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Adjusting to Key Influences of the 1960's

FROM TIME TO TIME, fundamental changes of great investment significance affect large groups of common stocks. Usually for some time after these new influences are felt, the great majority of the investment community have little appreciation of their true importance. Then as the real significance of what has happened dawns, a spectacular change occurs in the market price of the affected securities. Fortunes are sometimes made by those who appreciated the significance of what was happening early—before it was importantly reflected in changed quotations for individual stocks.

Let us examine two of the great adjustments to new conditions made by the financial community during the 1950's. Examining such readjustments of the past will better enable us to understand and anticipate some of those that will come during the 1960's.

One of these was the awareness of what a quarter century of progress in the art of corporate management had done to bring real investment stature to "blue chip" industrial equities. It is easy to forget that as recently as the late 1940's large segments of the investment community felt that those not in a position to face sizable risks should confine their security holdings to bonds, high-grade preferred and possibly a few public utility common stocks. Still remembered were the days when corporate management was largely a family affair. Those who controlled a corporation might be quite capable or just the opposite. However, following the practices of the times, authority was delegated only occasionally and almost never with the thought of building up continuity of management in the interest of the outside stockholder. When training a successor was thought of at all, it was usually from the standpoint of eventually handing authority to some favorite young relative who would continue managing in order to maintain the family interest. The corporate head was usually an autocrat, making decisions, good or bad, on the basis of personal conviction. The idea of assembling vast amounts of background material and a variety of outside specialized experts to provide a better factual basis for decision making was never considered. It hardly is surprising that the eventual realization of the enormous stride made by the more alert managements in the handling of their day-to-day affairs, in long-range planning, and in a sense of deep responsibility to the outside stockholder eventually caused a major upward revision in the price investors would pay for the shares of companies benefitting from these important new influences. What is surprising is that this trend toward making certain stocks intrinsically more valuable through radically improved management factors had been running on so long before stock prices began to reflect in a major way what had been going on for years.

Let us consider another and possibly equally important new development affecting certain classes of common stocks. This was the awareness by increasing numbers of companies of how properly guided “research” into one or another field of the natural sciences could open up a technique for ever greater growth in sales and profits through the creation and marketing of endless new but related products developed in this way. Again, important developments along these lines had started many years before. By the late 1940’s, this trend had attained quite considerable stature. But it was not until the 1950’s that the financial community gave widespread recognition to the enormous investment significance of companies that had genuinely learned to master this tremendously profitable management art. It was only as the 1950’s progressed that these most promising companies began to sell at price earnings ratios actually reflecting this attribute.

I believe there are two important lessons that can be learned from studying the (then considered) “new” factors to which stock prices adjusted in the 1950's. One is a realization of the profit (or at times the avoidance of loss) which can accrue to those who take such new influences into consideration before everyone else also does. The second is that these so-called new influences only start to affect most stock prices after they have been running on for quite some time. Therefore, to anticipate some of the comparable influences that will make themselves felt in the 1960's, it is not necessary to anticipate future background forces. Rather, it simply requires examining some of the more recent background influences to which certain groups of stocks have either not sufficiently adjusted themselves or adjusted themselves in an unjustified manner.

A. Stocks and Inflation

In the 1960's (as in the preceding three decades), the threat of further inflation will continue to be of major importance to all investors. However, as the 1960's progress, I believe it certain that the true relationship of common stock ownership to inflation will become more clearly understood. As a result, certain groups of stocks may sell at rather different price levels than they now do. Those who now understand these relationships may save themselves from considerable loss in the years ahead.

Because this whole matter has such great investment importance, I believe it may be worthwhile to explore inflation's fundamental nature before examining its relationship to various groups of common stocks. When its true cause is understood, the investor is unlikely to be confused in his basic thinking by various dogmatic comments of some of our political leaders.

The first thing to consider, of course, is just what we mean by inflation. While there are many complex definitions, I do not believe that for investment purposes it is either necessary or desirable to become involved in intricate definition. For practical purposes, it is sufficient to consider inflation as a condition whereby (with only minor and temporary reversals) the total amount of things and services that can be obtained for the same number of dollars (or other monetary units) grows less and less. Such a situation is in sharp contrast to the background condition that has prevailed over most of American history when the fairly long periods of years when the dollar would decrease in value were succeeded by roughly equivalent, lengthy cycles when the level of all prices would tend to fall and the value of the dollar to rise correspondingly.

The first and probably the most important thing for the investor to recognize about inflation is this: As long as the overwhelming majority of Americans maintain firmly held existing opinions concerning the duties and obligations of their government, more and more inflation is inevitable. Eliminating governmental waste and balancing budgets are highly desirable goals. If brought about without touching off a sharp downward spiral in general business, they can be extremely beneficial in slowing down the rate of further inflation and may even appear to have stopped it completely for a while. However, any talk by political leaders that in present-day America this by itself will put a permanent stop to further inflation is merely talk and nothing more.

Why is more inflation so sure to come? Because under the economic system we have established, the seeds of inflation sprout not in times of prosperity but in times of depression. About eighty per cent of our federal revenue is derived from corporate and individual income taxes. This basic source of federal funds is notoriously sensitive to the level of general business. It shrinks sharply on even moderate downturns in the general economy.

However, this is not all that happens when general business gets bad. We have enacted laws, including unemployment insurance and farm relief, which make mandatory a sharp increase of government payments in just these same periods of bad business when federal income is lowest. Furthermore, these laws already on the statute books are almost certainly but the smallest part of the special outpouring of government money that would occur whenever a truly severe depression might develop. Examine the actions of Congress in even the mild depression of 1958, and this becomes obvious. All sorts of proposals were immediately advanced for helping the economy at the expense of the national treasury. These ranged all the way from drastic reductions in taxes on individuals and corporations (so as to expand shrinking purchasing power) to setting up organizations to make special loans to distressed groups and to vastly expanded programs of public works. While most of these proposals failed to be enacted, the interesting thing is why they failed. Hardly a voice in either major party was raised in opposition to such a program "if it were really needed to end the slump." Rather, the Republicans took the stand that the slump gave promise of ending so soon anyway that it would be better to wait and only enact such inflation-producing measures if the expected upturn failed to materialize and "such measures became necessary."

While in 1958 events proved the slide so short-lived that few such measures were put into effect, can anyone with the least understanding of the practicalities of partisan politics doubt that in a more prolonged period of poor business our elected officials would almost unanimously choose tens of billions of annual deficits in preference to having the voters again undergo the hardships of a major depression? For that matter, can anyone say with even a semblance of surety that this deficit-producing course is not the right one in the national interest? It can be granted that huge deficits are bound to produce more inflation. We can also be well aware of the injustices and hardships that result from important rises in the general price level. However, are these injustices and hardships as great for those who feel their pinch as the suffering and hardships imposed on workers and proprietors alike by a great depression such as that of the early 1930's?

Whatever each of us as individuals may think of this matter, it has already been decided for us by the overwhelming weight of public conviction. One hundred and fifty years ago, public opinion would have no more held it was the business of our government to assure constantly prosperous economic conditions than, to mention the example I used when I wrote *Common Stocks and Uncommon Profits*, they would have thought it was the business of government to guarantee everyone a happy marriage. Fifty years ago, public opinion would have thought it necessary to do such relatively inexpensive things as to establish bread lines and soup kitchens so no one actually starved. At that time, public opinion would have done little more. In the then still strongly agricultural economy, this was hardly enough to have produced deficits of inflationary proportion. The federal income tax, of course, was still a thing of the future. Percentage-wise, the national government's incoming revenues did not fluctuate quite as violently with every change in the economic weathervane as they do today.

Where does all this leave us? The historically recent but now almost unanimous opinion of both our public officials and their constituents that it is the duty of government to maintain endless prosperity is not likely to change. Unfortunately, when hard times come, the only major cure known to government is to spend enough more than is taken in taxes to create sufficient new purchasing power to reverse the trend. This also produces more inflation. Occasional downturns in business seem as much a part of the price we must pay for all the other advantages of a system of free private enterprise as a lower standard of living for everybody, less goods produced, and a loss of personal freedom seem the price that must be paid by those living in countries where the government is the only employer. Therefore, as long as we maintain the benefits of our free economic system, unexpected downturns will occasionally appear. As long as we are democratically governed and public opinion reacts as it now does, these will be followed by more and more inflation.

However, at this point there is something else to be considered. Just as there are many people who erroneously hold that inflation can be halted short of dictatorship, so there are even more who have an equally false view. This is that there is something inherent in the inflationary process that inevitably makes it proceed at an ever faster and faster pace. Inflation is sometimes compared to a horse that may start at a slow walk but will eventually end in a furious and dangerous gallop. The often heard terms of "galloping" and "runaway" inflation have doubtless arisen from this analogy.

The arguments of those who believe in the inevitability of this speeding-up process of inflation run something like this: As prices start rising, far-sighted people realize the inflationary implications of what is happening. They start buying things they will need in the future before the price of these things rises still higher. This extra demand tends to make the prices of these things rise even faster than they otherwise would. These ever more rapid price increases alert still others to the inflationary implications of what is occurring. As they in turn anticipate future needs, further and further boosts are given to the momentum of this inflationary spiral. Consumers buying today what they normally would purchase in the future, businessmen piling up inventory materials far beyond normal practices, and speculators simply trying to make a quick profit from the situation all contribute their part to the whirlwind.

It is strange that in the face of all of the evidence to the contrary, so many people who evaluate the evils of our existing inflation quite realistically then go on to frighten themselves and totally mislead investors by proclaiming that our present leisurely type of inflation must inevitably break loose in a far more virulent galloping sort of inflation. Although these people have been forecasting this development for years and have so far been totally wrong, their convictions have gained considerable general acceptance. This acceptance has had important implications for the investor, which I will come to presently. But first, why does this view run contrary to what has actually happened? For some years, a sizable part of the business community has accepted the great probability of more and more inflation. Yet nowhere in the business world do we find any tendency in times of peace to build up inventories because of this. In contrast, we find constant effort to find more and more ways to cut down inventory totals. The reason for this is not hard to find. There are so many costs to carrying inventory that it does not pay to stock up just because eventually the general price level will rise further.

To understand this matter clearly, it might be well to examine these costs in detail. First, there is the interest that could be earned on funds tied up in excess inventory. If available funds are not on hand and excess inventory must be carried with borrowed money, this cost is even greater. Then there is the cost of warehousing or storing this inventory. To this must be added the cost of insuring it against fire, theft, or other damage. Next come local property taxes, which will be levied if the inventory is held at whatever time of year such assessments are made in the particular locality. Finally, in the case of certain commodities, there is the risk of physical spoilage with age. In other cases, there is danger of style or technical changes which would give them less value.

For these reasons, with all of the inflation and inflation awareness that has occurred in the United States since World War II, we find no tendency whatever to build up stocks of goods as an inflation hedge. Such advance buying as has occasionally occurred has nearly always been because of fear of physical scarcity (as in the early stages of the Korean War) or fear of a price rise in a particular commodity, but never because of concern about general inflation. At times, advance buying has not been stimulated even when immediate but moderate future price advances for a particular commodity have been announced. The increase was just too small in relation to the carrying charge.

None of this means that a speed-up to the type of truly galloping inflation witnessed in Germany and France shortly after World War I is an impossibility in the United States. It could happen here. However, to occur, the whole inflationary process first would have to be speeded up a great deal. There should be many advance signs of this well before it might happen. Furthermore, for reasons already discussed, such a speed-up, if it happens, will do so at a time of depression rather than prosperity. At such times, investment bargains in common shares usually abound. This has major significance to the investor for it means that when stock prices are high he need not rush surplus cash into the market for fear inflation will otherwise gobble up the value of his cash at any moment.

What is the actual pace at which inflation has been developing? No one can say with complete certainty exactly how fast inflation is growing (that is, just how much less the same amount of money will buy) each year. This is because no one can be positive that some margin of error may not exist in the various indices that have been devised to measure this matter. But the Consumer Price Index (CPI) of the U.S. Bureau of Labor Statistics has been compiled with so much care that it probably comes reasonably close to measuring accurately as complex a matter as this one. For the ten years from January 1, 1950 to December 31, 1959, it shows an average annual increase of a little over 2 per cent a year. Let us suppose this index should be inaccurate in measuring price changes by as much as 50 per cent, which seems quite unlikely. This would still leave us with an average annual increase of only a little over 3 per cent.

The full investment significance of this should be obvious, yet investors frequently fail to grasp it. It means that, from the long term standpoint, inflation is a major force to be reckoned with. Any investment which does not have within itself the means of increasing its value by at least from twenty to thirty per cent every ten years may be regarded as a poor one.

On the other hand, and here is where many investors go badly astray, just because cash, bonds, and many classes of stock contain no inherent inflationary protection, this emphatically does not mean that this type of asset should be pitched over and the right type of equity investment acquired at the first possible moment. In the average year, the shrinkage in the real value of cash might be in the 2 to 3 per cent range at most. This roughly represents about what (after taxes) cash is currently earning in interest income. This means that in as much as four years there might be a real shrinkage of not over 8 to 12 per cent if the interest factor is ignored. Yet in any year, the most desirable types of common shares will fluctuate far more than 3 per cent in value, and over a four-year span, the fluctuations will be many, many times 8 to 12 per cent.

The wise investor should get the inflation matter in proper perspective. Long range, I believe this should be his goal: No investments that fail to give promise of at least enough gain to balance the inevitable further shrinkage of the dollar. But short range, he should also realize that selecting the right investment and buying it at the right time is tremendously more important than getting this inflation protection quickly. Conversely, when an investor has set aside a given sum of money for a given purpose for which he will want to use that money in a relatively few years (for example, to build a house or take his family on a trip abroad), I believe he should leave such sums in cash and not try to protect them against inflation. If he has bought the right type of inflation hedge, it may be down in price just when he wants his cash by far more than the relatively modest amount the purchasing value of his original savings would have shrunk in the meantime.

Why do so many investors in this inflation-conscious age get almost panicky about holding much cash? They rush in to buy with a total unwillingness to take the time necessary to find a genuinely outstanding investment opportunity. In some cases, this may just be the sign of an impatient or immature individual. Frequently, however, I believe there is something quite different behind their actions—the uncritical acceptance of the widespread fallacy that the tempo of inflation is so sure to increase, so that speed in disposing of cash or its equivalent becomes of paramount importance.

Because I have heard it so often, I am well aware of the objection to my basic conclusions that many thoughtful people will make at this point. They will say that my statement that major inflationary spurts will only occur as a result of the deficits caused by wars or business depressions (so that there is no tremendous rush to hedge against inflation at other times) is based entirely on the assumption that inflation is being caused by an expanding money base. Actually, they will claim steadily rising prices are being caused by something far different. This is the unfair advantage in our economy that our laws give to our labor unions. By enabling single organizations to have monopoly power to supply vitally needed workers or to withhold this supply from entire industries, these unions have been given a strength which the rest of the community cannot match. This has caused wages to rise so much that a business has no choice but to pass the increases on to the public in the form of higher prices. Here is a force that in good times even more than bad will be working for more and more inflation.

