Chapter 4:
General Portfolio Policy:
The Defensive Investor

Basic Characteristics of an Investment Portfolio

1. The basic characteristics of an investment portfolio are usually determined by the position and characteristics of the owner or owners.
2. It has been an old and sound principle that those who cannot afford to take risks should be content with a relatively low return on their invested funds. From this there has developed the general notion that the rate of return which the investor should aim for is more or less proportionate to the degree of risk he is ready to run.
3. Our view is different. The rate of return sought should be dependent, rather, on the amount of intelligent effort the investor is willing and able to bring to bear on his task.
4. The minimum return goes to our passive investor, who wants both safety and freedom from concern. The maximum return would be realized by the alert and enterprising investor who exercises maximum intelligence and skill.

The Basic Problem of Bond-Stock Allocation

1. We have suggested as a fundamental guiding rule that the investor should never have less than 25% or more than 75% of his funds in common stocks, with a consequent inverse range of between 75% and 25% in bonds. There is an implication here that the standard division should be an equal one, or 50–50, between the two major investment mediums.
2. According to tradition the sound reason for increasing the percentage in common stocks would be the appearance of the “bargain price” levels created in a protracted bear market. Conversely, sound procedure would call for reducing the common-stock component below 50% when in the judgment of the investor the market level has become dangerously high.
3. These copybook maxims have always been easy to enunciate and always difficult to follow—because they go against that very human nature which produces that excesses of bull and bear markets.
4. A truly conservative investor will be satisfied with the gains shown on half his portfolio in a rising market, while in a severe decline he may derive much solace from reflecting how much better off he is than many of his more venturesome friends.

The Bond Component

The choice of issues in the bond component of the investor's portfolio will turn about two main questions: Should he buy taxable or tax-free bonds, and should he buy shorter- or longer-term maturities?

1. The tax decision should be mainly a matter of arithmetic, turning on the difference in yields as compared with the investor's tax bracket. In January 1972 the choice in 20-year maturities was between obtaining, say, 7 1⁄2% on "grade Aa" corporate bonds and 5.3% on prime tax-free issues. It is evident that a large proportion of individual investors would obtain a higher return after taxes from good municipals than from good corporate bonds.
2. The choice of longer versus shorter maturities involves quite a different question, viz.: Does the investor want to assure himself against a decline in the price of his bonds, but at the cost of (1) a lower annual yield and (2) loss of the possibility of an appreciable gain in principal value? We think it best to discuss this question in Chapter 8, The Investor and Market Fluctuations.

The Bond Component – cont.

3. As we shall point out, U.S. savings bonds still possess certain unique merits that make them a suitable purchase by any individual investor. For the man of modest capital—with, say, not more than $10,000 to put into bonds—we think they are still the easiest and the best choice. But those with larger funds may find other mediums more desirable.

The Bond Component – Major Types of Bonds

Let us list a few major types of bonds that deserve investor consideration, and discuss them briefly with respect to general description, safety, yield, market price, risk, income-tax status, and other features.

1. u.s. savings bonds, series E and series H: The Series H bonds pay interest semiannually, as do other bonds. The rate is 4.29% for the first year, and then a flat 5.10% for the next nine years to maturity. Interest on the Series E bonds is not paid out, but accrues to the holder through increase in redemption value. The bonds are sold at 75% of their face value, and mature at 100% in 5 years 10 months after purchase. If held to maturity the yield works out at 5%, compounded semiannually.
    - Interest on the bonds is subject to Federal income tax, but is exempt from state income tax.
    - In our view the special advantages enjoyed by owners of savings bonds now will more than compensate for their lower current return as compared with other direct government obligations.

The Bond Component – Major Types of Bonds – cont.

2. other united states bonds: A profusion of these issues exists, covering a wide variety of coupon rates and maturity dates. All of them are completely safe with respect to payment of interest and principal. They are subject to Federal income taxes but free from state income tax. In late 1971 the long-term issues—over ten years— showed an average yield of 6.09%, intermediate issues (three to five years) returned 6.35%, and short issues returned 6.03%.
    1. In 1970 it was possible to buy a number of old issues at large discounts.
    2. It is interesting to note also that in many cases the indirect obligations of the U.S. government yield appreciably more than its direct obligations of the same maturity.
    3. Perhaps the chief impact of this situation has been the creation of tax-free Housing Authority bonds, enjoying the equivalent of a U.S. guarantee, and virtually the only tax exempt issues that are equivalent to government bonds.
    4. Another type of government-backed issues is the recently created New Community Debentures, offered to yield 7.60% in September 1971.

The Bond Component – Major Types of Bonds – cont.

3. state and municipal bonds: These enjoy exemption from Federal income tax. They are also ordinarily free of income tax in the state of issue but not elsewhere. They are either direct obligations of a state or subdivision, or “revenue bonds” dependent for interest payments on receipts from a toll road, bridge, building lease, etc.

