not know how it could have been otherwise. You could not have purchased that amount in open market, could you?

Mr. GRAHAM. No, but we made a blanket offer to the stockholders to turn in their stock to us at a given price, which was above the market at the time the offer was made.

The CHAIRMAN. What was your offer?

Mr. GRAHAM. I think it was \$26 a share.

The CHAIRMAN. When was that?

Mr. GRAHAM. Four years ago, perhaps.

The CHAIRMAN. What is it selling for now?

Mr. GRAHAM. I do not know.

The CHAIRMAN. Has it been split?

Mr. GRAHAM. It has advanced, and the name has been changed.

The CHAIRMAN. What is the name of it now?

Mr. GRAHAM. Dragon Portland Cement.

The CHAIRMAN. I am told that, allowing for the split, it is now selling for \$130 a share. That vindicates your judgment, does it not?

Mr. GRAHAM. I wish we had been able to buy it; yes.

The CHAIRMAN. Was it true that in that case you got no stock at all?

Mr. GRAHAM. No; because our offer was a contingent offer. We made an offer to the stockholders to buy their shares at a price above the then market, provided a sufficient number of shares would be deposited. What happened then was, as I said before, that the officers of the company, not wishing this bid to succeed, went into the market and pushed the price of the stock above our price. As a result, people did not turn in any number of shares to speak of, and we dropped the whole thing.

The CHAIRMAN. I am not sure—do you wish to discuss these individual cases or not?

Mr. GRAHAM. Well, I have no strong feeling on the matter. I do not know to what extent it would be useful to the committee. If it is useful to the committee, I have no objection.

The CHAIRMAN. I do not wish to embarrass you about it. I had understood that it was quite all right. The only purpose is that we have had a number of people here who have discussed general principles. None of them, I believe, were what we call active traders. I suppose that is what you are, is it not?

Mr. GRAHAM. Well, we do not consider ourselves as traders in the ordinary sense. Technically you might call us that.

The CHAIRMAN. What I was trying to do was to illustrate procedures that are followed by people actually in the market. If you do not care to be questioned about individual cases, I would not want to press the matter.

Mr. GRAHAM. I have no sensitiveness on the subject at all. We are very proud of our achievements in our company.

The CHAIRMAN. I thought maybe you were a little reluctant in the

Mr. GRAHAM. No, that was a different situation. You are referring now to our own experience. The Atlantic Gulf and West Indies was quite a different situation. At that time we made an arrangement with the chief stockholder of that company to purchase, I think, the greater part of his holdings, and made a corresponding bid to everybody else to buy their shares at the same price, which was considerably above the market at the time we began our negotiations.

The CHAIRMAN. Was that a negotiated sale you were trying to effect off the exchange, or was it a listed stock?

Mr. GRAHAM. Yes, it was a listed stock. The negotiation was done with the large stockholder, and the rest was an offer extended to all the stockholders on the same terms.

The CHAIRMAN. Was that negotiation directly with the stockholder?

Mr. GRAHAM. That is correct.

The CHAIRMAN. Did it succeed?

Mr. GRAHAM. Yes, it did.

The CHAIRMAN. You did not use an intermediary in that case?

Mr. GRAHAM. No, that offer went over our name, I believe. The difference was this: At that time we had already arranged to buy a large amount of this stock, and we felt that, for one thing, that should be a matter of record and was made a matter of record.

The CHAIRMAN. So that is an illustration of the successful way to purchase control of a company?

Mr. GRAHAM. Yes. It is much more desirable to buy it by negotiation to begin with.

The CHAIRMAN. Do you think there is any serious problem from the public's point of view with regard to the anonymous purchase of stock, especially with regard to gaining control of a company?

Mr. GRAHAM. Senator, I have observed this thing for the last 40 years. I cannot think of a single instance in which the public has been hurt by offers to buy control whether the names were revealed or not revealed. In every such instance the public has been helped because they have been able to get a higher price for their shares than they would have been able to get if no such bid had been made.

The CHAIRMAN. You see nothing wrong with that procedure? I am not arguing with you. I am only asking you.

Mr. GRAHAM. I have had occasion to think about that matter for a long time, Senator, and it seems to me that the true arguments are all, from the public's standpoint, in favor of not preventing bids being made to the public at higher than the prices previously ruling.

The CHAIRMAN. Is your company an open-end or closed-end company?

Mr. GRAHAM. We are technically an open-end company, and practically a closed-end company. Let me explain that.

The CHAIRMAN. I will be very happy for you to.

Mr. GRAHAM. We are registered under the Investment Company Act of 1940 as an open-end company, which means that we are contractually obligated to repurchase shares at any time at the net asset value when presented to us. However, no such shares have been presented to us for a great many years. Our shares have sold consistently at well over their net asset value. Furthermore, we have not sold any shares of stock to the public at any time and have not increased our capitalization for many years, so that we operate actually as a closed-end company, namely, with a fixed capitalization.

The CHAIRMAN. What is the capital? Are these trade secrets or not?

Mr. GRAHAM. Not at all. They would not be a secret in any case, Senator, but as it happens our figures are made public. They are filed with the Securities and Exchange Commission. We have 5,000 shares of stock with a present asset value on the order of \$1,100 a share and with a market price rather considerably above that.

The CHAIRMAN. A market price above that?

Mr. GRAHAM. That is right.

The CHAIRMAN. But the shares sell very seldom, I understand?

Mr. GRAHAM. That is true. There are very infrequent sales. Nonetheless, there are quite a number of them in the course of a year or two.

The CHAIRMAN. When was your company started?

Mr. GRAHAM. The company was incorporated in 1936, but it was a continuation of a business which was set up in 1926.

The CHAIRMAN. To what do you attribute your great success in this business?

Mr. GRAHAM. Well, Senator, that is assuming that we have made a great success.

The CHAIRMAN. Would you not consider it a success?

Mr. GRAHAM. I will admit that we think it is, but I did not want to be in the position of passing over your question as taking for granted that we have made a great success.

The CHAIRMAN. I will take responsibility for saying you obviously have made a success.

Mr. GRAHAM. I think our success is due to our having established sound principles of purchase and sale of securities, and having followed them consistently through all kinds of markets.

The CHAIRMAN. I take it that ordinary members of the public cannot buy your shares; is that right?

Mr. GRAHAM. Well, they cannot buy them in unlimited amounts, but they can buy them over the counter in small amounts.

The CHAIRMAN. Are they quoted over the counter?

Mr. GRAHAM. They are quoted over the counter; yes, sir.