I agree with much of this argument, but I believe it to be only part of the entire picture. While it is a larger money supply and not higher wage rates that directly causes inflation, the two are still largely the same thing. This is because when wage increases are granted that are greater than increased productivity, management has no choice but to pass most or all of this on in the form of higher prices. This in turn is because, with the average of all business profits only a few cents of each dollar of sales and the total wage bill many times this amount, there is no place such a wage increase can be absorbed except in higher prices. Then, however, the government is also placed in a position in which sooner or later it has no choice. It can, through the Federal Reserve System, "ratify" a round of wage-price increases by increasing the money supply enough so the public can purchase the normal amount of goods at the increased price level resulting from this latest wave of wage increases. However, it can refuse to "ratify" and keep the money supply where it was before. If it refused to "ratify," there would then not be enough money to support the former normal volume of transactions at the higher price level. Bad times would then begin. Either the so-called "money managers" must reverse their own policy, or the depression deepens. Then with federal revenue shrinking and expenses rising, enough deficit occurs to increase the money supply through this means, and the wage price increase gets ratified anyway.

Fortunately, there is another major force which today is almost as powerful as the power of big labor unions and which tends to exert just the opposite effect on the general price structure. This is the amazing growth in recent years of scientific research and developmental engineering in industry. So profitable has been the teamwork of the business executive, the scientist, and the engineer, that what Professor Sumner Schlichter of Harvard University has so aptly called the "Industry of Discovery" has been growing at a truly amazing rate. It has tripled in the last six years and currently embraces annual expenditures somewhere in the neighborhood of nine billion dollars. This is almost a straight-line progression from expenditures only thirty years ago that totalled a relatively few million.

It is easy to visualize the influence on the price structure of the sizable group of engineering people who through new machinery and new methods are constantly finding ways of making things cheaper. Sometimes lost sight of—because their work does not lend itself so readily to statistical treatment—is the influence on the price structure of that other large group of researchers who are working to make things better. An example might make this clear. Suppose a tire costs the same price today as it did thirty-five years ago. Then, punctures were common every few thousand miles. Today they are quite rare. Then, the total mileage per tire, even at vastly slower driving speeds, was but a minor fraction of that which is standard today. Therefore, in total cost including maintenance, a sizable price reduction has occurred.

Here in the ever-growing "Industry of Discovery," we have a countervailing force that with its tendency to make things cheaper has gone a long way toward balancing much of the influence of rising wage rates to make them dearer. There is a considerable time lag between when expenditures are made in research and when the results appear in cheaper or better products. Since expenditures are steadily rising, there is every assurance that in the years ahead there will be an equally rising curve of benefits. Therefore, it seems rather sure that the price-reducing influence from this source will grow stronger not weaker. This is why I believe not that inflation will stop, but that with this powerful brake tending to hold down otherwise inflationary influences, excepting in times of large deficit producing depressions, the investor can take his time to find the occasional outstanding investment. He need not be so frightened of the speed of inflation's progress that he must rush into the first inflation hedge that comes along.

Once the investor realizes the certainty of more and more inflation, his natural tendency is to concentrate his thinking upon what to him is quite correctly the heart of the subject—where to place his funds in an inflationary world. However, I believe there is still one remaining background matter which it can be quite profitable for any investor to understand before getting to the specifics of just what type of holding best fits into the kind of inflation most apt to be encountered in the 1960's.

What I am about to say will challenge the accuracy of an almost universally accepted belief. Just because so many accept something as true without further thought on the subject will cause some to feel that any questioning is out of place. To those, I would point out that history has shown that, in every age and in every field of human knowledge, many of the views which almost everyone accepted as true and never bothered to think about further were in time proven completely wrong. It took centuries of civilization before it was realized that the earth went round the sun and not the other way around. Only a generation ago, learned scientists would have ridiculed the idea that even the most solid of objects are almost entirely empty space, yet today we know this to be the case. Can you remember when pregnant women were told to eat enough for two, a practice we have since learned is highly undesirable? Because something is generally taken for granted and even though respected leaders in places of power tailor their policies accordingly, this does not of itself make it correct.

In modern times, nearly all bankers and many governments have held that the way to fight inflation is to raise interest rates. This would be an effective curb if, in our type of slow-moving inflation, people acted as they are supposed to do in the theoretical economist's traditional concept of inflation or as they actually do act in a faster moving inflation. Then businessmen, consumers, and speculators would all compete to stock up on things they do not need now but believe will cost more later. This would raise prices faster and faster until many became so overstocked and overbought that the boom would burst. Most such extra buying is done on credit or borrowed money. Therefore, raising the cost of such money by refusing to make more credit available would stop this type of dangerous procedure and would be a true inflation-curbing measure. However, since in actual practice none of these groups show any tendency to make unneeded or advanced purchases, raising interest rates to cure our type of inflation may be like using a drug that can quickly cure pneumonia on a patient whose ills result solely from overeating.

Because it can be quite helpful in the proper timing of investments, let us examine considerably more closely what raising interest rates actually does. First, let us see what our central banking authorities have been telling us. Remember, these are the people who have the power. Since they can control the supply of bank credit, they are in a position to exert tremendous influence on money rates.

Raise wages, they say, and that is inflationary. It increases the cost of doing business and therefore the cost of what the consumer must buy. Raise the price of raw materials, finished products, or services, and that is, of course, inflationary. It not only raises the cost of products directly affected, but by raising the cost for still other businesses who buy these products or services, it forces still other price increases. But raise the cost of money, say our central bankers, and this is deflationary! They say this even though, business must borrow money to carry on and grow, and though this raises the cost of doing business just as does any other type of price increase in the things which a business needs to operate. Does this make sense?

Strangely enough, under certain conditions it does. Unfortunately, these happen to be conditions which are quite different from those under which the American economy normally operates. But suppose our economy were operating close to capacity. Most major industries would then be turning out as much as could be squeezed out of their plants. Further suppose that the real rate at which, say steel, was being consumed were not as great as this demand. However, suppose the steel plants were being overworked trying to turn out enough steel not only to meet the real needs of the nation but also to build some additional steel plants to take care of the need that appeared to be there as long as the industry was being called upon to supply enough steel for *both* current demand and the proposed steel plants, too. In such an instance, choking back the amount of money business could borrow could do two quite worthwhile things. It could slow down how rapidly new steel plants would be built. This would force some of the extra steel demand into the future, thereby prolonging the boom. More important, it would force most companies to get along with the least amount of steel inventories that they could keep on hand and still carry on their business. In this way, it might well prevent the type of runaway rise in steel prices that would otherwise occur if all the customers of the steel industry were bidding against each other for just a little more steel than the mills could possibly turn out. Under circumstances like these—but only under circumstances like these—high interest rates and so-called "tight-money" can be of great help in curbing inflationary tendencies.

In the 1960's, however, the American economy is in a quite different position from the example just described. Except when faced by an industry-wide strike, most major industries are operating at rates varying between seventy and ninety per cent of capacity. Almost everywhere there is surplus unused capacity. There are, and may continue to be, several million people unemployed. Most importantly, a large part of new equipment and machinery projects under consideration by industry today, the type of projects which get approved in large numbers when interest rates are low but which are cut down drastically when they are high, are not for new capacity at all. Rather they are for modernization of old capacity. They are projects which will permit the turning out of products at a lower cost per unit, usually by the replacement of old machines and old methods with new machines and better methods.

Nothing could be more important in curbing the rate of inflation than this. Here is a two-pronged anti-inflationary weapon. On the one hand, through helping industry borrow at low rates to carry through many more of these modernization programs, industry is being helped to cut its costs. Because of the normal workings of our competitive system, such cost savings nearly always are passed on to the consumer, although at times this has only been in the form of enabling industry to absorb further wage increases without corresponding price increases. On the other hand, the volume of additional orders to industry which these additional modernization programs would produce would increase sufficiently the total volume of all business, to say nothing of the increase it would bring to total payrolls. It inevitably would bring dramatic improvement to a federal budget picture as dependent as is ours on the ups and downs of total corporation and individual income taxes.

It now should begin to become clear why creation of "tight money" does not accomplish what it is supposed to do in slowing down inflation. It actually sets in motion forces that in time are sure to speed up inflation. I already have tried to show how through constantly finding ways of making things cheaper or better, research and developmental engineering have been a powerful force slowing down this inflationary process. However, because nearly all of these cost-saving engineering developments require capital, their introduction into industry is directly affected by the money markets. When money is costly and hard to borrow, most corporations are under pressure to utilize only the most outstanding of the fruits of their research and engineering departments. Otherwise attractive programs tend to become postponed or abandoned as the means of financing them become unavailable or too costly. So the very interest rates that have been raised to prevent inflation curtail doing things that are designed to reduce production costs and bring about lower prices!

Nor is this the only or the most fundamental way that tight money brings on more and more inflation. I have also tried to show that the basic producer of inflation is business depression because of the huge increase in deficit financing that a period of severe business decline must bring. Whether it was as long ago as 1930 or as recently as 1957, whenever the Federal Reserve banks have encouraged a drastic tightening of money rates, the effect on general business has been the same. Industry curtails capital spending. Home building and other key industries in which financing costs play a big part in final prices to the consumer usually become equally affected. The decline in these "swing" industries begins to hurt other lines, and a general decline is on its way. Ever since the great depression of the 1930's, each of these business declines has resulted in still another hefty boost in the federal deficit and that much more inflation has become part of the economy.

If I have dwelled at what may have appeared to be an unreasonable length upon this matter of the effect of high interest rates, it is because I think it of far more significance to investors than most of them realize. While investors should never lose sight of the great probability of more and more inflation, in normal times, this inflation moves sufficiently slowly so that the investor should take his time waiting for an outstanding opportunity rather than grab anything that might be a hedge against rising prices. However, when money rates start climbing toward higher levels and the money managers appear to be encouraging the rise, the rules change somewhat. The investor should then move with even more caution than normally. Business may well be about to turn down. Even if it does not, the yield factor is likely to cause stocks to follow bonds toward lower levels. This does not mean that the investor should refrain from all buying during this period (for a genuinely outstanding opportunity should never be passed over because of the purely near-term influences) but that he should be more and more demanding of what he does buy.

After tight-money conditions have prevailed for some time, however, the picture changes radically. In tightening money rates to combat higher prices, the central banking authorities are like an individual who has a dangerous virus in his system and who decides to take no nourishment in an attempt to starve out the virus. He will die of starvation himself long before he eliminates the virus. Furthermore, the Federal Reserve, like most individuals, will usually give up the attempt and reverse policy as the starvation approach gets more and more painful. The investor has usually no sure way of knowing exactly when this change will take place. But the longer the starvation period has been going on and the more federal deficits are piling up while the capital goods and construction industry are suffering, the greater the possibility of a sharp reversal followed by another inflationary spurt. Therefore, the longer a deficit-producing period runs on, the more eager the individual should be to see that his securities are of a type suitable for long-range holding.

What type of holdings will provide protection from inflation? Here I think the crude and naive notions of the past decade are going to be in for a rude awakening as the 1960's unfold. It has been generally believed that almost any type of common stock which represents ownership of assets was, is, and will continue to be an inflation hedge. None of this is correct. So far as the past is concerned, this is easily demonstrated by citing the sizable number of stocks representing ownership of significant amounts of assets which over the past 15 years of steadily rising prices (and therefore shrinking purchasing power of the dollar) have shown no increase in their own price and in many instances have substantially declined. This in itself should refute the widely accepted and plausible sounding argument that since stocks represent the ownership of tangible things (as land, factories, inventories, etc.) and since in an inflation the value of things goes up in relation to dollars, owning these things through stock ownership will protect stockholders against further shrinkage in the value of the dollar.

Many investors carry this reasoning one step further. They claim that corporations which own vast amounts of natural raw materials in the ground, such as mining and petroleum companies, are ideal inflation hedges. As the dollar shrinks in value, ownership of such real assets will rise proportionately in value, so that shareholders in such companies have built-in protection. For reasons I will attempt to explain, some of these companies may prove quite worthwhile inflation hedges. However, this is due to a completely different set of factors, far removed from their happening to own sizable amounts of just any useful raw material. This is something which, in 1958 and 1959, many previously complacent owners of shares in oil-producing companies began to discover for themselves.

We can rid ourselves more easily of this common fallacy that "because stocks represent ownership of tangible things they automatically protect us against inflation" if we keep one basic concept in mind. Within the general price level, the things we buy are constantly changing their values in relation to each other. Even though this general price level may be steadily (but slowly) rising—within that great and rather glacier-like movement—some things are going up in price while others are going down. In these times of frequent inventions and the discovery of new processes that sometimes make possible major reductions in the cost of doing things, some of these downs can be rather spectacular. Similarly, shifts in public taste can cause noticeable increases or decreases in the price of the products or services affected.

To illustrate this point, I am going to cite an extreme case—one which may seem rather exaggerated. Nevertheless, I believe it to be one which stockholders might well keep in mind if they are to avoid the easy mistake of buying the wrong type of stock for an inflationary period. Furthermore, let us place our example in as extreme an inflation as the modern world has seen. Let us place it in Germany in the early 1920's. At that time, the German mark (worth about 25¢ prior to World War I) became so utterly worthless that a billion marks at one period had less trading value than ownership of a loaf of bread. Many Germans, recognizing what was coming, did their best to convert their deteriorating money into ownership of physical things. But suppose one of them acquired as his hedge against inflation a warehouse full of bustles. In the 1890's when the feminine population, for reasons far beyond my ability to comprehend, desired to disguise (or possibly accentuate?) a certain portion of their anatomy, this ownership would have been highly desirable. In that period, the merchandise would have retained much of its value. However, in the 1920's, outside of an occasional demand for theatrical costumes, bustles would have had no value whatsoever. It would not have made the slightest difference whether the price was high, low, or even if it was quoted in a currency which everyone thought soon to be worthless. No one would want them, and no one would buy them. Bustles in the 1920's would not have been the least protection against inflation.

