Chapter 6:
Portfolio Policy for the Enterprising Investor: Negative Approach

Introduction

1. The “aggressive” investor should start from the same base as the defensive investor, namely, a division of his funds between high grade bonds and high-grade common stocks bought at reasonable prices. He will be prepared to branch out into other kinds of security commitments, but in each case he will want a well-reasoned justification for the departure.
2. The most useful generalizations for the enterprising investor are of a negative sort.
   - Let him leave high-grade preferred stocks to corporate buyers.
   - Let him also avoid inferior types of bonds and preferred stocks unless they can be bought at bargain levels—which means ordinarily at prices at least 30% under par for high-coupon issues, and much less for the lower coupons.
   - He will let someone else buy foreign-government bond issues, even though the yield may be attractive.
   - He will also be wary of all kinds of new issues, including convertible bonds and preferreds that seem quite tempting and common stocks with excellent earnings confined to the recent past.
3. For standard bond investments the aggressive investor would do well to follow the pattern suggested to his defensive confrere, and make his choice between high-grade taxable issues, which can now be selected to yield about 7 1⁄4%, and good-quality tax-free bonds, which yield up to 5.30% on longer maturities.

Second-Grade Bonds and Preferred Stocks

1. Since in late-1971 it is possible to find first-rate corporate bonds to yield 7¼%, and even more, it would not make much sense to buy second-grade issues merely for the higher return they offer.even in the matter of price discounts and resultant chance of principal gain, the second-grade bonds are in competition with better issues
2. Many investors buy securities of this kind because they “need income” and cannot get along with the meager return offered by top-grade issues. Experience clearly shows that it is unwise to buy a bond or a preferred which lacks adequate safety merely because the yield is attractive. Where such securities are bought at full prices—that is, not many points under 100*—the chances are very great that at some future time the holder will see much lower quotations. For when bad business comes, or just a bad market, issues of this kind prove highly susceptible to severe sinking spells.
3. Second-grade bonds and preferred stocks possess two contradictory attributes which the intelligent investor must bear clearly in mind. Nearly all suffer severe sinking spells in bad markets. On the other hand, a large proportion recover their position when favorable conditions return, and these ultimately “work out all right.” This is true even of (cumulative) preferred stocks that fail to pay dividends for many years.
4. the buyer of second-grade issues at full prices will be worried and discommoded when their price declines precipitately. Furthermore, he cannot buy enough issues to assure an “average” result, nor is he in a position to set aside a portion of his larger income to offset or “amortize” those principal losses which prove to be permanent.

Foreign Government Bonds

1. All investors with even small experience know that foreign bonds, as a whole, have had a bad investment history since 1914.
2. For many years past we have questioned the inherent attractiveness of such investments from the standpoint of the buyer; perhaps we should add now that the latter would benefit both his country and himself if he declined these opportunities.

New Issues Generally

1. It might seem ill-advised to attempt any broad statements about new issues as a class, since they cover the widest possible range of quality and attractiveness. Certainly there will be exceptions to any suggested rule. Our one recommendation is that all investors should be wary of new issues—which means, simply, that these should be subjected to careful examination and unusually severe tests before they are purchased.
2. There are two reasons for this double caveat.
   - The first is that new issues have special salesmanship behind them, which calls therefore for a special degree of sales resistance.*
   - The second is that most new issues are sold under “favorable market conditions”— which means favorable for the seller and consequently less favorable for the buyer

New Common-Stock Offerings

1. Common-stock financing takes two different forms.
   - In the case of companies already listed, additional shares are offered pro rata to the existing stockholders. The subscription price is set below the current market, and the “rights” to subscribe have an initial money value.
   - The second type is the placement with the public of common stock of what were formerly privately owned enterprises. Most of this stock is sold for the account of the controlling interests to enable them to cash in on a favorable market and to diversify their own finances. (When new money is raised for the business it comes often via the sale of preferred stock, as previously noted.) This activity follows a well-defined pattern, which by the nature of the security markets must bring many losses and disappointments to the public.
2. An elementary requirement for the intelligent investor is an ability to resist the blandishments of salesmen offering new common stock issues during bull markets. Even if one or two can be found that can pass severe tests of quality and value, it is probably bad policy to get mixed up in this sort of business.
3. Some of these issues may prove excellent buys—a few years later, when nobody wants them and they can be had at a small fraction of their true worth.