The CHAIRMAN. At what, \$1,100?

Mr. GRAHAM. I would say probably around \$1,250 or \$1,300 a share now.

The CHAIRMAN. Above the asset value?

Mr. GRAHAM. That is correct, sir.

The CHAIRMAN. Is it customary for open-end companies to be selling above their asset value?

Mr. GRAHAM. Well, it is unusual for any investment company to sell above its asset value, but there are a number of instances. The best-known instance is the Lehman Corp., which for a good part of the time sells above its asset value. That, however, is a closed-end company. It is impossible for an open-end company to sell at more than the selling premium over its asset value as long as it offers shares of stock to the public. That is obvious. In some instances a company like State Street Investment has followed a policy like ours and has not offered shares generally to the public, and the shares have sold at a premium.

The CHAIRMAN. Do you personally control your company?

Mr. GRAHAM. No; I am a comparatively small stockholder.

The CHAIRMAN. You are?

Mr. GRAHAM. Yes, sir.

The CHAIRMAN. Does your family control it?

Mr. GRAHAM. No. We have a comparatively small number of shares.

The CHAIRMAN. Does any one family or person control it, or is it distributed rather evenly?

Mr. GRAHAM. The shares are distributed fairly evenly. I would say there is a family with whom we have no relationship that represents the largest stockholding at the present time.

The CHAIRMAN. If someone wishes to sell their shares, they still can demand what from you?

Mr. GRAHAM. They can demand the net asset value.

The CHAIRMAN. Which, of course, they do not do, because they can get more?

Mr. GRAHAM. That is correct. We have not taken in any shares for many years.

The CHAIRMAN. What inspired you to form an investment company? You did start this investment company; did you not?

Mr. GRAHAM. Yes. May I say that I entered the brokerage business in 1914 and became a junior member of a stock-exchange firm, and in 1923 I believed that sound investing principles would be successful, and I started a private fund in 1923, which was changed around in 1926.

The CHAIRMAN. What is a private fund?

Mr. GRAHAM. A private fund would be one in which no offering was made to the general public through advertisements, circulars, or any other way, but merely to friends who were permitted or asked to contribute.

The CHAIRMAN. How large was that company?

Mr. GRAHAM. It was about a half million dollars at the beginning.

The CHAIRMAN. Just you and your friends?

Mr. GRAHAM. That is correct, sir. My own participation was very small. I had very little money.

The CHAIRMAN. You started buying stock; is that right?

Mr. GRAHAM. Stocks and bonds; yes.

The CHAIRMAN. I would be interested, if you do not mind telling us, to have the history of this development.

Mr. GRAHAM. Well, Senator, if you feel there is any value in this.

The CHAIRMAN. There is, because we like to get some feel of how these trust companies develop. However, I do not wish to embarrass you. If you think it puts you at a disadvantage with competitors or anyone else, you do not have to.

Mr. GRAHAM. No, Senator. I have been accused of telling all my secrets. I have written a number of books, and I reveal them all in these books.

The CHAIRMAN. I was particularly interested to know what happened to you in 1932.

Mr. GRAHAM. We had rough going.

The CHAIRMAN. You first started at the beginning with a half million dollars. What happened then up until 1929?

Mr. GRAHAM. We were quite successful, and the fund grew to \$21½ million at the beginning of 1929.

The CHAIRMAN. In stocks, I take it?

Mr. GRAHAM. In stocks and bonds.

The CHAIRMAN. What did you do in 1929?

Mr. GRAHAM. In 1929 we lost money.

The CHAIRMAN. Well, a lot? Did you go down with the market or see it coming or what?

Mr. GRAHAM. We did pretty well in 1929 alone, but the real difficulty we experienced in 1930 and 1931 when the market went much further downward than we had anticipated. We had pretty well anticipated the 1929 decline. And so our resources were shrunk pretty much. I do not think they shrank as much as General Woods' pension fund did, which he mentioned before, but they went down fairly low, and it was not until 1936 that a person who had been with us in 1929 and had held on would find himself even, but by 1936 he was even in our business.

The CHAIRMAN. You said you changed. When did it become a registered investment company?

Mr. GRAHAM. It became a registered investment company in 1941 after the passage of the Investment Company Act.

The CHAIRMAN. What happened in 1936? Did not some change occur?

Mr. GRAHAM. We incorporated, for a very peculiar reason. We had originally operated as a joint account, and the individual members reported on a partnership basis.

The CHAIRMAN. Each participant in the fund?

Mr. GRAHAM. That is correct, reported his share of the results. But before 1936 the Treasury claimed that we were an association taxable as a corporation, and we had considerable problems as to where we stood, whether we were or were not a corporation. So our counsel said, "You had better incorporate and settle this matter once and for all, because the Treasury will get you either way."

The CHAIRMAN. This was the original group of friends; is that right?

Mr. GRAHAM. That is correct.

The CHAIRMAN. That is all that were in it in 1936?

Mr. GRAHAM. There were accretions on a private basis. I had more friends in 1936 than I had in 1923.

The CHAIRMAN. When did you make them, during the depression?

Mr. GRAHAM. Not so many as afterward.

The CHAIRMAN. Go ahead. You incorporated in 1936 and in 1941 you registered. When did you sell any stock to the public, or did you ever sell any? You have 5,000 shares, you say?

Mr. GRAHAM. Yes. May I say that we originally had more shares, that is, we sold stock up to 50,000 shares with a nominal par value and stated value of \$100 a share.

The CHAIRMAN. When did you do that?

Mr. GRAHAM. Well, we did that in series by offering rights primarily to our older stockholders, and that built our capital up to \$5 million, consisting of 50,000 shares worth about \$100 a share. But we discovered—this may interest you, Senator—that we were beginning to get a great many one-share stockholders, people we had never heard of who came in and invested a hundred-odd dollars and then got our reports and found out what we were doing and imitated it. So to deal with that situation we perpetrated a reverse split-up in which we issued 1 share for 10, increased the unit value in the market

to about \$1,200 or \$1,300 a share, and from that time on we did not get quite so many 1-share stockholders.

The CHAIRMAN. What do you charge for managing the investment company? You are the manager of the company; is that right?

Mr. GRAHAM. Their capital may be a hundred times ours. Their expenses are much less than a hundred times ours. Their expense burden is very little, percentagewise, as compared with ours. The trustees receive compensation on the order of maybe one-fourth of 1 percent on capital.

The CHAIRMAN. Wait a minute. Of earnings or capital?

Mr. GRAHAM. This would be capital.

The CHAIRMAN. Per year? One-quarter of 1 percent?

