ECONOMIC EDUCATION BULLETIN

HOW TO INVEST WISELY

by

C. Russell Doane

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CONTENTS

I. THE BACKGROUND OF INVESTMENT

THE formulation of investment policy is particularly difficult at present. In addition to the limitations that may be imposed on an individual by lack of time and perhaps lack of knowledge, an investor today is faced with an economic situation much more complex than that of four or five decades ago.

In order to make clear the nature of the influences that now must be considered in formulating investment policies, we must explain more than the relatively simple facts about the different investments available. Anyone attempting to invest wisely today should take into consideration the shifting background of monetary changes that have made the most conservative policies of an earlier time extremely reckless in recent years. As an aid to understanding the changes occurring, a brief explanation of money and banking is necessary.

Money Income and Production[1]

In a modern economic system, such as that now existing in the United States, money incomes should be visualized as a flow of money or purchasing media that is almost continuously in motion. Funds received by individuals and businesses pass through their hands, or rather through their pockets and checking accounts, directly or indirectly to the market places of the Nation. The goods purchased vary widely, from locomotives to sewing-machine needles, from steers to restaurant meals, and from nylon by the ton to dainty squares of cambric handkerchiefs; but all are alike in that they are purchased by the flow of money incomes.

On the other hand, these goods can be differentiated in one respect that is important from the investor's point of view. Some of the goods are bought by ultimate consumers, but others are purchased by those who will use the goods for production of other goods. For example, the purchaser of a new locomotive, a new factory, a new machine tool, or any similar item intends not to consume the article for his personal gratification but to use it for the production of other goods or for adding value to other goods by such means as transporting or storing them.

[1]Space limitations force us to make this explanation brief. Readers desiring a more complete exposition will be interested in reading the Institute publications *Cause and Control of the Business Cycle* by E. C. Harwood and *What Would More Inflation Mean to You?* edited by E. C. Harwood.

The distinguishing characteristic of the two general subdivisions of goods produced is the fact that some are consumed for the gratification of the buyers and that others are used in the subsequent processes of production. Although the latter eventually are worn out or "used up," they are not consumed in the sense that word is here used; they are slowly converted into goods by means of the manufacturing processes. Therefore, the goods used as capital equipment are not available for consumption; that portion of the flow of goods produced that is used as capital must be saved rather than consumed.

Just as the stream of goods can be considered in two portions, those to be consumed and those to be saved, so also can the stream of money incomes be divided. Individuals and businesses save a portion of their incomes and spend the remainder for goods to be consumed. Of course, the portion of money incomes saved also is spent; but ordinarily the spending is done by someone other than the original saver. In effect, he lends his savings either directly to some individual, business, or Government agency or indirectly through a bank, a life-insurance company, or possibly through the purchase of securities of some business that will spend the money thus placed at its disposal.

Ordinarily, the money incomes represent all goods currently produced. Those individuals who participate in the productive processes receive wages, salaries, dividends or interest (the reward obtained by the participating capitalists), etc., all of which are, in effect, representative portions of the goods produced. (Other individuals, such as lawyers, physicians, etc., obtain money incomes by transfers from those who do participate in the production of goods.) Obviously, the flow of money incomes must in the long run equal the parallel flow of goods to market, because only money incomes can buy goods. If one flow does not equal the other, price adjustments have to be made in order to complete the process.

Commercial Banking

One function of the commercial banking system is to place in circulation the purchasing media (currency plus demand deposits) needed to facilitate the production and distribution of goods. For example, a manufacturer who has completed several automobiles and loaded them for shipment may need funds to pay wages and other current bills before the automobiles are sold and the proceeds received. The manufacturer may borrow from his bank, and he will receive a credit to his checking account in the amount of the loan. This credit to the manufacturer's checking account is not deducted from some other deposit but is simply created by a bookkeeping entry, and the amount is added to the sum total of checking accounts in use.

When the manufacturer writes checks to pay wages, taxes, and other bills, his bank deposit is transferred to other businesses and individuals as part of the flow of money incomes. Eventually the purchasing media thus placed in other hands reach the market place for goods. At that time either the same purchasing media or purchasing media that have been placed in circulation to represent other goods produced are used to buy automobiles that presumably have also reached the market. When the manufacturer receives payment for the sales, he can use those receipts to repay his loan from the bank and thus retire from circulation the purchasing media originally created. In view of the fact that new loans and therefore additions to demand deposits are being made daily and that old commercial loans are also being repaid currently, the purchasing media in circulation should be pictured as a flow that is continually being added to as production goes on and is continually being drawn upon and retired as goods are sold.

Another important function of the banking system of this country is to receive and invest savings. Individuals who desire to save a portion of their incomes may deliver currency or a check to the savings department of a bank. A record of this transaction will be made, and the bank will then use the funds to buy capital goods coming to market or will lend the funds to some business or individual who desires to buy capital goods.

Although the bank's record of the transaction is ordinarily called a savings or time deposit, readers will readily see that this record is not the same type of deposit that is customarily used as a purchasing medium. In other words, savings deposits are not part of the purchasing media in circulation but are merely a record of the fact that purchasing media in the amount indicated were delivered to the bank for investment and presumably were invested . The bank involved buys bonds, mortgages, and other securities with the purchasing media thus placed at its disposal or otherwise lends the money to some individual or business desiring to procure new capital.

Excess Credit Abuses

Because the commercial banking system has been performing both of the functions described in the paragraphs above, there has been a tendency on the part of the bankers as a group to depart from the strict procedure called for with respect to the commercial part of their business. Having gradually absorbed the idea that the safety and propriety of a given loan are governed by the adequacy of the collateral, bankers have come to disregard the limitation that should exist with respect to loans of an investment character. Bank credit has been provided for capital purposes through the process of investing *more* than the savings deposits

plus capital funds of the banking system. Loans thus made on real estate and securities have resulted in net additions to the total of demand deposits (checking accounts) and consequent excesses of purchasing media in circulation over and above those representing goods coming to market.

Whenever purchasing media are made available to individuals and businesses by such methods, the funds ordinarily will be used. Therefore, those concerned will be buyers of goods in the markets of the country to a greater extent than would have been possible had there been no excess purchasing media placed in circulation. The result is a temporary excess of demand with respect to supply, a condition that sooner or later leads to higher prices, greater profits, and an artificial stimulus to production. Readers will recognize these as signs of a business boom or an inflationary progression similar to that which occurred during and since World War II.

Another method of putting excess purchasing media into circulation is less obvious and perhaps not so well understood. Printing Government bonds and having the banks create new checking accounts for the Treasury in payment for them are processes similar to printing dollar bills directly. However, readers who have followed through the foregoing discussion of excess credit originations by means of loans on real estate and securities in excess of savings deposits will realize that Government borrowing from the commercial banking system to an amount greater than the savings available for such purposes is the same kind of inflationary procedure with minor technical differences.

Sources of Purchasing Media

The accompanying chart may help to clarify the foregoing discussion and also give some idea of the amount of types of purchasing media in circulation.

