Chapter 5:
The Defensive Investor and Common Stocks

Investment Merits of Common Stocks

1. Common stocks had offered a considerable degree of protection against the erosion of the investor's dollar caused by inflation, whereas bonds offered no protection at all.
2. Common stocks have higher average return to investors over the years. This was produced both by an average dividend income exceeding the yield on good bonds and by an underlying tendency for market value to increase over the years in consequence of the reinvestment of undistributed profits.
3. While these two advantages have been of major importance— and have given common stocks a far better record than bonds over the long-term past—we have consistently warned that these benefits could be lost by the stock buyer if he pays too high a price for his shares.

Rules for the Common-Stock Component

1. There should be adequate though not excessive diversification. This might mean a minimum of ten different issues and a maximum of about thirty.
2. Each company selected should be large, prominent, and conservatively financed. Indefinite as these adjectives must be, their general sense is clear. Observations on this point are added at the end of the chapter.
3. Each company should have a long record of continuous dividend payments. (All the issues in the Dow Jones Industrial Average met this dividend requirement in 1971.) To be specific on this point we would suggest the requirement of continuous dividend payments beginning at least in 1950.
4. The investor should impose some limit on the price he will pay for an issue in relation to its average earnings over, say, the past seven years. We suggest that this limit be set at 25 times such average earnings, and not more than 20 times those of the last twelve-month period. But such a restriction would eliminate nearly all the strongest and most popular companies from the portfolio. In particular, it would ban virtually the entire category of “growth stocks,”.

Growth Stocks and the Defensive Investor

1. The term “growth stock” is applied to one which has increased its per-share earnings in the past at well above the rate for common stocks generally and is expected to continue to do so in the future. (Some authorities would say that a true growth stock should be expected at least to double its per-share earnings in ten years—i.e., to increase them at a compounded annual rate of over 7.1%.).
2. Obviously stocks of this kind are attractive to buy and to own, provided the price paid is not excessive. The problem lies there, of course, since growth stocks have long sold at high prices in relation to current earnings and at much higher multiples of their average profits over a past period. This has introduced a speculative element of considerable weight in the growth-stock picture and has made successful operations in this field a far from simple matter.
3. The leading growth issue has long been IBM (for example).
4. The reader will understand from these instances why we regard growth stocks as a whole as too uncertain and risky a vehicle for the defensive investor.
5. In contrast we think that the group of large companies that are relatively unpopular, and therefore obtainable at reasonable earnings multipliers,* offers a sound if unspectacular area of choice by the general public.

Portfolio Changes

1. Presumably our defensive investor should obtain—at least once a year—the same kind of advice regarding changes in his portfolio as he sought when his funds were first committed.
2. Since he will have little expertness of his own on which to rely, it is essential that he entrust himself only to firms of the highest reputation; otherwise he may easily fall into incompetent or unscrupulous hands. It is important, in any case, that at every such consultation he make clear to his adviser that he wishes to adhere closely to the four rules of common-stock selection given earlier in this chapter.
3. Incidentally, if his list has been competently selected in the first instance, there should be no need for frequent or numerous changes.

Dollar-Cost Averaging

1. The New York Stock Exchange has put considerable effort into popularizing its “monthly purchase plan,” under which an investor devotes the same dollar amount each month to buying one or more common stocks. This is an application of a special type of “formula investment” known as dollar-cost averaging. During the predominantly rising-market experience since 1949 the results from such a procedure were certain to be highly satisfactory, especially since they prevented the practitioner from concentrating his buying at the wrong times.
2. It may be objected that dollar-cost averaging, while sound in principle, is rather unrealistic in practice, because few people are so situated that they can have available for common-stock investment the same amount of money each year for, say, 20 years. It seems to me that this apparent objection has lost much of its force in recent years.

The Investor’s Personal Situation

1. To what extent should the type of securities selected by the investor vary with his circumstances? As concrete examples representing widely different conditions, we shall take: (1) a widow left $200,000 with which to support herself and her children; (2) a successful doctor in mid-career, with savings of $100,000 and yearly accretions of $10,000; and (3) a young man earning $200 per week and saving $1,000 a year.
2. The kind of securities to be purchased and the rate of return to be sought depend not on the investor’s financial resources but on his financial equipment in terms of knowledge, experience, and temperament.

Note on the Concept of “Risk”

1. A bond is clearly proved unsafe when it defaults its interest or principal payments. Similarly, if a preferred stock or even a common stock is bought with the expectation that a given rate of dividend will be continued, then a reduction or passing of the dividend means that it has proved unsafe.

2. Many common stocks do involve risks of such deterioration. But it is our thesis that a properly executed group investment in common stocks does not carry any substantial risk of this sort and that therefore it should not be termed “risky” merely because of the element of price fluctuation. But such risk is present if there is danger that the price may prove to have been clearly too high by intrinsic value standards—even if any subsequent severe market decline may be recouped many years later.

Note on the Category of “Large, Prominent, and Conservatively Financed Corporations”

Where is the dividing line for size, for prominence, and for conservatism of financial structure?

1. An industrial company’s finances are not conservative unless the common stock (at book value) represents at least half of the total capitalization, including all bank debt.3 For a railroad or public utility the figure should be at least 30%.
2. The words “large” and “prominent” carry the notion of substantial size combined with a leading position in the industry. Such companies are often referred to as “primary”; all other common stocks are then called “secondary,” except that growth stocks are ordinarily placed in a separate class by those who buy them as such.
3. To supply an element of concreteness here, let us suggest that to be “large” in present-day terms a company should have $50 million of assets or do $50 million of business.* Again to be “prominent” a company should rank among the first quarter or first third in size within its industry group. In today’s markets, to be considered large, a company should have a total stock value (or “market capitalization”) of at least $10 billion.