

The Importance of Studying History

Many outstanding investors have been fanatical students of history because history teaches you to place events into perspective, to understand that industries boom and fade; cycle's repeat and human folly is never-ending. *Bill Gross* of *Pimco* (The Fixed Income Money Manager) said that the history books in his office have been a better guide to making money in the bond markets than any financial analysis. *Seth Klarman*, value investor extraordinaire, has endowed a history chair. *Warren Buffett* sat for hours in the Columbia University Library reading newspapers—including the ads--from the 1930s to gain a sense of the Great Depression.

Jim Rogers, the peripatetic investor, speaks about the value of studying history as an investor in the foreword to *Financial Reckoning Day Fallout* (2009) by William Bonner and Addison Wiggin. Jim Rogers: "The only other way (besides visiting countries around the world yourself) to know what is going on is to study history. When I teach or speak at universities, young people always ask me: "I want to be successful and travel around the world; what should I study?"

I always tell them the same thing: "Study history."

And they always look at me very perplexed and say, "What are you talking about....what about economics, what about marketing?"

"If you want to be successful, "I always say, "You've got to understand history. You will see how the world his always changing. You will see how a lot of the things we see today have happened before. Believe it or not, the stock market didn't begin the day you graduated from school. The stock market's been around for centuries. All markets have. These things have happened before. And will happen again."

Alan Greenspan went on record before he left his post at the Federal Reserve saying he had never seen a bubble before. I know in his adult lifetime there have been several bubbles. There was a bubble in the late 1960s in the U.S. stock market. There was the oil bubble (in the late 1970s). The gold bubble (in the 1980s). The (stock) bubble in Kuwait. The bubble in Japan. The bubble in real estate in Texas. So what is he talking about? Had he not seen those things, he could have at least read some histories...all these things and others have been written about repeatedly.

Another lesson to learn from studying past market cycles is about market psychology. As the late Peter Bernstein observed, "In their calmer moments, investors recognize their inability to know what the future holds. In moments of extreme panic or enthusiasm, however, they become remarkably bold in their predictions: they act as though uncertainty has vanished and the outcome is beyond doubt. Reality is abruptly transformed into that hypothetical future where the outcome is known. These are rare occasions, but they are unforgettable: major tops and bottoms in markets are defined by this switch from doubt to certainty."

The venerable Ben Graham argued that an investor should "have an adequate idea of stock market history, in terms, particularly, of the major fluctuations. With this background he may be in a position to form some worthwhile judgment of the attractiveness or dangers...of the market."

John Templeton in the book, *The Templeton Way* by Lauren C. Templeton, said that understanding the history of the market is a huge asset for investing. This is the case not because events repeat themselves exactly but because patterns of events and the way the people who make up the market react can be typical and predictable. History shows that crises always appear worse at the outset and that all panics are subdued in time. When panics die down, stock prices rise.

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Benjamin Graham interview in *An Hour with Mr. Graham* by Hartman L. Butler, Jr. from the book, *Benjamin Graham Building a Profession*, Ed. By Jason Zweig

Hartman L. Butler, Jr. (“HB”): Mr. Graham, what *advice* would you give to a young man or woman coming along now who wants to be a security analyst and a Chartered Financial Analyst?

Graham: I would tell them to study the past record of the stock market, study their own capabilities, and find out whether they can identify an approach to investment that they feel would be satisfactory to their own case. And if they have done that, pursue that without any reference to what other people do or think or say. Stick to their own methods. That is what we did with our own business (*Graham-Newman Corp.*). We never followed the crowd, and I think that is favorable for the young analyst. If he or she reads the Intelligent Investor—which I feel would be more useful than Security Analysis of the two books—and selects from what we say some approach which one thinks would be profitable, then I way that one should do this and stick to it.

I had a nephew who started in Wall Street a number of years ago and came to me for some advice. I said to him, “Dick, I have some practical advice to give you, which is this. You can buy closed-end investment companies at 15% discounts on an average. Get your friends to put ‘x’ amount of dollars a month in these closed-end companies at discounts and you will start ahead of the game and you will make out all right.”

.....They used to say about the Bourbons that they forgot nothing and they learned nothing, and (what) I will say about the Wall Street people, typically, is that **they learn nothing, and they forget everything**. I have no confidence whatever in the future behavior of the Wall Street people. I think this business of greed—the excessive hopes and fears and so on—will be with us as long as there will be people.

....There are two requirements for success in Wall Street. One, you have to think correctly; and secondly, you have to think independently.

John Schultz (Forbes Columnist, 1959 – 1976) laid down this simple truth, “The stock market is rarely ‘sensible’ in commonsense terms. Stock prices have always gone up or down in response to rationalizations rather than reasons, and to levels that, in retrospect, appeared to be unmistakably excessive and irrational.”

The following articles will give you a perspective on how to think about prices versus stock market valuation.

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When Ben Graham’s three part series, “Is American Business Worth More Dead than Alive?” was published in *Forbes* magazine, America, and indeed the world, had gone through the punishing stock market crashes of 1929 and 1930 and was in the depths of the Great Depression. Though the Depression continued until nearly the end of the decade, Graham’s articles signaled to investors that it was now safe to

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return to the stock market. At that time, Graham pointed out, more than 30 percent of the companies listed on the NYSE were selling at less than what they would be worth if they were broken up and sold. In this series of articles, Graham took corporate management to task for taking advantage of investors and putting their own welfare ahead of that of the shareholders.

FORBES published a series of three articles by Benjamin Graham written at the bottom of the Great Crash. This is the first, Are Corporations Milking Their Owners?

At its worst level, the Dow dropped to 40.56 in July, 1932. That is a drop of **89%**.



Inflated Treasuries and Deflated Stockholders (Article 1) by **Benjamin Graham** on June 01, 1932

SELLING AMERICA FOR 50 CENTS ON THE DOLLAR

More than one-third of all industrial stocks are selling in the open market for less than the companies' net quick assets¹.

Scores of common stocks are selling for less than their pro-rata cash in the company's treasury.

Corporations who are good risks for commercial loans do not need to borrow. They still have large unused cash balances furnished by their stockholders in the New Era days.

Corporation treasurers sleep soundly while stockholders walk the floor.

Banks no longer lend directly to big corporations. They lend to stockholders who have over-financed the companies through rights to buy stock at inflated prices.

¹ **Net Quick Assets:** cash, marketable securities, and accounts receivable minus current liabilities. Inventory is excluded in order to determine whether, if sales evaporate, a business could meet its current liabilities with the readily convertible (to cash) assets on hand.

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What the responsibilities of the corporation, its directors, its stockholders? What is the proper way out? Are stockholders part-owners of their companies, or just suckers?

Shall companies reverse the 1929 method—give the stockholder rights to sell back the stock he bought, reduce capitalization, and equalize the burden between the corporations and the stockholder?

If market quotations discount huge cash reserves due to probable long continued future losses then should not the stockholder demand liquidation before his money is thus dissipated?

Are corporation playing fair with their stockholders?

Suppose you were the owner of a large manufacturing business. Like many others, you lost money in 1931; the immediate prospects are not encouraging; you feel pessimistic and willing to sell out--*cheap*. A prospective purchaser asks you for your statement. You show him a very healthy balance sheet, indeed. It shapes up something like this:

Cash and U.S. Gov. Bonds	\$8,500,000
Receivables and Merchandise	\$15,000,000
Factories, Real Estate, etc	+ \$14,000,000
	\$37,500,000
Less owing for current accts	<u>-\$1,300,000</u>
Net Worth	\$36,200,000

The purchaser looks it over casually, and then makes you a bid of \$5,000,000 for your business--the cash, Liberty Bonds and everything else included. **Would you sell?** The question seems like a joke, we admit. No one in his right mind would exchange 8 1-2 millions in cash for five million dollars, to say nothing of the \$28 millions more in other assets. But preposterous as such a transaction sounds, the many owners of *White Motors* stock who sold out between \$7 and \$8 per share did that very thing--or as close to it as they could come.

The figures given above represent *White Motors* condition on December 31st last year. At \$7 3/8 per share, the low price, the company's 650,000 shares were selling for \$4,800,000--about 60 per cent of the cash and equivalent alone, and *only one-fifth of the net quick assets*. There were no capital obligations ahead of the common stock, and the only liabilities were those shown above for current accounts payable.

The spectacle of a large and old established company selling in the market for such a small fraction of its quick assets is undoubtedly a startling one. But the picture becomes more impressive when we observe that there are literally dozens of other companies which also have a **quoted value less than their cash in bank**. And more significant still is the fact that an amazingly large percentage of all industrial companies are selling for less than their quick assets alone--leaving out their plant and other fixed assets entirely.

This means that a great number of American businesses are quoted in **liquidating value**; that in the best recent judgment of Wall Street, *these businesses are worth more dead than alive*.

For most industrial companies should bring, in orderly liquidation, at least as much as their quick assets alone. Admitting that the factories, real estate, etc. could not fetch anywhere near their carrying price, they should still realize enough to make up the shrinkage in the proceeds of the receivables and merchandise below book figures. If this is not a reasonable assumption there must be something radically wrong about the accounting methods of our large corporations.

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A study made at the *Columbia University School of Business* under the writer's direction, covering some 600 industrial companies listed on the New York Stock Exchange, disclosed that over 200 of them--or fully one out of three--have been selling at less than their net quick assets. Over fifty of them have sold for less than their cash and marketable securities alone. In the Appendix at the end of this document is given a partial list, comprising the more representative companies in the latter category. What is the meaning of this situation? The experienced financier is likely to answer that stocks always sell at unduly low prices after a boom collapses. As the president of the *New York Stock Exchange* testified, "in times like these frightened people give the United States of ours away." Or stated differently, it happens because those with enterprise haven't the money, and those with money haven't the enterprise, to buy stocks when they are cheap. Should we not find the same phenomenon existing in previous bear markets--for example, in 1921?

The facts are quite otherwise, however. **Stocks sold at low prices in the severe post-war depression, but very few of them could be bought on the Stock Exchange for less than quick assets, and not one for less than the company's available cash.**

The comparative figures for both periods, covering representative companies, are little short of astounding, especially when it is noted that they showed no materially poorer operating results in 1931 than in 1921. Today, these companies are selling in the aggregate for half their working capital; ten years ago working capital was only half the bottom prices. With respect to cash assets alone, present prices are relatively *six times* lower than in 1921.

We must recognize, therefore, that the situation existing today is not typical of all bear markets. Broadly speaking, it is new and unprecedented. It is a strange, ironical aftermath of the "new era" madness of 1921-1929. It reflects the extraordinary results of profound but little understood changes in the financial attitude of the people, and the financial fabric of the country.

Two plausible and seemingly innocent ideas, the first, that good stocks are good investments; the second, that values depend on earning power--were distorted and exploited into a frenzied financial gospel which ended by converting all our investors into speculators, by making our corporations rich and their stockholders poor, by reversing the relative importance of commercial loans and Wall Street loans, by producing topsy-turvy accounting policies and wholly irrational standards of value--and in no small measure was responsible for the paradoxical depression in which we find ourselves submerged.

Behind the simple fact that a great many stocks are selling for much less than their working capital lies a complex of causes, results and implications. The remainder of this article will deal with the causes of the present unique situation, while other ramified aspects will be developed in succeeding articles.

The current contrast between market prices and liquid assets is accounted for in large measure by the huge flood of new cash which stockholders in recent years have poured into the treasuries of their corporations by the exercise of **subscription rights**. This phenomenon, which was one of the distinguishing features of the 1928-1929 bull market, had two quite opposite consequences. On the one hand the additional funds received greatly improved the companies' cash and their working capital position; on the other hand the additional shares issued greatly increased the supply of stocks, weakened their technical position, and intensified their market decline. **The same circumstance, therefore, served both to improve the values behind a stock and to depress the price.** (*This circumstance occurs today with "Busted Initial Public Offerings or IPOs" when after raising substantial amounts of cash from investors when going public, the company has a hiccup in operations and/or markets turn down and the IPO's price declines significantly*).

It is doubtful, however, that the declines would have gone to the current extraordinary lengths if during the last decade investors had not lost the habit of looking at balance sheets. Much of the past year's selling of stocks has been due to fear rather than necessity. If these timid holders were thoroughly aware that they were selling out at only a fraction of the liquid assets behind their shares, many of them might have acted differently.

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But since value has come to be associated exclusively with earning power, the stockholder no longer pays any attention to what his company owns--not even its money in the bank.

It is undoubtedly true that the old-time investor laid too much stress upon book values and too little upon what the property could earn. It was a salutary step to ignore the figures at which the plants were carried on the books, unless they showed a commensurate earning power. (*The asset values should earn at least their cost of capital.*)

But like most sound ideas in Wall Street, this one was carried too far. It resulted in excessive emphasis being laid on the reported earnings--which might only be temporary or even deceptive--and in a complete eclipse of what had always been regarded as a vital factor in security values, namely the company's working capital position.

Businesses have come to be valued in Wall Street on an entirely different basis from that applied to private enterprise. In good times the prices paid on the Stock Exchange were fantastically high, judged by ordinary business standards; and now, by the law of compensation, the assets of these same companies are suffering an equally fantastic undervaluation.

A third reason that stocks now sell below their liquid asset value is the fear of future operating losses. Many readers will assert that this is the overshadowing cause of the present low market level. These quotations reflect not only the absence of earning power, but the existence of "losing power" which threatened to **dissipate the working capital behind the shares today**.

Is it true that one out of three American businesses is destined to continue losing money until the stockholders have no equity remaining? This is what the stock market says in no uncertain terms.

In all probability it is wrong, as it always has been wrong in its major judgments of the future. The logic of Wall Street is proverbially weak. It is hardly consistent, for example, to despair of the railroads because the trucks are going to take most of their business, and at the same time to be so despondent over the truck industry as to give away shares in its largest units for a small fraction of their liquid capital alone.

But since even in prosperous times many undertakings fall by the wayside, it is certain that the number of such ill-starred ventures must now be greatly increased. The weakly situated business will find it difficult, perhaps impossible, to survive. Hence in a number of individual cases the market's prophecy of extinction will be borne out. Nevertheless, there must still be a basic error in this wholesale dumping of shares at a small fraction of liquidating value.

If a business is doomed to lose money, why continue it? If its future is so hopeless that it is worth much less as a going concern than if it were wound up, **why not wind it up?**

Surely the owners of a business have a better alternative than to give its present cash away; for fear that it is later going to be dissipated. We are back to the contrast between the *White Motors* stockholder and the individual factory owner, with which we started our article.

The issue is merely one of simple logic. Either *White Motors* is worth more as a going concern than its cash in bank, or it is not. If it is worth more, the stockholder is foolish to sell out for much less than this cash, unless he is compelled to do so. If it isn't, the business should be liquidated and each stockholder paid out his share of the cash plus whatever the other assets will bring.

Evidently stockholders have forgotten more than to look at balance sheets. They have forgotten also that they are *owners of a business* and not merely owners of a quotation on the stock ticker. It is time, and high time, that the millions of American shareholders turned their eyes from the daily market reports long enough to give some

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attention to the enterprises themselves of which they are the proprietors, and which exist for their benefit and at their pleasure.

The supervision of these businesses must, of course, be delegated to directors and their operation to paid officials. But whether the owners' money should be dissipated by operating losses, and whether it should be tied up unproductively in excessive cash balances while they themselves are in dire need of funds, are questions of major policy which each stockholder must ponder and decide for himself.

These are not management problems; these are **ownership problems**. On these questions the management's opinion may be weighty but it is not controlling.

What stockholders need today is not alone to become "balance sheet conscious," but more than that, to become "ownership conscious." If they realized their rights as business owners, **we would not have before us the insane spectacle of treasuries bloated with cash and their proprietors in a wild scramble to give away their interests on any terms they can get.** Perhaps the corporation itself buys back the shares they throw out of irony; we see the stockholders' pitifully inadequate payment made to them *with their own cash*. (*Shareholders were desperately selling shares at prices below the net cash owned by their own companies to raise funds rather than have their management payout excess cash to them!*)

The waggish barber of the legend painted on his sign:

What, do you think --?

We shave you for nothing and give you a drink!

That, without the saving comma, might well be blazoned as the motto of the stock seller of to-day, who hands over his share in inventories and receivables for less than nothing, and throws in real estate, buildings, machinery and what-not as a lagniappe or trading stamp.

The humor of the situation could be exploited further, but the need is not for witticism but for a straightforward presentation of the vitally important issues that face stockholders, managements, and bankers.

Should Rich Corporations Return Stockholders' Cash? (Article 2) by **Benjamin Graham**,

June 15, 1932

FORBES presents herewith the second in this spectacular series of articles on the maladjustment between finances of corporations and their owners.

In our [first article](#), the present disparity between the cash asset position of many companies and the price of their stocks was ascribed in part to the huge issues of additional shares which transferred money from stockholders' pockets into corporate treasuries. According to the *New York Stock Exchange's* compilation, the funds so absorbed by listed companies alone, between 1926 and 1930, amounted to no less than five billion dollars.

The total sale of corporate securities to the public in this period exceeded twenty-nine billions, of which a small part perhaps was turned over to private individuals, but the major portion was paid into the businesses, and either expended in plant additions or added to working capital.

It must not be forgotten that other enormous sums have also been accumulated in the form of undistributed earnings. After this tremendous influx of cash it is no wonder that corporate treasuries are still bulging, despite all the money that has been spent, or lost, or paid in dividends.

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But what of the people who supplied the bulk of this money; the investor who bought new offerings; the stockholder who subscribed to additional shares? They are not rolling in wealth to-day, nor burdened with a plethora of idle funds. They stripped themselves of cash to enrich their corporations' treasuries; they borrowed heavily in order that these corporations might be able to pay off their debts.

The grotesque result is that the people who own these rich American businesses are themselves poor, that the typical stockholder is weighed down with financial problems while his corporation wallows in cash. *Treasurers are sleeping soundly these nights, while their stockholders walk the floor in worried desperation.*

True, the public has more stock certificates to represent the new shares which it paid for, and each certificate carries ownership in the cash held by the company. But somehow this doesn't help the stockholder very much. He can't borrow from the bank, or margin his existing loans, on the basis of the cash behind his shares. If he wants to sell he must accept the verdict of the ticker. If he should appeal to the officers of the company for a little of his own cash, they would probably wave him away with a pitying smile. Or perhaps they may be charitable enough to buy his stock back at the current market price--which means a small fraction of its fair value.

Meanwhile, the prodigal transfer of cash by the public to corporations in the new-era days has not only made infinite trouble for the security holder, but it has seriously demoralized our banking structure. Commercial loans have always been the heart and the bulwark of our credit system. Loans on securities have been secondary in volume and drastically subordinated in their standing.

But what have the corporations and the public done between them in recent years? They have paid off the cream of the country's commercial borrowings and substituted security loans in their place. Instead of lending directly to big business, the banks have been forced to lend to their stockholders against pledges of their shares, or to purchase securities on their own account.

Some idea of the extent of this shift of banking accommodation can be gleaned from the comparative figures of the reporting Member Banks of the Federal Reserve System:

Change in the Composition of Banking Resources--1920-1932 (In Millions)

	Commercial Loans	Loans on Securities	Total
Oct., 1920	\$9,741	\$7,451	\$17,192
May, 1932	\$6,779	\$12,498	\$19,277

The whole development has proved most disastrous to stockholders and most embarrassing to the banks. **The best form of borrowing has been replaced by the worst.** The safety of the loans, and to some extent the solvency of the banks making them, has been placed at the mercy of stock market fluctuations, instead of resting on the financial strength of our large corporations.

Thousands of stockholders--*the owners of their company's business*--find themselves today in an absurd position. The market value of their stock may be, for instance, only ten \$ millions, its borrowing value at best eight millions. Yet not only may the company have fifteen \$ millions in the treasury, but it could borrow large additional amounts against its many millions of other quick assets. **If the owners of the business really controlled such a company, they could draw out not only the fifteen millions in cash but another five millions from bank loans, and still have a business in sound condition with substantial equities.** (*Graham illustrates the absurd prices—the value of a company can not be worth less than what a lender would be willing to lend against it.*)

The very banks which hesitate to lend ten dollars per share on a stock would probably be glad to lend the company itself enough to enable it to pay out fifteen dollars per share to the stockholders.

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Consider on the one hand a typical standard business with its enormous cash and credit resources; and then consider the people who own this business and who poured millions into its treasury, unable to realize or borrow more than a miserable fraction of the cash value of their own property.

This is the result of undue generosity by stockholders towards their corporations in good times--and of undue parsimony by the corporations towards the stockholders today.

The banks may seem like co-villains in such a situation, but in fact they, too, are victims of circumstance--handicapped by a soundly conceived system which is out of harmony with the actualities of the present situation. They have been educated, and they are directed, to give first consideration to commercial loans.

But who now are the commercial borrowers? Strong corporations with good past (if not recent) records, requiring money for seasonal requirements? Not at all. Such corporations don't need the banks; they raised all the money they could use from the stockholders when the raising was good. (*The 1922-1928 Bull Market.*)

There are left three classes of bank borrowers: (a) Small or privately owned enterprises--maybe good, maybe not; (b) Large industrial corporations with poor records even in the late prosperity; (c) Railroads and utilities needing temporary (?) accommodation, to be paid off by permanent financing--a fruitful source of trouble for all concerned.

It must be recognized, therefore, that the replacement of good commercial loans by vulnerable loans on stock collateral has been harmful alike to our banking system and to the vast army of stockholders. Is there a remedy for this condition? There certainly is, and a very simple one.

Let corporations return to their stockholders the surplus cash holdings not needed for the normal conduct of their business.

The immediate result of such a movement would be to benefit the individual stockholder by placing funds in his hands to meet his urgent needs or to use as he sees fit. The secondary result would be to improve the price of the shares affected and the stock market generally, as the public is made aware in this forceful fashion of the enormous cash values behind American business today. The third result would be to improve the balance of our banking structure, making for a larger proportion of sound commercial loans (especially when business again expands) and permitting the repayment of a certain quantity of frozen security loans.

How should this return of cash be accomplished? Preferably by the direct retracing of the financial steps which have led to the present predicament. Instead of rights to buy stocks, let companies offer their stockholders the right to sell stock in a fixed proportion and at a stated price. This price should be above the current market but in most cases below the net quick assets per share and therefore far below the book value. From the corporation's point of view the result of such repurchases at a discount will be an increase both in the surplus and in the net current assets per share of stock remaining.

A few corporations have followed this procedure, one of the earliest being *Simms Petroleum*. Recently *Hamilton Woolen* has offered to buy one-sixth of the outstanding shares pro rata at \$65, which is about equal to the net quick assets and considerably above the previous market price. This represents the return of a large portion of the new money paid in by stockholders in 1929.

Other companies have returned surplus cash to stockholders in the form of special distributions without cancellation of stock. *Peerless Motors* is a case in point, and another is *Eureka Vacuum Cleaner*, which accompanied its action by a statement recommending a similar move to other corporations as an aid in relieving the depression. A few companies, notably the *Standard Oil* pipe lines and some New England mills, **have returned surplus cash capital to shareholders by reducing the par value of the stock.**

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All these methods accomplish the same purpose and the differences between them are largely technical. The repurchase of shares pro rata, which we recommend, is more practical in most cases than a reduction in par value, and it has certain bookkeeping advantages over a straight special dividend. Furthermore, as a direct reversal of the process of taking money from stockholders by issuing subscription rights, this method undoubtedly has a strong logical appeal.

A sizable number of enterprises have been employing surplus funds to acquire stock by purchase in the open market. This also represents a transfer of corporate funds to stockholders. It is undoubtedly helpful to the market price and hence to those constrained to sell, and **the repurchase of shares at bargain prices presumably benefits the surviving stockholders.** Certainly corporations using excess cash in this manner are acting more liberally than those who hold on like grim death to every dollar in bank.

But this form of procedure is open to objections of various kinds. If the price paid turns out to have been too high, the directors are subject to criticism from those whom they still represent, while those they have benefited are no longer interested in them or in the company. If, to avoid this danger, they buy only when the price is exceedingly low, they cannot avoid the appearance of having taken unfair advantage of the necessities of their stockholders. Furthermore, such undisclosed market operations may afford opportunities for questionable profit by directors and insiders.

The *Bendix Aviation Company* recently passed its dividend and concurrently announced its intention of purchasing a large block of shares in the open market. Other companies rich in cash have followed the same policy, though generally without even this saving grace of revealing their plan to buy in stock. Such a procedure contains possibilities of grave injustice to the shareholders. **When there is an accumulated surplus and excess cash on hand, the directors' first duty is to use the free cash to maintain a reasonable dividend.** (*Today—2009--paying dividends vs. buying back stock below intrinsic value may or may not be a good choice depending upon circumstances. Graham puts a premium on paying out cash directly to shareholders because he says that corporate managements may be taking advantage of selling shareholders by repurchasing their stock at low prices*).

The prime reason for accumulating the surplus in good years was to make possible the continuance of dividends in bad years. Hence the absence of earnings is in itself no justification for stopping all payments to shareholders. To withhold the owners' money from them by suspending dividends, and then to use this same money to buy back their stock at the abnormally low price thus created, comes perilously close to sharp practice.

Such considerations should make it clear why the writer does not regard open-market purchases as the best method of returning corporate cash to stockholders. Retirement of stock pro rata involves no conflict of interest between those selling out and those staying in; and it provides no opportunity for errors in judgment or unfair tactics on the part of the management.

Examination of the partial list in Table 1 on page 16 of companies selling in the market for less than their net current assets, as well as reference to the table offered in our first article last issue, will disclose many instances in which the **cash holdings are clearly excessive.** If stockholders will bring sufficiently strong pressure upon their managements, they can secure the return of a good part of such surplus cash, with great benefit to their own position, to stock market sentiment, and to the general banking situation.

In order to obtain these desirable results, stockholders must first be aware that surplus cash exists; and therefore they must direct at least a fleeting glance to their company's balance sheet. In recent years financial writers have been unanimous in pointing out how unimportant are asset values as compared with earning power; but no one seems to have realized that both the ignoring of assets and the emphasis on earnings can be--and have been--carried too far, with results of the most disastrous kind.

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The whole "new-era" and "blue chip" madness derived from this exclusive preoccupation with the earnings trend. A mere \$1 increase in profits, from \$4 to \$5 per share, raised the value of a stock from 40 to 75, on the joyous assumption that an upward trend had been established which justified a multiple of 15 instead of 10. **The basis of calculating values thus became arbitrary and mainly psychological**, with the result that everyone felt free to gamble unrestrainedly under the respectable title of "investment."

It was this enticement of investors into rampant speculation which made possible the unexampled duration and extent of the 1928-1929 advance, which also made the ensuing collapse correspondingly disastrous, and which--as later appeared--carried the business structure down into ruin with the stock market.

A peculiar offshoot of the obsession with earnings is the new practice of writing fixed assets down to \$1, in order to eliminate depreciation charges and thus report larger profits. The theory is that by destroying asset values we can increase earning power and therefore enhance the market value. Since no one pays any attention to assets, why carry any assets on the books? This is another example of *Alice in Wonderland* financial logic.

It is in amusing contrast with the much berated *stock watering*² practice of a generation ago. In those days fixed assets were arbitrarily written up, in order to enlarge the book values, and thus facilitate a fictitious market price. In place of watering of assets, we now have watering of earnings. The procedures are directly opposite, but the object and the underlying deception are exactly the same. (*Here Graham describes the misuse of accounting rules by promoters to obscure economic reality and fleece the public.*)

Because of the superstitious reverence now accorded the earnings statement by both investors and speculators, wide variations in market prices can be occasioned by purely arbitrary differences in accounting methods. The opportunities for downright crookedness are legion, nor are they ignored.

One company, listed on the *New York Stock Exchange*, recently turned an operating loss into a profit by the simple expedient of marking up its goodwill and adding the difference to earnings, without bothering to mention this little detail. The management apparently relied, and not unreasonably, on the fact that stockholders would not examine the balance sheets closely enough to detect their charming artifice.

The disregard of assets has also introduced some new wrinkles into reorganizations and mergers. Creditors are no longer permitted to receive the cash directly available to pay off their claims; stockholders are forced into consolidations which give other securities a prior claim on cash which formerly was theirs.

The *Fisk Rubber Co.*, for example, showed around \$400 in cash on hand for each \$1,000 of overdue debt, and nearly \$900 in net quick assets, excluding the extensive factories, etc. Yet the proposed reorganization plan offers these creditors no cash at all, but only stock in a new company.

Similarly, while *Prairie Pipe Line* stockholders were taking comfort from the fact that there had lately appeared to be \$12 per share in cash equivalent behind their stock, they suddenly found themselves owners of shares in another company which had no cash at all directly applicable to their holdings, this new stock, moreover, having a total market value equal to less than half the cash equivalent alone which they formerly owned.