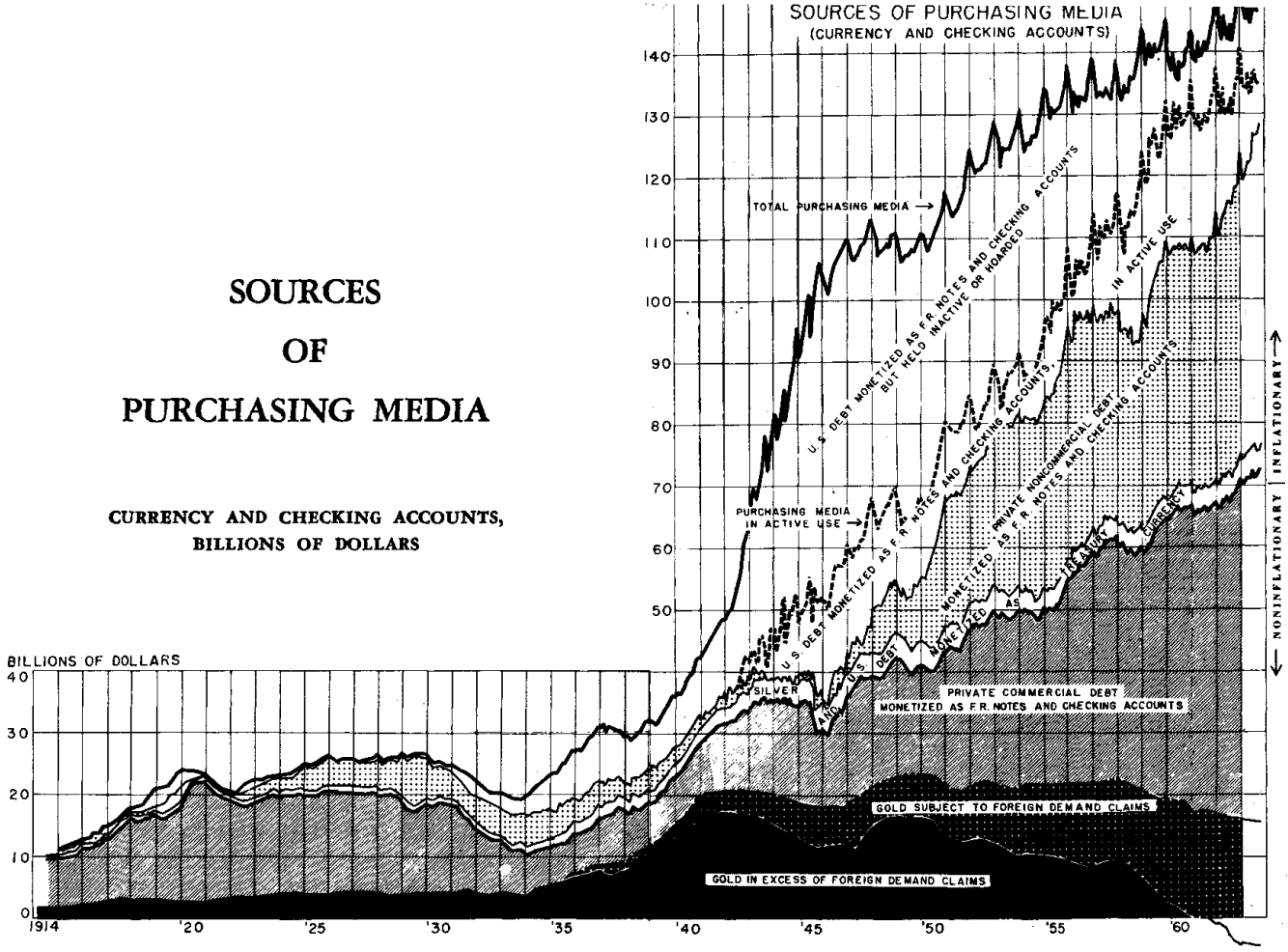
The purchasing media available to the public in the United States include all coins, the paper currency (consisting largely of Federal Reserve notes)[1], and checking accounts (or, as the banks label them, demand deposits).

The first and most important source of purchasing media is the money commodity, which in the present industrial civilization is gold. In spite of the so-called departure from the gold standard, gold is still the money commodity of modern civilization. There is no need here to trace its history or to forecast its remote future. For our purposes at this time we need only to point out that existing gold held as monetary reserves of the various banking systems is actually being used as purchasing media and that new gold, except that used in industry and the

[1]One dollar and two dollar as well as some five and ten dollar silver certificates now are in circulation, but they gradually will be retired and replaced by Federal Reserve notes in accordance with legislation enacted by Congress in 1963.

SOURCES OF PURCHASING MEDIA

CURRENCY AND CHECKING ACCOUNTS, BILLIONS OF DOLLARS



arts, becomes purchasing media, although it may circulate in an altogether different form than the gold coins that formerly were available.

The second source of purchasing media is credit resulting from the commercial lending function of the commercial banking system, the procedure already described.

The third source of purchasing media also arises from the commercial banking system, but a different procedure on the part of the banks is involved than that in making commercial loans. As was described in previous paragraphs, commercial banks have made loans in excess of the savings available to the banks plus the capital of the banking system. The resulting excess purchasing media are inflationary because they do not represent goods currently coming to the market.

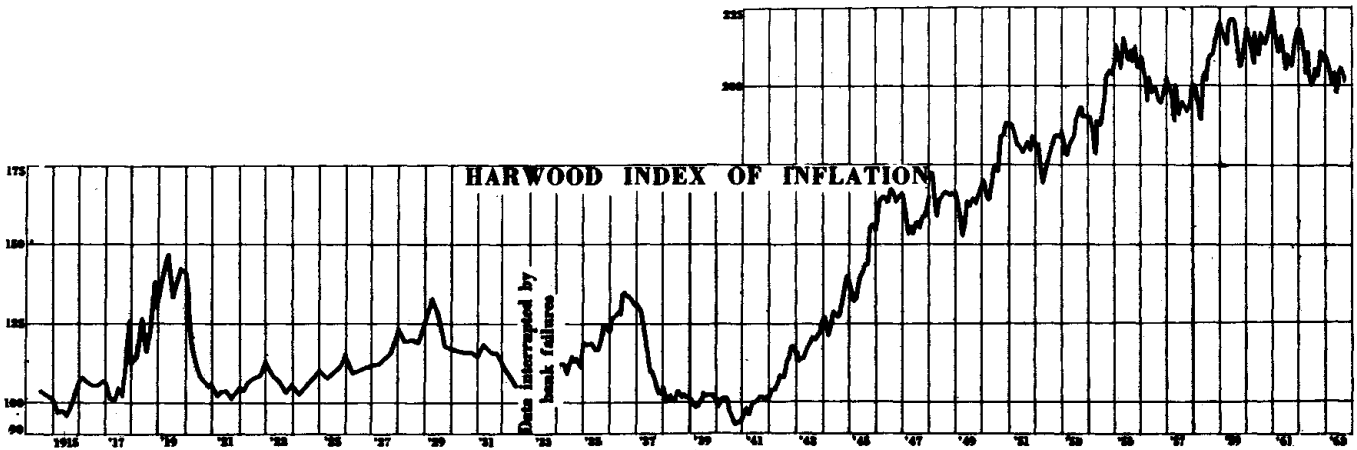
The fourth source of purchasing media is the credits to the Treasury checking accounts that are created when Government bonds are sold to the commercial banks. These credits become purchasing media in the channels of business when the Treasury spends the funds thus created for its use. (Sale of Government bonds to the commercial banks should not be confused with sale of United States Savings bonds to individuals. Purchase of savings bonds represents a transfer of savings from an individual to the Government in return for a promise to pay in the future; no purchasing media are created in this transaction.)

A brief glance at the chart will give the reader some idea of the vast amount of purchasing media now in circulation and the portion that is inflationary. The business boom after the war was directly attributable to the effects of inflationary purchasing media on prices, profits, and production.

In addition to the chart showing sources of purchasing media the Institute has devised an index of inflation, which is shown on page 11. Briefly, this index is derived by dividing the total purchasing media available by the portion that is noninflationary. Referring now to the chart, the 100 line represents the condition that exists when all purchasing media in circulation represents either gold or goods produced and en route to market. Fluctuations of the index above the 100 level reflect varying degrees of inflation. For example, although the amount of inflationary purchasing media in use has decreased somewhat from the peak reached at the end of 1960, the total still is more than twice that needed to represent gold and goods produced at the prices that would have prevailed in the absence of inflation.

After more than 20 years of almost continuous inflation, it is small wonder that the problems of the average investor are more complex than ever before. The purchasing power of the consumer's dollar has decreased to half of its prewar value, so that the returns from funds invested before and during the war will not purchase as much now as they

HARWOOD INDEX OF INFLATION



formerly did. Not only has the value of his original savings been affected, but the investor today is faced with a continuing dilemma. If the purchasing power of savings continues to depreciate, such further depreciation of the dollar may offset the results of prudent saving. On the other hand, if some type of investments are made, an investor faces the possibility of a substantial decrease in the value of investments made at inflated prices. In addition, money-credit instability and the increased participation of Government in individual and corporate activities are certainly factors that imperil the future of investments in the United States.

The foregoing paragraphs present a somewhat depressing picture of the problems faced by the investor today. These hazards, however, do not justify despair; rather, they emphasize the need for studying economic trends and adapting one's investment program to changing circumstances.

The Investment Position of the United States

Until recent years, it has been appropriate for individuals to confine their investments to the securities of companies operating primarily in the United States. However, by following the path of prolonged inflation and monetary depreciation, the United States has seriously distorted its economy and has created a dangerous situation. When a new administration, pledged to restore the gold standard, was elected in 1952, an opportunity was provided to end inflation and restore balanced economic relationships. This opportunity was not seized but was put aside in 1953-54 as more inflation was fostered in the hope of avoiding a worse recession.

During the inflationary boom that followed, the economic distortion became greater with one of the results a rapid accumulation of foreign demand claims on U.S. monetary gold. Again during the 1957-58 and 1960 recessions opportunities were provided to force deflation and correct the existing maladjustments. Again, however, the politically "easy way out," more inflation, was chosen.

Despite the relatively high level of business activity now prevailing, and with apparent disregard for the further adverse effects that such a policy may have on the Nation's already serious financial problem, the present Administration proposes to increase the Federal deficit by several billions of dollars during the coming year.

Among the major distortions that have been created by prolonged inflating and unsound fiscal policies are the great increases in wages and prices in some segments of the economy here in the United States. The distortions thus developed here have surpassed the similar distortions abroad with the results that much of United States production is unable to compete in world markets and increasing quantities of foreign cars and other goods are being sold here. In turn this has been reflected in increasing claims on U.S. gold and, in recent years, a large outflow of gold.

