BENJAMIN GRAHAM
updated with new commentary by JASON ZWEIG

Preface and Appendix by WARREN E. BUFFETT

THE INTELLIGENT INVESTOR

"By far the best book on investing ever written." — Warren E. Buffett

REVISED EDITION

THE DEFINITIVE BOOK ON VALUE INVESTING

HarperBusiness Essentials

THE INTELLIGENT INVESTOR

A BOOK OF PRACTICAL COUNSEL

REVISED EDITION

BENJAMIN GRAHAM
Updated with New Commentary by Jason Zweig

To E.M.G.

Through chances various, through all
vicissitudes, we make our way. . . .

Aeneid

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The text reproduced here is the Fourth Revised Edition, updated by Graham in 1971–1972 and initially published in 1973. Please be advised that the text of Graham's original footnotes (designated in his chapters with superscript numerals) can be found in the Endnotes section beginning on p. 579. The new footnotes that Jason Zweig has introduced appear at the bottom of Graham's pages (and, in the typeface used here, as occasional additions to Graham's endnotes).

Preface to the Fourth Edition, by Warren E. Buffett

I read the first edition of this book early in 1950, when I was nineteen. I thought then that it was by far the best book about investing ever written. I still think it is.

To invest successfully over a lifetime does not require a stratospheric IQ, unusual business insights, or inside information. What's needed is a sound intellectual framework for making decisions and the ability to keep emotions from corroding that framework. This book precisely and clearly prescribes the proper framework. You must supply the emotional discipline.

If you follow the behavioral and business principles that Graham advocates—and if you pay special attention to the invaluable advice in Chapters 8 and 20—you will not get a poor result from your investments. (That represents more of an accomplishment than you might think.) Whether you achieve outstanding results will depend on the effort and intellect you apply to your investments, as well as on the amplitudes of stock-market folly that prevail during your investing career. The sillier the market's behavior, the greater the opportunity for the business-like investor. Follow Graham and you will profit from folly rather than participate in it.

To me, Ben Graham was far more than an author or a teacher. More than any other man except my father, he influenced my life. Shortly after Ben's death in 1976, I wrote the following short remembrance about him in the *Financial Analysts Journal.* As you read the book, I believe you'll perceive some of the qualities I mentioned in this tribute.

BENJAMIN GRAHAM
1894–1976

Several years ago Ben Graham, then almost eighty, expressed to a friend the thought that he hoped every day to do "something foolish, something creative and something generous."

The inclusion of that first whimsical goal reflected his knack for packaging ideas in a form that avoided any overtones of sermonizing or self-importance. Although his ideas were powerful, their delivery was unfailingly gentle.

Readers of this magazine need no elaboration of his achievements as measured by the standard of creativity. It is rare that the founder of a discipline does not find his work eclipsed in rather short order by successors. But over forty years after publication of the book that brought structure and logic to a disorderly and confused activity, it is difficult to think of possible candidates for even the runner-up position in the field of security analysis. In an area where much looks foolish within weeks or months after publication, Ben's principles have remained sound—their value often enhanced and better understood in the wake of financial storms that demolished flimsier intellectual structures. His counsel of soundness brought unfailing rewards to his followers—even to those with natural abilities inferior to more gifted practitioners who stumbled while following counsels of brilliance or fashion.

A remarkable aspect of Ben's dominance of his professional field was that he achieved it without that narrowness of mental activity that concentrates all effort on a single end. It was, rather, the incidental by-product of an intellect whose breadth almost exceeded definition. Certainly I have never met anyone with a mind of similar scope. Virtually total recall, unending fascination with new knowledge, and an ability to recast it in a form applicable to seemingly unrelated problems made exposure to his thinking in any field a delight.

But his third imperative—generosity—was where he succeeded beyond all others. I knew Ben as my teacher, my employer, and my friend. In each relationship—just as with all his students, employees, and friends—there was an absolutely open-ended, no-scores-kept generosity of ideas, time, and spirit. If clarity of thinking was required, there was no better place to go. And if encouragement or counsel was needed, Ben was there.

Walter Lippmann spoke of men who plant trees that other men will sit under. Ben Graham was such a man.

Reprinted from the *Financial Analysts Journal,* November/December 1976.

A Note About Benjamin Graham by Jason Zweig

Who was Benjamin Graham, and why should you listen to him?

Graham was not only one of the best investors who ever lived; he was also the greatest practical investment thinker of all time. Before Graham, money managers behaved much like a medieval guild, guided largely by superstition, guesswork, and arcane rituals. Graham's *Security Analysis* was the textbook that transformed this musty circle into a modern profession.[1]

And *The Intelligent Investor* is the first book ever to describe, for individual investors, the emotional framework and analytical tools that are essential to financial success. It remains the single best book on investing ever written for the general public. *The Intelligent Investor* was the first book I read when I joined *Forbes* Magazine as a cub reporter in 1987, and I was struck by Graham's certainty that, sooner or later, all bull markets must end badly. That October, U.S. stocks suffered their worst one-day crash in history, and I was hooked. (Today, after the wild bull market of the late 1990s and the brutal bear market that began in early 2000, *The Intelligent Investor* reads more prophetically than ever.)

Graham came by his insights the hard way: by feeling firsthand the anguish of financial loss and by studying for decades the history and psychology of the markets. He was born Benjamin Grossbaum on May 9, 1894, in London; his father was a dealer in china dishes and figurines.[2] The family moved to New York when Ben was a year old. At first they lived the good life—with a maid, a cook, and a French gov-

[1] Coauthored with David Dodd and first published in 1934.

[2] The Grossbaums changed their name to Graham during World War I, when German-sounding names were regarded with suspicion.

erness–on upper Fifth Avenue. But Ben's father died in 1903, the porcelain business faltered, and the family slid haltingly into poverty. Ben's mother turned their home into a boardinghouse; then, borrowing money to trade stocks "on margin," she was wiped out in the crash of 1907. For the rest of his life, Ben would recall the humiliation of cashing a check for his mother and hearing the bank teller ask, "Is Dorothy Grossbaum good for five dollars?"

Fortunately, Graham won a scholarship at Columbia, where his brilliance burst into full flower. He graduated in 1914, second in his class. Before the end of Graham's final semester, three departments–English, philosophy, and mathematics–asked him to join the faculty. He was all of 20 years old.

Instead of academia, Graham decided to give Wall Street a shot. He started as a clerk at a bond-trading firm, soon became an analyst, then a partner, and before long was running his own investment partnership.

The Internet boom and bust would not have surprised Graham. In April 1919, he earned a 250% return on the first day of trading for Savold Tire, a new offering in the booming automotive business; by October, the company had been exposed as a fraud and the stock was worthless.

Graham became a master at researching stocks in microscopic, almost molecular, detail. In 1925, plowing through the obscure reports filed by oil pipelines with the U.S. Interstate Commerce Commission, he learned that Northern Pipe Line Co.–then trading at $65 per share–held at least $80 per share in high-quality bonds. (He bought the stock, pestered its managers into raising the dividend, and came away with $110 per share three years later.)

Despite a harrowing loss of nearly 70% during the Great Crash of 1929–1932, Graham survived and thrived in its aftermath, harvesting bargains from the wreckage of the bull market. There is no exact record of Graham's earliest returns, but from 1936 until he retired in 1956, his Graham-Newman Corp. gained at least 14.7% annually, versus 12.2% for the stock market as a whole–one of the best long-term track records on Wall Street history.[3]

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[3] Graham-Newman Corp. was an open-end mutual fund (see Chapter 9) that Graham ran in partnership with Jerome Newman, a skilled investor in his own right. For much of its history, the fund was closed to new investors. I am

How did Graham do it? Combining his extraordinary intellectual powers with profound common sense and vast experience, Graham developed his core principles, which are at least as valid today as they were during his lifetime:

- A stock is not just a ticker symbol or an electronic blip; it is an ownership interest in an actual business, with an underlying value that does not depend on its share price.
- The market is a pendulum that forever swings between unsustainable optimism (which makes stocks too expensive) and unjustified pessimism (which makes them too cheap). The intelligent investor is a realist who sells to optimists and buys from pessimists.
- The future value of every investment is a function of its present price. The higher the price you pay, the lower your return will be.
- No matter how careful you are, the one risk no investor can ever eliminate is the risk of being wrong. Only by insisting on what Graham called the "margin of safety"–never overpaying, no matter how exciting an investment seems to be–can you minimize your odds of error.
- The secret to your financial success is inside yourself. If you become a critical thinker who takes no Wall Street "fact" on faith, and you invest with patient confidence, you can take steady advantage of even the worst bear markets. By developing your discipline and courage, you can refuse to let other people's mood swings govern your financial destiny. In the end, how your investments behave is much less important than how you behave.

The goal of this revised edition of *The Intelligent Investor* is to apply Graham's ideas to today's financial markets while leaving his text entirely intact (with the exception of footnotes for clarification).[4] After each of Graham's chapters you'll find a new commentary. In these reader's guides, I've added recent examples that should show you just how relevant–and how liberating–Graham's principles remain today.

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grateful to Walter Schloss for providing data essential to estimating Graham-Newman's returns. The 20% annual average return that Graham cites in his Postscript (p. 532) appears not to take management fees into account.

[4] The text reproduced here is the Fourth Revised Edition, updated by Graham in 1971–1972 and initially published in 1973.

I envy you the excitement and enlightenment of reading Graham's masterpiece for the first time—or even the third or fourth time. Like all classics, it alters how we view the world and renews itself by educating us. And the more you read it, the better it gets. With Graham as your guide, you are guaranteed to become a vastly more intelligent investor.

INTRODUCTION:

What This Book Expects to Accomplish

The purpose of this book is to supply, in a form suitable for laymen, guidance in the adoption and execution of an investment policy. Comparatively little will be said here about the technique of analyzing securities; attention will be paid chiefly to investment principles and investors' attitudes. We shall, however, provide a number of condensed comparisons of specific securities—chiefly in pairs appearing side by side in the New York Stock Exchange list—in order to bring home in concrete fashion the important elements involved in specific choices of common stocks.

But much of our space will be devoted to the historical patterns of financial markets, in some cases running back over many decades. To invest intelligently in securities one should be forearmed with an adequate knowledge of how the various types of bonds and stocks have actually behaved under varying conditions—some of which, at least, one is likely to meet again in one's own experience. No statement is more true and better applicable to Wall Street than the famous warning of Santayana: "Those who do not remember the past are condemned to repeat it."

Our text is directed to investors as distinguished from speculators, and our first task will be to clarify and emphasize this now all but forgotten distinction. We may say at the outset that this is not a "how to make a million" book. There are no sure and easy paths to riches on Wall Street or anywhere else. It may be well to point up what we have just said by a bit of financial history—especially since there is more than one moral to be drawn from it. In the climactic year 1929 John J. Raskob, a most important figure nationally as well as on Wall Street, extolled the blessings of capitalism in an article in the *Ladies' Home Journal*, entitled "Everybody Ought to Be

Rich."* His thesis was that savings of only $15 per month invested in good common stocks—with dividends reinvested—would produce an estate of $80,000 in twenty years against total contributions of only $3,600. If the General Motors tycoon was right, this was indeed a simple road to riches. How nearly right was he? Our rough calculation—based on assumed investment in the 30 stocks making up the Dow Jones Industrial Average (DJIA)—indicates that if Raskob's prescription had been followed during 1929–1948, the investor's holdings at the beginning of 1949 would have been worth about $8,500. This is a far cry from the great man's promise of $80,000, and it shows how little reliance can be placed on such optimistic forecasts and assurances. But, as an aside, we should remark that the return actually realized by the 20-year operation would have been better than 8% compounded annually—and this despite the fact that the investor would have begun his purchases with the DJIA at 300 and ended with a valuation based on the 1948 closing level of 177. This record may be regarded as a persuasive argument for the principle of regular monthly purchases of strong common stocks through thick and thin—a program known as "dollar-cost averaging."

Since our book is not addressed to speculators, it is not meant for those who trade in the market. Most of these people are guided by charts or other largely mechanical means of determining the right moments to buy and sell. The one principle that applies to nearly all these so-called "technical approaches" is that one should buy *because* a stock or the market has gone up and one should sell *because* it has declined. This is the exact opposite of sound business sense everywhere else, and it is most unlikely that it can lead to

* Raskob (1879–1950) was a director of Du Pont, the giant chemical company, and chairman of the finance committee at General Motors. He also served as national chairman of the Democratic Party and was the driving force behind the construction of the Empire State Building. Calculations by finance professor Jeremy Siegel confirm that Raskob's plan would have grown to just under $9,000 after 20 years, although inflation would have eaten away much of that gain. For the best recent look at Raskob's views on long-term stock investing, see the essay by financial adviser William Bernstein at www.efficientfrontier.com/ef/197/raskob.htm.

lasting success on Wall Street. In our own stock-market experience and observation, extending over 50 years, we have not known a single person who has consistently or lastingly made money by thus "following the market." We do not hesitate to declare that this approach is as fallacious as it is popular. We shall illustrate what we have just said—though, of course this should not be taken as proof—by a later brief discussion of the famous Dow theory for trading in the stock market.*

Since its first publication in 1949, revisions of *The Intelligent Investor* have appeared at intervals of approximately five years. In updating the current version we shall have to deal with quite a number of new developments since the 1965 edition was written. These include:

1. An unprecedented advance in the interest rate on high-grade bonds.
2. A fall of about 35% in the price level of leading common stocks, ending in May 1970. This was the highest percentage decline in some 30 years. (Countless issues of lower quality had a much larger shrinkage.)
3. A persistent inflation of wholesale and consumer's prices, which gained momentum even in the face of a decline of general business in 1970.
4. The rapid development of "conglomerate" companies, franchise operations, and other relative novelties in business and finance. (These include a number of tricky devices such as "letter stock,"[1] proliferation of stock-option warrants, misleading names, use of foreign banks, and others.)†

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* Graham's "brief discussion" is in two parts, on p. 33 and pp. 191–192. For more detail on the Dow Theory, see http://viking.som.yale.edu/will/dow/dowpage.html.

† Mutual funds bought "letter stock" in private transactions, then immediately revalued these shares at a higher public price (see Graham's definition on p. 579). That enabled these "go-go" funds to report unsustainably high returns in the mid-1960s. The U.S. Securities and Exchange Commission cracked down on this abuse in 1969, and it is no longer a concern for fund investors. Stock-option warrants are explained in Chapter 16.

5. Bankruptcy of our largest railroad, excessive short- and long-term debt of many formerly strongly entrenched companies, and even a disturbing problem of solvency among Wall Street houses.*
6. The advent of the "performance" vogue in the management of investment funds, including some bank-operated trust funds, with disquieting results.

These phenomena will have our careful consideration, and some will require changes in conclusions and emphasis from our previous edition. The underlying principles of sound investment should not alter from decade to decade, but the application of these principles must be adapted to significant changes in the financial mechanisms and climate.

The last statement was put to the test during the writing of the present edition, the first draft of which was finished in January 1971. At that time the DJIA was in a strong recovery from its 1970 low of 632 and was advancing toward a 1971 high of 951, with attendant general optimism. As the last draft was finished, in November 1971, the market was in the throes of a new decline, carrying it down to 797 with a renewed general uneasiness about its future. We have not allowed these fluctuations to affect our general attitude toward sound investment policy, which remains substantially unchanged since the first edition of this book in 1949.

The extent of the market's shrinkage in 1969–70 should have served to dispel an illusion that had been gaining ground during the past two decades. This was that leading common stocks could be bought at any time and at any price, with the assurance not only of ultimate profit but also that any intervening loss would soon be recouped by a renewed advance of the market to new high lev-

* The Penn Central Transportation Co., then the biggest railroad in the United States, sought bankruptcy protection on June 21, 1970—shocking investors, who had never expected such a giant company to go under (see p. 423). Among the companies with "excessive" debt Graham had in mind were Ling-Temco-Vought and National General Corp. (see pp. 425 and 463). The "problem of solvency" on Wall Street emerged between 1968 and 1971, when several prestigious brokerages suddenly went bust.

els. That was too good to be true. At long last the stock market has "returned to normal," in the sense that both speculators and stock investors must again be prepared to experience significant and perhaps protracted falls as well as rises in the value of their holdings.

In the area of many secondary and third-line common stocks, especially recently floated enterprises, the havoc wrought by the last market break was catastrophic. This was nothing new in itself—it had happened to a similar degree in 1961–62—but there was now a novel element in the fact that some of the investment funds had large commitments in highly speculative and obviously overvalued issues of this type. Evidently it is not only the tyro who needs to be warned that while enthusiasm may be necessary for great accomplishments elsewhere, on Wall Street it almost invariably leads to disaster.

The major question we shall have to deal with grows out of the huge rise in the rate of interest on first-quality bonds. Since late 1967 the investor has been able to obtain more than twice as much income from such bonds as he could from dividends on representative common stocks. At the beginning of 1972 the return was 7.19% on highest-grade bonds versus only 2.76% on industrial stocks. (This compares with 4.40% and 2.92% respectively at the end of 1964.) It is hard to realize that when we first wrote this book in 1949 the figures were almost the exact opposite: the bonds returned only 2.66% and the stocks yielded 6.82%.[2] In previous editions we have consistently urged that at least 25% of the conservative investor's portfolio be held in common stocks, and we have favored in general a 50–50 division between the two media. We must now consider whether the current great advantage of bond yields over stock yields would justify an all-bond policy until a more sensible relationship returns, as we expect it will. Naturally the question of continued inflation will be of great importance in reaching our decision here. A chapter will be devoted to this discussion.*

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* See Chapter 2. As of the beginning of 2003, U.S. Treasury bonds maturing in 10 years yielded 3.8%, while stocks (as measured by the Dow Jones Industrial Average) yielded 1.9%. (Note that this relationship is not all that different from the 1964 figures that Graham cites.) The income generated by top-quality bonds has been falling steadily since 1981.

In the past we have made a basic distinction between two kinds of investors to whom this book was addressed—the "defensive" and the "enterprising." The defensive (or passive) investor will place his chief emphasis on the avoidance of serious mistakes or losses. His second aim will be freedom from effort, annoyance, and the need for making frequent decisions. The determining trait of the enterprising (or active, or aggressive) investor is his willingness to devote time and care to the selection of securities that are both sound and more attractive than the average. Over many decades an enterprising investor of this sort could expect a worthwhile reward for his extra skill and effort, in the form of a better average return than that realized by the passive investor. We have some doubt whether a really substantial extra recompense is promised to the active investor under today's conditions. But next year or the years after may well be different. We shall accordingly continue to devote attention to the possibilities for enterprising investment, as they existed in former periods and may return.

It has long been the prevalent view that the art of successful investment lies first in the choice of those industries that are most likely to grow in the future and then in identifying the most promising companies in these industries. For example, smart investors—or their smart advisers—would long ago have recognized the great growth possibilities of the computer industry as a whole and of International Business Machines in particular. And similarly for a number of other growth industries and growth companies. But this is not as easy as it always looks in retrospect. To bring this point home at the outset let us add here a paragraph that we included first in the 1949 edition of this book.