In the writer's view, all these strange happenings flow from the failure of the stockholder to realize that he occupies the same fundamental position and enjoys the same legal rights as the part-owner in a private business. The panoply and pyrotechnics of Wall Street have obscured this simple fact. If it only could be brought home to

² This term came from the activities of *Daniel Drew* in the 1870s during his early life as a cattle drover--his discovery of the profit to be gained from "watered" cattle which he later used in watering the stock in the famed Erie Railroad operation. After driving them to the stockyards for sale *Drew* would feed salt to his cattle and his cattle would drink lots of water. Obviously, watering cattle artificially boosted the weight of his cattle and thus his profits.

the millions of investors the country over, a long step would be taken in the direction of sounder corporate practices and a saner attitude towards stock values.

Treasurers Sleep Soundly While Stockholders Walk the Floor!

Why is the stockholder poor today?

Because he borrowed from the banks in 1929 to put more cash into the companies he owns. Where is that cash now? Much of it is still held intact by his company. Does the stockholder need that money more than his company? You bet he does. Has he done anything to get it? No. **He thinks his company is broke because stock prices say so.** He has forgotten asset value. He has forgotten that his officers and directors are supposed to be his own representatives, working for his own best good. **He has forgotten that he is a part-owner and manager of the company in which he owns stock.**

Should Rich But Losing Corporations Be Liquidated by Benjamin Graham, July 01, 1932

Which is Right--the Stock Market or Corporation Management?

Another aspect of the current maladjustment between corporation and their stockholders is the question of possible liquidation. Many stocks sell for less than their cash value because the market judges that future operating losses will dissipate this cash.

If that is the case, then should not the stockholder demand liquidation before his cash is used up? The management says "No"--naturally, but the stock market says "Yes,"—emphatically. Which is right? What are the salient factors on both sides of the question?

Forbes presents herewith the third, and last, article in this series by Mr. Graham, which reaches down to the very roots of the present troublesome situation.

The unprecedented spectacle confronts us of more than one industrial company in three selling for less than its net current assets, with a large number quoted at less than their unencumbered cash. For this situation we have pointed out, in our previous articles, three possible causes:

- (a) Ignorance of the facts;
- (b) Compulsion to sell and inability to buy;
- (c) Unwillingness to buy from fear that the present liquid assets will be dissipated.

In the preceding articles [Inflated Treasuries And Deflated Stockholders](#) (Article 1) and [Should Rich Corporations Return Stockholders' Cash?](#) (Article 2) we discussed the first two causes and their numerous implications. But neither the ignorance nor the financial straits of the public could fully account for the current market levels.

If *gold dollars without any strings attached* could actually be purchased for 50 cents, plenty of publicity and plenty of buying power would quickly be marshaled to take advantage of the bargain. Corporate gold dollars are now available in quantity at 50 cents and less--but they *do* have strings attached. Although they belong to the stockholder, he doesn't control them. He may have to sit back and watch them dwindle and disappear as operating losses take their toll. For that reason the public refuses to accept even the cash holdings of corporations at their face value.

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In fact, the hardhearted reader may well ask impatiently: "Why all this talk about liquidating values, *when companies are not going to liquidate*? As far as the stockholders are concerned, their interest in the corporation's cash account is just as theoretical as their interest in the plant account. *If* the business were wound up, the stockholders would get the cash; *if* the enterprise were profitable, the plants would be worth their book value. "If we had some ham, etc., etc."

This criticism has force, but there is an answer to it. **The stockholders do not have it in their power to make a business profitable, but they do have it in their power to liquidate it.** At bottom it is not a theoretical question at all; the issue is both very practical and very pressing.

It is also a highly controversial one. It includes an undoubted conflict of *judgment* between corporate managements and the stock market, and a probable conflict of *interest* between corporate managements and their stockholders.

In its simplest terms the question comes down to this: Are these managements wrong or is the market wrong? Are these low prices merely the product of unreasoning fear, or do they convey a stern warning to liquidate while there is yet time?

Today stockholders are leaving the answer to this problem, as to all other corporate problems, in the hands of their management. But when the latter's judgment is violently challenged by the verdict of the open market, it seems childish to let the management decide whether itself or the market is right. This is especially true when the issue involves a strong conflict of interest between the officials who draw salaries from the business and the owners whose capital is at stake. **If you owned a grocery store that was doing badly, you wouldn't leave it to the paid manager to decide whether to keep it going or to shut up shop.**

The innate helplessness of the public in the face of this critical problem is aggravated by its acceptance of two pernicious doctrines in the field of corporate administration. The first is that directors have no responsibility for, or interest in, the market price of their securities. The second is that outside stockholders know nothing about the business, and hence their views deserve no consideration unless sponsored by the management.

By virtue of dictum number one, directors succeed in evading all issues based upon the market price of their stock. Principle number two is invoked to excellent advantage in order to squelch any stockholder (not in control) who has the temerity to suggest that those in charge may not be proceeding wisely or in the best interests of their employers. The two together afford management perfect protection against the necessity of justifying to their stockholders the continuance of the business when the weight of sound opinion points to better results for the owners through liquidation.

The accepted notion that directors have no concern with the market price of their stock is as fallacious as it is hypocritical. Needless to say, managements are not responsible for market fluctuations, but they should take cognizance of excessively high or unduly low price levels for the shares. They have a duty to protect their stockholders against avoidable depreciation in market value--as far as is reasonable in their power--equal to the duty to protect them against avoidable losses of earnings or assets.

If this duty were admitted and insisted upon, the present absurd relationship between quoted prices and liquidating values would never have come into existence. Directors and stockholders both would recognize that the true value of their stock should under no circumstances be less than the realizable value of the business, which amount in turn would ordinarily be not less than the net quick assets.

They would recognize further that *if the business is not worth its realizable value as a going concern it should be wound up*. Finally, directors would acknowledge their responsibility to conserve the realizable value of the business against shrinkage and to prevent, as far as is reasonably possible, the establishment of a price level continuously and substantially below the reasonable value.

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Hence, instead of viewing with philosophic indifference the collapse of their stock to abysmally low levels; directors would take these declines as a challenge to constructive action. In the first place, they would make every effort to maintain a dividend at least commensurate with the minimum real value of the stock. For this purpose they would draw freely on accumulated surplus, provided the company's financial position remained unimpaired. Secondly, they would not hesitate to direct the stockholders' attention to the existence of minimum liquidating values in excess of the market price, and to assert their confidence in the reality of these values. In the third place, wherever possible, they would aid the stock-holders by returning to them surplus cash capital through retirement of shares pro rata at a fair price, as advocated in our previous article.

Finally, they would study carefully the company's situation and outlook, to make sure that the realizable value of the shares is not likely to suffer a substantial shrinkage. If they find there is danger of serious future loss, they would give earnest and fair-minded consideration to the question whether the stockholders' interest might not best be served by sale or liquidation.

However forcibly the stock market may be asserting the desirability of liquidation, there are no signs that managements are giving serious consideration to the issue. In fact, the infrequency of voluntary dissolution by companies with diversified ownership may well be a subject of wonder, or of cynicism. In the case of privately owned enterprises, withdrawing from business is an everyday occurrence. But with companies whose stock is widely held, it is the rarest of corporate developments.

Liquidation *after* insolvency is, of course, more frequent, but the idea of shutting up shop *before* the sheriff steps in seems repugnant to the canons of Wall Street. One thing can be said for our corporate managements--they are not quitters. Like *Josh Billings*, who in patriotic zeal stood ready to sacrifice all his wife's relations on the altar of his country, officials are willing to sacrifice their stockholders' last dollar to keep the business going.

But is it not true that the paid officials are subject to the decisions of the board of directors, who represent the stockholders, and whose duty it is to champion the owners' interests--if necessary, against the interests of the operating management? In theory this cannot be gain-said, but it doesn't work out in practice.

The reasons will appear from a study of any typical directorate. Here we find: (a) The paid officials themselves, who are interested in their jobs first and the stockholders second; (b) Investment bankers, whose first interest is in underwriting profits; (c) Commercial bankers, whose first interest is in making and protecting loans; (d) Individuals who do business of various kinds with the company; and finally--and almost always in a scant minority--(e) Directors who are interested only in the welfare of the stockholders.

Even the latter are usually bound by ties of friendship to the officers (that is how they came to be nominated), so that the whole atmosphere of a board meeting is not conducive to any assertion of stockholders' rights against the desires of the operating management. Directors are not dishonest, but they are human. The writer, being himself a member of several boards, knows something of this subject from personal experience.

The conclusion stands out that liquidation is peculiarly an issue for the stockholders. Not only must it be decided by their independent judgment and preference, but in most cases the initiative and pressure to effect liquidation must emanate from stockholders not on the board of directors. In this connection we believe that the recognition of the following principle would be exceedingly helpful:

The fact that a company's shares sell persistently below their liquidating value should fairly raise the question whether liquidation is advisable.

Please note we do not suggest that the low price proves the desirability of liquidation. It merely justifies any stockholder in raising the issue, and entitles his views to respectful attention.

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It means that stockholders should consider the issue with an open mind, and decide it on the basis of the facts presented and in accordance with their best individual judgment. No doubt in many of these cases--perhaps a majority--a fair minded study would show liquidation to be unjustified. The going concern value under normal conditions would be found so large, as compared with the sum realizable in liquidation, as to warrant seeing the depression through, despite current operating losses.

However, it is conceivable that under present difficult conditions the owners of a great many businesses might conclude that they would fare better by winding them up rather than continuing them. What would be the significance of such a movement to the economic situation as a whole? Would it mean further deflation, further unemployment, and further reduction of purchasing power? Would stockholders be harming the country while helping themselves? Superficially it might seem so, but powerful arguments can be advanced to the opposite effect.

The operation of unsoundly situated enterprises may be called a detriment, instead of an advantage, to the nation. We suffer not only from over-capacity, but still more from the disruptive competition of companies which have no chance to survive, but continue to exist none the less, to the loss of their stockholders and the unsettlement of their industry.

Without making any profits for themselves, they destroy the profit possibilities of other enterprises. Their removal might permit a better adjustment of supply to demand, and a larger output with consequent lower costs to the stronger companies which remain. An endeavor is now being made to accomplish this result in the cotton goods industry.

From the standpoint of employment, the demand for the product is not reduced by closing down unprofitable units. Hence, production is transferred elsewhere and employment in the aggregate may not be diminished. That great individual hardship would be involved cannot be denied, nor should it be minimized, but in any case the conditions for employment in a fundamentally unsound enterprise must be precarious in the extreme. Admitting that the employees must be given sympathetic consideration, it is only just to point out that our economic principles do not include the destruction of stockholders' capital for the sole purpose of providing employment.

We have not yet found any way to prevent depression from throttling us in the midst of our superabundance. But unquestioningly there *are* ways to relieve the plight of the **stockholders who today own so much and can realize so little**. A fresh viewpoint on these matters might work wonders for the sadly demoralized army of American stockholders.

A Study of Market History and Valuation through Graham and Buffett and Others

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Appendix:

Table 1: Some Stocks Which Are Selling for Less Than Their Cash Assets

Company	1932 Mkt. Low	(\$000s omitted) Mkt. Val. of Co. at L. Pr.	Mkt. Val. % Cash and Mkt. Secs.	(\$000s omitted) Cash Mkt. Secs.	MV %. Of CA -all Liabs.	(\$000s omitted) CA - All Liabs.	ML Pr. % of Cash A. /Sh.	Cash A. Per Share	MLP as % Net Quick A.	Net Quick Assets per sh.
Am. Car & Fdry Pref.	\$20.25	\$9,225	61.71%	\$14,950	46.23%	\$32,341	40.5%	\$50.00	18.8%	\$108.00
Am. Locomotive Pref.	30.25	14,709	99.19%	14,829	65.53%	22,630	73.8%	41.00	48.0%	63.00
Am Steel Fdry Pref	60.00	8,021	99.69%	8,046	68.65%	11,720	46.9%	128.00	32.3%	186.00
Am Woolen Pref.	15.25	8,354	57.21%	14,603	35.82%	40,769	50.0%	30.50	17.9%	85.00
Congoleum	7.00	10,078	93.30%	10,802	66.32%	16,288	100.0%	7.00	58.3%	12.00
Howe Sound	6.00	2,886	58.78%	4,910	93.45%	5,254	60.0%	10.00	54.5%	11.00
Hudson Motors	4.12	6,377	75.36%	8,462	79.00%	10,712	74.9%	5.50	58.9%	7.00
Hupp Motors	2.00	2,664	36.82%	7,236	72.36%	10,000	36.4%	5.50	26.7%	7.50
Lima Locomotive	8.50	1,581	43.67%	3,620	53.46%	6,772	44.7%	19.00	23.6%	36.00
Magna Copper	4.50	1,836	48.69%	3,771	78.16%	4,825	50.0%	9.00	37.5%	12.00
Marlin Rockwell	7.50	2,520	65.73%	3,834	88.96%	4,310	65.2%	11.50	57.7%	13.00
Motor Products	13.00	2,457	83.29%	2,950	81.60%	3,615	83.9%	15.50	68.4%	19.00
Munsingwear	10.87	1,805	62.50%	2,888	50.06%	5,769	63.9%	17.00	32.0%	34.00
Nash Motors	10.00	27,000	73.85%	36,560	98.61%	37,076	74.1%	13.50	71.4%	14.00
NY Air Brake	4.50	1,170	79.38%	1,474	62.27%	2,367	90.0%	5.00	50.0%	9.00
Opphm Collins	5.00	1,050	52.08%	2,016	64.00%	3,150	52.6%	9.50	33.3%	15.00
Reo Motors	1.50	2,716	51.04%	5,321	51.50%	10,332	50.0%	3.00	27.3%	5.50
S.O. of Kansas	7.00	2,240	81.16%	2,760	61.65%	4,477	82.4%	8.50	50.0%	14.00
Stewart Warner	2.38	3,023	65.04%	4,648	55.98%	8,303	68.0%	3.50	34.0%	7.00
White Motors	7.75	4,938	57.29%	8,620	38.89%	22,167	59.6%	13.00	22.8%	34.00

Blue Chip Performance: 1929-1932

AT&T -	76.9%
Bethlehem Steel	-94.8%
General Electric	-97.9%
Montgomery Ward	-97.5%
Nat'l Cash Register	-95.1%
Radio Corp of Amer.	-97.5%

http://newsfrom1930.blogspot.com/2009/06/why-this-blog-socratic-monologue_3441.html

"I would get these newspapers from 1929. I couldn't get enough of it. I read everything - not just the business and stock-market stories. History is interesting, and there is something about history in a newspaper, just seeing a place, the stories, even the ads, everything. It takes you into a different world, told by someone who was an eyewitness, and you are really living in that time." - Warren Buffett

The Snowball, A. Schroeder (Bantam), p 148

June 1, 2009

Why this blog - A Socratic monologue

*Q. Okay, why **are** you doing this blog? Are you saying we're in for a replay of the 30's?*

A. How did I know you were going to ask me that? No, I don't think things are going to get as bad as in the 30's.

Q. So you're an optimist.

A. Well, that's only mildly optimistic. I mean things in the 30s got really, really bad. For example, between 1929 and 1932, the number of cars produced declined from 4.8 million to 1.2 million ...

Q. Okay - that's pretty bad, but it's only one industry ...

A. Looking at the economy as a whole, GDP went down by 40% and unemployment went from around 3% to 24% ...

*Q. Wow! That **is** really bad.*

A. It's actually even worse than that, because back then many more people worked on farms. When you take out farm workers, unemployment hit 37% - an almost unimaginable level for us today ...

Q. You must be a blast at parties ... Well then, if you don't think we'll repeat the 30's, are you saying, in Mark Twain's words, that history won't repeat but it will rhyme?

A. Hey! I wanted to use that line!

Q. Sorry. Well, do you think that?

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A. Yes. I believe 1929-1930 has a couple of important similarities to 2008-2009. First and fundamentally, there was a big buildup of debt leading up to both. This was followed by a couple of major economic problems, including many banks running into trouble and a loss in perceived wealth by lots of people. These problems in turn have deflationary implications since they lead to less credit and spending ...

Q. Could you get to the second point before I fall asleep?

A. Second, for the technical stock people, the markets in the two periods do have interesting similarities. In both, the stock markets hit a high and then had a very scary, sharp crash where the panic level was high for a short time, followed by a nice relief rally when the immediate panic abated.

In the case of 1929 this market break is what is commonly known as the Great Crash, including Black Thursday on October 24, 1929, quickly followed by Blacks Monday and Tuesday on October 28 and 29. The Dow began 1929 at about the 300 level; hit a peak of about 380, and the Crash cut it almost in half to 200.

What's not as commonly known about 1929 is that the Great Crash was followed by a nice rally with the Dow almost hitting 300 again in April 1930, and, at the point where we begin this blog in June 1930, still hovering in the 270's - not that far off where it was at the start of 1929. The real damage was done in the following two years when, following a spectacular series of further declines and rallies, the Dow bottomed out at 42 - almost 90% off its peak.

More recently, of course, we had a brief period of sheer panic in March 2009 when the Dow hit the 6500's, down from a high over 14000, then had the nice rally we're currently in ...

*Q. Zzzzzz ... *snort*! Ah yes, that's all very interesting, but are there any other similarities between the two times?*

A. Umm ... homina homina ... other similarities will be left as an exercise for the reader.

*Q. Well, have you noticed **anything** interesting yet?*

A. In histories of the Depression the leaders of the time are commonly portrayed as oblivious to what was going on, do-nothing, and stupidly optimistic. For example, every schoolkid has seen the much ridiculed pronouncement by Herbert Hoover that "prosperity is just around the corner." Even from my limited reading so far it's clear this criticism is mostly unfair. It appears that the people in charge at the time were well aware of what was happening, and did most of the things that we're doing now to alleviate it (with a couple of notable exceptions). And as for unjustified optimism, we will see that at least in mid-1930 there was a fair amount of good news coming out about the economy. And I mean actual good news where things were improving month-to-month, not the asinine stories we see today where bad numbers are interpreted as good because they were "better than expected," and declining numbers are called good because the rate of decline is slowing down (AKA second derivative stories).

Q. Anything else interesting?

A. Well, I'm a history buff, especially New York history, so it's interesting to me to see a day-by-day chronicle of a pretty eventful period. Or, as Warren Buffett said in *The Snowball* by Alice Schroeder (Bantam 2008, pg. 148):

"I would get these newspapers from 1929. I couldn't get enough of it. I read everything - not just the business and stock-market stories. History is interesting, and there is something about history in a

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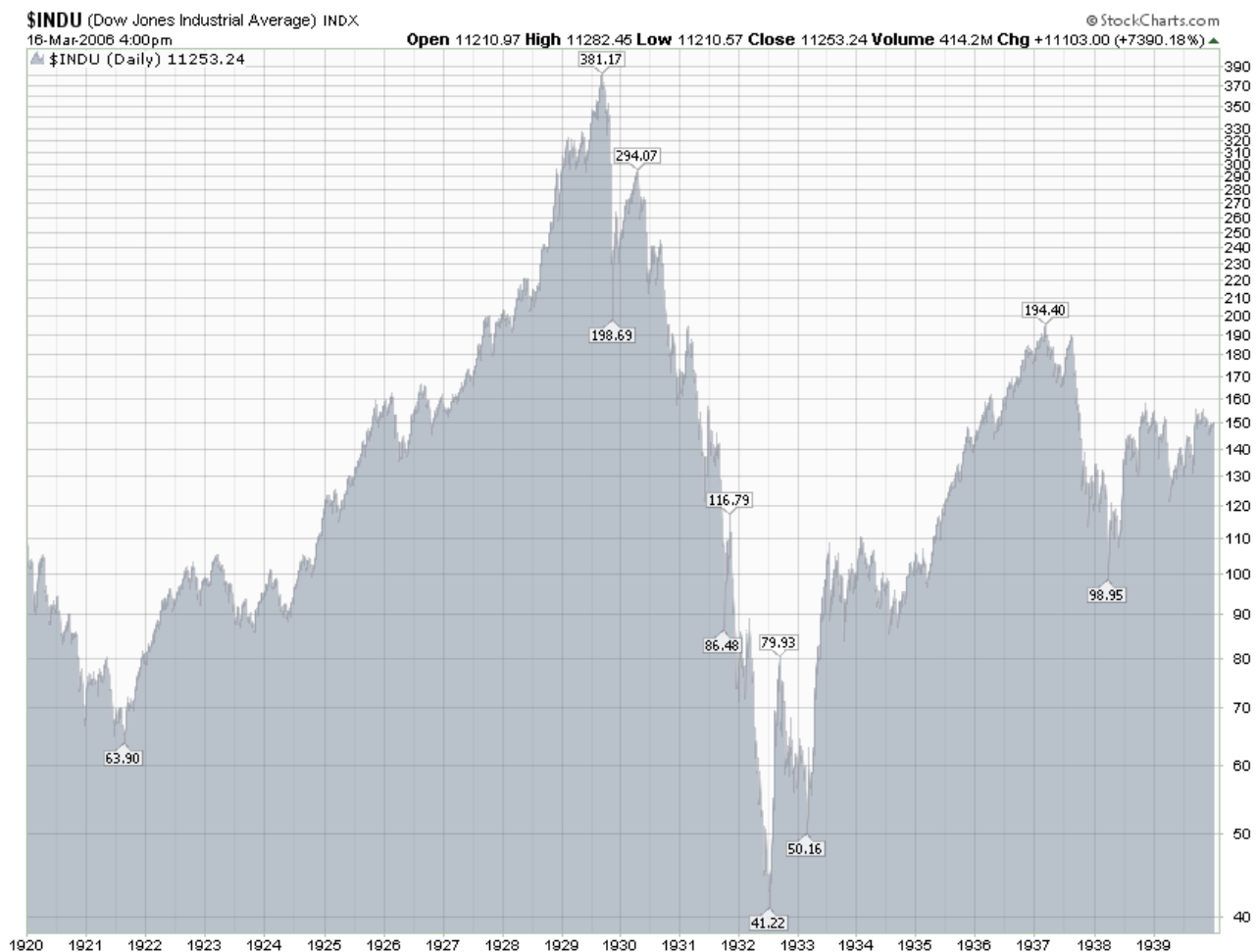
newspaper, just seeing a place, the stories, even the ads, everything. It takes you into a different world, told by someone who was an eyewitness, and you are really living in that time."

Q. I knew you wouldn't be able to go the whole interview without sneaking a Buffett quote in. Does he have you on commission or something?

A. No comment. Seriously, though, I do think you get a different feel for history seeing it day-by-day like this - less tidy, but more real. And it just might give you a useful skepticism for some of the more Panglossian commentary we're seeing today when you see that similar things were said back then - and probably with more reason!

Q. Oooohhh ... Panglossian! Fancy Shmancy! You couldn't just say optimistic?

A. So – you want to suppress the truth just like the rest of the mainstream media! This interview is over!



--

Dean Witter in a 1932 Memorandum Calls a Bottom

As he explained in this 1932 memorandum, Mr. Dean Witter had been worried by high stock prices in the spring of 1929. Three years later, he was trying to get investors to think about buying: "I wish to say emphatically that in a few years present prices will appear so ridiculously low as 1929 values already appear fantastically high."

A very interesting book could be written on mass psychology and the effect thereof. That everyone is influenced more or less by the opinion of others is obvious. There was no reason for the unwarranted heights which the market reached in 1929 except universal over optimism—there is no excuse for the present market value of good bonds and stocks today except undue pessimism. In 1929 no pessimistic comment could survive. Today an expression of confidence in the future of the country is unpopular. Strangely, the peaks of 1929 and the low quotations of today are both due to the same cause, which is lack of intelligent and sound analysis. It is strange that such divergent conditions should come within such a short period and should be due to such identical factors.

We are no longer much interested in the fantastic heights of 1929 except that we marvel at our lack of sane judgment. We are keenly interested in the present, and until some time elapses and we can obtain a better perspective it is difficult to realize that present conditions and markets are just as abnormally low as 1929 conditions and market were excessively high.

There are only two premises which are tenable as to the future. Either we are going to have chaos or else recovery. The former theory is foolish. If chaos ensues, nothing will maintain value; neither bonds nor stocks nor bank deposits nor gold will remain valuable. Real estate will be a worthless asset because titles will be insecure. No policy can be based upon this impossible contingency. Policy must therefore be predicated upon the theory of recovery. The present is not the first depression; it may be the worst, but just as surely as conditions have righted themselves in the past and have gradually readjusted to normal, so this will again occur. The only uncertainty is when it will occur.

Everyone now seems to be indulging in the futile desire to buy at the bottom, just as everyone sought the very top in 1929. Most conservative people thought that values were much too high in 1928. Their judgment has since been fully vindicated in spite of the fact that value went much higher in 1929. Someone once said that they had made their fortune because they had never tried to buy at the bottom or sell at the top. The only means that they had not driven for the impossible but had been satisfied to buy when values were in general low and had been satisfied to sell when values were in general high, and without regard to peaks, which no one can identify and which, except by accident, are impossible to attain.

I think everyone must know that values are now abnormally low. In a few years and with a better perspective they will realize that they were low in 1931. In other words, they were even then way below normal. People are deterred from buying good stocks and bonds now only because of an unwarranted terror. Almost everyone says that prices are going still lower. All sorts of bugaboos are paraded to destroy the last vestige of confidence. Stories of disaster which are incredible and untrue are told to foolish and credulous listeners, who appear willing to believe the worst.

I wish to say definitely that values were low in the latter half of 1931 and that they are now ridiculous. To prove this one has only to take an average period of 10 to 20 years of earnings, which should provide a proper normal, and compare present values with the value which such normal earning power would adequately support. The stocks of many good companies which are faced with no ascertainable financial hazard are selling at only 2 or 3 times 10-year earnings, and at from 5% to 50% of sound book value, disregarding such valuable intangibles as good will, going concern value and trained intelligent organizations which it has taken years and the expenditure of vast sums of money to develop. **I wish to say emphatically that in a few years present prices will appear as ridiculously low as 1929 values already appear fantastically high.**

In 1929 one could only profit by selling. Many of us are instinctively reluctant to sell. There was the problem or reinvestment—there were taxes to be paid on profits. Today the situation is reversed. The present offers a splendid opportunity to the buyer. Great fortunes will be made out of securities bought today. There is no tax on buying and there is not sentimental deterrent. Only unwarranted fear or a futile desire to buy at the very bottom deters people from investment now, most people who are buying at all are buying Treasury Certificates or the highest grade of municipals. Some are even putting money in their safe deposit boxes. None of these things are cheap. By comparison they are most expensive.

The time to have bought Treasury Certificates and the highest grade of short term obligations was in 1928 and 1929 when values were high and in order to preserve the dollar intact. The present is the time to use the dollar in the purchase of good securities, whether they be greatly depreciated bonds or excessively deflated common stocks. All of our customers who have money must some day put that money to work, and into some type of revenue producing investment. Why not invest it now when securities are cheap? Why leave it in cash or invest in Treasury Certificates which are dear? Some people say that they wish to await a clearer view of the future. When the future is again clear the present bargains will no longer be available. Does anyone think that present prices will continue when confidence has been fully restored. Such bargains exist only because of terror and distress. When the future is assured the dollar will long since have ceased to have its present buying power. If one holds either cash or the very highest grade of short term bonds as a temporary medium of investment, he will find that he has only permitted great investment opportunities in tremendously underpriced securities to escape him.

It requires courage to be optimistic as to the future of the country when nearly everyone is pessimistic. It is, however, cowardly to assume that the future of the country is in peril.

No successful policy can be established upon this unsound theory. It is easy to run with the crowd. The path of least resistance is to join in the wailings that are now so popular. The constructive policy, however, is to maintain your courage and your optimism, to have faith in the ultimate future of your country and to proclaim your faith and to recommend the purchase of good bonds and good stocks, which are inordinately depreciated. You will gain the respect of those people with whom you come in contact by such an attitude. If you can persuade them to evidence their confidence in the future of the country by the purchase of good securities now you will do them a great favor and they will be grateful to you later.

It is disconcerting to have recommended the purchase of securities in 1931 as they have gone much lower since. This shakes one's confidence in his own judgment. You were just as right, however, in 1931 as you are now in recommending investment in securities which were even then cheap. I can remember distinctly that I could find no justification for values which existed in 1928 and in many cases recommended sale or advised against purchase. I was decidedly wrong, as prices went much higher in 1929. I was only wrong, however, in that I failed to pick the very top of the market. It is true that values in 1928 were already inordinately high as judged by normal and average yard-sticks.

On April 18, 1929, I dictated a memorandum which was published to the entire organization, copies of which are still available in the files. The subject matter of the memorandum was unpopular. It stated that people were buying stocks without regard to value, earning power and dividends, present and prospective." It stated that people were buying stocks not because they were worth the price at which they were selling, but because they hoped they would go higher and could be sold at a profit. The memorandum stated that the average speculator who bought stocks upon that theory in the long run lost money. It compared the psychology which then existed (April, 1929) with the psychology of the Florida land boom, the commodity inflation of 1919 and other characteristics periods of inflation. It pointed out that one could not afford to buy stocks that earned less than 5% and paid less than 3% on market values then prevailing. It stated that "perhaps we are going to have the greatest era of prosperity in our history.