Mr. GRAHAM. No, I think I have overstated it. It might have been that much at one time. I think it is less now. As the capital grows, the percentage of compensation to the trustees has diminished. Frankly speaking, I should not be talking about this because I do not know it well enough, but I do know in general that their rate of

Mr. GRAHAM. That is true.

The CHAIRMAN. Well, I take it you are worth it. You manage it more effectively than they do. Is that not correct?

Mr. GRAHAM. Well, naturally we have to believe that, and our stockholders believe that.

The CHAIRMAN. I take it you approach this whole business in quite a different way. Those big funds do not look for special situations. They go into the market and just buy the run of the mine, do they not—the blue chips and the bonds, and so on. Is that not correct?

Mr. GRAHAM. Well, that is correct in a general way, but not completely. Some of the bigger funds, particularly like the Lehman Corp., which is a large fund, has always had a rather keen interest in special situations, and a certain amount of their capital—by no means the major amount—has gone into special situations.

The CHAIRMAN. When you say "large," how large is Lehman?

Mr. GRAHAM. Lehman would be over \$100 million.

The CHAIRMAN. Of invested capital?

Mr. GRAHAM. At present market values.

The CHAIRMAN. As compared to yours?

Mr. GRAHAM. Ours is on the order of 6½ million.

The CHAIRMAN. On market value. That is not the original investment. That is the capital as now valued on the market; is that correct?

Mr. GRAHAM. That is right. We have paid back to our stockholders virtually all the earnings that have been made, so that in a sense our present value is very similar to the amount of money paid in.

The CHAIRMAN. You do not seek to increase the invested capital, I take it. Any particular reason for that?

Mr. GRAHAM. The basic reason, Senator, has been that we have not believed that we could get the same satisfactory results on very large capital as we can get on a moderate amount of capital.

The CHAIRMAN. Why is that?

Mr. GRAHAM. Because if you deal with special situations and undervalued securities, the markets in those for the most part are not very large. It is not possible to acquire an unlimited amount without affecting the market price, and if we had 10 times as much capital it would be very difficult for us to invest it the same way as our present capital.

The CHAIRMAN. I know some who have undervalued stocks down in Arkansas in my hometown who might talk to you about it.

Mr. GRAHAM. We are always open to suggestions, Senator.

The CHAIRMAN. There is no market for them. I believe you said in your statement that as far as whether the market is too high or too low right now, you could not say it is too high or too low. I take it that you think it is a period that requires caution, and you do not believe in jumping in and purchasing stocks?

Mr. GRAHAM. Well, let us put it this way, Senator: Quantitatively the market seems to be about right, but qualitatively I consider it to be on the high side and getting into a dangerous situation.

The CHAIRMAN. Well, that is, I think, a very understandable statement. That ought to be plain to anyone. If it is about right, that means it is not likely to go up or down? It is about on dead center?

Mr. GRAHAM. On the contrary, Senator, it may be about right, but that is likely to be accidental. A year from now—pardon me, sir.

The CHAIRMAN. I take it you meant the relationship between prices and earnings and income is at a figure that is not clearly undervalued or overvalued; is that right?

Mr. GRAHAM. I would say that is true for the most representative

generate a sentiment, as he put it, of overenthusiasm that disturbed him. He recommended, as you know, an increase in the margin requirements. Would you recommend an increase in margin requirements?

Mr. GRAHAM. I would like to duck the responsibility to this extent: I said in my statement that I feel the Federal Reserve should have no hesitation about increasing margin requirements further if it became increasingly concerned over the extent of speculation. I do not think it is necessary for me to make the decision for my friend Bill Martin, but I think the Federal Reserve has as good judgment as anyone in that connection.

The CHAIRMAN. That is a proper answer. I see nothing wrong with that. It is not your responsibility. Some, though, have taken the position that it would be discriminatory and a bad thing to increase the margin requirements to 100 percent.

Do you think if the capital gains tax were eliminated and there was no tax upon capital gains that that would increase the attractiveness of speculation or decrease it?

Mr. GRAHAM. On the whole it would increase the attractiveness of speculation.

The CHAIRMAN. If it did, that would tend to increase the level of prices; would it not?

Mr. GRAHAM. That is my best judgment. It is true that there would be some unfreezing of shares now held by long-time owners, but my own feeling is that very likely the net result would be an increase in speculative enthusiasm.

The CHAIRMAN. Is it fair to ask you now whether your own company—and you do not have to answer if you do not want to—is buying or selling stocks? You can be perfectly free to say you do not care to answer.

Mr. GRAHAM. We have been selling on balance from our general portfolio of undervalued securities and endeavoring to put our money into special situations which are not at the risk of the market.

The CHAIRMAN. Has it happened that in the past year or two you have made any particular study of any industry which is primarily dependent upon defense contracts for its business?

Mr. GRAHAM. No: we have had no occasion to study them in any detail. We just have a general knowledge of the picture.

The CHAIRMAN. Would you care to elaborate at all about your knowledge of the defense industry picture?

Mr. GRAHAM. Well, it is common knowledge, of course, that the aircraft-manufacturing companies are largely dependent on the defense program.

The CHAIRMAN. Would the fact that a company which is wholly dependent upon a defense contract had profits which increased in the last 6 months of 400 or 500 percent over the preceding year or similar period mean anything to you at all with regard to the Government's contracts with that company?

Mr. GRAHAM. Senator, I did not state in my statement that I was chairman of the research committee of the War Contracts Price Adjustment Board during the war. That is the renegotiation board, and we had to consider principles of renegotiation, including the profits of aircraft-manufacturing concerns. The mere increase in

profits as such is not an indication that the contracts are improvident, but there is a prima facie suggestion that they be examined into.

The CHAIRMAN. Do you not think that 400 or 500 percent is a rather unusual increase in profits in the course of 12 months?

Mr. GRAHAM. I do not recall any particular instances in which that ratio existed, but if it should exist I am sure the renegotiation people will study that with care.

The CHAIRMAN. Do you think the Renegotiation Act ought to be reenacted? It expired, you know, at the end of December.

Mr. GRAHAM. I am convinced that it should be, or something similar.

The CHAIRMAN. The administration has not requested it, has it?

Mr. GRAHAM. I am not part of the administration, Senator.

The CHAIRMAN. I understand they did last weekend; yes. It was also in the state of the Union message. I had forgotten that. If nothing else happens in these hearings, maybe that is worthwhile. But you are in favor of the reenactment of that?

Mr. GRAHAM. Yes, indeed.