> Such an investor may for example be a buyer of air-transport stocks because he believes their future is even more brilliant than the trend the market already reflects. For this class of investor the value of our book will lie more in its warnings against the pitfalls lurking in this favorite investment approach than in any positive technique that will help him along his path.*

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* "Air-transport stocks," of course, generated as much excitement in the late 1940s and early 1950s as Internet stocks did a half century later. Among the hottest mutual funds of that era were Aeronautical Securities and the

The pitfalls have proved particularly dangerous in the industry we mentioned. It was, of course, easy to forecast that the volume of air traffic would grow spectacularly over the years. Because of this factor their shares became a favorite choice of the investment funds. But despite the expansion of revenues—at a pace even greater than in the computer industry—a combination of technological problems and overexpansion of capacity made for fluctuating and even disastrous profit figures. In the year 1970, despite a new high in traffic figures, the airlines sustained a loss of some $200 million for their shareholders. (They had shown losses also in 1945 and 1961.) The stocks of these companies once again showed a greater decline in 1969–70 than did the general market. The record shows that even the highly paid full-time experts of the mutual funds were completely wrong about the fairly short-term future of a major and nonesoteric industry.

On the other hand, while the investment funds had substantial investments and substantial gains in IBM, the combination of its apparently high price and the impossibility of being *certain* about its rate of growth prevented them from having more than, say, 3% of their funds in this wonderful performer. Hence the effect of this excellent choice on their overall results was by no means decisive. Furthermore, many—if not most—of their investments in computer-industry companies other than IBM appear to have been unprofitable. From these two broad examples we draw two morals for our readers:

1. Obvious prospects for physical growth in a business do not translate into obvious profits for investors.
2. The experts do not have dependable ways of selecting and concentrating on the most promising companies in the most promising industries.

Missiles-Rockets-Jets & Automation Fund. They, like the stocks they owned, turned out to be an investing disaster. It is commonly accepted today that the cumulative earnings of the airline industry over its entire history have been negative. The lesson Graham is driving at is not that you should avoid buying airline stocks, but that you should never succumb to the "certainty" that any industry will outperform all others in the future.

The author did not follow this approach in his financial career as fund manager, and he cannot offer either specific counsel or much encouragement to those who may wish to try it.

What then will we aim to accomplish in this book? Our main objective will be to guide the reader against the areas of possible substantial error and to develop policies with which he will be comfortable. We shall say quite a bit about the psychology of investors. For indeed, the investor's chief problem—and even his worst enemy—is likely to be himself. ("The fault, dear investor, is not in our stars—and not in our stocks—but in ourselves. . . .") This has proved the more true over recent decades as it has become more necessary for conservative investors to acquire common stocks and thus to expose themselves, willy-nilly, to the excitement and the temptations of the stock market. By arguments, examples, and exhortation, we hope to aid our readers to establish the proper mental and emotional attitudes toward their investment decisions. We have seen much more money made and *kept* by "ordinary people" who were temperamentally well suited for the investment process than by those who lacked this quality, even though they had an extensive knowledge of finance, accounting, and stock-market lore.

Additionally, we hope to implant in the reader a tendency to measure or quantify. For 99 issues out of 100 we could say that at some price they are cheap enough to buy and at some other price they would be so dear that they should be sold. The habit of relating what is paid to what is being offered is an invaluable trait in investment. In an article in a women's magazine many years ago we advised the readers to buy their stocks as they bought their groceries, not as they bought their perfume. The really dreadful losses of the past few years (and on many similar occasions before) were realized in those common-stock issues where the buyer forgot to ask "How much?"

In June 1970 the question "How much?" could be answered by the magic figure 9.40%—the yield obtainable on new offerings of high-grade public-utility bonds. This has now dropped to about 7.3%, but even that return tempts us to ask, "Why give any other answer?" But there are other possible answers, and these must be carefully considered. Besides which, we repeat that both we and our readers must be prepared in advance for the possibly quite different conditions of, say, 1973–1977.

We shall therefore present in some detail a positive program for common-stock investment, part of which is within the purview of both classes of investors and part is intended mainly for the enterprising group. Strangely enough, we shall suggest as one of our chief requirements here that our readers limit themselves to issues selling not far above their tangible-asset value.* The reason for this seemingly outmoded counsel is both practical and psychological. Experience has taught us that, while there are many good growth companies worth several times net assets, the buyer of such shares will be too dependent on the vagaries and fluctuations of the stock market. By contrast, the investor in shares, say, of public-utility companies at about their net-asset value can always consider himself the owner of an interest in sound and expanding businesses, acquired at a rational price—regardless of what the stock market might say to the contrary. The ultimate result of such a conservative policy is likely to work out better than exciting adventures into the glamorous and dangerous fields of anticipated growth.

The art of investment has one characteristic that is not generally appreciated. A creditable, if unspectacular, result can be achieved by the lay investor with a minimum of effort and capability; but to improve this easily attainable standard requires much application and more than a trace of wisdom. If you merely try to bring *just a little* extra knowledge and cleverness to bear upon your investment program, instead of realizing a little better than normal results, you may well find that you have done worse.

Since anyone—by just buying and holding a representative list—can equal the performance of the market averages, it would seem a comparatively simple matter to "beat the averages"; but as a matter of fact the proportion of smart people who try this and fail is surprisingly large. Even the majority of the investment funds, with all their experienced personnel, have not performed so well

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* Tangible assets include a company's physical property (like real estate, factories, equipment, and inventories) as well as its financial balances (such as cash, short-term investments, and accounts receivable). Among the elements not included in tangible assets are brands, copyrights, patents, franchises, goodwill, and trademarks. To see how to calculate tangible-asset value, see footnote † on p. 198.

over the years as has the general market. Allied to the foregoing is the record of the published stock-market predictions of the brokerage houses, for there is strong evidence that their calculated forecasts have been somewhat less reliable than the simple tossing of a coin.

In writing this book we have tried to keep this basic pitfall of investment in mind. The virtues of a simple portfolio policy have been emphasized—the purchase of high-grade bonds plus a diversified list of leading common stocks—which any investor can carry out with a little expert assistance. The adventure beyond this safe and sound territory has been presented as fraught with challenging difficulties, especially in the area of temperament. Before attempting such a venture the investor should feel sure of himself and of his advisers—particularly as to whether they have a clear concept of the differences between investment and speculation and between market price and underlying value.

A strong-minded approach to investment, firmly based on the margin-of-safety principle, can yield handsome rewards. But a decision to try for these emoluments rather than for the assured fruits of defensive investment should not be made without much self-examination.

A final retrospective thought. When the young author entered Wall Street in June 1914 no one had any inkling of what the next half-century had in store. (The stock market did not even suspect that a World War was to break out in two months, and close down the New York Stock Exchange.) Now, in 1972, we find ourselves the richest and most powerful country on earth, but beset by all sorts of major problems and more apprehensive than confident of the future. Yet if we confine our attention to American investment experience, there is some comfort to be gleaned from the last 57 years. Through all their vicissitudes and casualties, as earth-shaking as they were unforeseen, it remained true that sound investment principles produced generally sound results. We must act on the assumption that they will continue to do so.

Note to the Reader: This book does not address itself to the *overall* financial policy of savers and investors; it deals only with that portion of their funds which they are prepared to place in marketable (or redeemable) securities, that is, in bonds and stocks.

Consequently we do not discuss such important media as savings and time desposits, savings-and-loan-association accounts, life insurance, annuities, and real-estate mortgages or equity ownership. The reader should bear in mind that when he finds the word "now," or the equivalent, in the text, it refers to late 1971 or early 1972.

COMMENTARY ON THE INTRODUCTION

> If you have built castles in the air, your work need not be lost; that is where they should be. Now put the foundations under them.
>
> –*Henry David Thoreau,* Walden

Notice that Graham announces from the start that this book will not tell you how to beat the market. No truthful book can.

Instead, this book will teach you three powerful lessons:

- how you can minimize the odds of suffering irreversible losses;
- how you can maximize the chances of achieving sustainable gains;
- how you can control the self-defeating behavior that keeps most investors from reaching their full potential.

Back in the boom years of the late 1990s, when technology stocks seemed to be doubling in value every day, the notion that you could lose almost all your money seemed absurd. But, by the end of 2002, many of the dot-com and telecom stocks had lost 95% of their value or more. Once you lose 95% of your money, you have to gain 1,900% *just to get back to where you started.*[1] Taking a foolish risk can put you so deep in the hole that it's virtually impossible to get out. That's why Graham constantly emphasizes the importance of avoiding losses–not just in Chapters 6, 14, and 20, but in the threads of warning that he has woven throughout his entire text.

But no matter how careful you are, the price of your investments *will* go down from time to time. While no one can eliminate that risk,

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[1] To put this statement in perspective, consider how often you are likely to buy a stock at $30 and be able to sell it at $600.

Graham will show you how to manage it—and how to get your fears under control.

ARE YOU AN INTELLIGENT INVESTOR?

Now let's answer a vitally important question. What exactly does Graham mean by an "intelligent" investor? Back in the first edition of this book, Graham defines the term—and he makes it clear that this kind of intelligence has nothing to do with IQ or SAT scores. It simply means being patient, disciplined, and eager to learn; you must also be able to harness your emotions and think for yourself. This kind of intelligence, explains Graham, "is a trait more of the character than of the brain."[2]

There's proof that high IQ and higher education are not enough to make an investor intelligent. In 1998, Long-Term Capital Management L.P., a hedge fund run by a battalion of mathematicians, computer scientists, and two Nobel Prize–winning economists, lost more than $2 billion in a matter of weeks on a huge bet that the bond market would return to "normal." But the bond market kept right on becoming more and more abnormal—and LTCM had borrowed so much money that its collapse nearly capsized the global financial system.[3]

And back in the spring of 1720, Sir Isaac Newton owned shares in the South Sea Company, the hottest stock in England. Sensing that the market was getting out of hand, the great physicist muttered that he "could calculate the motions of the heavenly bodies, but not the madness of the people." Newton dumped his South Sea shares, pocketing a 100% profit totaling £7,000. But just months later, swept up in the wild enthusiasm of the market, Newton jumped back in at a much higher price—and lost £20,000 (or more than $3 million in today's money). For the rest of his life, he forbade anyone to speak the words "South Sea" in his presence.[4]

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[2] Benjamin Graham, *The Intelligent Investor* (Harper & Row, 1949), p. 4.

[3] A "hedge fund" is a pool of money, largely unregulated by the government, invested aggressively for wealthy clients. For a superb telling of the LTCM story, see Roger Lowenstein, *When Genius Failed* (Random House, 2000).

[4] John Carswell, *The South Sea Bubble* (Cresset Press, London, 1960), pp. 131, 199. Also see www.harvard-magazine.com/issues/mj99/damnd.html.

Sir Isaac Newton was one of the most intelligent people who ever lived, as most of us would define intelligence. But, in Graham's terms, Newton was far from an intelligent investor. By letting the roar of the crowd override his own judgment, the world's greatest scientist acted like a fool.

In short, if you've failed at investing so far, it's not because you're stupid. It's because, like Sir Isaac Newton, you haven't developed the emotional discipline that successful investing requires. In Chapter 8, Graham describes how to enhance your intelligence by harnessing your emotions and refusing to stoop to the market's level of irrationality. There you can master his lesson that being an intelligent investor is more a matter of "character" than "brain."

A CHRONICLE OF CALAMITY

Now let's take a moment to look at some of the major financial developments of the past few years:

1. The worst market crash since the Great Depression, with U.S. stocks losing 50.2% of their value—or *$7.4 trillion*—between March 2000 and October 2002.
2. Far deeper drops in the share prices of the hottest companies of the 1990s, including AOL, Cisco, JDS Uniphase, Lucent, and Qualcomm—plus the utter destruction of hundreds of Internet stocks.
3. Accusations of massive financial fraud at some of the largest and most respected corporations in America, including Enron, Tyco, and Xerox.
4. The bankruptcies of such once-glistening companies as Conseco, Global Crossing, and WorldCom.
5. Allegations that accounting firms cooked the books, and even destroyed records, to help their clients mislead the investing public.
6. Charges that top executives at leading companies siphoned off hundreds of millions of dollars for their own personal gain.
7. Proof that security analysts on Wall Street praised stocks publicly but admitted privately that they were garbage.
8. A stock market that, even after its bloodcurdling decline, seems overvalued by historical measures, suggesting to many experts that stocks have further yet to fall.

9. A relentless decline in interest rates that has left investors with no attractive alternative to stocks.
10. An investing environment bristling with the unpredictable menace of global terrorism and war in the Middle East.

Much of this damage could have been (and was!) avoided by investors who learned and lived by Graham's principles. As Graham puts it, "while enthusiasm may be necessary for great accomplishments elsewhere, on Wall Street it almost invariably leads to disaster." By letting themselves get carried away—on Internet stocks, on big "growth" stocks, on stocks as a whole—many people made the same stupid mistakes as Sir Isaac Newton. They let other investors' judgments determine their own. They ignored Graham's warning that "the really dreadful losses" always occur after "the buyer forgot to ask 'How much?' " Most painfully of all, by losing their self-control just when they needed it the most, these people proved Graham's assertion that "the investor's chief problem—and even his worst enemy—is likely to be himself."

THE SURE THING THAT WASN'T

Many of those people got especially carried away on technology and Internet stocks, believing the high-tech hype that this industry would keep outgrowing every other for years to come, if not forever:

- In mid-1999, after earning a 117.3% return in just the first five months of the year, Monument Internet Fund portfolio manager Alexander Cheung predicted that his fund would gain 50% a year over the next three to five years and an annual average of 35% "over the next 20 years."[5]

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[5] Constance Loizos, "Q&A: Alex Cheung," *InvestmentNews,* May 17, 1999, p. 38. The highest 20-year return in mutual fund history was 25.8% per year, achieved by the legendary Peter Lynch of Fidelity Magellan over the two decades ending December 31, 1994. Lynch's performance turned $10,000 into more than $982,000 in 20 years. Cheung was predicting that his fund would turn $10,000 into more than $4 million over the same length of time. Instead of regarding Cheung as ridiculously overoptimistic, investors threw

- After his Amerindo Technology Fund rose an incredible 248.9% in 1999, portfolio manager Alberto Vilar ridiculed anyone who dared to doubt that the Internet was a perpetual moneymaking machine: "If you're out of this sector, you're going to underperform. You're in a horse and buggy, and I'm in a Porsche. You don't like tenfold growth opportunities? Then go with someone else." [6]
- In February 2000, hedge-fund manager James J. Cramer proclaimed that Internet-related companies "are the only ones worth owning right now." These "winners of the new world," as he called them, "are the only ones that are going higher consistently in good days and bad." Cramer even took a potshot at Graham: "You have to throw out all of the matrices and formulas and texts that existed before the Web. . . . If we used any of what Graham and Dodd teach us, we wouldn't have a dime under management." [7]

All these so-called experts ignored Graham's sober words of warning: "Obvious prospects for physical growth in a business do not translate into obvious profits for investors." While it seems easy to foresee which industry will grow the fastest, that foresight has no real value if most other investors are already expecting the same thing. By the time everyone decides that a given industry is "obviously" the best

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money at him, flinging more than $100 million into his fund over the next year. A $10,000 investment in the Monument Internet Fund in May 1999 would have shrunk to roughly $2,000 by year-end 2002. (The Monument fund no longer exists in its original form and is now known as Orbitex Emerging Technology Fund.)

[6] Lisa Reilly Cullen, "The Triple Digit Club," *Money,* December, 1999, p. 170. If you had invested $10,000 in Vilar's fund at the end of 1999, you would have finished 2002 with just $1,195 left—one of the worst destructions of wealth in the history of the mutual-fund industry.

[7] See www.thestreet.com/funds/smarter/891820.html. Cramer's favorite stocks did not go "higher consistently in good days and bad." By year-end 2002, one of the 10 had already gone bankrupt, and a $10,000 investment spread equally across Cramer's picks would have lost 94%, leaving you with a grand total of $597.44. Perhaps Cramer meant that his stocks would be "winners" not in "the new world," but in the world to come.

one to invest in, the prices of its stocks have been bid up so high that its future returns have nowhere to go but down.

For now at least, no one has the gall to try claiming that technology will still be the world's greatest growth industry. But make sure you remember this: The people who now claim that the next "sure thing" will be health care, or energy, or real estate, or gold, are no more likely to be right in the end than the hypesters of high tech turned out to be.

THE SILVER LINING

If no price seemed too high for stocks in the 1990s, in 2003 we've reached the point at which no price appears to be low enough. The pendulum has swung, as Graham knew it always does, from irrational exuberance to unjustifiable pessimism. In 2002, investors yanked $27 billion out of stock mutual funds, and a survey conducted by the Securities Industry Association found that one out of 10 investors had cut back on stocks by at least 25%. The same people who were eager to buy stocks in the late 1990s—when they were going up in price and, therefore, becoming expensive—sold stocks as they went down in price and, by definition, became cheaper.

As Graham shows so brilliantly in Chapter 8, this is exactly backwards. The intelligent investor realizes that stocks become more risky, not less, as their prices rise—and less risky, not more, as their prices fall. The intelligent investor dreads a bull market, since it makes stocks more costly to buy. And conversely (so long as you keep enough cash on hand to meet your spending needs), you should welcome a bear market, since it puts stocks back on sale.[8]

So take heart: The death of the bull market is not the bad news everyone believes it to be. Thanks to the decline in stock prices, now is a considerably safer—and saner—time to be building wealth. Read on, and let Graham show you how.

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[8] The only exception to this rule is an investor in the advanced stage of retirement, who may not be able to outlast a long bear market. Yet even an elderly investor should not sell her stocks merely because they have gone down in price; that approach not only turns her paper losses into real ones but deprives her heirs of the potential to inherit those stocks at lower costs for tax purposes.

CHAPTER 1

Investment versus Speculation: Results to Be Expected by the Intelligent Investor

This chapter will outline the viewpoints that will be set forth in the remainder of the book. In particular we wish to develop at the outset our concept of appropriate portfolio policy for the individual, nonprofessional investor.

Investment versus Speculation

What do we mean by "investor"? Throughout this book the term will be used in contradistinction to "speculator." As far back as 1934, in our textbook *Security Analysis*,[1] we attempted a precise formulation of the difference between the two, as follows: "An investment operation is one which, upon thorough analysis promises safety of principal and an adequate return. Operations not meeting these requirements are speculative."

While we have clung tenaciously to this definition over the ensuing 38 years, it is worthwhile noting the radical changes that have occurred in the use of the term "investor" during this period. After the great market decline of 1929–1932 *all* common stocks were widely regarded as speculative by nature. (A leading authority stated flatly that only bonds could be bought for investment.[2]) Thus we had then to defend our definition against the charge that it gave too wide scope to the concept of investment.

Now our concern is of the opposite sort. We must prevent our readers from accepting the common jargon which applies the term "investor" to anybody and everybody in the stock market. In our last edition we cited the following headline of a front-page article of our leading financial journal in June 1962:

SMALL INVESTORS BEARISH, THEY ARE SELLING ODD-LOTS SHORT

In October 1970 the same journal had an editorial critical of what it called "reckless investors," who this time were rushing in on the buying side.

These quotations well illustrate the confusion that has been dominant for many years in the use of the words investment and speculation. Think of our suggested definition of investment given above, and compare it with the sale of a few shares of stock by an inexperienced member of the public, who does not even own what he is selling, and has some largely emotional conviction that he will be able to buy them back at a much lower price. (It is not irrelevant to point out that when the 1962 article appeared the market had already experienced a decline of major size, and was now getting ready for an even greater upswing. It was about as poor a time as possible for selling short.) In a more general sense, the later-used phrase "reckless investors" could be regarded as a laughable contradiction in terms—something like "spendthrift misers"—were this misuse of language not so mischievous.