Maybe we have already had this era. Perhaps we have nothing but increasing earnings and increasing dividends ahead of us. I hope so. If we have, present values are hardly justified; if we haven't they will decline. "Many things can happen, most of them unforeseen—politics, wars, economic changes, European competition, money shortage, withdrawal of foreign balances, adverse foreign trade balances, sudden withdrawal of large sums of bootleg money in the call market, Federal Reserve restrictions, interference by Congress or by the Government. These things probably won't happen but they might. If they don't present levels may be all right—if they do, the last holder will suffer and not the next to the last, but we can't all be next to the last.

The danger signals are waving—higher time money than we have ever known—more speculation than ever before—and tremendous brokers' loans, though this may be a proper and normal increase in a very rapidly

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growing country. Not only are the rich and intelligent speculating but many have their last dollar in the stock market on margin. \$5,500,000,000 of record and a great deal more, unrecorded, is borrowed to carry stocks. People are paying 8% or 9% for this money and generally getting 3% or 4%. How long can this last? Can it last until the 3% or 4% catches up to the 8%? Probably not.

I am neither a stock market prognosticator nor an analyst. I do not pretend to be a *Moody*, a *Babson*, or a *Brookmire*. I have been rather pessimistic about stock market prices for two years. If I had been an unqualified optimist I could have made a great fortune. I am not a pessimist—I think this country will prosper beyond conception in the next 20 years. I don't however, believe in over-speculation. **I don't believe in 9% money for 3% stocks.** The former may be temporary—the latter is more or less permanent unless price levels change. I have been taught that a good stock should earn 10% not 5%. Probably I am old fashioned. In any event, this is not the prevailing customer today. I believe that people should speak honestly and not too guardedly. I would not want our brokerage department to be the means or vehicle of severe loss to people. It is hard to be patient with 3% stocks carried on 9% money. Will they stay at a level which produces a 3% return? *John Moody* and a great many other excellent authorities seem to think so. I don't know but I would not gamble on it."

(Source: Classics: An Investor's Anthology. The most interesting ideas and concepts from the literature of investing. Edited by Charles D. Ellis, pages 157-161)

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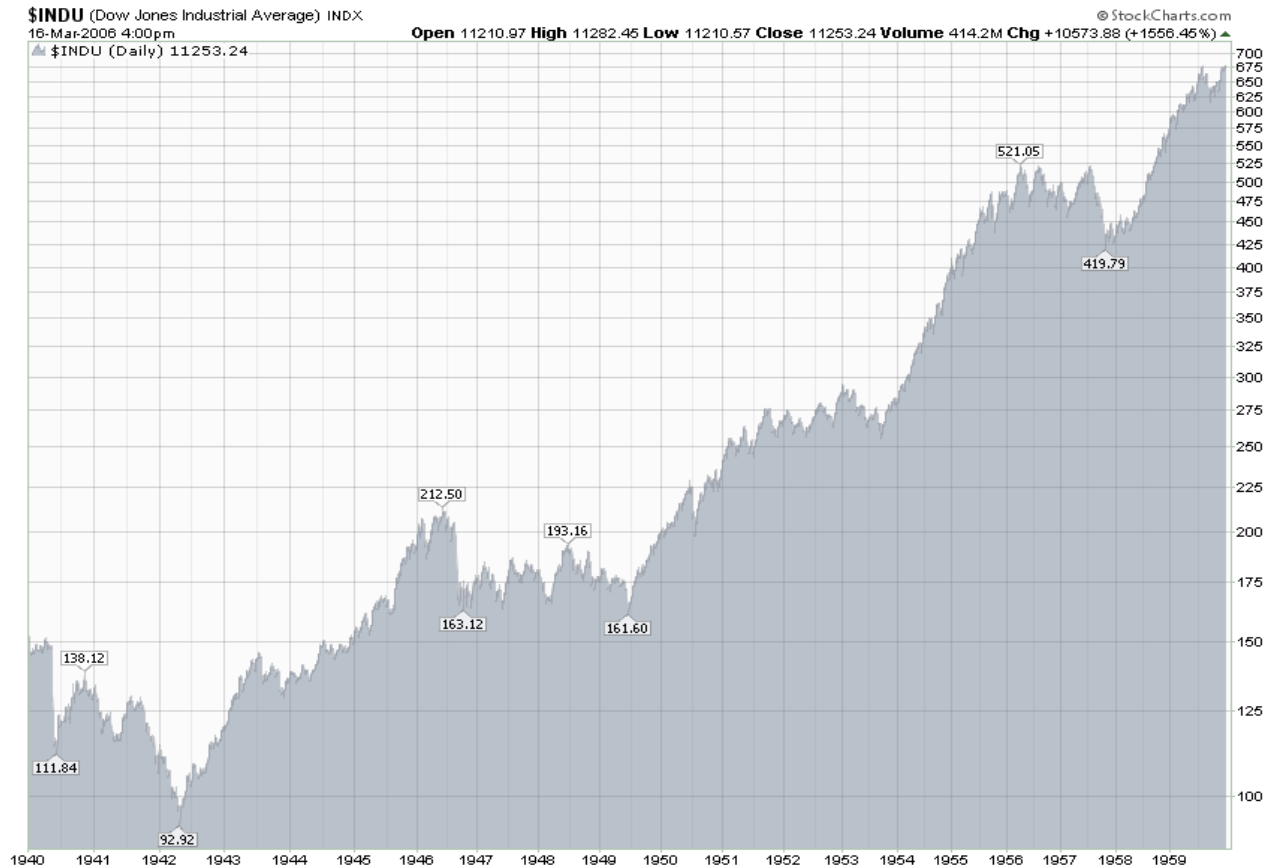
It is a gloomy moment in the history of our country. Not in the lifetime of most men has there been such grief and deep apprehension; never has the future seemed so incalculable as at this time. The domestic economic situation is in chaos. Our dollar is weak throughout the world. Prices are so high as to be utterly impossible. The political cauldron seethes and bubbles with uncertainty. Russia hangs, as usual, like a cloud, dark and silent, upon the horizon. It is a solemn moment. Of our troubles, no man can see the end.

-- *1857 Harper's Weekly*.

"The 'new-era' doctrine - that 'good' stocks (or 'blue chips') were sound investments regardless of how high the price paid for them -- was at bottom only a means for rationalizing under the title of 'investment' the well-nigh universal capitulation to the gambling fever... Why did the investing public turn its attention from dividends, from asset values, and from earnings, to transfer it almost exclusively to the earnings trend? The answer was, first, that the records of the past were proving an undependable guide to investment; and secondly, that the rewards offered by the future had become irresistibly alluring ... The notion that the desirability of a common stock was entirely independent of its prices seems incredibly absurd. Yet the new-era theory led directly to this thesis. If a stock was selling at 35 times the maximum recorded earnings, instead of 10 times its average earnings, which was the pre-boom standard, **the conclusion to be drawn was not that the stock was too high but merely that the standard of value had been raised.** Instead of judging the market price by established standards of value, the new-era based its standards of value on the market price." (*In 1996-2000, the absurdly high prices for Internet stocks seemed to justify "new" standards of value such as the number of eyeballs and click-throughs on Internet sites*)

- Benjamin Graham & David Dodd, *Security Analysis*, 1934.

Graham on the 1959 Bull Market



A stock market warning: danger ahead!

Based on a speech ran delivered at UCLA, December 17, 1959

The stock market has been advancing with only one significant setback throughout the decade of the 1950s. It has thus established a new record for the length of its rise, although it has not equaled the extent of the record advance of the 1920s: 325 percent in this market versus 450 percent from 1921-1929.

What does this phenomenal upward movement portend for investors and speculators in the future? There are various ways of approaching this question. To answer it, I shall divide the question into two parts. First, what indications are given us by past experience? Second, how relevant is past experience to the present situation and prospects?

As to the first part of my answer, I should be able to make some definite statements—which will be the reverse of encouraging. But as to the applicability of the record of the past to present, I cannot express a categorical judgment. I shall present certain facts on the one side and certain facts on the one side and certain expectations pointing the other way; I shall state my own opinion as to the probable answer; but in the end, each must resolve that part of the question for himself.

INDICATIONS FROM PAST EXPERIENCE

However, in order to judge today's market level, it is desirable—perhaps essential—to have a clear picture of its past behavior. Speculators often prosper through ignorance; it is a cliché that in a roaring bull market knowledge is superfluous and experience a handicap. But the market knowledge is superfluous and experience a handicap. But the typical experience of the speculator is one of temporary profit and ultimately loss. If experience cannot help today's investor, then we must be logical and conclude that there is no such thing as investment in common stocks and that everyone interested in them should confess himself a speculator. This is just about what has actually happened in recent years—only in reverse. Everyone now calls himself an investor, including a huge horde of speculators.

This point is neatly illustrated by the opening lines of an article in a recent issue of *Business Week* describing the annual convention of Investment clubs. The writer says: "Like all investors, large and small, they were mainly interested in which way the market--and particular stocks—would move next." If that sentence accurately describes a *bona fide* investor of 1960, then—to use a phrase made famous by a certain Mr. Khrushchev—the shrimps have really begun to whistle on the mountain tops.

BULL MARKET OR NEW MARKET?

The main issue before the investor may be expressed this way: Have we been in a bull market or in a new sort of market? If this is a bull market, then the term itself implies a bear market to follow it some day. What could be the probable extent of a decline in a traditional bear market? Here are some figures, which apply the experience of the 12 bear markets since 1874 to the recent high level of 685 for the *Dow Jones Industrial Average*.

The average of these 12 declines (all taken from *Cowles Standard indexes*) would indicate a market low of about 400, a fall of over 40 percent from the 685 high. Investors may consider themselves mentally prepared for a 40 percent shrinkage in stock prices, especially if they envisage such a drop as taking place from a level far above today's average. At this point, however, a second factor of past experience becomes relevant. The record shows that declines have tended to be roughly proportional to the previous advances. Thus, the six largest advances averaging 63 percent of the high level reached were followed by declines averaging 46 percent while the other six advances averaging 38 percent of the high produced declines averaging 37 percent.

Comparison of Twelve Bear-Market Decline		
Time Period	Percent Decline	Equivalent Low from 885
1874-77	36	435
1881-84	26	500
1889-97	40	410
1901-03	44	385
1906-07	45	375
1909-14	29	485
1916-17	36	435
1919-21	44	385
1929-32	85	115
1937-38	44	385
1939-42	39	415
1946-49	27	490

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Experience gives us another measure of the possible bear-market decline. This measure is based on the principle that the higher the market advances above a computed normal, the further it is likely to decline below such normal. If this principle—enunciated long ago by *Roger Babson*—were to hold in the future as in the present, then a further rise of the market from these levels—in itself an alluring probability--would actually carry with it an intensified future penalty.

Let me illustrate this point of experience by some horrifying assumptions—to present the worst of the picture. Let us assume that the market makes everyone happy by advancing fairly soon to that millennial level of 1,000 for the Dow Jones Industrials, of which some predictions are already on file. Assume further that this is a speculative advance—very like that of the late 1920s—and that the Central Value of the D-J Average at the time is only 400. By applying the old *Babson* economic law of “action and reaction—equal and opposite,” the corrective downswing would carry the average as low as 160, a loss of 84 percent. Impossible, you say, and no doubt you are right. But a condition similar to the one I am assuming actually occurred in 1929, and the ensuing shrinkage in the DJ Average was not 86 percent but 89 percent—from 382 to 42.

There is a paradox in this economic law which makes it virtually impossible for it to find acceptance in practice. For the almost universal optimism that accompanies the great advances in the stock market precludes even the most conservative observer from imagining a decline so drastic as these figures illustrate.

CURRENT OPTIMISM

Let me turn now from this Cassandra-like utterance to the picture of the future stock market that is strongly etched in the minds of most investors and speculators and of their expert advisors. Past experience may not be entirely eliminated from this picture, but it enters in a very muted way. The keynote, of course, is optimism. We are enthusiastic about business prospects for the next decade. In fact, that period received its name in many quarters—the *Fabulous Sixties*—even before it had begun. *Herodotus* recounts a saying of *Solon the Wise* that rich *King Croesus* sadly recalled before his execution—namely, that no man’s life should be accounted a happy one until it is over. Perhaps man’s life should be accounted a happy one until it is over. Perhaps the more prudent time to characterize the 1960s would be when they are over rather than when they have just begun.

Most people are equally optimistic about the stock market. One of my friends—a brilliant analyst—was quoted recently in the *Wall Street Journal* as saying that the bull market is about to enter its 19th year and soon will be able to vote. Translated, that means he is carrying the bull market both backward in time to include 1942—ignoring the 1946-49 setback and doldrums—and confidently forward in time to 1963.

The optimism is about both business and the stock market is founded on a host of favorable facts and expectations, including an important “favorable factor,” the likelihood of continued price inflation. I shall discuss these a little later.

Investors accept in theory the premise that the stock market may have its recessions in the future. But these drops are envisaged in terms of the experience of the past 10 years when the maximum decline was only 19 percent—from 521 to 420 in 1957. The public is confident that such setbacks will be made up speedily and hence that a small amount of patience and courage will bring great rewards in the form of a much higher price level soon thereafter. (*Buy on the “dips” which was a saying prevalent in the 1990’s Bull Market*)

Investors may think they are basing this view of the future on past experience, but in this they are surely mistaken. The experience of the 1949-1959—or of all bull market put together—reflects only the sunny side of the investment. It is one thing to say airily that the market has always come back after declines and made new heights; it is another to reflect on the fact that it took 25 years for the market to reach again the high level of 1929, or that the D-J Average sold at the same high point in 1919 as it did in 1942-23 years later.

The Present Bull Market in Relation To Past Ones

Up to now I have been talking only in terms of past fluctuations on the one hand, and present confidence and optimism on the other. It is time to fill in the picture with certain financial and economic data which will place the present stock market quantitatively in relation to past bull markets.

We have a number of authoritative measures of the factors of earnings, dividends, and asset values in relation to price, as applied to the market as a whole—with more emphasis placed on the industrial list. My data will apply to the industrials only. There are figures for the 30 D-J issues published by *Barron's*; on 125 issues of *Moody's* and the very comprehensive group of 425 industrial of *Standard-Poor's*. Rather strangely, all three indexes give very much the same indications, both currently and over the last 30 years. At the high levels of 1959, the dividend yields on all three indices were just about 3 percent, and the ratio of price to earnings of the past 12 months was about 19 times. Let us compare these ratios with some figures for the high levels of the past bull markets

Table 4					
Moody's 125 Industrials			Standard-Poor's 425 Industrials		
	P/E Ratio	Div. Yld.	LT Bond Yld. (Moody's AAA corp.)	P/E Ratio	Div. Yld.
1959 High	19.0x	3.06%	4.55%	18.2x	2.95%
1949 Low	Av. 7.1	(Av) 6.82	2.65%	5.6	7.50
1946 High	15.9	3.58	2.49%	16.1	3.55
1937 High	17.3	4.15	2.27%	17.6	4.08
1929 High	19.4	3.23	4.95%	19.0	3.10

And now compare them with the situation just before this bull market started in 1949.

These figures illustrate two important points. The first is that the ratios of price to dividends and to earnings are just about where they were at the top of the markets in 1946, 1937, 1929, and about 2.5 times what these ratios were 10 years ago. The second point is that the actual increase in earnings between 1949 and 1959 was very modest—only about 50 percent or less. During this period, the interest rate on highest grade points advanced from 2.65% to 4.55%, or about 75 percent. This means that if the proper rate of capitalization of current earnings should vary with long term interest rates—a not implausible theory—then common stocks would actually be worth less now than in 1949, although they are selling four times as high.

Table 5						
DJI – 30				S&P 425 Industrials		
	Earnings	Dividends	Price	Earnings	Dividends	Price
Calendar Year 1949	23.54	12.79	Low 161	2.46	1.03	13.9
12 mos., Sept. 1959	35.14	20.00	High 678	3.50	1.92	65.3
Percent Increase	49	57	322	42	86	370

The value situation is not as bad as that, however. On the other hand, we find that dividends have increased more than earnings, and have nearly doubled in the 10 years—at least for the *Moody's* and *Standard* indexes. Again, if we capitalize average earnings, say of the past 10 years' rather than the last 12 months' earnings, we would find an increase of about 120 percent between the 1940-1949 and the 1950-1959 decades. **What is most important, perhaps, is that the 1947-1949 price level was clearly too low.** But even making allowance for these three factors, the actual figures would probably not produce an increase more than 100 percent in value from the 1949 year-end figures of 200 for the D-J Index.

If the rise of interest rates is not taken into account—and most of the valuation methods applied to the D-J index do not do so—various techniques will produce, for the most part, higher figures. These figures cover a wide range, but they all have one thing in common: they are appreciably lower than the present market price. Let me summarize a few of the valuations referred to in the 1959 edition of the *Intelligent Investor*, which apply to the

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beginning of that year; *Gerstein*—383; *Molodovsky*—560; *Value-line*—471; *Weston*—600; *Graham*—365. Not all these methods have been applied consistently in the past—the high ones are definitely influenced by the new and more favorable attitude toward common stocks. I would estimate that the older valuation methods—i.e., those in use prior to 1955, let us say—would yield a current average figure of no more than 450, or one-third less than the present level.

Two of the large financial counsel firms have made valuations applicable to the year 1963—four years ahead of their valuation date. One found a value for the D-J of 664, the other of 634. These were based on rather optimistic assumptions of earnings growth in the next four years. If we assume that their conclusion are sound, we then should have to observe the stock market is already paying a full price for the much better earning and dividends expected in 1963. (Note that these 1963 valuations cannot properly be said to derive from past experience, in the manner of the other figures presented.)

This ends my presentation of the direct implication of past experience as applied to the current market level. My conclusions are not favorable. They would imply that the current bull market is repeating the excesses of the past bull markets and is destined to pay a penalty correspondingly severe. But now I must approach the second part of my review, and raise the companion question: “How relevant and useful is past experience as applied to the present situation?”

NEW ECONOMIC FACTORS

Most investors, businessmen, and economists are convinced that the business world we find ourselves in now is radically different and more favorable than that of the past. The improvement is of two kinds: First, the positive drive towards an expanding economy. This is powered by rising population, more research, more sustained capital investment, aggressive attitude in all the important sectors of the economy. Then we have new defenses against recession, which will guarantee us more stability than in the past. These include the government’s obligation to maintain high-level employment, assumed in the 1946 (Employment) Act, and the automatic built-in stabilizers, such as unemployment benefits, social security, farm supports. Two other factors—not as respectable as those just described—are also counted on by many to help beneficial to business if not overdone. The other is the Cold War, with the huge defense spending that it entails.

This array of favorable factors is most imposing, and it has captured the imagination of man, perhaps most, experienced economists. The case for very good business in the 1960s is made energetically in a current book, New Forces in American Business, by *Dexter Keezer* and the *McGraw-Hill* economics staff.

The optimism about business is no doubt the chief factor in producing the present optimism about the stock market. But here the factor of inflation plays a stronger and almost separate role. People tell themselves, on the one hand, that the inescapable inflation of the future guarantees ever-higher earnings and prices for common stocks—and, conversely, that if their funds are held in bonds or other cash equivalents their real value, in terms of purchasing power, will dwindle constantly. This combination of prospects for the 1960s—good business mixed with steady inflation—has produced a powerful stock market cocktail which the public—young and old, experienced and inexperienced—is finding intoxicating and most agreeable.

THE ROSY VIEW OF THE FUTURE

Now what can past experience tell us about the validity and dependability of this rosy view as to the future of business and common stocks? Its verdict cannot be conclusive, because no prediction—whether of a repetition of past patterns or of a complete break with past patterns—can be proven in advance to be right. Nevertheless, past experience does have some things to say that are at least relevant to our problem. The first is that optimism and confidence have always accompanied bull markets; they have grown as the bull market advanced, and they had to grow, otherwise the bull markets could not have continued to their dizzy levels--and they have been replaced by distrust and pessimism when the bull markets of the past collapsed.

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As might be expected, the previous period of greatest enthusiasm about the economic prospect of the US coincided with the tumultuous bull market of the late 1920s. Then as now, nearly everyone was convinced that we had entered a new era of continued and dynamic prosperity which made all past markets experience worse than useless. You all know that the phrase New Era became almost the official description of the American economy of 1928-1929. It is a bit ironical to not that today nearly everyone is again convinced that we have entered into a new era of sustained and dynamic prosperity, but also that everyone is careful not to use the words New Era, because they would remind us too uncomfortably of what happened in and after 1929.

In the 1920s, alas, the new idea that good common stocks are intrinsically sounder than bonds gained ground rapidly. The financial services explained away the apparent dangers of stock yields below bond yields on the ground that the growth factor would eventually more than repay the stock buyer for his present sacrifice of income return.

INFLUENCE OF PRICE INFLATION

The factor of price inflation did not enter into the market of the 1920s, since the price level remained steady throughout. However, it did enter into the thinking of investors and speculators in 1936-37; for between the June 1932 low and the March 1937 high, wholesale prices advanced about 90 percent between the 1949 low and the recent 1959 high). You may be interested to know that between 1901 and 1910, wholesale prices advanced steadily to a total of 17.5%—quite a bit more than in the 1950s. Nevertheless, in that decade, the market experienced two declines of about 50% each, and the rise to March 1937 was also followed by a decline of nearly 50 percent.

Past experience shows us two things about commodity price inflation as a stock market factor. First, inflation has existed most of the time in this century, and often at a much greater average rate than we have seen since 1949. But this has not prevented the stock market from falling disconcertingly after large advances. Secondly, the investor – speculator view as to the significance of inflation has varied greatly in this period. Paradoxically, three of the six bear markets since 1914 have been accompanied by rising whole-sale prices—two of them very substantial. *Arnold Bernhard* in his recent book, The Evaluation of Common Stocks, points out that in the bear market lows of 1949, many financial experts were writing about inflation as an unfavorable factor for common stocks---this at a time when the price level had advanced nearly 40 percent in the three years 1946-1949.

The past record shows clearly that inflation has been chiefly a subjective stock market factor. It has exerted an important bullish influence only when wholesale prices and the stock market happened to be rising at the same time. Investors seem to forget about inflation when stocks turn definitely downward.

An arithmetical aspect of the inflation element was brought to my attention recently by *William Miller*, executive secretary of *Town Hall*. **At current levels, tax-exempt bonds returned fully twice as much to most investors as representative common stocks, after allowing for income tax on the latter.** The investor in tax-free bonds could accordingly set aside about two percent per annum out of his bond interest as a fund to take care of future inflation, and still remain in as good a net disposable income position as he would with common stocks today.

There are some factors in our present economy which were not duplicated in previous bull markets. Most of you will think of the great funds and other institutional holders—as one of these new factors. There could be some doubt on this point; for the popularity of common stocks in 1929 may have been not very different from that of today. The NYSE points to the approximate doubling of the number of shareholders—from six million to 12 million—as an indication of the greatly improved standing of common stocks; this, too, is a phenomenon characteristic of a long bull market. No doubt the number of holders had scored a similar advance in the bull market running from 1921 to 1929. In fact, Simon pure experience suggests that the increase of small shareholders may be more of a danger than a strength for future stock markets.

INCREASED STABILITY

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The factors I would recognize as new relate mainly to economic stability—as exemplified by the government’s commitment under the Employment Act of 1946, the institution of unemployment insurance, old age pensions, and the like. There are few predictions I am willing to make—but one is that the intensity of future business recessions or depressions will be less than it has been in the past. And this is an important bullish factor.

Another new factor in today’s balance sheet is the Cold War—a really unparalleled phenomenon in former times. My view—not held by many authorities—is that the Cold War has contributed a good deal on balance to stimulating our economy during the 1950s. To what extent it will continue in the 1960s is a matter of opinion; it is also a matter of opinion as to whether or not the related military expenditures will carry the same weight in the total economy as in the last decade.

POSSIBILITIES OF DECLINE

If the last two factors I have mentioned are both new and favorable to the business climate, it is proper to ask whether they also guarantee investors a favorable stock market experience indefinitely in the future—more specifically, whether they guarantee him against those market declines on the order of 40 percent or more which we have had so often in the past. The answer to this question even tentatively requires me to depart to some extent from consideration of past experience and to indulge in some more abstract reasoning. If business is to have more stability in the future than before 1950—as seems likely—then common stock earning and dividends should also be more stable. This, in turn, should entitle them to be valued more liberally than in the past, which means that a higher normal or central value for common stocks generally may well be more justified than would be indicated solely by past experience. How much higher? If the D-J, judged solely by past experience, is worth 450 today, would it be worth 670 or more in the light of these new stabilizing factors? I don’t know---and I don’t think anyone else knows. My own guess is that under the bull market conditions of today, most financial experts would be inclined to answer yes—thus justifying the present level. But if the market should decline to 450, the same experts will persuade themselves that the old valuation relationships are still valid and that the new ones were only a bull market mirage.

In support of this rather cynical opinion, let me refer once more to condition in 1949 just before our great bull market started. *The Employment Act* was three years old, but it was completely ignored as a stabilizing factor—indeed, organized business was violently opposed to it. What is more to the point is the fact that, as recently as 10 years ago, the multipliers or valuation rate for stock earnings were the lowest for any three-year period in history since the *Cowles* records began in 1871, except for the World War 1 years 1916-1918, when everyone recognized the earnings to be temporary. Now let us see what one of the leading investment services said about the stock market in September 1949—just before the rise began—when confronted with the current price level of less than six times earnings. I summarized their remarks “Historically the price earnings ratio is extremely low. Stocks are intrinsically cheap. But the growing factor is public sentiment. Renewal of confidence is needed. Because of these problems we have for some time recommended that a portion of investment funds be in the form of reserves.” The last sentence is a professional way of expressing a generally bearish view on the stock market.

Now let us contrast this analysis of the record low price-earnings ratio of 1959 with the reaction of another leading service to the near record high multipliers in 1959. This service lists the variation in these ratios from 1929 to 1959, and points out that “stocks are now in the upper reaches of the valuation scale.” But then the report adds that business prospects are favorable for 1960, that earnings and dividends should rise further, and “they should support new market pushes.” This service does not suggest that during future periods of strength, the investor should move away from stocks to a more balanced position between stocks and bonds. This is a mildly cautionary view, and certainly not to be criticized. But the point I do want to make is how weak and equivocal was the reaction of one service to the record-low price earnings ratios in 1949 and of the other service to the record-high multipliers of today.

All my experience goes to show that most investment advisers take their options and measures of stock values from stock prices. In the stock market, value standards don’t determine prices; prices determine value standards.

Let me return to the question of whether new economic conditions justify higher multipliers of earnings and dividends than in the past. Let me assume, as is likely, that the answer is yes. Would that fact assure the investor against a costly and discouraging bear market experience? It seems to me that this is most improbable. The central level of values will be raised, but the fluctuations around these levels may well be just as wide as in the past, in fact, one might expect even wider fluctuations. For since no one has any clear idea of just how the new central values are to be determined, it will be done by a process of trial and error in which speculative excess on the upside and undue pessimism on the downside may play an even greater part than in most market cycles of former years.

SPECULATIVER EXCESSES IN THE CURRENT MARKET

In this connection, I arrive finally at a “law” about human nature that cannot be repeated and is unlikely to be modified to any great extent. This law says that people without experience or superior abilities may make a lot of money fast in the stock market, but they cannot keep what they make, and most of them will end up as net losers. (This is true even though the long term trend of stock prices has been definitely upward.) This is a particular application of a much wider natural law, which may be state simply as: “There is no such thing as a free lunch, “that, for those too young to remember, was offered in the good old days to patrons of the corner saloon.

