Chapter 8:
The Investor and Market Fluctuations

Introduction

1. It is easy for us to tell you not to speculate; the hard thing will be for you to follow this advice. Let us repeat what we said at the outset: If you want to speculate do so with your eyes open, knowing that you will probably lose money in the end; be sure to limit the amount at risk and to separate it completely from your investment program.
2. In this section we shall return to that material from time to time, in order to see what the past record promises the investor—in either the form of long-term appreciation of a portfolio held relatively unchanged through successive rises and declines, or in the possibilities of buying near bear-market lows and selling not too far below bull-market highs.

Market Fluctuations as a Guide to Investment Decisions

1. Since common stocks, even of investment grade, are subject to recurrent and wide fluctuations in their prices, the intelligent investor should be interested in the possibilities of profiting from these pendulum swings.
2. There are two possible ways by which he may try to do this: the way of timing and the way of pricing. By timing we mean the endeavor to anticipate the action of the stock market—to buy or hold when the future course is deemed to be upward, to sell or refrain from buying when the course is downward. By pricing we mean the endeavor to buy stocks when they are quoted below their fair value and to sell them when they rise above such value.
3. We are convinced that the intelligent investor can derive satisfactory results from pricing of either type. We are equally sure that if he places his emphasis on timing, in the sense of forecasting, he will end up as a speculator and with a speculator's financial results.
4. it is absurd to think that the general public can ever make money out of market forecasts. In this respect the famous Dow theory for timing purchases and sales has had an unusual history.

Buy-Low–Sell-High Approach

1. We are convinced that the average investor cannot deal successfully with price movements by endeavoring to forecast them. Can he benefit from them after they have taken place—i.e., by buying after each major decline and selling out after each major advance? The fluctuations of the market over a period of many years prior to 1950 lent considerable encouragement to that idea.
2. Nearly all the bull markets had a number of well-defined characteristics in common, such as (1) a historically high price level, (2) high price/earnings ratios, (3) low dividend yields as against bond yields, (4) much speculation on margin, and (5) many offerings of new common-stock issues of poor quality. Thus to the student of stock-market history it appeared that the intelligent investor should have been able to identify the recurrent bear and bull markets, to buy in the former and sell in the latter, and to do so for the most part at reasonably short intervals of time.
3. But we must point out that even prior to the unprecedented bull market that began in 1949, there were sufficient variations in the successive market cycles to complicate and sometimes frustrate the desirable process of buying low and selling high.
4. Whether the old, fairly regular bull-and-bear-market pattern will eventually return we do not know. But it seems unrealistic to us for the investor to endeavor to base his present policy on the classic formula—i.e., to wait for demonstrable bear-market levels before buying any common stocks.
5. Our recommendation is to make provision for changes in the proportion of common stocks to bonds in the portfolio according as the level of stock price appears less or more attractive by value standard.

Formula Plans

1. In the early years of the stock-market rise that began in 1949–50 considerable interest was attracted to various methods of taking advantage of the stock market's cycles. These have been known as "formula investment plans." The essence of all such plans—except the simple case of dollar averaging—is that the investor automatically does some selling of common stocks when the market advances substantially.
2. This approach had the double appeal of sounding logical (and conservative) and of showing excellent results when applied retrospectively to the stock market over many years in the past. Unfortunately, its vogue grew greatest at the very time when it was destined to work least well.

Market Fluctuations of the Investor's Portfolio

1. Every investor who owns common stocks must expect to see them fluctuate in value over the years.
2. The overall value of DJIA advanced from an average level of about 890 to a high of 995 in 1966 (and 985 again in 1968), fell to 631 in 1970, and made an almost full recovery to 940 in early 1971. In general, the shares of second-line companies* fluctuate more widely than the major ones, but this does not necessarily mean that a group of well established but smaller companies will make a poorer showing over a fairly long period.
3. It is for these reasons of human nature, even more than by calculation of financial gain or loss, that we favor some kind of mechanical method for varying the proportion of bonds to stocks in the investor's portfolio. The chief advantage, perhaps, is that such a formula will give him something to do.
4. These activities will provide some outlet for his otherwise too-pent-up energies. If he is the right kind of investor he will take added satisfaction from the thought that his operations are exactly opposite from those of the crowd.

Business Valuations versus Stock-Market Valuations

1. The impact of market fluctuations upon the investor's true situation may be considered also from the standpoint of the shareholder as the part owner of various businesses.
2. The holder of marketable shares actually has a double status, and with it the privilege of taking advantage of either at his choice. On the one hand his position is analogous to that of a minority shareholder or silent partner in a private business. Here his results are entirely dependent on the profits of the enterprise or on a change in the underlying value of its assets. On the other hand, the common-stock investor holds a piece of paper, an engraved stock certificate, which can be sold in a matter of minutes at a price which varies from moment to moment—when the market is open, that is—and often is far removed from the balance sheet value.
3. The development of the stock market in recent decades has made the typical investor more dependent on the course of price quotations and less free than formerly to consider himself merely a business owner.

