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## Clues from the Past

**Y**ou have some money in the bank. You decide you would like to buy some common stock. You may have reached this decision because you desire to have more income than you would if you used these funds in other ways. You may have reached it because you want to grow with America. Possibly you think of earlier years when Henry Ford was starting the Ford Motor Company or Andrew Mellon was building up the Aluminum Company of America, and you wonder if you could not discover some young enterprise which might today lay the groundwork for a great fortune for you, too. Just as likely you are more afraid than hopeful and want to have a nest egg against a rainy day. Consequently, after hearing more and more about inflation, you desire something which will be safe and yet protected from further shrinkage in the buying power of the dollar.

Probably your real motives are a mixture of a number of these things, influenced somewhat by knowing a neighbor who has made some money in the market and, possibly, by receiving a pamphlet in the mail explaining just why Midwestern Pumpnickel is now a bargain. A single basic motive lies behind all this, however. For one reason or another, through one method or another, you buy common stocks in order to make money.

Therefore, it seems logical that before even thinking of buying any common stock the first step is to see how money has been most successfully made in the past. Even a casual glance at American stock market history will show that two very different methods have been used to amass spectacular fortunes. In the nineteenth century and in the early

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part of the twentieth century, a number of big fortunes and many small ones were made largely by betting on the business cycle. In a period when an unstable banking system caused recurring boom and bust, buying stocks in bad times and selling them in good had strong elements of value. This was particularly true for those with good financial connections who might have some advance information about when the banking system was becoming a bit strained.

But perhaps the most significant fact to be realized is that even in the stock market era which started to end with the coming of the Federal Reserve System in 1913 and became history with the passage of the securities and exchange legislation in the early days of the Roosevelt administration, those who used a different method made far more money and took far less risk. Even in those earlier times, finding the really outstanding companies and staying with them through all the fluctuations of a gyrating market proved far more profitable to far more people than did the more colorful practice of trying to buy them cheap and sell them dear.

If this statement appears surprising, further amplification of it may prove even more so. It may also provide the key to open the first door to successful investing. Listed on the various stock exchanges of the nation today are not just a few, but scores of companies in which it would have been possible to invest, say, \$10,000 somewhere between twenty-five and fifty years ago and today have this purchase represent anywhere from \$250,000 to several times this amount. In other words, within the lifetime of most investors and within the period in which their parents could have acted for nearly all of them, there were available scores of opportunities to lay the groundwork for substantial fortunes for oneself or one's children. These opportunities did not require purchasing on a particular day at the bottom of a great panic. The shares of these companies were available year after year at prices that were to make this kind of profit possible. What was required was the ability to distinguish these relatively few companies with outstanding investment possibilities from the much greater number whose future would vary all the way from the moderately successful to the complete failure.

Are there opportunities existing today to make investments that in the years ahead will yield corresponding percentage gains? The answer to this question deserves rather detailed attention. If it be in the affirmative, the path for making real profits through common stock investment starts to become clear. Fortunately, there is strong evidence indicating

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that the opportunities of today are not only as good as those of the first quarter of this century but are actually much better.

One reason for this is the change that has occurred during this period in the fundamental concept of corporate management and the corresponding changes in handling corporate affairs that this has brought about. A generation ago, heads of a large corporation were usually members of the owning family. They regarded the corporation as a personal possession. The interests of outside stockholders were largely ignored. If any consideration at all was given to the problem of management continuity—that is, of training younger men to step into the shoes of those whose age might make them no longer available—the motive was largely that of taking care of a son or a nephew who would inherit the job. Providing the best available talent to protect the average stockholder's investment was seldom a matter in the forefront of the minds of management. In that age of autocratic personal domination, the tendency of aging management was to resist innovation or improvement and frequently to refuse even to listen to suggestions or criticism. This is a far cry from today's constant competitive search to find ways of doing things better. Today's top corporate management is usually engaged in continuous self-analysis and, in a never-ending search for improvement, frequently even goes outside its own organization by consulting all sorts of experts in its effort to get good advice.

In former days there was always great danger that the most attractive corporation of the moment would not continue to stay ahead in its field or, if it did, that the insiders would grab all the benefits for themselves. Today, investment dangers like these, while not entirely a thing of the past, are much less likely to prove a hazard for the careful investor.