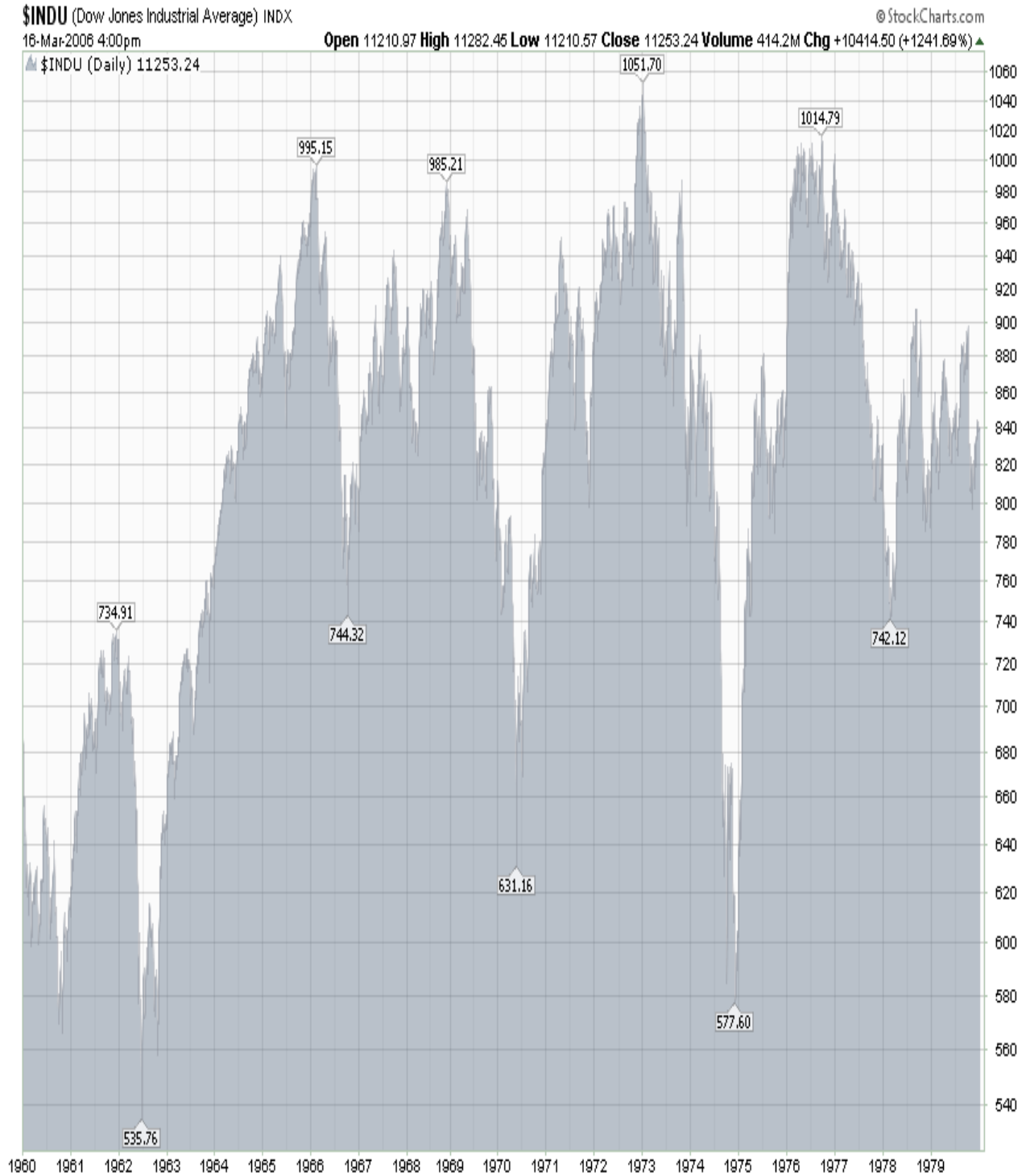
The stock market has undoubtedly reached the stage where there are many people interested in free lunches. The extraordinary price levels of stock of rather new companies in the electronics and similar fields, the more times their average earnings and three times their net worth (with immediate price advances upon issuance), the completely unwarranted price discrepancies such as these established by speculators between the three issues of *Studebaker-Packard*—all indicate reckless elements in the present stock market picture which foretell serious trouble ahead, if past experience means anything at all.

Let me conclude with one of my favorite clichés---“**The more it changes the more it is the same thing.**” I have always thought this motto applied to the stock market better than anywhere else. Now the really important part of this proverb is the phrase, “the more it changes,” The economic world has changed radically and will change even more. Most people think now that the essential nature of the stock market has been undergoing a corresponding change. But if my cliché is sound—and a cliché’s only excuse, I suppose, is that it is sound—then the stock market will continue to be essentially what it always was in the past—**a place where a big bull market is inevitably followed by a big bear market.** In other words, a place where today’s free lunches are paid for doubly tomorrow. In the lights of experience, I think the present level of the stock market is an extremely dangerous one.

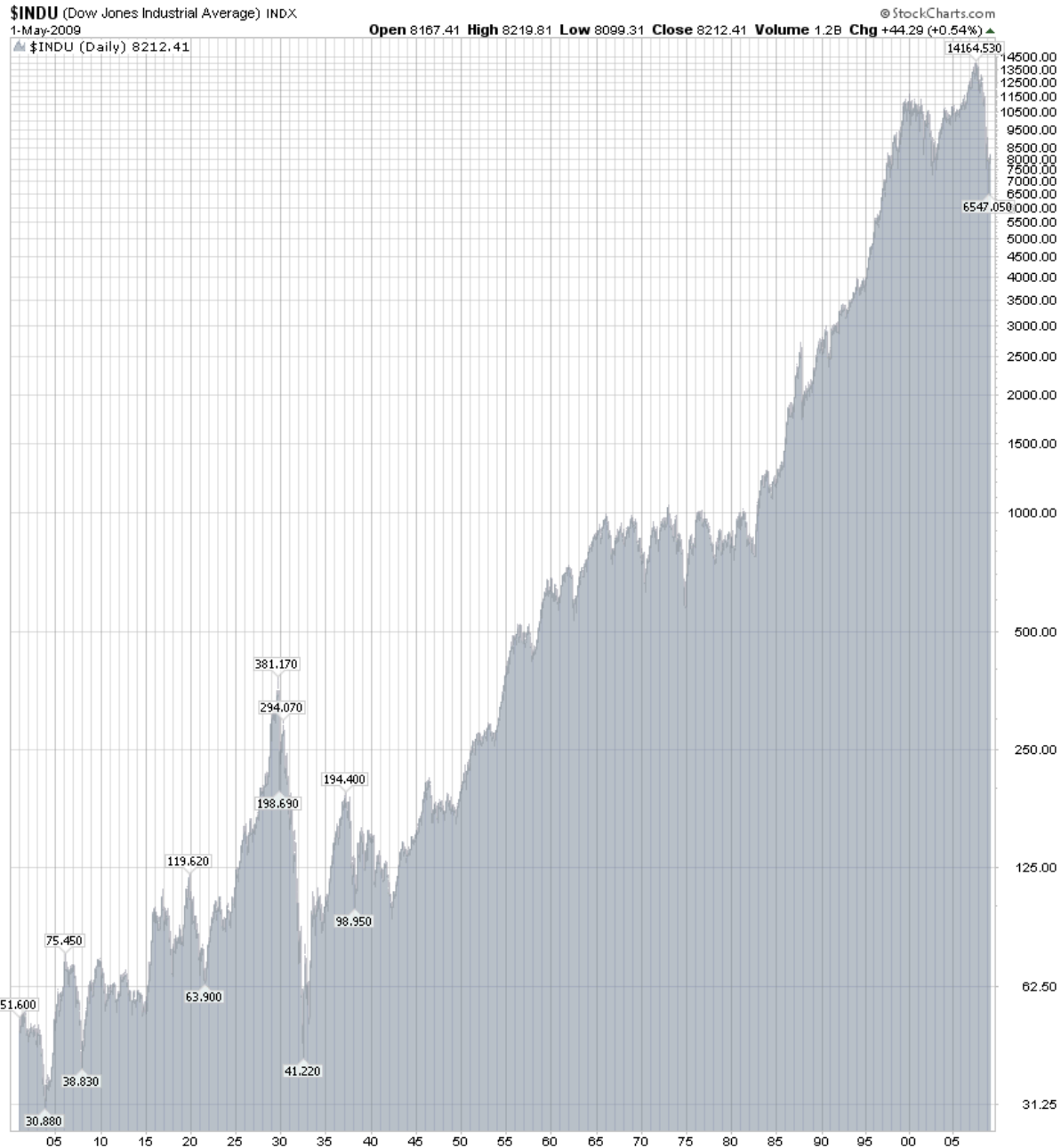
See charts on following pages

A Study of Market History and Valuation through Graham and Buffett and Others

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How the Terrible Two-Tier Market Came to Wall Street by Carol J. Loomis in July 1973, Fortune.

To many business men the stock market this year has seemed inexplicable, about as bizarre, say, as *Watergate*. The market has ignored the large, and often sensational, earnings gains being rewarded by corporations, and had gone relentlessly down. More than that, it has gone down with a great unevenness, much as a giant popover might lose steam.

On the one hand prices and price earning ratios of few dozen institutional favorites--known around as "the Vestal Virgins"—have fallen only moderately. In fact, some of these stocks, among them *Eli Lilly* at about 40 times estimated 1973 earnings) and *Avon* (at about fifty-two times), were recently selling very near their highs ever. In

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contrast, the great majority of stocks have sunk to levels that suggest they have become virtual pariahs. In the early months of this year, Wall Street was already talking about a “two-tier market” of remarkable proportions. By May, stocks that had seemed cheap at March prices had collapsed still further—many to levels of four or five times expected 1973 earnings—and the situation was being described as unique in stock-market history.

The description is probably accurate, though a bit difficult to check out. What can be said with certainty is that there has been no comparable situation in recent history. This conclusion emerges from a special statistical study of price-earnings ratios that *Fortune* made for this article. Covering the period since 1948 the year before the great postwar bull market got under way, the study embraced 382 companies, most of them prominent members of the business community. It ascertained their p-e ratios at the end of every year through 1972 (the year-end price was measured against that year’s earnings) and also at the end of the first quarter of 1973. Then for each period a “frequency distribution” analysis was done; that is, *Fortune* determined how many of those 382 companies had p-e ratios under 5 at the end of each period, how many had a p-e between 5 and 10, and so on up the scale.

The results show clearly that 1973 has been an extraordinary year in the market, to be ranked with such aberrant years as 1948 and 1961. In 1948 stocks were so out of favor that a company was a real high-flyer if its p-e was above 10. The median p-e for those 382 stocks that year was an incredibly low 5.8. In contrast, 1961 was a euphoric time when a p-e ratio below 10 was an oddity; the median was way up at 19.4.

Two Extremes at Once

But those were periods when the whole market was carried to extremes. The market this year has been something else, a caw of two extremes at once, and in between them a very deflated median. Specifically, at the end of 1973’s first quarter, before the severe decline of April and May, the median p-e for those 382 stocks was 11.5, the lowest level since 1957. And in a pattern not otherwise seen during the twenty-six years under examination, 128 stocks had a p-e above 30. Moreover, because the stocks in that upper tier were so highly valued by the market, they absorbed a far greater proportion of investment dollars than the number of companies represented there would indicate. (*This was similar to the “herding” into large Internet companies like Yahoo! AOL, Cisco vs. “old economy” stocks during the 1996 to 2000 dot com boom.*)

No doubt, then, there is today a two-tier market of major dimensions....No doubt, also, that this situation is raising some new and very serious economic questions. The basic questions concern the country’s capital markets, which have in the past demonstrated an outstanding ability to deliver equity capital to a broad range of companies. The two-tier market suggests, however, that the range is narrowing and the universe in which investors are willing to sink their money is shrinking. If this situation persists, how are the great majority of companies to raise the equity capital they may need? Beyond that, what happens to the new company seeking equity capital for the first time? Optimistic answers to these questions are hard to come by.

Inevitably, these questions also lead to others about the role of the institutions in the stock market. The two-tier market owes its existence to the action, and the non-actions of both institutional and individual investors. But market conditions at the moment suggest that control of the situation lies in the hands of the institutions, and that the two-tier market will disappear only if they—and in particular those giants, the bank trust departments—decide to swerve from the investment policies on which they have leaned very heavily in the last few years. The power of the institutions to shape events seems right now more awesome than ever before—and also more subject to attack.

Already, of course, all sorts of companies in the lower tier of the market have expressed outrage at the low valuation placed on their stocks. Their very specific complaints have lately been joined by others focusing on the broader problem. Two notable protests came recently from *Reginald H. Jones*, chairman of *General Electric*, and *James M. Roche*, retired chairman of *General Motors*. Jones was brought to worry about the ability of the “industrial backbone” of the economy to attract risk capital, and Roche warned that “our system cannot flourish solely on the basis of the health and strength of seventy five glamour companies.”

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Even the Chairman of the NYSE, *James J. Needham*, who would not normally think it his business to tout some stocks over others, was pushed to doing just about that. "It is certainly pertinent to inquire," he said deplorably in a speech, "Why the large institutions persist in tightening their concentration in a favorite few stocks while ignoring hundreds of other choice investment opportunities."

Inflation Is the Thief

That does sound like a pertinent line of inquiry to follow, and its pursuit should probably begin with a look at the bear market in which stocks have been trapped. This market it would appear, reflects investors' growing recognition....that inflation is robbing stocks of their value. For one thing, the "cost-push" inflation of the late 1960s put enormous pressure on corporate profits. Even now, with inflation more of the "demand-pull" variety and corporate profits booming, investors are obviously looking ahead with apprehension, fearing both a return to a cost-push era and a decent into a recession.

Second, inflation had by 1970 raised interest rates to very high levels and had forced investors to begin reconsidering what returns they expect from stocks. Historically, those returns, taken over the long term and on the average, have worked out to about 9.5%, including both capital gains and dividends. As long as interest rates were at much lower levels than 9.5 percent, which was the case during most of the postwar period, an expectation of such a return on stocks shaped up as very satisfactory. But with yields of high grade utility bonds above 9%, as they were for a time in 1970, or between 7.5 percent and 8 percent, as they have been recently a return of 9.5 percent on stocks scarcely seems adequate compensation for the added risks that stocks involve.

The logical reaction of investors is to market down the prices of stocks to levels that suggest future returns will comfortably exceed the rates available on bonds (although one investor's conception of what stock premium is "comfortable" may differ from another's). It would appear that investors have recently been in the process of making such a markdown.

It is clear that these institutions do not see in the lower tier those same "choice investment opportunities" that *Jim Needham* does. Yet *Fortune's* study of price-earnings ratios shows clearly that a whole army of stocks are at levels that are in the postwar periods have come to be considered "cheap." Furthermore, if one focused on companies rather than on stocks, a good case can be made that there are excellent values around.

All sorts of companies, in cyclical industries mainly, that could recently be bought at book value (or lower) have for at least several years averaged a return on book value of, say, 11 percent or better, and have reasonable expectations of maintaining (or improving) that return. An investor who buys into such a company at no more than book can also figure to earn 11 percent (or better) on his investment, both on the money with which he originally buys a piece of the action and also on every dollar of his earnings that the company retains and puts back to work in the company.

Yet the interest of these institutions in that 11 percent proposition appears almost nonexistent. Their attention, instead, is on the companies whose returns on capital are considerable higher--say, 14% and up--and whose earnings growth is considerable less subject to cyclical bumps and potentially much faster--perhaps 10 percent or more. These are the "good businesses" of the world, and could all stocks be bought at the same multiple of earnings, these are the ones that everyone would want to own. But the prices of these stocks have been affected relatively little by the bear market that has ravaged the rest of the list, and they can be had only at upper-tier prices. The question then becomes: **is it rational for the institutions to stay with these expensive stocks when so many others can be bought at greatly reduced prices?**

There are arguments on both sides of that question, and they are best looked at in terms of two forces that dominate the market: the corporate pension funds, which own about \$110 billion of stocks (out of total assets of about \$150 billion) and earlier this year were adding to stock-holdings at a \$7 billion annual rate; and the bank trust departments, which manage about 80 percent of all corporate pension-fund dollars. The banks also manage

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an estimated \$240 billion for individuals. Their assets, however, do not get the flow of “new money” that the pension funds do, not turn over as rapidly in the market.

There is vigorous competition for the pension funds’ business. Insurance companies and investment advisers would like to steal business away from the banks. The banks down the line would like to steal from the Big Two, *Morgan Guaranty* (\$16.6 billion in employee-benefit assets at the end of 1972) and *Bankers Trust* (\$15 billion). And *Bankers Trust*, of course, is gunning for *Morgan*. It so happens that *Morgan* has a history of investing in growth stocks, and it has outperformed most big banks; some of its accounts have had, with their stock portfolios, a compounded return better than 13 percent over the ten years ending with 1972. Because of its performance and its size, *Morgan* has become the player that everybody in the game watches. Its influence clearly extends beyond the sums it manages.

Morgan operates under certain constraints that set a rather special pattern. In total, the bank manages \$287 billion, about \$21 billion of it in stocks, and it fervently wishes to keep most of that in a relatively few stock in which it has maximum confidence. As a result, it needs big companies in which to invest—those whose stocks can absorb, say, \$50 million or more without going into orbit. “Big” companies, by *Morgan*’s definition, are those that have at least \$500 million in both value and revenues; companies of that size, of which there are perhaps 300 in the country, qualify for large, direct investments by the pension funds that *Morgan* manages. Smaller companies usually are reached through pools of money (rather like mutual funds) that *Morgan* sets up, and in which its pension accounts participate.

Morgan’s employee-benefit accounts recently had \$13.3 billion in stocks, of which about 49 billion (or 68 percent) was in fifty big companies. That makes an average investment of \$180 million per company. The remaining \$4.3 billion was invested in more than 550 company’s assorted sizes, for an average around \$7.8 million. In that assortment were 182 relatively small companies (generally with under \$100 million in market value and revenues) that *Morgan* believes to be comers and that hare held in a \$970-million pooled account. There are varying ways to look at all these numbers. *Morgan* thinks of them as showing that its arms are wide open to smaller companies. Others would no doubt be struck by the degree of concentration in a relatively few stocks.

When *Morgan* invests in a big stock, it has every intention of staying in that stock, if not forever, at least for a long time. “We are not trading, we are investors,” goes the *Morgan* pitch for new pension fund business. “We do not buy stocks with the idea of selling them at a specific price objective. We do not buy with the idea of selling high and buying back low.” *Morgan*’s belief in these principles is undoubtedly strong, but it should be noted that the bank really has no alternative strategy open to it. You cannot swing \$27 billion around from flower to flower. For that matter, you cannot easily swing even a few billion dollars around.

So *Morgan* and other big banks are constantly looking for what Wall Street has come to call “one-decision stocks”—i.e., stocks that can be bought and put away, with an expectation that they will produce at least some earnings growth in almost any kind of economic situation and will, over the long term, though not necessarily over any given shorter term period, outperform the market as a whole.

Warren Buffett, a well-known and very successful private investor whose own preferences run strongly to investing in low p-e “value” situations, thinks that *Morgan*’s strategy is quite rational—for the bank. “*Morgan* is sort of like a large conglomerate which must make decisions for the long term as to what kind of business it wants to be in. Would it be right for a conglomerate to sell its most profitable, best business just because it has a chance to pick up a not-so-great business at a cheap price? I doubt it. So I think, with all that money it is got to worry about, *Morgan* is probably handling things about as well at it can. Which doesn’t mean, of course, that what they are doing is necessarily right for me.”

It’s Rational Because It Worked

Nor does it mean that what may be rational for a giant like *Morgan*, or even for a few of its biggest competitors, is necessarily rational for all the smaller banks that are today playing follow-the-leader, and that could instead, if

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they chose to, go hunting for bargains. Nor are the tactics of any big bank necessarily rational for its clients, the pension funds. These investors are not obligated to place their money with giant institutions whose policies are significantly determined by the huge amounts of money they have to manage. They could instead manage their money themselves, or place it with smaller institutions with greater investment flexibility.

The few banks that have tried to steer a different course by moving into what they see as bargains in the lower tier have lately found the going rather tough. Once such bank is *First National of Chicago*. Its portfolio, though studded with such standbys as *I.B.M* and *Kodak*, is committed also to cyclical stocks and is less concentrated in the very largest companies than most other big bank portfolios are. As a result, the returns First National delivered its pension accounts last year, though these ran to around 14 percent, did not compare well with the returns of more than 20 percent realized by some of the NY Banks.....

While (First National) waits, it can at least keep telling itself that it has bought low-tier stocks at prices that can be rationalized. That is clearly more than most top-tier buyers can do. Their thoughts about the intrinsic value of growth stocks—which is admittedly one of the murkier subjects around—tend to be underdeveloped. The banks seem to buy instead mainly on the basis of “feel” and historical p/e ranges. We buy *I.B.M*, they say, when it approaches the lower limits of its range; we avoid it at the upper limits. The banks tend also to retreat into arguments that price doesn’t mean that much anyway. What counts, they say, is to pick the right companies, and even then, they add, you can get by with an occasional misjudgment. “This is a batting –average game,” says one trust officer. “You are going to lose a stock now and then—say, a *Litton*. But if your universe is a bunch of other very profitable companies, you can stand it.”

That is true, of course, only so long as the universe itself is not marked down sharply. Were such a markdown to occur today, it should probably imply a switch from buying to selling by the banks themselves. It is not easy to see this kind of a move taking place right now, but it is always possible. Some market commentators identify weakness in the growth stocks with the end of a bear market, and expect firmly to see these stocks begin to crack.

Is It Harder to Be Superior?

There can be no doubt, looking at the data that Fortune gathered on the largest holdings of the largest trust departments, that cracks in a few big stocks would do broad damage. Fourteen out of the seventeen banks included in the data have *I.B.M*, the market’s biggest stock, as their No. 1 holding (the other three have it in second place) and better than half have 7 percent or more of their common-stock assets in that one company. (One bank, *Chemical*, has 13 percent.)

The tendency to bunch their investments in the same few big stocks suggests that the banks have created a kind of neutralized environment in which any one bank will find it extremely difficult to achieve a standout performance. These circumstances should logically prove most adverse to the banks that in the past have done better than others.

Morgan, however, disagrees that superior performance has become harder to achieve; one of its executives describes this premise as another example of the “mythologies” that are forever being created by Wall Street. It is *Morgan*’s contention that the banks will continue to disagree about certain important stocks—as, for example, they are now disagreeing about *Polaroid*. Other banks also react testily to the thought that they have been “neutralized” and predict that the men will keep separating themselves from the boys.

Still, the banks do not feel at ease with the present degree of concentration, since they appreciate all too well the drastic price changes that can take place if a stock goes bad and everybody, as the saying goes, tries to get through the door at once. “Yes,” says *Quentin Ford*, head of trust investments for *Bankers Trust*, “it does bother me that everybody is going the same thing.” But he finds “solace: in the quality of his research and is none too surprised that research leads other banks to so many of the same stocks. **End**

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(Source: www.hussmanfunds.com compares the "Nifty-Fifty" stocks of the 1970's to the Internet bubble stocks in December 1999)

"The 'new-era' doctrine - that 'good' stocks (or 'blue chips') were sound investments regardless of how high the price paid for them -- was at bottom only a means for rationalizing under the title of 'investment' the well-nigh universal capitulation to the gambling fever... Why did the investing public turn its attention from dividends, from asset values, and from earnings, to transfer it almost exclusively to the earnings trend? The answer was, first, that the records of the past were proving an undependable guide to investment; and secondly, that the rewards offered by the future had become irresistibly alluring ... **The notion that the desirability of a common stock was entirely independent of its prices seems incredibly absurd.** Yet the new-era theory led directly to this thesis. If a stock was selling at 35 times the maximum recorded earnings, instead of 10 times its average earnings, which was the pre-boom standard, the conclusion to be drawn was not that the stock was too high but merely that the standard of value had been raised. Instead of judging the market price by established standards of value, the new-era based its standards of value on the market price."

- Benjamin Graham & David Dodd, *Security Analysis*, 1934.

Blue Chip Performance: 1973-1974

Du Pont -58.4%
Eastman Kodak -62.1%
Exxon -46.9%
Ford Motor -64.8%
General Electric -60.5%
General Motors -71.2%
Goodyear -63.0%
IBM -58.8%
McDonalds -72.4%
Mobil -59.8%
Motorola -54.3%
PepsiCo -67.0%
Philip Morris -50.3%
Polaroid -90.2%
Sears -66.2%
Sony -80.9%
Westinghouse -83.1%

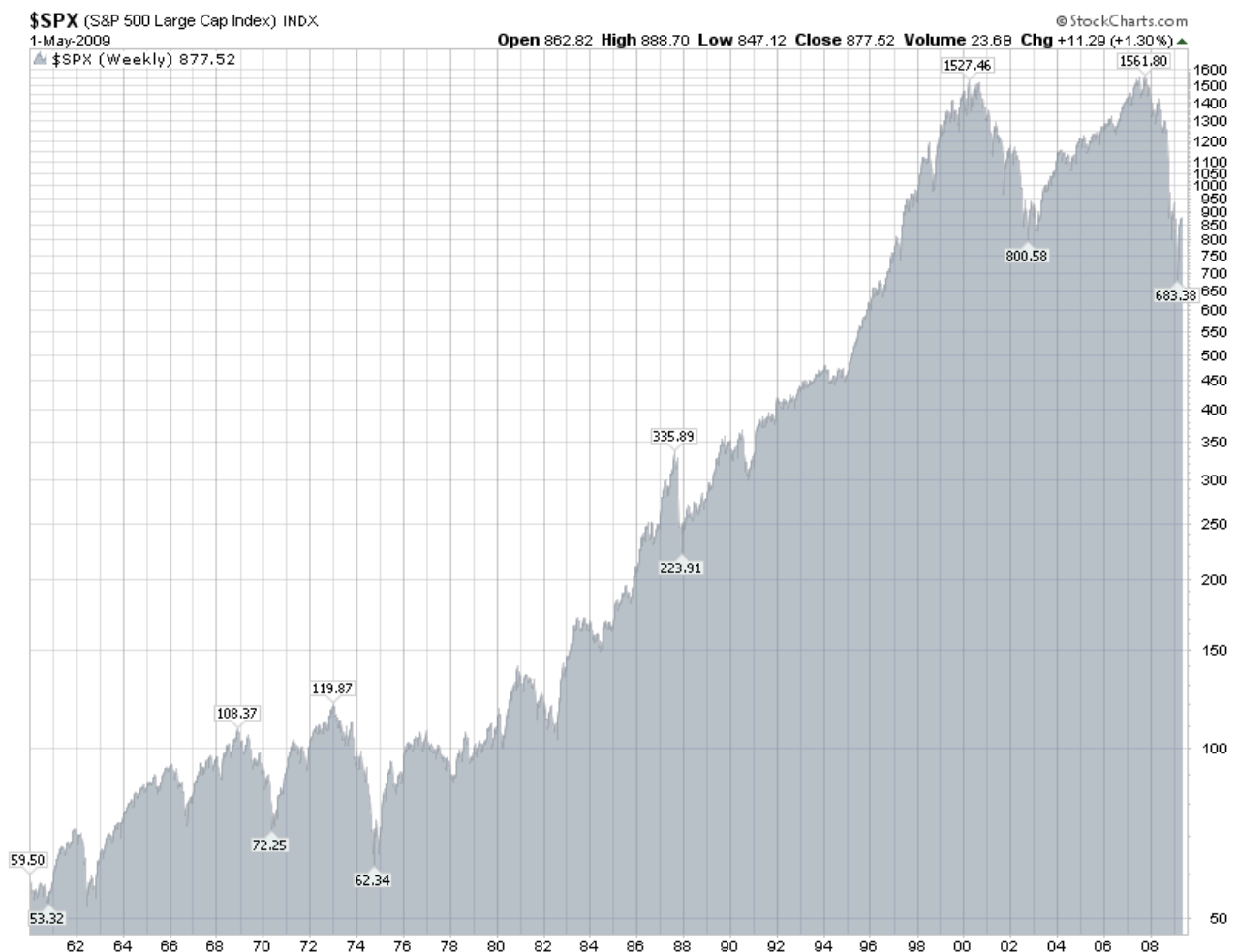
"The Nifty Fifty appeared to rise up from the ocean; it was as though all of the U.S. but Nebraska had sunk into the sea. The two-tier market really consisted of one tier and a lot of rubble down below. What held the Nifty Fifty up? The same thing that held up tulip-bulb prices long ago in Holland - popular delusions and the madness of crowds. The delusion was that these companies were so good that it *didn't matter* what you paid for them; their inexorable growth would bail you out."

You've just lived through the 1973-74 bear market. Actual figures. Actual headlines. Not pleasant. At the January 1973 market peak, earnings had hit a new high, and stock prices were selling at a P/E multiple of 20, which is extreme on the basis of record earnings. Over the next 2 years, corporate earnings grew by 56%, yet the market fell by half. **The 73-74 bear market teaches that stock prices can decline from extreme valuations even if earnings grow dramatically.** Imagine what could happen if both P/E multiples and earnings contract simultaneously ($\text{Price} = \text{P/E} \times \text{E}$). Now suppose they don't. Suppose that earnings surprise everyone by growing by 12% annually over the next 4 years. Suppose the P/E multiple doesn't contract to the historical average 12 times record earnings, but is still a high 18 times record earnings even 5 years from now. Guess what. Even if this happy scenario comes true, stock prices will be at the same level 5 years from now as they are today.

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The bottom line, it is uniform trend conditions, and only uniform trend conditions, that have kept us in a constructive position. This is, without question, a market that could fall by half. A 50% decline in the *S&P 500 Index* would put the P/E multiple at 14, still above the historical average P/E that has been applied to record earnings. Not even undervalued. It would put the dividend yield at just 2.8%, far below the historical average of 4% which has been attained at every bear market low. And as noted last month, even if dividend payouts were boosted to the historical average 52% of earnings, the current dividend yield would be only 1.8%. A 50% market drop would bring it only to 3.6%.