The newspaper employed the word "investor" in these instances because, in the easy language of Wall Street, everyone who buys or sells a security has become an investor, regardless of what he buys, or for what purpose, or at what price, or whether for cash or on margin. Compare this with the attitude of the public toward common stocks in 1948, when over 90% of those queried expressed themselves as opposed to the purchase of common stocks.[3] About half gave as their reason "not safe, a gamble," and about half, the reason "not familiar with."* It is indeed ironical

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* The survey Graham cites was conducted for the Fed by the University of Michigan and was published in the *Federal Reserve Bulletin*, July, 1948. People were asked, "Suppose a man decides not to spend his money. He can either put it in a bank or in bonds or he can invest it. What do you think would be the wisest thing for him to do with the money nowadays—put it in the bank, buy savings bonds with it, invest it in real estate, or buy common stock with it?" Only 4% thought common stock would offer a "satisfactory" return; 26% considered it "not safe" or a "gamble." From 1949 through 1958, the stock market earned one of its highest 10-year returns in history,

(though not surprising) that common-stock purchases of all kinds were quite generally regarded as highly speculative or risky at a time when they were selling on a most attractive basis, and due soon to begin their greatest advance in history; conversely the very fact they had advanced to what were undoubtedly dangerous levels as judged by *past experience* later transformed them into "investments," and the entire stock-buying public into "investors."

The distinction between investment and speculation in common stocks has always been a useful one and its disappearance is a cause for concern. We have often said that Wall Street as an institution would be well advised to reinstate this distinction and to emphasize it in all its dealings with the public. Otherwise the stock exchanges may some day be blamed for heavy speculative losses, which those who suffered them had not been properly warned against. Ironically, once more, much of the recent financial embarrassment of some stock-exchange firms seems to have come from the inclusion of speculative common stocks in their own capital funds. We trust that the reader of this book will gain a reasonably clear idea of the risks that are inherent in common-stock commitments—risks which are inseparable from the opportunities of profit that they offer, and both of which must be allowed for in the investor's calculations.

What we have just said indicates that there may no longer be such a thing as a simon-pure investment policy comprising representative common stocks—in the sense that one can always wait to buy them at a price that involves no risk of a market or "quotational" loss large enough to be disquieting. In most periods the investor must recognize the existence of a *speculative factor* in his common-stock holdings. It is his task to keep this component within minor limits, and to be prepared financially and psychologically for adverse results that may be of short or long duration.

Two paragraphs should be added about stock speculation per se, as distinguished from the speculative component now inherent

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averaging 18.7% annually. In a fascinating echo of that early Fed survey, a poll conducted by *BusinessWeek* at year-end 2002 found that only 24% of investors were willing to invest more in their mutual funds or stock portfolios, down from 47% just three years earlier.

in most representative common stocks. Outright speculation is neither illegal, immoral, nor (for most people) fattening to the pocketbook. More than that, some speculation is necessary and unavoidable, for in many common-stock situations there are substantial possibilities of both profit and loss, and the risks therein must be assumed by someone.* There is intelligent speculation as there is intelligent investing. But there are many ways in which speculation may be unintelligent. Of these the foremost are: (1) speculating when you think you are investing; (2) speculating seriously instead of as a pastime, when you lack proper knowledge and skill for it; and (3) risking more money in speculation than you can afford to lose.

In our conservative view every nonprofessional who operates *on margin*† should recognize that he is *ipso facto* speculating, and it is his broker's duty so to advise him. And everyone who buys a so-called "hot" common-stock issue, or makes a purchase in any way similar thereto, is either speculating or gambling. Speculation is always fascinating, and it can be a lot of fun while you are ahead of the game. If you want to try your luck at it, put aside a portion—the smaller the better—of your capital in a separate fund for this purpose. Never add more money to this account just because the

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* Speculation is beneficial on two levels: First, without speculation, untested new companies (like Amazon.com or, in earlier times, the Edison Electric Light Co.) would never be able to raise the necessary capital for expansion. The alluring, long-shot chance of a huge gain is the grease that lubricates the machinery of innovation. Secondly, risk is exchanged (but never eliminated) every time a stock is bought or sold. The buyer purchases the primary risk that this stock may go down. Meanwhile, the seller still retains a residual risk–the chance that the stock he just sold may go up!

† A margin account enables you to buy stocks using money you borrow from the brokerage firm. By investing with borrowed money, you make more when your stocks go up–but you can be wiped out when they go down. The collateral for the loan is the value of the investments in your account–so you must put up more money if that value falls below the amount you borrowed. For more information about margin accounts, see www.sec.gov/investor/pubs/margin.htm, www.sia.com/publications/pdf/MarginsA.pdf, and www.nyse.com/pdfs/2001_factbook_09.pdf.

market has gone up and profits are rolling in. (That's the time to think of taking money *out* of your speculative fund.) Never mingle your speculative and investment operations in the same account, nor in any part of your thinking.

Results to Be Expected by the Defensive Investor

We have already defined the defensive investor as one interested chiefly in safety plus freedom from bother. In general what course should he follow and what return can he expect under "average normal conditions"—if such conditions really exist? To answer these questions we shall consider first what we wrote on the subject seven years ago, next what significant changes have occurred since then in the underlying factors governing the investor's expectable return, and finally what he should do and what he should expect under present-day (early 1972) conditions.

1. What We Said Six Years Ago

We recommended that the investor divide his holdings between high-grade bonds and leading common stocks; that the proportion held in bonds be never less than 25% or more than 75%, with the converse being necessarily true for the common-stock component; that his simplest choice would be to maintain a 50–50 proportion between the two, with adjustments to restore the equality when market developments had disturbed it by as much as, say, 5%. As an alternative policy he might choose to reduce his common-stock component to 25% "if he felt the market was dangerously high," and conversely to advance it toward the maximum of 75% "if he felt that a decline in stock prices was making them increasingly attractive."

In 1965 the investor could obtain about 4½% on high-grade taxable bonds and 3¼% on good tax-free bonds. The dividend return on leading common stocks (with the DJIA at 892) was only about 3.2%. This fact, and others, suggested caution. We implied that "at normal levels of the market" the investor should be able to obtain an initial dividend return of between 3½% and 4½% on his stock purchases, to which should be added a steady increase in underlying value (and in the "normal market price") of a representative

stock list of about the same amount, giving a return from dividends and appreciation combined of about 7½% per year. The half and half division between bonds and stocks would yield about 6% before income tax. We added that the stock component should carry a fair degree of protection against a loss of purchasing power caused by large-scale inflation.

It should be pointed out that the above arithmetic indicated expectation of a much lower rate of advance in the stock market than had been realized between 1949 and 1964. That rate had averaged a good deal better than 10% for listed stocks as a whole, and it was quite generally regarded as a sort of guarantee that similarly satisfactory results could be counted on in the future. Few people were willing to consider seriously the possibility that the high rate of advance in the past means that stock prices are "now too high," and hence that "the wonderful results since 1949 would imply not very good but *bad* results for the future."[4]

2. What Has Happened Since 1964

The major change since 1964 has been the rise in interest rates on first-grade bonds to record high levels, although there has since been a considerable recovery from the lowest prices of 1970. The obtainable return on good corporate issues is now about 7½% and even more against 4½% in 1964. In the meantime the dividend return on DJIA-type stocks had a fair advance also during the market decline of 1969–70, but as we write (with "the Dow" at 900) it is less than 3.5% against 3.2% at the end of 1964. The change in going interest rates produced a maximum decline of about 38% in the market price of medium-term (say 20-year) bonds during this period.

There is a paradoxical aspect to these developments. In 1964 we discussed at length the possibility that the price of stocks might be too high and subject ultimately to a serious decline; but we did not consider specifically the possibility that the same might happen to the price of high-grade bonds. (Neither did anyone else that we know of.) We did warn (on p. 90) that "a long-term bond may vary widely in price in response to changes in interest rates." In the light of what has since happened we think that this warning—with attendant examples—was insufficiently stressed. For the fact is that

if the investor had a given sum in the DJIA at its closing price of 874 in 1964 he would have had a small profit thereon in late 1971; even at the lowest level (631) in 1970 his indicated loss would have been less than that shown on good long-term bonds. On the other hand, if he had confined his bond-type investments to U.S. savings bonds, short-term corporate issues, or savings accounts, he would have had no loss in market value of his principal during this period and he would have enjoyed a higher income return than was offered by good stocks. It turned out, therefore, that true "cash equivalents" proved to be better investments in 1964 than common stocks—in spite of the inflation experience that in theory should have favored stocks over cash. The decline in quoted principal value of good longer-term bonds was due to developments in the money market, an abstruse area which ordinarily does not have an important bearing on the investment policy of individuals.

This is just another of an endless series of experiences over time that have demonstrated that the future of security prices is never predictable.* Almost always bonds have fluctuated much less than stock prices, and investors generally could buy good bonds of any maturity without having to worry about changes in their market value. There were a few exceptions to this rule, and the period after 1964 proved to be one of them. We shall have more to say about change in bond prices in a later chapter.

3. Expectations and Policy in Late 1971 and Early 1972

Toward the end of 1971 it was possible to obtain 8% taxable interest on good medium-term corporate bonds, and 5.7% tax-free on good state or municipal securities. In the shorter-term field the investor could realize about 6% on U.S. government issues due in five years. In the latter case the buyer need not be concerned about

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* Read Graham's sentence again, and note what this greatest of investing experts is saying: The future of security prices is never predictable. And as you read ahead in the book, notice how everything else Graham tells you is designed to help you grapple with that truth. Since you cannot predict the behavior of the markets, you must learn how to predict and control your own behavior.

a possible loss in market value, since he is sure of full repayment, including the 6% interest return, at the end of a comparatively short holding period. The DJIA at its recurrent price level of 900 in 1971 yields only 3.5%.

Let us assume that now, as in the past, the basic policy decision to be made is how to divide the fund between high-grade bonds (or other so-called "cash equivalents") and leading DJIA-type stocks. What course should the investor follow under present conditions, if we have no strong reason to predict either a significant upward or a significant downward movement for some time in the future? First let us point out that if there is no serious adverse change, the defensive investor should be able to count on the current 3.5% dividend return on his stocks and also on an *average* annual appreciation of about 4%. As we shall explain later this appreciation is based essentially on the reinvestment by the various companies of a corresponding amount annually out of undistributed profits. On a before-tax basis the combined return of his stocks would then average, say, 7.5%, somewhat less than his interest on high-grade bonds.* On an after-tax basis the average return on stocks would work out at some 5.3%.[5] This would be about the same as is now obtainable on good tax-free medium-term bonds.

These expectations are much less favorable for stocks against bonds than they were in our 1964 analysis. (That conclusion follows inevitably from the basic fact that bond yields have gone up much more than stock yields since 1964.) We must never lose sight

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* How well did Graham's forecast pan out? At first blush, it seems, very well: From the beginning of 1972 through the end of 1981, stocks earned an annual average return of 6.5%. (Graham did not specify the time period for his forecast, but it's plausible to assume that he was thinking of a 10-year time horizon.) However, inflation raged at 8.6% annually over this period, eating up the entire gain that stocks produced. In this section of his chapter, Graham is summarizing what is known as the "Gordon equation," which essentially holds that the stock market's future return is the sum of the current dividend yield plus expected earnings growth. With a dividend yield of just under 2% in early 2003, and long-term earnings growth of around 2%, plus inflation at a bit over 2%, a future average annual return of roughly 6% is plausible. (See the commentary on Chapter 3.)

of the fact that the interest and principal payments on good bonds are much better protected and therefore more certain than the dividends and price appreciation on stocks. Consequently we are forced to the conclusion that now, toward the end of 1971, bond investment appears clearly preferable to stock investment. If we could be sure that this conclusion is right we would have to advise the defensive investor to put *all* his money in bonds and *none* in common stocks until the current yield relationship changes significantly in favor of stocks.

But of course we cannot be certain that bonds will work out better than stocks from today's levels. The reader will immediately think of the inflation factor as a potent reason on the other side. In the next chapter we shall argue that our considerable experience with inflation in the United States during this century would not support the choice of stocks against bonds at present differentials in yield. But there is always the possibility—though we consider it remote—of an accelerating inflation, which in one way or another would have to make stock equities preferable to bonds payable in a fixed amount of dollars.* There is the alternative possibility—which we also consider highly unlikely—that American business will become so profitable, without stepped-up inflation, as to justify a large increase in common-stock values in the next few years. Finally, there is the more familiar possibility that we shall witness another great speculative rise in the stock market without a real justification in the underlying values. Any of these reasons, and perhaps others we haven't thought of, *might* cause the investor to regret a 100% concentration on bonds even at their more favorable yield levels.

Hence, after this foreshortened discussion of the major considerations, we once again enunciate the same basic compromise policy

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* Since 1997, when Treasury Inflation-Protected Securities (or TIPS) were introduced, stocks have no longer been the automatically superior choice for investors who expect inflation to increase. TIPS, unlike other bonds, rise in value if the Consumer Price Index goes up, effectively immunizing the investor against losing money after inflation. Stocks carry no such guarantee and, in fact, are a relatively poor hedge against high rates of inflation. (For more details, see the commentary to Chapter 2.)

for defensive investors—namely that at all times they have a significant part of their funds in bond-type holdings and a significant part also in equities. It is still true that they may choose between maintaining a simple 50–50 division between the two components or a ratio, dependent on their judgment, varying between a minimum of 25% and a maximum of 75% of either. We shall give our more detailed view of these alternative policies in a later chapter.

Since at present the overall return envisaged from common stocks is nearly the same as that from bonds, the presently expectable return (including growth of stock values) for the investor would change little regardless of how he divides his fund between the two components. As calculated above, the aggregate return from both parts should be about 7.8% before taxes or 5.5% on a tax-free (or estimated tax-paid) basis. A return of this order is appreciably higher than that realized by the typical conservative investor over most of the long-term past. It may not seem attractive in relation to the 14%, or so, return shown by common stocks during the 20 years of the predominantly bull market after 1949. But it should be remembered that between 1949 and 1969 the price of the DJIA had advanced more than fivefold while its earnings and dividends had about doubled. Hence the greater part of the impressive market record for that period was based on a change in investors' and speculators' attitudes rather than in underlying corporate values. To that extent it might well be called a "bootstrap operation."

In discussing the common-stock portfolio of the defensive investor, we have spoken only of leading issues of the type included in the 30 components of the Dow Jones Industrial Average. We have done this for convenience, and not to imply that these 30 issues alone are suitable for purchase by him. Actually, there are many other companies of quality equal to or excelling the average of the Dow Jones list; these would include a host of public utilities (which have a separate Dow Jones average to represent them).* But

* Today, the most widely available alternatives to the Dow Jones Industrial Average are the Standard & Poor's 500-stock index (the "S & P") and the Wilshire 5000 index. The S & P focuses on 500 large, well-known companies that make up roughly 70% of the total value of the U.S. equity market. The Wilshire 5000 follows the returns of nearly every significant, publicly

the major point here is that the defensive investor's overall results are not likely to be decisively different from one diversified or representative list than from another, or—more accurately—that neither he nor his advisers could predict with certainty whatever differences would ultimately develop. It is true that the art of skillful or shrewd investment is supposed to lie particularly in the selection of issues that will give better results than the general market. For reasons to be developed elsewhere we are skeptical of the ability of defensive investors generally to get better than average results—which in fact would mean to beat their own overall performance.* (Our skepticism extends to the management of large funds by experts.)

Let us illustrate our point by an example that at first may seem to prove the opposite. Between December 1960 and December 1970 the DJIA advanced from 616 to 839, or 36%. But in the same period the much larger Standard & Poor's weighted index of 500 stocks rose from 58.11 to 92.15, or 58%. Obviously the second group had proved a better "buy" than the first. But who would have been so rash as to predict in 1960 that what seemed like a miscellaneous assortment of all sorts of common stocks would definitely outperform the aristocratic "thirty tyrants" of the Dow? All this proves, we insist, that only rarely can one make dependable predictions about price changes, absolute or relative.

We shall repeat here without apology—for the warning cannot be given too often—that the investor cannot hope for better than average results by buying new offerings, or "hot" issues of any sort, meaning thereby those recommended for a quick profit.† The contrary is almost certain to be true in the long run. The defensive investor must confine himself to the shares of important companies with a long record of profitable operations and in strong financial condition. (Any security analyst worth his salt could make up such

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traded stock in America, roughly 6,700 in all; but, since the largest companies account for most of the total value of the index, the return of the Wilshire 5000 is usually quite similar to that of the S & P 500. Several low-cost mutual funds enable investors to hold the stocks in these indexes as a single, convenient portfolio. (See Chapter 9.)

* See pp. 363–366 and pp. 376–380.

† For greater detail, see Chapter 6.

a list.) Aggressive investors may buy other types of common stocks, but they should be on a definitely attractive basis as established by intelligent analysis.

To conclude this section, let us mention briefly three supplementary concepts or practices for the defensive investor. The first is the purchase of the shares of well-established investment funds as an alternative to creating his own common-stock portfolio. He might also utilize one of the "common trust funds," or "commingled funds," operated by trust companies and banks in many states; or, if his funds are substantial, use the services of a recognized investment-counsel firm. This will give him professional administration of his investment program along standard lines. The third is the device of "dollar-cost averaging," which means simply that the practitioner invests in common stocks the same number of dollars each month or each quarter. In this way he buys more shares when the market is low than when it is high, and he is likely to end up with a satisfactory overall price for all his holdings. Strictly speaking, this method is an application of a broader approach known as "formula investing." The latter was already alluded to in our suggestion that the investor may vary his holdings of common stocks between the 25% minimum and the 75% maximum, in inverse relationship to the action of the market. These ideas have merit for the defensive investor, and they will be discussed more amply in later chapters.*

Results to Be Expected by the Aggressive Investor

Our enterprising security buyer, of course, will desire and expect to attain better overall results than his defensive or passive companion. But first he must make sure that his results will not be worse. It is no difficult trick to bring a great deal of energy, study, and native ability into Wall Street and to end up with losses instead of profits. These virtues, if channeled in the wrong directions, become indistinguishable from handicaps. Thus it is most essential that the enterprising investor start with a clear conception as to

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* For more advice on "well-established investment funds," see Chapter 9. "Professional administration" by "a recognized investment-counsel firm" is discussed in Chapter 10. "Dollar-cost averaging" is explained in Chapter 5.

which courses of action offer reasonable chances of success and which do not.

First let us consider several ways in which investors and speculators generally have endeavored to obtain better than average results. These include:

1. Trading in the market. This usually means buying stocks when the market has been advancing and selling them after it has turned downward. The stocks selected are likely to be among those which have been "behaving" better than the market average. A small number of professionals frequently engage in short selling. Here they will sell issues they do not own but borrow through the established mechanism of the stock exchanges. Their object is to benefit from a subsequent decline in the price of these issues, by buying them back at a price lower than they sold them for. (As our quotation from the *Wall Street Journal* on p. 19 indicates, even "small investors"—perish the term!—sometimes try their unskilled hand at short selling.)

2. Short-term selectivity. This means buying stocks of companies which are reporting or expected to report increased earnings, or for which some other favorable development is anticipated.

3. Long-term selectivity. Here the usual emphasis is on an excellent record of past growth, which is considered likely to continue in the future. In some cases also the "investor" may choose companies which have not yet shown impressive results, but are expected to establish a high earning power later. (Such companies belong frequently in some technological area—e.g., computers, drugs, electronics—and they often are developing new processes or products that are deemed to be especially promising.)