During the past several years we have warned repeatedly that the continuing deficit in the Nation's balance of international payments and the attendant outflow of gold reflected serious economic maladjustments, and that continued failure to apply the remedial measures needed to cope effectively with those fundamental distortions would, in the long run, jeopardize not only the future of the dollar but also the liberty of individuals to manage their own financial affairs. As we have pointed out, the steps thus far taken purportedly to cope with these problems have been, at best, pseudo remedies designed to treat symptoms but not the cause of the malady; and they could not, therefore, be expected to remedy the situation. Also, we frequently have expressed the fear that when the Government's ingenuity in devising palliatives had been exhausted the imposition of increasingly stringent controls over first one and then another aspect of the financial affairs of individuals probably would be undertaken.

Events have been following a course similar to that described above. Since early in 1962 pseudo remedies have been devised and applied in rapid succession. A gold pool was organized to influence the world gold markets, currency swaps were arranged to support the dollar in foreign exchange markets, several countries were persuaded to repay in advance long-term debts owed to the United States, and sales of short-term Treasury notes to foreign creditor nations payable in their currencies as a protection for them against devaluation of the dollar have been made on a substantial scale. These devices temporarily reduced the outflow of gold and helped to reduce the reported deficit in the U.S. balance-of-payments accounts to about $2.2 billion for the year 1962. Presumably encouraged or perhaps deluded by the apparent success of these superficial treatments of the problem the Administration confidently predicted an early end of the balance-of-payments problem. Instead, the deficit increased during the first quarter of 1963 to an annual rate of approximately $3.5 billion, and preliminary estimates indicate that during the second quarter the adverse balance reached an annual rate of about $5.2 billion.

We are convinced that the American economy has been so seriously mismanaged for so long a time that another devaluation of the dollar within the next several years has become highly probable. The recent recessions provided opportunities for the Nation's money managers and political leadership to remedy or at least reduce the serious distortions that have developed. Instead of seizing those opportunities and using them, the Federal Reserve Board repeated its acknowledged error of 1953 by initiating an extremely easy-money policy during each subsequent recession and the Government has sponsored a renewal of deficit financing on a large scale. In short, the actions taken in an effort to stimulate business activity seem certain to increase rather than decrease the dis-

tortions mentioned above.

Present indications are that at some time during the next several years the gold outflow will become so great that the Government will be forced or will deem it wise to stop meeting its obligations to pay gold to foreign holders of claims on U.S. dollars. As that time is approached, the available means of coping with the situation are almost certain to crystallize out in the minds of political leaders as a choice between: 1, another devaluation of the dollar; and 2, forcing drastic deflation with the inevitable accompanying severe depression. Our guess today is that another devaluation of the dollar will be undertaken in spite of the fact that we do not believe that course of action necessarily will prevent a severe depression. (Whether or not a severe depression occurs may depend on other circumstances such as the extent to which private debtors generally are seriously vulnerable at that time, etc.)

In view of the situation that now exists and probable future developments, we now believe that investors whose funds are large enough to justify such increased diversification should purchase with a portion of their funds shares in some foreign companies, especially stocks of companies primarily engaged in gold mining directly or through subsidiaries. The particular advantage of gold-mining companies is that regardless of which of the two courses mentioned above is chosen, the investor probably will benefit

If the Nation's political leaders and money-credit authorities eventually choose to force deflation as a means of remedying economic distortions, the accompanying major depression, which probably would have some effects in most nations of the world, would benefit gold producers by reducing their basic costs of labor, materials, and equipment. On the other hand, if devaluation is chosen in the hope (even if a vain one) of avoiding major readjustments during a depression, the gold producers will benefit by the fact that each ounce of gold produced will be exchangeable for more of the paper currency (Canadian dollars, British pounds, etc.) with which the mining companies pay wages and other costs. We assume that the devaluation of the dollar would be accompanied or closely followed by devaluation of the Canadian dollar, British pound, and the currencies of most other major industrialized nations. Such other devaluations presumably would be undertaken in order to improve foreign gold reserves and preserve present parities between the various foreign currencies and the dollar.

II. THE PRINCIPAL TYPES OF INVESTMENTS

IN the first section the effects of recent economic and fiscal developments on the investor's program were discussed. The purpose of this section is to consider the specific types of investments available to the average investor.

Savings Deposits

The first of these investments is the savings-bank deposit. Such deposits are the record of funds turned over to savings banks, which then use the funds thus acquired to purchase securities and mortgages for long-term investment. Banks customarily pay interest on savings deposits. This interest rate is now about 3½ to 4 percent. The depositor's contract with a savings bank permits the bank to require advance notice of withdrawals (primarily because of the long-term nature of the bank's investments and the difficulty of liquidating them readily). However, this requirement seldom is enforced.

Federally Insured Savings-and-Loan Associations

Shares of federally insured savings-and-loan associations are similar in many respects to savings deposits. These associations, which are located throughout the United States, are private organizations that invest most of their funds in regularly amortized, high-grade mortgages on real estate within 50 miles of the association's home office. Shares of most associations are insured by the Federal Savings and Loan Insurance Corporation up to a maximum of $10,000 in any one account. As additional protection, each member association is required to purchase stock in the Federal Home Loan Bank System. This membership makes possible borrowing from the system as much as 12 times the association's payments on the Federal Home Loan Bank stock that it owns.

Many State-chartered building-and-loan associations are federally insured, a fact that usually is indicated on the letterhead or balance sheet of the association.

As the result of an extensive investigation of these associations, we believe that those in sound financial condition paying annual dividends of 4¾ percent or more and whose shares are insured by the Federal Savings and Loan Insurance Corporation are attractive for investment of a portion of one's cash reserves. Placing a portion of one's funds in this form of investment is recommended for two reasons. In the first place, the Nation still is experiencing the effects of the greatest inflation in its history; and some conservative investments are recommended because of the

uncertanities ahead. Savings-and-loan shares represent a fixed-dollar-value type of investment for the principal involved. However, the annual dividends paid by better situated, financially strong associations have increased from about 2½ percent to more than 4¾ percent since World War II. Thus, from the standpoint of current income, savings-and-loan shares in recent years have provided adequate protection against inflation and the accompanying rising cost of living, in contrast with the fixed income that has been available from bonds generally and most preferred stocks. In the second place, high-grade real-estate mortgages have long been excellent investments; and these shares provide indirect ownership of regularly amortized and well-diversified mortgages together with a guarantee of principal by a Government agency.

Savings-and-loan shares are considered nearly equivalent to cash because many such associations permit withdrawals on demand or on short notice and because a Government agency guarantees that there will be no ultimate loss of principal. A substantial portion of funds invested in the savings-and-loan associations probably would be available within a reasonable period after applications for withdrawals are made.

The primary reason for liquidating a part of these shares at any time probably would be to invest the funds in corporate securities during a business depression. Past experience during such depressions has shown that security prices usually are depressed for a period of several months, at least, so that the immediate availability of all of one's savings-and-loan funds is not considered important.

We believe that only an extraordinarily severe business depression, certainly one more serious than that of 1929-32, would force well managed, financially sound savings-and-loan associations to close their doors. In the first place, security is provided by home mortgages, which, over a period of years, have proved to be extremely safe investments.

Second, during any period of severe depression we assume that steps would be taken by the Federal Government to prevent any large portion of individual savings from being frozen for an extended period. In our opinion, the Government virtually will be forced to see that withdrawal requests are paid promptly. Failure to do so might cause a large segment of the investing public to question the guarantee of a Government agency, which in turn could lead to a widespread demand for redemption of all types of Federally guaranteed obligations; a situation that the Government cannot afford to permit.

In the event of the default and liquidation of an insured association the Federal Savings and Loan Insurance Corporation is obligated either to pay all insured account holders in cash, or to make available to them new accounts in other operating insured associations equal to the amounts for which the old accounts were insured.

Some States, notably Massachusetts, have encouraged the organization of so-called cooperative banks, which are similar to savings-and-loan associations in most important respects. Insurance of shares is provided by State agencies. These organizations may be considered the equivalent of savings-and-loan associations. However, purchase of shares of associations within such a relatively small area as a single State does not enable the investor to obtain adequate geographical diversification of his investments.

Public Obligations

An essential distinction must be made between the purchase of public obligations and investments in productive enterprise. The expectation of return from the latter is based on the earning power of the corporation, but an investment in public securities is ordinarily an investment in a government's power to tax in order to make interest payments and meet the maturities of its obligations.

Federal Government Securities

The largest amount of public obligations outstanding in the United States at present is that of the Federal Government. The Federal debt now exceeds $300 billion. About $215 billion of this debt was added during and after World War II.

In view of the tremendous size of the national debt and the inability of recent administrations to reduce appreciably the amount outstanding, the question may well be raised whether the Government will default on this debt.