[Editor's note: In May 1998, the S&P 500 stood at 1,112, with the DJIA at 9,063. It is important to recognize that overvaluation does not require stock prices to decline. Overvaluation simply means that stocks are priced to deliver unsatisfactory long-term returns. Indeed, the market typically ignores valuation when trends exhibit what we call "favorable uniformity." This uniformity (which can be measured objectively) can sustain an overvalued market for months or even years. It is during those periods when valuations are unfavorable and trends lack favorable uniformity that overvaluation suddenly matters. When interest rates are rising as well, overvaluation generally matters with a vengeance.]



Warren Buffett--In November 1, 1974 Forbes Magazine

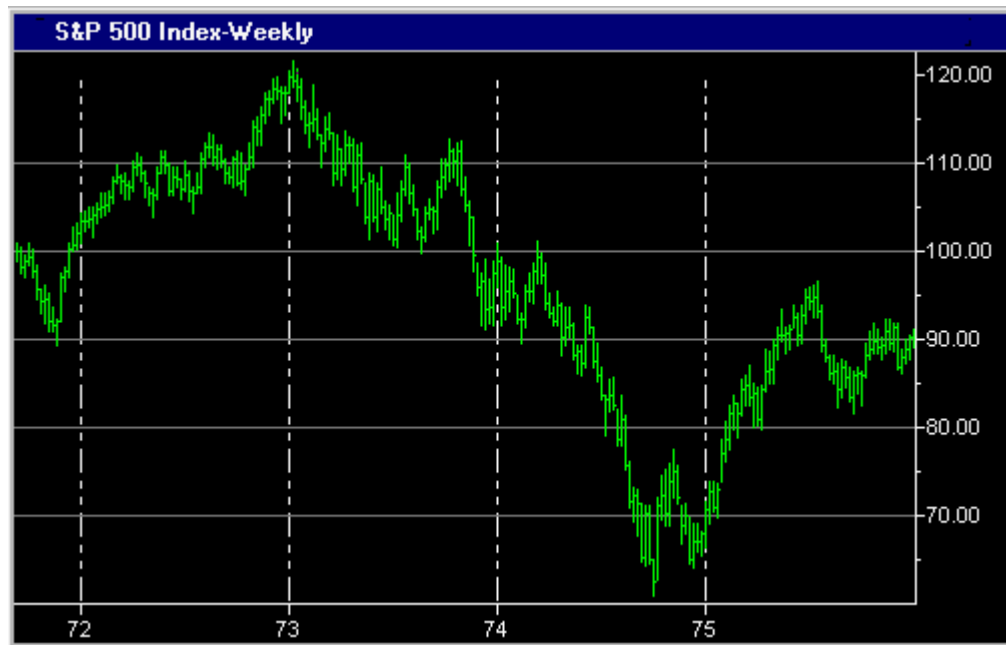
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Under the 1974 headline, "Look At All Those Beautiful, Scantly Clad Girls Out There!," this profile in Forbes magazine captures Warren Buffett's personality and chronicles the singular path he cut through the investment world. Though the piece is 34 years old, it sheds light on the man behind Berkshire Hathaway as the company's shareholders meet this weekend in Omaha, Neb.

How do you contemplate the current stock market, we asked *Warren Buffett*, the sage of Omaha, Neb.

"Like an oversexed guy in a harem," he shot back. "This is the time to start investing."

The Dow was below 600 (approximately 580) when he said that. Before we could get Buffett's words in print, it was up almost 15% in one of the fastest rallies ever.



We called him back and asked if he found the market as sexy at 660 as he did at 580. "I don't know what the averages are going to do next," he replied, "but there are still plenty of bargains around." He remarked that the situation reminded him of the early '50s.

Warren Buffett doesn't talk much, but when he does it's well worth listening to. His sense of timing has been remarkable. Five years ago, late in 1969, when he was 39, he called it quits on the market³. He liquidated his money management pool, *Buffett Partnership, Ltd.*, and gave his clients their money back. Before that, in good years and bad, he had been beating the averages, making the partnership grow at a compounded annual rate of 30% before fees between 1957 and 1969. (That works out to a \$10,000 investment growing to \$300,000 and change.)

He quit essentially because he found the game no longer worth playing. Multiples on good stocks were sky-high, the go-go boys were "performing" and the list was so picked over that the kind of solid bargains that Buffett likes were not to be had. He told his clients that they might do better in tax-exempt bonds than in playing the market. "When I got started," he says, "the bargains were flowing like the *Johnstown* flood; by 1969 it was like a leaky

³ In his May 29, 1969 *Buffett Partnership Letter* he stated his intention to require because: "However, it seems to me that opportunities for investment that are open to the analyst who stresses quantitative factors have virtually disappeared after rather steadily drying up over the past 20 years. \$100 million eliminates a lot of this barren world. And a swelling interest in investment performance has created an increasingly short term and (in my mind) more speculative market.

toilet in *Altoona*." Pretty cagey, this *Buffett*. When all the sharp MBAs were crowding into the investment business, *Buffett* was quietly walking away.

Buffett settled back to manage the business interests he had acquired, including *Diversified Retailing*, a chain of women's apparel stores; *Blue Chip Stamps*, a western states trading stamp operation; and *Berkshire Hathaway*, a diversified banking and insurance company that owned, among other things, a weekly newspaper, *The Omaha Sun*. The businesses did well. Under *Buffett's* management, the *Sun* won a Pulitzer prize for its exposé of how Boys Town, despite pleas of poverty, had been turned into a "moneymaking machine."

Swing, You Bum!

Buffett is like the legendary guy who sold his stocks in 1928 and went fishing until 1933. That guy probably didn't exist. The stock market is habit-forming: You can always persuade yourself that there are bargains around. Even in 1929. Or in 1970. But *Buffett* did kick the habit. He did "go fishing" from 1969 to 1974. If he had stuck around, he concedes, he would have had mediocre results.

"I call investing the greatest business in the world," he says, "because you never have to swing." You stand at the plate, the pitcher throws you *General Motors* at 47! *U.S. Steel* at 39! And nobody calls a strike on you. There's no penalty except opportunity lost. All day you wait for the pitch you like; then when the fielders are asleep, you step up and hit it."

But pity the pros at the investment institutions. They're the victims of impossible "performance" measurements. Says *Buffett*, continuing his baseball imagery, "It's like *Babe Ruth* at bat with 50,000 fans and the club owner yelling, 'Swing, you bum!' and some guy is trying to pitch him an intentional walk. They know if they don't take a swing at the next pitch, the guy will say, 'Turn in your uniform.'" *Buffett* claims he set up his partnership to avoid these pressures.

Stay dispassionate and be patient is *Buffett's* message. "You're dealing with a lot of silly people in the marketplace; it's like a great big casino and everyone else is boozing. If you can stick with *Pepsi*, you should be OK." First the crowd is boozy on optimism and buying every new issue in sight. The next moment it is boozy on pessimism, buying gold bars and predicting another Great Depression.

Fine, we said, if you're so bullish, what are you buying? His answer: "I don't want to tout my own stocks."

Any *general* suggestions, we asked?

Just common sense ones. Buy stocks that sell at ridiculously low prices. Low by what standards? By the conventional ones of net worth, book value, the value of the business as a going concern. Above all, stick with what you know; don't get too fancy. "Draw a circle around the businesses you understand and then eliminate those that fail to qualify on the basis of value, good management and limited exposure to hard times." No high technology. No multicompanies. "I don't understand them," says *Buffett*. "Buy into a company because you want to *own* it, not because you want the stock to go up."

"A water company is pretty simple," he says, adding that *Blue Chip Stamps* has a 5% interest in the *San Jose Water Works*. "So is a newspaper. Or a major retailer." He'll even buy a Street favorite if he isn't paying a big premium for things that haven't happened yet. He mentions *Polaroid*. "At some price, you don't pay anything for the future, and you even discount the present. Then, if *Dr. Land* has some surprises up his sleeve, you get them for nothing." (*Free "Optionality" to use a fancy hedge fund term*).

Have faith in your own judgment or your adviser's, *Buffett* advises. Don't be swayed by every opinion you hear and every suggestion you read. *Buffett* recalls a favorite saying of Professor Benjamin Graham, the father of

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modern security analysis and *Buffett's* teacher at *Columbia Business School*: **"You are neither right nor wrong because people agree with you."** Another way of saying that wisdom, truth, lies elsewhere than in the moment's moods.

All Alone?

What good, though, is a bargain if the market never recognizes it as a bargain? What if the stock market *never* comes back? *Buffett* replies: "When I worked for *Graham-Newman*, I asked *Ben Graham*, who then was my boss, about that. He just shrugged and replied that the market always eventually does. He was right--in the short run, it's a voting machine; in the long run, it's a weighing machine. Today on Wall Street they say, '**Yes, it's cheap, but it's not going to go up.**' That's silly. People have been successful investors because they've stuck with successful companies. Sooner or later the market mirrors the business." Such classic advice is likely to remain sound in the future when they write musical comedies about the go-go boys.

We reminded *Buffett* of the old play on the *Kipling* lines: "If you can keep your head when all about you are losing theirs ... maybe they know something you don't."

Buffett responded that, yes, he was well aware that the world is in a mess. "What the *DeBeers* did with diamonds, the Arabs are doing with oil; the trouble is we need oil more than diamonds." And there is the population explosion, resource scarcity, nuclear proliferation. But, he went on, you can't invest in the anticipation of calamity; gold coins and art collections can't protect you against Doomsday. If the world really is burning up, "you might as well be like *Nero* and say, 'It's only burning on the south side.'"

"Look, I can't construct a disaster-proof portfolio. But if you're only worried about corporate profits, panic or depression, **these things don't bother me at these prices.**"

Buffett's final word: "Now is the time to invest and get rich."

Next is a transcript of a speech by *Ben Graham* in September 1974 discussing how cheap the market was.

Renaissance of Value

Rare Investment Opportunities Are Emerging.

The title of this seminar—"The Renaissance of Value"—implies that the concept of value had previously been in eclipse in Wall Street. This eclipse may be identified with the virtual disappearance of the once well-established distinction between investment and speculation. In the last decade, everyone became an investor—including buyers of stock options and odd-lot short-sellers. In my own thinking, the concept of value, along with that of margin of safety, has always lain at the heart of true investment, while price expectations have been at the center of speculation.

At this point let me consider briefly an approach with which we were closely identified when managing the *Graham-Newman* fund. This was the purchase of shares at less than their working-capital value (*current assets minus current liabilities*). That gave such good results for us over a 40-year period of decision-making that we eventually denounced all other common-stock choices based on the usual valuation procedures, and concentrated on the sub-asset stocks. The "renaissance of value," which we are talking about today, involves the reappearance of this kind of investment opportunity. A *Value-Line* publication last month listed 1,000 such issues in the non-financial category. Their compilation suggests that there must be at least twice as many sub-working-capital choices in the *Standard & Poor's Monthly Stock Guide*. (However, don't waste \$25 sending for an advertised list of "1,000 stocks priced at less than Working Capital." Those responsible inexcusably omitted to deduct the debt and preferred stock liabilities from the working capital in arriving at the amount available for the common.)

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It seems no more than ordinary sense to conclude that if one can make up, say, a 30-stock portfolio of issues obtainable at less than working capital, and if these issues meet other value criteria, including the analysts' belief that the enterprise has reasonably good long-term prospects, why not limit one's selection to such issues and forget the more standard valuation methods and choices? I think the question is a logical one, but it raises various practical issues: How long will such "fire-sale stocks"--as *Value Line* called them--continue to be available; what would be the consequences if a large number of decision-makers began as of tomorrow to concentrate on that group; what should the analyst do when these are no longer available?

Such questions are actually related to broader aspects of the value approach, involving the availability of attractive investment opportunities if and when most investors and their advisors followed this doctrine.

Some interesting questions relating to intrinsic value versus market price are raised by the takeover bids that are now part of our daily financial fare. The most spectacular such event occurred a few weeks ago, when two large companies actively competed to buy a third, with the result that within a single month the price of *ESB inc.* advanced from \$17.50 over \$41. We have always considered the **value of the business to a private owner as a significant element in appraising a stock issue**. We now have a parallel figure for security analysts to think about: the price that might be offered for a given company by a would-be acquirer. In that respect, the *ESB* transaction and the *Marcor* one that followed it offer much encouragement to those who believe that the real value of most common stocks is well above their present market level.

There is another aspect of takeovers that I want to bring up here, on a somewhat personal basis, because it relates to an old losing battle that I have long fought to make shareholders less sheep like vis-à-vis their managements. You will recall that the first bid of *INCO* was termed a "hostile act" by the *ESB* management, who vowed to fight it tooth and nail. Several managements have recently asked stockholders to vote charter changes that would make such acquisitions more difficult to accomplish against their opposition--in other words, make it more difficult for stockholders to obtain an attractive price for their shares. The stockholders, still sheep-like, generally approve such proposals. If this movement becomes widespread, it could really harm investors' interests. I hope that financial analysts will form a sound judgment about what is involved here and do what they can to dissuade stockholders from cutting their own throats in such a foolish and reckless fashion. This might well be a subject for the *Financial Analyst Federation* to discuss and take an official stand on.

There is at least a superficial similarity between the prices offered in takeovers and those formerly ruling in the market for the first-tier issues, as represented by "the favorite 50." (*Graham is referring to the Nifty-Fifty Glamour, Growth stocks-see Loomis Article.*) The large institutions have acted somewhat in the role of conglomerates extending their empires by extravagant acquisitions. The P-E ratio of *Avon Products* averaged 55x in 1972, and reached 65x at the high \$140. (*Graham speaks here of the "Nifty 50" which were the stocks that institutions could pile into at "any" price because of their high quality earnings growth and performance.*) This multiplier could not have been justified by any conservative valuation formulae. It was not made by speculators in a runaway bull market; it had the active or passive support of the institutions that have been large holders of *Avon*.

As I see it, institutions have been persuaded to pay outlandish multipliers for shares of the *Avon* type by a combination of three influences. First, the huge amounts of money they have to administer, most of which they decide to place in equities. Second, the comparatively small number of issues to which their operations were confirmed, in part because they had to choose multimillion-share companies for their block transactions, and partly by their insistence on high-growth prospects. The third influence was the cult of performance, especially pension fund management.

The arithmetic here is deceptively simple. If a company's earnings will increase 15% this year, and if the P-E ratio remains unchanged, then presto! The "investment" shows a 15 percent performance, plus the small dividend. If the P-E ratio advances—as it did for *Avon* in almost every year--the performance becomes that much better. These results are entirely independent of the price levels at which these issues are bought. Of course, in this fantasia, the institutions were pulling themselves up by their own bootstraps--something not hard to do in Wall Street, but impossible to maintain forever.

These institutional policies raise two implications of importance for financial analysts. **First, what should a conservative analyst have done in the heady area and era of high growth, high multiplier companies?** I must say mournfully that he would have to do the near impossible--namely, turn his back on them and let them alone. The institutions themselves had gradually transformed these investment-type *companies* into speculative *stocks*. I repeat that the ordinary analyst cannot expect long-term satisfactory results in the field of speculative issues, whether they are speculative by the company's circumstances or by the high price levels at which they habitually sell.

My second implication is a positive one for the investing public and for the analyst who may advise a non-institutional clientele. We have many complaints that institutional dominance of the stock market has put the small investor at a disadvantage because he can't compete with the trust companies huge resources, etc. The facts are quite the opposite. It may be that the institutions are better equipped than the individual to speculate in the market; I'm not competent to pass judgment on that. **But I am convinced that an individual investor with sound principles, and soundly advised, can do distinctly better over the long pull than a large institution.** Where the trust company may have to confine its operation to 300 concerns or less, the individual has up to 3,000 issues for his investigations and choice. Most true bargains are not available in large blocks; by this very fact the institutions are well-nigh eliminated as competitors of the bargain hunter.

Assuming all this is true, we must revert to the question we raised at the outset. How many financial analysts can earn a good living by locating undervalued issues and recommending them to individual investors? In all honesty I cannot say that there is room for 13,000 analysts, or a large portion thereof, in this area of activity. But I can assert that the influx of analysts into the undervalued sphere in the past has never been so great as to cut down its profit possibilities through that kind of over-cultivation and over-competition. (The value analyst is more likely to suffer from loneliness.)

True, bargain issues have repeatedly become scarce in bull markets, but that was not because all the analysts became value-conscious, but because of the general upswing in prices. (Perhaps one could have determined whether the market level was getting too high or too low by counting the number of issues selling below working-capital value. When such opportunities have virtually disappeared, past experience indicates that investors should have taken themselves out of the stock market and plunged up to their necks in US Treasury bills.)

So far I have been talking about the virtues of the value approach as if I never heard of such newer discoveries as "the random walk," "the efficient portfolios," the Beta coefficient, and others such. I have heard about them, and I want to talk first for a moment about *Beta*. This is a more or less useful measure of past price fluctuations of common stocks. **What bothers me is that authorities now equate the Beta idea with the concept of "risk."** Price variability yes; risk no. **Real investment risk is measured not by the percent the stock may decline in price in relation to the general market in a given period, but by the danger of a loss of quality and earnings power economic changes or deterioration in management.**

In the five editions of *The Intelligent Investor*, I have used the example of *A&P* shares in 1936 to 1939 to illustrate the basic difference between fluctuations in price and changes in value. By contrast, in the last decade the price decline of *A&P* shares from \$43 to \$8 paralleled pretty well a corresponding loss of trade position, profitability, and intrinsic value. The idea of measuring investment risks by price fluctuations is repugnant to me, for the very reason that it confuses what the stock market says with what actually happens to the owners' stake in the business....

The value approach is always been more dependable when applied to senior issues than to common stocks. Its particular purpose in bond analysis is to determine whether the enterprise has a fair value so comfortably in excess of its debt as to provide an adequate margin of safety. The standard calculation of interest coverage has much the same function. There is much work of truly professional caliber that analysts can do in the vast area of bonds and preferred stocks--and, to some degree also, in that of convertible issues. The field has become an increasingly important one, especially since all well-rounded portfolios should have their bonds component.

Any security analyst worth his salt should be able to decide whether a given senior issue has enough statistically based protection to warrant its consideration for investment. The job has been neglected at times in the past 10 years--most glaringly in the case of the *Penn-Central Railroad* debt structure. It is an unforgivable blot on the record of our profession that the *Penn-Central* bonds were allowed to sell in 1968 at the same prices as good public- utility issues. An examination of that system's record in previous years--noting, inter alia, its peculiar accounting and the fact that it paid virtually no income taxes—would have clearly called for moving out of the bonds, to say nothing of the stock even at prices well below its high of \$86.

We now have a situation which all bonds sell at high yields, but many companies have an overextended debt position. Also, many of them do not seem to have sufficiently strong protective provisions in their bond indentures to prevent them from offering new debt in exchange for their own common stock. (A striking example is the current bond for stock operations of *Caesar's World*.) These widespread present maneuvers seem to me to be so many daggers thrust in the soft bodies of the poor creditors.

Thus security analysts could well advise a host of worthwhile switching in the bond field. Even in the Federal debt structure--where safety is not an issue--the multiplicity of indirect US government obligations all sorts, including some tax-exempts, suggests many opportunities for investors to improve their yields. Similarly, we have seen many convertible issues selling close to a parity with the common; in the typical case, the senior issue has offered a higher yield than the junior shares. Thus, a switch from the common stock into the senior issue in these cases would be a plain matter of common sense. (Examples: *Studebaker-Worthington* and *Engelhard Industries* preferred vs. common.)

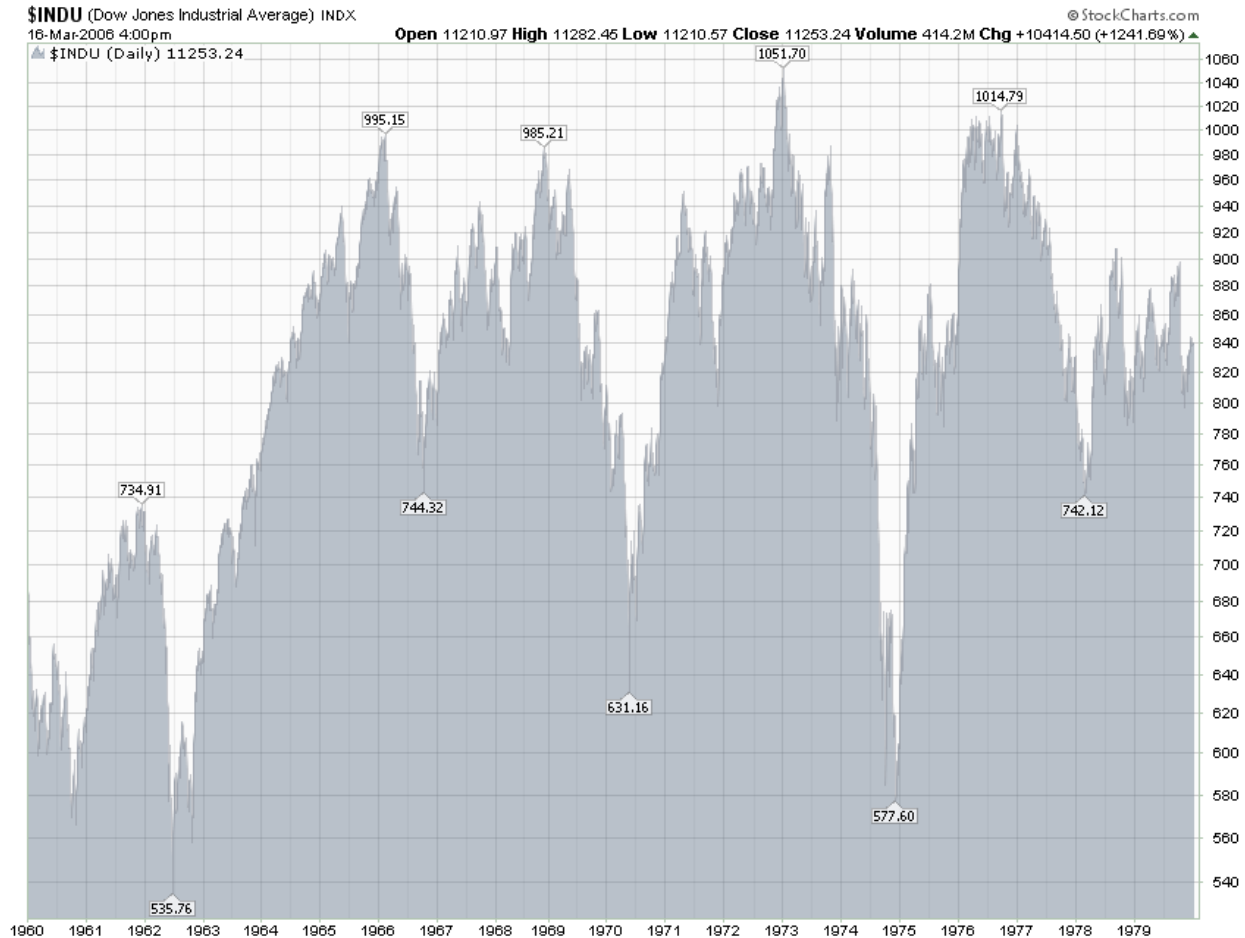
Let me close with a few words of counsel from an 80-year-old veteran of many a bull and bear market. **Do those things as an analyst you know you could do well, and only those things.** If you can really beat the market by charts, by astrology, or by some rare and valuable gift of your own, that's the row you should hoe. If you are really good at picking stocks most likely to succeed in the next 12 months, base your work on that endeavor. If can foretell the next important development in the economy, or in technology, or in consumers' preferences, and gauge its consequences for various equity values, then concentrate on that particular activity. But in each case you must prove to yourself by honest, no bluffing self-examination and by continuous testing of performance, that you have what it takes to produce worthwhile results.

If you believe--as I've always believed--that the value approach is inherently sound, workable, and profitable, then devote yourself to that principle. Stick to it, and don't be led astray by Wall Street's fashions, illusions, and its constant chase after the fast dollar. Let me emphasize that it does not take a genius or even a superior talent to be successful as a value analyst. What it needs is, first, reasonably good intelligence; second, sound principles of operation; third, and most important, firmness of character.

But whatever path you follow as financial analysts, hold onto your moral and intellectual integrity. Wall Street in the past decade fell far short of its once-praiseworthy ethical standards, to the great detriment of the public it serves and the financial community itself. When I was in elementary school in this city, more than 70 years ago, we had to write various maxims in our copybooks. The first on that list was "Honesty is the best policy." It is still the best policy...

A Study of Market History and Valuation through Graham and Buffett and Others

Editorial Comments by: Aldridge56@aol.com.



YOU PAY A VERY HIGH PRICE IN THE STOCK MARKET FOR A CHEERY CONSENSUS

by Warren E. Buffett

Forbes, Vol. 124, No. 3, **August 6, 1979**, 24-26 by permission of the author.

Pension fund managers continue to make investment decision with their eyes firmly fixed on the rear-view mirror. This generals-fighting-the-last-war approach has proven costly in the past and will likely prove equally costly this time around.

Stocks now sell at levels that should produce long-term returns far superior to bonds. Yet pension managers, usually encouraged by corporate sponsors they must necessarily please (*"whose bread I eat, his song I sing"*), are pouring funds in record proportions into bonds.

Meanwhile, orders for stocks are being placed with an eyedropper. *Parkinson*—of *Parkinson's Law* fame—might conclude that the enthusiasm of professionals for stocks varies proportionately with the recent pleasure derived from ownership. This always was the way John Q. Public was expected to behave. John Q. Expert seems similarly afflicted. Here's the record.

In 1972, when the Dow earned \$67.11 or 11% on beginning book value of 607, it closed the year selling at 1020 and pension managers couldn't buy stocks fast enough. Purchases of equities in 1972 were 105% of net funds

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available (i.e., bonds were sold), a record except for the 122% of the even more buoyant prior year. This two-year stampede increased the equity portion of total pension assets from 61% to 74%—an all-time record which coincided nicely with a record high price for the *Dow*. The more investment managers paid for stocks, the better they felt about them.

And then the market went into a tail-spin in 1973-74. Although the *Dow* earned \$99.04 in 1974, or 14% on beginning book value of 690, it finished the year selling at 616 (16.1%). A bargain? Alas, such **bargain prices produced panic rather than purchases**; only 21% of net investable funds went into equities that year, a 25-year record low. The proportion of equities held by private noninsured pension plans fell to 54% of net assets, a full 20 point-drop from the level deemed appropriate when the *Dow* was 400 points higher.

By 1976 the courage of pension managers rose in tandem with the price level, and 56% of available funds were committed to stocks. The *Dow* that year averaged close to 1,000, a level then about 25% above book value.

In 1978 stocks were valued far more reasonably, with the *Dow* selling below book value most of the time. Yet a new low of 9% of net funds was invested in equities during the year. The first quarter of 1979 continued at very close to the same level.

By these actions pension managers, in record-setting manner, are voting for purchase of bonds—at interest of 9% to 10%—and against purchase of American equities at prices aggregating book value or less. **But these same pension managers probably would concede that those American equities, in aggregate and over the longer term, would earn about 13% (the average in recent years) on book value.** And, overwhelmingly, the managers of their corporate sponsors would agree.

Many corporate managers, in fact, exhibit a bit of schizophrenia regarding equities. They consider their own stocks to be screamingly attractive. But, concomitantly, they stamp approval on pension policies rejecting purchases of common stocks in general. And the boss, while wearing his acquisition hat, will scorn investment in similar companies at book value. Can his own talents be so unique that he is justified both in paying 200 cents on the dollar for a business if he can get his hands on it, and in rejecting it as an unwise pension investment at 100 cents on the dollar if it must be left to be run by his companions at the Business Roundtable?

A simple *Pavlovian* response may be the major cause of this puzzling behavior. During the last decade stocks have produced pain—both for corporate sponsors and for the investment managers the sponsors hire. Neither group wishes to return to the scene of the accident. But the pain as not been produced because business has performed badly, but rather because stocks have underperformed business. Such underperformance cannot prevail indefinitely, any more than could the earlier over-performance of stocks versus business that lured pension money into equities at high prices.

Can better results be obtained over, say, 20 years from a group of 9½% bonds of leading American companies maturing in 1999 than from a group of *Dow*-type equities purchased, in aggregate, at around book value and likely to earn, in aggregate, around 13% on that book value? The probabilities seem exceptionally low. The choice of equities would prove inferior only if either a major sustained decline in return on equity occurs or a ludicrously low valuation of earnings prevails at the end of the 20-year period. Should price-earnings ratios expand over the 20-year period—and that 13% return on equity be averaged—purchases made now at book value will result in better than a 13% annual return. **How can bonds at only 9½% be a better buy?**

Think for a moment of book value of the *Dow* as equivalent to par or the principal value of a bond. And think of the 13% or so expectable average rate of earnings on that book value as a sort of fluctuating coupon on the bond—a portion of which is retained to add to principal amount just like the interest return on U.S. Savings Bonds. Currently our “*Dow Bond*” can be purchased at a significant discount (at about 840 vs. 940 “principal amount” or book value of the *Dow*). That *Dow Bond* purchased at a discount with an average coupon of 13%—even though the coupon will fluctuate with business conditions—seems to me to be a long-term investment far superior to a conventional 9 ½% 20-year bond purchased at par.