We have already expressed a negative view about the investor's overall chances of success in these areas of activity. The first we have ruled out, on both theoretical and realistic grounds, from the domain of investment. Stock trading is not an operation "which, on thorough analysis, offers safety of principal and a satisfactory return." More will be said on stock trading in a later chapter.*

* See Chapter 8.

In his endeavor to select the most promising stocks either for the near term or the longer future, the investor faces obstacles of two kinds—the first stemming from human fallibility and the second from the nature of his competition. He may be wrong in his estimate of the future; or even if he is right, the current market price may already fully reflect what he is anticipating. In the area of near-term selectivity, the current year's results of the company are generally common property on Wall Street; next year's results, to the extent they are predictable, are already being carefully considered. Hence the investor who selects issues chiefly on the basis of this year's superior results, or on what he is told he may expect for next year, is likely to find that others have done the same thing for the same reason.

In choosing stocks for their *long-term* prospects, the investor's handicaps are basically the same. The possibility of outright error in the prediction—which we illustrated by our airlines example on p. 6—is no doubt greater than when dealing with near-term earnings. Because the experts frequently go astray in such forecasts, it is theoretically possible for an investor to benefit greatly by making correct predictions when Wall Street as a whole is making incorrect ones. But that is only theoretical. How many enterprising investors could count on having the acumen or prophetic gift to beat the professional analysts at their favorite game of estimating long-term future earnings?

We are thus led to the following logical if disconcerting conclusion: To enjoy a reasonable chance for continued better than average results, the investor must follow policies which are (1) inherently sound and promising, and (2) not popular on Wall Street.

Are there any such policies available for the enterprising investor? In theory once again, the answer should be yes; and there are broad reasons to think that the answer should be affirmative in practice as well. Everyone knows that speculative stock movements are carried too far in both directions, frequently in the general market and at all times in at least some of the individual issues. Furthermore, a common stock may be undervalued because of lack of interest or unjustified popular prejudice. We can go further and assert that in an astonishingly large proportion of the trading in common stocks, those engaged therein don't appear to know—in polite terms—one part of their anatomy from another. In this book we shall point out numerous examples of (past) dis-

crepancies between price and value. Thus it seems that any intelligent person, with a good head for figures, should have a veritable picnic on Wall Street, battening off other people's foolishness. So it seems, but somehow it doesn't work out that simply. Buying a neglected and therefore undervalued issue for profit generally proves a protracted and patience-trying experience. And selling short a too popular and therefore overvalued issue is apt to be a test not only of one's courage and stamina but also of the depth of one's pocketbook.* The principle is sound, its successful application is not impossible, but it is distinctly not an easy art to master.

There is also a fairly wide group of "special situations," which over many years could be counted on to bring a nice annual return of 20% or better, with a minimum of overall risk to those who knew their way around in this field. They include intersecurity arbitrages, payouts or workouts in liquidations, protected hedges of certain kinds. The most typical case is a projected merger or acquisition which offers a substantially higher value for certain shares than their price on the date of the announcement. The number of such deals increased greatly in recent years, and it should have been a highly profitable period for the cognoscenti. But with the multiplication of merger announcements came a multiplication of obstacles to mergers and of deals that didn't go through; quite a few individual losses were thus realized in these once-reliable operations. Perhaps, too, the overall rate of profit was diminished by too much competition.†

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* In "selling short" (or "shorting") a stock, you make a bet that its share price will go down, not up. Shorting is a three-step process: First, you borrow shares from someone who owns them; then you immediately sell the borrowed shares; finally, you replace them with shares you buy later. If the stock drops, you will be able to buy your replacement shares at a lower price. The difference between the price at which you sold your borrowed shares and the price you paid for the replacement shares is your gross profit (reduced by dividend or interest charges, along with brokerage costs). However, if the stock goes up in price instead of down, your potential loss is unlimited—making short sales unacceptably speculative for most individual investors.

† In the late 1980s, as hostile corporate takeovers and leveraged buyouts multiplied, Wall Street set up institutional arbitrage desks to profit from any

The lessened profitability of these special situations appears one manifestation of a kind of self-destructive process—akin to the law of diminishing returns—which has developed during the lifetime of this book. In 1949 we could present a study of stock-market fluctuations over the preceding 75 years, which supported a formula—based on earnings and current interest rates—for determining a level to buy the DJIA below its "central" or "intrinsic" value, and to sell out above such value. It was an application of the governing maxim of the Rothschilds: "Buy cheap and sell dear."* And it had the advantage of running directly counter to the ingrained and pernicious maxim of Wall Street that stocks should be bought because they have gone up and sold because they have gone down. Alas, after 1949 this formula no longer worked. A second illustration is provided by the famous "Dow Theory" of stock-market movements, in a comparison of its indicated splendid results for 1897–1933 and its much more questionable performance since 1934.

A third and final example of the golden opportunities not recently available: A good part of our own operations on Wall Street had been concentrated on the purchase of *bargain issues* easily identified as such by the fact that they were selling at less than their share in the net current assets (working capital) alone, not counting the plant account and other assets, and after deducting all liabilities ahead of the stock. It is clear that these issues were selling at a price well below the value of the enterprise as a private business. No proprietor or majority holder would think of selling what he owned at so ridiculously low a figure. Strangely enough, such

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errors in pricing these complex deals. They became so good at it that the easy profits disappeared and many of these desks have been closed down. Although Graham does discuss it again (see pp. 174–175), this sort of trading is no longer feasible or appropriate for most people, since only multi-million-dollar trades are large enough to generate worthwhile profits. Wealthy individuals and institutions can utilize this strategy through hedge funds that specialize in merger or "event" arbitrage.

* The Rothschild family, led by Nathan Mayer Rothschild, was the dominant power in European investment banking and brokerage in the nineteenth century. For a brilliant history, see Niall Ferguson, *The House of Rothschild: Money's Prophets, 1798–1848* (Viking, 1998).

anomalies were not hard to find. In 1957 a list was published showing nearly 200 issues of this type available in the market. In various ways practically all these bargain issues turned out to be profitable, and the average annual result proved much more remunerative than most other investments. But they too virtually disappeared from the stock market in the next decade, and with them a dependable area for shrewd and successful operation by the enterprising investor. However, at the low prices of 1970 there again appeared a considerable number of such "sub-working-capital" issues, and despite the strong recovery of the market, enough of them remained at the end of the year to make up a full-sized portfolio.

The enterprising investor under today's conditions still has various possibilities of achieving better than average results. The huge list of marketable securities must include a fair number that can be identified as undervalued by logical and reasonably dependable standards. These should yield more satisfactory results on the average than will the DJIA or any similarly representative list. In our view the search for these would not be worth the investor's effort unless he could hope to add, say, 5% before taxes to the average annual return from the stock portion of his portfolio. We shall try to develop one or more such approaches to stock selection for use by the active investor.

COMMENTARY ON CHAPTER 1

> All of human unhappiness comes from one single thing: not knowing how to remain at rest in a room.
>
> *–Blaise Pascal*

Why do you suppose the brokers on the floor of the New York Stock Exchange always cheer at the sound of the closing bell–no matter what the market did that day? Because whenever you trade, *they* make money–whether you did or not. By speculating instead of investing, you lower your own odds of building wealth and raise someone else's.

Graham's definition of investing could not be clearer: "An investment operation is one which, upon thorough analysis, promises safety of principal and an adequate return."[1] Note that investing, according to Graham, consists equally of three elements:

- you must thoroughly analyze a company, and the soundness of its underlying businesses, before you buy its stock;
- you must deliberately protect yourself against serious losses;
- you must aspire to "adequate," not extraordinary, performance.

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[1] Graham goes even further, fleshing out each of the key terms in his definition: "thorough analysis" means "the study of the facts in the light of established standards of safety and value" while "safety of principal" signifies "protection against loss under all normal or reasonably likely conditions or variations" and "adequate" (or "satisfactory") return refers to "any rate or amount of return, however low, which the investor is willing to accept, provided he acts with reasonable intelligence." (*Security Analysis,* 1934 ed., pp. 55–56).

An investor calculates what a stock is worth, based on the value of its businesses. A speculator gambles that a stock will go up in price because somebody else will pay even more for it. As Graham once put it, investors judge "the market price by established standards of value," while speculators "base [their] standards of value upon the market price."[2] For a speculator, the incessant stream of stock quotes is like oxygen; cut it off and he dies. For an investor, what Graham called "quotational" values matter much less. Graham urges you to invest only if you would be comfortable owning a stock even if you had no way of knowing its daily share price.[3]

Like casino gambling or betting on the horses, speculating in the market can be exciting or even rewarding (if you happen to get lucky). But it's the worst imaginable way to build your wealth. That's because Wall Street, like Las Vegas or the racetrack, has calibrated the odds so that the house always prevails, in the end, against everyone who tries to beat the house at its own speculative game.

On the other hand, *investing* is a unique kind of casino—one where you cannot lose in the end, so long as you play only by the rules that put the odds squarely in your favor. People who *invest* make money for themselves; people who *speculate* make money for their brokers. And that, in turn, is why Wall Street perennially downplays the durable virtues of investing and hypes the gaudy appeal of speculation.

UNSAFE AT HIGH SPEED

Confusing speculation with investment, Graham warns, is always a mistake. In the 1990s, that confusion led to mass destruction. Almost everyone, it seems, ran out of patience at once, and America became the Speculation Nation, populated with traders who went shooting from stock to stock like grasshoppers whizzing around in an August hay field.

People began believing that the test of an investment technique was simply whether it "worked." If they beat the market over any

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[2] *Security Analysis,* 1934 ed., p. 310.

[3] As Graham advised in an interview, "Ask yourself: If there was no market for these shares, would I be willing to have an investment in this company on these terms?" (*Forbes,* January 1, 1972, p. 90.)

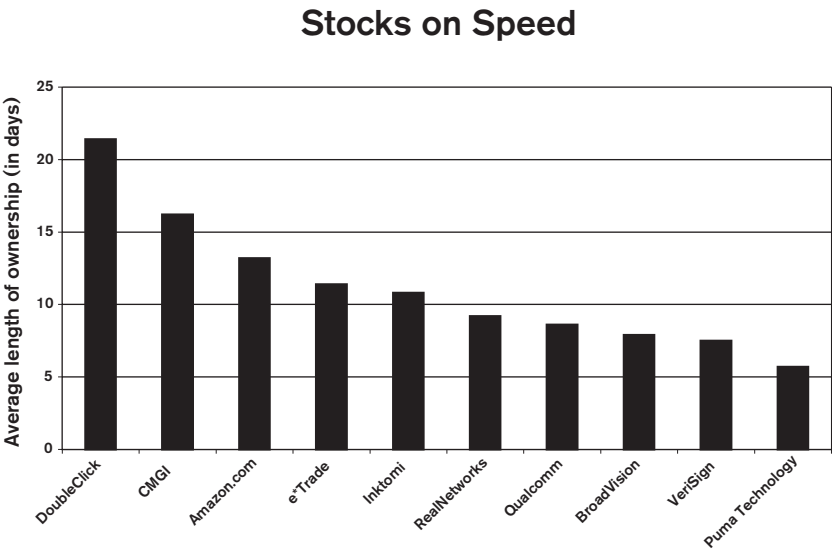
period, no matter how dangerous or dumb their tactics, people boasted that they were "right." But the intelligent investor has no interest in being temporarily right. To reach your long-term financial goals, you must be sustainably and reliably right. The techniques that became so trendy in the 1990s—day trading, ignoring diversification, flipping hot mutual funds, following stock-picking "systems"—seemed to work. But they had no chance of prevailing in the long run, because they failed to meet all three of Graham's criteria for investing.

To see why temporarily high returns don't prove anything, imagine that two places are 130 miles apart. If I observe the 65-mph speed limit, I can drive that distance in two hours. But if I drive 130 mph, I can get there in one hour. If I try this and survive, am I "right"? Should you be tempted to try it, too, because you hear me bragging that it "worked"? Flashy gimmicks for beating the market are much the same: In short streaks, so long as your luck holds out, they work. Over time, they will get you killed.

In 1973, when Graham last revised *The Intelligent Investor,* the annual turnover rate on the New York Stock Exchange was 20%, meaning that the typical shareholder held a stock for five years before selling it. By 2002, the turnover rate had hit 105%—a holding period of only 11.4 months. Back in 1973, the average mutual fund held on to a stock for nearly three years; by 2002, that ownership period had shrunk to just 10.9 months. It's as if mutual-fund managers were studying their stocks just long enough to learn they shouldn't have bought them in the first place, then promptly dumping them and starting all over.

Even the most respected money-management firms got antsy. In early 1995, Jeffrey Vinik, manager of Fidelity Magellan (then the world's largest mutual fund), had 42.5% of its assets in technology stocks. Vinik proclaimed that most of his shareholders "have invested in the fund for goals that are years away. . . . I think their objectives are the same as mine, and that they believe, as I do, that a long-term approach is best." But six months after he wrote those high-minded words, Vinik sold off almost all his technology shares, unloading nearly $19 billion worth in eight frenzied weeks. So much for the "long term"! And by 1999, Fidelity's discount brokerage division was egging on its clients to trade anywhere, anytime, using a Palm handheld computer—which was perfectly in tune with the firm's new slogan, "Every second counts."

FIGURE 1-1



And on the NASDAQ exchange, turnover hit warp speed, as Figure 1-1 shows.[4]

In 1999, shares in Puma Technology, for instance, changed hands an average of once every 5.7 days. Despite NASDAQ's grandiose motto—"The Stock Market for the Next Hundred Years"—many of its customers could barely hold on to a stock for a hundred hours.

THE FINANCIAL VIDEO GAME

Wall Street made online trading sound like an instant way to mint money: Discover Brokerage, the online arm of the venerable firm of

[4] Source: Steve Galbraith, Sanford C. Bernstein & Co. research report, January 10, 2000. The stocks in this table had an average return of 1196.4% in 1999. They lost an average of 79.1% in 2000, 35.5% in 2001, and 44.5% in 2002—destroying all the gains of 1999, and then some.

Morgan Stanley, ran a TV commercial in which a scruffy tow-truck driver picks up a prosperous-looking executive. Spotting a photo of a tropical beachfront posted on the dashboard, the executive asks, "Vacation?" "Actually," replies the driver, "that's my home." Taken aback, the suit says, "Looks like an island." With quiet triumph, the driver answers, "Technically, it's a country."

The propaganda went further. Online trading would take no work and require no thought. A television ad from Ameritrade, the online broker, showed two housewives just back from jogging; one logs on to her computer, clicks the mouse a few times, and exults, "I think I just made about $1,700!" In a TV commercial for the Waterhouse brokerage firm, someone asked basketball coach Phil Jackson, "You know anything about the trade?" His answer: "I'm going to make it right now." (How many games would Jackson's NBA teams have won if he had brought that philosophy to courtside? Somehow, knowing nothing about the other team, but saying, "I'm ready to play them right now," doesn't sound like a championship formula.)

By 1999 at least six million people were trading online—and roughly a tenth of them were "day trading," using the Internet to buy and sell stocks at lightning speed. Everyone from showbiz diva Barbra Streisand to Nicholas Birbas, a 25-year-old former waiter in Queens, New York, was flinging stocks around like live coals. "Before," scoffed Birbas, "I was investing for the long term and I found out that it was not smart." Now, Birbas traded stocks up to 10 times a day and expected to earn $100,000 in a year. "I can't stand to see red in my profit-or-loss column," Streisand shuddered in an interview with *Fortune.* "I'm Taurus the bull, so I react to red. If I see red, I sell my stocks quickly."[5]

By pouring continuous data about stocks into bars and barbershops, kitchens and cafés, taxicabs and truck stops, financial websites and financial TV turned the stock market into a nonstop national video game. The public felt more knowledgeable about the markets than ever before. Unfortunately, while people were drowning in data, knowledge was nowhere to be found. Stocks became entirely decou-

[5] Instead of stargazing, Streisand should have been channeling Graham. The intelligent investor never dumps a stock purely because its share price has fallen; she always asks first whether the value of the company's underlying businesses has changed.

pled from the companies that had issued them—pure abstractions, just blips moving across a TV or computer screen. If the blips were moving up, nothing else mattered.

On December 20, 1999, Juno Online Services unveiled a trailblazing business plan: to lose as much money as possible, on purpose. Juno announced that it would henceforth offer all its retail services for free—no charge for e-mail, no charge for Internet access—and that it would spend millions of dollars more on advertising over the next year. On this declaration of corporate hara-kiri, Juno's stock roared up from $16.375 to $66.75 in two days.[6]

Why bother learning whether a business was profitable, or what goods or services a company produced, or who its management was, or even what the company's name was? All you needed to know about stocks was the catchy code of their ticker symbols: CBLT, INKT, PCLN, TGLO, VRSN, WBVN.[7] That way you could buy them even faster, without the pesky two-second delay of looking them up on an Internet search engine. In late 1998, the stock of a tiny, rarely traded building-maintenance company, Temco Services, nearly tripled in a matter of minutes on record-high volume. Why? In a bizarre form of financial dyslexia, thousands of traders bought Temco after mistaking its ticker symbol, TMCO, for that of Ticketmaster Online (TMCS), an Internet darling whose stock began trading publicly for the first time that day.[8]

Oscar Wilde joked that a cynic "knows the price of everything, and the value of nothing." Under that definition, the stock market is always cynical, but by the late 1990s it would have shocked Oscar himself. A single half-baked opinion on *price* could double a company's stock even as its *value* went entirely unexamined. In late 1998, Henry Blodget, an analyst at CIBC Oppenheimer, warned that "as with all Internet stocks, a valuation is clearly more art than science." Then, citing only the possibility of future growth, he jacked up his "price target" on

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[6] Just 12 months later, Juno's shares had shriveled to $1.093.

[7] A ticker symbol is an abbreviation, usually one to four letters long, of a company's name used as shorthand to identify a stock for trading purposes.

[8] This was not an isolated incident; on at least three other occasions in the late 1990s, day traders sent the wrong stock soaring when they mistook its ticker symbol for that of a newly minted Internet company.

Amazon.com from $150 to $400 in one fell swoop. Amazon.com shot up 19% that day and–despite Blodget's protest that his price target was a one-year forecast–soared past $400 in just three weeks. A year later, PaineWebber analyst Walter Piecyk predicted that Qualcomm stock would hit $1,000 a share over the next 12 months. The stock–already up 1,842% that year–soared another 31% that day, hitting $659 a share.[9]

FROM FORMULA TO FIASCO

But trading as if your underpants are on fire is not the only form of speculation. Throughout the past decade or so, one speculative formula after another was promoted, popularized, and then thrown aside. All of them shared a few traits–This is quick! This is easy! And it won't hurt a bit!–and all of them violated at least one of Graham's distinctions between investing and speculating. Here are a few of the trendy formulas that fell flat:

- **Cash in on the calendar.** The "January effect"–the tendency of small stocks to produce big gains around the turn of the year–was widely promoted in scholarly articles and popular books published in the 1980s. These studies showed that if you piled into small stocks in the second half of December and held them into January, you would beat the market by five to 10 percentage points. That amazed many experts. After all, if it were this easy, surely everyone would hear about it, lots of people would do it, and the opportunity would wither away.