We believe that there are sufficiently compelling reasons that will require the Government to meet its full responsibilities to holders of Government securities. The Government must maintain its credit standing so that its borrowing position will be unimpaired in the event of future emergencies. Most important, the Government debt is a major factor in the operation of our entire economic structure. In addition to the large volume of debt held by the commercial banking system (with the effects on prices, profits, and production already described in chapter I), large portions of the Federal debt are owned by savings banks, insurance companies, and individuals. Any default would be of serious consequence to the entire economic and social structure.

Of course, a somewhat more subtle means of repudiating a portion of the debt might be adopted. Were the dollar to be devalued again, the *number* of dollars returned to the investor would be unchanged, but the *purchasing power* of the dollar would be permanently reduced. Such an action would seriously affect the purchasing power of all fixed-income obligations. This factor should be considered in determining the portions

of an investment fund to be allocated to fixed-income securities and to other securities respectively. However, the relative desirability of Government bonds compared with other types of fixed-income obligations is not altered.

Obligations of the U. S. Government may be classified as either marketable or nonmarketable. The nonmarketable savings bonds are specifically intended for purchase by individual investors in relatively small amounts. These bonds may not be sold or pledged as collateral for a bank loan. However, redemption at specified prices is guaranteed directly by the U. S. Government at the option of the registered owner of the bonds. Savings bonds now are being issued in two series: E and H.

We no longer recommend the purchase of U. S. savings bonds for most investors. Moreover, in view of existing conditions, we suggest that holders of such bonds consider carefully the desirability of redeeming present holdings.

The maximum yield available from U. S. savings bonds is 3¾ percent, and that rate is obtained only from series E- and H-bonds that are held to maturity. The maximum yield on other series is somewhat less.

On the other hand, many savings banks now pay 4 percent, and 4¾ percent dividends have become relatively common among savings-and-loan associations. Moreover, tax-exempt-bond yields now are at favorable levels.

In view of the foregoing U. S. savings bonds are appropriate only in instances where the bonds probably will be held to maturity and where postponing a portion of the investor's tax liability is advisable. In other instances redemption of savings bonds and reinvestment of the proceeds either in savings-and-loan shares or in tax-exempt bonds, as may be advisable in individual instances, will provide a more favorable yield.

Marketable securities of the U. S. Government include bills, certificates, notes, and bonds. These issues are sold with maturities of from 91 days for the bills to as much as 40 years for bonds. Some of the bonds are callable at par a few years prior to maturity at the option of the Treasury. The most active trading of these issues occurs in the over-the-counter market. Commercial banks own large amounts of these securities, especially the shorter term issues. Therefore, because purchases and sales of U. S. Government securities by the Federal Reserve Banks are employed as devices for augmenting or contracting the supply of money and credit, the prices and yields of these securities tend to fluctuate in accordance with changes in the credit policies of the Federal Reserve Board. In addition, there is, of course, the usual risk of price fluctuations inherent in any marketable security.

State and Municipal Obligations

The States of the Union, like the United States Government, are sovereign powers; therefore, the individual purchasers of State obligations cannot enforce their claims by the regular legal procedure that applies to corporations. Local government units do not have the status of sovereign powers in law; therefore, the position of investors in their securities is similar to that of investors in private corporations. However, the local governments are subject to regulation by their State governments; and standards vary considerably among the States. Moreover, some obligations are not supported by the full faith and credit of a State or municipality; instead, interest and maturity payments are met from the revenue received from a particular enterprise. Therefore, care must be exercised before purchasing these issues in order to ascertain just what protection is offered.

Moody's Governments and Municipals manual, available in most broker's offices, banks, and many public libraries includes descriptions, statistical data, and quality ratings for the bonds of most public issuers.

The interest on State and local obligations has enjoyed immunity from Federal income-tax assessments. This tax status has been an important factor in establishing a relatively low yield on these issues in relation to the rate for high-grade corporate bonds and thus in determining the nature of the market for such securities.

During most periods in the past tax-exempt bonds have been attractive primarily to investors whose income was subject to relatively high income-tax rates. However, such bonds now may be attractive to most investors. For example, good-quality tax-exempt issues having medium-term maturity dates (10 to 20 years) may now be purchased to yield 3 percent or more. A 3-percent tax-free yield is approximately equal to a taxable yield of 4 percent for an individual whose maximum income-tax rate is 26 percent.

In view of the foregoing we suggest that investors consider the advisability of including some tax-exempt bonds in their portfolios at this time.

Although the particular circumstances of the individual concerned must be considered in ascertaining the suitability of tax-exempt bonds for his needs, the following general considerations may be helpful.

Because smaller lots are not always readily marketable, we do not recommend the purchase of less than $5,000 worth of a single tax-exempt issue, and $10,000 lots are preferable. Moreover, we do not believe that more than about 20 percent of most funds should be invested in tax-exempt securities. Therefore, such bonds probably will not be suitable for funds of less than $40,000 to $50,000.

Bond prices are subject to market fluctuations. Therefore, except for highest-grade, short-term issues these securities should not be considered a substitute for cash or equivalent.

Finally, because the availability of specific issues changes from day to day in the tax-exempt bond market we suggest that subscribers consult *The Blue List of Current Municipal Offerings* when selecting particular issues for purchase. *TheBlue List* is published daily and includes all issues currently available throughout the Nation. It is available in most brokerage offices and many banks.

From 1933 to 1946, tax-exempt issues sold at gradually decreasing yields; in mid-1946 the Dow-Jones average of municipal bonds indicated an average yield of less than 1.5 percent. This decreasing yield was a result of several factors. The efforts of the Federal Reserve banks to keep interest rates low on the Federal debt resulted in depressing interest rates on other governmental issues. Furthermore, higher taxes encouraged increasing demand for municipal issues. On the other hand, the supply was relatively stable until 1942 and decreased thereafter, so that this supply-demand factor had a depressing effect on interest rates.

Developments after the war caused a reversal of the upward trend of municipal-bond prices; consequently, yields increased. There were large issues of bonds for public housing, toll highways and bridges, veterans' bonuses, as well as for the more traditional types of State and municipal undertakings. By the summer of 1953, the yield on tax-exempt bonds had increased to about 3 percent, double the low level reached in 1946.

During the past decade the average yield on tax-exempt bonds has fluctuated between about 2½ and 3½ percent. Yields have approached or for a few brief periods exceeded the upper limits of the aforementioned range when business activity was at a high level and the Federal Reserve Board adopted tighter-money policies in order to retard what was considered to be excessive inflationary expansion. However, during most of the past 10 years money-rates including tax-exempt bond yields deliberately have been held at artificially low levels in deference to the widespread popular belief that low interest rates foster economic growth.

Foreign Public Obligations

Until after the First World War, United States investors held a relatively insignificant amount of foreign government bonds. During the period between the end of World War I and the depression of the early 1930's, investment banking houses in this country distributed several billion dollars in foreign government and civil obligations to investors here. The depression, which was international in scope, combined with

he effects of World War II, adversely affected the worth of most of these ssues.

The development of inflation in the United States led some investors o consider the possibility of protecting themselves by means of investnents in foreign bonds. Until recently we did not recommend such a course because World War II was followed by currency depreciation in nearly all the important nations of the world. In some instances the countries that were not active participants in the conflict escaped the most extreme effects of monetary disorganization. However, the nations that suffered inflation to a lesser degree than the average were not enough better than the United States in this respect to outweigh other disadvantages involved. For example, even in peacetime, foreign exchange restrictions and fluctuations in rates of exchange are potential adverse factors beyond an investor's control.

During the past few years, however, the situation has changed markedly. While the United States has continued to inflate its money-credit system many of the major industrialized nations of the free world, especially those that have suffered the ill effects of prolonged inflation on one or more occasions in the past, have discarded the inflation panacea and have established sound monetary and fiscal policies. As a result not only has the strength of the dollar been impaired in relation to that of other major currencies but also the entire money-credit structure of the United States has been placed in jeopardy. Therefore, we now believe that investors whose funds are large enough (in general about $100,000 or more) to permit such diversification, might well invest a portion of their funds in short-term bonds of those European countries that have demonstrated their determination to follow sound fiscal practices.

Insurance

One of the more important investments for most individuals, particularly those of modest means, is insurance. Insurance has been discussed at length in another Institute publication[1], and the relationship of insurance to investments is discussed in section VI of this one. At this point it seems sufficient to mention that a fundamental distinction exists between insurance and investments. Insurance is the pooling or sharing of risks by many persons so that the financial loss of one individual will be covered when the loss insured against occurs. Investment involves the assumption of risk by the individual himself, which can be done only when funds are sufficient for that purpose.

Insurance may be considered a supplement to investments. To the extent that investments do not provide sufficient income for retirement

[1]William J. Matteson, *Life Insurance and Annuities From the Buyer's Point of View.*

or sufficient protection for dependents in the event of the death of the breadwinner, insurance or annuities may be used. However, when investments can provide the necessary protection, insurance is unnecessary; and continuation of insurance may involve a waste of assets.