The CHAIRMAN. Would you mind commenting upon the situation which I notice recurs in many instances—there was a notable one this morning in the case of Du Pont, one of our big companies, and the same thing is true with General Motors—where so many of them have shown during 1954 a substantial increase in profits on a decreased volume. In some instances, of course, as we saw in the figures of General Motors, it was the difference in excess-profits tax, but I believe in many cases that plays a relatively minor part. What do you think is going on in our big industries that accounts for that?

Mr. GRAHAM. Well, of course, the first point is what you have mentioned—that the good showing for 1954 earnings in the large companies (approximately equal to the 1953 earnings in the aggregate) is due to a considerable degree to the repeal of the excess-profits tax. To some extent it is also due to the fact that corporations, both large and small, have been getting somewhat better control over their costs in recent years. That I would say is more true actually in the case of the small companies than it is in the big ones, because the small companies suffered most from the costs getting out of hand.

The CHAIRMAN. Would such a circumstance indicate a lack of competition?

Mr. GRAHAM. I do not think so, because for one thing the margin of profit in and of itself is no larger now than it was in previous years.

Mr. GRAHAM. Well, the point is this: General Motors has to make a very good profit in order that other automobile companies can exist at all. If it made a small profit, some of the other automobile companies would go out of business completely.

The CHAIRMAN. Why do you want to subsidize these other automobile companies at the expense of the poor farmer, who is struggling along on a starvation diet now?

Mr. GRAHAM. Senator, I did not suggest that.

The CHAIRMAN. The prices for these Chevrolets are enormous. If they could cut them \$800, it would help a lot.

Mr. GRAHAM. I would like to make my point of view clear again. I am not expressing my own opinion as to what should or should not be done. I am only telling you what I think is General Motors' policy, and that General Motors itself cannot dare in the present state of the economy and the political sentiment to reduce its prices to a point where other companies were forced out of business and General Motors had almost a monopoly of the business.

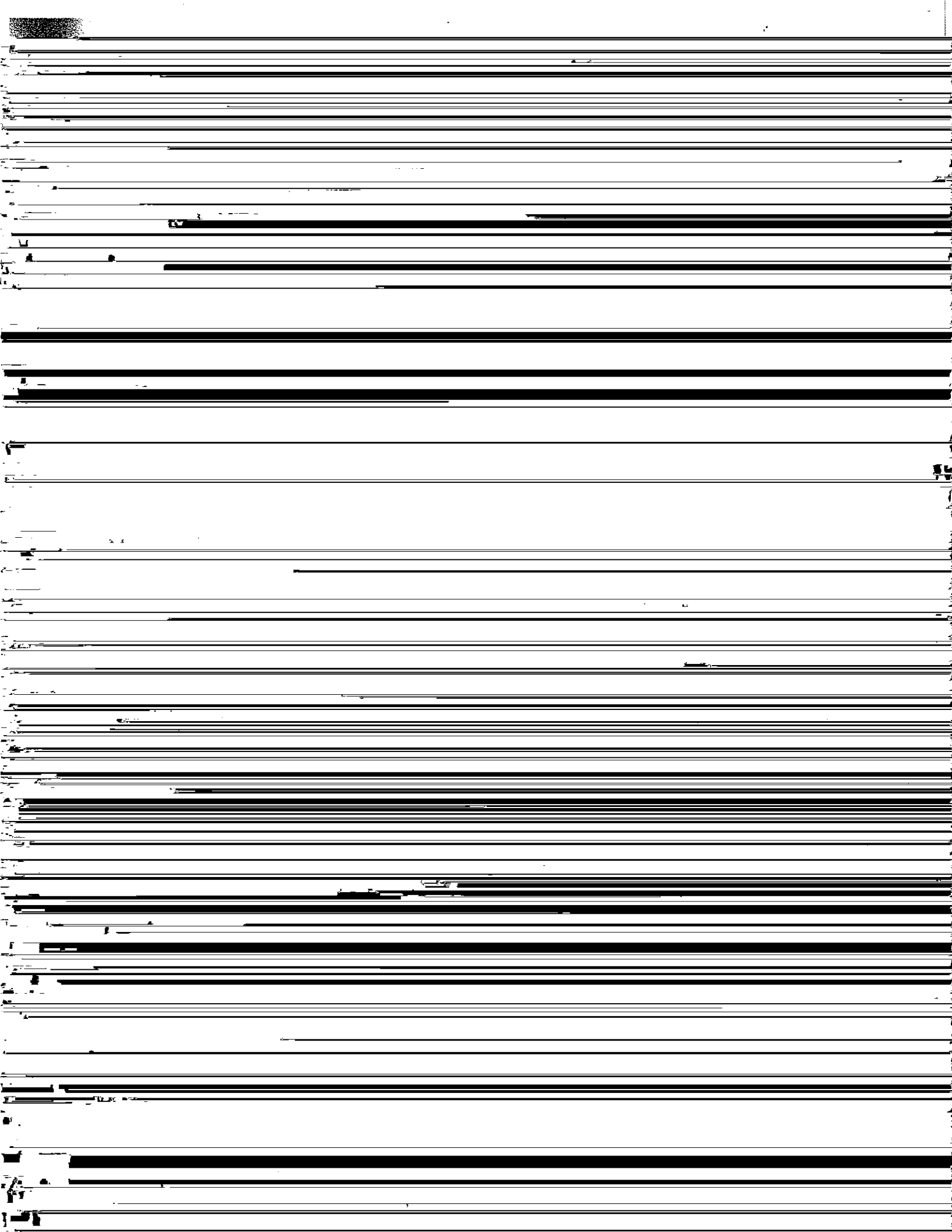
The CHAIRMAN. Well, in another way you are saying there is no competition in the automobile business; are you not?

Mr. GRAHAM. No, sir, that is not true either, because in the first place the competition between General Motors and Ford is very keen, and the competition between General Motors and Chrysler used to be very keen and is now again becoming keen.

The CHAIRMAN. To show you how innocent I am, I do not understand it at all. I always thought price happened to be the principal element in competition, that you could not have competition if you did not care what the price was, and that all the rest was shadowboxing and just make-believe. If you were really competitive and your desired to have the market, I had thought one of the first things to do was sell cheaper. That used to be the orthodox doctrine. This idea that the competition is just in advertising, to keep the price up, makes no sense to an old-fashioned man. It sounds exactly like the cartel system in Germany—"We split up the market and all take our part, and then we advertise and make people believe we are competing"—and there is no real competition. If General Motors really is competing and is desirous of obtaining the market, she would get it, would she not, by cutting the prices?