Of course there is no guarantee that future corporate earnings *will* average 13%. It may be that some pension managers shun stocks because they expect reported returns on equity to fall sharply in the next decade. However, I don't believe such a view is widespread.

Instead, investment managers usually set forth two major objections to the thought that stocks should not be favored over bonds. Some say earnings are currently overstated, with real earnings after replacement-value depreciation far less than those reported. Thus, they say, real 13% earnings aren't available. But that argument ignores the evidence in such investment areas as life insurance, banking, fire-casualty insurance, finance companies, service businesses, etc. In those industries replacement-value accounting would produce results virtually identical with those produced by conventional accounting. And yet, one can put together a very attractive package of large companies in those fields with an expectable return of 13% or better on book value and with a price which, in aggregate, approximates book value. Furthermore, I see no evidence that corporate managers turn their backs on 13% returns in their acquisition decisions because of replacement-value accounting considerations.

A second argument is made that there are just too many question marks about the near future; wouldn't be better to wait until things clear up a bit? You know the prose: "Maintain buying reserves until current uncertainties are resolved," etc. Before reaching for that crutch, face up to two unpleasant facts: The future is *never* clear; **you pay a very high price for a cheery consensus.** Uncertainty actually is the friend of the buyer of long-term values.

If anyone can afford to have such a long-term perspective in making investment decisions, it should be pension fund managers. While corporate managers frequently incur large obligations in order to acquire businesses at premium prices, most pension plans have very minor flow-of-funds problems. If they wish to invest for the long term—as they do in buying those 20- 30- year bonds they now embrace—they certainly are in a position to do so. They can, and should, buy stocks with the attitude and expectations of an investor entering into a long-term partnership.

Corporate managers who duck responsibility for pension management by making easy, conventional or faddish decisions are making an expensive mistake. Pension assets probably total about one-third of overall industrial net worth and, of course, bulk far larger in the case of many specific industrial corporations. Thus poor management of those assets frequently equates to poor management of the largest single segment of the business. Soundly achieved higher returns will produce significantly greater earnings for the corporate sponsors and will also enhance the security and prospective payments available to pensioners.

Managers currently opting for lower equity ratios either have a highly negative opinion of future American business results or expect to be nimble enough do dance back into stocks at even lower levels. There may well be some period in the near future when financial markets are demoralized and much better buys are available in equities; that possibility exists at all times. But you can be sure that at such a time the future will seem neither predictable nor pleasant. Those now awaiting a "better time" for equity investing are highly likely to maintain that posture until well into the next bull market.

FOOTNOTES

1. Figures are based on the old Dow, prior to the recent substitutions. The returns would be moderately higher and the book values somewhat lower if the new Dow had been used.

Additional Notes:

As happened in 1921 and 1932 US equity prices stopped falling when they reached a 70% discount to the replacement value of their assets.

Dec. 1974 was the fifth great bottom

		Q Ratio Yr. End	Q Ratio Est. at bottom
1921	7.4x	.35	.28
1932	4.7x	.43	.30
1949	11.7x	.36	.29
1974	11.2x	.36	.35
1982	9.9x	.38	.27

In **July 1985**, Buffett said, “In today’s stock market, equities are priced at an average of 30% to 40% above their intrinsic worth (their asset or book value). And I ask myself, “What kind of return can corporations get on that intrinsic value?” I assume they can get 14% return on their assets, which sounds good in relation to today’s bond yields. But there is a big problem. Since you are paying a 30% to 40% over the asset value, your rate of return is that much less. Then, when the return is taxed at capital gains rate, it turns out, on average, not very attractive compared with current tax-exempt bonds. (At the time an investor, for example, could purchase a tax-free income on a *California AA-rated muni bond* of 8.5%. In contrast, the investor can only keep 50% of the income from taxable stocks and bonds. The investor would have to receive roughly a 17% return on a taxable investment to equal the equivalent tax-free return on a muni-bond.

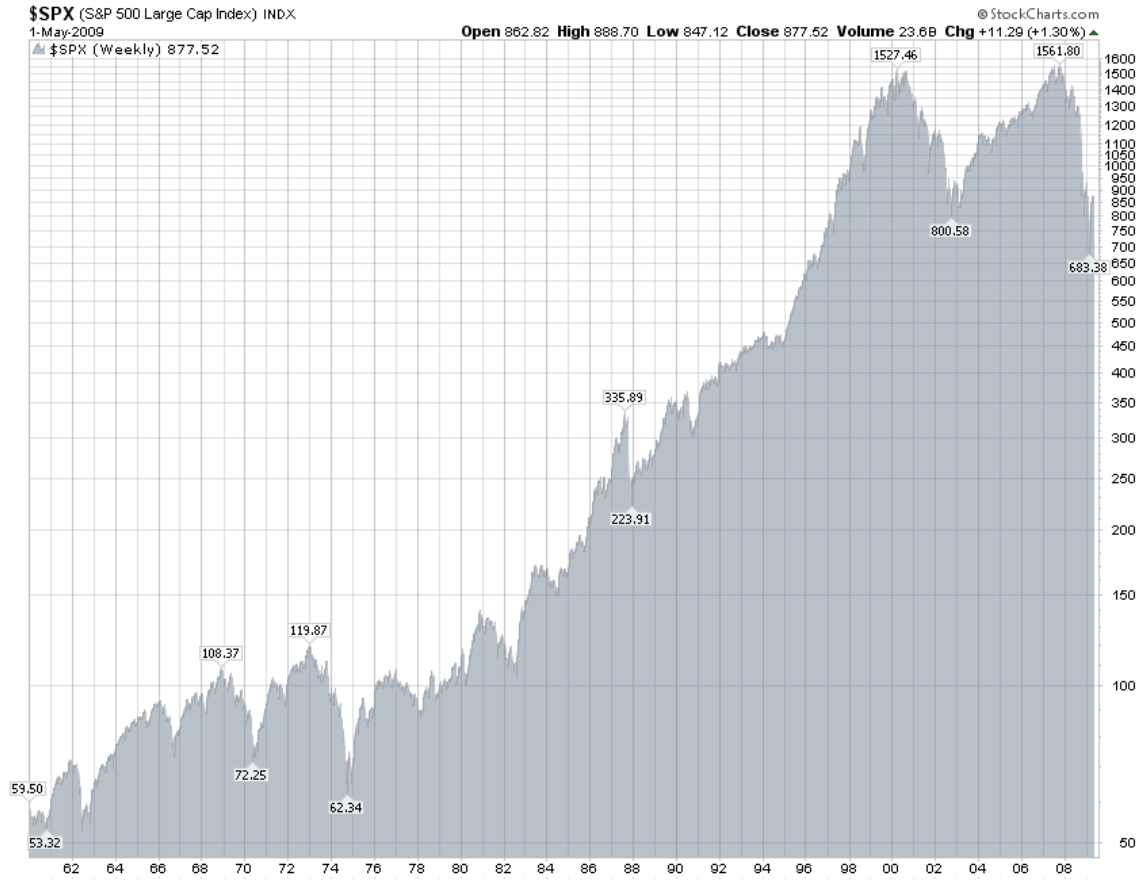
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*“Thirty years ago, no one could have foreseen the huge expansion of the Vietnam War, wage and price control, two oil shocks, the resignation of a president, the dissolution of the Soviet Union, a one-day drop in the Dow of 508 points, or treasury bill yields fluctuating between 2.8 per cent and 17.4 per cent. But, surprise! None of these events made the slightest dent in Ben Graham’s investment principles. Nor did they render unsound the negotiated purchases of fine businesses at sensible prices. Imagine the cost to us, then, if we had let fear of the unknowns cause us to defer or alter the deployment of capital. Indeed, we have usually made our best purchases when apprehensions about some macro event were at a peak. Fear is the foe of the faddist, but the friend of the fundamentalist. A different set of major shocks is sure to occur in the next 30 years. We will neither try to predict these nor profit from them. **If we can identify businesses similar to those we have purchased in the past, external surprises will have little effect on our long -term results.**”*

(Warren Buffet, 1994)

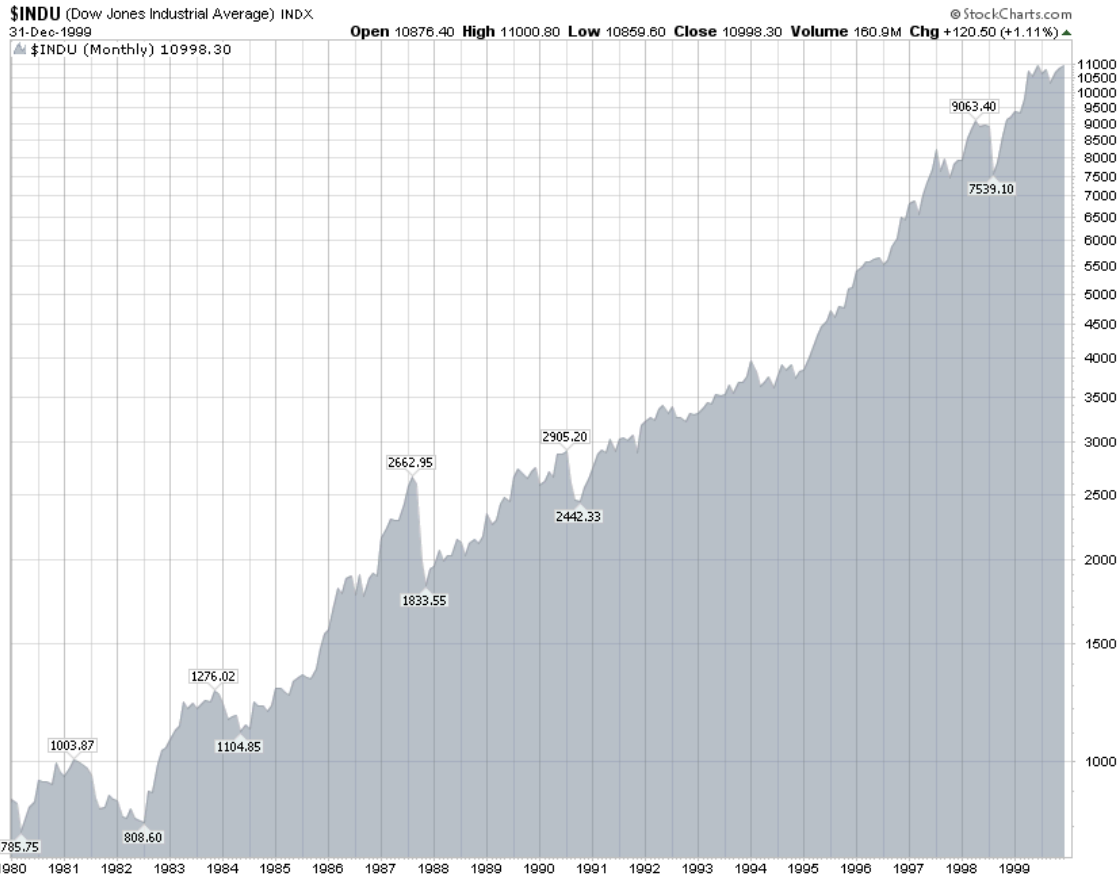
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Buffett Offers an Opinion on the Over Valuation of the NASDAQ During July 1999

(From the book, *The Snowball* by Alice Schroeder), pages 16-23.

Buffett's Speech at the *Allen & Company Sun Valley Conference* on July 1999.

I would like to talk about the stock market, he (*Buffett*) said. I will be talking about pricing stocks, but I will not be talking about predicting their course of action next month or next year. **Valuing is not the same as predicting.**

“In the short run, the market is a voting machine. In the long run, it is a weighing machine. Weight counts eventually. But votes count in the short term. And it is a very undemocratic way of voting. Unfortunately, they have no literacy tests in terms of voting qualification, as you have all learned.”

Dow Jones Industrial Average	
December 31, 1964	874.12
December 31, 1981	875.00

During these 17 years, the size of the economy grew more than fivefold. The sales of the *Fortune Five Hundred* companies grew more than fivefold.⁴ Yet, during these seventeen years, the stock market went exactly nowhere.”

⁴ Fortune magazine ranks the largest 500 companies based on sales and refers to them as the Fortune 500.” This group of companies can be used as a rough proxy for U.S. -based business.

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He backed up a step or two. “What you are doing when you invest is deferring consumption and laying money out now to get more money back at a later time. And there are really only two questions. One is how much you are going to get back and the other if when.

Now. *Aesop* was not much of a finance major, because he said something like, ‘A bird in hand is worth two in the bush.’ But he doesn’t say when.” They are to finance as gravity is to physics. As interest rates vary, the value of all financial assets—houses, stocks, bonds—changes, as if the price of birds had fluctuated. “And that is why sometimes a bird in the hand is better than two birds in the bush and sometimes two in the bush are better than one in the hand.”

Buffett related *Aesop* to the great bull market of 1990s, which he described as baloney. Profits had grown much less than in that previous period, but birds in the bush were expensive because interest rates were low. Fewer people wanted cash—the bird in the hand—at such low rates. So investors were paying unheard of price for those birds in the bush. Casually, Buffett referred to this as the “greed factor.”

Buffett continued, “There were only three ways the stock market could keep raising at ten percent or more a year. One was if interest rates fell and remained below historic levels. The second was if the share of the economy that went to investors, as opposed to employees and government and other thing, rose above its already historically high level.”⁵ Or, he said, the economy could start growing faster than normal.⁶ He called it “wishful thinking” to use optimistic assumptions like these. Some people, he said, were not thinking that the whole market would flourish. They just believed they could pick the winners from the rest. Swinging his arms like an orchestra conductor, he succeeded in putting up another slide while explaining that, although innovation might lift the world out of poverty, people who invest in innovation historically have not been glad afterward.

This is half of a page which comes from a list seventy pages long of all the auto companies in the United States.” He waved the complete list in the air.⁷ “There were two thousand auto companies: the most important invention, probably, of the first half of the twentieth century. It had enormous impact on people’s lives. If you had seen at the time of the first car how this country would develop in connection with autos you would have said, ‘This is the place I must be.’ But of the two thousand companies, as of a few years ago, only three car companies survived. And, at one time or the other, all three were selling for less than book value, which is the amount of money that had been put into the companies and left there. So autos had an enormous impact on America, but in the opposite direction on investors.” Below is a chart of *General Motors (GM)*, *Ford (F)* and the *DJIA*. Note the massive under-performance of *Ford* and *GM* as compared to the *DJIA*.

⁵ Corporate profits at the time were more than 6% of GDP, compared to a long-term average of 4.88%. They have since risen to over 9%, far above \ historic levels.

⁶ Over long periods the U.S. economy has grown at a real rate of 3% and a nominal rate (after inflation) of 5%. Other than a postwar boom or recovery from severe recession, this level is rarely exceeded.

⁷ Some of the Auto companies operating in 1903 were Electric Vehicle Company, The Winton Motor Carriage Company, Packard Motor Car company, Olds Motor Works, Knox Automobile Company, The Peerless Motor Car Co., Waltham Manufacturing Co., Berg Automobile Co., Cadillac Automobile Co., Buffalo Gasoline Motor Co., etc.



But, sometimes it is much easier to figure out the losers. There was, I think, one obvious decision back then. And of course, the thing you should have been doing was shorting horses.”

U.S. Horse Population	
1900	17 million
1998	5 million

“Frankly, I’m kind of disappointed that the Buffett family was not shorting horses throughout this entire period. There are always losers.”

Spotting the losers is easier than spotting the winners. In fact, the losers from technological change are much easier to spot than the winners. Losing technologies often have a barrier that proves clearly insurmountable in their quest to react to their new competitors. Canals, for example, simply could not achieve the speed of throughput that railways could. The telephone allowed voice transmission, the telegraph did not. The digital computer provided greater accuracy and speed than any analog equivalent could achieve. (Source: *Engines that Move Markets* by Alasdair Nairn.)

Now the other great invention of the first half of the century was the airplane. In this period from 1919 to 1939, there were about two hundred companies. Imagine if you could have seen the future of the airline industry back there at *Kitty Hawk*. You would have seen a world undreamed of. But assume you had the insight, and you saw all of these people wishing to fly and to visit their relatives or run away from their relatives or whatever you do in an airplane, and you decided this was the place to be.

As of a couple of years ago, there had been zero money made from the aggregate of all stock investments in the airline industry in history. (Insert 1990 and 2008 charts)

“So I submit to you: I really like to think that if I had been down there at *Kitty Hawk*, I would have been farsighted enough and public spirited enough to have shot *Orville* down. I owed it to future capitalists.”

A short financial history of the automobile from Engines That Move Markets: Technology Investing from Railroad to the Internet and Beyond by Alasdair Nairn.

The losers from the old technology (*Horse-drawn carriages and buggy whip manufacturers*) were fairly easy to spot, but selection of which companies would prove the winners was much more difficult. Literally hundreds of companies sprang up, many of them genuine competitors, some of them effectively stock market scams. For the outsider, there was little to distinguish between the genuine and the fake, let alone which of the genuine companies would succeed.

Even the companies that did eventually succeed did so only after a rocky road. Henry Ford was successful only on his third corporate attempt and only after splitting with his partners over the strategic direction of the company. *General Motors* had to be rescued twice, and *Chrysler* was effectively a company resuscitated from previous misfortune. Furthermore, it was only with the introduction of the *Ford Model T* and its impact in bringing the automobile within the range of the affluent middle classes that the market emerged as a strong growth one. From that point forward, automobile production became an expanding market, but with a price point that was being continually lowered. Those who could not compete were forced to exit, in many cases moving in a very short period from a position of profitability and apparent stability to liquidation.

Despite the growth in demand and production, the car industry was to consolidate from the early part of the century onward. There were many forces driving this, but principle among them were the initially fragile financial base of the majority of companies and the greater capital required for increased production volume and distribution. While production in the early years had concentrated on high-cost, high-margin vehicles, as the technology improved and the car became a product also for the middle classes, the production process itself grew in importance. The economies to be gained from mass production militated against a large number of producers, and the industry began an inexorable move toward consolidation.

The consolidation phase that began early, during the phases of high top-line growth, was to continue in the industry from that point forward. The initial very high returns on capital for the fortunate few gradually reduced, even as the consolidation took place and the rate of growth in net income for the participants was on a downward path almost from the 1920s until the 1970s when, in real terms, profits followed the classic boom-and-bust cycle of a highly capital-intensive and competitive industry. In the early years, the American manufacturers undoubtedly gained from the poor road conditions that forced the production of a more lightweight and standardized vehicle than their more technologically advanced European counterparts. In a domestic economy growing strongly and protected by tariffs, the producers took full advantage to become the major players in the world industry. On both sides of the Atlantic, the investor was faced with the same issues, selecting a small number of survivors from the larger number of initial competitors. Growth alone was not sufficient to underpin an investment. Returns may have been potentially very strong, but, given the downside, they needed to be. Equally, the investor needed to pay close attention to the profitability of the industry since top-line growth alone proved no guarantee of income growth. *The car industry faced the burden of high capital costs along with low barriers to entry.*

“It’s much easier to promote an esoteric product, even particularly one with losses, because there is no quantitative guideline. But people will keep coming back to invest, you know. It reminds me a little of that story of the oil prospector who died and went to heaven. And *St Peter* said, “Well, I checked you out, and you meet all of the qualifications. But there is one problem.’ He said, ‘We have some tough zoning laws up here, and we keep all of the oil prospectors over in that pen. And as you can see, it is absolutely chuck-full. There is no room for you.’

“And the prospector said, ‘Do you mind if I just say four words?’

“*St. Peter* said, ‘No harm in that.’

So the prospector cupped his hands and yells out, ‘Oil discovered in hell!’

“And of course, the lock comes off the cage and all of the prospectors start heading right straight down.

“*St. Peter* said, ‘That is a pretty slick trick. So’, He says, ‘go on in, and make yourself at home. You have all the room in the world.’

“The prospector paused for a minute, then said, ‘No, I think I will go along with the rest of the buys. There might be some truth to that rumor after all.’

Well, that is the way people feel with stocks. It is very easy to believe that there is some truth to that rumor after all.”

This got a mild laugh for a half second, which choked off as soon as the audience caught on to *Buffett’s* point, which was that, like the prospectors, they might be mindless enough to follow rumors and drill for oil in hell.

He closed by returning to the proverbial bird in the bush. There was no new paradigm, he said. **Ultimately, the value of the stock market could only reflect the output of the economy.**

He put up a slide to illustrate how, for several years the market’s valuation had outstripped the economy’s growth by an enormous degree. This meant, *Buffett* said, that the next seventeen years might not look much better than that long stretch from 1964 to 1981 when the Dow had gone exactly nowhere—that is, unless the market plummeted. “If I had to pick the most probable return over that period, he said, “it would probably be six (6%) percent. Yet a recent *Paine-Webber-Gallup* poll had shown that investors expected stocks to return thirteen to twenty-two percent.

He walked over to the screen, waggling his bushy eyebrows, he gestured at the cartoon of a naked man and woman, taken from the legendary book on the stock market, *Where Are The Customers’ Yachts?* “The man said to the woman, ‘There are certain things that cannot be adequately explained to a virgin either by words or pictures.’”

The audience took his point, which was that people who bought Internet stocks were about to get screwed. They sat in stony silence. Nobody laughed. Nobody chuckled or snickered or guffawed.

Seeming not to notice, *Buffett* moved back to podium and told the audience about the goody bag he had brought for them from *Berkshire Hathaway*. “I just bought a company that sells fractional jets, *Netjets*,” he said. “I thought about giving each of you a quarter share of a *Gulfstream IV*. But when I went to the airport, I realized that would be a step down for most of you.” At that, they laughed. So, he continued, he was giving each of them a jeweler’s loupe instead, which he said they should use to look at one another’s wives’ rings—the third wives’ especially.

That hit its mark. The audience laughed and applauded. Then they stopped.

A resentful undercurrent was washing trough the room. Sermonizing on the stock market’s excesses at Sun Valley in 1999 was like preaching chastity in a house of ill repute. The speech might rivet the audience to its chairs, but that didn’t mean that they would go forth and abstain.

Buffett waved a book in the air. “This book was the intellectual underpinning of the 1929 stock-market mania. *Edgar Lawrence Smith’s Common Stocks as Long-Term Investments* proved that stocks always yielded more than bonds. Smith identified five reasons, but the most novel of these was the fact that companies retained some of their earnings, which they could reinvest at the same rate of return. That was the plowback—a novel idea in 1924! But as my mentor, *Ben Graham*, always used to say, ‘You can get in way more trouble with a good idea than a bad idea,’ because you forget that the good idea has limits. *Lord Keynes*, in his preface to this book, said, ‘There is a danger of expecting the results of the future to be predicted from the past.’”

He had worked his way back around to the same subject: that one couldn't extrapolate from the past few years of accelerating stock prices. "Now, is there anyone I haven't insulted" He paused. The question was rhetorical; nobody raised a hand.

"Thank you," he said, and ended.

"Praise by name, criticize by category" was *Buffett's* rule. The speech was meant to be provocative, not off-putting—for he cared a great deal what they thought of him. He named no culprits, and he assumed they would get over his jokes. His argument was so powerful, almost unassailable, that he thought even those who didn't like its message must acknowledge its force. And whatever unease the audience felt was not expressed aloud. He answered question until the session ended.

Many believed that *Buffett* was rationalizing having missed the technology boom, and they were startled to see him make such specific predictions, prophecies that surely would turn out to be wrong. Beyond his earshot, the rumbling went on: "*Good ol' Warren*. He missed the boat. How could he miss the tech boat? He is a friend of *Bill Gates*."

End

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Editor's Comments

When *NASDAQ* market prices proceeded to almost double within 8 months of *Buffett's Sun Valley Speech*, naysayers had a field day. They probably thought that *Mr. Buffett* was washed up, a has-been, and he just "Didn't get 'it.'"

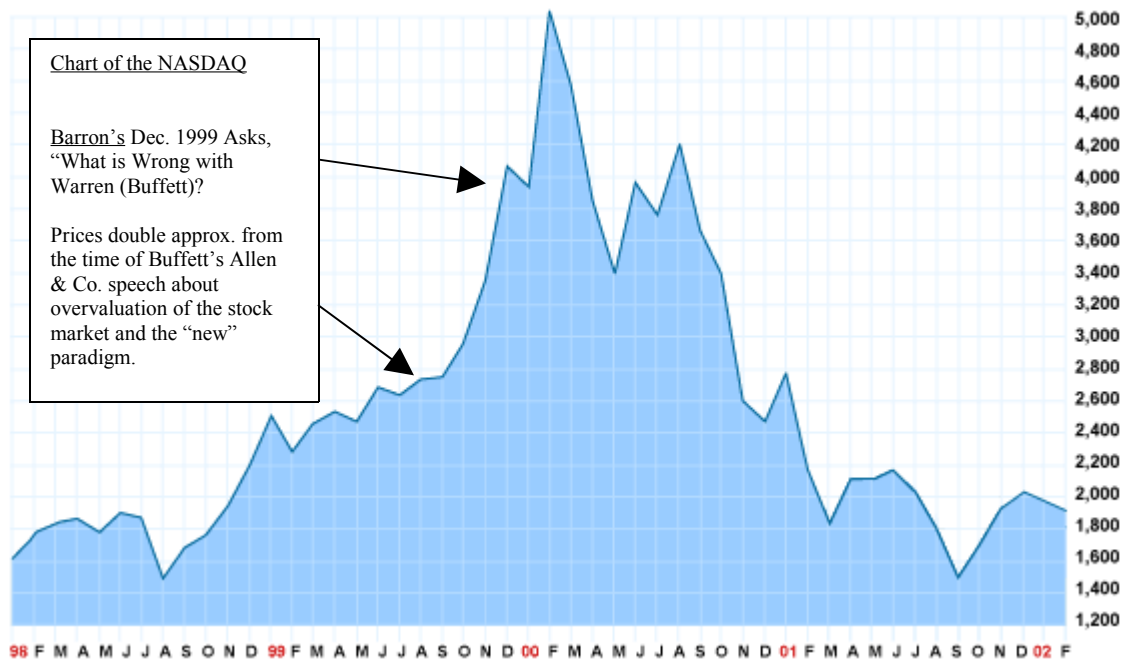
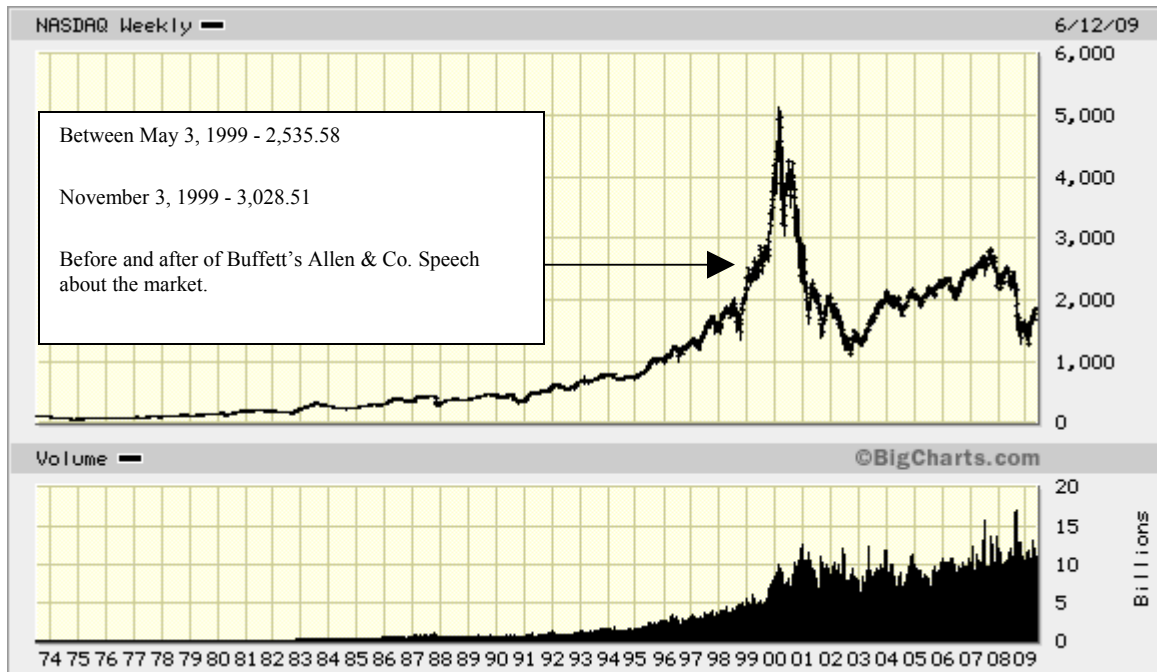
What critics didn't realize was that *Buffett* was not predicting prices, but simple cause and effect. If prices were unsustainable, then prices would eventually revert to their mean and come back to earth. The exact timing of when this would occur--no one knows, but knowing that prices will revert is critical to understanding and avoiding risk of permanent capital loss.

