

by Benjamin Graham

The Future Of Common Stocks

The following article is taken with slight revisions, from a paper prepared for delivery before a group of corporate pension executives in June 1974. The last half of the article aims to answer specific questions raised in connection with the address.

Before I came down to Wall Street in 1914 the future of the stock market had already been forecast—once for all—in the famous dictum of J.P. Morgan the elder: “It will fluctuate.” It is a safe prediction for me to make that, in future years as in the past, common stocks will advance too far and decline too far, and that investors like

stood at 90 in mid-1924, advanced to 381 by September 1929, from which high estate it collapsed—as I remember only too well—to an ignominious low of 41 in 1932.

On that date the market's level was the lowest it had registered for more than 30 years. For both General Electric and for the Dow, the highpoint of 1929 was not to be regained for 25 years.

Here was a striking example of the calamity that can ensue when reasoning that is entirely sound when applied to past conditions is blindly followed long after the relevant conditions have changed. What was true of the attractiveness of equity investments when the Dow stood at 90 was doubtful when the level had advanced to 200 and was com-

I think the future of equities will be roughly the same as their past; in particular, common-stock purchases will prove satisfactory when made at appropriate price levels. It may be objected that is far too cursory and superficial a conclusion; that it

failed to take into account that AAA bonds were then yielding 7.3 per cent and had been above 8.5 per cent not long before. (As it happened they were destined to surpass the 8.5 per cent rate in 1974.) In 1964 the AAA rate

Standard and Poor's 500 (S&P 500)? b) Even if the averages may not be at an attractive level, can investors expect satisfactory results by choosing individual issues that are undoubtedly worth at least what they are selling for? The distinction I have just made is clearly relevant to the present situation because of the recent advent of the "two-tiered market," resulting from the massive preference of institutions for large, high-growth companies. This in turn has brought about disparities in the P/E ratios for issues of investment character—differences as high as ten to one—that have been unexampled in all my experience, except perhaps at the height of the 1929 madness with its celebrated "blue-chip" issues.

My own answer to the double question just posed is as follows: As to the present level of the averages—say, 850 for the Dow and 93 for the S&P 500—the factor most directly affecting current security values and prices is most assuredly the high rate of interest now established for the entire spectrum of bond and note issues. One of the glaring defects of institutional attitudes has been that as recently as early 1973—when they supported the record price level of the averages—they

viewing the matter from another angle, I should want the Dow or Standard and Poor's to return an earnings yield of at least four-thirds that on AAA bonds to give them competitive attractiveness with bond investments. This would mean an earnings yield of 11 per cent, and it brings us smack back to the valuation of about 775 for the Dow that we found by comparing the early 1974 situation with that ten years before.

Furthermore, my calculations of growth rates over the past 25 years give an annual figure for the Dow of only 4-1/2 per cent. If this rate were to continue in the future, the expectable combination of growth plus dividends would produce less than a ten per cent overall return, consisting of four and one-half per cent growth plus a compounded dividend yield of, say, five per cent. This second calculation would make my current 775 valuation for the Dow appear over generous. Incidentally, a corresponding approach to the S&P 500 Index gives a somewhat less favorable result than for the Dow at current levels. The S&P 425 and 500 indexes have both grown at about a five per cent rate over the past 25 years. But this advantage appears to be offset by their higher P/E ratios compared with the DJIA. *(continued next page)*

coincided with reality. This is the hypothesis of "the efficient market." In its extreme form it makes two declarations: 1) The price of nearly every stock at nearly all times reflects whatever is knowable about the company's affairs; hence no consistent profits can be made by seeking out and using additional information, including that held by "insiders." 2) Because the market has complete or at least adequate information about each issue, the prices it registers are therefore "correct," "reasonable" or "appropriate." This would imply that it is fruitless, or at least insufficiently rewarding, for security analysts to look for discrepancies between price and value.

I have no particular quarrel with declaration one, though assuredly there are times when a researcher may unearth significant information about a stock, not generally known and reflected in the price. But I deny emphatically that because the market has all the information it needs to establish a correct price the prices it actually registers are in fact correct. Take as my example a fine company such as Avon Products. How can it make sense to say that its price of 140 was "correct" in 1973 and that its price of 32 was also "correct" in 1974? Could anything have happened—outside of stock-market psychology—to reduce the value of that enterprise by 77 per cent or nearly six billion dollars? The market may have had all the information it needed about Avon; what it has lacked is the right kind of judgment in evaluating its knowledge.

Descartes summed up the matter more than three centuries ago, when he wrote in his *Discours de la Méthode*: "Ce n'est pas assez d'avoir l'esprit bon, mais le principal est de l'appliquer bien." In English: "It is not enough to have a good intelligence"—and I add, "enough information"—"the principal thing is to apply it well."

I can assure the reader that among the 500-odd NYSE issues selling below seven times earnings today, there are plenty to be found for which the prices are not "correct" ones, in any meaningful sense of the term. They are clearly worth more

question should even suggest itself. It seems only yesterday that everyone was saying that stocks, even at high prices, were definitely preferable to bonds because equities carried an important measure of protection against future inflation.

But it should be admitted that not only recently, but for many years and perhaps decades past, equities as a whole have failed to provide the protection against inflation that was expected from them. I refer to the natural surmise that a higher general price level would produce a higher value for business assets and hence correspondingly higher profit rates in relation to original costs. This has not been borne out by the statistics. The rate of return on book equities as a whole—much understated as they must be in terms of reproduction costs—has at best held constant at around the 10 to 12 level. If anything, it has declined from the 1948 to 1953 period when the Dow was selling at only seven times earnings.

