Chapter 7: Portfolio Policy for the Enterprising Investor: The Positive Side

Bond Investments

1. He might be interested in special opportunities of the following kinds (details see chapter 4)
    - Tax-free New Housing Authority bonds effectively guaranteed by the United States government.
    - Taxable but high-yielding New Community bonds, also guaranteed by the United States government.
    - Tax-free industrial bonds issued by municipalities, but serviced by lease payments made by strong corporations.
2. At the other end of the spectrum there may be lower-quality bonds obtainable at such low prices as to constitute true bargain opportunities. But these would belong in the "special situation" area, where no true distinction exists between bonds and common stocks.

*Today these "lower-quality bonds" in the "special situation" area are known as distressed or defaulted bonds.

Operations in Common Stocks

1. Buying in low markets and selling in high markets
2. Buying carefully chosen “growth stocks”
3. Buying bargain issues of various types
4. Buying into “special situations”

General Market Policy—Formula Timing

1. The 50–50 plan, which we proposed to the defensive investor and described on p. 90, is about the best specific or automatic formula we can recommend to all investors under the conditions of 1972.
2. But we have retained a broad leeway between the 25% minimum and the 75% maximum in common stocks, which we allow to those investors who have strong convictions about either the danger or the attractiveness of the general market level.

Growth-Stock Approach

1. Every investor would like to select the stocks of companies that will do better than the average over a period of years. A growth stock may be defined as one that has done this in the past and is expected to do so in the future. Thus it seems only logical that the intelligent investor should concentrate upon the selection of growth stocks. Actually the matter is more complicated, as we shall try to show.
2. There are two catches to this simple idea.
   - The first is that common stocks with good records and apparently good prospects sell at correspondingly high prices.
   - The second is that his judgment as to the future may prove wrong. Unusually rapid growth cannot keep up forever; when a company has already registered a brilliant expansion, its very increase in size makes a repetition of its achievement more difficult. At some point the growth curve flattens out, and in many cases it turns downward.
3. No outstanding rewards came from diversified investment in growth companies as compared with that in common stocks generally.

Growth-Stock Approach – cont.

4. There is no reason at all for thinking that the average intelligent investor, even with much devoted effort, can derive better results over the years from the purchase of growth stocks than the investment companies specializing in this area.
5. The striking thing about growth stocks as a class is their tendency toward wide swings in market price. The more enthusiastic the public grows about it, and the faster its advance as compared with the actual growth in its earnings, the riskier a proposition it becomes.
6. But is it not true, the reader may ask, that the really big fortunes from common stocks have been garnered by those who made a substantial commitment in the early years of a company in whose future they had great confidence, and who held their original shares unwaveringly while they increased 100-fold or more in value? The answer is "Yes." But the big fortunes from single company investments are almost always realized by persons who have a close relationship with the particular company—through employment, family connection, etc.—which justifies them in placing a large part of their resources in one medium and holding on to this commitment through all vicissitudes, despite numerous temptations to sell out at apparently high prices along the way.

Three Recommended Fields for “Enterprising Investment”

- To obtain better than average investment results over a long pull requires a policy of selection or operation possessing a twofold merit: (1) It must meet objective or rational tests of underlying soundness; and (2) it must be different from the policy followed by most investors or speculators.
- Our experience and study leads us to recommend three investment approaches that meet these criteria.

  1. The Relatively Unpopular Large Company

     a) The key requirement here is that the enterprising investor concentrate on the larger companies that are going through a period of unpopularity. While small companies may also be undervalued for similar reasons, and in many cases may later increase their earnings and share price, they entail the risk of a definitive loss of profitability and also of protracted neglect by the market in spite of better earnings. The large companies thus have a double advantage over the others. First, they have the resources in capital and brain power to carry them through adversity and back to a satisfactory earnings base. Second, the market is likely to respond with reasonable speed to any improvement shown.

Three Recommended Fields for "Enterprising Investment" – cont.

1. The Relatively Unpopular Large Company

b) A remarkable demonstration of the soundness of this thesis is found in studies of the price behavior of the unpopular issues in the Dow Jones Industrial Average. The consistently better performance of the low-multiplier stocks is shown (Table 7-2) by the average results for successive five-year periods, when compared with those of the DJIA and of the ten high-multipliers.

c) The concept of buying "unpopular large companies" and its execution on a group basis, as described above, are both quite simple. But in considering individual companies a special factor of opposite import must sometimes to be taken into account. Companies that are inherently speculative because of widely varying earnings tend to sell both at a relatively high price and at a relatively low multiplier in their good years, and conversely at low prices and high multipliers in their bad years. This time the figures proved quite disappointing, showing a sharp loss for the low multiplier six or ten and a good profit for the high-multiplier selections.

d) Perhaps the aggressive investor should start with the "low-multiplier" idea, but add other quantitative and qualitative requirements thereto in making up his portfolio.