Now let us get to common stocks. Except when a company is about to be liquidated, the value of the assets behind each share of stock has very little to do with the price at which that stock normally sells in the market. Reason for this is essentially that unless assets are going to be passed out to stockholders, they are only desirable for either what they will earn or what the financial community as a whole thinks they will earn. If you doubt this and want confirmation of it, make a very simple test. The list of stocks traded on the New York Stock Exchange nearly always is presented in alphabetical order. Pick any spot at random on this list and study the next twenty stocks. Notice the complete lack of relationship between market price and asset value of whichever group you happen to choose. Some stocks will be selling at a huge discount from asset value. Others will be selling at many times their asset value. There is no relationship to be found at all. If this does not convince you, make another type of test. While they appear far less often than they did years ago, a broker will occasionally put out the type of bulletin that calls attention to stocks that are bargains because of their asset value. Get one of these that was published some years ago. With the ease of hindsight, compare the subsequent market action of these stocks with that of any of the recognized market indices. You will find that lots of assets by themselves have little relationship to what stocks are going to do in the market. These assets may or may not increase in value in an inflationary period. But this in itself is not enough to make the stocks go up proportionately. Asset value, by itself, has no power to produce rising stock prices.

What does cause stocks to rise in value are two things that are rather closely interrelated. One is an increase in a stock's earning power. The other, and usually the more important, is the consensus of investment opinion as to the future course of that earning power. The reason these are so closely related is the strong tendency of the financial community to conclude that because a particular company has been increasing per-share earnings at a brilliant rate year after year, this trend will continue for a long time in the future. Plus or minus the temporary influence of the business cycle, this line of reasoning is often quite correct, although occasionally it can be quite wrong. At any rate, it is steadily increasing per-share earnings upon which is superimposed a steadily rising ratio of market price to these earnings (as the financial community accords a particular stock more and more status) that produces much of the great increase in values commonly associated with growth stocks. This combination produces the greatest net gains for investors in times of sound money. It also provides the greatest protection against inflation in times of depreciating currency.

In other words, stocks that are going to have a big rise regardless of inflationary conditions are the only type of stocks that will safeguard the investors' assets against inflation. This is not because of any deep intrinsic relationship between common stocks and inflation protection. No such built-in relationship exists at all. It is solely because of the happy accident that the company involved is so conducting the affairs that it is making its shares intrinsically more valuable by a degree as great or greater than inflation is decreasing the value of the investor's money. This means that the investor's real assets will be maintained by as much as inflation would otherwise shrink them. If a true growth stock is bought before most of the financial community recognizes the full attractiveness of the company, it nearly always means in a slow-moving inflation such as ours that the stock will go up even more than money will shrink. Therefore, over and above his genuine inflationary hedge, an investor will have a sizable further real profit.

In other words, the rules for selecting the only type of stocks that will give real inflation protection are identical with those that I sketched in *Common Stocks and Uncommon Profits.* Find the company with a highly competent management that through research or some other means has found a way to increase its per-share earnings year after year (after allowing each year for the temporary ups and downs of the business cycle). Be sure that management is determined to continue this growth and safeguard it through the build-up of younger executives trained in the same general policies. Then, if you can buy these shares before most of the financial community fully appreciates the situation, get them and hang on to them, regardless of how high they go, for as long as these policies continue. Do all this, and you will have a real hedge against inflation and a great deal more. Buy this same company after its unusual qualities are pretty generally appreciated and you probably will still have your inflation hedge but not much more. In contrast, buy shares in a mediocre company, particularly when so many others are bidding up the price of any and all stocks, and you probably will not have any real protection from inflation at all.

Many people ask, "If most common stocks do not give full protection against inflation, do they not at least provide some protection?" After all, our type of inflation tends to make the periods of poor business shorter than they might otherwise be and may tend to stimulate activity when general business is good. Does not all this help create some additional earning power for nearly all stocks? Will not this earning power create enough additional real value to offset at least partially the declining worth of money?

I do not think enough dependable evidence is available to give a positive answer to this. However, I am inclined to suspect that as the 1950's progressed and the belief swept the investment community that common stocks are (just by being common stocks) a haven against inflation, far too much weight has been given these matters. This is because investors have been ignoring the other side of the same situation, that is, the way in which inflation hurts common stocks as well as helps them.

As prices rise, it takes more and more money to do the same physical amount of business. Assuming a company is already so efficient that it operates with the smallest amount of inventory needed to meet its customers' needs promptly, each round of price increases means it must set aside that much more money to maintain this same minimum level of raw materials, work in process, and finished goods on hand. Remember, excepting in accounting fiction, this is not a liquid resource. It represents a permanent additional investment that the company must keep on hand at all times, since it must maintain its minimum inventory at this level if it is to retain its existing position. Similarly, as prices rise, more and more money must be tied up in accounts receivable to finance not more but the same amount of business. Finally and most important of all is the financial drain resulting from plant and equipment. Remember, some of these machinery and building items have shorter periods before they wear out and become useless while others may have a longer life. However, all of them wear out in time. The depreciation rate a company is allowed to charge depends on the taxing authorities' estimate of how long it takes to wear out each item. However, this rate under our archaic and rather unfair depreciation laws only allows a company to recover the amount each of these assets originally cost, not what it will cost to replace it when a new one must be put in its place. Therefore, in an inflationary period, there is a constant financial drain and erosion on the plant and equipment of all companies. This amounts to the rather sizable sum that represents the difference between the price at which these items are being depreciated on the books and the real cost of replacing them.

From the standpoint of the common stockholder, there is only one protection against all this inflationary produced financial attrition. This is a management of such ability that it can produce a steadily increasing stream of profits. Such increasing profits usually come from increasing the size of existing activities or starting new activities in related lines. To be great enough to nourish a business in inflationary times, this growth must be truly large; for in addition to supplying the additional capital needed by the older parts of the business, there is the problem of supplying the capital for the newer lines as well. To do this requires management of great capability and great judgment in selecting the right spot for expansion. Companies with such managements are usually exactly the same ones that in non-inflationary times would make the most worthwhile investments. This is why the common stock of just any company with a mediocre management is not likely to prove much protection against inflation.

As the 1960's start, I believe, understanding this one point can be of tremendous importance in avoiding losses that might otherwise occur when greater financial sophistication concerning inflation develops in the years immediately ahead. In the 1940's and the early part of the 1950's, all the signs pointing to the inevitability of more and more inflation were just as clear as they were later on in the past decade. However, for some reason, until a very few years ago, a great many investors did not read these signs. Then in 1956 to 1957 and even more so in 1958 and 1959, millions of investors heretofore not overly concerned about the matter began developing a great mass phobia about inflation. With no change in fundamentals whatsoever and inflation no more (and no less) dangerous than it had been for many years before, they acted as though their funds would be wiped out if they did not get protection by acquiring common stocks (almost any kind of common stock) immediately. The result was a great uprush in the quotations for and the price-earnings ratios of all sorts of common stocks. Some are of a sort that should genuinely protect against further inflation. Others, because of situations affecting the course of their own future earning power, may prove either inadequate protection or no protection whatsoever.

Most of the many wealthy individuals who flocked into the market to make their first common stock purchases in the period of 1956 through 1959 might be considered genuine long-term investors and not speculators. They became sincerely concerned about inflation. This made them lose their fondness for tax-free municipal bonds and the greater net income after taxes which these tax-free securities offer to wealthy investors. They bought their common shares, sometimes almost regardless of price. They put them away in their strong boxes with the comfortable feeling that they were now protected against the further inflation that was sure to come and that, no matter how much they paid per share, in time inflation would make the price a lot higher.

I believe this has created a situation which in the early 1960's the shrewd investor will watch with close attention. I say this because I think it reasonable to conclude that many of these wealthier newcomers to the stock market may have great ability in other directions but are people with relatively low investment I.Q.'s. Otherwise with all of the inflationary signs just as apparent at least ten years earlier, they would neither have concentrated upon the inflationary dangerous tax-frees for so long nor so quickly and uncritically have embraced the doctrine that any stock—regardless of price—would protect them against inflation.

What I believe may very well occur is this: Many of these recent inflationary-induced converts to common stocks may well act about as you might expect someone to behave who had previously spent his whole life underground and who knew almost nothing of celestial mechanics. You show such a person the moon at exactly eight o'clock in the evening. You tell him that as the night goes on the moon will appear to travel clear across the heavens. He looks at it with intense interest. But he cannot see it move. So he keeps watching. At 8:01 it seems to be in just the same place. At 8:02 he can still see no change. 8:03 still brings nothing he can see for himself, and by 8:04, he gives up in disgust as still things seem the same. He decided he can spend his time to better and to greater advantage doing something else. Yet by two o'clock in the morning if he came back and looked, there would be the type of spectacular change for which he got tired of looking at 8:04.

I think this is just what is rather apt to happen to many of the relatively recent converts to the ranks of those who hold common stocks primarily because of inflation. Many months, perhaps several more years, will go by. At the speed inflation has been advancing it may be pretty hard to see that in the time since they bought their common shares inflation has been a mighty force. Their psychological 8:04 P.M. will come. They will be influenced by the prevailing feeling of the moment that "inflation really isn't so important" just as when they bought they were influenced by the mass fear of not protecting themselves at once. If this happens, and it could happen just when the real need of protection against inflation is greatest, before the 1960's are too far advanced, a mass movement away from common stocks might prove a major influence for a short period of time.

To the alert investor, such a possibility opens up two avenues of possible immediate action. Now, when many routine stocks are selling at what, judged by most past standards, seems extremely high prices, he might re-examine his holdings with the thought of eliminating any investments that are not of truly outstanding character. On the other hand, as I reiterated again and again in my *Common Stocks and Uncommon Profits*, any possibility that the really unusual stock may be temporarily overpriced should not be the least inducement toward causing an investor to sell that type of security. There are just too many chances that (1) the expected price reaction will not occur, (2) if it does the investor will wait for still lower prices and will not get back until the stock has again climbed to even higher levels, or (3) by the time the reaction does come the stock will have continued to climb so much that at its coming bottom it will still be above present prices.

Mass disenchantment with the idea of "any stock as an inflation hedge" might also, at such time as it may come, open up future avenues of action for the alert investor. The always hard to find genuine growth company will, for the moment at least, go down in the general selling. If such a selling wave should come, it might present that rare buying opportunity in the type of stock that represents true inflation protection. In typical, normal major-market setbacks, all kinds of stocks go down sharply during the decline, but only the truly good ones make the kind of sharp recovery that leads on to new all-time highs.

In summary, I think there is every probability that by the end of the 1960's there will be general investor confirmation of the current view that more and more inflation is inevitable and that one of the most important considerations in making any kind of investment is protection against this tremendous force. However, I think by that time the investor will have a degree of sophistication undreamed of today regarding the mechanics of so protecting his holdings. Not just any stocks but solely stocks that would do unusually well in any non-inflationary period will be recognized as the only true common-stock inflation protection. It will be realized that there is no direct relationship causing common stocks to rise as the purchasing power of money goes down. Meanwhile, it will also be recognized that, excepting in times of depression when common stocks are likely to be cheap anyway, there is seldom any reason for rushing into such buying for inflation protection. Selecting exactly the right stock to buy is so important and the shrinkage in the real value of cash occurs so gradually that there is every reason to take several years, if necessary, until just the right purchase comes along. However, the process of obtaining this degree of general investor sophistication on this subject may not be easy or painless. Earlier in the 1960's, there may well be a period of considerable frustration and disenchantment with "any common stock as an inflation hedge." The alert investor might well consider whether any of his present holdings are not intrinsically attractive but are selling at abnormal prices chiefly because of an erroneously imputed value given them as a possible inflation hedge. Later on, he may also have an opportunity to make some unusually attractive purchases if a period of mass disenchantment should occur.

B. Institutional Buying

Institutional buying in the stock market comes largely from five major sources. These are (1) pension and profit-sharing funds, (2) trustees for the benefit of private individuals, represented mainly by the trust departments of large banks, (3) investment trusts, (4) insurance companies, and (5) educational and charitable organizations, including the sizable transactions of our wealthier universities.

The importance of the impact of these institutional buyers on the stock will not be unique to the 1960's any more than the inflationary influence we have already discussed are brand new. Just as in the case of inflation, what will be different will be increased investor awareness of the real significance of this relatively new influence—a better understanding of how to take advantage of it and, even more important, how to avoid being hurt by it.

In order to understand these matters, a little financial history might be helpful. A relatively low level of common stock prices prevailed over most of the 1930's. Two influences are usually considered to be the principal reasons for this. One was the correspondingly low level of general business. The other was the uneasy feeling of a very large number of investors about what the Roosevelt administration might try to do to them next. However, in addition to these, there was a third and much less understood major force tending to push stock prices down. This was a financial mechanism that our tax laws had built into the market.

In the 1930's, our state as well as our federal income taxes, while not as high as today, had reached levels that by previous peace-time standards were tremendous. This meant that when most wealthy stockholders died, sizable blocks of shares had to be liquidated to pay the necessary taxes. This dissavings (or forcing on the market of large amounts of shares that otherwise would have remained off the market in strong boxes) was occurring just when high income taxes were cutting heavily into the ability to save by the wealthier classes. It was this wealthy group from which most stock buying had always come. In other words, all during this decade there was a built-in downward bias to stock prices. The fresh savings of those interested in buying stocks was not enough to meet the combined new stock issues of the period together with the sizable and constant supply of shares from the liquidation of estates.

Then after World War II, a largely new force appeared that, in time, was completely to reverse this imbalance. This was the institutional buyer. Of course, all institutional buying did not have its origins in this period. Private and bank trustees, insurance companies, and educational and charitable institutions had owned a considerable volume of common shares for many years. Also, there were a number of investment trusts in existence, although not nearly as many as were soon to flourish. Rather, what was to occur were several new influences, all in logical sequence and all to exert the same type of increased pull on certain parts of the stock market.

First was to come the sharp upgrading of the general public's opinion about the respectability of common stocks for conservative investment. This was to result in importantly increasing the per cent of their total assets that professional trustees and educational and charitable organizations invested in common stocks. It was to increase moderately the proportion for insurance companies. It was to pave the way for the spectacular growth of the common-stock slanted open-end investment trusts and for the most important development of all—the tremendous growth of the common-stock-slanted pension and profit-sharing funds.

One of the financially most significant aspects of the steady growth of these pension and profit-sharing funds is that they tended to tap an entirely new and important source of savings for common-stock purchases. Funds that would normally flow into the pockets of factory workers and lower-income office workers, neither of which groups had been conspicuous for the size of their common stock holdings, were now flowing toward the stock market. Similarly, a steadily growing number of salesmen for investment trusts are finding it profitable to sell to these same groups who had never thought of putting their savings in common stocks. In this way, still more demand for common stocks has come from groups whose savings have previously gone into other types of assets.