Corporate Securities

The vast number of business corporations provide many of the investment opportunities available today. Our present economic organization has been influenced greatly by the development of modern industry, and World War II increased rather than diminished the dominant position of great industrial corporations in the economic life of the Nation. Industry, therefore, provides many investment opportunities and probably will continue to do so during the foreseeable future. For the most part, the growth trends of industry will affect the prosperity of other forms of business activity, including the organizations engaged in the distribution of industrial products and the rendering of services to corporations and individuals.

There are two ways of investing in corporate securities. The first is to purchase securities when originally issued by a corporation, usually from investment-banking underwriters. The second is to purchase such securities from present owners, thus effecting the transfer of their interest in the corporation. The second procedure may be followed by making purchases on the several security exchanges or in the over-the-counter markets throughout the country.

The number and variety of corporate securities and their importance in any investment program require an understanding of the general types of securities and their distinctive features.

Bonds

Corporate securities may be divided into two general classes. The first includes those that represent loans to the businesses concerned and are commonly called bonds. The second includes those that represent part ownership of the business and are usually known as stocks or shares.

The bondholder is a creditor of the corporation and in return for the use of his capital the corporation promises him a fixed-interest payment that has priority over the claims of stockholders to dividends. The bondholder's claim usually is constant in dollar value and must be paid regularly by the company in order to avoid insolvency. Moreover, bonds usually have a maturity date when the principal sum is due. Because of the prior claim and the greater security of principal, bonds usually yield less than stocks. That the reverse is now true reflects an unusual situation that has existed only on a few previous occasions in the Nation's history.

Bonds are of various types, and care should be taken to understand

the nature and protective provisions of a bond before purchase. One of the more important protective provisions is the security, or the pledge of assets by a corporation in order to insure performance of the contract. Mortgage bonds are secured by liens on property. The mortgage may be a general mortgage on all property now owned or on property now owned plus any subsequently acquired or may be a specific pledge of certain enumerated assets. The security may be a restricted mortgage in that no additional bonds may be issued on a particular piece of property; or, as in the case of series bonds, additional bonds with the same property as a pledge may be issued at the option of the corporation.

Debenture bonds usually are unsecured promises of the corporation to pay a certain sum at some stated future date. The debenture holder is in the same position as other general creditors of the corporation.

Another type of bond is the income bond. These bonds may or may not be secured by a mortgage. The important feature is that interest ordinarily is paid only if earned; if not paid, interest usually accumulates only to a limited amount.

One type of bond that includes some of the advantages of both bonds and stocks is the convertible bond. This type of security provides for payment of a fixed amount of principal and interest and includes a provision permitting the investor at his option and on stated terms to convert his bond into shares of common stock. Depending on the attractiveness of the convertibility feature, the price of a bond may or may not reflect the advantages of the conversion.

There are several provisions frequently found in bond agreements, or indentures, as they are called, that should be mentioned. For example, the bonds may be subject to redemption by the corporation before the maturity date. Such redemption may be for sinking-fund purposes or for retirement of the entire issue at the option of the company.

A sinking fund is a sum of money set aside for the purpose of retiring a portion of the bonds outstanding either at regularly stated intervals or at maturity. Usually the price to be paid for bonds redeemed in this manner is specified. Such provisions, in effect, spread the redemption of the issue over a period of time. Although the purchaser of a bond subject to redemption before maturity runs the risk of not being able to hold his bond until the maturity date stated, the sinking-fund provision is further assurance that the principal will be met at or before maturity and is ordinarily considered an advantage for the bondholder.

Bond indentures frequently provide that the company at its option may call an entire bond issue before its maturity date. This protective provision for the company permits repayment or refinancing of the debt at a time when better terms may be obtained. Care should be taken in the purchase of such bonds in order to avoid paying much more than

the call price. A high price for a bond usually indicates that low interest rates prevail in the market and that the credit position of the company is good. When these conditions are present, it is possible that the bond may be called or refunded (that is, replaced by an issue of a lower interest rate). Consequently, the owner of the bond who has paid more than the call price may experience a loss equal to the difference between the purchase price and the call price, a loss that may not be compensated for by the payment of interest that he has received.

Because almost all bonds stipulate payment of a principal amount at some specific date in the future, the return (or yield) on bonds is computed in a somewhat different manner than that on stocks. Bonds traded in public markets ordinarily fluctuate above or below their face value. Bond prices are expressed as a percent of the face value of the bond. For example, a bond selling at 92 represents a price of $920 per $1,000 of face value, although the denomination purchased may be $100, $500, $1,000, etc.

Bonds selling below 100 are said to be selling at a discount; bonds selling above 100 are said to be selling at a premium. The total income return on bonds selling at a discount takes into consideration not only the annual cash return specified in the coupon rate of the bond but also the fact that at maturity the payment of principal will be greater than the purchase price. Conversely, for bonds selling at a premium, the payment at maturity will be less than the purchase price; and the income return is reduced correspondingly.

For example, assume that a $1,000 5-percent bond due in 20 years is selling at 90. The interest rate is 5 percent; and the current yield, as it is called, is $50 (the annual interest payment) divided by $900 (the market price of the bond), or 5.55 percent. However, at maturity the purchaser would receive $1,000 in payment of principal, $100 more than he paid for it 20 years earlier. By custom this increase is averaged over the life of the bond and included as annual income over and above the interest received. The annual income return is thus $50 in interest plus an average annual increase of $5 ($100 divided by 20 years) in the value of the bond, or an annual average income of $55. The average value of the bond during the 20-year period would be $950 (midway between $900 at the time of purchase and $1,000 at maturity). An annual return of $55 is approximately 5.79 percent on an investment of $950. More accurate yields to maturity can be obtained by consulting a bond-yield book.

One further point regarding the sale of bonds may be helpful. Bonds are sold either "flat" or on an "and interest" basis. When bonds are purchased between interest dates, interest from the last interest date to the date of sale is paid to the seller and is included in the broker's charge for the bond. However, this is not a part of the cost basis of the security for

tax purposes ;and it is recovered by the purchaser when he receives a full interest payment the next time it falls due. Of course, for income-tax purposes, the amount paid to the seller of the bond is deducted from the full interest received in determining the amount of taxable income received.

If the interest payment on a bond is not certain for some reason, the bond is sold "flat." This means that the purchaser pays only the price for the bond and is not required to reimburse the seller for the interest accrued.

Two types of bonds are usually included in the class of those sold "flat." The first is the income bond. The payment of interest of such bonds is contingent on the earnings of the corporation concerned. Inasmuch as the payment of interest is contingent on earnings, it is not included in the amount the purchaser must pay. (Presumably this is reflected in the market price.)

The second type of bond sold "flat" includes those on which the interest is in default. The purchaser of this type of bond acquires a claim for the arrears of interest as well as for the principal in his purchase price.

If payment of the interest in arrears is made, this payment is considered a return of capital rather than income; and it is therefore not reported as taxable income for income-tax purposes. However, the payment must be deducted from the cost price of the security, so that, in any subsequent sale, a gain is increased by the amount of interest received; and a loss is correspondingly reduced.

Stocks

The stockholder owns the corporation. Consequently, the earnings remaining after the payment of all other obligations belong, in effect, to the stockholder. The stockholder in general has, by means of his vote, the right to elect the directors and, through them, to select the management of the company. However, the stockholder can take for his personal use only such dividends as may be declared by the board of directors. His certificate of ownership has no maturity date and is valid as long as the corporation exists. Because dividend payments and exact value are less certain, common stocks usually provide a higher yield than does the intrest on the bonds of successful corporations.

Stocks may or may not have a stated par value. This par value has no economic significance to the owner of the stock; it is merely the value at which the stock is carried on the books of the company and is used for convenience or to satisfy legal requirements. The equity, or claim, of the stockholders to the net assets of a company may be deter-

mined by adding the value at which the stock is carried to the surplus, or undistributed profits, of the corporation.

Preferred stock is a special type of stock that should be mentioned. This security in general has some of the features and rights of common stock. However, owners of preferred stock have a fixed prior claim on earnings and may or may not have voting privileges. The owner's claim to dividends may or may not be cumulative if a dividend is not paid.

Preferred stocks sometimes have other features. Convertible preferred stock may be converted at the option of the holder into shares of common at the rate specified in the conversion provision. If this particular provision is valuable (that is, if procurement of common stocks is permitted at less than the current market price), the price of the preferred stock ordinarily will reflect this advantage, so that the yield will be lower than that of similar issues without the conversion feature.

The participating preferred is still another type. A minimum fixed dividend is paid, after which the preferred stock shares with the common in further dividend payments. This type of issue is comparatively rare.

Many preferred stocks are callable at a fixed price at the option of the company. For obvious reasons, the purchaser of such preferred stock should avoid paying substantially more than the call price.

Of course, a purchaser of securities should read the various provisions describing the rights and privileges of any particular issue. However, understanding the relationship of each security to others issued by a company is also important. For example, ownership of common stock of a company that has only common stock outstanding is a much more effective claim on assets than possession of the debenture bond of a company in which 60 percent of the value of all security issues is mortgage obligations with prior liens.