Business Valuations versus Stock-Market Valuations – cont.

4. The whole structure of stock-market quotations contains a built-in contradiction. The better a company's record and prospects, the less relationship the price of its shares will have to their book value. But the greater the premium above book value, the less certain the basis of determining its intrinsic value—i.e., the more this "value" will depend on the changing moods and measurements of the stock market. Thus we reach the final paradox, that the more successful the company, the greater are likely to be the fluctuations in the price of its shares. This really means that, in a very real sense, the better the quality of a common stock, the more speculative it is likely to be—at least as compared with the unspectacular middle-grade issues.
5. The previous discussion leads us to a conclusion of practical importance to the conservative investor in common stocks. If he is to pay some special attention to the selection of his portfolio, it might be best for him to concentrate on issues selling at a reasonably close approximation to their tangible-asset value—say, at not more than one-third above that figure.

Business Valuations versus Stock-Market Valuations – cont.

5. A caution is needed here. A stock does not become a sound investment merely because it can be bought at close to its asset value. The investor should demand, in addition, a satisfactory ratio of earnings to price, a sufficiently strong financial position, and the prospect that its earnings will at least be maintained over the years. This may appear like demanding a lot from a modestly priced stock, but the prescription is not hard to fill under all but dangerously high market conditions. Once the investor is willing to forgo brilliant prospects—i.e., better than average expected growth—he will have no difficulty in finding a wide selection of issues meeting these criteria.
6. The investor with a stock portfolio having such book values behind it can take a much more independent and detached view of stock-market fluctuations than those who have paid high multipliers of both earnings and tangible assets. As long as the earning power of his holdings remains satisfactory, he can give as little attention as he pleases to the vagaries of the stock market. More than that, at times he can use these vagaries to play the master game of buying low and selling high.

The A. & P. Example

1. This company combines so many aspects of corporate and investment experience.
2. A. & P. shares were introduced to trading on the "Curb" market, now the American Stock Exchange, in 1929 and sold as high as 494. By 1932 they had declined to 104, although the company's earnings were nearly as large in that generally catastrophic year as previously. In 1936 the range was between 111 and 131. Then in the business recession and bear market of 1938 the shares fell to a new low of 36.
3. That price was extraordinary. It meant that the preferred and common were together selling for $126 million, although the company had just reported that it held $85 million in cash alone and a working capital (or net current assets) of $134 million. A. & P. was the largest retail enterprise in America, if not in the world, with a continuous and impressive record of large earnings for many years. Yet in 1938 this outstanding business was considered on Wall Street to be worth less than its current assets alone.
4. Why? First, because there were threats of special taxes on chain stores; second, because net profits had fallen off in the previous year; and, third, because the general market was depressed. The first of these reasons was an exaggerated and eventually groundless fear; the other two were typical of temporary influences.

The A. & P. Example – cont.

5. The true investor scarcely ever is forced to sell his shares, and at all other times he is free to disregard the current price quotation. He need pay attention to it and act upon it only to the extent that it suits his book, and no more.* Thus the investor who permits himself to be stampeded or unduly worried by unjustified market declines in his holdings is perversely transforming his basic advantage into a basic disadvantage. That man would be better off if his stocks had no market quotation at all, for he would then be spared the mental anguish caused him by other persons' mistakes of judgment.
6. Incidentally, a widespread situation of this kind actually existed during the dark depression days of 1931–1933.
7. Returning to our A. & P. shareholder in 1938, we assert that as long as he held on to his shares he suffered no loss in their price decline, beyond what his own judgment may have told him was occasioned by a shrinkage in their underlying or intrinsic value.

The A. & P. Example – cont.

8. Critics of the value approach to stock investment argue that listed common stocks cannot properly be regarded or appraised in the same way as an interest in a similar private enterprise, because the presence of an organized security market "injects into equity ownership the new and extremely important attribute of liquidity." But what this liquidity really means is, first, that the investor has the benefit of the stock market's daily and changing appraisal of his holdings, for whatever that appraisal may be worth, and, second, that the investor is able to increase or decrease his investment at the market's daily figure—if he chooses. Thus the existence of a quoted market gives the investor certain options that he does not have if his security is unquoted. But it does not impose the current quotation on an investor who prefers to take his idea of value from some other source.
9. The true investor is in that very position when he owns a listed common stock. He can take advantage of the daily market price or leave it alone, as dictated by his own judgment and inclination. At other times he will do better if he forgets about the stock market and pays attention to his dividend returns and to the operating results of his companies.