In short, as the 1950's developed, institutional buying became a force that far outbalanced with an upward bias the prewar tendency of high estate taxes and high income taxes to provide the stock market with a downward slant. Furthermore, as has been pointed out many times, the buying of most of these institutional groups had an even greater impact on stock prices than would have occurred from even a comparably large volume of fresh buying from individuals. This is because (while one stock holding might be switched into another) most of these fresh purchases of stocks would remain as common-stock investments for a long period of years, if not forever. It would not be subject to sale sooner or later as so often happens with many individual holdings. The available supply of stock was being reduced. Only a major change in basic thinking as to the intrinsic desirability of common stocks in contrast to other types of investments would be likely to cause most of this stock to come back on the market. Such a switch in fundamental concepts usually comes about quite slowly and (as when stocks acquired their present high regard), years later, changed background conditions started to warrant a change in general thought.

No one knows for sure exactly how to measure quantitatively just how much fresh buying arose from these institutional sources as the 1950's progressed. Nevertheless, a few random figures will show something of the size of the forces involved. Toward the close of 1959, Byron K. Elliott, President of the John Hancock Mutual Life Insurance Company, in a speech in San Francisco predicted that by the end of 1960 private pension fund reserves would show a twenty-fold' increase over 1940 and would total $48 billion. In July of the same year, Victor L. Andrews, Assistant Professor of Finance in the Massachusetts Institute of Technology School of Industrial Management, reported in the *Monthly Labor Review* published by the U.S. Labor Department that the amount of common stocks held by pension-plan trust funds had risen from 12 per cent of total assets in 1951 to 27 per cent of such assets in 1958. In the same month, the *Wall Street Journal* reported that estimates made by the American Bankers Association, based on a nationwide survey that used scientific sampling and was "far more dependable than estimates that had been made in the past", showed that $30,664,500,000 or 61.7 per cent of the total assets held by U.S. banks in personal trust accounts was invested in common stocks. In November 1959, the Boston Fund (a mutual fund) reported a survey showing that on June 30, 1959, 68 colleges and universities owned $3,912,919,958 of common stocks which accounted for 56.6 per cent of their assets as against 51.7 per cent being represented by this class of investment one year earlier. Even life insurance companies, which traditionally have negligible appetites for common stocks, seem to be beginning to join the trend. Recently, James F. Oates Jr., President of the giant Equitable Life, reported that, while until recently his company had relatively few common stocks in its $9.6 billion portfolio, it plans to buy them at a rate of about $40 million yearly for the next ten years. Some idea of how big a potential impact on the stock market might arise from a life insurance company trend toward more common stock holdings can be seen from a recent *Wall Street Journal* survey showing that

Equitable had less than two-fifths of 1 per cent of total assets in common stocks; Metropolitan, the largest life insurance company, had less than one-fifth of 1 per cent; Prudential had 2.3 per cent; New York Life had 3.1 per cent; and John Hancock Mutual had 5 per cent.

Similarly, the National Association of Investment Companies estimated that investors bought $2.3 billion of mutual fund shares in 1959 as against $1.6 in 1958. As this organization also reported redemptions at $780 million in 1959 as against $511 million a year earlier, it would appear that new cash available for investment from this source was about $1.8 billion in 1959 and $1.1 billion in 1958. It therefore seems probable that investment trusts are each year taking in excess of $1 billion of common stocks out of the market and adding them to their portfolios.

Possibly all of these trends may be summarized by a recent study made by the New York Stock Exchange. This study showed that, at year end 1959, institutions as a group owned $51 billion of all stocks listed on the exchange, which was by value 16.6 per cent of the total. Ten years earlier they were reported to own $9.5 billion or 12.4 per cent of total value.

However, all this is history. Understanding what has happened will only make money for us, as it helps us to form a more accurate judgment of what will happen. Turning now to the 1960's, the first question that confronts us is this: Will institutional buying be an even greater force during these next ten years or will it diminish in importance?

The first thing to consider here is that by no means have all the huge impact of institutional purchases on the stock market come from the investment of fresh funds. An important part came from switching into common stocks a proportion of funds previously invested in other media. Today common stocks are so highly regarded that from a historical standpoint a quite high proportion of total assets are already so invested. Will this proportion grow even higher in the 1960's? If so, the impact on the market would be great, even without any further growth in these various types of stock-buying institutions themselves.

I believe the answer to this is that there will be somewhat of a further switch in overall institutional holdings into common stocks, although the switch will not be of as great a proportion as occurred in the 1950's. However, it need not be as big a percentage to have very great implications for stock prices. Remember that the institutional purchases of the 1950's (I refer to overall stock acquisitions, not the switch from one stock to another) have already taken the purchase of the 1950's off the market. Therefore the purchases of the 1960's are in addition to this in their impact.

There are several reasons which I believe forecast a further switch toward common-stock investment. However, it will be of more modest proportions than in the recent past. Favoring common-stock increases is the important fact that among states and other political subdivisions a trend has just barely started toward investing in equities part of the tremendous assets some of these units hold as pension funds. Unless this quite new development gets nipped in the bud by the sudden emergence of a bear market before this recent trend gathers enough momentum to survive such a one-time setback, it may grow to quite important proportions.

Meanwhile, particularly among trustees in the older age bracket, there is still a tendency in some quarters to hold bonds at some fixed proportion of a particular trust. This is not because of any specific logical reason why bonds fit into the needs of that trust but because they formed their financial habits at a time when bonds were considered the natural backbone of any trust. They simply cannot visualize any properly run trust fund without bonds. As these older men are replaced by younger trustees reared in an atmosphere where bonds have been less highly regarded, the proportion of bonds held in such trust accounts will shrink still more. Common stocks in many instances will replace them.

Partially, but far from entirely offsetting all this, there are certain other influences. It is probable but not certain (political influences can play a major part here) that the relative yield of bonds as compared to stocks will be much more favorable to bonds than it was in most of the 1950's. If this happens, there are always many (including a few who may have good reason for so doing) who prefer a larger current income and a risk of decline in the real value of principal to a smaller income and a long-term increase in the value of principal. This well could cause some movement back toward bonds. This would be noticeable particularly in periods when either (a) bond prices are so low that bonds might be expected to have enough of a recovery to more than balance in the near term any further inflationary inroads into their value or (b) stock prices are so high that instead of the usual rewards of further growth, the near-term outlook might be for significant declines.

Furthermore, there is another and, I believe, even more important influence that will tend to cut down on the proportion of existing funds that institutions as a group will place in stocks in the 1960's. *If properly handled*, in an economy where technology is opening up as many opportunities for investment as it is now doing, common stocks are magnificently suited to be one of the mainstays of much institutional investment. However, there are many such investment managers, both trustee and otherwise, who I suspect are quite inept at handling stock investment. The great bull markets that prevailed in much of the 1950's largely helped conceal the incompetence (so far as common-stock management is concerned) of such people. This largely one-way trend of the stock markets is abnormal and cannot be expected to go on forever. Sometime in the 1960's, a more long-lived bear market than that of 1957 to 1958 is apt to uncover this type of past management weakness. Institutions and the beneficiaries of trusts who perhaps should then become disillusioned with the individual managers will find it easier on their pride to become disillusioned with common stocks instead. This too will probably cause an important further offset to the 1960's institutional trend toward more common stocks, but I doubt more than a year or two's time will be strong enough to reverse it.

All of these influences affect the percentage of funds that will flow to common stocks from assets already managed by institutions. Now we come to a matter that can have an equally important influence on the markets. Will the total funds of the institutions grow or shrink? Will important *freshly raised funds* flow into the stock market in the 1960's as they did in the 1950's? If so, all common-stock investors must reckon with this force! I believe the clearest answer to this question can be obtained by appraising the individual outlook for each of the quite divergent groups of institutional holders.

However, before doing so, I believe we should take into account a basic change that with little fanfare is steadily improving the performance of many of the larger types of institutional buyers. This is not a change in form. On an organization chart, most such groups are conducting their affairs just as they did a decade ago. Some have made little or no change in actual practice. Nevertheless, many of the more important have made noticeable changes with corresponding improvement in their performance record. If their activities have grown significantly in the face of less-adept handling of common stocks in the past, the probabilities are that their growth is that much more assured as their efficiency increases.

As large banking, charitable, insurance, or investment trust organizations first tackled the intricate job of buying and selling sizable holdings in common stocks, they did so to quite a degree by setting up "investment committees." These groups would consist in some instances solely of major full-time officers of the organization. In others, some members would be officers of the organization, others would be prominent businessmen, frequently members of the board of directors. One or more full-time investment specialists would then be hired to make recommendations to this investment committee. However, it was (and in form in nearly all cases still is) the investment committee which had the final authority and made the actual decisions.

In many instances, these full-time investment specialists, often called "security analysts," were anything but outstanding experts. Mediocre, as is apt to be the work of an institutional investment committee, it was probably quite necessary in the early days when institutions had their first big experience with common stock purchasing, that there be such committees to pass upon the recommendations of unproven full-time advisers.

However, here and there, security analysts of real ability started to be heard in investment committee meetings. Frequently at first, this was a morale shattering experience for a thoroughly competent investment man. Being cashier or treasurer of the organization, president of the local public utility, or having inherited three million dollars might cause a man to be appointed to an investment committee. It would not necessarily qualify such a member to be any more efficient at judging what stock should be bought or sold than it would qualify him to pass judgment on whether the Vice President's appendix should be removed by surgery or whether a lawsuit should be compromised rather than brought to trial. However, while these investment committee members might be the first to defer such medical or legal decisions to qualified experts in those fields, the fact that they all handled money and had been appointed on an investment committee usually resulted in erasing any possible suspicion as to the wisdom of their exerting their full legal right to pass judgment on each recommendation of their full-time alleged experts.

Everything was stacked against a capable investment employee in dealing with a skeptical investment committee. Usually most (if not all) of the committee considerably outranked him, not only in the organization but also in the general business and social hierarchy of the community. This made fighting for his ideas that much more difficult. Furthermore, the investment expert was usually for a course of action. Therefore, any committeeman who opposed him would in general prevail, since with a division of opinion no action is apt to be taken. All of this tended to limit results down to the denominator of the least-able member of an investment committee. Time and again, I have heard an outstanding investment man who was still fairly new in an organization say, "I know that is a stock we should buy. But there is no use recommending it. It will never get by my committee."

However, in instance after instance as the 1950's progressed, many of the most able of the full-time investment men began enjoying a quite different status within their organizations. As events proved the majority of their recommendations to have been far better than the committee's own choice, in substance if not in form, certain investment committees began leaving the real choice in these investment men's hands. If this worked well and the trust department of a bank, the insurance company, or the university did noticeably better than others in its field, the tendency would be to leave the decision making more and more to the qualified experts, not to a large investment committee. I do not know if the samples I have seen represent a large enough per cent of the total to enable me to say that there may not be important exceptions, but it has been my experience that the more power given to the investment specialist and the smaller the influence of the individuals on investment committees, the better the quality of the work accomplished. This is partly because in principle it makes sense to leave decisions in the hands of those best qualified to make them. It is partly because only where thoroughly competent investment men are found have they been able gradually to dominate rather than be dominated by the prominent names often found on such committees. At any rate, competition will cause this trend to develop even more as the 1960's continue. As it does, the work of many of the larger institutional stock buyers will still further improve in quality. As this goes on, more and more people will turn to such organizations for their services, and the impact of these organizations on certain sections of the stock market will become greater and greater.

Turning now to examine one by one the coming trend of the major subdivisions of institutional buyers, it is noteworthy that, by far, the most rapid growth among any one subdivision of this group during the past ten years was in the pension and profit-sharing fund classification. I see nothing in the next ten years indicating that these organizations will do anything but continue to increase their total stock holdings by enormous amounts. It is true so many such funds have been organized already that the number of additional ones may not be so great. However, the established funding plans of the already existing pension funds and the additional contributions that may be expected in the years ahead for the profit-sharing trusts all indicate a steady, persistent demand for more and more common shares.

I believe the forward plans of these pension and profit-sharing funds are so well established that only one thing could prevent them from exerting a strong, bullish influence on the market in the years ahead. This is if incompetence or dishonesty in the financial management of these funds should cause the whole idea of them to lose its present appeal. The affairs of so many of the smaller funds of this type are shrouded in secrecy, so it is impossible to pass judgment on them. However, some of the largest appear run with sufficient skill so as to make it seem rather unlikely the entire system will become discredited.

As to the trust funds for individuals, I think it equally certain that there will be further growth for them too in the 1960's. This should largely parallel the probable growth of the trust business (and investment management business) of the large metropolitan banks and independent trust companies. My frank opinion, with which many would disagree, is that prior to World War II an unpleasantly large amount of such business was managed in a way somewhat less than brilliant. However, starting with the post-war period, a number of banks extending all the way across the nation from Boston and New York to San Diego began making giant strides toward much higher levels of investment management. Competition forced others to adopt similar changed ways. The results have been that trust departments as a whole have prospered. If this growth has gone on in the 1950's when standards were improving, I see little reason why it should stop in the 1960's when the overall level of efficiency gives promise of being higher. Therefore, this important group, too, should add fresh demand for common stocks.

Similarly, I see no great reason why total additional stock purchase by insurance companies should not occur at about the same moderate growth rate that has prevailed in the recent past. As to educational and charitable organizations, the advent of the first Sputnik focussed public opinion on the need for the former. The endless strains of modern living keep everyone aware of the need for the latter. If times remain prosperous, more fresh gifts and major capital donations are likely to flow toward such organizations than if adversity comes, but in any event, whatever changed totals occur should be in an upward direction.

This leaves only investment trusts among the major classes of institutional buyers. As to this group, I believe an estimate of the future trend is impossible. Almost anything might happen in the 1960's. The better-run investment trusts do perform a useful service in that they offer those needing some diversification and with too few assets to obtain it elsewhere, a means whereby they can attain a diversified investment. Furthermore, because of this diversification, many investment trusts include in their portfolios a significant amount of "non-institutional" type holdings, that is, stocks of companies which would not meet the full qualifications of most other classes of institutional buyers. Under today's conditions, they also provide a useful service to a certain number of larger investors who for one reason or another seem unable to find qualified professional investment sources to advise them. The great diversification of most of these trusts gives promise that the assets placed in them will not shrink much except in bear markets and then not much faster and quite probably slightly less fast than the market may decline as a whole. All this is distinctly to the good.

On the other hand, this great diversification also means that in rising markets most of these funds will probably also rise about as the market does. Many will disagree with me about this, but I believe it so hard to find genuinely outstanding investments that no individual or organization is likely to end up with a huge list of them. Therefore, I believe investment trusts by their basic nature are to a degree tied in with mediocrity and the concept of average performance. The able investment-trust management is usually striving for and achieving something above average performance. However, it is still a long way from the type of outstanding performance it would seem to me most investors should desire to attain.

For these reasons, I think that whether investment trusts increase or decrease in importance in the 1960's may depend a lot on whether the security business as a whole develops during the 1960's any better facilities than it has done so far in giving the small- and medium-sized common-stock buyer the service he may be trying to get today. I will discuss this matter of possible future trends in the security business in another section of this book. However, if radical developments do not take place within the structure of the investment business itself (and certain unpleasant things do not happen in the stock market) the investment trust business will continue to appeal to many and should grow.