One facet of the change that has come over corporate management is worthy of attention. This is the growth of the corporate research and engineering laboratory—an occurrence that would hardly have benefited the stockholder if it had not been accompanied by corporate management's learning a parallel technique whereby this research could be made a tool to open up a golden harvest of ever-growing profits to the stockholder. Even today, many investors seem but slightly aware of how fast this development has come, how much further it is almost certainly going, and its impact on basic investment policy.

Actually, even by the late 1920's, only a half dozen or so industrial corporations had significant research organizations. By today's standards, their size was small. It was not until the fear of Adolf Hitler accelerated

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this type of activity for military purposes that industrial research really started to grow.

It has been growing ever since. A survey made in the spring of 1956, published in *Business Week* and a number of other McGraw-Hill trade publications, indicated that in 1953 private corporate expenditures for research and development were about \$3.7 billion. By 1956 they had grown to \$5.5 billion and present corporate planning called for this to be running at the rate of better than \$6.3 billion by 1959. Equally startling, this survey indicated that by 1959, or in just three years, a number of our leading industries expect to get from 15 per cent to more than 20 per cent of their total sales from products which were not in commercial existence in 1956.

In the spring of 1957 the same source made a similar survey. If the totals revealed in 1956 were startling in their significance, those revealed just one year later might be termed explosive. Research expenditures were up 20 per cent from the previous year's total to \$7.3 billion! This represents almost a 100 per cent growth in four years. It means the actual growth in twelve months was \$1 billion more than only a year before had been expected as the total growth that would occur in the ensuing thirty-six months. Meanwhile, anticipated research expenditures in 1960 were estimated at \$9 billion! Furthermore, all manufacturing industries, rather than just a few selected industries as represented in the earlier survey, expected that 10 per cent of 1960 sales would be from products not yet in commercial existence only three years before. For certain selected industries, this percentage—from which sales representing merely new model and style changes had been excluded—was several times higher.

The impact of this sort of thing on investment can hardly be overstated. The cost of this type of research is becoming so great that the corporation which fails to handle it wisely from a commercial standpoint may stagger under a crushing burden of operating expense. Furthermore, there is no quick and easy yardstick for either management or the investor to measure the profitability of research. Just as even the ablest professional baseball player cannot expect to get a hit much more often than one out of every three times he comes to bat, so a sizable number of research projects, governed merely by the law of averages, are bound to produce nothing profitable at all. Furthermore, by pure chance, an abnormal number of such unprofitable projects may happen to be bunched together in one particular span of time in even the best-run

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commercial laboratory. Finally, it is apt to take from seven to eleven years from the time a project is first conceived until it has a significant favorable effect on corporate earnings. Therefore, even the most profitable of research projects is pretty sure to be a financial drain before it eventually adds to the stockholder's profit.

But if the cost of poorly organized research is both high and hard to detect, the cost of too little research may be even higher. During the next few years, the introduction of many kinds of new materials and new types of machinery will steadily narrow the market for thousands of companies, possibly entire industries, which fail to keep pace with the times. So will such major changes in basic ways of doing things as will be brought about by the adoption of electronic computers for the keeping of records and the use of irradiation for industrial processing. However, other companies will be alert to the trends and will maneuver to make enormous sales gains from such awareness. The managements of certain of such companies may continue to maintain the highest standards of efficiency in handling their day-to-day operations while using equally good judgment in keeping ahead of the field on these matters affecting the long-range future. Their fortunate stockholders, rather than the proverbial meek, may well inherit the earth.

In addition to these influences of the changed outlook in corporate management and the rise of research, there is a third factor likewise tending to give today's investor greater opportunities than those existing in most past periods. Later in this book—in those sections dealing with when stocks should be bought and sold—it would seem more appropriate to discuss what, if any, influence the business cycle should have on investment policies. But discussion of one segment of this subject seems called for at this point. This is the greater advantage in owning certain types of common stocks, as a result of a basic policy change that has occurred within the framework of our federal government, largely since 1932.

