Chapter 1:
Investment versus Speculation: Results to be expected by the Intelligent Investor

Investment versus Speculation

An investment operation is one which, upon thorough analysis promises safety of principal and an adequate return. Operations not meeting these requirements are speculative.

• 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.

• 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.

• 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".

- 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.
  - 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."

Results to Be Expected by the Defensive Investor – cont.

- 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.
  - 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.

Results to Be Expected by the Defensive Investor – cont.

- 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 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%. we are forced to the conclusion that now, toward the end of 1971, bond investment appears clearly preferable to stock investment.
  - 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.
  - 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.

Results to Be Expected by the Defensive Investor – conclusion

- Three supplementary concepts or practices for the defensive investor

  1. purchase of the shares of well-established investment funds as an alternative to creating his own common-stock portfolio. portfolio. He might also utilize one of the "common trust funds," or "commingled funds," operated by trust companies and banks in many states;
  2. 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.
  3. 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. 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.

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.

Several ways in which investors and speculators generally have endeavored to obtain better than average results.

1. Trading in the market: short selling. 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 processesor products that are deemed to be especially promising.)

Results to Be Expected by the Aggressive Investor – cont.

We have already expressed a negative view about the investor's overall chances of success in these areas of activity (previous slide)

- 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.
- In choosing stocks for their long-term prospects, the investor's handicaps are basically the same. The possibility of outright error in the prediction. 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.

Results to Be Expected by the Aggressive Investor – cont.

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.

1. Buying a neglected and therefore undervalued issue for profit generally proves a protracted and patience-trying experience. 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.

2. 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.

Results to Be Expected by the Aggressive Investor – cont.

3. 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.

Conclusion: 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.

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