  What caused the January jolt? First of all, many investors sell their crummiest stocks late in the year to lock in losses that can cut their tax bills. Second, professional money managers grow more cautious as the year draws to a close, seeking to preserve their outperformance (or minimize their underperformance). That makes them reluctant to buy (or even hang on to) a falling stock. And if an underperforming stock is also small and obscure, a money manager will be even less eager to show it in his year-end

[9] In 2000 and 2001, Amazon.com and Qualcomm lost a cumulative total of 85.8% and 71.3% of their value, respectively.

list of holdings. All these factors turn small stocks into momentary bargains; when the tax-driven selling ceases in January, they typically bounce back, producing a robust and rapid gain.

The January effect has not withered away, but it has weakened. According to finance professor William Schwert of the University of Rochester, if you had bought small stocks in late December and sold them in early January, you would have beaten the market by 8.5 percentage points from 1962 through 1979, by 4.4 points from 1980 through 1989, and by 5.8 points from 1990 through 2001.[10]

As more people learned about the January effect, more traders bought small stocks in December, making them less of a bargain and thus reducing their returns. Also, the January effect is biggest among the smallest stocks–but according to Plexus Group, the leading authority on brokerage expenses, the total cost of buying and selling such tiny stocks can run up to 8% of your investment.[11] Sadly, by the time you're done paying your broker, all your gains on the January effect will melt away.

- **Just do "what works."** In 1996, an obscure money manager named James O'Shaughnessy published a book called *What Works on Wall Street.* In it, he argued that "investors can do *much better* than the market." O'Shaughnessy made a stunning claim: From 1954 through 1994, you could have turned $10,000 into $8,074,504, beating the market by more than 10-fold–a towering 18.2% average annual return. How? By buying a basket of 50 stocks with the highest one-year returns, five straight years of rising earnings, and share prices less than 1.5 times their corporate revenues.[12] As if he were the Edison of Wall Street, O'Shaughnessy obtained U.S. Patent No. 5,978,778 for his "automated strategies" and launched a group of four mutual funds based on his findings. By late 1999 the funds had sucked in more than $175 million from the public–and, in his annual letter to shareholders, O'Shaughnessy stated grandly: "As always, I hope

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[10] Schwert discusses these findings in a brilliant research paper, "Anomalies and Market Efficiency," available at http://schwert.ssb.rochester.edu/papers.htm.

[11] See Plexus Group Commentary 54, "The Official Icebergs of Transaction Costs," January, 1998, at www.plexusgroup.com/fs_research.html.

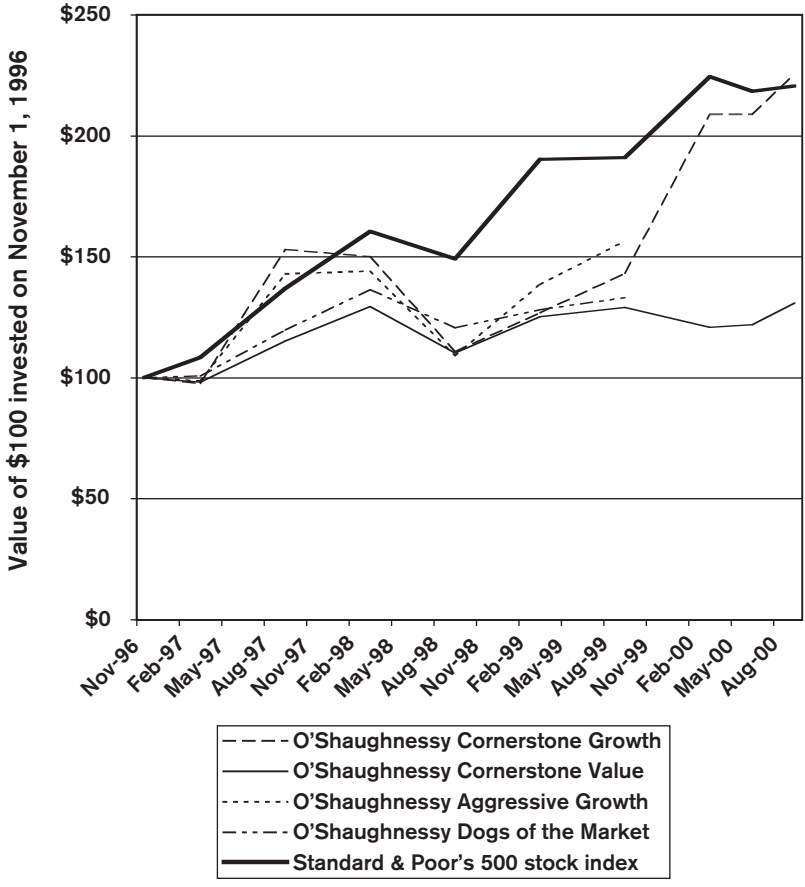
[12] James O'Shaughnessy, *What Works on Wall Street* (McGraw-Hill, 1996), pp. xvi, 273–295.

that together, we can reach our long-term goals by staying the course and sticking with our time-tested investment strategies."

But "what works on Wall Street" stopped working right after O'Shaughnessy publicized it. As Figure 1-2 shows, two of his funds stank so badly that they shut down in early 2000, and the

FIGURE 1-2

What Used to Work on Wall Street . . .



Source: Morningstar, Inc.

overall stock market (as measured by the S & P 500 index) walloped every O'Shaughnessy fund almost nonstop for nearly four years running.

In June 2000, O'Shaughnessy moved closer to his own "long-term goals" by turning the funds over to a new manager, leaving his customers to fend for themselves with those "time-tested investment strategies."[13] O'Shaughnessy's shareholders might have been less upset if he had given his book a more precise title–for instance, *What Used to Work on Wall Street . . . Until I Wrote This Book.*

- **Follow "The Foolish Four."** In the mid-1990s, the Motley Fool website (and several books) hyped the daylights out of a technique called "The Foolish Four." According to the Motley Fool, you would have "trashed the market averages over the last 25 years" and could "crush your mutual funds" by spending "only 15 minutes a year" on planning your investments. Best of all, this technique had "minimal risk." All you needed to do was this:

  1. Take the five stocks in the Dow Jones Industrial Average with the lowest stock prices and highest dividend yields.
  2. Discard the one with the lowest price.
  3. Put 40% of your money in the stock with the second-lowest price.
  4. Put 20% in each of the three remaining stocks.
  5. One year later, sort the Dow the same way and reset the portfolio according to steps 1 through 4.
  6. Repeat until wealthy.

  Over a 25-year period, the Motley Fool claimed, this technique would have beaten the market by a remarkable 10.1 percentage

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[13] In a remarkable irony, the surviving two O'Shaughnessy funds (now known as the Hennessy funds) began performing quite well just as O'Shaughnessy announced that he was turning over the management to another company. The funds' shareholders were furious. In a chat room at www.morningstar.com, one fumed: "I guess 'long term' for O'S is 3 years. . . . I feel your pain. I, too, had faith in O'S's method. . . . I had told several friends and relatives about this fund, and now am glad they didn't act on my advice."

points annually. Over the next two decades, they suggested, $20,000 invested in The Foolish Four should flower into $1,791,000. (And, they claimed, you could do still better by picking the five Dow stocks with the highest ratio of dividend yield to the square root of stock price, dropping the one that scored the highest, and buying the next four.)

Let's consider whether this "strategy" could meet Graham's definitions of an investment:

- What kind of "thorough analysis" could justify discarding the stock with the single most attractive price and dividend–but keeping the four that score lower for those desirable qualities?
- How could putting 40% of your money into only one stock be a "minimal risk"?
- And how could a portfolio of only four stocks be diversified enough to provide "safety of principal"?

The Foolish Four, in short, was one of the most cockamamie stock-picking formulas ever concocted. The Fools made the same mistake as O'Shaughnessy: If you look at a large quantity of data long enough, a huge number of patterns will emerge–if only by chance. By random luck alone, the companies that produce above-average stock returns will have plenty of things in common. But unless those factors *cause* the stocks to outperform, they can't be used to predict future returns.

None of the factors that the Motley Fools "discovered" with such fanfare–dropping the stock with the best score, doubling up on the one with the second-highest score, dividing the dividend yield by the square root of stock price–could possibly cause or explain the future performance of a stock. *Money* Magazine found that a portfolio made up of stocks whose names contained no repeating letters would have performed nearly as well as The Foolish Four–and for the same reason: luck alone.[14] As Graham never stops reminding us, stocks do well or poorly in the future because the businesses behind them do well or poorly–nothing more, and nothing less.

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[14] See Jason Zweig, "False Profits," *Money,* August, 1999, pp. 55–57. A thorough discussion of The Foolish Four can also be found at www.investorhome.com/fool.htm.

> Sure enough, instead of crushing the market, The Foolish Four crushed the thousands of people who were fooled into believing that it was a form of investing. In 2000 alone, the four Foolish stocks—Caterpillar, Eastman Kodak, SBC, and General Motors—lost 14% while the Dow dropped by just 4.7%.

As these examples show, there's only one thing that never suffers a bear market on Wall Street: dopey ideas. Each of these so-called investing approaches fell prey to Graham's Law. All mechanical formulas for earning higher stock performance are "a kind of self-destructive process—akin to the law of diminishing returns." There are two reasons the returns fade away. If the formula was just based on random statistical flukes (like The Foolish Four), the mere passage of time will expose that it made no sense in the first place. On the other hand, if the formula actually did work in the past (like the January effect), then by publicizing it, market pundits always erode—and usually eliminate—its ability to do so in the future.

All this reinforces Graham's warning that you must treat speculation as veteran gamblers treat their trips to the casino:

- You must never delude yourself into thinking that you're investing when you're speculating.
- Speculating becomes mortally dangerous the moment you begin to take it seriously.
- You must put strict limits on the amount you are willing to wager.

Just as sensible gamblers take, say, $100 down to the casino floor and leave the rest of their money locked in the safe in their hotel room, the intelligent investor designates a tiny portion of her total portfolio as a "mad money" account. For most of us, 10% of our overall wealth is the maximum permissible amount to put at speculative risk. *Never* mingle the money in your speculative account with what's in your investment accounts; *never* allow your speculative thinking to spill over into your investing activities; and *never* put more than 10% of your assets into your mad money account, no matter what happens.

For better or worse, the gambling instinct is part of human nature—so it's futile for most people even to try suppressing it. But you must confine and restrain it. That's the single best way to make sure you will never fool yourself into confusing speculation with investment.

CHAPTER 2

The Investor and Inflation

Inflation, and the fight against it, has been very much in the public's mind in recent years. The shrinkage in the purchasing power of the dollar in the past, and particularly the fear (or hope by speculators) of a serious further decline in the future, has greatly influenced the thinking of Wall Street. It is clear that those with a fixed dollar income will suffer when the cost of living advances, and the same applies to a fixed amount of dollar principal. Holders of stocks, on the other hand, have the possibility that a loss of the dollar's purchasing power may be offset by advances in their dividends and the prices of their shares.

On the basis of these undeniable facts many financial authorities have concluded that (1) bonds are an inherently undesirable form of investment, and (2) consequently, common stocks are by their very nature more desirable investments than bonds. We have heard of charitable institutions being advised that their portfolios should consist 100% of stocks and zero percent of bonds.* This is quite a reversal from the earlier days when trust investments were

* By the late 1990s, this advice—which can be appropriate for a foundation or endowment with an infinitely long investment horizon—had spread to individual investors, whose life spans are finite. In the 1994 edition of his influential book, *Stocks for the Long Run*, finance professor Jeremy Siegel of the Wharton School recommended that "risk-taking" investors should buy on margin, borrowing more than a third of their net worth to sink 135% of their assets into stocks. Even government officials got in on the act: In February 1999, the Honorable Richard Dixon, state treasurer of Maryland, told the audience at an investment conference: "It doesn't make any sense for anyone to have any money in a bond fund."

restricted by law to high-grade bonds (and a few choice preferred stocks).

Our readers must have enough intelligence to recognize that even high-quality stocks cannot be a better purchase than bonds *under all conditions*—i.e., regardless of how high the stock market may be and how low the current dividend return compared with the rates available on bonds. A statement of this kind would be as absurd as was the contrary one—too often heard years ago—that any bond is safer than any stock. In this chapter we shall try to apply various measurements to the inflation factor, in order to reach some conclusions as to the extent to which the investor may wisely be influenced by expectations regarding future rises in the price level.

In this matter, as in so many others in finance, we must base our views of future policy on a knowledge of past experience. Is inflation something new for this country, at least in the serious form it has taken since 1965? If we have seen comparable (or worse) inflations in living experience, what lessons can be learned from them in confronting the inflation of today? Let us start with Table 2-1, a condensed historical tabulation that contains much information about changes in the general price level and concomitant changes in the earnings and market value of common stocks. Our figures will begin with 1915, and thus cover 55 years, presented at five-year intervals. (We use 1946 instead of 1945 to avoid the last year of wartime price controls.)

The first thing we notice is that we have had inflation in the past—lots of it. The largest five-year dose was between 1915 and 1920, when the cost of living nearly doubled. This compares with the advance of 15% between 1965 and 1970. In between, we have had three periods of declining prices and then six of advances at varying rates, some rather small. On this showing, the investor should clearly allow for the probability of continuing or recurrent inflation to come.

Can we tell what the rate of inflation is likely to be? No clear answer is suggested by our table; it shows variations of all sorts. It would seem sensible, however, to take our cue from the rather consistent record of the past 20 years. The average annual rise in the consumer price level for this period has been 2.5%; that for 1965–1970 was 4.5%; that for 1970 alone was 5.4%. Official govern-

TABLE 2-1 The General Price Level, Stock Earnings, and Stock Prices at Five-Year Intervals, 1915–1970

	Price Level[a]		*S & P 500-Stock Index*[b]		*Percent Change from Previous Level*			
Year	Wholesale	Consumer	Earnings	Price	Wholesale Prices	Consumer Prices	Stock Earnings	Stock Prices
1915	38.0	35.4		8.31				
1920	84.5	69.8		7.98	+96.0%	+96.8%		– 4.0%
1925	56.6	61.1	1.24	11.15	–33.4	–12.4		+ 41.5
1930	47.3	58.2	.97	21.63	–16.5	– 4.7	– 21.9%	+ 88.0
1935	43.8	47.8	.76	15.47	– 7.4	–18.0	– 21.6	– 26.0
1940	43.0	48.8	1.05	11.02	– 0.2	+ 2.1	+ 33.1	– 28.8
1946[c]	66.1	68.0	1.06	17.08	+53.7	+40.0	+ 1.0	+ 55.0
1950	86.8	83.8	2.84	18.40	+31.5	+23.1	+168.0	+ 21.4
1955	97.2	93.3	3.62	40.49	+ 6.2	+11.4	+ 27.4	+121.0
1960	100.7	103.1	3.27	55.85	+ 9.2	+10.5	– 9.7	+ 38.0
1965	102.5	109.9	5.19	88.17	+ 1.8	+ 6.6	+ 58.8	+ 57.0
1970	117.5	134.0	5.36	92.15	+14.6	+21.9	+ 3.3	+ 4.4

[a] Annual averages. For price level 1957 = 100 in table; but using new base, 1967 = 100, the average for 1970 is 116.3 for consumers' prices and 110.4 for wholesale prices for the stock index.

[b] 1941–1943 average = 10.

[c] 1946 used, to avoid price controls.

ment policy has been strongly against large-scale inflation, and there are some reasons to believe that Federal policies will be more effective in the future than in recent years.* We think it would be reasonable for an investor at this point to base his thinking and decisions on a *probable* (far from certain) rate of future inflation of, say, 3% per annum. (This would compare with an annual rate of about 2½% for the entire period 1915–1970.)[1]

What would be the implications of such an advance? It would eat up, in higher living costs, about one-half the income now obtainable on good medium-term tax-free bonds (or our assumed after-tax equivalent from high-grade corporate bonds). This would be a serious shrinkage, but it should not be exaggerated. It would not mean that the true value, or the purchasing power, of the investor's fortune need be reduced over the years. If he spent half his interest income after taxes he would maintain this buying power intact, even against a 3% annual inflation.

But the next question, naturally, is, "Can the investor be reasonably sure of doing better by buying and holding other things than high-grade bonds, even at the unprecedented rate of return offered in 1970–1971?" Would not, for example, an all-stock program be preferable to a part-bond, part-stock program? Do not common stocks have a built-in protection against inflation, and are they not almost certain to give a better return over the years than will bonds? Have not in fact stocks treated the investor far better than have bonds over the 55-year period of our study?

The answer to these questions is somewhat complicated. Common stocks have indeed done better than bonds over a long period of time in the past. The rise of the DJIA from an average of 77 in 1915 to an average of 753 in 1970 works out at an annual compounded rate of just about 4%, to which we may add another 4% for average dividend return. (The corresponding figures for the S & P composite are about the same.) These combined figures of 8%

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* This is one of Graham's rare misjudgments. In 1973, just two years after President Richard Nixon imposed wage and price controls, inflation hit 8.7%, its highest level since the end of World War II. The decade from 1973 through 1982 was the most inflationary in modern American history, as the cost of living more than doubled.

per year are of course much better than the return enjoyed from bonds over the same 55-year period. But they do not exceed that *now* offered by high-grade bonds. This brings us to the next logical question: Is there a persuasive reason to believe that common stocks are likely to do much better in future years than they have in the last five and one-half decades?

Our answer to this crucial question must be a flat *no.* Common stocks *may* do better in the future than in the past, but they are far from certain to do so. We must deal here with two different time elements in investment results. The first covers what is likely to occur over the long-term future—say, the next 25 years. The second applies to what is likely to happen to the investor—both financially and psychologically—over short or intermediate periods, say five years or less. His frame of mind, his hopes and apprehensions, his satisfaction or discontent with what he has done, above all his decisions what to do next, are all determined not in the retrospect of a lifetime of investment but rather by his experience from year to year.

On this point we can be categorical. There is no close time connection between inflationary (or deflationary) conditions and the movement of common-stock earnings and prices. The obvious example is the recent period, 1966–1970. The rise in the cost of living was 22%, the largest in a five-year period since 1946–1950. But both stock earnings and stock prices as a whole have declined since 1965. There are similar contradictions in both directions in the record of previous five-year periods.

Inflation and Corporate Earnings

Another and highly important approach to the subject is by a study of the earnings rate on capital shown by American business. This has fluctuated, of course, with the general rate of economic activity, but it has shown no general tendency to advance with wholesale prices or the cost of living. Actually this rate has fallen rather markedly in the past twenty years in spite of the inflation of the period. (To some degree the decline was due to the charging of more liberal depreciation rates. See Table 2-2.) Our extended studies have led to the conclusion that the investor cannot count on much above the recent five-year rate earned on the DJIA group—

about 10% on net tangible assets (book value) behind the shares.[2] Since the market value of these issues is well above their book value—say, 900 market vs. 560 book in mid-1971—the earnings on current market price work out only at some 6¼%. (This relationship is generally expressed in the reverse, or "times earnings," manner—e.g., that the DJIA price of 900 equals 18 times the actual earnings for the 12 months ended June 1971.)

Our figures gear in directly with the suggestion in the previous chapter* that the investor may assume an average dividend return of about 3.5% on the market value of his stocks, plus an appreciation of, say, 4% annually resulting from reinvested profits. (Note that each dollar added to book value is here assumed to increase the market price by about $1.60.)