Summary

1. The most realistic distinction between the investor and the speculator is found in their attitude toward stock-market movements. The speculator's primary interest lies in anticipating and profiting from market fluctuations. The investor's primary interest lies in acquiring and holding suitable securities at suitable prices. Market movements are important to him in a practical sense.
2. Aside from forecasting the movements of the general market, much effort and ability are directed on Wall Street toward selecting stocks or industrial groups that in matter of price will "do better" than the rest over a fairly short period in the future. Logical as this endeavor may seem, we do not believe it is suited to the needs or temperament of the true investor—particularly since he would be competing with a large number of stock-market traders and first class financial analysts who are trying to do the same thing.
3. He should always remember that market quotations are there for his convenience, either to be taken advantage of or to be ignored. He should never buy a stock because it has gone up or sell one because it has gone down. He would not be far wrong if this motto read more simply: "Never buy a stock immediately after a substantial rise or sell one immediately after a substantial drop."

Summary - An Added Consideration

1. Something should be said about the significance of average market prices as a measure of managerial competence.
2. This statement may sound like a truism, but it needs to be emphasized. For as yet there is no accepted technique or approach by which management is brought to the bar of market opinion.
3. Good managements produce a good average market price, and bad managements produce bad market prices.

Fluctuations in Bond Prices

The investor should be aware that even though safety of its principal and interest may be unquestioned, a long-term bond could vary widely in market price in response to changes in interest rates.

TABLE 8-1 Fluctuations in Bond Yields, and in Prices of Two Representative Bond Issues, 1902–1970

	Bond Yields			*Bond Prices*	
	S & P AAA Composite	S & P Municipals		A. T. & S. F. 4s, 1995	Nor. Pac. 3s, 2047
1902 low	4.31%	3.11%	1905 high	105½	79
1920 high	6.40	5.28	1920 low	69	49¾
1928 low	4.53	3.90	1930 high	105	73
1932 high	5.52	5.27	1932 low	75	46¾
1946 low	2.44	1.45	1936 high	117¼	85¼
1970 high	8.44	7.06	1939–40 low	99½	31½
1971 close	7.14	5.35	1946 high	141	94¾
			1970 low	51	32¾
			1971 close	64	37¼

Fluctuations in Bond Prices – cont.

1. Because of their inverse relationship the low yields correspond to the high prices and vice versa.
2. Note that bond prices do not fluctuate in the same (inverse) proportion as the calculated yields, because their fixed maturity value of 100% exerts a moderating influence. However, for very long maturities, as in our Northern Pacific example, prices and yields change at close to the same rate.
3. Moral: Nothing important on Wall Street can be counted on to occur exactly in the same way as it happened before. This represents the first half of our favorite dictum: “The more it changes, the more it’s the same thing.”
4. If it is virtually impossible to make worthwhile predictions about the price movements of stocks, it is completely impossible to do so for bonds.

Fluctuations in Bond Prices – cont.

5. In the old days, at least, one could often find a useful clue to the coming end of a bull or bear market by studying the prior action of bonds, but no similar clues were given to a coming change in interest rates and bond prices. Hence the investor must choose between long-term and short-term bond investments on the basis chiefly of his personal preferences.
6. Note that bond prices do not fluctuate in the same (inverse) proportion as the calculated yields, because their fixed maturity value of 100% exerts a moderating influence. However, for very long maturities, as in our Northern Pacific example, prices and yields change at close to the same rate.
7. The price fluctuations of convertible bonds and preferred stocks are the resultant of three different factors: (1) variations in the price of the related common stock, (2) variations in the credit standing of the company, and (3) variations in general interest rates.

Fluctuations in Bond Prices – cont.

8. Over the past decade the bond investor has been confronted by an increasingly serious dilemma: Shall he choose complete stability of principal value, but with varying and usually low (short-term) interest rates? Or shall he choose a fixed-interest income, with considerable variations (usually downward, it seems) in his principal value?
9. It would be good for most investors if they could compromise between these extremes, and be assured that neither their interest return nor their principal value will fall below a stated minimum over, say, a 20-year period. In effect the U.S. government has done a similar thing in its combination of the original savings bonds contracts with their extensions at higher interest rates. The suggestion we make here would cover a longer fixed investment period than the savings bonds, and would introduce more flexibility in the interest-rate provisions.
10. The nonconvertible preferred stocks, since their special tax status makes the safe ones much more desirable holdings by corporations—e.g., insurance companies—than by individuals. The poorer-quality ones almost always fluctuate over a wide range, percentagewise, not too differently from common stocks.