Mr. GRAHAM. Well, Senator, my view of this thing may be wrong, but it differs quite a bit from yours. I think the competition that existed between General Motors and Chrysler, for example, was very intense, and its effect on Chrysler was almost disastrous. Chrysler lost virtually all its earning power last year, and although its business remained high in terms of dollars, it lost out on sales of cars to a point where the earnings almost disappeared and tremendous effort was necessary by Chrysler to improve its cars and to improve its selling practice. Now, that, as far as I can see, is more or less a classical example of the actual working of competition.

The CHAIRMAN. I am afraid I gave a false impression. I am not now at least trying to express an opinion for or against it. I am trying to develop whether or not there is competition in the automobile field. I am unable to see that there is, in view of your statement that all General Motors needs to do to put them all out of business is lower the prices to where it could still get along and it would not go broke but it could break its competitors. In orthodox competitive



Mr. GRAHAM. Well, where the purchase was made by agreement with large stockholders who are part of the management, we would ordinarily get, say, a copy of the audit report and material of that kind which is not published, largely, I think, because it is just a matter of inconvenience to publish it. But I should add, in order to avoid a misconception, that I can think of no instance in which we have gotten any information of importance which had any effect on our judgment, which information was not given to the stockholders in connection with the offer to buy.

Mr. WALLACE. To the degree that reports are published quarterly, you might get a report on earnings in between these reports, for example, which was not published?

Mr. GRAHAM. Well, that is conceivable, a monthly report; but it would be very unusual if it had any effect. I might give you an example of that. When we made our offer to purchase the Atlantic Gulf and West Indies stock—and, incidentally, I might say the offer was made through the Manufacturers Trust Co.—we published, and, I think, at the suggestion of the Securities and Exchange Commission, with whom we had discussed the matter before, a semiannual balance sheet which had been supplied to us by management and had not been made public. It did not give any particular information of value, but it was published as a matter of general policy.

Mr. WALLACE. In general, when you buy a block of stock, do the people from whom you buy the stock have the same information that you have?

Mr. GRAHAM. As far as any important pieces of information are concerned, I would say "Yes."

Mr. WALLACE. But if you were to buy stock on the open market on the basis of information that you had gotten in conferring with management, would this be considered trading on the basis of inside information?

Mr. GRAHAM. No, sir; because, as I understand the interpretation of the rules, trading on inside information applies only to those who have a fiduciary relationship toward the stockholders, namely, officers, directors, and major stockholders.

Mr. WALLACE. Is it not illegal for an officer of a corporation to divulge to you any inside information which is not available to the public?

Mr. GRAHAM. I would like to clear that point up a little, because I am on both sides of that fence. I am an officer and director of a number of corporations, and I think it is worthwhile for the Senators to get a realistic view of the way corporate affairs actually operate. A good deal of information from day to day and month to month naturally comes to the attention of directors and officers. It is not at all feasible to publish every day a report on the progress of the company in the newspapers or send out letters to the stockholders. On the other hand, as a practical matter, there is no oath of secrecy imposed upon the officers or directors so that they cannot say anything about information that may come to their attention from week to week. The basic point involved is that where there is a matter of major importance it is generally felt that prompt disclosure should be made to all the stockholders so that nobody would get a substantial advantage in knowing that. But there are all degrees of importance, and it is very difficult to determine exactly what kind of infor-

mation should or must be published and what kind should just go the usual grapevine route.

Mr. WALLACE. Of course, the SEC act itself makes it illegal for an officer of a corporation to trade on the basis of inside information himself. At least, if he does trade on the basis of inside information the corporation or stockholders may sue to get his profits back?

Mr. GRAHAM. Yes. That is defined in the law in relation to 6-months' trades, and I imagine that there is a general idea of the law that it applies to any other kind of trade.

Mr. WALLACE. Am I to understand that an officer of a corporation can reveal inside information which would enable a person to trade in stocks on the basis of such information which is not available to the public?

Mr. GRAHAM. I believe you are right about that, Mr. Wallace, and it is an interesting area for consideration. It has given me a great deal of thought.

Mr. WALLACE. I was going to ask you what your opinion was of the adequacy of the present law. As I understand it, in talking with Mr. Wood when he was here, of the National Association of Securities Dealers, he said that it was not illegal for a director of a corporation whose stock is not listed to do all the trading he wants on the basis of inside information. The question I am raising with you in the case of listed stock is trading on the basis of inside information, not by the director himself but by the director divulging information to someone else. For example, if there is consideration of a merger that is not generally known about, but the officer knows about it and he can tell whether the merger may come off, or on earnings reports he may be in a position to know the dividend will be higher than it was originally thought, or a stock dividend or a stock split, the officer is in a position to have inside information. He is prohibited from trading on a 6-months' basis himself, but I would like to ask your opinion if you think the law should be tightened up with respect to his divulging information so that others may trade on the basis of inside information which is not available to the public generally.

Mr. GRAHAM. Well, if a feasible method of tightening the law could be devised which would get that objective without countervailing disadvantages of many sorts, I would be for it. But my experience in these things makes me hesitate to endorse the idea because of gradations of knowledge between the mere beginning of a possibility of something and its finalization. That would be particularly true with respect to a merger. When a merger is only a gleam in a person's eye, it is undesirable, of course, to make any public statement of it. On the other hand, it is very difficult for people to be so discreet that not a word can leak out from anybody when somebody has sat down with somebody else, and from that earliest idea to the later point the grada-

Mr. GRAHAM. Some do and some do not. I think that the average experienced person would assume that some people are bound to know more about the company than he would, and possibly trade on the additional knowledge.

Mr. WALLACE. Now, Mr. Graham, just for the record. You are an expert in this field. Could you explain some terms to us? Could you tell us what is meant by the term "profit-taking"?

Mr. GRAHAM. Well, profit-taking is very simple. It means that people who have a paper profit in their shares realize on their paper profit by selling, and the general inference is that there is some pressure on prices as a result of that which puts the market down when that happens. There is some profit-taking going on all the time.

Mr. WALLACE. Profit-taking would have in general an effect of depressing the market slightly for a temporary period?

Mr. GRAHAM. Well, profit-taking as it is used in markets means there is enough profit-taking to depress prices, because there is profit-taking all the time in the market even while it is going up.

Mr. WALLACE. Is that similar to a sell-off?

Mr. GRAHAM. Well, a sell-off is simply a decline, presumably temporary, in the market, for any number of reasons. Profit-taking may be the reason advanced, or a war scare, or something that happens in this committee room or anything else.