Both prior to and since that date, regardless of how little they had to do with bringing it about, both major parties took and usually received credit for any prosperity that might occur when they were in power. Similarly, they were usually blamed by both the opposition and the general public if a bad slump occurred. However, prior to 1932 there would have been serious question from the responsible leadership of either party as to whether there was any moral justification or even political wisdom in deliberately running a huge deficit in order to buttress ailing

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segments of business. Fighting unemployment by methods far more costly than the opening of bread lines and soup kitchens would not have been given serious consideration, regardless of which party might have been in office.

Since 1932 all that is reversed. The Democrats may or may not be less concerned with a balanced federal budget than the Republicans. However, from President Eisenhower on down, with the possible exception of former Secretary of the Treasury Humphrey, the responsible Republican leadership has said again and again that if business should really turn down they would not hesitate to lower taxes or make whatever other deficit-producing moves were necessary to restore prosperity and eliminate unemployment. This is a far cry from the doctrines that prevailed prior to the big depression.

Even if this change in policy had not become generally accepted, certain other changes have occurred that would produce much the same results, though possibly not so quickly. The income tax only became legal during the Wilson administration. It was not a major influence on the economy until the 1930's. In earlier years, much of the federal revenue came from customs duties and similar excise sources. These fluctuated moderately with the level of prosperity but as a whole were fairly stable. Today, in contrast, about 80 per cent of the federal revenue comes from corporate and personal income taxes. This means that any sharp decline in the general level of business causes a corresponding decline in federal revenue.

Meanwhile, various devices such as farm price supports and unemployment compensation have become imbedded in our laws. At just the time that a business decline would be greatly reducing the federal government's income, expenditures in these fields made mandatory by legislation would cause governmental expenses to mount sharply. Add to this the definite intention of reversing any unfavorable business trend by cutting taxes, building more public works, and lending money to various hard-pressed business groups, and it becomes increasingly plain that if a real depression were to occur the federal deficit could easily run at a rate of \$25 to \$30 billion per annum. Deficits of this type would produce further inflation in much the same way that the deficits resulting from wartime expenditures produced the major price spirals of the postwar period.

This means that when a depression does occur it is apt to be shorter than some of the great depressions of the past. It is almost bound to be

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followed by enough further inflation to produce the type of general price rise that in the past has helped certain industries and hurt others. With this general economic background, the menace of the business cycle may well be as great as it ever was for the stockholder in the financially weak or marginal company. But to the stockholder in the growth company with sufficient financial strength or borrowing ability to withstand a year or two of hard times, a business decline under today's economic conditions represents far more a temporary shrinking of the market value of his holdings than the basic threat to the very existence of the investment itself that had to be reckoned with prior to 1932.

Another basic financial trend has resulted from this built-in inflationary bias having become imbedded so deeply in both our laws and our accepted concepts of the economic duties of government. Bonds have become undesirable investments for the strictly long-term holdings of the average individual investor. The rise in interest rates that had been going on for several years gained major momentum in the fall of 1956. With high-grade bonds subsequently selling at the lowest prices in twenty-five years, many voices in the financial community were raised to advocate switching from stocks which were selling at historically high levels into such fixed-income securities. The abnormally high yield of bonds over dividend return on stocks—in relation to the ratio that normally prevails—would appear to have given strong support to the soundness of this policy. For the short term, such a policy sooner or later may prove profitable. As such, it might have great appeal for those making short- or medium-term investments—that is, for “traders” with the acuteness and sense of timing to judge when to make the necessary buying and selling moves. This is because the coming of any significant business recession is almost certain to cause an easing of money rates and a corresponding rise in bond prices at a time when equity quotations are hardly likely to be buoyant. This leads us to the conclusion that high-grade bonds may be good for the speculator and bad for the long-term investor. This seems to run directly counter to all normally accepted thinking on this subject. However, any understanding of the influences of inflation will show why this is likely to be the case.