There is, I believe, one other threat to the investment trust field. Since the great growth of open-end trusts got under way, cynics have been pointing out that all would be fine in a bull market. However, the right of stockholders to redeem their shares at or close to liquidating value at all times might cause self-generating trouble in a bear market. Heavy calls for redemption of these shares would force the sale of so much of the investment trusts' general holdings to raise the funds to pay for this redemption so as (in an already falling market) to drive down the liquidating or redemption value to a point where still more holders might become frightened and want cash. This in turn would force more liquidation of assets which would further depress share prices and might cause still more holders to want cash.

In theory at least, this self-generating downward spiral could go a long way. In practice, however, no significant trouble has occurred at all in the bear markets of the 1950's. However, on the whole, the 1950's had what may prove to be an abnormally bullish tinge. If bigger or more prolonged bear markets should develop in the 1960's, will the open-end trusts lose shareholders and therefore shrink in size?

I do not know. However, I do not believe it safe to toss the matter off by claiming that because this did not happen in the last ten years it will not in the future. I believe the average investment-trust holder may now be having an extremely optimistic expectation of what his trust shares will do for him in the time ahead. I think it is unreasonable to believe that this expectation can be matched by the performance of most trust managements, because the great diversification in the portfolios of so many of them is almost sure to mean results somewhere near the average, rather than results that are spectacularly good or spectacularly bad. With so many stocks involved, the mediocre performance of some is almost sure to dilute the highly creditable performance of others. If most investment trusts produce results that are really rather favorable if allowance is made for this "built-in stabilizer" but still are not as good as many of their stockholders think they should be, a period of disillusionment and share liquidation may well be accentuated.

If this happens, the situation will be aggravated by a practice many of these trusts have encouraged but which I believe to be quite deceptive to the unsophisticated stockholder. This is the matter of capital gains dividends. All investors know that capital gains (which in tax language means a profit on an investment held for six months or longer) are taxed at only half the rate of current income and never at a rate greater than 25 per cent of the profit. Investment trusts that make such gains are allowed to "pass them through" to shareholders. They can declare dividends from these profits. These dividends understandably have great appeal to investors, since they are taxed at a so much lower rate than other investment income.

What is wrong with this system? Nothing if non-tax considerations made the sale a wise one and if the stockholder would only consider as genuine profit the amount by which the shares sold had gone up *more* than the market as a whole. Unfortunately, this is not what often happens. Stockholders have come to like these tax-saving dividends. They always want more of them. The fund's salesmen know how effective a selling argument are these capital gains dividends. They, too, want more. The whole market has risen. So the fund sells something that has gone up just about as much as the market. After paying out the capital gains, it reinvests the balance in something else that has also risen by this amount. However, the fund has already paid out its profit to stockholders in the form of the capital gains dividend. Therefore, all it can reinvest is the proceeds less the dividend. Since the stock being bought has also about risen with the market, it must buy considerably less of this stock than it formerly owned of the stock it sold. Therefore, excepting when an extremely clean-cut case can be made for the stock that is being bought having much better prospects than the stock that was sold, these capital gains dividends come very close (in a true investment sense, although not in accounting theory) to resembling dividends paid out of principal.

Because so many people do not understand this, let us take a theoretical example. Ten thousand shares of Northern Steel were bought by an investment trust at 20, for $200,000. It goes to 30 and is sold for $300,000. Under conventional accounting, this is a capital gains profit of $100,000. Since the stock was held for over six months, this $100,000 is passed on to stockholders in the form of an appealing capital gains dividend. The remaining $200,000 is then reinvested in Southern Steel which was at 40 when Northern Steel was bought at 20 but which, in line with a generally stronger steel stock market, is now at 60. So, instead of buying the 5,000 shares which would give the trust the same relative position in the industry (half as many shares of a stock selling at double the price), only 3,333 can be bought. In a real sense, the fund has lost one-third of its position in the industry because that third has been passed out as a so-called "profit."

Of course, if Southern Steel does increase in value 50 per cent more than Northern Steel, this loss will be made up and the capital gains dividend will be compensated for by a real—rather than just an accounting—profit. Furthermore, in the day-to-day transactions of investment trusts out of which these capital gains dividends arise, it is not quite this simple to see what is happening. Instead of an investment trust selling one steel stock and buying another in the hope of making a greater profit, it may, for example, sell an oil and a motor stock and buy copper, container, and merchandising shares. However, the point remains that because of the amount it has passed on as capital gains dividends it cannot reinvest as much as it has sold. The only real test that will show whether these capital gains dividends do not impair the amount of the stockholder's accrued principal at the time the dividend was declared would be to discover a few years later if the smaller amount reinvested in other securities had appreciated in value enough more than the subsequent change in value of the securities that had been sold to make up the capital gains dividend. Some day, enlightened legislation enacted for the stockholders' own protection may demand that investment trusts either prove that funds have been reinvested sufficiently wisely to have made up for these capital gains dividends within a given period of years or the investment trust will lose its right to declare such dividends until they do. However, until this happens, when bear markets occur and the securities sold and the smaller amounts repurchased both react to about the same degree, the way in which these capital gains dividends can erode capital may be a lot more clear to many investors than it seems to be today.

It is at this point that in the hands of an unscrupulous management these capital gains dividends could become a real investment hazard. Stockholders and salesmen are used to them and want them. But there has been a general market decline. Only one or two stocks in the portfolio still show a big profit. A basic rule of good investment practice is to let your profits run and take your losses. Put another way, the only reason these few stocks are up, when the rest of the market has gone down, is because they are unusually attractive. Will the investment trust yield to stockholder and salesmen pressure and sell the very stocks out of its holding that give promise of bringing the greatest future gains? Will it sell the very last stocks with which it should part? If it does, future performance may be rather bleak.

Because problems of these sorts might overtake the investment trusts during the 1960's, they are the one segment of the institutional stock market that might (but not necessarily will) break away from the general upward trend. However, regardless of whether the buying power of investment trusts grows or shrinks, further demand from every other segment of institutional common stock buyers is going to have terrific impact on common stockholders all during the 1960's. The reason this force is one no investor can afford to ignore is that there are two background causes, one economic and the other legal, that almost guarantee that this steady demand, this constant taking of shares out of the market, will be concentrated on a rather restricted number of stocks. It cannot and will not be spread over the market as a whole.

Let us first look at the economic reason for this. A dollar of earnings from a low-cost producer in an industry has always been so much safer than from a marginal producer that the low-cost producer has always been the choice of the conservative investor. Similarly, if production costs are about equal, the company that could year in and year out do a large volume of business in a given industry has investment appeal over another that could never attain more than a small volume. When, as often happens, size and low-cost operations go together, the investment appeal is that much greater.

However, in the last thirty years, a number of basic business trends have combined to give large or fairly large low-cost companies a greater and greater degree of investment attractiveness in relation to others. There is the increase of scientific research as one of the great influences causing companies to rise or fall. The large company can afford a combined effort of a size that permits flexibility of approach in a way the small company may find difficult. The rise of big government and large labor unions has created need for a whole host of specialists on the business staff. The large company does enough business to warrant various tax specialists, industrial (or labor relations) experts, sales representatives in Washington, and experts on foreign trade in various regions of the world, to say nothing of innumerable other specialists. The manager of a small company may have to be a jack-of-all-trades. In today's complex world, this is sometimes quite expensive. The large company often has a distinct advantage in the basic matter of management itself. It has more maneuverability in achieving both management in depth and continuity of management policies. In a company that is generally well run, all of this has real investment value and is well worth the payment of a considerable premium in the price-earnings ratio. Finally, a large company is usually in a somewhat better position to be in touch with alert managements in fields far removed from its own, to become aware of what others are doing to make business operations more efficient, and to take advantage of this quickly. All this has dollar value, too.

For all of these reasons, even if no huge institutional stock market had developed, at least a part of what is sometimes called "blue chipitis" would have appeared. A relatively small number of magnificently run large companies would gradually have sold at more and more of a premium over most other companies—the rising premium of course, being expressed in financial terms as a gradually increasing price for such shares in relation to their earnings over that commanded by companies that did not have these investment advantages. The greater safety and the strong probability that continuity of good management would assure growth trends at least somewhat above average would have assured this much.

However, an ever-growing institutional demand did come with the 1950's. The nature of the ultimate beneficiary of the overwhelming majority of such institutional funds calls for placing nearly all of them in the intrinsically strongest class of security. While there may be strong reason for putting into something as risky as common stocks large amounts of the funds of the university, the widow, or the corporate-pension trust, it just makes business and economic sense to select only the finest class of such equities for this type of investor.

However, these basically sensible economic reasons are not the only ones focussing this huge institutional demand upon just one segment of the stock market. The men who have the responsibility for most institutional buying are trustees with all of the legal responsibilities of a trustee. The rules of trustee liability as they have been built up, as a result of many court decisions, are fairly clear. They are not comparably conducive toward providing the wisest management of common stocks in an age where conditions are changing with ever increasing rapidity. These background rules should be understood by all investors, whether they are trustees or not, because these rules have and will continue to have a most important influence on the prices of all kinds of common stocks.

A trustee is seldom specially rewarded for handling investments outstandingly well. His fee is fixed in advance and is never increased because his performance has been unusually good. In contrast, he can be penalized heavily if he loses money. However, he will not necessarily incur this penalty just because he does his job badly. He will only incur significant risk of personally having to make good a loss in the trust if in losing money for his beneficiaries he violates certain rules! Now, remember that a beneficiary suing a trustee for a recovery of losses has all the benefits of hindsight. After the events have happened, he can take action claiming the trustee should have known better at the time. In contrast, the trustee can only use foresight. Under such circumstances it is hardly surprising that any trustee will pay the closest attention to the legal rules which will protect him from incurring heavy personal liability, even though as a result of his actions the trust has heavy losses.

What is the legal rule that will protect a trustee against suit for honestly incurred losses? In legal language, it is that a trustee can not be held personally responsible if he does as any prudent man would have done at the time. This is beautiful language, but what does it mean? How can you prove what a prudent man would or would not have done? In practical language, as most attorneys would explain it, this means that if the trustee buys or holds the same securities that most other trustees are holding and holds them in about the same proportions, he is running little risk of personal liability. Since again you cannot prove what all other trustees are holding, this puts great weight on what the largest, most prominent, and presumably best-informed trustees (the trust departments of New York banks, for example) are holding. As one cynic put it, "It is all right to lose heavily, as long as you do it in good company!"

Under rules like these, it is rather surprising that results for beneficiaries have not gone from bad to worse. Even the courts that have set this pattern must know that constant change is taking place in the business world. A stock that may have been eminently suited for trustee purchase five years ago may have had a change of management, so that it should not even be considered for this type of holding today. Stock of another company that five years ago, in spite of its superb management, was still too small and new for trustee acquisition, today and for years to come might be just the security a conscientious trustee should buy. Yet under the rules, a trustee might be penalized not for holding the former but for buying the latter, should hindsight prove his judgment wrong.

It is to the great credit of courageous individual trustees and the pioneering trust departments of a small number of metropolitan banks that in spite of the legal background against which they must work, trust management has progressed as much as it has.

What essentially has happened, is happening, and will continue to happen is this: A relatively small number of particularly strong companies (mainly the ones intrinsically most suited to trustee purchases) get what is called "institutional acceptance." Most of them have attributes that would warrant a quite high price-earnings ratio anyway. However, because these stocks are the ones into which trustee buying is concentrated, they have a certain scarcity value and the price-earnings ratio becomes even higher. Other non-trusteed institutional funds, such as insurance companies and most investment trusts,* for at least part of their holdings feel that since these are the strongest companies they, too, should have them. With all of these buyers taking stock out of the market, the "spread" in price between such companies and those without institutional acceptance remains extremely wide.

As the 1960's progress, sophisticated non-institutional investors as well as the more able institutional stock buyers will become far more alert as to how they will benefit from these background conditions than they are today. They will recognize that the composition of the small group of stocks attaining greatest institutional acceptance changes quite slowly, but it does change. It is like the membership list of a very exclusive and very expensive club. Each year there are very few changes. However, a few people who have recently risen to great wealth and power are taken in. A few die or resign because the cost of keeping up their membership is too much for them. But these are the exceptions. The great majority of the membership remains the same.

No method of making important profits in common stocks is ever easy. However, this background condition permits what will probably prove one of the least difficult ways of making major gains available in the 1960's. Careful study can be made of stocks just on the edge of institutional acceptance. By this, I mean medium-sized corporations that are having or are about to have a steady upward trend in earnings. They may already be included in the approved purchase list of a small segment of institutional buyers, or they may not as yet be so approved by any. However, they must have a management of outstanding ability, those attributes of growth, relatively wide profit margin for their industry, and adequate size to appeal eventually to institutional investors. If they are growing into a position where intrinsically they will be highly suitable for purchase by professional trustees, sooner or later the pressure of all the funds such trustees must invest and the relatively high price of much of what shares they can invest in will cause such companies to "be included in the club," that is, to win widespread institutional acceptance and enjoy the sharply higher price-earnings ratio that this acceptance brings.

* Investment trusts are usually corporations controlled by boards of directors, in which cases they are technically not trusts at all.

The fortunate owners who have bought such a stock before it gains this sort of financial status makes a double profit. In the first place, the stock would not be gaining this status if its earnings were not growing faster than those of industry in general. Therefore, the shareholder first gains the benefit of this rising earnings trend. But the shareholder also gains something else. Let us suppose such a company, still considered by most of the financial community as run-of-the-mill or mediocre, was earning $2 per share in a year of neither great depression or great boom and was selling at 12 times earnings or 24. Five years later, in another year of neither great boom nor depression, earnings had shown a year by year rise and were now at $4 a share. This of itself would double the value of the shares which at the same price-earnings ratio of 12 times earnings would cause the stock to sell at 48. However, in the meantime, the financial community had started to accept this as truly an institutional stock—something undreamed of five years before. Instead of selling at 12 times earnings, such a company would easily command a price of 24 times earnings or 96. In other words, because the alert buyer had correctly anticipated this institutional acceptance and the changed market price this would bring, he had converted a doubling of his earning power into not a doubling but a quadrupling of the value of his holding.

This investor's wealth has quadrupled in five years. It has come about partly because of an increase in the price-earnings ratio at which his shares are now selling and partly because of an increase in the earning power of these shares. Is this investor entitled to feel that the increase in his net worth is as sound and rests on as firm a foundation as though all of it had come about through a quadrupling of the earning power of his stocks alone?