It is true of course that the earnings on the DJIA and the S&P 425 Industrials have tripled from 1947-1951 to 1969-1973. But in the same period the book value of both indexes has quadrupled. Hence we may say that all the increase in post-war earnings may be ascribed to the simple building up of net worth by the reinvestment of undistributed profits, and none of it to the more than doubling of the general price level in those 28 years. In other words, inflation as such has not helped common-stock earnings.

This is a good reason, and there are others, not to be enthusiastic about equities at every market level. This caution is part of my long-held investment philosophy. But what about the current situation? Should inflation prospects dissuade an investor from buying strong companies on a 15 per cent earnings return? My answer would be "no."

What are the investors' real choices—whether as an institution or as an individual? He can elect to keep his money in short-term obligations, at a good yield, expecting that future inflation will eventually produce lower market levels for all kinds of stocks,

that institutional investment does not appear to have contributed either stability or rationality to stock prices—American Airlines. The Standard and Poor's Monthly Stock Guide shows the holdings of this and other concerns by about 2000 insurance companies and investment funds, though not by banks and their trust departments. In 1970

A modification of my "fixed fund" suggestion would leave more leeway for the work of financial analysts. This modification would base equity portfolios initially on an actual or presumed imitation of the S&P Index, or—more simply—the DJIA. The operating manager or decision maker would be permitted to make substitutions

... investors questioning the standard fees must of them are paying financial institutions to handle these investments. The standard fees... S&P Index... DJIA... investors questioning the standard fees must of them are paying financial institutions to handle these investments. The standard fees... S&P Index... DJIA... investors questioning the standard fees must of them are paying financial institutions to handle these investments. The standard fees... S&P Index... DJIA...

seasoned liquidity in other alternatives? There are various answers to this query. The first is, of course, that the standard fees... S&P Index... DJIA... investors questioning the standard fees must of them are paying financial institutions to handle these investments. The standard fees... S&P Index... DJIA... investors questioning the standard fees must of them are paying financial institutions to handle these investments. The standard fees... S&P Index... DJIA...

An Indexed Economy and a Managed Economy

What are the implications of an "indexed economy"? I have already stated views of inflation's effect on equities. I feel that an indexed economy—in the full sense of Milton Friedman's recent proposal—is too impractical and remote to warrant serious discussion here. We have it in part in cost-of-living adjustments in union contracts, including to some degree pension plans. There was once an indexed bond issue, put out by Remington-Rand Corporation at the instance of Irving Fisher (then a director), which varied the coupon payments with the cost-of-living index. Conceivably—though not probably—that idea may be revived. However, we have a growing number of debt obligations that vary the coupon rates with changes in current bond yields or bank lending rates. The floodgates seem to be opening here with the offering of \$650 million of Citicorp Floating Rate Notes due in 1989.

We have all become so familiar with a more or less managed economy since the Roosevelt era beginning 40 years ago, that we should be quite inured to its effect on everything including equities. Basically, the intervention of government in the economy has had two opposite effects on common stock values. It has benefited them greatly through its virtual guarantee against the money panics and large-scale depressions of the pre-1935 decades. But it was hurt profits through the maze of restrictions and the numerous other burdens it has imposed on business operations. Up to now the net effect seems to have been favorable to equity values—or at least to their prices. This can be seen at first glance by comparing the Dow or S&P Index lines on a chart before and after 1949. In such comparisons the price declines in 1969 to 70 and 1973 to 74 appear like minor downturns in a massive upward sweep.

Experience suggests therefore that the various threats to equities implied in the last question are not very different from other obstacles that common stocks have faced and surmounted in the past. My prediction is that stocks will surmount them in the future.

But I cannot leave my subject without alluding to another menace to equity values not touched on in my terms of reference. This is the loss of public

Oliver Goldsmith both wrote that, "History is little more than a register of the crimes, the follies and the misfortunes of mankind." This phrase applies

to Wall Street history in the 1968 to 73 period, but with more emphasis to be given to its crimes and follies than to its misfortunes. I have not time even to list all the glaring categories of imprudent and inefficient business practice, of shabby and shoddy ethics perpetrated by financial houses and individuals, without the excuse of poverty or ignorance to palliate their misdemeanors. Just one incredible example: Did anyone ever hear of a whole industry almost going bankrupt because it was accepting more business than it could handle? That is what happened to our proud NYSE community in 1969, with their back-office mix ups, missing securities, etc. The abuses in the financial practices of many corporations during the same period paint the same melancholy picture.

It may take many years—and new legislation—for public confidence in Wall Street to be restored, and in the meantime stock prices may languish. But I should think the true investor would be pleased, rather than discouraged, at the prospect of investing his new savings on very satisfactory terms. To pension-fund managers, especially with large and annual increments to invest, the prospects are especially inviting. Could they have imagined five years ago that they would be able to buy AAA bonds on an eight to nine per cent basis, and the shares of sound companies on a 15 per cent or better earnings yield? The opportunities available today afford a more promising investment approach than the recent absurd idea of aiming at, say, 25 per cent market appreciation by shifting equities among institutions at constantly higher price levels—a bootstrap operation if there ever was one.

Let me close with a quotation from Virgil, my favorite poet. It is inscribed beneath a large picture panel at the head of the grand staircase of the Department of Agriculture building in Washington. It reads:

"O fortunati nimium... (etc.) Agricolaе!"

Virgil addressed this apostrophe to the Roman farmers of his day, but I shall direct it at the common-stock buyers of this and future years:

"O enviously fortunate Investors, if only you realized your current advantages!" ■

Copyright of Financial Analysts Journal is the property of CFA Institute and its content may not be copied or emailed to multiple sites or posted to a listserv without the copyright holder's express written permission. However, users may print, download, or email articles for individual use.