Mr. WALLACE. Or a technical adjustment is another term?

Mr. GRAHAM. The technical adjustment is very likely related to profit-taking.

The CHAIRMAN. You do not think anything we have been doing here has accounted for any fluctuations in the stock market, do you?

Mr. GRAHAM. Yes, sir.

The CHAIRMAN. You do?

Mr. GRAHAM. I do, yes. I think that the market, being at a rather sensitive level, is subject to a vast number of influences which might put the market down or up, and among those influences are these hearings.

Mr. WALLACE. Mr. Graham, one of the reasons I was discussing these questions is that the market reached a pretty high level on Friday last, did it not? The total market was pretty strong last Friday?

Mr. GRAHAM. Yes.

Mr. WALLACE. Over the weekend the President announced he was going to extend the Renegotiation Act, did he not?

Mr. GRAHAM. Yes.

Mr. WALLACE. The foreign picture was in the news considerably, was it not?

Mr. GRAHAM. Well, I saw rather minor reference to it in the news.

Mr. WALLACE. Then you have this tendency for profit-taking, sell-offs, technical adjustments, following on a relatively high market, do you not?

Mr. GRAHAM. Yes.

Mr. WALLACE. So that would you not say that all these factors entered into what happened to the market on Monday and Tuesday—all these factors had some bearing and you cannot really decide which one had the most bearing. But there are many, many factors influencing the market, including the feeling of the stockholder and whether his ulcers are acting up?

Mr. GRAHAM. That takes a few sentences to answer. In the first place, I have made studies on that subject and have written on the subject, and in the past it was possible to show that a dollar of paid-out earnings had four times the value of a dollar of retained earnings in their effect on the market for the average stock, the exception being stocks that were bought mainly for their long-term prospects and were treated in the market in a separate category. I have a feeling, however, that we are now going through a transition period on the question of the weighting of dividends as against retained earnings. I think the transition is going on fairly rapidly. I cannot tell you just where we stand at this minute, but I will predict that in a few years from now the weight of retained earnings will be better, considerably better, than it had been as against distributed earnings.

The CHAIRMAN. Is that not very largely influenced by the tax structure—the difference between capital gains and normal and sur-tax rates?

Mr. GRAHAM. Well, no, sir; it has not been influenced in the past. On the contrary, the behavior of investors and speculators has been very illogical. In theory they should have preferred retained earnings by successful companies, because those earnings were subject to only one tax to begin with and ultimately only to a capital-gains tax in addition, whereas the distributed earnings were subject to two large taxes immediately. However, the ingrained desire of investors for dividends was so great that it has not yet adjusted itself to the facts of life in the tax structure. It is only beginning now to do so.

The CHAIRMAN. I see. What you mean is they will slowly catch up?

Mr. GRAHAM. They have been extremely slow, and I think extremely unintelligent.

The CHAIRMAN. That is a very understandable statement.

Incidentally, do you think that stock options are largely motivated by the desire to compensate directors by capital gains rather than salaries?

Mr. GRAHAM. Well, sir, it is the desire to compensate officers by capital gains. There is no doubt about that at all. That is the admitted purpose of stock options.

The CHAIRMAN. No, it is not admitted by some of the people that we have had on the stand. They say, "Oh, it is just to inspire loyalty. It has nothing to do with the retaining of earnings." You do not subscribe to that?

Mr. GRAHAM. I do not, sir.

The CHAIRMAN. I agree with your views quite often.

Mr. GRAHAM. Senator, I have no intention of shaping my views with the expectation of your agreement.

The CHAIRMAN. I did not accuse you of that. I was only impressed with your wisdom.

Mr. GRAHAM. Thank you, Senator.

The CHAIRMAN. I used to be a professor. Maybe that is my weakness.

You noticed this morning that Sears Roebuck has found a way to

Because this is very important. If you took the ordinary company

another set doing almost the same thing paying the other rate? If you were in my place and they blamed you for all governmental policies, what would you say to them?

Mr. GRAHAM. I would say that what we are talking about is a marginal part of the total compensation of employees. The Sears, Roebuck case, of course, is not so marginal, because you have had this extraordinary success of the corporation itself. But if you take a typical corporation, which sets aside 10 percent of its earnings for this purpose, the amount of additional gains and income to the employees would represent not an inconsiderable part of their earnings, but at least a minor part of their earnings, and the tax advantage I should think should be accepted philosophically because of the desirable consequences that flow from it.

The CHAIRMAN. Supposing they devoted 50 percent? Supposing they reduced everybody's wages and transferred that to a 50-percent payment into the fund. If you accept the principle, why could you not pay them all on a capital-gains basis?

Mr. GRAHAM. No; the principle cannot be accepted to an unlimited application, and the present act, if I understand it correctly, imposes a limitation on that. The amounts which can be put to the benefit of employees in pension funds and profit-sharing funds I believe are limited to 15 percent of the compensation in each year.

The CHAIRMAN. I wonder if you would give us your views in a broad sense about the economic future of the next few years. Do you see any culmination of a business cycle, or do you subscribe to this view that I read the other day of one of your colleagues in the investment field in New York that a final blowout is necessary?

Mr. GRAHAM. Is not necessary?

The CHAIRMAN. I read into the record an opinion that it always must come, that we have to have this final orgy of buying. I wonder if you would give us an idea of your views for the next few years. How has your mind been working?

Mr. GRAHAM. I will do it with the proviso that these views should not be taken too seriously.

The CHAIRMAN. I do not believe you are infallible.

Mr. GRAHAM. As a matter of fact, I have never specialized in economic forecasting or market forecasting either. My own business has been largely based on the principle that if you can make your results independent of any views as to the future you are that much better off. Nevertheless, as an economist of a sort I have studied this question, and I will be glad to give you my view on the matter.

I think that in all probability we would have some economic recession of an appreciable amount, not necessarily a very serious amount,

the business activity which is accompanied by substantial unemployment. I might say that you could have substantial unemployment with an increase in the gross national product and with apparent prosperity, merely because of the development of productivity. And we are approaching an interesting period, in which, I believe, the intentions of the Government vis-a-vis employment will be tested out. Last year we expected that it would be tested out, but it was not. We were all very pleasantly surprised. I think in the next 5 years such a test will take place, and I think you will see, in all probability, the Government taking action of an important kind to prevent large-scale unemployment.

The CHAIRMAN. You think the Government should add an element of stability to the normally fluctuating economy?

Mr. GRAHAM. The Government will try.