In a sense, we already have the answer to this question from our lengthy discussion of whether overall institutional demand for common stocks will grow or shrink in the time ahead. If the indications are as clear as I believe them to be that in the years ahead there will be at least as much concentrated demand focussed on a relatively small number of stocks as there is now, the investor need have no worry as to the best of the institutional stocks continuing to sell at a very much higher price in relation to earnings than does the great body of stocks as a whole. Therefore, if he is sure that the significant increase that these changed price-earnings ratios have made in the value of his holdings is due to his stock now having a justified institutional acceptance it did not previously enjoy, he can be rather certain that this state of things will continue and that his gain is just as "real" (i.e., permanent) as though it had come solely from improvement in earning power.

There is one thing in this connection about which the investor should be on guard, however. Every so often, for one reason or another, a particular industry becomes the momentary darling of the market place. Sometimes the reasoning behind this great enthusiasm by the investing public is quite sound. At others, the favorable factors may all be true, but prices can get well out of line with reality because little or no weight is momentarily given to the unfavorable factors. Chemicals, aluminums, life insurance companies, uranium companies, and drugs are all groups that have enjoyed this type of great, momentary investment acclaim in one period or another since the close of World War II. The electronics were such a public favorite as the 1950's were drawing to a close.

When the reasoning behind such general enthusiasm has been sound, the eventual ebbing of surface public excitement about this particular class of stock has usually resulted in not too severe a drop from the peak for the stocks of the best-run companies in the industry. More important, within a few years and usually with much less public fanfare, these outstanding stocks have gone on to new highs. However, even when this background excitement about an industry's investment prospects are basically sound, the stocks of secondary and less well-run companies in that industry can be carried up to price-earnings ratios which do not represent sound values. When excitement about a whole industry may be greatly overdone (as could have been the case with the uraniums and life insurance companies in the mid 1950's), this danger can be even more pronounced.

In other words, the investor who wants to take great advantage of the more permanent type of higher price-earnings ratio that will accrue from a heretofore non-institutional stock obtaining institutional acceptance should always do this: Whenever a stock he owns has attained a major upward revision of its price-earnings ratio in relation to those of stocks as a whole, he should examine the matter most carefully. He should determine whether this change is actually due to institutions starting to hold his stock or to some completely different set of factors.

In either case, he should determine for his particular company (not for the industry as a whole) whether its management, its prospects, its inherent risks, and all the other factors on which its true investment status will depend justify the increased price in relation to each dollar of earnings. If they do, he need not be afraid that the increase in his net worth coming from this source is any more fictitious, temporary, or unsound than if it came from increased earning power of his shares.

This brings us to the other side of the coin—the second thing for which alert investors will have to watch if they would gain rather than lose from the great impact institutional buyers will have on the price of many stocks in the 1960's. Long accepted stocks take as long to disappear from the approved institutional groups as new ones are slow to be added. However, eventually these changes do take place. Just as rising companies eventually get included, so, usually years after the weakness should have been clearly apparent, other companies, with managements that have become stodgy and lost their drive or in industries no longer able to hold their own, get dropped from institutional favor.

The thing to remember here is that the prices of institutionally accepted stocks resemble what would happen if it were the custom of our country for all of the unusually fine and able people (but only those recognized as being unusually fine and able) to go around on very high stilts. Getting up on these stilts would be the only way to associate with these leaders. Furthermore, as long as these people kept their fine qualities, there would not be the slightest danger they would fall off their high stilts. However, if any one of them was to lose his fine and unusual traits (not immediately but after considerable time) his stilts would have become rotten and suddenly he would come crashing down off them with a spectacular tumble.

In just this way, the price of the intrinsically finest investments are up on stilts because of institutional demand. There is nothing particularly dangerous about this. They will stay at this high price-earnings ratio and will continue to go up in price about in proportion to how their earnings expand so long as they retain their unusual qualities. If they lose the characteristics that put them on stilts, then they become extremely dangerous. They will decline not alone in proportion to the decrease in their profits but a great deal more. As institutions eventually sell them, they lose their premium value. However, this price decline usually will not occur until long after an institutional stock has begun to lose much of its former attractiveness. This lag is partly because of the normal tendency of investors to recognize belatedly the changed characteristics of a stock that has attained a reputation for being particularly attractive. To this must be added the sluggish response that results from the legal pressure on trustees to follow in the accepted paths, particularly the paths being followed by trustees bigger and more prominent than they are. For these reasons and with all the advance warning that should be available, the holders of the highest price-earnings ratio stocks need have no fear of the high price-earnings ratios themselves, as long as they have strong reason to believe their holdings will continue in the intrinsic nature warranting them.

But why should the individual investor of the 1960's continue holding these institutionally favored stocks at all? Once they are at or near the peak of institutional acceptance, they will only grow in value about as fast as their earnings. Therefore, would not the investor be wiser to sell them? Then he can reinvest his profits in some other stock on the verge of institutional acceptance. If he is right in his judgment, he will then continue to have his assets grow at the unusually fast rate that results from multiplying the increase in per-share earnings by the improved price-earnings ratio that institutional acceptance brings. Obviously, stocks growing in value just from increased earnings alone can seldom grow in value at this fast a rate.

While all of these things are true, I believe the investor who follows such a practice exclusively fails to understand the true nature of institutional stocks. The very fact that a stock has gained institutional acceptance and is now selling at this new and sharply advanced earnings ratio is usually because *it has such assured prospects of further profit growth at such risk.* As an investor becomes successful and amasses a significant amount of wealth, one of his benefits, I believe, should be to have at least part of this wealth in the finest and safest type of investment. Further growth with security, particularly for those who have already amassed a fair sized profit, can be as desirable as the prospects of still faster growth in market value at much greater risk. Since, to use my analogy, stocks, once they get investment status for being outstanding, tend to come down off their stilts so tardily that the alert investor should have ample warning, there seems but little reason for any large investor who watches his holdings reasonably carefully not to enjoy the benefit of this highest class of equity assets for a worthwhile part of his assets. This will avoid the heavy toll of the capital-gains tax on the work of the more successful investor. After all, the history of American business has shown that many of the most prominent of these high price-earnings ratio institutional stocks keep their managements fresh and vigorous to a point where they never do come down off their stilts but keep on growing decade after decade.

C. Foreign Competition

Until mid-year 1957, most Americans were complacent to the point of smugness about their country's economic supremacy. The European compact car had already made sharp inroads into the U.S. home market. In most markets abroad, U.S. automobiles, machine tools, and numerous other domestic products were beginning to disappear before the onslaught of European and occasionally Japanese goods produced by much lower-cost labor. The long-range implications of this, however, had not yet been recognized by the average U.S citizen.

Then came a dramatic reversal of public sentiment. The deepening business slump, a sizable outflow of gold from Fort Knox, and a steadily rising sales total of heretofore exotic low-priced foreign cars all contributed to the changed outlook. Prior to this time, plenty of people had been aware that hourly wage rates abroad, depending upon the country involved, were from one-quarter to one-ninth those paid here. But, so the reasoning went, those countries did not have the technical skills. U.S. "know how" could make up the difference. Overlooked was the fundamental fact that basic intelligence abroad was comparable to that found here. Frequently aided by export of U.S. "know how" and U.S. machinery, which was often financed by our own government, alert foreigners were becoming as efficient as we were.

As the 1950's drew to a close, the true magnitude of the problem became more and more apparent. There is no easy solution in sight. During much of the 1960's, the alert U.S. investor is going to be confronted with the dilemma: "How can I manage my affairs so as not to be dragged down either by investments in companies directly hurt by low-cost imports or by investments in companies with important customers that will be weakened in this way?"

Already, three separate routes to hoped-for investor safety are discernible. The first of these is the obvious one of investing in these foreign companies themselves. This has gained great popularity. However, in time, many of those who have been rushing to buy shares of leading companies in the "European Common Market" and elsewhere may be in for some rather unpleasant surprises. The heart of any type of successful common-stock investment is knowing what you are doing. Companies headquartered much farther from home than the average U.S. corporation are usually correspondingly more difficult to investigate than similar types of companies here. This problem is compounded not only by language barriers in the case of all but British companies, but by so many of the customers and other normal suppliers of investment information also being abroad. Even more important, foreign companies have grown up in a quite different investment atmosphere. They are traditionally far less free with basic information than are U.S. companies. At times, even their accounting systems may be considerably different. Finally, the shares of many such companies sell in markets much less liquid than our own. Therefore, small amounts of buying or selling may have a far greater effect on prices than the changes with which the investor is familiar here.

All of these things do not mean that it is impossible to make a magnificent investment in a foreign company. It does mean that for most Americans it is a much more difficult thing to do than making a correspondingly good domestic investment. It also means that much of the uncritical and undiluted enthusiasm with which the U.S. financial community was greeting most kinds of foreign investment as the 1960's arrived may fade noticeably as the decade goes on. This may occur even if special problems of foreign exchange taxes or political confiscation do not arise to further threaten investment safety.

The second route sought by investors also does not lend itself to easy analysis. This is to buy into U.S. companies with major (and often increasing) investments abroad. Such foreign plants with their low labor costs and American management methods usually offer a far better return on the investment than do the domestic operations of the same companies. At times, these plants will enable a domestic company to survive against foreign imports by making all or part of its products sold in the U.S. market at a price comparable to that at which purely foreign competitors are shipping into this country.

Why may these foreign based plants not be as attractive as they seem? We do not have to travel far from our shores to find the answer. Let us take one of the countries in which U.S. corporate investments seemed particularly strongly entrenched. Cuba is a striking example. Here is a country which owes its very freedom to U.S. action, which for the first forty-eight years of its forty-nine-year history was the friend of the United States. Its basic economic well-being has been due to preferential treatment for sugar, its largest industry, in the U.S. market. Yet all this did not prevent a revolutionary and supposedly popular government from taking action after action that gives promise of eventually resulting in the investments of U.S. corporations in Cuba having about the same value as those which were located in Shanghai after the Communists took over. Incidentally, it is well to remember that the Chinese Reds were never so impolite as to confiscate or even threaten to confiscate American investments in their country. At first they merely "regulated" these companies so they could not earn a profit, assuring them all the while that foreign investments would be respected. Then more and more "unpaid" back taxes and employee claims were found. Before too long, particularly if the former managers wanted to keep out of jail, it just seemed better to turn over the properties in settlement of these claims.

It might be argued that Cuba is an extreme case, although in the same part of the world, the Central American experience of the United Fruit Company can hardly be called encouraging to long-term investors. But is Cuba so extreme or is it symbolic of what can and probably will happen in many parts of the world? Why, psychologically, is the Cuban development so liable to be repeated time and time again?

In the first place, it is nearly always the rich member of any family that the others envy and dislike. To most of the ordinary people all over the world, the U.S.A. is a land of incredible riches. Our movies and the ever-present American tourist have carried this impression to people in every part of the globe. I would guess that 90 per cent of our tourists act in a manner that does our nation credit. However, anyone who has been abroad has seen the bad manners, freely-expressed criticism of the ways of the area, and generally loud-mouthed boorishness with which other compatriots comport themselves. Unfortunately, one ill-mannered American of this type can do more damage to international goodwill than fifty other Americans who act as visitors to a country should. Our tourists have left us with a sizable residue of ill-will in most parts of the world.

Add to this the almost universal tendency of all people to dislike the foreigner with his different ways of doing things, and what do we find? The foreign investor, particularly if he is an impersonal U.S. corporation, is a natural target to be used by the native politician desiring to increase his influence. Why should what has happened in supposedly friendly Cuba not happen again and again elsewhere?

If it is going to happen, why has it not happened more often already? The reasons for this are not hard to find. In the first place, as the 1950's were drawing to a close, stimulated by the much lower labor costs abroad, the amount of U.S. investment in branch plants in foreign lands was reaching almost tidal wave proportions. This was both creating abnormal prosperity in the affected countries and a certain amount of competition between various countries to get as much as possible of this golden flood. As long as more and more prosperity was flowing in with new construction contracts and other benefits to be gained, it is only natural that the foreigner be made most welcome. It is when money stops pouring in and operating profits start to flow back toward home that sentiment is more likely to change. Perhaps this is not so different from the comments wryly made by competent observers in Europe at the time the United States was negotiating with Franco for bases in Spain. Almost everywhere else in Western Europe, into which United States funds had been poured, anti-American feeling was rising and in some places had reached sizable proportions. But in Spain, to which nothing had been given but where there was hope of getting something soon, United States popularity was never higher.

The other reason Cuban-type developments are more likely to happen in the future than in the past is that such movements get much of their momentum in times of depression, not of prosperity. It is in hard times that either by ballot or bullet, those in power traditionally are turned out and others take over. If Cuba had not been so poverty-ridden, Castro might well have failed in his attempt. Those in power in many foreign lands today are eagerly bidding for more U.S. branch plant investments and are therefore favorable to the U.S. investor. Does not this suggest what the stand will be of many of the opposition politicians who may topple such regimes when and if a depression may strike?

For these reasons, investing in companies with a major stake abroad may not always appear as desirable as current earning figures indicate. Companies with many foreign plants may do magnificently for a few years. However, if such foreign earnings are capitalized in the price of these shares as highly as domestic earnings, a year may come when a lot of the profits along with some even more important assets may disappear rather suddenly. Of course, the experience in different lands may vary. In some, no serious troubles may come at all.

If, therefore, these branch plants abroad provide no easy answer to the investor seeking protection against foreign competition during the 1960's, is there any other route to safety? I believe there is. Attaining and maintaining technical leadership in one or another field of a rapidly advancing technology is the one sure way a U.S. corporation can make itself independent of the threat of low-cost foreign competition. Investors with shares in such companies need not fear the general threat of low-cost foreign labor to the U.S. economy and may actually benefit from it without having to run the great risks of foreign investment.

Why is this? Since research costs are also cheaper abroad, why would not a foreign competitor soon take the technological lead? The answer definitely is not because there are more or better scientific brains here than there are abroad. Rather, it is because some of these technologies are so complex and there are so many of them developing in such different directions that some U.S. companies are building up commanding leads in certain highly technical areas while other foreign companies are developing similar outstanding leadership in completely different areas. The thing to do is to find the management with technical teams capable of staying in front. In other words, some companies seem to develop enough skill in their particular field (or important parts of it) so that the competition is forever trying to arrive tomorrow where they are today. By tomorrow, when the competition attains this objective, they will have again moved one step ahead. If a company can do this, it need not fear foreign competition any more than domestic.

Furthermore, such a company may benefit from the strength that foreign industrial nations will undoubtedly have during the 1960's. If the company's product line is technically superior, foreigners will want to buy it just as they would have in the period prior to the recent great rise of foreign industry. But until recently these potential foreign buyers would have been limited by currency problems as to how much U.S. goods their governments would let them buy. In the 1960's this should be much less of a problem. Therefore, the technically superior company may have export markets open to it of a size undreamed of in prior decades.