In December 27, 1999 *Barron's* Magazine printed a headline, "What's Wrong Warren? Berkshire is Down for the Year But Don't Count It Out." His methods of investing were extremely out of fashion and against the grain in the dot-com explosion of the late 1990s. The year 1999 was *Buffett's* first down year in a decade, with *Berkshire's* per-share book value under-performing the *S&P 500* index for the first time in 20 years. At the time, the judgmental pronounced his insistence on investing in firmly established, proven businesses out of date for the much-heralded, dot-com-heavy new economy. In 2000 however, *Buffett* appeared to have the last laugh, as reality weighed down the dot-com mania and the high-tech stock bubble burst. *Buffett's* portfolio, meanwhile, bounced back as investors ran to established companies, and once again pundits and analysts were praising the far-sighted wisdom of *Buffett*.

Through it all, *Buffett* never wavered nor questioned himself, because he operates with his own inner score card. He was neither right nor wrong because others agreed or disagreed with him, but because his facts and reasoning were correct.

A Study of Market History and Valuation through Graham and Buffett and Others

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Mr. Buffett on the Stock Market

FORTUNE Monday, November 22, 1999 By Warren Buffett

Warren Buffett, chairman of *Berkshire Hathaway*, almost never talks publicly about the general level of stock prices--neither in his famed annual report nor at *Berkshire's* thronged annual meetings nor in the rare speeches he gives. But in the past few months, on four occasions, Buffett did step up to that subject, laying out his opinions, in ways both analytical and creative, about the long-term future for stocks. *FORTUNE's* Carol Loomis heard the last of those talks, given in September to a group of Buffett's friends (of whom she is one), and also watched a videotape of the first speech, given in July at *Allen & Co.'s* Sun Valley, Idaho, bash for business leaders. From those extemporaneous talks (the first made with the *Dow Jones Industrial Average* at 11,194), Loomis distilled the following account of what Buffett said. Buffett reviewed it and weighed in with some clarifications.

Investors in stocks these days are expecting far too much, and I'm going to explain why. That will inevitably set me to talking about the general stock market, a subject I'm usually unwilling to discuss. But I want to make one thing clear going in: Though I will be talking about the level of the market, I will not be predicting its next moves. At *Berkshire* we focus almost exclusively on the valuations of individual companies, looking only to a very limited extent at the valuation of the overall market. Even then, valuing the market has nothing to do with where it's going to go next week or next month or next year, a line of thought we never get into. **The fact is that markets behave in ways, sometimes for a very long stretch, that are not linked to value.** Sooner or later, though, value counts. So what I am going to be saying--assuming it's correct--will have implications for the long-term results to be realized by American stockholders.

Let's start by defining 'investing.' The definition is simple but often forgotten: Investing is laying out money now to get more money back in the future--more money in real terms, after taking inflation into account.

Now, to get some historical perspective, let's look back at the 34 years before this one--and here we are going to see an almost Biblical kind of symmetry, in the sense of lean years and fat years--to observe what happened in the stock market. Take, to begin with, the first 17 years of the period, from the end of 1964 through 1981. Here's what took place in that interval:

DOW JONES INDUSTRIAL AVERAGE Dec. 31, 1964: 874.12 Dec. 31, 1981: 875.00

Now I'm known as a long-term investor and a patient guy, but that is not my idea of a big move.

And here's a major and very opposite fact: During that same 17 years, the GDP of the U.S.--that is, the business being done in this country--almost quintupled, rising by 370%. Or, if we look at another measure, the sales of the FORTUNE 500 (a changing mix of companies, of course) more than sextupled. And yet the Dow went exactly nowhere.

To understand why that happened, we need first to look at one of the two important variables that affect investment results: interest rates. These act on financial valuations the way gravity acts on matter: The higher the rate, the greater the downward pull. That's because the rates of return that investors need from any kind of investment are directly tied to the risk-free rate that they can earn from government securities. So if the government rate rises, the prices of all other investments must adjust downward, to a level that brings their expected rates of return into line. Conversely, if government interest rates fall, the move pushes the prices of all other investments upward. The basic proposition is this: What an investor should pay today for a dollar to be received tomorrow can only be determined by first looking at the risk-free interest rate.

Consequently, every time the risk-free rate moves by one basis point--by 0.01%--the value of every investment in the country changes. People can see this easily in the case of bonds, whose value is normally affected only by interest rates. In the case of equities or real estate or farms or whatever, other very important variables are almost always at work, and that means the effect of interest rate changes is usually obscured. Nonetheless, the effect--like the invisible pull of gravity--is constantly there.

In the 1964-81 period, there was a tremendous increase in the rates on long-term government bonds, which moved from just over 4% at year-end 1964 to more than 15% by late 1981. That rise in rates had a huge depressing effect on the value of all investments, but the one we noticed, of course, was the price of equities. So there--in that tripling of the gravitational pull of interest rates--lies the major explanation of why tremendous growth in the economy was accompanied by a stock market going nowhere.

Then, in the early 1980s, the situation reversed itself. You will remember *Paul Volcker* coming in as chairman of the Fed and remember also how unpopular he was. But the heroic things he did--his taking a two-by-four to the economy and breaking the back of inflation--caused the interest rate trend to reverse, with some rather spectacular results. Let's say you put \$1 million into the 14% 30-year U.S. bond issued Nov. 16, 1981, and reinvested the coupons. That is, every time you got an interest payment, you used it to buy more of that same bond. At the end of 1998, with long-term governments by then selling at 5%, you would have had \$8,181,219 and would have earned an annual return of more than 13%.

That 13% annual return is better than stocks have done in a great many 17-year periods in history--in most 17-year periods, in fact. It was a helluva result, and from none other than a stodgy bond.

The power of interest rates had the effect of pushing up equities as well, though other things that we will get to pushed additionally. And so here's what equities did in that same 17 years: If you'd invested \$1 million in the Dow on Nov. 16, 1981, and reinvested all dividends, you'd have had \$19,720,112 on Dec. 31, 1998. And your annual return would have been 19%.

The increase in equity values since 1981 beats anything you can find in history. This increase even surpasses what you would have realized if you'd bought stocks in 1932, at their Depression bottom--on its lowest day, July 8, 1932, the *Dow* closed at 41.22--and held them for 17 years.

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The second thing bearing on stock prices during this 17 years was after-tax corporate profits, which this chart [above] displays as a percentage of GDP. In effect, what this chart tells you is what portion of the GDP ended up every year with the shareholders of American business.

The chart, as you will see, starts in 1929. I'm quite fond of 1929, since that's when it all began for me. My dad was a stock salesman at the time, and after the Crash came, in the fall, he was afraid to call anyone--all those people who'd been burned. So he just stayed home in the afternoons. And there wasn't television then. Soooo... I was conceived on or about Nov. 30, 1929 (and born nine months later, on Aug. 30, 1930), and I've forever had a kind of warm feeling about the Crash.

As you can see, corporate profits as a percentage of GDP peaked in 1929, and then they tanked. The left-hand side of the chart, in fact, is filled with aberrations: not only the Depression but also a wartime profits boom--sedated by the excess-profits tax--and another boom after the war. But from 1951 on, the percentage settled down pretty much to a 4% to 6.5% range.

By 1981, though, the trend was headed toward the bottom of that band, and in 1982 profits tumbled to 3.5%. So at that point investors were looking at two strong negatives: Profits were sub-par and interest rates were sky-high.

And as is so typical, investors projected out into the future what they were seeing. That's their unshakable habit: looking into the rear-view mirror instead of through the windshield. What they were observing, looking backward, made them very discouraged about the country. They were projecting high interest rates, they were projecting low profits, and they were therefore valuing the Dow at a level that was the same as 17 years earlier, even though GDP had nearly quintupled.

Now, what happened in the 17 years beginning with 1982? One thing that didn't happen was comparable growth in GDP: In this second 17-year period, GDP less than tripled. But interest rates began their descent, and after the Volcker effect wore off, profits began to climb--not steadily, but nonetheless with real power. You can see the profit trend in the chart, which shows that by the late 1990s, after-tax profits as a percent of GDP were running close to 6%, which is on the upper part of the 'normalcy' band. And at the end of 1998, long-term government interest rates had made their way down to that 5%.

These dramatic changes in the two fundamentals that matter most to investors explain much, though not all, of the more than tenfold rise in equity prices--the Dow went from 875 to 9,181-- during this 17-year period. What was at work also, of course, was market psychology. Once a bull market gets under way, and once you reach the point where everybody has made money no matter what system he or she followed, a crowd is attracted into the game that is responding not to interest rates and profits but simply to the fact that it seems a mistake to be out of stocks. In effect, these people superimpose an I-can't-miss-the-party factor on top of the fundamental factors that drive the market. Like Pavlov's dog, these 'investors' learn that when the bell rings--in this case, the one that opens the New York Stock Exchange at 9:30 a.m.--they get fed. Through this daily reinforcement, they become convinced that there is a God and that He wants them to get rich.

Today, staring fixedly back at the road they just traveled, most investors have rosy expectations. A Paine Webber and Gallup Organization survey released in July shows that the least experienced investors--those who have invested for less than five years--expect annual returns over the next ten years of 22.6%. Even those who have invested for more than 20 years are expecting 12.9%.

Now, I'd like to argue that we can't come even remotely close to that 12.9%, and make my case by examining the key value-determining factors. Today, if an investor is to achieve juicy profits in the market over ten years or 17 or 20, one or more of three things must happen. I'll delay talking about the last of them for a bit, but here are the first two:

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(1) Interest rates must fall further. If government interest rates, now at a level of about 6%, were to fall to 3%, that factor alone would come close to doubling the value of common stocks. Incidentally, if you think interest rates are going to do that--or fall to the 1% that Japan has experienced--you should head for where you can really make a bundle: bond options.

(2) Corporate profitability in relation to GDP must rise. You know, someone once told me that New York has more lawyers than people. I think that's the same fellow who thinks profits will become larger than GDP. When you begin to expect the growth of a component factor to forever outpace that of the aggregate, you get into certain mathematical problems. In my opinion, you have to be wildly optimistic to believe that corporate profits as a percent of GDP can, for any sustained period, hold much above 6%. One thing keeping the percentage down will be competition, which is alive and well. In addition, there's a public-policy point: If corporate investors, in aggregate, are going to eat an ever-growing portion of the American economic pie, some other group will have to settle for a smaller portion. That would justifiably raise political problems--and in my view a major reslicing of the pie just isn't going to happen.

So where do some reasonable assumptions lead us? Let's say that GDP grows at an average 5% a year--3% real growth, which is pretty darn good, plus 2% inflation. If GDP grows at 5%, and you don't have some help from interest rates, the aggregate value of equities is not going to grow a whole lot more. Yes, you can add on a bit of return from dividends. But with stocks selling where they are today, the importance of dividends to total return is way down from what it used to be. Nor can investors expect to score because companies are busy boosting their per-share earnings by buying in their stock. The offset here is that the companies are just about as busy issuing new stock, both through primary offerings and those ever present stock options.

So I come back to my postulation of 5% growth in GDP and remind you that it is a limiting factor in the returns you're going to get: You cannot expect to forever realize a 12% annual increase--much less 22%--in the valuation of American business if its profitability is growing only at 5%. The inescapable fact is that the **value of an asset, whatever its character, cannot over the long term grow faster than its earnings do.**

Now, maybe you'd like to argue a different case. Fair enough. But give me your assumptions. If you think the American public is going to make 12% a year in stocks, I think you have to say, for example, 'Well, that's because I expect GDP to grow at 10% a year, dividends to add two percentage points to returns, and interest rates to stay at a constant level.' Or you've got to rearrange these key variables in some other manner. The Tinker Bell approach--clap if you believe--just won't cut it.

Beyond that, you need to remember that future returns are always affected by current valuations and give some thought to what you're getting for your money in the stock market right now. Here are two 1998 figures for the FORTUNE 500. The companies in this universe account for about 75% of the value of all publicly owned American businesses, so when you look at the 500, you're really talking about America Inc.

FORTUNE 500 1998 profits: \$334,335,000,000 Market value on March 15, 1999: \$9,907,233,000,000

As we focus on those two numbers, we need to be aware that the profits figure has its quirks. Profits in 1998 included one very unusual item--a \$16 billion bookkeeping gain that *Ford* reported from its spinoff of *Associates*--and profits also included, as they always do in the 500, the earnings of a few mutual companies, such as *State Farm* (a mutual insurance company), that do not have a market value. Additionally, one major corporate expense, stock-option compensation costs, is not deducted from profits. On the other hand, the profits figure has been reduced in some cases by write-offs that probably didn't reflect economic reality and could just as well be added back in. But leaving aside these qualifications, investors were saying on March 15 this year that they would pay a hefty \$10 trillion for the \$334 billion in profits.

Bear in mind--this is a critical fact often ignored--that investors as a whole cannot get anything out of their businesses except what the businesses earn. Sure, you and I can sell each other stocks at higher and higher prices.

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Let's say the FORTUNE 500 was just one business and that the people in this room each owned a piece of it. In that case, we could sit here and sell each other pieces at ever-ascending prices. You personally might outsmart the next fellow by buying low and selling high. But no money would leave the game when that happened: You'd simply take out what he put in. Meanwhile, the experience of the group wouldn't have been affected a whit, because its fate would still be tied to profits. The absolute most that the owners of a business, in aggregate, can get out of it in the end--between now and Judgment Day--is what that business earns over time.

And there's still another major qualification to be considered. If you and I were trading pieces of our business in this room, we could escape transactional costs because there would be no brokers around to take a bite out of every trade we made. But in the real world investors have a habit of wanting to change chairs, or of at least getting advice as to whether they should, and that costs money--big money. The expenses they bear--I call them frictional costs--are for a wide range of items. There's the market maker's spread, and commissions, and sales loads, and 12b-1 fees, and management fees, and custodial fees, and wrap fees, and even subscriptions to financial publications. And don't brush these expenses off as irrelevancies. If you were evaluating a piece of investment real estate, would you not deduct management costs in figuring your return? Yes, of course--and in exactly the same way, stock market investors who are figuring their returns must face up to the frictional costs they bear.

And what do they come to? My estimate is that investors in American stocks pay out well over \$100 billion a year--say, \$130 billion--to move around on those chairs or to buy advice as to whether they should! Perhaps \$100 billion of that relates to the FORTUNE 500. In other words, investors are dissipating almost a third of everything that the FORTUNE 500 is earning for them--that \$334 billion in 1998--by handing it over to various types of chair-changing and chair-advisory 'helpers.' And when that handoff is completed, the investors who own the 500 are reaping less than a \$250 billion return on their \$10 trillion investment. In my view, that's slim pickings.

Perhaps by now you're mentally quarreling with my estimate that \$100 billion flows to those 'helpers.' How do they charge thee? Let me count the ways. Start with transaction costs, including commissions, the market maker's take, and the spread on underwritten offerings: With double counting stripped out, there will this year be at least 350 billion shares of stock traded in the U.S., and I would estimate that the transaction cost per share for each side--that is, for both the buyer and the seller--will average 6 cents. That adds up to \$42 billion.

Move on to the additional costs: hefty charges for little guys who have wrap accounts; management fees for big guys; and, looming very large, a raft of expenses for the holders of domestic equity mutual funds. These funds now have assets of about \$3.5 trillion, and you have to conclude that the annual cost of these to their investors--counting management fees, sales loads, 12b-1 fees, general operating costs--runs to at least 1%, or \$35 billion.

And none of the damage I've so far described counts the commissions and spreads on options and futures, or the costs borne by holders of variable annuities, or the myriad other charges that the 'helpers' manage to think up. In short, \$100 billion of frictional costs for the owners of the FORTUNE 500--which is 1% of the 500's market value--looks to me not only highly defensible as an estimate, but quite possibly on the low side.

It also looks like a horrendous cost. I heard once about a cartoon in which a news commentator says, 'There was no trading on the New York Stock Exchange today. Everyone was happy with what they owned.' Well, if that were really the case, investors would every year keep around \$130 billion in their pockets.

Let me summarize what I've been saying about the stock market: I think it's very hard to come up with a persuasive case that equities will over the next 17 years perform anything like--anything like--they've performed in the past 17. If I had to pick the most probable return, from appreciation and dividends combined, that investors in aggregate--repeat, aggregate--would earn in a world of constant interest rates, 2% inflation, and those ever hurtful frictional costs, it would be 6%. If you strip out the inflation component from this nominal return (which you would need to do however inflation fluctuates), that's 4% in real terms. And if 4% is wrong, I believe that the percentage is just as likely to be less as more.

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Let me come back to what I said earlier: that there are three things that might allow investors to realize significant profits in the market going forward. The first was that interest rates might fall, and the second was that corporate profits as a percent of GDP might rise dramatically. I get to the third point now: Perhaps you are an optimist who believes that though investors as a whole may slog along, you yourself will be a winner. That thought might be particularly seductive in these early days of the information revolution (which I wholeheartedly believe in). Just pick the obvious winners, your broker will tell you, and ride the wave.

Well, I thought it would be instructive to go back and look at a couple of industries that transformed this country much earlier in this century: automobiles and aviation. Take automobiles first: I have here one page, out of 70 in total, of car and truck manufacturers that have operated in this country. At one time, there was a *Berkshire* car and an *Omaha* car. Naturally I noticed those. But there was also a telephone book of others.

All told, there appear to have been at least 2,000 car makes, in an industry that had an incredible impact on people's lives. If you had foreseen in the early days of cars how this industry would develop, you would have said, 'Here is the road to riches.' So what did we progress to by the 1990s? After corporate carnage that never let up, we came down to three U.S. car companies--themselves no lollapaloozas for investors. So here is an industry that had an enormous impact on America--and also an enormous impact, though not the anticipated one, on investors.

Sometimes, incidentally, it's much easier in these transforming events to figure out the losers. You could have grasped the importance of the auto when it came along but still found it hard to pick companies that would make you money. But there was one obvious decision you could have made back then--it's better sometimes to turn these things upside down--and that was to short horses. Frankly, I'm disappointed that the Buffett family was not short horses through this entire period. And we really had no excuse: Living in Nebraska, we would have found it super-easy to borrow horses and avoid a 'short squeeze.'

U.S. Horse Population 1900: 21 million 1998: 5 million

The other truly transforming business invention of the first quarter of the century, besides the car, was the airplane--another industry whose plainly brilliant future would have caused investors to salivate. So I went back to check out aircraft manufacturers and found that in the 1919-39 period, there were about 300 companies, only a handful still breathing today. Among the planes made then--we must have been the Silicon Valley of that age--were both the Nebraska and the Omaha, two aircraft that even the most loyal Nebraskan no longer relies upon.

Move on to failures of airlines. Here's a list of 129 airlines that in the past 20 years filed for bankruptcy. Continental was smart enough to make that list twice. As of 1992, in fact--though the picture would have improved since then--the money that had been made since the dawn of aviation by all of this country's airline companies was zero. Absolutely zero.

Sizing all this up, I like to think that if I'd been at Kitty Hawk in 1903 when Orville Wright took off, I would have been farsighted enough, and public-spirited enough--I owed this to future capitalists--to shoot him down. I mean, Karl Marx couldn't have done as much damage to capitalists as Orville did.

I won't dwell on other glamorous businesses that dramatically changed our lives but concurrently failed to deliver rewards to U.S. investors: the manufacture of radios and televisions, for example. But I will draw a lesson from these businesses: **The key to investing is not assessing how much an industry is going to affect society, or how much it will grow, but rather determining the competitive advantage of any given company and, above all, the durability of that advantage.** The products or services that have wide, sustainable moats around them are the ones that deliver rewards to investors.

This talk of 17-year periods makes me think--incongruously, I admit--of 17-year locusts [pictured below]. What could a current brood of these critters, scheduled to take flight in 2016, expect to encounter? I see them entering a

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world in which the public is less euphoric about stocks than it is now. Naturally, investors will be feeling disappointment--but only because they started out expecting too much.

Grumpy or not, they will have by then grown considerably wealthier, simply because the American business establishment that they own will have been chugging along, increasing its profits by 3% annually in real terms. Best of all, the rewards from this creation of wealth will have flowed through to Americans in general, who will be enjoying a far higher standard of living than they do today. That wouldn't be a bad world at all--even if it doesn't measure up to what investors got used to in the 17 years just passed.

(Source: www.hussmanfunds.com writing on December 1999 about the market)

But while the internet issues remain the most obvious bubble, the most significant objects of speculation, in terms of market capitalization, are stocks which might be considered "blue chip" technology issues. Consider for example, some of the better growth companies on Wall Street (listed below in order of market capitalization), and you can see how profoundly future earnings growth has been impounded into current prices. While these companies are likely to perform very well as businesses, the performance of the stocks hinges much more delicately on the continued willingness of investors to pay exorbitant valuation multiples. Moreover, the fact that the current P/E multiples are based on record earnings should be some cause for alarm.

Stock	Current P/E	10-Year Average P/E
Microsoft	70	27
Intel	38	14
Cisco	165	28
Lucent	59	27
IBM	27	14
America Online	297	NA
Dell	67	18
Sun Microsystems	114	17
Oracle	88	29

Similarly extreme valuations appear in other mega-capitalization stocks such as *General Electric*, *Wal-Mart*, *Home Depot*, *MCI/Worldcom* and *Vodafone*. Why do these multiples matter? Because the market is currently displaying not only extreme valuations, but also poor market action and rising interest rate trends. That complete combination is what we characterize as a "Crash Warning", because that phrase has typically been descriptive of the subsequent market action.

There have only been two times in history that market breadth (as measured by the advance-decline line) has diverged so widely from the performance of the *S&P 500*: 1929 and 1972. The current breadth divergence now exceeds these previous instances both in extent and duration. With the *S&P* and *Nasdaq* near new highs, bonds, utilities, transports and the advance-decline line are all plunging. Indeed, the NYSE advance-decline line is now well below the lows of the late-summer 1998 selloff. In the week ended December 3rd, the Dow soared 297 points, and the *Nasdaq* vaulted nearly 73 points. Yet on the *NYSE*, *AMEX* and *Nasdaq* markets, more stocks declined than advanced on the week. Just 162 stocks on the *NYSE* hit new 52-week highs, while 780 hit new lows. So in addition to hypervaluation, the most overwhelming characteristic of the market is lack of uniformity.

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Historically, the current combination of market conditions has ultimately led to unusually swift declines in Price/Earnings ratios. So even if earnings hold up, prices can endure harsh plunges. During 1973-74, stock prices plunged by half, even though S&P earnings grew rapidly. Given that the P/E ratio of the S&P is currently over 50% higher than it was at the 1929 and 1972 tops, it is clear that valuation multiples have a lot of room to decline.

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WARREN BUFFETT ON THE STOCK MARKET

FORTUNE

Thursday, December 6, 2001

By Carol Loomis

From Fortune Magazine:

"Two years ago, following a July 1999 speech by Warren Buffett, chairman of Berkshire Hathaway, on the stock market--a rare subject for him to discuss publicly--FORTUNE ran what he had to say under the title Mr. Buffett on the Stock Market (Nov. 22, 1999). His main points then concerned two consecutive and amazing periods that American investors had experienced, and his belief that returns from stocks were due to fall dramatically. Since the Dow Jones Industrial Average was 11194 when he gave his speech and recently was about 9900, no one yet has the goods to argue with him.

So where do we stand now--with the stock market seeming to reflect a dismal profit outlook, an unfamiliar war, and rattled consumer confidence? Who better to supply perspective on that question than Buffett?

The thoughts that follow come from a second Buffett speech, given last July at the site of the first talk, Allen & Co.'s annual Sun Valley bash for corporate executives. There, the renowned stock picker returned to the themes he'd discussed before, bringing new data and insights to the subject. Working with FORTUNE's Carol Loomis, Buffett distilled that speech into this essay, a fitting opening for this year's Investor's Guide. Here again is Mr. Buffett on the Stock Market. "

Warren Buffett:

The last time I tackled this subject, in 1999, I broke down the previous 34 years into two 17-year periods, which in the sense of lean years and fat were astonishingly symmetrical. Here's the first period. As you can see, over 17 years the Dow gained exactly one-tenth of one percent.

Dow Jones Industrial Average

Dec. 31, 1964: **874.12**

Dec. 31, 1981: **875.00**

And here's the second, marked by an incredible bull market that, as I laid out my thoughts, was about to end (though I didn't know that).

Dow Industrials

Dec. 31, 1981: **875.00**

Dec. 31, 1998: **9181.43**

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Now, you couldn't explain this remarkable divergence in markets by, say, differences in the growth of gross national product. In the first period--that dismal time for the market--GNP actually grew more than twice as fast as it did in the second period.

Gain in Gross National Product

1964-1981: **373%**

1981-1998: **177%**

So what was the explanation? I concluded that the market's contrasting moves were caused by extraordinary changes in two critical economic variables--and by a related psychological force that eventually came into play.

Here I need to remind you about the definition of "investing," which though simple is often forgotten. **Investing is laying out money today to receive more money tomorrow.**

That gets to the first of the economic variables that affected stock prices in the two periods--interest rates. In economics, interest rates act as gravity behaves in the physical world. At all times, in all markets, in all parts of the world, the tiniest change in rates changes the value of every financial asset. You see that clearly with the fluctuating prices of bonds. But the rule applies as well to farmland, oil reserves, stocks, and every other financial asset. And the effects can be huge on values. If interest rates are, say, 13%, the present value of a dollar that you're going to receive in the future from an investment is not nearly as high as the present value of a dollar if rates are 4%.

So here's the record on interest rates at key dates in our 34-year span. They moved dramatically up--that was bad for investors--in the first half of that period and dramatically down--a boon for investors--in the second half.

Interest Rates, Long-Term Government Bonds

Dec. 31, 1964: **4.20%**

Dec. 31, 1981: **13.65%**

Dec. 31, 1998: **5.09%**

The other critical variable here is how many dollars investors expected to get from the companies in which they invested. During the first period expectations fell significantly because corporate profits weren't looking good. By the early 1980s Fed Chairman Paul Volcker's economic sledgehammer had, in fact, driven corporate profitability to a level that people hadn't seen since the 1930s.

The upshot is that investors lost their confidence in the American economy: They were looking at a future they believed would be plagued by two negatives. First, they didn't see much good coming in the way of corporate profits. Second, the sky-high interest rates prevailing caused them to discount those meager profits further. These two factors, working together, caused stagnation in the stock market from 1964 to 1981, even though those years featured huge improvements in GNP. The business of the country grew while investors' valuation of that business shrank!

And then the reversal of those factors created a period during which much lower GNP gains were accompanied by a bonanza for the market. First, you got a major increase in the rate of profitability. Second, you got an enormous drop in interest rates, which made a dollar of future profit that much more valuable. Both phenomena were real and powerful fuels for a major bull market. And in time the psychological factor I mentioned was added to the equation: Speculative trading exploded, simply because of the market action that people had seen. Later, we'll look at the pathology of this dangerous and oft-recurring malady.

Two years ago I believed the favorable fundamental trends had largely run their course. For the market to go dramatically up from where it was then would have required long-term interest rates to drop much further (which

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is always possible) or for there to be a major improvement in corporate profitability (which seemed, at the time, considerably less possible). If you take a look at a 50-year chart of after-tax profits as a percent of gross domestic product, you find that the rate normally falls between 4%--that was its neighborhood in the bad year of 1981, for example--and 6.5%. For the rate to go above 6.5% is rare. In the very good profit years of 1999 and 2000, the rate was under 6% and this year it may well fall below 5%.

So there you have my explanation of those two wildly different 17-year periods. The question is, How much do those periods of the past for the market say about its future?

To suggest an answer, I'd like to look back over the 20th century. As you know, this was really the American century. We had the advent of autos, we had aircraft, we had radio, TV, and computers. It was an incredible period. Indeed, the per capita growth in U.S. output, measured in real dollars (that is, with no impact from inflation), was a breathtaking 702%.

The century included some very tough years, of course--like the Depression years of 1929 to 1933. But a decade-by-decade look at per capita GNP shows something remarkable: As a nation, we made relatively consistent progress throughout the century. So you might think that the economic value of the U.S.--at least as measured by its securities markets--would have grown at a reasonably consistent pace as well.

The U.S. Never Stopped Growing

Per capita GNP gains crept in the 20th century's early years.
But if you think of the U.S. as a stock, it was overall one helluva mover.

Year	20th-Century growth in per capita GNP (constant dollars)
1900-10	29%
1910-20	1%
1920-30	13%
1930-40	21%
1940-50	50%
1950-60	18%
1960-70	33%
1970-80	24%
1980-90	24%
1990-2000	24%

That's not what happened. We know from our earlier examination of the 1964-98 period that parallelism broke down completely in that era. But the whole century makes this point as well. At its beginning, for example, between 1900 and 1920, the country was chugging ahead, explosively expanding its use of electricity, autos, and the telephone. Yet the market barely moved, recording a 0.4% annual increase that was roughly analogous to the slim pickings between 1964 and 1981.