The CHAIRMAN. It will depend upon the wisdom of the Government's policy?

Mr. GRAHAM. Yes; I guess if you judge wisdom in terms of results.

The CHAIRMAN. How do you judge wisdom?

Mr. GRAHAM. I have an a priori test of wisdom in most cases, but I think in economics it is very difficult to tell what is wise until you have been through it.

The CHAIRMAN. I suppose I should not ask you to look back and see what happened in the twenties to see who was wise in administration of government; should I?

Mr. GRAHAM. I think not.

The CHAIRMAN. What is your commodity reserve plan? I understand you have one.

Mr. GRAHAM. I can put it in a very few words. It is related to your question as to the future of our economic system. In the last 20 years I have been identified with a concept of stabilizing the economy by stabilizing the price level of raw materials taken as a whole and not in individual commodities. The objective has been to permit individual commodities to fluctuate but to establish a narrow range of fluctuation and virtual stability for the value of a market basket of the important commodities. I have added to it the very important factor, quite radical, that those commodities would represent a sound backing for our money, because they represent the things that we need and use, and by so doing they would become commodity reserves and would be self-financing in the same way our gold reserves are self-financing. The consequence would be that by stabilizing pretty well the general level of raw materials prices you would add a very important degree of stability to the general economy.

The CHAIRMAN. I do not think I quite understood what the limitation of the commodities involved would be?

Mr. GRAHAM. These are major storable commodities for the most part, those dealt in on commodity exchanges, but not absolutely.

The CHAIRMAN. What agricultural commodities, if any, would it include?

Mr. GRAHAM. They would include such products as wheat, corn, cotton, sugar, and rubber.

The CHAIRMAN. Rubber and cotton would be storable indefinitely?

Mr. GRAHAM. They would be storable indefinitely through rotation.

The CHAIRMAN. I forgot to mention one thing. With regard to Government policy and interference, do you regard tax policy as of major importance in this element of interference in the economic system?

Mr. GRAHAM. It could be. That is to say that one of the means by which the Government could intervene to an important degree in the economy would be through a tax-reduction plan. Another method would be through an increase of its expenditures.

The CHAIRMAN. Did you hear Mr. Eccles yesterday? I am not using him as a model, but simply to save the time of describing the situation, because it does take time. Do you remember his proposal yesterday on taxes?

Mr. GRAHAM. I have forgotten it.

The CHAIRMAN. Well, it does not matter. One other question and I will desist. When you find a special situation and you decide, just for illustration, that you can buy for 10 and it is worth 30, and you take a position, and then you cannot realize it until a lot of other people decide it is worth 30, how is that process brought about—by advertising, or what happens?

Mr. GRAHAM. That is one of the mysteries of our business, and it is a mystery to me as well as to everybody else. We know from experience that eventually the market catches up with value. It realizes it in one way or another.

The CHAIRMAN. But do you do anything to help that? Do you advertise, or what do you do?

Mr. GRAHAM. On the contrary, we try, as a matter of fact, to keep our operations as confidential as we can.

The CHAIRMAN. Even after you buy?

Mr. GRAHAM. Even after we have acquired our shares.

The CHAIRMAN. Why?

Mr. GRAHAM. Basically for the reason that we just are not interested in other people knowing about our business, and we have no interest in endeavoring to persuade people to buy stocks in which we have an ownership. We have never done it and we never will do it.

The CHAIRMAN. That is rather unusual. Since you make your capital gains, a lot of people have got to decide it is worth 30.

Mr. GRAHAM. We have been very fortunate in our experience by finding that people decide that that stock that you mention is worth 30 without the necessity of our doing anything about it on the advertising side. We might conceivably at times intervene in a managerial policy. We might suggest some change in the procedure, but that of course is merely because we are substantial stockholders.

The CHAIRMAN. I think that is about all. There are many other things we could ask you about, I am sure. However, you have other things to do, and the hour is late.

I would like to express the appreciation of the committee for your having taken your time to come down here and volunteer this information. I am sure it is not very pleasant for you to have to talk about these things, but I know no other way we can learn about them. I do appreciate the contribution you have made to our knowledge of the market.

Mr. GRAHAM. If I have made a contribution, I do not mind the discomfort.

The CHAIRMAN. If you have any further suggestions that occur to you which you think we ought to know about we will welcome your writing them to us. Thank you very much for coming.

(Mr. Graham's full prepared statement is as follows:)

STATEMENT OF BENJAMIN GRAHAM, CHAIRMAN OF GRAHAM-NEWMAN CORP.

My name is Benjamin Graham. I live in Scarsdale, N. Y. I am chairman of Graham-Newman Corp., a registered investment company or investment fund. I am also adjunct professor of finance at the Graduate School of Business, Columbia University.

This statement will address itself mainly to three points;

(a) The present level of stock prices from the standpoint of the relationship between price and value.

(b) Causes of the rise in the market since September 1953.

(c) Feasible methods of controlling excessive speculation in the future.

With regard to the present level of stock prices, common stocks look high and are high, but they are not as high as they look. The market level of industrial stock is far above the 1929 high as shown by the Standard & Poor's index of 420 industrials. The present figure is above 300 as compared with the 1929 high of 195. The Dow-Jones industrials average at about 410 is now only moderately above its 1929 high of 382, but the difference would be much larger except for the substitutions made in the average. However, the railroad and utility issues as a whole are well below their 1929 highs.

The true measure of common stock values, of course, is not found by reference to price movements alone, but by price in relation to earnings, dividends, future prospects and, to a small extent, asset values.

Present concepts of common stock valuation turn largely on estimating average future earnings and dividends and applying thereto a suitable capitalization rate or multiplier. Since these elements are all matters of prediction or judgment, there is room for a wide difference of informed opinion as to the proper value for a single stock or group of stocks at any time. Uninformed or speculative opinion will, of course, cover an even wider range as the market swings from the depth of pessimism to the heights of optimism.

As a guide to identifying the present level of stock prices in the light of past experience, I have made 2 sets of comparisons—1 relating to the Dow-Jones industrial average, the other to General Electric, a component of that average and an outstanding blue chip issue. I have related the present prices and the high prices in 1929, 1937, and 1946 to earnings of the preceding year, the preceding 5 years and the preceding 10 years. This information, together with certain other data, appears on the appended table.

The Dow-Jones industrials are now at a lower ratio to their average earnings in the past than they were at their highs in 1929, 1937, and 1946. The same applies to General Electric as an individual stock. It is clear that the issues referred to—which may be considered as reasonably representative of the larger industrials as a whole—have a considerable way to go before reaching the ratios shown at their former tops. It should be pointed out also that high-grade interest rates are now definitely lower than in previous bull markets except for 1946. Lower basic interest rates presumably justify a higher value for each dollar of dividends or earnings.