The reader will object that in the end our calculations make no allowance for an increase in common-stock earnings and values to result from our projected 3% annual inflation. Our justification is the absence of any sign that the inflation of a comparable amount in the past has had any *direct* effect on reported per-share earnings. The cold figures demonstrate that *all* the large gain in the earnings of the DJIA unit in the past 20 years was due to a proportionately large growth of invested capital coming from reinvested profits. If inflation had operated as a separate favorable factor, its effect would have been to increase the "value" of previously existing capital; this in turn should increase the rate of earnings on such old capital and therefore on the old and new capital combined. But nothing of the kind actually happened in the past 20 years, during which the wholesale price level has advanced nearly 40%. (Business earnings should be influenced more by wholesale prices than by "consumer prices.") The only way that inflation can add to common stock values is by raising the rate of earnings on capital investment. On the basis of the past record this has not been the case.

In the economic cycles of the past, good business was accompanied by a rising price level and poor business by falling prices. It was generally felt that "a little inflation" was helpful to business profits. This view is not contradicted by the history of 1950–1970,

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* See p. 25.

which reveals a combination of generally continued prosperity and generally rising prices. But the figures indicate that the effect of all this on the *earning power* of common-stock capital ("equity capital") has been quite limited; in fact it has not even served to maintain the rate of earnings on the investment. Clearly there have been important offsetting influences which have prevented any increase in the real profitability of American corporations as a whole. Perhaps the most important of these have been (1) a rise in wage rates exceeding the gains in productivity, and (2) the need for huge amounts of new capital, thus holding down the ratio of sales to capital employed.

Our figures in Table 2-2 indicate that so far from inflation having benefited our corporations and their shareholders, its effect has been quite the opposite. The most striking figures in our table are those for the growth of corporate debt between 1950 and 1969. It is surprising how little attention has been paid by economists and by Wall Street to this development. The debt of corporations has expanded nearly fivefold while their profits before taxes a little more than doubled. With the great rise in interest rates during this period, it is evident that the aggregate corporate debt is now an

TABLE 2-2 Corporate Debt, Profits, and Earnings on Capital, 1950–1969

		Corporate Profits			
	Net Corporate	Before	After	*Percent Earned on Capital*	
	Debt	Income Tax	Tax	S & P	Other
Year	*(billions)*	(millions)	(millions)	Data[a]	Data[b]
1950	$140.2	$42.6	$17 8	18.3%	15.0%
1955	212.1	48.6	27.0	18.3	12.9
1960	302.8	49.7	26.7	10.4	9.1
1965	453.3	77.8	46.5	10.8	11.8
1969	692.9	91.2	48.5	11.8	11.3

[a] Earnings of Standard & Poor's industrial index divided by average book value for year.

[b] Figures for 1950 and 1955 from Cottle and Whitman; those for 1960–1969 from *Fortune.*

adverse economic factor of some magnitude and a real problem for many individual enterprises. (Note that in 1950 net earnings after interest but before income tax were about 30% of corporate debt, while in 1969 they were only 13.2% of debt. The 1970 ratio must have been even less satisfactory.) In sum it appears that a significant part of the 11% being earned on corporate equities as a whole is accomplished by the use of a large amount of new debt costing 4% or less after tax credit. If our corporations had maintained the debt ratio of 1950, their earnings rate on stock capital would have fallen still lower, in spite of the inflation.

The stock market has considered that the public-utility enterprises have been a chief victim of inflation, being caught between a great advance in the cost of borrowed money and the difficulty of raising the rates charged under the regulatory process. But this may be the place to remark that the very fact that the unit costs of electricity, gas, and telephone services have advanced so much less than the general price index puts these companies in a strong strategic position for the future.[3] They are entitled by law to charge rates sufficient for an adequate return on their invested capital, and this will probably protect their shareholders in the future as it has in the inflations of the past.

All of the above brings us back to our conclusion that the investor has no sound basis for expecting more than an average overall return of, say, 8% on a portfolio of DJIA-type common stocks purchased at the late 1971 price level. But even if these expectations should prove to be understated by a substantial amount, the case would not be made for an all-stock investment program. If there is one thing guaranteed for the future, it is that the earnings and average annual market value of a stock portfolio will *not* grow at the uniform rate of 4%, or any other figure. In the memorable words of the elder J. P. Morgan, "*They will fluctuate.*"* This means, first, that the common-stock buyer at today's prices—

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* John Pierpont Morgan was the most powerful financier of the late nineteenth and early twentieth centuries. Because of his vast influence, he was constantly asked what the stock market would do next. Morgan developed a mercifully short and unfailingly accurate answer: "It will fluctuate." See Jean Strouse, *Morgan: American Financier* (Random House, 1999), p. 11.

or tomorrow's—will be running a real risk of having unsatisfactory results therefrom over a period of years. It took 25 years for General Electric (and the DJIA itself) to recover the ground lost in the 1929–1932 debacle. Besides that, if the investor concentrates his portfolio on common stocks he is very likely to be led astray either by exhilarating advances or by distressing declines. This is particularly true if his reasoning is geared closely to expectations of further inflation. For then, if another bull market comes along, he will take the big rise not as a danger signal of an inevitable fall, not as a chance to cash in on his handsome profits, but rather as a vindication of the inflation hypothesis and as a reason to keep on buying common stocks no matter how high the market level nor how low the dividend return. That way lies sorrow.

Alternatives to Common Stocks as Inflation Hedges

The standard policy of people all over the world who mistrust their currency has been to buy and hold gold. This has been against the law for American citizens since 1935—luckily for them. In the past 35 years the price of gold in the open market has advanced from $35 per ounce to $48 in early 1972—a rise of only 35%. But during all this time the holder of gold has received no income return on his capital, and instead has incurred some annual expense for storage. Obviously, he would have done much better with his money at interest in a savings bank, in spite of the rise in the general price level.

The near-complete failure of gold to protect against a loss in the purchasing power of the dollar must cast grave doubt on the ability of the ordinary investor to protect himself against inflation by putting his money in "things."* Quite a few categories of valuable

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* The investment philosopher Peter L. Bernstein feels that Graham was "dead wrong" about precious metals, particularly gold, which (at least in the years after Graham wrote this chapter) has shown a robust ability to outpace inflation. Financial adviser William Bernstein agrees, pointing out that a tiny allocation to a precious-metals fund (say, 2% of your total assets) is too small to hurt your overall returns when gold does poorly. But, when gold does well, its returns are often so spectacular—sometimes exceeding 100%

objects have had striking advances in market value over the years—such as diamonds, paintings by masters, first editions of books, rare stamps and coins, etc. But in many, perhaps most, of these cases there seems to be an element of the artificial or the precarious or even the unreal about the quoted prices. Somehow it is hard to think of paying $67,500 for a U.S. silver dollar dated 1804 (but not even minted that year) as an "investment operation."[4] We acknowledge we are out of our depth in this area. Very few of our readers will find the swimming safe and easy there.

The outright ownership of real estate has long been considered as a sound long-term investment, carrying with it a goodly amount of protection against inflation. Unfortunately, real-estate values are also subject to wide fluctuations; serious errors can be made in location, price paid, etc.; there are pitfalls in salesmen's wiles. Finally, diversification is not practical for the investor of moderate means, except by various types of participations with others and with the special hazards that attach to new flotations—not too different from common-stock ownership. This too is not our field. All we should say to the investor is, "Be sure it's yours before you go into it."

Conclusion

Naturally, we return to the policy recommended in our previous chapter. Just because of the uncertainties of the future the investor cannot afford to put all his funds into one basket—neither in the bond basket, despite the unprecedentedly high returns that bonds have recently offered; nor in the stock basket, despite the prospect of continuing inflation.

The more the investor depends on his portfolio and the income therefrom, the more necessary it is for him to guard against the

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in a year—that it can, all by itself, set an otherwise lackluster portfolio glittering. However, the intelligent investor avoids investing in gold directly, with its high storage and insurance costs; instead, seek out a well-diversified mutual fund specializing in the stocks of precious-metal companies and charging below 1% in annual expenses. Limit your stake to 2% of your total financial assets (or perhaps 5% if you are over the age of 65).

unexpected and the disconcerting in this part of his life. It is axiomatic that the conservative investor should seek to minimize his risks. We think strongly that the risks involved in buying, say, a telephone-company bond at yields of nearly 7½% are much less than those involved in buying the DJIA at 900 (or any stock list equivalent thereto). But the possibility of *large-scale* inflation remains, and the investor must carry some insurance against it. There is no certainty that a stock component will insure adequately against such inflation, but it should carry more protection than the bond component.

This is what we said on the subject in our 1965 edition (p. 97), and we would write the same today:

> It must be evident to the reader that we have no enthusiasm for common stocks at these levels (892 for the DJIA). For reasons already given we feel that the defensive investor cannot afford to be without an appreciable proportion of common stocks in his portfolio, even if we regard them as the lesser of two evils—the greater being the risks in an all-bond holding.

COMMENTARY ON CHAPTER 2

> Americans are getting stronger. Twenty years ago, it took two people to carry ten dollars' worth of groceries. Today, a five-year-old can do it.
>
> *–Henny Youngman*

Inflation? Who cares about *that*?

After all, the annual rise in the cost of goods and services averaged less than 2.2% between 1997 and 2002–and economists believe that even that rock-bottom rate may be overstated.[1] (Think, for instance, of how the prices of computers and home electronics have plummeted–and how the quality of many goods has risen, meaning that consumers are getting better value for their money.) In recent years, the true rate of inflation in the United States has probably run around 1% annually–an increase so infinitesimal that many pundits have proclaimed that "inflation is dead."[2]

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[1] The U.S. Bureau of Labor Statistics, which calculates the Consumer Price Index that measures inflation, maintains a comprehensive and helpful website at www.bls.gov/cpi/home.htm.

[2] For a lively discussion of the "inflation is dead" scenario, see www.pbs.org/newshour/bb/economy/july-dec97/inflation_12-16.html. In 1996, the Boskin Commission, a group of economists asked by the government to investigate whether the official rate of inflation is accurate, estimated that it has been overstated, often by nearly two percentage points per year. For the commission's report, see www.ssa.gov/history/reports/boskinrpt.html. Many investment experts now feel that deflation, or falling prices, is an even greater threat than inflation; the best way to hedge against that risk is by including bonds as a permanent component of your portfolio. (See the commentary on Chapter 4.)

THE MONEY ILLUSION

There's another reason investors overlook the importance of inflation: what psychologists call the "money illusion." If you receive a 2% raise in a year when inflation runs at 4%, you will almost certainly feel better than you will if you take a 2% pay cut during a year when inflation is zero. Yet both changes in your salary leave you in a virtually identical position–2% worse off after inflation. So long as the *nominal* (or absolute) change is positive, we view it as a good thing–even if the *real* (or after-inflation) result is negative. And any change in your own salary is more vivid and specific than the generalized change of prices in the economy as a whole.[3] Likewise, investors were delighted to earn 11% on bank certificates of deposit (CDs) in 1980 and are bitterly disappointed to be earning only around 2% in 2003–even though they were losing money after inflation back then but are keeping up with inflation now. The nominal rate we earn is printed in the bank's ads and posted in its window, where a high number makes us feel good. But inflation eats away at that high number in secret. Instead of taking out ads, inflation just takes away our wealth. That's why inflation is so easy to overlook–and why it's so important to measure your investing success not just by what you make, but by how much you keep after inflation.

More basically still, the intelligent investor must always be on guard against whatever is unexpected and underestimated. There are three good reasons to believe that inflation is not dead:

- As recently as 1973–1982, the United States went through one of the most painful bursts of inflation in our history. As measured by the Consumer Price Index, prices more than doubled over that period, rising at an annualized rate of nearly 9%. In 1979 alone, inflation raged at 13.3%, paralyzing the economy in what became known as "stagflation"–and leading many commentators to question whether America could compete in the global market-

[3] For more insights into this behavioral pitfall, see Eldar Shafir, Peter Diamond, and Amos Tversky, "Money Illusion," in Daniel Kahneman and Amos Tversky, eds., *Choices, Values, and Frames* (Cambridge University Press, 2000), pp. 335–355.

place.[4] Goods and services priced at $100 in the beginning of 1973 cost $230 by the end of 1982, shriveling the value of a dollar to less than 45 cents. No one who lived through it would scoff at such destruction of wealth; no one who is prudent can fail to protect against the risk that it might recur.

- Since 1960, 69% of the world's market-oriented countries have suffered at least one year in which inflation ran at an annualized rate of 25% or more. On average, those inflationary periods destroyed 53% of an investor's purchasing power.[5] We would be crazy not to hope that America is somehow exempt from such a disaster. But we would be even crazier to conclude that it can never happen here.[6]
- Rising prices allow Uncle Sam to pay off his debts with dollars that have been cheapened by inflation. Completely eradicating inflation runs against the economic self-interest of any government that regularly borrows money.[7]

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[4] That year, President Jimmy Carter gave his famous "malaise" speech, in which he warned of "a crisis in confidence" that "strikes at the very heart and soul and spirit of our national will" and "threatens to destroy the social and the political fabric of America."

[5] See Stanley Fischer, Ratna Sahay, and Carlos A. Vegh, "Modern Hyper- and High Inflations," National Bureau of Economic Research, Working Paper 8930, at www.nber.org/papers/w8930.

[6] In fact, the United States has had two periods of hyperinflation. During the American Revolution, prices roughly tripled every year from 1777 through 1779, with a pound of butter costing $12 and a barrel of flour fetching nearly $1,600 in Revolutionary Massachusetts. During the Civil War, inflation raged at annual rates of 29% (in the North) and nearly 200% (in the Confederacy). As recently as 1946, inflation hit 18.1% in the United States.

[7] I am indebted to Laurence Siegel of the Ford Foundation for this cynical, but accurate, insight. Conversely, in a time of deflation (or steadily falling prices) it's more advantageous to be a lender than a borrower—which is why most investors should keep at least a small portion of their assets in bonds, as a form of insurance against deflating prices.

HALF A HEDGE

What, then, can the intelligent investor do to guard against inflation? The standard answer is "buy stocks"—but, as common answers so often are, it is not entirely true.

Figure 2-1 shows, for each year from 1926 through 2002, the relationship between inflation and stock prices.

As you can see, in years when the prices of consumer goods and services fell, as on the left side of the graph, stock returns were terrible—with the market losing up to 43% of its value.[8] When inflation shot above 6%, as in the years on the right end of the graph, stocks also stank. The stock market lost money in eight of the 14 years in which inflation exceeded 6%; the average return for those 14 years was a measly 2.6%.

While mild inflation allows companies to pass the increased costs of their own raw materials on to customers, high inflation wreaks havoc—forcing customers to slash their purchases and depressing activity throughout the economy.

The historical evidence is clear: Since the advent of accurate stock-market data in 1926, there have been 64 five-year periods (i.e., 1926–1930, 1927–1931, 1928–1932, and so on through 1998–2002). In 50 of those 64 five-year periods (or 78% of the time), stocks outpaced inflation.[9] That's impressive, but imperfect; it means that stocks failed to keep up with inflation about one-fifth of the time.

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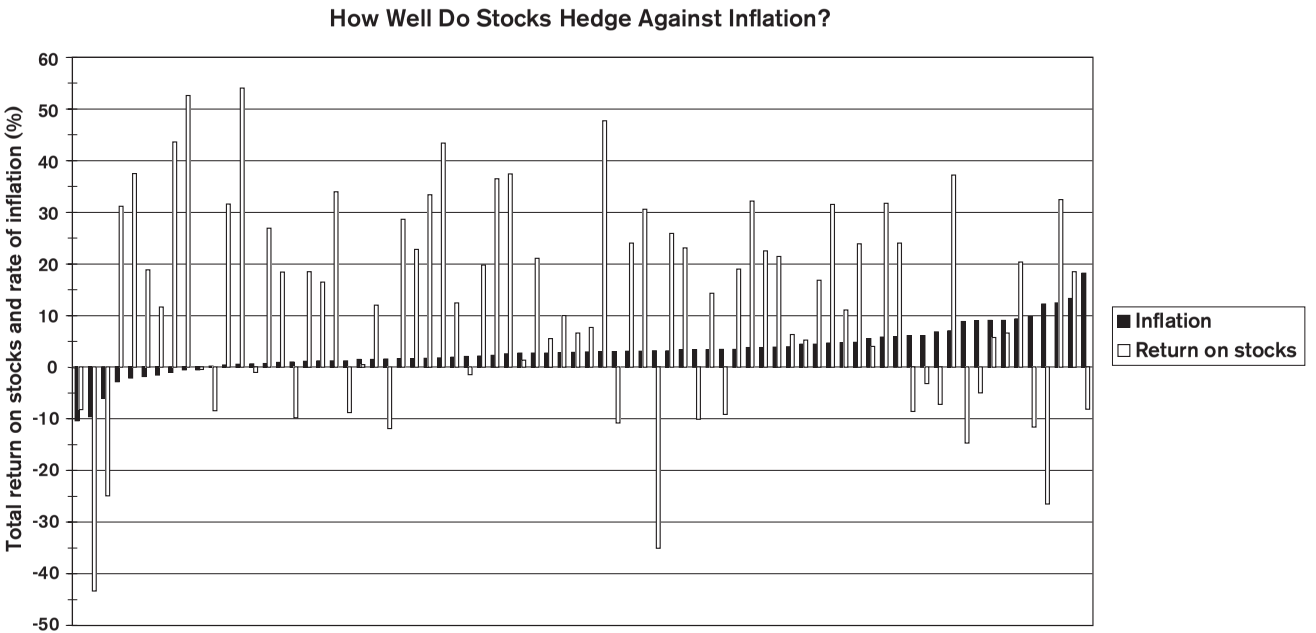
[8] When inflation is negative, it is technically termed "deflation." Regularly falling prices may at first sound appealing, until you think of the Japanese example. Prices have been deflating in Japan since 1989, with real estate and the stock market dropping in value year after year—a relentless water torture for the world's second-largest economy.

[9] Ibbotson Associates, *Stocks, Bonds, Bills, and Inflation, 2003 Handbook* (Ibbotson Associates, Chicago, 2003), Table 2-8. The same pattern is evident outside the United States: In Belgium, Italy, and Germany, where inflation was especially high in the twentieth century, "inflation appears to have had a negative impact on both stock and bond markets," note Elroy Dimson, Paul Marsh, and Mike Staunton in *Triumph of the Optimists: 101 Years of Global Investment Returns* (Princeton University Press, 2002), p. 53.

FIGURE 2-1



This graph shows inflation and stock returns for each year between 1926 and 2002—arrayed not in chronological order but from the lowest annual inflation rates to the highest. When inflation is highly negative (see far left), stocks do very poorly. When inflation is moderate, as it was in most years during this period, stocks generally do well. But when inflation heats up to very high levels (see far right), stocks perform erratically, often losing at least 10%.

Source: Ibbotson Associates

TWO ACRONYMS TO THE RESCUE

Fortunately, you can bolster your defenses against inflation by branching out beyond stocks. Since Graham last wrote, two inflation-fighters have become widely available to investors:

REITs. Real Estate Investment Trusts, or REITs (pronounced "reets"), are companies that own and collect rent from commercial and residential properties.[10] Bundled into real-estate mutual funds, REITs do a decent job of combating inflation. The best choice is Vanguard REIT Index Fund; other relatively low-cost choices include Cohen & Steers Realty Shares, Columbia Real Estate Equity Fund, and Fidelity Real Estate Investment Fund.[11] While a REIT fund is unlikely to be a foolproof inflation-fighter, in the long run it should give you some defense against the erosion of purchasing power without hampering your overall returns.