Three Recommended Fields for “Enterprising Investment” – cont.

2. Purchase of Bargain Issues

a) The genus includes bonds and preferred stocks selling well under par, as well as common stocks. To be as concrete as possible, let us suggest that an issue is not a true “bargain” unless the indicated value is at least 50% more than the price. What kind of facts would warrant the conclusion that so great a discrepancy exists? How do bargains come into existence, and how does the investor profit from them?

b) There are two tests by which a bargain common stock is detected.

   I. The first is by the method of appraisal. This relies largely on estimating future earnings and then multiplying these by a factor appropriate to the particular issue. If the resultant value is sufficiently above the market price—and if the investor has confidence in the technique employed—he can tag the stock as a bargain.

   II. The second test is the value of the business to a private owner. This value also is often determined chiefly by expected future earnings— in which case the result may be identical with the first. But in the second test more attention is likely to be paid to the realizable value of the assets, with particular emphasis on the net current assets or working capital.

Three Recommended Fields for “Enterprising Investment” – cont.

2. Purchase of Bargain Issues

c) The market is fond of making mountains out of molehills and exaggerating ordinary vicissitudes into major setbacks.* Even a mere lack of interest or enthusiasm may impel a price decline to absurdly low levels. Thus we have what appear to be two major sources of undervaluation: (1) currently disappointing results and (2) protracted neglect or unpopularity.

d) However, neither of these causes, if considered by itself alone, can be relied on as a guide to successful common-stock investment. How can we be sure that the currently disappointing results are indeed going to be only temporary?

e) The many experiences of this type suggest that the investor would need more than a mere falling off in both earnings and price to give him a sound basis for purchase. He should require an indication of at least reasonable stability of earnings over the past decade or more—i.e., no year of earnings deficit—plus sufficient size and financial strength to meet possible setbacks in the future. The ideal combination here is thus that of a large and prominent company selling both well below its past average price and its past average price/earnings multiplier. This would no doubt have ruled out most of the profitable opportunities in companies such as Chrysler, since their low-price years are generally accompanied by high price/earnings ratios.

Three Recommended Fields for "Enterprising Investment" – cont.

2. Purchase of Bargain Issues

f) We have mentioned protracted neglect or unpopularity as a second cause of price declines to unduly low levels. A current case of this kind would appear to be National Presto Industries. Another example of this type is provided currently by Standard Oil of California, a concern of major importance. A third cause for an unduly low price for a common stock may be the market's failure to recognize its true earnings picture. Our classic example here is Northern Pacific Railway which in 1946–47 declined from 36 to 13 1⁄2. The price of the stock was held down in great part by its $1 dividend. It was neglected also because much of its earnings power was concealed by accounting methods peculiar to railroads.

g) The type of bargain issue that can be most readily identified is a common stock that sells for less than the company's net working capital alone, after deducting all prior obligations.* This would mean that the buyer would pay nothing at all for the fixed assets— buildings, machinery, etc., or any good-will items that might exist. It can probably be affirmed without hesitation that it constitutes a safe and profitable method of determining and taking advantage of undervalued situations. The market decline of 1969–70 produced a new crop of these "sub-working-capital" stocks. We discuss this group in Chapter 15, on stock selection for the enterprising investor.

Three Recommended Fields for "Enterprising Investment" – cont.

2. Purchase of Bargain Issues

h) Bargain-Issue Pattern in Secondary Companies

   I. This brief review indicates that the stock market's attitude toward secondary companies tends to be unrealistic and consequently to create in normal times innumerable instances of major undervaluation.

   II. If most secondary issues tend normally to be undervalued, what reason has the investor to believe that he can profit from such a situation? For if it persists indefinitely, will he not always be in the same market position as when he bought the issue? The answer here is somewhat complicated. Substantial profits from the purchase of secondary companies at bargain prices arise in a variety of ways.

      i. the dividend return is relatively high

      ii. the reinvested earnings are substantial in relation to the price paid and will ultimately affect the price. In a five- to seven-year period these advantages can bulk quite large in a well-selected list.

      iii. a bull market is ordinarily most generous to low-priced issues; thus it tends to raise the typical bargain issue to at least a reasonable level.

      iv. even during relatively featureless market periods a continuous process of price adjustment goes on, under which secondary issues that were undervalued may rise at least to the normal level for their type of security.

Three Recommended Fields for "Enterprising Investment" – cont.

2. Purchase of Bargain Issues

h) Bargain-Issue Pattern in Secondary Companies

III. If most secondary issues tend normally to be undervalued, what reason has the investor to believe that he can profit from such a situation? For if it persists indefinitely, will he not always be in the same market position as when he bought the issue? The answer here is somewhat complicated. Substantial profits from the purchase of secondary companies at bargain prices arise in a variety of ways.

v. the specific factors that in many cases made for a disappointing record of earnings may be corrected by the advent of new conditions, or the adoption of new policies, or by a change in management.