Much has been made of these relationships as indicating that the market is still on safe ground. However, such comparisons fail to take into account the extent of the subsequent declines from past bull market highs. Since the Dow-Jones average lost 90 percent of its price from 1929 to 1932, it is evident not only that 381 was much too high in 1929, but that the market had entered dangerous ground at a point far below that figure.

I have found it useful to estimate the central value of the Dow-Jones industrial average by the simple method of capitalizing 10-year average earnings at twice the interest rate for high-grade bonds. This technique presupposes that the average past earnings of a group of stocks presents a fair basis for estimating future earnings, but with a conservative bias on the low side. It also assumes that by doubling the capitalization rate presented by high-grade bonds, we allow properly for the differential in imputed risk between good bonds and good stocks. Although this method is open to serious theoretical objections, it has in fact given a reasonably accurate reflection of the central value of industrial common stock averages since 1881. It may be interesting to note that the central value

found by this method in 1929 was 120, which happens to be about the geometric mean between the high of 381 and the subsequent 1932 low of 41. Similarly, the central value in 1936 was 138, higher than in 1938, and this proved to be about the mean between the 1937 high of 194 and the low of 99 in 1938.

This mechanical method applied to the situation in the beginning of 1955 yields a central value for the Dow-Jones industrials of 396, or only slightly under their present value. Such a figure, if reliable, would have to be regarded as rather reassuring. It would indicate that the market in terms of value is no higher now than it was in early 1926, or in early 1936, or late 1945. However, the validity of this central value figure may be open to question if we observe that the 10 years ending in 1954, used to obtain average earnings, did not include any period of real depression. In a sense, therefore, the soundness of this appraisal of central value is bound up with our ability to escape serious business depression in the future as we have in the recent past. It is probably fair to say that the market is not too high today if we have really managed to lick the business cycle.

Although such a development would involve a revolutionary break with the past, I am not prepared to deny its possibility. There is some reason for concluding that in the future serious depressions will be prevented, if not by the natural vitality of American business, then by governmental intervention and possible inflationary moves. The above analysis is by no means unfavorable to the present level of stock prices. However, in reaching my overall conclusion on the subject, I am inclined to hark back to the analysis I made of the stock market in October 1945 at a time when the Dow-Jones average stood at 185. This was published in *The Commercial and Financial Chronicle*, October 18, 1945. I should like to quote intact the summary appearing at the end of that article and state that it expresses my view with respect to the stock market today.

"The three different approaches used in judging the present level of stock prices have yielded diverse indications. From the first, or historical, approach the market appears distinctly on the high side and vulnerable to a substantial setback. Contrariwise, our second category—that of appraisal based on figures and formula—about supports the present level, and suggests that the familiar bull-market enthusiasm might well carry prices considerably higher. Our third approach, through guesses and projections as to future developments, supplies plenty of material but no definite verdict.

"What is the net significance of this analysis for the speculator and the prudent stock investor? Let us define the speculator as one who seeks to profit from market movements, without primary regard to intrinsic values; the prudent stock-investor as one who (a) buys only at prices amply supported by underlying value, and (b) who determinedly reduces his stock holdings when the market enters the speculative phase of a sustained advance.

"This speculative stage, we are convinced, is now at hand. Hence, the principles of the prudent investor will require him to lighten significantly his holdings of common stocks—the precise selling policy to depend, of course, on his individual position and methods. For the stock speculator we can say little that is helpful. We think he has a 50-50 chance—or perhaps a little better—of seeing the market attain substantially higher than present heights, subject to the probability of intervening reactions. But his chance of eventually holding on to the profits he makes beyond the current level, we should term no better than in former bull markets—and that is none too good."

As to reasons for the market rise since September 1953, in general I agree with the answers by President Funston, of the New York Stock Exchange, to question 1 of the committee's questionnaire. However, I should like to emphasize more than he did the role of investment and speculative sentiment in determining the wide variations in stock market prices.

In my view, the fundamental reason for the rise was the swing from doubt to confidence—from emphasis on the risks in common stocks to the emphasis on the opportunities in common stocks.

There has been no change of importance in the earnings of the Dow-Jones industrial average since 1949. Actually, however, earnings of most secondary companies fell a great deal in 1953-54 from the levels of the previous 5 years. But prior to 1954, the public was expecting a substantial setback and was braced for a large falling off in earnings when business turned down after the middle of 1953. It was the mildness of the shrinkage—especially in gross national product and disposable incomes—that reversed the tide of sentiment and gave currency to the view that we no longer have to fear deep depressions.

This change in sentiment produced a change in the public's valuation of stocks, especially in what it considered suitable multipliers of current earnings. In

effect, the multiplier advanced from about 8 for the Dow-Jones industrials in 1948-50 to 10 in 1953, and to a current 14, which is slightly less than the 1936-40 average.

My studies have led to the conclusion that sentiment alone, not supported by any visible change in value, will produce a swing on the order of 100 to 250 or 100 to 300 in price. It is interesting to note that while American Telephone & Telegraph has paid a uniform dividend of \$9 since 1922, and while its earnings have fluctuated comparatively little, its price advanced from 115 in 1922 to 310 in 1929, declined to 70 in 1932, and since then it has fluctuated between lows of about 110 and highs of about 200.

Among the secondary companies, the present situation is more complicated. Prices were very low as against earnings prior to 1953, but many of these companies had poor earnings results in 1953-54. The price behavior of this large group lagged behind the blue-chip advance until July 1954. Recently the rise in secondary issues has more than kept pace with that of the leaders. Bargains are fast disappearing and there are numerous instances of overspeculation in this field. On the whole, however, the typical second-grade stock appears less overvalued today than it was in early 1946.

Regarding feasible ways of controlling undue speculation in the future, I believe the committee should consider carefully and cautiously whether any plan of control is feasible. Speculation has not gone too far as yet, but there may be a grave danger that it will do so. Assuming that measures could be found that are useful and feasible, it would be wise to agree to such measures in advance

arrangement would have the desired effect of increasing the supply of common stocks at a time when such increase is deemed necessary. From the standpoint of the Treasury, the result might well be that a larger revenue would be realized, in spite of the reduced tax rate, because of the inducement to sell locked-up shares. Whatever its effect on the level of stock prices, bona fide investors could not be harmed by such a concession, even if it was for a limited period.

