Chapter 10:
The Investor and His Advisers

Introduction

1. If the reason people invest is to make money, then in seeking advice they are asking others to tell them how to make money. That idea has some element of naïveté. Businessmen seek professional advice on various elements of their business, but they do not expect to be told how to make a profit. That is their own bailiwick. When they, or nonbusiness people, rely on others to make investment profits for them, they are expecting a kind of result for which there is no true counterpart in ordinary business affairs.

2. If the investor is to rely chiefly on the advice of others in handling his funds, then either he must limit himself and his advisers strictly to standard, conservative, and even unimaginative forms of investment, or he must have an unusually intimate and favorable knowledge of the person who is going to direct his funds into other channels.

3. But if the ordinary business or professional relationship exists between the investor and his advisers, he can be receptive to less conventional suggestions only to the extent that he himself has grown in knowledge and experience and has therefore become competent to pass independent judgment on the recommendations of others. He has then passed from the category of defensive or unenterprising investor into that of aggressive or enterprising investor.

Investment Counsel and Trust Services of Banks

1. The truly professional investment advisers—that is, the well established investment counsel firms, who charge substantial annual fees—are quite modest in their promises and pretentions.
2. The leading investment-counsel firms make no claim to being brilliant; they do pride themselves on being careful, conservative, and competent. Their primary aim is to conserve the principal value over the years and produce a conservatively acceptable rate of income. Any accomplishment beyond that—and they do strive to better the goal—they regard in the nature of extra service rendered.

Financial Services

1. The so-called financial services are organizations that send out uniform bulletins (sometimes in the form of telegrams) to their subscribers. The subjects covered may include the state and prospects of business, the behavior and prospect of the securities markets, and information and advice regarding individual issues. There is often an “inquiry department” which will answer questions affecting an individual subscriber. The cost of the service averages much less than the fee that investment counselors charge their individual clients.
2. The financial services offer information and guidance to those who are directing their own financial affairs or are themselves advising others.
3. On the other hand, some of the best known—such as Moody’s Investment Service and Standard & Poor’s—are identified with statistical organizations that compile the voluminous statistical data that form the basis for all serious security analysis. Their interpretations and forecasts of business conditions, of course, are much more authoritative and informing.
4. This is their general view that a stock should be bought if the near-term prospects of the business are favorable and should be sold if these are unfavorable—regardless of the current price. Such a superficial principle often prevents the services from doing the sound analytical job of which their staffs are capable—namely, to ascertain whether a given stock appears over- or undervalued at the current price in the light of its indicated long-term future earning power.
5. The intelligent investor will not do his buying and selling solely on the basis of recommendations received from a financial service.

Advice from Brokerage Houses

1. Probably the largest volume of information and advice to the security-owning public comes from stockbrokers. These are members of the New York Stock Exchange, and of other exchanges, who execute buying and selling orders for a standard commission.
2. Most stock-exchange houses, however, still adhere to the old time slogans that they are in business to make commissions and that the way to succeed in business is to give the customers what they want. Since the most profitable customers want speculative advice and suggestions, the thinking and activities of the typical firm are pretty closely geared to day-to-day trading in the market.
3. The investor obtains advice and information from stock exchange houses through two types of employees, now known officially as "customers' brokers" (or "account executives") and financial analysts.
    1) The customer's broker, also called a "registered representative," formerly bore the less dignified title of "customer's man." Today he is for the most part an individual of good character and considerable knowledge of securities, who operates under a rigid code of right conduct. Nevertheless, since his business is to earn commissions.

Advice from Brokerage Houses

3. The investor obtains advice and information from stock exchange houses through two types of employees, now known officially as “customers’ brokers” (or “account executives”) and financial analysts.
   2) The financial analyst, formerly known chiefly as security analyst, is a person of particular concern to the author, who has been one himself for more than five decades and has helped educate countless others. By what must seem a quirk to the outsider there are no formal requirements for being a security analyst.
   3) Contrast with this the facts that a customer’s broker must pass an examination, meet the required character tests, and be duly accepted and registered by the New York Stock Exchange.
4. The analysts hired by brokerage houses, we are convinced, are greatly handicapped by the general feeling that they are supposed to be market analysts as well. When they are asked whether a given common stock is “sound,” the question often means, “Is this stock likely to advance during the next few months?” As a result many of them are compelled to analyze with one eye on the stock ticker—a pose not conducive to sound thinking or worthwhile conclusions.

The CFA Certificate for Financial Analysts

1. The official title of chartered financial analyst (CFA) is now awarded to those senior practitioners who pass required examinations and meet other tests of fitness. The subjects covered include security analysis and portfolio management.