TIPS. Treasury Inflation-Protected Securities, or TIPS, are U.S. government bonds, first issued in 1997, that automatically go up in value when inflation rises. Because the full faith and credit of the United States stands behind them, all Treasury bonds are safe from the risk of default (or nonpayment of interest). But TIPS also guarantee that the value of your investment won't be eroded by inflation. In one easy package, you insure yourself against financial loss and the loss of purchasing power.[12]

There is one catch, however. When the value of your TIPS bond rises as inflation heats up, the Internal Revenue Service regards that increase in value as taxable income—even though it is purely a paper

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[10] Thorough, if sometimes outdated, information on REITs can be found at www.nareit.com.

[11] For further information, see www.vanguard.com, www.cohenandsteers.com, www.columbiafunds.com, and www.fidelity.com. The case for investing in a REIT fund is weaker if you own a home, since that gives you an inherent stake in real-estate ownership.

[12] A good introduction to TIPS can be found at www.publicdebt.treas.gov/of/ofinflin.htm. For more advanced discussions, see www.federalreserve.gov/Pubs/feds/2002/200232/200232pap.pdf, www.tiaa-crefinstitute.org/Publications/resdiags/73_09-2002.htm, and www.bwater.com/research_ibonds.htm.

gain (unless you sold the bond at its newly higher price). Why does this make sense to the IRS? The intelligent investor will remember the wise words of financial analyst Mark Schweber: "The one question never to ask a bureaucrat is 'Why?' " Because of this exasperating tax complication, TIPS are best suited for a tax-deferred retirement account like an IRA, Keogh, or 401(k), where they will not jack up your taxable income.

You can buy TIPS directly from the U.S. government at www.publicdebt.treas.gov/of/ofinflin.htm, or in a low-cost mutual fund like Vanguard Inflation-Protected Securities or Fidelity Inflation-Protected Bond Fund.[13] Either directly or through a fund, TIPS are the ideal substitute for the proportion of your retirement funds you would otherwise keep in cash. Do not trade them: TIPS can be volatile in the short run, so they work best as a permanent, lifelong holding. For most investors, allocating at least 10% of your retirement assets to TIPS is an intelligent way to keep a portion of your money absolutely safe—and entirely beyond the reach of the long, invisible claws of inflation.

[13] For details on these funds, see www.vanguard.com or www.fidelity.com.

CHAPTER 3

A Century of Stock-Market History: The Level of Stock Prices in Early 1972

The investor's portfolio of common stocks will represent a small cross-section of that immense and formidable institution known as the stock market. Prudence suggests that he have an adequate idea of stock-market history, in terms particularly of the major fluctuations in its price level and of the varying relationships between stock prices as a whole and their earnings and dividends. With this background he may be in a position to form some worthwhile judgment of the attractiveness or dangers of the level of the market as it presents itself at different times. By a coincidence, useful statistical data on prices, earnings, and dividends go back just 100 years, to 1871. (The material is not nearly as full or dependable in the first half-period as in the second, but it will serve.) In this chapter we shall present the figures, in highly condensed form, with two objects in view. The first is to show the general manner in which stocks have made their underlying advance through the many cycles of the past century. The second is to view the picture in terms of successive ten-year averages, not only of stock prices but of earnings and dividends as well, to bring out the varying relationship between the three important factors. With this wealth of material as a background we shall pass to a consideration of the level of stock prices at the beginning of 1972.

The long-term history of the stock market is summarized in two tables and a chart. Table 3-1 sets forth the low and high points of nineteen bear- and bull-market cycles in the past 100 years. We have used two indexes here. The first represents a combination of an early study by the Cowles Commission going back to 1870, which has been spliced on to and continued to date in the well-

TABLE 3-1 Major Stock-Market Swings Between 1871 and 1971

	Cowles-Standard 500 Composite			*Dow-Jones Industrial Average*		
Year	High	Low	Decline	High	Low	Decline
1871		4.64				
1881	6.58					
1885		4.24	28%			
1887	5.90					
1893		4.08	31			
1897					38.85	
1899				77.6		
1900					53.5	31%
1901	8.50			78.3		
1903		6.26	26		43.2	45
1906	10.03			103		
1907		6.25	38		53	48
1909	10.30			100.5		
1914		7.35	29		53.2	47
1916–18	10.21			110.2		
1917		6.80	33		73.4	33
1919	9.51			119.6		
1921		6.45	32		63.9	47
1929	31.92			381		
1932		4.40	86		41.2	89
1937	18.68			197.4		
1938		8.50	55		99	50
1939	13.23			158		
1942		7.47	44		92.9	41
1946	19.25			212.5		
1949		13.55	30		161.2	24
1952	26.6			292		
1952–53		22.7	15		256	13
1956	49.7			521		
1957		39.0	24		420	20
1961	76.7			735		
1962		54.8	29		536	27
1966–68	108.4			995		
1970		69.3	36		631	37
early 1972	100		—	900		—

known Standard & Poor's composite index of 500 stocks. The second is the even more celebrated Dow Jones Industrial Average (the DJIA, or "the Dow"), which dates back to 1897; it contains 30 companies, of which one is American Telephone & Telegraph and the other 29 are large industrial enterprises.[1]

Chart I, presented by courtesy of Standard & Poor's, depicts the market fluctuations of its 425-industrial-stock index from 1900 through 1970. (A corresponding chart available for the DJIA will look very much the same.) The reader will note three quite distinct patterns, each covering about a third of the 70 years. The first runs from 1900 to 1924, and shows for the most part a series of rather similar market cycles lasting from three to five years. The annual advance in this period averaged just about 3%. We move on to the "New Era" bull market, culminating in 1929, with its terrible aftermath of collapse, followed by quite irregular fluctuations until 1949. Comparing the average level of 1949 with that of 1924, we find the annual rate of advance to be a mere 1½%; hence the close of our second period found the public with no enthusiasm at all for common stocks. By the rule of opposites the time was ripe for the beginning of the greatest bull market in our history, presented in the last third of our chart. This phenomenon may have reached its culmination in December 1968 at 118 for Standard & Poor's 425 industrials (and 108 for its 500-stock composite). As Table 3-1 shows, there were fairly important setbacks between 1949 and 1968 (especially in 1956–57 and 1961–62), but the recoveries therefrom were so rapid that they had to be denominated (in the long-accepted semantics) as recessions in a single bull market, rather than as separate market cycles. Between the low level of 162 for "the Dow" in mid-1949 and the high of 995 in early 1966, the advance had been more than sixfold in 17 years—which is at the average compounded rate of 11% per year, not counting dividends of, say, 3½% per annum. (The advance for the Standard & Poor's composite index was somewhat greater than that of the DJIA—actually from 14 to 96.)

These 14% and better returns were documented in 1963, and later, in a much publicized study.*[2] It created a natural satisfaction

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* The study, in its final form, was Lawrence Fisher and James H. Lorie, "Rates of Return on Investments in Common Stock: the Year-by-Year

CHART 1


STANDARD & POOR'S STOCK PRICE INDEXES
1941–1943 = 10
125
100
90
80
70
60
50
40
30
20
18
16
14
12
10
8
6
5
4
2
MONTHLY AVERAGE OF 425 STOCKS
RATIO SCALE
1900 — 04
05 — 09
10 — 14
15 — 19
20 — 24
25 — 29
30 — 34
35 — 39
40 — 44
45 — 49
50 — 54
55 — 59
60 — 64
65 — 69
70 — 74

on Wall Street with such fine achievements, and a quite illogical and dangerous conviction that equally marvelous results could be expected for common stocks in the future. Few people seem to have been bothered by the thought that the very extent of the rise might indicate that it had been overdone. The subsequent decline from the 1968 high to the 1970 low was 36% for the Standard & Poor's composite (and 37% for the DJIA), the largest since the 44% suffered in 1939–1942, which had reflected the perils and uncertainties after Pearl Harbor. In the dramatic manner so characteristic of Wall Street, the low level of May 1970 was followed by a massive and speedy recovery of both averages, and the establishment of a new all-time high for the Standard & Poor's industrials in early 1972. The annual rate of price advance between 1949 and 1970 works out at about 9% for the S & P composite (or the industrial index), using the average figures for both years. That rate of climb was, of course, much greater than for any similar period before 1950. (But in the last decade the rate of advance was much lower—5¼% for the S & P composite index and only the once familiar 3% for the DJIA.)

The record of price movements should be supplemented by corresponding figures for earnings and dividends, in order to provide an overall view of what has happened to our share economy over the ten decades. We present a conspectus of this kind in our Table 3-2 (p. 71). It is a good deal to expect from the reader that he study all these figures with care, but for some we hope they will be interesting and instructive.

Let us comment on them as follows: The full decade figures smooth out the year-to-year fluctuations and leave a general picture of persistent growth. Only two of the nine decades after the first show a decrease in earnings and average prices (in 1891–1900 and 1931–1940), and no decade after 1900 shows a decrease in average dividends. But the rates of growth in all three categories are quite variable. In general the performance since World War II has been superior to that of earlier decades, but the advance in the 1960s was less pronounced than that of the 1950s. Today's investor

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Record, 1926–65," *The Journal of Business*, vol. XLI, no. 3 (July, 1968), pp. 291–316. For a summary of the study's wide influence, see http://library.dfaus.com/reprints/work_of_art/.

cannot tell from this record what percentage gain in earnings dividends and prices he may expect in the next ten years, but it does supply all the encouragement he needs for a consistent policy of common-stock investment.

However, a point should be made here that is not disclosed in our table. The year 1970 was marked by a definite deterioration in the overall earnings posture of our corporations. The rate of profit on invested capital fell to the lowest percentage since the World War years. Equally striking is the fact that a considerable number of companies reported net losses for the year; many became "financially troubled," and for the first time in three decades there were quite a few important bankruptcy proceedings. These facts as much as any others have prompted the statement made above* that the great boom era may have come to an end in 1969–1970.

A striking feature of Table 3-2 is the change in the price/earnings ratios since World War II.† In June 1949 the S & P composite index sold at only 6.3 times the applicable earnings of the past 12 months; in March 1961 the ratio was 22.9 times. Similarly, the dividend yield on the S & P index had fallen from over 7% in 1949 to only 3.0% in 1961, a contrast heightened by the fact that interest rates on high-grade bonds had meanwhile risen from 2.60% to 4.50%. This is certainly the most remarkable turnabout in the public's attitude in all stock-market history.

To people of long experience and innate caution the passage from one extreme to another carried a strong warning of trouble ahead. They could not help thinking apprehensively of the 1926–1929 bull market and its tragic aftermath. But these fears have not been confirmed by the event. True, the closing price of the DJIA

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* See pp. 50–52.

† The "price/earnings ratio" of a stock, or of a market average like the S & P 500-stock index, is a simple tool for taking the market's temperature. If, for instance, a company earned $1 per share of net income over the past year, and its stock is selling at $8.93 per share, its price/earnings ratio would be 8.93; if, however, the stock is selling at $69.70, then the price/earnings ratio would be 69.7. In general, a price/earnings ratio (or "P/E" ratio) below 10 is considered low, between 10 and 20 is considered moderate, and greater than 20 is considered expensive. (For more on P/E ratios, see p. 168.)

TABLE 3-2 A Picture of Stock-Market Performance, 1871–1970[a]

Period	*Average Price*	*Average Earnings*	*Average P/E Ratio*	*Dividend Average*	*Average Yield*	*Average Payout*	*Annual Growth Rate[b]*	
							Earnings	Dividends
1871–1880	3.58	0.32	11.3	0.21	6.0%	67%	—	—
1881–1890	5.00	0.32	15.6	0.24	4.7	75	– 0.64%	–0.66%
1891–1900	4.65	0.30	15.5	0.19	4.0	64	– 1.04	–2.23
1901–1910	8.32	0.63	13.1	0.35	4.2	58	+ 6.91	+5.33
1911–1920	8.62	0.86	10.0	0.50	5.8	58	+ 3.85	+3.94
1921–1930	13.89	1.05	13.3	0.71	5.1	68	+ 2.84	+2.29
1931–1940	11.55	0.68	17.0	0.78	5.1	85	– 2.15	–0.23
1941–1950	13.90	1.46	9.5	0.87	6.3	60	+10.60	+3.25
1951–1960	39.20	3.00	13.1	1.63	4.2	54	+ 6.74	+5.90
1961–1970	82.50	4.83	17.1	2.68	3.2	55	+ 5.80[c]	+5.40[c]
1954–1956	38.19	2.56	15.1	1.64	4.3	65	+ 2.40[d]	+7.80[d]
1961–1963	66.10	3.66	18.1	2.14	3.2	58	+ 5.15[d]	+4.42[d]
1968–1970	93.25	5.60	16.7	3.13	3.3	56	+ 6.30[d]	+5.60[d]

[a] The following data based largely on figures appearing in N. Molodovsky's article, "Stock Values and Stock Prices," *Financial Analysts Journal*, May 1960. These, in turn, are taken from the Cowles Commission book *Common Stock Indexes* for years before 1926 and from the spliced-on Standard & Poor's 500-stock composite index for 1926 to date.

[b] The annual growth-rate figures are Molodovsky compilations covering successive 21-year periods ending in 1890, 1900, etc.

[c] Growth rate for 1968–1970 vs. 1958–1960.

[d] These growth-rate figures are for 1954–1956 vs. 1947–1949, 1961–1963 vs. 1954–1956, and for 1968–1970 vs. 1958–1960.

in 1970 was the same as it was 6½ years earlier, and the much heralded "Soaring Sixties" proved to be mainly a march up a series of high hills and then down again. But nothing has happened either to business or to stock prices that can compare with the bear market and depression of 1929–1932.

The Stock-Market Level in Early 1972

With a century-long conspectus of stock, prices, earnings, and dividends before our eyes, let us try to draw some conclusions about the level of 900 for the DJIA and 100 for the S & P composite index in January 1972.

In each of our former editions we have discussed the level of the stock market at the time of writing, and endeavored to answer the question whether it was too high for conservative purchase. The reader may find it informing to review the conclusions we reached on these earlier occasions. This is not entirely an exercise in self-punishment. It will supply a sort of connecting tissue that links the various stages of the stock market in the past twenty years and also a taken-from-life picture of the difficulties facing anyone who tries to reach an informed and critical judgment of current market levels. Let us, first, reproduce the summary of the 1948, 1953, and 1959 analyses that we gave in the 1965 edition:

> In 1948 we applied conservative standards to the Dow Jones level of 180, and found no difficulty in reaching the conclusion that "it was not too high in relation to underlying values." When we approached this problem in 1953 the average market level for that year had reached 275, a gain of over 50% in five years. We asked ourselves the same question—namely, "whether in our opinion the level of 275 for the Dow Jones Industrials was or was not too high for sound investment." In the light of the subsequent spectacular advance, it may seem strange to have to report that it was by no means easy for us to reach a definitive conclusion as to the attractiveness of the 1953 level. We did say, positively enough, that "from the standpoint of value indications—our chief investment guide—the conclusion about 1953 stock prices must be favorable." But we were concerned about the fact that in 1953, the averages had advanced for a longer period than in most bull markets of the

past, and that its absolute level was historically high. Setting these factors against our favorable value judgment, we advised a cautious or compromise policy. As it turned out, this was not a particularly brilliant counsel. A good prophet would have foreseen that the market level was due to advance an additional 100% in the next five years. Perhaps we should add in self-defense that few if any of those whose business was stock-market forecasting—as ours was not—had any better inkling than we did of what lay ahead.

At the beginning of 1959 we found the DJIA at an all-time high of 584. Our lengthy analysis made from all points of view may be summarized in the following (from page 59 of the 1959 edition): "In sum, we feel compelled to express the conclusion that the present level of stock prices is a dangerous one. It may well be perilous because prices are already far too high. But even if this is not the case the market's momentum is such as inevitably to carry it to unjustifiable heights. Frankly, we cannot imagine a market of the future in which there will never be any serious losses, and in which, every tyro will be guaranteed a large profit on his stock purchases."

The caution we expressed in 1959 was somewhat better justified by the sequel than was our corresponding attitude in 1954. Yet it was far from fully vindicated. The DJIA advanced to 685 in 1961; then fell a little below our 584 level (to 566) later in the year; advanced again to 735 in late 1961; and then declined in near panic to 536 in May 1962, showing a loss of 27% within the brief period of six months. At the same time there was a far more serious shrinkage in the most popular "growth stocks"—as evidenced by the striking fall of the indisputable leader, International Business Machines, from a high of 607 in December 1961 to a low of 300 in June 1962.

This period saw a complete debacle in a host of newly launched common stocks of small enterprises—the so-called hot issues—which had been offered to the public at ridiculously high prices and then had been further pushed up by needless speculation to levels little short of insane. Many of these lost 90% and more of the quotations in just a few months.

The collapse in the first half of 1962 was disconcerting, if not disastrous, to many self-acknowledged speculators and perhaps

to many more imprudent people who called themselves "investors." But the turnabout that came later that year was equally unsuspected by the financial community. The stock-market averages resumed their upward course, producing the following sequence:

	DJIA	*Standard & Poor's 500-Stock Composite*
December 1961	735	72.64
June 1962	536	52.32
November 1964	892	86.28

The recovery and new ascent of common-stock prices was indeed remarkable and created a corresponding revision of Wall Street sentiment. At the low level of June 1962 predictions had appeared predominantly bearish, and after the partial recovery to the end of that year they were mixed, leaning to the skeptical side. But at the outset of 1964 the natural optimism of brokerage firms was again manifest; nearly all the forecasts were on the bullish side, and they so continued through the 1964 advance.

We then approached the task of appraising the November 1964 levels of the stock market (892 for the DJIA). After discussing it learnedly from numerous angles we reached three main conclusions. The first was that "old standards (of valuation) appear inapplicable; new standards have not yet been tested by time." The second was that the investor "must base his policy on the existence of major uncertainties. The possibilities compass the extremes, on the one hand, of a protracted and further advance in the market's level—say by 50%, or to 1350 for the DJIA; or, on the other hand, of a largely unheralded collapse of the same magnitude, bringing the average in the neighborhood of, say, 450" (p. 63). The third was expressed in much more definite terms. We said: "Speaking bluntly, if the 1964 price level is not too high how could we say that *any* price level is too high?" And the chapter closed as follows:

WHAT COURSE TO FOLLOW

Investors should not conclude that the 1964 market level is dangerous merely because they read it in this book. They must weigh our reasoning against the contrary reasoning they will hear from most competent and experienced people on Wall Street. In the end each one must make his own decision and accept responsibility therefor. We suggest, however, that if the investor is in doubt as to which course to pursue he should choose the path of caution. The principles of investment, as set forth herein, would call for the following policy under 1964 conditions, in order of urgency:

1. No borrowing to buy or hold securities.
2. No increase in the proportion of funds held in common stocks.
3. A reduction in common-stock holdings where needed to bring it down to a maximum of 50 per cent of the total portfolio. The capital-gains tax must be paid with as good grace as possible, and the proceeds invested in first-quality bonds or held as a savings deposit.

Investors who for some time have been following a bona fide dollar-cost averaging plan can in logic elect either to continue their periodic purchases unchanged or to suspend them until they feel the market level is no longer dangerous. We should advise rather strongly against the initiation of a new dollar-averaging plan at the late 1964 levels, since many investors would not have the stamina to pursue such a scheme if the results soon after initiation should appear highly unfavorable.