    - Not all tax-free bonds are strongly enough protected to justify their purchase by a defensive investor. He may be guided in his selection by the rating given to each issue by Moody’s or Standard & Poor’s. One of three highest ratings by both services—Aaa (AAA), Aa (AA), or A—should constitute a sufficient indication of adequate safety.
    - The yield on these bonds will vary both with the quality and the maturity, with the shorter maturities giving the lower return. In late 1971 the issues represented in Standard & Poor’s municipal bond index averaged AA in quality rating, 20 years in maturity, and 5.78% in yield.

The Bond Component – Major Types of Bonds – cont.

4. corporation bonds: These bonds are subject to both Federal and state tax. In early 1972 those of highest quality yielded 7.19% for a 25-year maturity, as reflected in the published yield of Moody's Aaa corporate bond index. The so-called lower-mediumgrade issues—rated Baa—returned 8.23% for long maturities. In each class shorter-term issues would yield somewhat less than longer-term obligations.

Comments: The above summaries indicate that the average investor has several choices among high-grade bonds.

- Those in high income-tax brackets can undoubtedly obtain a better net yield from good tax-free issues than from taxable ones.
- For others the early 1972 range of taxable yield would seem to be from 5.00% on U.S. savings bonds, with their special options, to about 7 1⁄2% on high-grade corporate issues.

The Bond Component – Higher-Yielding Bond Investments

1. By sacrificing quality an investor can obtain a higher income return from his bonds. Long experience has demonstrated that the ordinary investor is wiser to keep away from such high-yield bonds.
2. It is true that bargain opportunities occur fairly often in lower grade bonds, but these require special study and skill to exploit successfully.
3. Perhaps we should add here that the limits imposed by Congress on direct bond issues of the United States have produced at least two sorts of "bargain opportunities" for investors in the purchase of government-backed obligations.
4. One is provided by the tax-exempt "New Housing" issues, and the other by the recently created (taxable) "New Community debentures." Both obligations have the "full faith and credit" of the United States government behind them and hence are safe without question. And—on a net basis—they yield considerably more than ordinary United States bonds.

The Bond Component – Savings Deposits in Lieu of Bonds

An investor may now obtain as high an interest rate from a savings deposit in a commercial or savings bank (or from a bank certificate of deposit) as he can from a first-grade bond of short maturity

The Bond Component – Convertible Issues & Call Provisions

1. Convertible Issues: is treated in Chapter 8

2. Call Provisions:
   - In the typical case bonds were callable fairly soon after issuance, and at modest premiums—say 5%—above the issue price. This meant that during a period of wide fluctuations in the underlying interest rates the investor had to bear the full brunt of unfavorable changes and was deprived of all but a meager participation in favorable ones.
   - The call feature in these bond contracts was a thinly disguised instance of "heads I win, tails you lose."
   - In practical terms, we advise the investor in long-term issues to sacrifice a small amount of yield to obtain the assurance of noncallability— say for 20 or 25 years. Similarly, there is an advantage in buying a low-coupon bond* at a discount rather than a high coupon bond selling at about par and callable in a few years.

Straight—i.e., Nonconvertible—Preferred Stocks

1. Really good preferred stocks can and do exist, but they are good in spite of their investment form, which is an inherently bad one.
2. The typical preferred shareholder is dependent for his safety on the ability and desire of the company to pay dividends on its common stock.
3. Once the common dividends are omitted, or even in danger, his own position becomes precarious, for the directors are under no obligation to continue paying him unless they also pay on the common. On the other hand, the typical preferred stock carries no share in the company's profits beyond the fixed dividend rate. Thus the preferred holder lacks both the legal claim of the bondholder (or creditor) and the profit possibilities of a common shareholder (or partner).
4. These weaknesses in the legal position of preferred stocks tend to come to the fore recurrently in periods of depression. Only a small percentage of all preferred issues are so strongly entrenched as to maintain an unquestioned investment status through all vicissitudes. Experience teaches that the time to buy preferred stocks is when their price is unduly depressed by temporary adversity.
5. Another peculiarity in the general position of preferred stocks deserves mention. They have a much better tax status for corporation buyers than for individual investors. Thus, All investment-grade preferred stocks should be bought by corporations, just as all tax-exempt bonds should be bought by investors who pay income tax.

Security Forms

1. standard provisions: Bonds and the preferred-stock form
2. Departure forms: convertible and similar issues, and income bonds
3. Income bonds: interest does not have to be paid unless it is earned by the company. The terms of income bonds can be tailored to the advantage of both the borrower and the lender in the manner best suited to both.
    1. the deductibility of the interest paid from the company's taxable income, which in effect cuts the cost of that form of capital in half.
    2. From the investor's standpoint it is probably best for him in most cases that he should have (1) an unconditional right to receive interest payments when they are earned by the company, and (2) a right to other forms of protection than bankruptcy proceedings if interest is not earned and paid.
4. The acceptance by everybody of the inherently weak preferred-stock form and the rejection of the stronger income-bond form is a fascinating illustration of the way in which traditional institutions and habits often tend to persist on Wall Street despite new conditions calling for a fresh point of view.