2. elevate the standards of financial analysts and eventually to place their work on a truly professional basis

Dealings with Brokerage Houses

1. One of the most disquieting developments of the period in which we write this revision has been the financial embarrassment— in plain words, bankruptcy or near-bankruptcy—of quite a few New York Stock Exchange firms, including at least two of considerable size.

2. The first financial troubles of the brokerage houses (in 1969) were attributed to the increase in volume itself. This, it was claimed, overtaxed their facilities, increased their overhead, and produced many troubles in making financial settlements. It should be pointed out this was probably the first time in history that important enterprises have gone broke because they had more business than they could handle.

3. A third explanation of the financial trouble finally emerged out of a mist of concealment, and we suspect that it is the most plausible and significant of the three. It seems that a good part of the capital of certain brokerage houses was held in the form of common stocks owned by the individual partners. Some of these seem to have been highly speculative and carried at inflated values. When the market declined in 1969 the quotations of such securities fell drastically and a substantial part of the capital of the firms vanished with them.

Dealings with Brokerage Houses – cont.

4. The investor should use his intelligence not only in formulating his financial policies but also in the associated details. These include the choice of a reputable broker to execute his orders.
5. We think that people who do not carry margin accounts—and in our vocabulary this means all nonprofessional investors—should have the delivery and receipt of their securities handled by their bank.*
6. * Nearly all brokerage transactions are now conducted electronically, and securities are no longer physically “delivered.” Thanks to the establishment of the Securities Investor Protection Corporation, or SIPC, in 1970, investors are generally assured of recovering their full account values if their brokerage firm becomes insolvent.

Investment Bankers

1. The term “investment banker” is applied to a firm that engages to an important extent in originating, underwriting, and selling new issues of stocks and bonds.
2. There is an additional tendency for brokerage firms to originate and sponsor a minor amount of new-issue financing, particularly in the form of smaller issues of common stocks when a bull market is in full swing.
3. Investment banking is perhaps the most respectable department of the Wall Street community, because it is here that finance plays its constructive role of supplying new capital for the expansion of industry.
4. The relationship between the investment banker and the investor is basically that of the salesman to the prospective buyer. For many years past the great bulk of the new offerings in dollar value has consisted of bond issues that were purchased in the main by financial institutions such as banks and insurance companies. In this business the security salesmen have been dealing with shrewd and experienced buyers. Any recommendations made by the investment bankers to these customers have had to pass careful and skeptical scrutiny. Thus these transactions are almost always effected on a businesslike footing.

Investment Bankers – cont.

5. But a different situation obtains in a relationship between the individual security buyer and the investment banking firms, including the stockbrokers acting as underwriters. Here the purchaser is frequently inexperienced and seldom shrewd. He is easily influenced by what the salesman tells him, especially in the case of common-stock issues.
6. It is a tribute to the honesty and competence of the underwriting firms that they are able to combine fairly well the discordant roles of adviser and salesman. But it is imprudent for the buyer to trust himself to the judgment of the seller.
7. The intelligent investor will pay attention to the advice and recommendations received from investment banking houses, especially those known by him to have an excellent reputation; but he will be sure to bring sound and independent judgment to bear upon these suggestions—either his own, if he is competent, or that of some other type of adviser

Other Advisers

1. It is a good old custom, especially in the smaller towns, to consult one's local banker about investments. A commercial banker may not be a thoroughgoing expert on security values, but he is experienced and conservative.
2. We take a more critical attitude toward the widespread custom of asking investment advice from relatives or friends. Our own observation indicates that it is almost as difficult to select satisfactory lay advisers as it is to select the proper securities unaided. Much bad advice is given free.

Summary

1. Investors who are prepared to pay a fee for the management of their funds may wisely select some well-established and well recommended investment-counsel firm. Alternatively, they may use the investment department of a large trust company or the supervisory service supplied on a fee basis by a few of the leading New York Stock Exchange houses. The results to be expected are in no wise exceptional.
2. Most security buyers obtain advice without paying for it specifically. It stands to reason, therefore, that in the majority of cases they are not entitled to and should not expect better than average results.
3. Defensive investors will not ordinarily be equipped to pass independent judgment on the security recommendations made by their advisers. But they can be explicit—and even repetitiously so—in stating the kind of securities they want to buy.
4. The aggressive investor will ordinarily work in active cooperation with his advisers. He will want their recommendations explained in detail, and he will insist on passing his own judgment upon them. Only in the exceptional case, where the integrity and competence of the advisers have been thoroughly demonstrated, should the investor act upon the advice of others without understanding and approving the decision made.
5. There have always been unprincipled stock salesmen and flyby-night stock brokers, and—as a matter of course—we have advised our readers to confine their dealings, if possible, to membersof the New York Stock Exchange.