In its letter of December 1956, the First National City Bank of New York furnished a table showing the worldwide nature of the depreciation in the purchasing power of money that occurred in the ten years from 1946 to 1956. Sixteen of the major nations of the free world were included in this table. In every one of them the value of

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money significantly declined. These declines ranged from a minimum in Switzerland, where at the end of the ten-year period money would buy 85 per cent of what could be purchased ten years before, to the other extreme in Chile, where in ten years it had lost 95 per cent of its former value. In the United States this decline amounted to 29 per cent and in Canada to 35 per cent. This means that in the United States the annual rate of monetary depreciation during the period was 3.4 per cent, and in Canada it was 4.2 per cent. In contrast, the yield offered by United States Government bonds bought at the beginning of the period, which admittedly was one of rather low interest rates, was only 2.19 per cent. This means that the holder of this type of high-grade, fixed-income security actually received negative interest (or loss) of better than 1 per cent per annum if the real value of his money is considered.

Suppose, however, that instead of acquiring bonds at the rather low rates that prevailed at the beginning of this period, the investor could have bought them at the rather high interest rates that prevailed ten years later. The First National City Bank of New York in the same article also supplied figures on this matter. At the end of the period covered in the article, they estimated the return on United States Government bonds at 3.27 per cent, which still would leave no return whatever, actually a slight loss, on the investment. However, six months after this article was written, interest rates had risen sharply, and were above 3.5 per cent. How would the investor actually have fared if he had had the opportunity at the beginning of this period to invest with the highest returns that have prevailed in over a quarter of a century? In the great majority of cases he would still have gotten no real return on his investment. In many instances he would have had an actual loss. This is because nearly all such bond purchasers would have had to pay at least a 20 per cent income tax on the interest received before the genuine rate of their return on the investment could have been calculated. In many cases the bondholder's tax would have been at a considerably higher rate, since only the first \$2000 to \$4000 of taxable income qualifies at this 20 per cent level. Similarly, if an investor had purchased tax-free municipal bonds at this all-time high, the somewhat lower interest rate that these tax-free securities carry would again not have provided any real return on his investment.

Of course, these figures are only conclusive for this one ten-year period. They do indicate, however, that these conditions are worldwide



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and therefore not too likely to be reversed by political trends in any one country. What is really important concerning the attractiveness of bonds as long-term investments is whether a similar trend can be expected in the period ahead. It seems to me that if this whole inflation mechanism is studied carefully it becomes clear that major inflationary spurts arise out of wholesale expansions of credit, which in turn result from large government deficits greatly enlarging the monetary base of the credit system. The huge deficit incurred in winning World War II laid such a base. The result was that prewar bondholders who have maintained their positions in fixed-income securities have lost over half the real value of their investments.

As already explained, our laws, and more importantly our accepted beliefs of what should be done in a depression, make one of two courses seem inevitable. Either business will remain good, in which event outstanding stocks will continue to out-perform bonds, or a significant recession will occur. If this happens, bonds should temporarily out-perform the best stocks, but a train of major deficit-producing actions will then be triggered that will cause another major decline in the true purchasing power of bond-type investments. It is almost certain that a depression will produce further major inflation; the extreme difficulty of determining when in such a disturbing period bonds should be sold makes me believe that securities of this type are, in our complex economy, primarily suited either to banks, insurance companies and other institutions that have dollar obligations to offset against them, or to individuals with short-term objectives. They do not provide for sufficient gain to the long-term investor to offset this probability of further depreciation in purchasing power.

Before going further, it might be well to summarize briefly the various investment clues that can be gleaned from a study of the past and from a comparison of the major differences, from an investment standpoint, between the past and the present. Such a study indicates that the greatest investment reward comes to those who by good luck or good sense find the occasional company that over the years can grow in sales and profits far more than industry as a whole. It further shows that when we believe we have found such a company we had better stick with it for a long period of time. It gives us a strong hint that such companies need not necessarily be young and small. Instead, regardless of size, what really counts is a management having both a determination to attain further important growth and an ability to bring its plans to completion.

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The past gives us a further clue that this growth is often associated with knowing how to organize research in the various fields of the natural sciences so as to bring to market economically worthwhile and usually interrelated product lines. It makes clear to us that a general characteristic of such companies is a management that does not let its preoccupation with long-range planning prevent it from exerting constant vigilance in performing the day-to-day tasks of ordinary business outstandingly well. Finally, it furnishes considerable assurance that in spite of the very many spectacular investment opportunities that existed twenty-five or fifty years ago, there are probably even more such opportunities available today.