There is no ideal apportionment of debt and stock in a corporation's capital structure. (The capital structure refers to the stated value of the various capital issues plus the surplus items.) Railroads, utilities, steel companies, and other organizations requiring a large amount of fixed assets frequently have a large fixed indebtedness. The investor should be aware of the problem involved and should be familiar with the industry he invests in, the position of the company in the industry, and the place that his security occupies in the capital structure of the company.

Investment Trusts and Mutual Funds

An investor whose fund is relatively small will experience difficulty in obtaining adequate diversification if he invests directly in corporate securities. Fortunately the development of investment trusts and mutual funds in this country has made possible a reasonably satisfactory degree

of diversification for those who have only a few thousand dollars available for investment.

A wide variety of investment-trust and mutual-fund securities is available representing different degrees of diversification by classes of investments, by industries, and by geographical locations. Some of these companies have favorable records, and the purchase of the common stocks of a few such organizations will give the owner of a small fund protection against the normal investment hazards as well as against some of the adverse effects of inflation. (Investment trusts and funds are discussed in detail in the Institute publication *Investment Trusts and Funds From the Investor's Point of View* by C. Russell Doane and Edward J. Hills.)

Real Estate

Ownership of real estate or mortgages on real estate also may be sources of investment income. However, such investments require a knowledge of local conditions and probable future property values if the investment is to be successful. Moreover, management of real estate requires the time and ability of the owner or of a paid professional manager. In addition, real-estate investments are subject to the political manipulation of tax assessments and to legislative restrictions such as the maximum allowable rent that may be received by the owner or agent. Another significant factor is the relative lack of marketability of real estate, particularly during periods of depressed general economic conditions.

For the purposes of investment analysis, first mortgages on real estate may be considered equivalent to medium-grade bonds. Income-producing real estate that is owned in fee may be allocated between the fixed-income and variable-income portions of an investment fund based upon the value of a high-grade first mortgage that could be obtained on the property. The equity interest in real property, as well as poorly secured loans on real estate, may be considered equivalent to an investment in common stocks, because the value of the property may be expected to fluctuate with changes in general business conditions as well as with changes in property values in the specific locality.

III. CLASSIFICATION OF TYPES OF INVESTMENTS

THE various types of investments discussed in the previous section may be classified for the purpose of investment-program planning into several major categories. The primary distinction that should be made is between those investments that provide a fixed income and those that provide a variable income. However, a further break-down of these major divisions is desirable in order to allow for the varying degrees of risk in fixed-income securities and the differences in performance of the securities of various types of industries.

Fixed-income investments, which promise a return in a specified number of dollars, are usually considered safer than variable-income investments, either (1) because of a mortgage guarantee or the guarantee of some outside agency or (2) because of the serious financial consequences that the debtor would incur if interest or principal were not paid. Although they provide a greater degree of safety of principal, the return on such investments usually is less than that obtainable from investments involving greater risk. However, individuals dependent on the income from their investments or persons for whom a conservative course is recommended ordinarily should have substantial amounts of relatively safe, fixed-income investments.

Variable-income investments are usually characterized by wider fluctuations in price than fixed-income securities. Because of the decreased safety of principal and the uncertainty of income, such investments are more speculative than fixed-income securities. However, during an inflationary period the purchasing power of a fixed income decreases. In order to offset this decrease in real income, even those persons who ordinarily would follow a conservative course probably will find the assumption of greater risks advisable. Dollars will buy less as prices rise. Certain variable-income investments benefit during an inflationary period and, in addition to increased income, may provide appreciation of principal during a prolonged period when the value of the dollar is depreciating. The opposite situation may exist during a deflationary period.

Classification of Investments

A suggested classification of assets that may facilitate consideration of the investor's problem follows:

Cash or equivalent
High-grade bonds or equivalent

Medium-grade bonds or equivalent
Lower-grade bonds or equivalent
Preferred stocks
Stocks of gold mining companies
Common stocks or equivalent:
    Transportation
    Utilities
    Natural-resource industries
    Special industries

Cash or equivalent includes cash in checking and savings accounts, shares in savings-and-loan institutions, and United States savings bonds. Highest grade bonds due to mature within 5 years also may be classified as equivalent to cash. These are investments of the greatest liquidity, and their dollar values will remain unchanged regardless of business-cycle fluctuations. On the other hand, both income and principal are vulnerable to decreases in the purchasing power of the dollar.

High-grade bonds or equivalent include United States Treasury bonds, the cash value of life-insurance policies, and corporate, State, or municipal bonds rated in the two or three highest brackets by the various statistical services.

United States Treasury bonds are considered high-grade bonds rather than the equivalent of cash because they are not redeemable on demand but can be converted to cash only by selling them at current market prices. The market values of these securities will vary from time to time although the face values will be paid at maturity.

The present value of annuities is included as the equivalent of high-grade bonds. For persons purchasing annuities, the cash value (for retirement annuities) or the purchase price (for single-premium annuities) is considered the present value. For persons receiving payments from an annuity, the present value is determined by the cost to the annuitant of purchasing at current rates at his present age an annuity providing payments equal to those being received. Pension payments should be treated in a similar fashion.

The cash value of life-insurance policies is included among high-grade bonds because the investment portion of a policy (the cash surrender value) is invested in high-grade bonds or the equivalent held by the insurance companies. The leading life-insurance companies are among the soundest financial organizations in the United States, and they are closely regulated by the various State governments. The cash value of a policy ordinarily would be promptly available as a loan or an outright payment.

Investments in high-grade bonds are adversely affected by inflation as is cash or the equivalent. The dollar amount of these investments can be expected to fluctuate relatively little. However, during an inflationary period the buying power provided by the income from these securities will diminish. Of course the reverse is true during a period of deflation.

Medium-grade bonds or equivalent include less secure fixed-income investments, the market values of which may be expected to fluctuate more than those of the securities listed above. This classification includes not only those corporate bonds rated in the three or four classes below the high-grade group but also real-estate mortgages and personal notes that are not readily marketable but that are considered by the investor to be relatively secure. The market prices of medium-grade corporate bonds can be expected to increase moderately in an inflationary period if the bonds are well secured and if interest payments are adequately covered by earnings. The income from this type of investment also is fixed in dollar amount and therefore is affected adversely by depreciation of the dollar. The primary reason for including these investments in a portfolio is to obtain a more favorable yield than that provided by high-grade bonds.

Lower-grade bonds or equivalent represent not only bonds in default but also income bonds, on which interest is paid only if earned. During the depression phase of the business cycle these bonds are usually low in price, and selected securities in this category may be desirable investments in funds where appreciation is sought. However, in the later stages of an inflationary period most of these securities reach the limits of possible appreciation. Because the interest payments are fixed in dollar amount and are uncertain in many instances, investment in these securities should be limited to selected issues that are either depressed in price or that offer favorable opportunities for treatment in reorganization.

Preferred stocks are included among the fixed-income type of securities inasmuch as the dividend payments are fixed in dollar amount. However, there is no guarantee that preferred dividends will be paid even when earned, because payments may be omitted at the discretion of the board of directors with no other effect than to have dividends accumulate (if the issue happens to have that feature). If the primary purpose of incurring the risks inherent in stock ownership is to obtain increased income during an inflationary period, purchase of preferred stocks on which dividend payments are fixed in dollar amount does not answer this purpose. Under other circumstances, however, preferred stocks may be suitable for income purposes.

Stocks of gold mining companies are in an intermediate classification between investments of fixed dollar value and common stocks generally. Because the various monetary units of the world (dollars, pounds, francs, etc.) are defined as fixed quantities of gold by weight, the "price"

of gold is fixed except when it can be sold in free markets at higher prices or when monetary units are devalued from time to time.

The stock of a well-established gold-mining company having adequate reserves of ore in the ground has some of the characteristics of a bond from the investor's viewpoint during a period when a monetary unit is depreciating. The investor has reasonable assurance that, in the long run, his principal will be safe; and some income presumably will be obtained if the company is able, by mining higher grade ore or by improved mining operations to offset the rising costs of materials and wages.

However, the stock of a sound gold-mining company has the added advantage of providing nearly complete protection against devaluation of a monetary unit, a process that almost invariably follows prolonged inflation and consequent depreciation of a currency. Under such circumstances, companies mining gold benefit markedly for a time after the devaluation because gold sells at a higher "price" but wages and other costs adjust to the situation gradually over a period of years rather than immediately. Thus the investor has some assurance that the buying power of his principal as well as his income will increase when the monetary unit is devalued unlike the situation in which the holder of a bond or savings account finds himself. The latter individual, no matter how much the dollar shrinks in buying power, will be entitled to no more dollars than the number he initially invested.