Dow Industrials

Dec. 31, 1899: **66.08**

Dec. 31, 1920: **71.95**

In the next period, we had the market boom of the '20s, when the Dow jumped 430% to 381 in September 1929. Then we go 19 years--19 years--and there is the Dow at 177, half the level where it began. That's true even though the 1940s displayed by far the largest gain in per capita GDP (50%) of any 20th-century decade. Following that

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came a 17-year period when stocks finally took off--making a great five-to-one gain. And then the two periods discussed at the start: stagnation until 1981, and the roaring boom that wrapped up this amazing century.

To break things down another way, we had three huge, secular bull markets that covered about 44 years, during which the Dow gained more than 11,000 points. And we had three periods of stagnation, covering some 56 years. During those 56 years the country made major economic progress and yet the Dow actually lost 292 points.

How could this have happened? In a flourishing country in which people are focused on making money, how could you have had three extended and anguishing periods of stagnation that in aggregate--leaving aside dividends--would have lost you money? The answer lies in the mistake that investors repeatedly make--that psychological force I mentioned above: People are habitually guided by the rear-view mirror and, for the most part, by the vistas immediately behind them.

The first part of the century offers a vivid illustration of that myopia. In the century's first 20 years, stocks normally yielded more than high-grade bonds. That relationship now seems quaint, but it was then almost axiomatic. Stocks were known to be riskier, so why buy them unless you were paid a premium?

And then came along a 1924 book--slim and initially unheralded, but destined to move markets as never before--written by a man named *Edgar Lawrence Smith*. The book, called Common Stocks as Long Term Investments, chronicled a study *Smith* had done of security price movements in the 56 years ended in 1922. *Smith* had started off his study with a hypothesis: Stocks would do better in times of inflation, and bonds would do better in times of deflation. It was a perfectly reasonable hypothesis.

But consider the first words in the book: "These studies are the record of a failure--the failure of facts to sustain a preconceived theory." *Smith* went on: "The facts assembled, however, seemed worthy of further examination. If they would not prove what we had hoped to have them prove, it seemed desirable to turn them loose and to follow them to whatever end they might lead."

Now, there was a smart man, who did just about the hardest thing in the world to do.⁸ *Charles Darwin* used to say that whenever he ran into something that contradicted a conclusion he cherished, he was obliged to write the new finding down within 30 minutes. Otherwise his mind would work to reject the discordant information, much as the body rejects transplants. Man's natural inclination is to cling to his beliefs, particularly if they are reinforced by recent experience--a flaw in our makeup that bears on what happens during secular bull markets and extended periods of stagnation.

--

Warren Buffett wrote about the irrationality of the late Internet bubble in his annual letter to Berkshire Hathaway shareholders:

"Far more irrational still were the huge valuations that market participants were then putting on businesses almost certain to end up being of modest or no value. Yet investors, mesmerized by soaring stock prices and ignoring all else, piled into these enterprises. It was as if some virus, racing wildly among investment professionals as well as

⁸ *Edgar Smith* used extensive original research on specific securities and their actual returns over many years to develop and support his conclusion that--in contrast to the prevailing judgment at that time--common stocks *were* better than bonds for long term investment. Some credit his 1924 book, Common Stocks as Long-Term Investments with providing the intellectual underpinnings to the bull market of the mid-and late 1920s. He mentions the fundamental difference between stocks and bonds is that *Stocks* represent ownership of property and processes; their value and income return fluctuating with the earning power of the property. *Bonds* represent a promise to pay a certain number of dollars at a future date with a fixed rate of interest each year during the life of the loan.

Mr. Smith points out in *A New Stock Market Chart, 1837-1923*, that well-diversified lists of common stocks selected on simple and broad principles of diversification respond to some underlying factor which gives them a margin of advantage over high grade bonds for long term investment. (*Jeremy Siegel* wrote a book in the mid-1990s called Stocks for the Long Run similar in concept to this 1924 book and some critics said that investors might have used the book as an excuse to pay any price for a company. To learn more go to <http://www.jeremysiegel.com/>)

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amateurs, induced hallucinations in which the values of stocks in certain sectors became decoupled from the values of the businesses that underlay them.

The fact is that a bubble market has allowed the creation of bubble companies, entities designed more with an eye to making money off investors rather than for the. Too often, an IPO, not profits was the primary goal of a company's promoters. At bottom, the 'business model' for these companies has been the old-fashioned chain letter, for which many fee-hungry investment bankers acted as eager postmen."

October 17, 2008 Op-Ed Contributor

Buy American. I Am. by WARREN E. BUFFETT

Omaha

THE financial world is a mess, both in the United States and abroad. Its problems, moreover, have been leaking into the general economy, and the leaks are now turning into a gusher. In the near term, unemployment will rise, business activity will falter and headlines will continue to be scary.

So ... I've been buying American stocks. This is my personal account I'm talking about, in which I previously owned nothing but United States government bonds. (This description leaves aside my Berkshire Hathaway holdings, which are all committed to philanthropy.) If prices keep looking attractive, my non-Berkshire net worth will soon be 100 percent in United States equities.

Why?

A simple rule dictates my buying: Be fearful when others are greedy, and be greedy when others are fearful. And most certainly, fear is now widespread, gripping even seasoned investors. To be sure, investors are right to be wary of highly leveraged entities or businesses in weak competitive positions. But fears regarding the long-term prosperity of the nation's many sound companies make no sense. These businesses will indeed suffer earnings hiccups, as they always have. But most major companies will be setting new profit records 5, 10 and 20 years from now.

Let me be clear on one point: I can't predict the short-term movements of the stock market. I haven't the faintest idea as to whether stocks will be higher or lower a month — or a year — from now. What is likely, however, is that the market will move higher, perhaps substantially so, well before either sentiment or the economy turns up. So if you wait for the robins, spring will be over.

A little history here: During the Depression, the *Dow* hit its low, 41, on July 8, 1932. Economic conditions, though, kept deteriorating until *Franklin D. Roosevelt* took office in March 1933. By that time, the market had already advanced 30 percent. Or think back to the early days of World War II, when things were going badly for the United States in Europe and the Pacific. The market hit bottom in April 1942, well before Allied fortunes turned. Again, in the early 1980s, the time to buy stocks was when inflation raged and the economy was in the tank. In short, bad news is an investor's best friend. It lets you buy a slice of America's future at a marked-down price.

Over the long term, the stock market news will be good. In the 20th century, the United States endured two world wars and other traumatic and expensive military conflicts; the Depression; a dozen or so recessions and financial panics; oil shocks; a flu epidemic; and the resignation of a disgraced president. Yet the *Dow* rose from 66 to 11,497.

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You might think it would have been impossible for an investor to lose money during a century marked by such an extraordinary gain. But some investors did. The hapless ones bought stocks only when they felt comfort in doing so and then proceeded to sell when the headlines made them queasy.

Today people who hold cash equivalents feel comfortable. They shouldn't. They have opted for a terrible long-term asset, one that pays virtually nothing and is certain to depreciate in value. Indeed, the policies that government will follow in its efforts to alleviate the current crisis will probably prove inflationary and therefore accelerate declines in the real value of cash accounts.

Equities will almost certainly outperform cash over the next decade, probably by a substantial degree. Those investors who cling now to cash are betting they can efficiently time their move away from it later. In waiting for the comfort of good news, they are ignoring *Wayne Gretzky's* advice: "I skate to where the puck is going to be, not to where it has been."

I don't like to opine on the stock market, and again I emphasize that I have no idea what the market will do in the short term. Nevertheless, I'll follow the lead of a restaurant that opened in an empty bank building and then advertised: "Put your mouth where your money was." Today my money and my mouth both say equities.

Warren E. Buffett is the chief executive of Berkshire Hathaway, a diversified holding company.



May 2, 2009 at the Berkshire Hathaway Annual Meeting with shareholders Buffett was asked about the relative severity of the current (2008-09) downturn.

Buffett: Stocks got much cheaper in 1974, about four times earnings, than now, but interest rates were far higher (Long term government bonds were about 7.5% vs. 4% today). So maybe they were not really cheaper. It is not as dramatic as in 1974 in terms of buying opportunities—that was the best period I have seen. I bought some equities and bonds, too. I like when things get cheap, as long as the value's in the business. I'd much rather pay half of X than X.

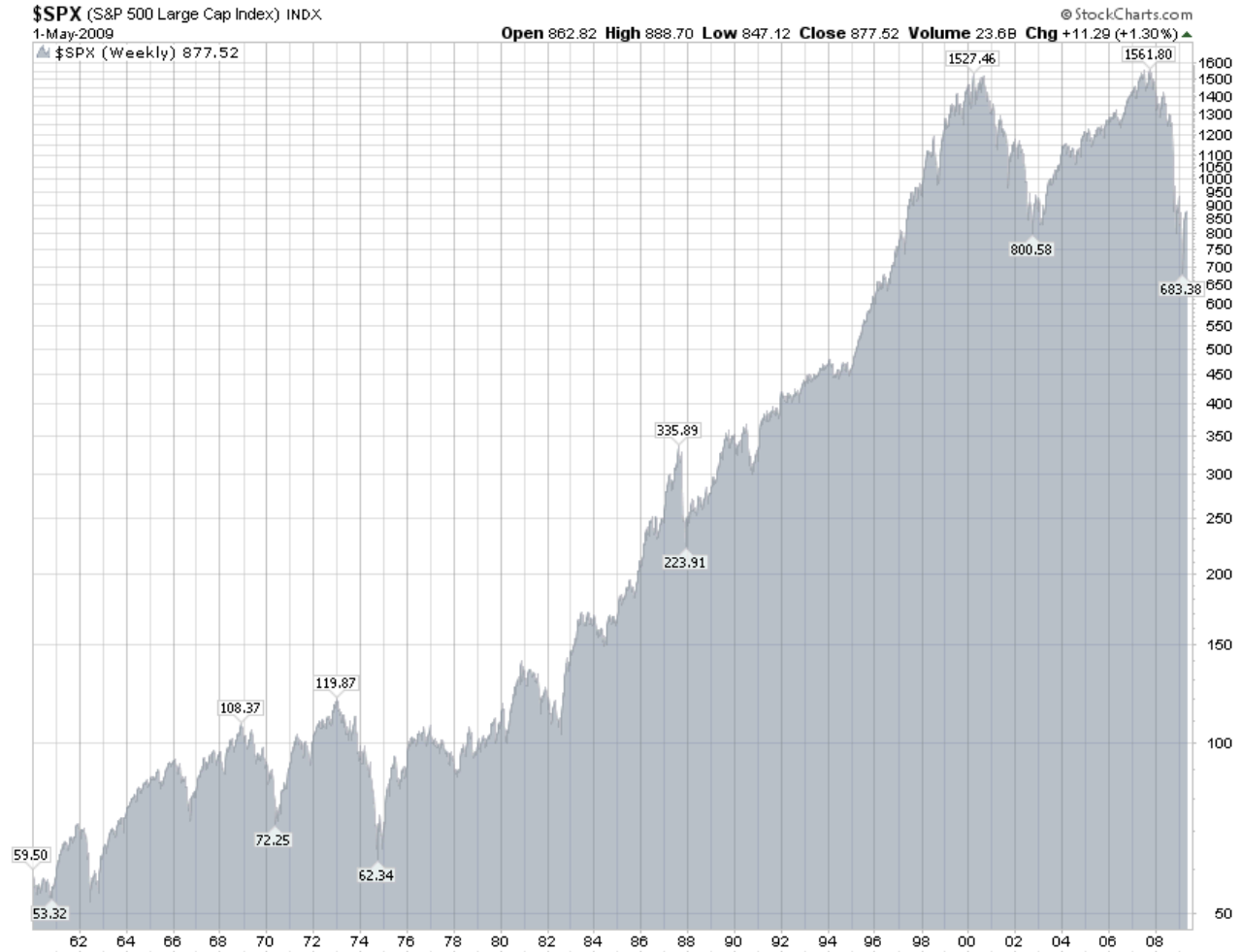
Munger: It is nothing like 1973-74. I knew at the time that was my time to invest, but I had no money that is part of the way it happens. 1974 was obvious. If I were you, I wouldn't try to wait for 1973-74 conditions.

A Study of Market History and Valuation through Graham and Buffett and Others

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Valuing the market has nothing to do with where it's going to go next week or nest month or next year.....The fact is that markets behave in ways, sometimes for a very long stretch, that are not linked to value. Sooner or later, though value counts.—Warren Buffett



Differences in Interest Rates and Earnings During 17-Year Periods				
Period	Growth in GDP	Interest Rates at Start/End	Profits as % of GDP at Start/End	DJIA at Start/End
1964-1981	373%	4.2% / 13.7%	5.7% / 3.5%	874 / 875
1981-1988	177%	13.7% / 5.1%	3.5% / 5.5%	875 / 9,181

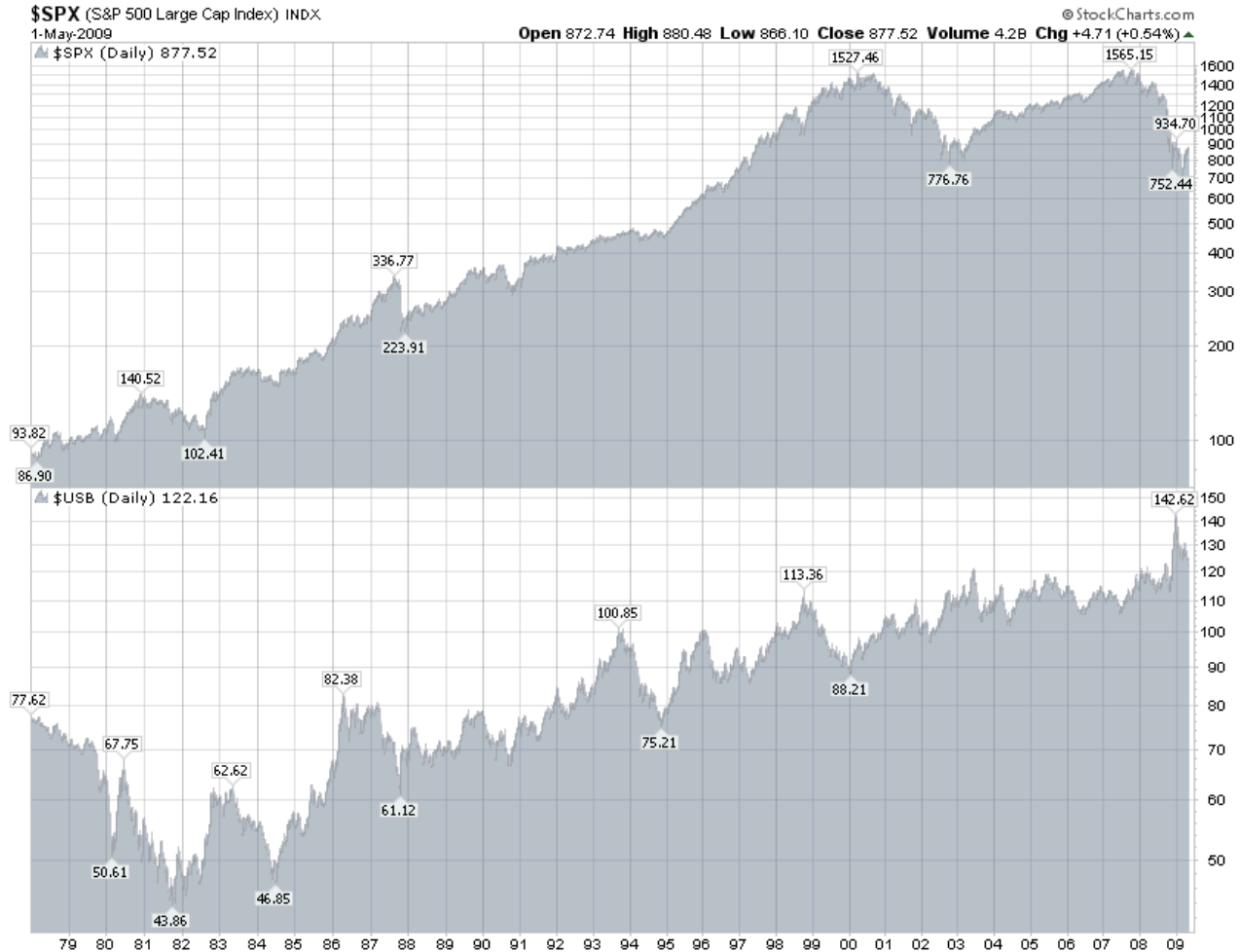


Chart 10
Major Events During and After Benjamin Graham's Life

One of the most profound lessons to be taken from Graham's writing is that no one could have predicted these events, just as no one can predict the major events of tomorrow. Economist John Maynard Keynes said, "The inevitable never happens. It is the unexpected always." Successful investing does not depend on being able to predict the future, but rather on using sound investment principles, since they will generally produce sound investment results. You have our commitment that we will continue to use sound investment principles in the management of your portfolios.

The Century Management Team
1914 World War I (1914-1918)

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1929 Great Depression (1929-1932)
1939 World War II Begins in Europe (1939-1945)
1941 Pearl Harbor Attacked
1945 U.S. Government Debt to GDP was 112% (As of September 2009 it is 84%)
1950 Korean War Begins
1962 Cuban Missile Crisis
1963 President Kennedy Assassinated
1968 Vietnam War (1959-1975)
1973 Arab Oil Embargo-Oil Prices Go From \$2 to \$10 Per Barrel
1974 Major Bear Market in Stocks / Price Controls / President Nixon Resigns
1980 18% to 19% Federal Funds Rates
1981 16% to 18% 30-Year Mortgage Rates
1987 U.S. Stock Market Crash / Dow Drops 22.48% In One Day
1991 Gulf War Begins
2000 Beginning of Three Year Stock Market Decline / NASDAQ Eventually Declines 78%
2001 Terrorist Attack on World Trade Center (9/11) / Afghanistan War Begins
2003 Iraq War Begins
2008 Major Stock Market Decline / Credit Crisis / National Real Estate Decline
Plus 12 Recessions Since 1948

The Eternal Secret of Successful Investing

A Little Wonderful Advice from Where Are The Customer's Yachts? by Fred Schwed, Jr., 1940 (pages 180-182)

For no fee at all I am prepared to offer to any wealthy person an investment program which will last a lifetime and will not only preserve the estate but greatly increase it. Like other great ideas, this one is simple:

When there is a stock-market boom, and everyone is scrambling for common stocks, take all your common stocks and sell them. Take the proceeds and buy conservative bonds. No doubt the stocks you sold will go higher. Pay no attention to this—just wait for the depression which will come sooner or later. When this depression—or panic—becomes a national catastrophe, sell out the bonds (perhaps at a loss) and buy back the stocks. No doubt the stocks will go still lower. Again pay no attention. Wait for the next boom. Continue to repeat this operation as long as you live, and you will have the pleasure of dying rich.

A glance at financial history will show that there never was a generation for whom this advice would not have worked splendidly. But it distresses me to report that I have never enjoyed the social acquaintance of anyone who managed to do it. **It looks as easy as rolling off a log, but it isn't.** The chief difficulties, of course, are **psychological**. It requires buying bonds when bonds are generally unpopular, and buying stocks when stocks are universally detested.

I suspect that there are actually a few people who do something like this, even though I have never had the pleasure of meeting them. I suspect it because someone must buy the stock that the suckers sell at those awful prices—a fact usually outside the consciousness of the public and of financial reporters. An experienced reporter's poetic account in the paper following a day of terrible panic reads this way:

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Large selling was in evidence at the opening bell and gained steadily in volume and violence throughout the morning session. At noon a rally, dishearteningly brief, took place as a result of short covering. But a new selling wave soon threw the market into utter chaos, and during the final hour equities were thrown overboard in huge lots, without regard for price or value.

The public reads the papers, and reading the foregoing, it gets the impression that on that catastrophic day everyone sold and nobody bought, except that little band of shorts (who most likely didn't exist). Of course, there is just no truth in that at all. If on that day the terrific "selling" amounted to seven million, three hundred and sixty-five thousand shares, the volume of the buying can also be calculated. In this case it was 7,365,000 shares.

CASE STUDY

How Mr. Womack Made a Killing by John Train (1978)

The man never had a loss on balance in 60 years.

His technique was the ultimate in simplicity. When during a bear market he would read in the papers that the market was down to new lows and the experts were predicting that it was sure to drop another 200 points in the Dow, the farmer would look through a S&P Stock Guide and select around 30 stocks that had fallen in price below \$10—solid, profit making, unheard of companies (pecan growers, home furnishings, etc.) and paid dividends. He would come to Houston and buy a \$25,000 "package" of them.

And then, one, two, three or four years later, when the stock market was bubbling and the prophets were talking about the Dow hitting 1500, he would come to town and sell his whole package. It was as simple as that.

He equated buying stocks with buying a truckload of pigs. The lower he could buy the pigs, when the pork market was depressed, the more profit he would make when the next seller's market would come along. He claimed that he would rather buy stocks under such conditions than pigs because pigs did not pay a dividend. You must feed pigs.

He took a "farming" approach to the stock market in general. In rice farming, there is a planting season and a harvesting season, in his stock purchases and sales he strictly observed the seasons.

Mr. Womack never seemed to buy stock at its bottom or sell it at its top. He seemed happy to buy or sell in the bottom or top range of its fluctuations. He had no regard whatsoever for the cliché—Never send Good Money After Bad—when he was buying. For example, when the bottom fell out of the market of 1970, he added another \$25,000 to his previous bargain price positions and made a virtual killing on the whole package.

I suppose that a modern stock market technician could have found a lot of alphas, betas, contrary opinions and other theories in Mr. Womack's simple approach to buying and selling stocks. But none I know put the emphasis on "buy price" that he did.

I realize that many things determine if a stock is a wise buy. But I have learned that during a depressed stock market, if you can get a cost position in a stock's bottom price range it will forgive a multitude of misjudgments later.

During a market rise, you can sell too soon and make a profit, sell at the top and make a very good profit. So, with so many profit probabilities in your favor, the best cost price possible is worth waiting for.

Knowing this is always comforting during a depressed market, when a "chartist" looks at you with alarm after you buy on his latest "sell signal."

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In sum, Mr. Womack didn't make anything complicated out of the stock market. He taught me that you can't be buying stocks every day, week or month of the year and make a profit, any more than you could plant rice every day, week or month and make a crop. He changed my investing lifestyle and I have made a profit ever since.

Keep this a secret!

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Of course after reading those pieces, you realize there is no secret to investing. All the principles are laid out in *Security Analysis* and *The Intelligent Investor* by Benjamin Graham. The application and evolution of value investing principles are laid out each year in Mr. Buffett's shareholder letters. The study, application and discipline are up to you, but then who would want it any other way?

Enjoy your journey!

Comments welcome: John Chew at aldridge56@aol.com, Telephone: (203) 622-1422

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Postscript

Warren Buffett's 'Buy American' - One Year Later

Published: Monday, 19 Oct 2009 |

By: [Alex Crippen](#)

Executive Producer

One year ago, even though the financial world was "a mess" and would probably get messier, Warren Buffett wrote in the *New York Times* that he was [buying U.S. stocks](#) to lock in a "slice of America's future at a marked-down price."

He cited his "simple" rule: "Be fearful when others are greedy, and be greedy when others are fearful."

One year later, the benchmark S&P 500 is 14.9 percent higher than it was the night before Buffett's "Buy American" op-ed ([read the complete article](#)) was published on Friday, October 17, 2008.

But that's beside the point.



In his op-ed, Buffett makes clear he wasn't trying to "time" the market. He wrote he didn't have the "faintest idea" whether stocks would be higher or lower one month, or one year later. Both qualify as short-term for Buffett. He was looking five, ten, or twenty years into the future.

And it's a good thing Buffett wasn't trying to pick a short-term bottom, because his timing was awful. The S&P continued to drop that fall and winter, closing at its bear-market low of 676.53 on March 9.

If you had been smart or lucky enough to go all-in on the S&P on that day, you'd be up 60 percent now.

But Buffett's key point is that very few of us are going to be that smart or that lucky. Those waiting for the perfect moment run a big risk of coming in too late, especially if they're looking for hints that things are getting better.

The Oracle of Omaha won't make predictions about specific stock market moves, but he does have one strongly-held prophecy about the future: "The market will move higher, perhaps substantially so, well before either sentiment or the economy turns up. So if you wait for the robins, spring will be over."

<http://www.cnbc.com/id/33>

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Always remember:

"Remember that there is nothing stable in human affairs; therefore avoid undue elation in prosperity or undue depression in adversity." Socrates, 399 B.C.

1980s Revisited March 6, 2000 Forbes. A Tale of Two Bubbles (oil and telecomm and tech sector)

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Tech stocks are in a late-stage bubble. It should break later this year (The top was put in a mere 4 days later). I usually dislike "bubble," a word bandied about too often by extremists. But I watched a bubble like this one 19 years ago, and I have seen how it ends. Right now technology stocks are just where oil stocks were in early 1981.

Recall how unstoppable energy appeared in 1980. That was a time of high and rising inflation, booming commodity prices, OPEC's success as a cartel and the Iran-Iraq war. By late 1980 oil was \$33 a barrel, with consensus forecasts of \$100 four years out. No one envisioned oil's falling.

It is happening all over again. This time around it isn't oil's price that is supposed to triple in four years but rather the population of Internet users.

Here are some other disturbing similarities. Tech's share of the S&P 500 has grown from just 6% in 1992 to 19% in 1998 and 30% in 1999. Energy's S&P 500 weight climbed from 7% in 1972 to 22% in 1979 to 23% a year in 1980. You know about technology's great returns: rising 44% in 1998 and 130% in 1999. In 1979 energy stocks were up 68% and in 1980, 83%.

Then the bubble popped. The energy sector's weight fell to 23% by the end of 1982, mostly in the second half of the year. Energy stocks lost 21%. The S&P 500 lost 4%. In 1982 energy stocks fell another 19%, while the S&P 500 rose 21%. Since 1980 the energy sector has returned 9% per year. It has lagged three points a year below the next worst performing S&P 500 sector. Yet energy consumption has grown steadily.

Check out America's 30 largest stocks. They represent 36% of the US market's entire value. Exactly half are tech stocks. At year-end 1980 exactly half the 30 largest stocks were energy stocks. Of course, if you believe in the demand for and future of technology, today's weights may make sense. But if you believe in the increasing supply of the stocks, it doesn't.

Here is another eerie similarity: Back then energy stocks sold at twice the S&P's average price to book. Now they sell at 2.5 times the average price to book.

Look at initial public offerings in 1980 and now. That year was a busy one, with energy making up 20% of the offerings. That boosted the overall number of US stocks by 2%. In 1999 tech comprised 21% of the offerings and, again, increased total stocks by 2%. While that may not sound big, it is. Newly public companies are where the bubble breaks, when they run out of cash.

Most energy IPOs were formed to develop some esoteric energy technology or to drill for oil in bizarre places. They were hardly the vertically integrated giants, like Exxon, which extract, refine and sell oil. And they weren't huge: None of the 1980's 50 largest energy stocks was a 1979 or 1980 IPO. Eventually most went bust. But now 11 of our 50 largest tech stocks are 1998 or 1999 initial offerings, which means the damage will be greater if any fail.

Most new techies are as shallow in their areas as 1980's offerings were in energy. Who has the most Internet sales? Amazon? No. Intel, selling chips to its customers, did more online business in 1999 than all the dot coms put together. Federal Express had more business on the Web than America Online and 17 times more business than Yahoo.

Most Internet stocks are merely marketing firms with no clearly defined or provable strategy. Most net vendors have no real gross margin on sales, and that lack is a disaster waiting to happen---later this year.

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As with 1980's energy initial offerings, these new techn companies burn feverishly through cash, hoping to catch on with their public. Later this year, just as happened two decades ago, dozens will run out of cash—there are 140 now with less than 12 months cash supply. Folks will then worry about who will run out of cash next, causing many more sound stock to fall. Selling will run rampant in tech from small to large, even hurting the most solid techn stocks.

I have no clue which ones will implode first. Some will float more stock and lengthen their lease on life. But the large group of them without a viable business model are top candidates to go down hard. I don't see this immediately ahead; but instead in the second half of 2000.

Last month I forecast a flat S&P 500 in 2000, with techn stocks down 15%. I stand by that forecast. As 1000 progresses, you should lighten your holdings in technology keeping the best and most solid companies. This is a year for moving forward with foreign equities while lowering US expectations.

The Making of Two Bubbles (page 286 - 287)

What can you fathom that others find unfathomable?

I tried to see how many parallels I could find between the two sectors that no one was commenting on. Because I know stock prices are determined—always and everywhere—by supply and demand, I started with the notion that a flood of supply might topple prices. The following table demonstrated the rapid increase of stock supply in both of these sectors through respective IPO booms in the late 1970s and late 1990s. In 1980, nearly half of the increase in value of new and existing U.S. companies came from the energy sector. In 1990, nearly all of the increase came from the technology sector.