Finally if the company has outstandingly superior products that foreigners can not come close to matching and if it should also have some branch plants abroad, it may have protection against anti-foreign taxation or confiscation such as less fortunate companies will not have. Hitler's extreme persecution of the Jews is too well known to need much discussion. However, extreme as was his treatment of the great majority, a handful of Jews were left completely unmolested because they had unusual technical skills which Hitler badly needed. Similarly a company which alone has the know-how to produce a key product that a foreign nation needs is in a position to bargain with an otherwise hostile foreign government in a way most corporations are not. In case the Hitler example seems exaggerated, the experience of the major oil companies in parts of the Near East might be recalled. It is not contractual agreements or love of those companies, but realization that they alone have the marketing facilities to transport and sell petroleum, that may be considered the reason these companies have not been treated a good deal worse than they have. Knowing how to make a vital product could be even more important should a wave of nationalism sweep a foreign land.

What does all this mean? From the investor's standpoint, the rules for protection against the great foreign competition of the 1960's are no different from those for finding outstanding investments regardless of foreign competition. If he seeks and finds the company that because of outstanding business management and technical superiority would have proven an investment bonanza in the days before foreign competition was such a general threat, he need not fear low foreign labor costs in the 1960's. It is the run-of-the-mill company making products the foreigner can easily copy which can be in danger.

All this is looking at this problem of foreign competition in the narrow sense—the means whereby individual investors can gain rather than lose. However, how about the broader picture? Will our entire nation suffer from being unable to compete with a flood of imports produced by lower-paid foreign workers?

I do not think the answer will be clear until it is known what kind of man or men will occupy the Presidency in the years ahead and what kind of leadership he or they will provide on this vital matter. Evidence is beginning to accumulate that American business management can meet this problem of wage discrepancies and equalize costs if from this point on domestic wages advance no more rapidly than foreign (which are also climbing) and provided the further burden of featherbedding is not added on to the cost load U.S. products must carry.

This problem of featherbedding, that is, of continuing work rules which call for job classifications that are not genuinely needed, is not an easy one. Business management can proclaim that featherbedding is outrageous (which it is), but workers are apt to fight stubbornly for these rules until such time as those affected have some assurance that as they are displaced by more efficient equipment other comparable paying jobs in the same community will be found for them. With the countless new industries that developmental engineering is creating at the same time that it is making it possible for older industries to turn out more products with fewer workers, this guaranteeing of comparable (or possibly even better) jobs to displaced workers should not be too difficult if major attention were given it. Should good fortune bring to the government in the 1960's an administration or administrations that will face up squarely to the problem of featherbedding, I believe most American industries can be brought around to the point where they can hold their own in domestic markets and still maintain current wage differentials. If this does not happen and U.S. wage costs rise still further in relation to those of the rest of the world, sizable unemployment and generally hard times will occur. However, I see no basis for predicting as yet which will happen. Too much of the outcome may depend on whether an as yet unknown President lets the nation drift into a totally unnecessary business crisis or whether he can exert the personal influence and magnetism needed for all groups to see what must be done if, without sacrificing our high current standards of living, American-made goods are to be permitted to hold their own against the current vigorous competition from much cheaper foreign labor. Leaders of business and of labor should work together on these matters. To date no sign of this has arisen. Should we reach a point where leadership can only come from government, it will all depend on who heads the government and how he acts. These are matters on which, as this is written, it is still too early to pass intelligent judgment.

D. Increased Population

Strictly speaking, this matter of the influence of the great population surge of the 1960's should not be included at all in comments on the major investment influences of the period ahead. This is because I do not believe it is in any sense going to be a major investment force, comparable in its influence to those we have already discussed. However, so much publicity has been given this matter and so closely has it been tied in to the concept of the "golden sixties" that I believe it worthy of examination, if only to judge it in its proper perspective.

In general, those who expound the pleasant-sounding but somewhat superficial line of reasoning that the population figures assure a great advance in business levels in the years just ahead rely on an extremely simple argument. They point out that the great increase in births started at the time of World War II. With but minor interruptions, this has continued ever since. So far, however, this population surge has caused the increase to be largely among infants, young school children, and more recently the younger teen-agers. These groups have relatively simple requirements compared with those they will be seeking in the period immediately ahead. As the population increase spills over into the older teen-age group, the demand will grow for automobiles and all that goes with them, more expensive clothes, additional travel facilities, and all the other economic desires of young adulthood. This, in turn, will be followed by a great increase in new family formations and the even greater economic demand this brings in the way of need for more homes, appliances, furnishings, etc. With the birth rate still holding up so that there is no slackening in demand from the infant and children's groups, the need for all of these things will create boom-time conditions and ever-increasing prosperity.

The cynics have a standard reply to this. They claim population of itself does not create prosperity. If it did, India, Egypt, and China would be among the most prosperous countries on earth instead of the most poverty-stricken. This young population will, by the very limitations of its age, largely be spending money, not working at high enough paid jobs to produce much wealth. Therefore, all that will happen will be that the already overloaded family budget will have to be reshuffled still further. The average family has just so much income to cover its needs. The extra spending of the teen-ager and the young adult will be about balanced by lesser sums the parents will spend on their own needs. The total volume of business done will be about the same. All that will happen is that there will be a further shift in how the money is spent and, with more mouths to feed, the per capita income and the standard of living will go down.

Which of these two estimates will prove correct? In the American economy as it exists today, probably neither. As so many parents have learned, the greater normal needs of children as they grow older do create problems in the family budget that to a considerable degree get solved by shifting how family income is spent and by the parents spending less on themselves. To this degree, the pessimists are correct and a great increase in demand for goods unaccompanied by an increase in the wherewithal to pay for these things certainly will not produce a major spurt in total national prosperity.

However, this is not quite all the picture. Unlike Egypt, China, and probably much of India, our economy does provide considerable leeway enabling individuals and more particularly families to increase their wealth (as well as the community's) if the urge to do so is great enough. Wives who might not otherwise work get useful jobs and become a second source of family revenue. Under the spur of greater family need, husbands work harder, make more effort to get ahead financially, and move into more important and more productive jobs. As the teen-agers grow older, they too, add to the work force. Therefore to some degree, at least, there is an increase in the total amount of wealth produced to meet the increased demands of the family unit with older children. To some degree, the total volume of available business does genuinely increase.

In short, insofar as the overall level of business is concerned, the influence of the growing population will fall somewhere short of the much talked of guaranteed boom for the golden sixties, but not as far short as claimed by those who visualize the only effect being a sharp decline in the standard of living. However, from the standpoint of the holder of common stocks, what increase in the total of all business is produced by these population changes and is much less significant than it might appear at first glance. This is because the investor does not hold common stock in the economy as a whole but in individual companies. While the potential market for these companies' products will expand with the growing work force, so will the competition. In many lines of business there will simply be that many more units dividing up the market.

Meanwhile, in many families the need to make changes in the family budget will partially apply. In some it will necessitate a major rearrangement. This means there will be many shifts in overall demand between one type of product and another. Some will gain, others will be fighting a declining trend.

Why not attempt to forecast which companies will gain most and make investment plans accordingly? Except in extremely rare instances, I do not believe this a wise course to pursue. The reason is the extreme complexity of trying to judge how, under the pressure of increased demands on the budget, family decisions will shift from one product to another. It is not, for example, simply a matter of whether the family will forego repainting the house to buy an extra car. They may switch to lower-priced model cars or to buying only used cars when previously they had always bought new ones. They may start serving more spaghetti and less meat. They may do any number of other things as they shift and reshift their expenditures. They may even find the necessary savings almost handed to them by a technological advance resulting in producing one of the products they desire at much lower cost than before. With the number of family units in this country and the number of choices they can exercise, about the most that can be done is to observe what is happening and then make a reasonable judgment as to whether this trend will continue. Only in rare instances is it likely to be of sufficient significance by itself to cause making many investment decisions. In short, this matter of population change has been overstressed.

Since this population influence has been one of the main props upon which has been based this whole concept of the "golden sixties" with its almost guaranteed built-in prosperity, is the whole idea little more than a mirage? It may not be. The steadily expanding pace of technology and invention could well create a flow of new industries and refurbishing of old industries that will provide an expanding and prosperous background such as the world has seldom seen. Whether it does or not will largely depend on whether unwise or restrictive policies in regard to taxation, credit, labor policy, and similar largely government-regulated matters are handled with such folly as to dam up the benefits of this flow. These are things which can only be judged as the decade progresses. In the meantime, it is well to keep in mind that the huge rise that had occurred in the price of so many stocks as the 1950's drew to a close has probably to a considerable degree already discounted much of this prospect. In other words, the spectacular gains among common stocks in the 1960's will almost surely be even more selective than in the 1950's. Such a general and widely publicized matter as the expanding population curve will, except in the rarest of instances, have little relationship to such gains.

The Economists Go Out—The Psychologists Come in

I have already commented on the strange tendency of the supposedly forward-looking financial community so often to fail to recognize a changed set of circumstances until the new influence has been in existence for many years. I believe this is why the man who attempted to forecast the course of general business was regarded as so important a factor in the making of investment decisions during all of the 1940's and much of the 1950's. Even today, a surprising number of both investors and professional investment men still believe that the heart of a wise investment policy is to obtain the best business forecast you can. If the outlook is one of expanding business, then buy. If the outlook is for a decline, sell.

Many years ago there was probably considerably more merit to such a policy than there could possibly be today. The banking structure was weaker. There was no assurance it would be shored up by the government in times of real trouble—a process bound to produce a massive dose of inflation. There was no tax system of a type that can hardly fail to produce strong inflationary spending whenever business (and therefore federal tax revenues) are at abnormally low levels. No public opinion had crystallized to assure that whenever business levels dipped sharply, the government would take strong countermeasures to stem the tide. Finally, the industrial base was much more narrow. The large number of industries in today's complex economy that bear little relationship to each other in their basic characteristics probably assures that even without the actions of government, the modern business recession would be somewhat less severe than its former counterpart. Some industries would be enjoying unusual background conditions enabling them to expand, while the majority might be in a declining phase. This tends somewhat to stabilize the economy as a whole.

All this means that a depression is of less significance to the investor than it was many years ago. It does not mean knowing what business is going to do would not be quite useful information to have. But having such information is not vital for obtaining magnificent results from common stock investments. Simple arithmetic should show this. When a stock market decline coincides with a fairly sizable economic slump as happened in 1937 to 1938 or 1957 to 1958, most stocks sell off from 35 to 50 per cent. The better ones then recover when the slump ends and usually go on to new high levels. Even in the greatest slump of all time, only a small percentage of all companies failed, that is, went down 100 per cent. Most of these were companies which had had fantastic amounts of debts and senior securities placed ahead of their common. After one of the wildest speculative booms ever known, much of it financed by borrowed money, the average stock slumped 80 or 90 per cent. In contrast, when stocks rise over a period of years, even the most casual study of stock market history shows many figures of a very much greater order of magnitude. Compared to the temporary declines, usually of 35 to 50 per cent, that frequently accompany depressions, the outstanding stocks (those of the unusually well-run companies that have maneuvered themselves into growth fields) go up several hundred per cent, stay at these levels, and then go still higher. Many can be found for which a decade's progress can be measured in multiples of 1000 per cent rather than 100 per cent.

All this is fortunate for, as I endeavored to point out in *Common Stocks and Uncommon Profits*, there are definite rules by which the unusual managements that produce these equally unusual and highly profitable stocks can be selected with at least a workable degree of precision. On the other hand, I think the record shows that economics in its present state of development has not reached the point where depression forecasts can be used as a reliable investment tool. In today's highly complex economy, there are too many factors that can affect these forecasts. The intricate interrelation between this evergrowing number of different influences is not yet sufficiently understood. This, I believe, is why so many economists tend to disagree with each other and why so many are sometimes so spectacularly wrong.

From the standpoint of obtaining results, I have noticed that investors who place heavy emphasis on economic forecasts in the making of investment decisions usually fall into one of two main groups. Those who are inclined to be cautious by nature can nearly always find an impressive sounding forecast that for quite plausible and persuasive reasons makes it appear that important economic difficulties lie ahead for the business community. Therefore, they seldom take advantage of opportunities when they present themselves and, on balance, these missed opportunities mean the economic forecasts have done them considerable harm. The other group are the perpetual optimists who can always find a favorable forecast to satisfy them. Since they always decide to go ahead with whatever action they are considering, it is hard to see how all the time they spend on business forecasting does much good.

More and more investors are coming to recognize the wisdom of making their decisions about common stocks largely on the basis of such outright business factors as appraisal of the quality of the management and the growth potential of the individual company's product line. These things both can be measured with a fair degree of preciseness and have a far greater influence on how good a long-range investment will be. Until such time as methods for forecasting the business cycle become vastly more scientific than they are today, I believe the role of the economist in the investment community will continue to shrink. I think economists themselves, many of whom are men of great intelligence, recognize increasingly that their specialty is not yet ready for the role of business forecasting, in which so many people both within and outside this specialty rushed to place it. Thus, press reports of the first annual convention of the National Association of Business Economists, held in the fall of 1959, told how there was a growing but not unanimous sentiment among these advisers to private business that they should drop their forecasting activities. There was noticeable sentiment for serving their employers by such functions as keeping management informed of the "perspective of the social, political and business environment in which their business functions" and providing a perhaps broader viewpoint on anti-trust work than the legal department might have. As one speaker was reported to have said, "I am out of the forecasting business" having lost confidence in "numbers placed off somewhere in the future." While this group were economists for private industry (i.e., largely manufacturers, merchandisers, and transportation companies), I believe the same thing is at least as applicable to stock market economists.

I believe it can be assumed that for these reasons forecasts of the trend of general business will play a steadily decreasing role as the 1960's go on. Is there, then, any other area outside of such already recognized influences as business management, variations in interest rates, and changes in such legislative fields as taxation to which investors will be paying increasing heed? I believe there is. For lack of a better term, I will call it the psychological factors affecting security prices.

To understand this, let us look at a few investment fundamentals. Why does a stock sell at a certain price at a certain time? It is not because of what it is doing, has done, or will do. It is because of what the majority of those investors who are actually or potentially interested in this stock *think* it will do. When we talk of what opinion people have about a stock at a particular time rather than about the intrinsic nature of the stock itself, we are talking of a psychological factor.

It is, of course, true that this psychological factor is nothing more than a short-term characteristic. A majority of the financial community may get carried away by overappreciation of the attractiveness of a certain stock or an entire industry. For a year or several years they may, as a result, continue to pay a premium for this stock (or most of the shares in this industry) well beyond what that stock is intrinsically worth. Sooner or later, however, when the stock or the industry fails to measure up to the glowing anticipations, a period of disillusionment sets in. The price-earnings ratio of the shares will then decline by enough to bring the stock closer to intrinsic value. Frequently, the reaction goes too far the other way and the shares for a while sell below what, for lack of a better term, I will call "intrinsic" value.