While a monetary unit is depreciating as a result of continuing inflation and prior to the next devaluation, most companies mining gold encounter difficulties in operating profitably. Wages and other costs keep rising; consequently, unless the gold content of the ore mined increases as new shafts are driven or new gravel deposits are dredged, the companies' net income may decrease. For this reason, the common stocks of most gold-mining companies are not desirable investments in the early stages of a prolonged period of inflation and monetary depreciation. However, after a prolonged period of inflation when most other common stocks are selling at relatively high prices, stocks of companies mining gold usually are selling at relatively low prices because of the prior prolonged adverse circumstances described above.

Gold stocks purchased in the later stages of a prolonged period of inflation offer protection in two principal ways:

1. If a business recession becomes serious because of the cumulative deflation attributable to the liquidation of unwisely incurred debt, wages and other costs of mining gold decrease with a resulting favorable effect on the earnings of companies mining gold.

2. If, in an effort to prevent a recession from becoming worse, a government indulges in more inflation at a time when an economy already had developed many serious distortions during a prior pro-

longed inflation, the chances of another devaluation within the next several years increase greatly. Such is the situation in the United States today. Under such circumstances, gold stocks may offer the best protection against the expected devaluation and further depreciation of the monetary unit.

Common stocks generally or equivalent. This classification includes all investments from which the income may be expected to fluctuate with changes in the business cycle. The assumption should not be made, however, that all common stocks will provide increased income during inflation and decreased income during any deflationary period. Certain companies may be expected to benefit from inflation; others find themselves in much the same position as the individual whose income is fixed and whose expenses are increasing.

Railroad stocks represent investment in an industry essential to the operation of business enterprise in the United States. The long-term growth of the railroads was retarded from 1920 to 1932 because of increased competition. However, the volume of freight traffic since World War II has been substantially greater than the prewar traffic volume. Apparently, in spite of the intense competition from trucks and air lines, the long-term growth of the railroads continues to be upward. The financial position of the railroads was much improved as a result of the extraordinarily large volume of business handled during the war. Moreover, the Interstate Commerce Commission has been relatively prompt and generous in granting rate increases, so that increasing costs have been offset to a substantial extent. As a result, increased earnings and dividends may be expected for certain companies. Therefore, a few selected railroad stocks are considered favorable investments.

Utility stocks, although they represent an investment in an essential industry, present a somewhat different situation from that of the railroads. Utility earnings ordinarily are adversely affected during an inflationary period because rates are relatively inflexible and operating expenses increase. However, long-term growth of the industry has been outstanding, and the utilities should benefit from the addition of more efficient equipment and increased business. Several utility companies located in favorable growth areas that have indicated an ability to increase earnings per common share even during the postwar inflationary boom are considered desirable investments. In recent years, utility stocks have been among the best investments.

Natural-resource-industries investments are those in companies that own or control their basic raw materials, as well as investments in land, such as farms or unimproved lots. Securities of companies in this classification that have a growing market for their products probably will provide the best protection against inflation's effects. The basic natural resource

ordinarily will increase in market value during an inflationary period. The companies concerned usually obtain an increased income that can be paid to stockholders in increased dividends, which provide the added income needed by an investor during an inflationary period. Typical examples are the oil, copper, aluminum, and steel industries.

Investments in land are classified as natural-resource common stocks because land is a natural resource. During an inflationary period land values ordinarily increase, although the earnings from operating farm land depend in a large part on the weather and on the political and other factors that may influence prices.

Special-industries investments are all other variable-income investments, including common stocks, rented buildings, and any personal business investments. The effects of inflation on investments in this category vary. For example, industries leading in the technological advance or those marked by superior management ordinarily benefit from the prosperous business conditions that usually accompany inflation. The same is true for those whose market is reaching the stage of expansion from rare to general use. On the other hand, some companies cannot increase the prices of their product enough to compensate for increased costs; and other companies cannot control the prices they pay for raw materials. Such organizations are adversely affected by inflation. The chemical industry, particularly the most progressive companies, is an example of an industry leading the technological advance; the food industry, particularly manufacturers of luxury foods, is an example of an industry faced with increasing costs and inability to increase selling prices correspondingly during a period of inflation.

We suggest that the market value or book value of any personal business owned be included in this section. The income from a personal business varies and may be sensitive to changes in business conditions. A substantial sum invested in a personal business that is subject to market fluctuations is the equivalent of an investment in speculative common stocks. An investment portfolio should not be considered separately from business investments as long as the same individual incurs both risks. On the other hand, it would not seem necessary for someone employed by another for a fixed salary to include the capitalized value of his salary among his investments, because the risks of the business are borne primarily by someone else.

IV. THE INDIVIDUAL'S PROGRAM

THE average person's savings are of vital importance in order to carry him and his family through the emergencies of his productive years and are essential to safeguard his years of retirement. Yet many, probably a majority of individuals, have no established program suitable to their special circumstances. Investments are frequently made on the casual advice of friends and on "tips" of dubious origin. Investment experience based on such a haphazard procedure usually leads to the dissipation of hard-won surplus earnings. Obviously, the individual who wishes to obtain the greatest benefits from his savings and who wants to protect them from unnecessary losses should formulate a sound program of investment. The determination of a suitable program should include the following considerations: (1) the nature and purposes of the investment fund, (2) the manner in which certain fundamental investment objectives apply to the individual's circumstances, and (3) the investment program appropriate to these circumstances.

Purposes of the Investment Fund

In the preceding sections we have discussed the types of investment media usually owned by individuals and indicated how these various types of investments can be classified. Although the nature of an individual's investment fund is thus apparent, the purposes of that fund are not so obvious. In order to establish definite investment objectives and obtain a purposeful investment program, the individual first should check carefully all his resources against the responsibilities for which they must provide. In the light of these factors he will be able to ascertain more accurately the nature and purposes of his investments. He also will recognize the manner in which his investments form a constitutent part of his over-all financial position. The following list indicates some of the more important factors influencing an individual's investment objectives.

1. Age and health of investor
2. Present and probable future earnings from business or profession
3. Present and probable income from other sources
4. Size of investment fund
5. Prospective additions to the fund
6. Number and age of dependents
7. Adequacy of life insurance
8. Current and contingent obligations

9. Present and prospective living expenses
10. Provision for emergencies
11. Retirement needs

A systematic enumeration of these items may be found in the Personal Appraisal Form in the back of this publication. On the basis of economic, social, physical, and financial factors, the individual may be included in one of several broad classifications that roughly correspond to the economic divisions of a person's life.

The economic lifetime of a man may be divided into three stages. During the earliest portion of his earning lifetime, he ordinarily has youth, adaptability, and surplus energy. These qualities should enable him to surmount difficulties, deal with changed conditions, and, most important of all, recover from severe set-backs in the business world.

While young, say prior to the age of 40, a man may be justified in risking a substantial portion of his capital in some venture that may not prove to be successful, because he can count on both the time and strength to recover from any reverses that may occur. This is particularly true of an individual who does not have the responsibilities of a family. A man who has dependents can afford to take risks at this stage of his life only if savings have been accumulated for emergencies and adequate life insurance has been obtained for the protection of his dependents in the event of his death.

At the ages of 40 to 50 most men lose some of the energy and vitality that were such valuable attributes of their earlier working years Although their business judgment is improving, men in this period of life will have lost some of their capacity to recover from the effects of financial difficulties. Moreover, from ages 40 to 50 a man's obligations to his family are usually greatest. The education of children must be paid for, living costs incidental to professional or executive positions are encountered, and aged parents may become dependents. Furthermore, in this period serious consideration should be given to planning a retirement program.

Certainly, highly speculative ventures should be avoided unless there is ample surplus capital in excess of probable future needs. Substantial life-insurance protection still will be needed, and investments should be more conservative in nature. Because a salary or other regular income is available, some risk can be assumed in order to obtain income and capital appreciation for a retirement fund. However, the risk that should be incurred is much less than that a younger man would be justified in assuming.

After ages 55 to 65 most men find their energies are somewhat lessening, and they probably will want to retire from active participation in business. Even if a man chooses to remain at work, the possibility of

some impairment of health will greatly increase the uncertainty of continued income from employment in the years after middle age.

In later life a man's needs for life insurance have decreased considerably, and the dependents for whom he must provide are usually only himself and his wife. After retirement a portion of living expenses may be provided for by annuities, pensions, and Social Security benefits. The additional income needed during one's declining years may be obtained from security investments.

Basic Investment Principles

Certain fundamental principles should be considered in appraising the investment position of each individual. These guides pertain to the principal and income of the investor's fund and are the determining factors in the allocation of funds and the selection of types of securities suitable for his particular program. Before offering some typical programs and discussing the degree in which the objectives are embodied in the programs, a general statement of the nature of the basic investment principles is desirable.