IV. An important new factor in recent years has been the acquisition of smaller companies by larger ones, usually as part of a diversification program. In these cases the consideration paid has almost always been relatively generous, and much in excess of the bargain levels existing not long before.

V. When interest rates were much lower than in 1970, the field of bargain issues extended to bonds and preferred stocks that sold at large discounts from the amount of their claim.

Three Recommended Fields for “Enterprising Investment” – cont.

2. Purchase of Bargain Issues

h) Bargain-Issue Pattern in Secondary Companies

VI. In the decade ending in 1948 the billion-dollar group of defaulted railroad bonds presented numerous and spectacular opportunities in this area. Such opportunities have been quite scarce since then; but they seem likely to return in the 1970s.

VII. * Defaulted railroad bonds do not offer significant opportunities today (from commentator). However, as already noted, distressed and defaulted junk bonds, as well as convertible bonds issued by high-tech companies, may offer real value in the wake of the 2000–2002 market crash. But diversification in this area is essential.

Three Recommended Fields for "Enterprising Investment" – cont.

3. Special Situations, or "Workouts"

a) Not so long ago this was a field which could almost guarantee an attractive rate of return to those who knew their way around in it; and this was true under almost any sort of general market situation.

b) But in recent years, for reasons we shall develop later, the field of "arbitrages and workouts" became riskier and less profitable. It may be that in years to come conditions in this field will become more propitious. In any case it is worthwhile outlining the general nature and origin of these operations, with one or two illustrative examples.

c) The typical "special situation" has grown out of the increasing number of acquisitions of smaller firms by large ones, as the gospel of diversification of products has been adopted by more and more managements.

d) A great deal of money was made by shrewd investors not so many years ago through the purchase of bonds of railroads in bankruptcy—bonds which they knew would be worth much more than their cost when the railroads were finally reorganized.

Three Recommended Fields for “Enterprising Investment” – cont.

3. Special Situations, or “Workouts”

e) There were similar opportunities growing out of the breakup of public-utility holding companies pursuant to 1935 legislation. Nearly all these enterprises proved to be worth considerably more when changed from holding companies to a group of separate operating companies.

f) The underlying factor here is the tendency of the security markets to undervalue issues that are involved in any sort of complicated legal proceedings. An old Wall Street motto has been: “Never buy into a lawsuit.” This may be sound advice to the speculator seeking quick action on his holdings. But the adoption of this attitude by the general public is bound to create bargain opportunities in the securities affected by it, since the prejudice against them holds their prices down to unduly low levels.

g) The exploitation of special situations is a technical branch of investment which requires a somewhat unusual mentality and equipment. Probably only a small percentage of our enterprising investors are likely to engage in it, and this book is not the appropriate medium for expounding its complications. Examples see p.292 – 395.

Broader Implications of Our Rules for Investment

1. Investment policy, as it has been developed here, depends in the first place on a choice by the investor of either the defensive (passive) or aggressive (enterprising) role.
2. The aggressive investor must have a considerable knowledge of security values—enough, in fact, to warrant viewing his security operations as equivalent to a business enterprise. There is no room in this philosophy for a middle ground, or a series of gradations, between the passive and aggressive status.
3. The enterprising investor may properly embark upon any security operation for which his training and judgment are adequate and which appears sufficiently promising when measured by established business standards.
4. In those for the defensive investor we have been guided largely by the three requirements of underlying safety, simplicity of choice, and promise of satisfactory results, in terms of psychology as well as arithmetic.
5. We have advised against the purchase at "full prices" of three important categories of securities: (1) foreign bonds, (2) ordinary preferred stocks, and (3) secondary common stocks, including, of course, original offerings of such issues.

Broader Implications of Our Rules for Investment – cont.

6. Financial history says clearly that the investor may expect satisfactory results, on the average, from secondary common stocks only if he buys them for less than their value to a private owner, that is, on a bargain basis.
7. The last sentence indicates that this principle relates to the ordinary outside investor. Anyone who can control a secondary company, or who is part of a cohesive group with such control, is fully justified in buying the shares on the same basis as if he were investing in a “close corporation” or other private business.
8. At the end of Chapter 5 we commented on the difficulty of making any hard and fast distinction between primary and secondary companies. The many common stocks in the boundary area may properly exhibit an intermediate price behavior. It would not be illogical for an investor to buy such an issue at a small discount from its indicated or appraisal value, on the theory that it is only a small distance away from a primary classification and that it may acquire such a rating unqualifiedly in the not too distant future.
9. Thus the distinction between primary and secondary issues need not be made too precise; for, if it were, then a small difference in quality must produce a large differential in justified purchase price.