This means that the price of any particular security can be pictured as something resembling a captive balloon attached, not to the ground, but to a wide line traveling through space. That line represents "intrinsic" value. As time goes on, if a company's earning power and true prospects improve, the line climbs higher and higher. If these or other basic ingredients of intrinsic value get worse, the line declines correspondingly. At any one time, the psychological influences (i.e., how the financial community is appraising these more fundamental matters of intrinsic value) will cause the price of the particular stock to be anywhere from well above this line to well below it. However, while momentary mass enthusiasm or unwarranted pessimism will cause the stock price to be far above or well below intrinsic value, it, like our captive balloon, can never get completely away from the line of true value and will always be pulled back toward that line sooner or later.

This whole matter of common stock evaluation is made more difficult by no one being able to pinpoint intrinsic value to an exact price. This is why I have, in our captive balloon illustration, described "intrinsic" value as a broad line and placed the word intrinsic in quotation marks. Enough can be known about a group of companies, some in the same field and others with comparable growth rates but in quite different industries, to make general approximations of intrinsic value. Thus, it is possible to say that from such a comparison and after taking into account such relevant factors as quality of management, growth rate, vulnerability to depression, etc., etc., the stock of the XYZ company currently has an intrinsic value of somewhere between $25 and $30 per share. I doubt if it can be pinpointed more closely. In the case of extremely rapidly growing companies, which legitimately are worth quite high price-earnings ratios, I doubt if it can be approximated anywhere near this closely. Too big a factor is not the current growth rate but how long into the more distant future this abnormal growth rate will continue.

The further off you get into the future, the greater your chances of misjudging what will happen. Therefore, the greater the allowance needed for a possible margin of error the more difficult it becomes to determine true value. In any event, there are so many factors involved that it is never wise to attempt to judge intrinsic value to the last eighth of a point or even point. If a stock has an attractive enough future (so that its true value line will be rising) and you can buy it within a range of not over 25 per cent or 30 per cent of what you estimate might be intrinsic value, that should be more than good enough to afford magnificent profit opportunities. The danger lies in being so carried away by overenthusiasm that you might buy at prices several times real worth.

In short, whether a stock is selling at a low price-earnings ratio or a high one has of itself nothing whatever to do with whether that stock is intrinsically cheap or overpriced. The vast differences in the quality and prospects of one company when compared with another fully warrant such wide variations. What does matter is whether the facts warrant this high or low price-earnings ratio. Has mass opinion so overaccentuated the appealing factors of an intrinsically good stock that while the investment would normally be a good one, it is anything but appealing at the current price? Or is just the opposite occurring, as also quite frequently happens? Is such a large part of the investment community so frightened at the high price-earnings ratio at which this inherently attractive company is selling that even at these levels it still has not been bid up to the levels that its future genuinely warrants? In other words, is the financial community's current psychological outlook on any particular stock causing it to be significantly above or below a point within striking distance of its real value?

It is important to understand the true role of this type of study in the proper handling of investments, if only so as not to overrate its importance. Current financial community psychology should have nothing whatever to do with what stocks should eventually be bought for investment. This should be determined solely on the basis of fundamental facts affecting the companies themselves. Under existing conditions, select good enough growth companies and in enough time you will be handsomely rewarded. This has been shown again and again throughout the entire business history of the twentieth century. Fundamentals, that is, ignoring the psychology of the moment, will bring you a good profit if you have enough patience. However, it may require a rather considerable amount of patience (as well as skill in mastering the fundamentals), and it will come rather short of providing the degree of profit that can come from allowing for current investors' psychological foibles in timing your purchases of otherwise properly selected common stocks. In other words, the psychologist far more than the economist may be of help in deciding when to buy. He can only be of help in the more important matter of what to buy in the secondary sense that if, on the basis of fundamental matters, two or more stocks appear highly desirable from the standpoint of long-range growth. He may help determine which is currently the most or the least attractive at current prices. He can do nothing on the basic matter of whether any of these stocks are worthy of investments in the first place.

Calling this a psychological approach means that we are considering how the investment community is evaluating particular stocks in relation both to their intrinsic worth and to how they may be evaluated similarly in the future. Thus, for example, even if the majority of investors had overvalued the shares of rocket-fuel manufacturers prior to Soviet Russia's surprise launching of the first Sputnik, the psychologist would have been on rather safe grounds in concluding that this event was proving such a shock to the American people that the overvaluation would go a great deal further.

An even simpler and far more important psychological conclusion was crystal clear in the spring of 1958. "Wall Street" was nearly unanimous in its view that the sharp declines that had occurred in corporate earning power as a result of the business depression that had begun a few months before was inadequately reflected in the stock market break that had reached its low point on November 15, 1957. I remember one representative after another of the larger stock brokerage firms saying he expected much lower prices and under prevailing conditions would buy nothing. Seldom have I seen the investment community so unanimous. Few seemed to consider that just as you would not cut the value of a good farm in half just because bad weather conditions caused a crop failure in a single year, so stocks should sell on the basis of what they might be expected to earn in the next several years, far more than as a multiple of what they were earning in a period that had all the economic earmarks of being of fairly short duration. Equally few seemed to give weight to the amount of cash available for investment that would be focussed on the stock market because of the then existing psychological appeal of common stocks for their reputed protection against inflation. Here was a psychological background that was almost ideal for acquiring any stock that was intrinsically a good long-range investment. If the depression had continued, the almost unanimous bearishness made it probable that much of the selling had already been done and that good stocks would decline only moderately further. If as actually happened, the business tide turned, the vast sums that had been moved from stocks into cash "to buy back at lower levels" would stampede into the stock market with the resulting rise that shortly was to prove so spectacular. This proved to be almost a perfect example of how constant alertness, as to whether current mass psychology may be out of step with fundamentals and as to how long such a trend may continue, can help enormously in determining when to buy into an outstanding company. It can frequently show us when to wait for a better opportunity and when to look around for a comparable opportunity in some other industry that is momentarily less popular.

However, there is a quite different way in which psychological-type studies of human behavior in regard to the handling of common stocks may prove even more helpful to investors. It is in this area that I believe sizable developments will come in the period ahead. For years, it has been known that few fields of human activity are inherently as deceptive as the managing of equity investments. What seems like so obviously the right thing to do is time and again exactly the wrong thing. Experienced stock brokers report that not just a few but the great majority of their clients make exactly the same mistakes over, and over, and over again.

I do not believe these things are happenstance or coincidence. In many ways, the art of common-stock investment has changed radically over the past fifty years. However, human nature en masse in relation to its attempt to make profits through buying capital assets does not change at all. What figures are available show that a chart of prices for tulip bulbs during the great speculative mania that occurred in that exotic commodity in Holland many centuries ago would parallel with amazing closeness a comparable chart of the rise and fall of leading stock prices in our own hectic period just before and after 1929. Even more illuminating is a study of what happened when nationwide optimism about the profit possibilities of the British East India Company caused a great wave of eagerness for common stocks to engulf the British Isles in the eighteenth century. The parallel between the difference in action of leading and secondary stocks then and in recent markets is astonishingly close. So are the resemblances in size and duration of the various dips or rallies that ran against the general price trend both on the way up and the way down. While these parallels are colorful, they merely confirm what most shrewd observers have recognized after they have had enough experience with the investment public: Human beings en masse always react about the same way to the same investment stimuli.

Now how can psychological studies take advantage of this constant factor to open up means of greater profit to the informed investor? Let me furnish an example of just one area where nothing is known today but where adequate study might give answers of great dollar value. I will make this example something that occurs not occasionally but time and again in our fast-moving technological age.

The research department of a publicly owned company develops a new process that up reaching full commercial fruition will probably produce about a 50 per cent increase in that company's total profits. The management submits the matter to a meeting of the Board of Directors to obtain authorization of the needed capital expenditures. This is granted. Work starts on the new plants with a scheduled calling for start-up operations in eighteen months. It actually takes twenty-four months. Six months after this start-up, the new process becomes profitable for the first time and three years later the full goal of a 50 per cent increase in total corporate profits is attained.

Obviously, such a development will produce a significant increase in the market price of the affected shares. But when will this happen? I am under the impression (so far as I know no one has ever made enough study of matters of this sort to enable anyone to be sure) that a key date is the presenting of this matter to the board of directors. These men can usually recognize a real investment opportunity. They may have the wealth themselves to cause enough buying significantly to change the stock's price. They are even more likely to have friends or associates in this position. At any rate I suspect, for I still have no data to support my general impressions, that from this point on the stock will follow a U-shaped course. It will go up to a surprising degree in the ensuing weeks as Wall Street excitement about the new process mounts. Months later, as profits from the new process are still far in the future, some of the eager recent buyers lose their enthusiasm and the shares sag. How far they sag may depend upon the time span that must elapse until the new process hits black ink figures. Then when the anticipated profits finally are attained, another rise occurs which, if no other new favorable developments have occurred in the meantime, strangely enough may or may not be as high a peak as on the original excitement.

All this is only my guess, which may be quite inaccurate, as to how the typical good stock behaves in relation to a situation that occurs time and time again. The remarkable thing is that with all the manpower employed by the financial community in the attempt to build up business by finding profit opportunities for present or prospective clients, thorough studies of this sort of thing (corrected, of course, for the influence of any major change in the general market level that may have occurred while these events were going on) have not been made. The reason they have not been made is that most of the financial community has paid so little attention to the psychological aspect, that is, how people were thinking about an event, and have concentrated upon the event itself. Also, such work requires close knowledge of internal affairs of any company being studied. When the board of directors recognizes the significance of a new product can only be learned from someone who is close enough to one or more directors to get the facts at the source. It can not be learned by an investigator who merely reads an annual report.

The example I have cited of the type of psychological study that will vastly improve informed investor performance in the time ahead leads to a still more fundamental psychological stock market problem. Particularly in periods of general market enthusiasm, stocks discount these favorable developments quite some time ahead. Some of these good things are almost sure to happen but will not occur for several years. How far ahead is it safe to discount such developments without a major danger of stockholders becoming tired of waiting and prior to the favorable development having its impact on earnings, selling their shares, and causing sharply lower stock prices? Does this time element vary significantly between periods of general optimism and general investment pessimism? If so, is there any approximate relationship that can be measured? In this day and age of such complex technology that greater and greater lead time is required between the completion of engineering on a product and its profitable production, these are matters affecting the shares of more and more outstanding companies. Since human beings en mass respond to the same investment stimuli of hope, confidence, fear, and impatience in exactly the same way, not alone year by year but century by century; these are all matters which proper financial psychological study should be able to solve. I believe that as the 1960's continue, increasing attention will be given such studies.

Is there any method by which some of these inherently psychological problems can be solved other than by accurately appraising how particular news items were being regarded at a particular time in a sufficient number of instances to permit the drawing of general conclusions? There seems to be. In 1950, an experiment was conducted by O. K. Burrell, Professor of Finance of the School of Business Administration of the University of Oregon. While this was subsequently reported in the *Commercial and Financial Chronicle*, I do not believe the financial community gave it the attention it deserved. It pioneered a technique which might be carried much further to learn how the average investor reacts to a particular kind of influence. By uncovering common investment errors, such a method can be invaluable in enabling investors to guard against actions which can prove quite costly.

Professor Burrell told each of a class of forty students they had $20,000 of theoretical purchasing power, which they must invest at once in any of six stocks designated "A" through "F." The only information they had about these equally imaginary stocks was the price arbitrarily set by Professor Burrell, the last year's earnings, dividend rate, and ex-dividend rates. The students had complete freedom of choice as to how they divided their funds between these six stocks, with no diversification being required.

The prices of each of the six stocks were then arbitrarily changed at regular intervals to simulate price changes that occur in the marketplace. Students were told to switch their holdings in whatever way they felt was most likely to increase their profit. Careful records were kept of total position in each stock after each price change and of the gains or losses of each student for the entire period. Because one of the matters Professor Burrell was trying to test was whether the average stock buyer would lose money in a period when some stocks were going up while others were declining, the students were required to keep fully invested at all times. Then at the end of the simulated three-year period, although some stocks had advanced and others declined, these gains and losses exactly balanced.

Some of the things this experiment showed were of considerable interest. In the first place, it indicated the strong tendency of all stock buyers to associate in their minds the price they pay for a stock with its real value. To this, Professor Burrell attributes the tendency of his entire class to average down, that is, to feel that if they paid 40 for a stock, it must be even more attractive now because it is selling at, say, 28. In addition to letting their losses run, he noted the tendency on the part of the students who were least successful (so far as this game was concerned) to take quick profits and for the more successful to let their profits ride somewhat longer. Another interesting observation which may confound those who are always advocating "splitting" high-priced shares on the grounds that it broadens the market, was the very slight preference for a lower-priced stock to a higher-priced one, deliberately designed to test this point by selling at the same price-earnings ratio and on the same yield basis.

However, possibly far more important than what this experiment may have shown is the opportunity it pioneered to develop a method that can test public reaction to a particular investment influence, isolated from all the other influences that in the real market are constantly pulling on investors' fears and hopes. For example, six actual stocks could have been chosen with their identity concealed so as to avoid the advantages of hindsight. These could have been six which over the same three-year period varied considerably from each other in their market action. Instead of students, experienced investors might have participated. As in real life, the participants might not be required to keep fully invested at all times, but would have a fixed original amount that they could invest or keep in cash as they pleased. The only motivation for buying or selling would be changes in quotation, as there would be no other data available to aid in decision making. Today, we know that price changes in themselves cause a good deal of buying and selling, but we do not know much more than this. Such an experiment, if carefully conducted, might greatly add to our knowledge of how (and probably why) investors act as they do. If (as would probably happen) a consistent pattern developed between the minority of participants who are highly successful and the majority who are not so successful, even more useful data would emerge on how the investor should or should not conduct himself.

It does not take great imagination to see how Professor Burrell's experimental method could be tailored to throw light on the significance (or lack of it) of many other investment matters besides stock split-up and investor response to price changes. Because the relationship of all of these essentially psychological matters to proper investment action has been so scantily explored, I am in no position to make dogmatic statements about all of the ways that such methods might enable an investor to improve his performance. All that can be said is that in place of some of the attention that the 1940's and 1950's put upon forecasting the business cycle, the 1960's may well devote to this completely different forms of endeavor. The pace of competition will probably cause this. For while no studies of this kind will have much bearing on the most basic problem of investors, which is selecting the particular stock to be bought or sold, it can have considerable bearing on the next most important problem of when to buy or sell it.