This time we can say that our caution was vindicated. The DJIA advanced about 11% further, to 995, but then fell irregularly to a low of 632 in 1970, and finished that year at 839. The same kind of debacle took place in the price of "hot issues"—i.e., with declines running as much as 90%—as had happened in the 1961–62 setback. And, as pointed out in the Introduction, the whole financial picture appeared to have changed in the direction of less enthusiasm and greater doubts. A single fact may summarize the story: The DJIA closed 1970 at a level lower than six years before—the first time such a thing had happened since 1944.

Such were our efforts to evaluate former stock-market levels. Is there anything we and our readers can learn from them? We considered the market level favorable for investment in 1948 and 1953 (but too cautiously in the latter year), "dangerous" in 1959 (at 584 for DJIA), and "too high" (at 892) in 1964. All of these judgments could be defended even today by adroit arguments. But it is doubtful if they have been as useful as our more pedestrian counsels—in favor of a consistent and controlled common-stock policy on the one hand, and discouraging endeavors to "beat the market" or to "pick the winners" on the other.

Nonetheless we think our readers may derive some benefit from a renewed consideration of the level of the stock market—this time as of late 1971—even if what we have to say will prove more interesting than practically useful, or more indicative than conclusive. There is a fine passage near the beginning of Aristotle's *Ethics* that goes: "It is the mark of an educated mind to expect that amount of exactness which the nature of the particular subject admits. It is equally unreasonable to accept merely probable conclusions from a mathematician and to demand strict demonstration from an orator." The work of a financial analyst falls somewhere in the middle between that of a mathematician and of an orator.

At various times in 1971 the Dow Jones Industrial Average stood at the 892 level of November 1964 that we considered in our previous edition. But in the present statistical study we have decided to use the price level and the related data for the Standard & Poor's composite index (or S & P 500), because it is more comprehensive and representative of the general market than the 30-stock DJIA. We shall concentrate on a comparison of this material near the four dates of our former editions—namely the year-ends of 1948, 1953, 1958 and 1963—plus 1968; for the current price level we shall take the convenient figure of 100, which was registered at various times in 1971 and in early 1972. The salient data are set forth in Table 3-3. For our earnings figures we present both the last year's showing and the average of three calendar years; for 1971 dividends we use the last twelve months' figures; and for 1971 bond interest and wholesale prices those of August 1971.

The 3-year price/earnings ratio for the market was lower in October 1971 than at year-end 1963 and 1968. It was about the same as in 1958, but much higher than in the early years of the long bull

TABLE 3-3 Data Relating to Standard & Poor's Composite Index in Various Years

Year[a]	*1948*	*1953*	*1958*	*1963*	*1968*	*1971*
Closing price	15.20	24.81	55.21	75.02	103.9	100[d]
Earned in current year	2.24	2.51	2.89	4.02	5.76	5.23
Average earnings of last 3 years	1.65	2.44	2.22	3.63	5.37	5.53
Dividend in current year	.93	1.48	1.75	2.28	2.99	3.10
High-grade bond interest[a]	2.77%	3.08%	4.12%	4.36%	6.51%	7.57%
Wholesale-price index	87.9	92.7	100.4	105.0	108.7	114.3
Ratios:						
Price/last year's earnings	6.3 ×	9.9 ×	18.4 ×	18.6 ×	18.0 ×	19.2 ×
Price/3-years' earnings	9.2 ×	10.2 ×	17.6 ×	20.7 ×	19.5 ×	18.1 ×
3-Years' "earnings yield"[c]	10.9 %	9.8 %	5.8 %	4.8 %	5.15%	5.53%
Dividend yield	5.6 %	5.5 %	3.3 %	3.04%	2.87%	3.11%
Stock-earnings yield/bond yield	3.96×	3.20×	1.41×	1.10×	.80×	.72×
Dividend yield/bond yield	2.1 ×	1.8 ×	.80×	.70×	.44×	.41×
Earnings/book value[e]	11.2 %	11.8 %	12.8 %	10.5 %	11.5 %	11.5 %

[a] Yield on S & P AAA bonds.

[b] Calendar years in 1948–1968, plus year ended June 1971.

[c] "Earnings yield" means the earnings divided by the price, in %.

[d] Price in Oct. 1971, equivalent to 900 for the DJIA.

[e] Three-year average figures.

market. This important indicator, taken by itself, could not be construed to indicate that the market was especially high in January 1972. But when the interest yield on high-grade bonds is brought into the picture, the implications become much less favorable. The reader will note from our table that the ratio of stock returns (earnings/price) to bond returns has grown worse during the entire period, so that the January 1972 figure was less favorable to stocks, by this criterion, than in any of the previous years examined. When dividend yields are compared with bond yields we find that the relationship was completely reversed between 1948 and 1972. In the early year stocks yielded twice as much as bonds; now bonds yield twice as much, and more, than stocks.

Our final judgment is that the adverse change in the bond-yield/stock-yield ratio fully offsets the better price/earnings ratio for late 1971, based on the 3-year earnings figures. Hence our view of the early 1972 market level would tend to be the same as it was some 7 years ago—i.e., that it is an unattractive one from the standpoint of conservative investment. (This would apply to most of the 1971 price range of the DJIA: between, say, 800 and 950.)

In terms of historical market swings the 1971 picture would still appear to be one of irregular recovery from the bad setback suffered in 1969–1970. In the past such recoveries have ushered in a new stage of the recurrent and persistent bull market that began in 1949. (This was the expectation of Wall Street generally during 1971.) After the terrible experience suffered by the public buyers of low-grade common-stock offerings in the 1968–1970 cycle, it is too early (in 1971) for another twirl of the new-issue merry-go-round. Hence that dependable sign of imminent danger in the market is lacking now, as it was at the 892 level of the DJIA in November 1964, considered in our previous edition. Technically, then, the outlook would appear to favor another substantial rise far beyond the 900 DJIA level before the next serious setback or collapse. But we cannot quite leave the matter there, as perhaps we should. To us, the early-1971-market's disregard of the harrowing experiences of less than a year before is a disquieting sign. Can such heedlessness go unpunished? We think the investor must be prepared for difficult times ahead—perhaps in the form of a fairly quick replay of the the 1969–1970 decline, or perhaps in the form of another bull-market fling, to be followed by a more catastrophic collapse.[3]

What Course to Follow

Turn back to what we said in the last edition, reproduced on p. 75. This is our view at the same price level—say 900—for the DJIA in early 1972 as it was in late 1964.

COMMENTARY ON CHAPTER 3

> You've got to be careful if you don't know where you're going, 'cause you might not get there.
>
> —*Yogi Berra*

BULL-MARKET BALONEY

In this chapter, Graham shows how prophetic he can be. He looks two years ahead, foreseeing the "catastrophic" bear market of 1973–1974, in which U.S. stocks lost 37% of their value.[1] He also looks more than two decades into the future, eviscerating the logic of market gurus and best-selling books that were not even on the horizon in his lifetime.

The heart of Graham's argument is that the intelligent investor must never forecast the future exclusively by extrapolating the past. Unfortunately, that's exactly the mistake that one pundit after another made in the 1990s. A stream of bullish books followed Wharton finance professor Jeremy Siegel's *Stocks for the Long Run* (1994)—culminating, in a wild crescendo, with James Glassman and Kevin Hassett's *Dow 36,000,* David Elias' *Dow 40,000,* and Charles Kadlec's *Dow 100,000* (all published in 1999). Forecasters argued that stocks had returned an annual average of 7% after inflation ever since 1802. Therefore, they concluded, that's what investors should expect in the future.

Some bulls went further. Since stocks had "always" beaten bonds over any period of at least 30 years, stocks must be less risky than bonds or even cash in the bank. And if you can eliminate all the risk of owning stocks simply by hanging on to them long enough, then why

[1] If dividends are not included, stocks fell 47.8% in those two years.

quibble over how much you pay for them in the first place? (To find out why, see the sidebar on p. 82.)

In 1999 and early 2000, bull-market baloney was everywhere:

- On December 7, 1999, Kevin Landis, portfolio manager of the Firsthand mutual funds, appeared on CNN's *Moneyline* telecast. Asked if wireless telecommunication stocks were overvalued–with many trading at infinite multiples of their earnings–Landis had a ready answer. "It's not a mania," he shot back. "Look at the outright growth, the absolute value of the growth. It's big."
- On January 18, 2000, Robert Froelich, chief investment strategist at the Kemper Funds, declared in the *Wall Street Journal:* "It's a new world order. We see people discard all the right companies with all the right people with the right vision because their stock price is too high–that's the worst mistake an investor can make."
- In the April 10, 2000, issue of *BusinessWeek,* Jeffrey M. Applegate, then the chief investment strategist at Lehman Brothers, asked rhetorically: "Is the stock market riskier today than two years ago simply because prices are higher? The answer is *no.*"

But the answer is *yes.* It always has been. It always will be.

And when Graham asked, "Can such heedlessness go unpunished?" he knew that the eternal answer to that question is *no.* Like an enraged Greek god, the stock market crushed everyone who had come to believe that the high returns of the late 1990s were some kind of divine right. Just look at how those forecasts by Landis, Froelich, and Applegate held up:

- From 2000 through 2002, the most stable of Landis's pet wireless stocks, Nokia, lost "only" 67%–while the worst, Winstar Communications, lost 99.9%.
- Froelich's favorite stocks–Cisco Systems and Motorola–fell more than 70% by late 2002. Investors lost over $400 billion on Cisco alone–more than the annual economic output of Hong Kong, Israel, Kuwait, and Singapore combined.
- In April 2000, when Applegate asked his rhetorical question, the Dow Jones Industrials stood at 11,187; the NASDAQ Composite Index was at 4446. By the end of 2002, the Dow was hobbling around the 8,300 level, while NASDAQ had withered to roughly 1300–eradicating all its gains over the previous six years.

SURVIVAL OF THE FATTEST

There was a fatal flaw in the argument that stocks have "always" beaten bonds in the long run: Reliable figures before 1871 do not exist. The indexes used to represent the U.S. stock market's earliest returns contain as few as seven (yes, 7!) stocks.[1] By 1800, however, there were some 300 companies in America (many in the Jeffersonian equivalents of the Internet: wooden turnpikes and canals). Most went bankrupt, and their investors lost their knickers.

But the stock indexes ignore all the companies that went bust in those early years, a problem technically known as "survivorship bias." Thus these indexes wildly overstate the results earned by real-life investors—who lacked the 20/20 hindsight necessary to know exactly which seven stocks to buy. A lonely handful of companies, including Bank of New York and J. P. Morgan Chase, have prospered continuously since the 1790s. But for every such miraculous survivor, there were thousands of financial disasters like the Dismal Swamp Canal Co., the Pennsylvania Cultivation of Vines Co., and the Snickers's Gap Turnpike Co.—all omitted from the "historical" stock indexes.

Jeremy Siegel's data show that, after inflation, from 1802 through 1870 stocks gained 7.0% per year, bonds 4.8%, and cash 5.1%. But Elroy Dimson and his colleagues at London Business School estimate that the pre-1871 stock returns are overstated by at least two percentage points per year.[2] In the real world, then, stocks did no better than cash and bonds—and perhaps a bit worse. Anyone who claims that the long-term record "proves" that stocks are guaranteed to outperform bonds or cash is an ignoramus.

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[1] By the 1840s, these indexes had widened to include a maximum of seven financial stocks and 27 railroad stocks—still an absurdly unrepresentative sample of the rambunctious young American stock market.

[2] See Jason Zweig, "New Cause for Caution on Stocks," *Time,* May 6, 2002, p. 71. As Graham hints on p. 65, even the stock indexes between 1871 and the 1920s suffer from survivorship bias, thanks to the hundreds of automobile, aviation, and radio companies that went bust without a trace. These returns, too, are probably overstated by one to two percentage points.

THE HIGHER THEY GO, THE HARDER THEY FALL

As the enduring antidote to this kind of bull-market baloney, Graham urges the intelligent investor to ask some simple, skeptical questions. Why should the future returns of stocks always be the same as their past returns? When every investor comes to believe that stocks are guaranteed to make money in the long run, won't the market end up being wildly overpriced? And once that happens, how can future returns possibly be high?

Graham's answers, as always, are rooted in logic and common sense. The value of any investment is, and always must be, a function of the price you pay for it. By the late 1990s, inflation was withering away, corporate profits appeared to be booming, and most of the world was at peace. But that did not mean—nor could it ever mean—that stocks were worth buying *at any price.* Since the profits that companies can earn are finite, the price that investors should be willing to pay for stocks must also be finite.

Think of it this way: Michael Jordan may well have been the greatest basketball player of all time, and he pulled fans into Chicago Stadium like a giant electromagnet. The Chicago Bulls got a bargain by paying Jordan up to $34 million a year to bounce a big leather ball around a wooden floor. But that does not mean the Bulls would have been justified paying him $340 million, or $3.4 billion, or $34 billion, per season.

THE LIMITS OF OPTIMISM

Focusing on the market's recent returns when they have been rosy, warns Graham, will lead to "a quite illogical and dangerous conclusion that equally marvelous results could be expected for common stocks in the future." From 1995 through 1999, as the market rose by at least 20% each year—a surge unprecedented in American history—stock buyers became ever more optimistic:

- In mid-1998, investors surveyed by the Gallup Organization for the PaineWebber brokerage firm expected their portfolios to earn an average of roughly 13% over the year to come. By early 2000, their average expected return had jumped to more than 18%.

- "Sophisticated professionals" were just as bullish, jacking up their own assumptions of future returns. In 2001, for instance, SBC Communications raised the projected return on its pension plan from 8.5% to 9.5%. By 2002, the average assumed rate of return on the pension plans of companies in the Standard & Poor's 500-stock index had swollen to a record-high 9.2%.

A quick follow-up shows the awful aftermath of excess enthusiasm:

- Gallup found in 2001 and 2002 that the average expectation of one-year returns on stocks had slumped to 7%—even though investors could now buy at prices nearly 50% lower than in 2000.[2]
- Those gung-ho assumptions about the returns on their pension plans will cost the companies in the S & P 500 a bare minimum of $32 billion between 2002 and 2004, according to recent Wall Street estimates.

Even though investors all know they're supposed to buy low and sell high, in practice they often end up getting it backwards. Graham's warning in this chapter is simple: "By the rule of opposites," the more enthusiastic investors become about the stock market in the long run, the more certain they are to be proved wrong in the short run. On March 24, 2000, the total value of the U.S. stock market peaked at $14.75 trillion. By October 9, 2002, just 30 months later, the total U.S. stock market was worth $7.34 trillion, or 50.2% less—a loss of $7.41 trillion. Meanwhile, many market pundits turned sourly bearish, predicting flat or even negative market returns for years—even decades—to come.

At this point, Graham would ask one simple question: Considering how calamitously wrong the "experts" were the last time they agreed on something, why on earth should the intelligent investor believe them now?

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[2] Those cheaper stock prices do not mean, of course, that investors' expectation of a 7% stock return will be realized.

WHAT'S NEXT?

Instead, let's tune out the noise and think about future returns as Graham might. The stock market's performance depends on three factors:

- real growth (the rise of companies' earnings and dividends)
- inflationary growth (the general rise of prices throughout the economy)
- speculative growth—or decline (any increase or decrease in the investing public's appetite for stocks)

In the long run, the yearly growth in corporate earnings per share has averaged 1.5% to 2% (not counting inflation).[3] As of early 2003, inflation was running around 2.4% annually; the dividend yield on stocks was 1.9%. So,

$$\begin{array}{r} 1.5\% \text{ to } 2\% \\ +\ 2.4\% \\ +\ 1.9\% \\ \hline = 5.8\% \text{ to } 6.3\% \end{array}$$

In the long run, that means you can reasonably expect stocks to average roughly a 6% return (or 4% after inflation). If the investing public gets greedy again and sends stocks back into orbit, then that speculative fever will temporarily drive returns higher. If, instead, investors are full of fear, as they were in the 1930s and 1970s, the returns on stocks will go temporarily lower. (That's where we are in 2003.)

Robert Shiller, a finance professor at Yale University, says Graham inspired his valuation approach: Shiller compares the current price of the Standard & Poor's 500-stock index against average corporate profits over the past 10 years (after inflation). By scanning the historical record, Shiller has shown that when his ratio goes well above 20, the market usually delivers poor returns afterward; when it drops well

[3] See Jeremy Siegel, *Stocks for the Long Run* (McGraw-Hill, 2002), p. 94, and Robert Arnott and William Bernstein, "The Two Percent Dilution," working paper, July, 2002.

below 10, stocks typically produce handsome gains down the road. In early 2003, by Shiller's math, stocks were priced at about 22.8 times the average inflation-adjusted earnings of the past decade—still in the danger zone, but way down from their demented level of 44.2 times earnings in December 1999.

How has the market done in the past when it was priced around today's levels? Figure 3-1 shows the previous periods when stocks were at similar highs, and how they fared over the 10-year stretches that followed:

FIGURE 3-1

Year	Price/earnings ratio	Total return over next 10 years
1898	21.4	9.2
1900	20.7	7.1
1901	21.7	5.9
1905	19.6	5.0
1929	22.0	−0.1
1936	21.1	4.4
1955	18.9	11.1
1959	18.6	7.8
1961	22.0	7.1
1962	18.6	9.9
1963	21.0	6.0
1964	22.8	1.2
1965	23.7	3.3
1966	19.7	6.6
1967	21.8	3.6
1968	22.3	3.2
1972	18.6	6.7
1992	20.4	9.3
Averages	**20.8**	**6.0**

Sources: http://aida.econ.yale.edu/~shiller/data/ie_data.htm;
Jack Wilson and Charles Jones, "An Analysis of the S & P 500 Index and Cowles' Extensions: Price Index and Stock Returns, 1870–1999," *The Journal of Business,* vol. 75, no. 3, July, 2002, pp. 527–529; Ibbotson Associates.

Notes: Price/earnings ratio is Shiller calculation (10-year average real earnings of S & P 500-stock index divided by December 31 index value). Total return is nominal annual average.

So, from valuation levels similar to those of early 2003, the stock market has sometimes done very well in the ensuing 10 years, sometimes poorly, and muddled along the rest of the time. I think Graham, ever the conservative, would split the difference between the lowest and highest past returns and project that over the next decade stocks will earn roughly 6% annually, or 4% after inflation. (Interestingly, that projection matches the estimate we got earlier when we added together real growth, inflationary growth, and speculative growth.) Compared to the 1990s, 6% is chicken feed. But it's a whisker better than the gains that bonds are likely to produce—and reason enough for most investors to hang on to stocks as part of a diversified portfolio.

But there is a second lesson in Graham's approach. The only thing you can be confident of while forecasting future stock returns is that you will probably turn out to be wrong. The only indisputable truth that the past teaches us is that the future will always surprise us—always! And the corollary to that law of financial history is that the markets will most brutally surprise the very people who are most certain that their views about the future are right. Staying humble about your forecasting powers, as Graham did, will keep you from risking too much on a view of the future that may well turn out to be wrong.

So, by all means, you should lower your expectations—but take care not to depress your spirit. For the intelligent investor, hope always springs eternal, because *it should.* In the financial markets, the worse the future looks, the better it usually turns out to be. A cynic once told G. K. Chesterton, the British novelist and essayist, "Blessed is he who expecteth nothing, for he shall not be disappointed." Chesterton's rejoinder? "Blessed is he who expecteth nothing, for he shall enjoy everything."

Acknowledgments from Jason Zweig

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