Security of principal in an absolute sense means that the investor's commitment would be secure at all times and in no danger whatsoever of being impaired in buying power; it implies that the investor would be certain to have his funds returned intact whenever he so desired plus enough additional to compensate him for any depreciation of the dollar; that is, enough more to compensate the investor for any increased cost of living. However, such absolute safety is unattainable. Consequently, the investor seeking preservation of his capital must understand that investment in even the highest quality of contractual obligations involves some element of risk and that investments of the highest quality insofar as assurance of the return of a stated number of dollars is concerned provide no protection against depreciation of the dollar.

Stability of income refers to the regularity of income in specific dollar amounts from an investment. Because the market value of an investment in an enterprise ultimately depends upon the ability of that enterprise to earn money, the income stability of an investment is related closely to its safety of principal. Relative stability in the rate of dollar income may best be obtained by holding various types of fixed-income investments discussed in section III. Some common stocks, although not contractually guaranteeing a fixed income, have yielded a relatively stable income in dividends for extended periods. However, the fact that a company has paid dividends on its stock for a long period does not provide assurance that the dividend rate will not be changed; nor does it even assure that dividends will continue to be paid. Among the risks inherent in ownership of common stock is the risk of a fluctuating income or

even none at all. On the other hand, this uncertainty, in the form of possible increases in income during the inflationary periods, provides a primary reason for owning any common stock. The risk of stock ownership, therefore, may be justified in those instances where purchasing power of the income is highly important and protection against a rising cost of living is necessary. Stability of income in the broadest sense implies the consideration of the buying power of income rather than the regularity of receipts fixed in dollar amount.

Appreciation of capital may be obtained when the market value of an investment increases to more than the purchase price. Common stocks as a class offer greater potentialities of appreciation than bonds, and lower grade bonds may increase in value more than the higher grade bonds. Certain industries and companies may benefit during periods of inflation. Price appreciation resulting from owning shares of these companies during inflationary booms will help the investor to counterbalance the decreased purchasing power of his fund. An increase in the value of securities also may occur during short-term market fluctuations. However, the average investor ordinarily should not seek to obtain profits by attempting to outguess the market's short-term fluctuations. Capital enhancement also may be obtained through ownership of investments that increase as a result of the growth of a company or an industry.

Marketability pertains to the facility with which a security can be bought and sold. Good marketability implies an accessible market where purchase or sale can be made quickly. An offer to sell a moderate amount of a given issue will not result in an appreciable decline in the market price. Investments vary widely as to this attribute; but good marketability most often is found in securities that are traded on one of the large securities exchanges, that are widely held by investors throughout the country, and that are part of a large issue of a security in the hands of investors.

Diversification is an important investment principle, because the investor thereby reduces the risk of large losses. Diversification does not eliminate loss: it merely confines a particular type of loss to a portion of the total fund. Diversification may be accomplished simply by investing in a large number of different companies. However, in order to obtain the maximum degree of protection, the investor should take advantage of at least five distinct types of diversification. Consideration of all these types is essential to a well-planned investment program.

Diversification according to types of securities requires that the investor purchase some common stocks as well as bonds; in other words, some of an individual's investments should be of the type that provide variable earning power, while others should be of the fixed-income type. The object of this form of diversification is to protect the investor from

the adverse effects of changes in the cost of living. When prices are rising, the decline in the purchasing power of fixed-income investments or in the market value of the fixed-income portion of a fund theoretically should be offset to some extent by a proportionate increase in the income from common stocks or in the market value of the common-stock portion of the fund. Thus this type of diversification is essential in order to obtain stability of real income and protection against inflation.

Diversification by industries may be obtained by purchasing securities of several different types of enterprises. This form of diversification is especially important with reference to ownership of common stocks. The primary object of industry diversification is to protect the investor from loss of principal resulting from an unanticipated decline in a single industry. Even industries that appear to have favorable growth prospects may encounter unusual circumstances, unforeseen competition, or adverse Government regulation that may cause a severe set-back. For this reason we recommend that the total amount invested in one industry be limited to a maximum of 10 percent of an investor's fund. Exceptions to this rule may be made in the case of the railroad and utility industries because adequate protection can be obtained by means of geographical diversification.

Diversification of investments among individual companies also is important. Although the investor will want to invest larger amounts in industries or areas with especially favorable growth trends, the future performance of any particular company cannot be guaranteed. A safe procedure, therefore, is to select several of the better companies in the area or industry and to limit the total amount invested in any one company to a maximum of 5 percent of a fund. On the other hand, because of the difficulties of proper supervision and accounting, the holding of too many issues should be avoided. For this reason a minimum should be set on the amount to be invested in any one company, ordinarily from 2 to 3 percent of a fund.

Diversification geographically is obtained by distributing investments among the different areas of the country. Geographical diversification of investment is important primarily as a protection against losses from disasters such as fire, flood, earthquake, or adverse business conditions affecting one geographical area. For investments in railroads and public utilities, geographical diversification is especially important. The principle may be used by the investor in order to take advantage of areas having superior growth trends.

Diversification according to maturity dates of bond issues is another method of insuring against large losses. No man can foresee whether or not we shall be in the midst of a serious depression 20 years from now. Obviously, the investor would suffer a serious loss of principal if a major

portion of his bonds were maturing at a time when the companies concerned were unable to pay as stipulated in the bond. On the other hand, the problem of reinvestment might be great if a large part of the bonds of a fund mature at a time when interest rates are extremely low. The investor might have difficulty in finding bonds of a suitable grade yielding as much as those maturing and the investor's fixed-income return from a given amount of principal would be reduced. Contingencies such as these can be guarded against by purchasing bonds with varying maturity dates.

Programs of Investment

In order to assist the investor to formulate a plan of investment that is suitable for his particular circumstances, the Institute has devised three typical investment programs. The Investment, Speculative-Investment, and Speculative Plans should be generally applicable to nearly all individuals who have funds for investment. Modifications can readily be made in order to allow for differences in circumstances from those indicated. The personal situations in which these plans apply, an outline of the recommended allocation of funds, and the investment objectives embodied in each plan are discussed in the following sections.

Investment Plan

The Investment Plan is designed for the investor who is dependent on income from his pension, annuities, or investments for his living expenses and other needs. Usually the individual will be in the so-called third phase of his economic lifetime and, therefore, will be retired or preparing for retirement. However, all persons who are not earning an income and whose total income from other sources is not more than adequate for living expenses should follow the Investment Plan.

Anyone charged with the care of assets that must be used to meet future liabilities should keep firmly in mind the purpose for which the funds are to be used. In the Investment Plan a regular and assured income must be obtained, or the handling of the fund cannot be considered successful. In normal times, when not faced with the danger of inflation and a higher cost of living, the fund should not have substantial holdings of common stocks. The possibility of further inflation makes it necessary for even the investor following this plan to accept risks that would be inadvisable during periods of monetary stability.

The following table indicates the approximate percentage of total investment funds (including cash reserves) that, in our opinion, should be allocated to the various groups at this time (September 1963):

Cash or equivalent	35%	
Bonds:		
Medium-grade bonds	15	
Total fixed income		50%
Gold stocks and other foreign holdings		20%
Common stocks:		
Transportation	4%	
Public utilities	18	
Natural-resource industries	4	
Special industries	4	
Total variable income		30%
Total		100%

Security of principal usually is considered important to followers of the Investment Plan. However, this does not imply that the principal sum should be available to the investor at all times. Principal will always be available only if the entire fund is in cash, a procedure that makes impossible any income return. The investor should be able to obtain a reasonable income and, at the same time, have virtual security of principal as far as repayment in the long run is concerned.

Stability of income is a vital consideration to an Investment Plan follower, because the return from his investments is necessary in order to meet his living expenses. Month-to-month receipts from investments need not be equal, but there should be no extreme variations in purchasing power from year to year or during the course of the business cycle. In order to augment his income from the fixed-income securities during periods of inflation, the Investment Plan follower will need to hold some common stocks.

Appreciation of capital is another feature with respect to investments that sometimes is regarded as desirable. However, except as was discussed in connection with ownership of common stock as a protection against inflation, we do not consider it feasible for the investor who is dependent on income to seek appreciation in capital.

Marketability with respect to his entire fund is not especially important to the Investment Plan follower because frequent shifts in investments are not desirable. Banks and insurance companies, which may be called upon to meet large demands for cash, or speculators who may need cash to take advantage of special situations, must give this aspect of the problem more serious consideration. However, individual investors should not sacrifice too much income in order to obtain marketability.

Freedom from care is a desirable objective of followers of the Investment Plan. By the time a man has accumulated sufficient funds for investment and is preparing for retirement, he is probably at the point where day-to-day worrying about the safety fo his securities or what should be done with them is not greatly to his liking. Furthermore, many investors faced by this aspect of the problem probably will not be in a position, because of lack of knowledge, to carry a burden of investment cares. For this reason, his program should be well planned and, if desirable, supervised by competent investment counsel. The investor's fund should be conservatively managed, and frequent trading or switching should be avoided.

Speculative-Investment Plan

The Speculative-Investment Plan is intended to meet the needs of the individual who has a reasonably certain and adequate business or other income and who desires to augment that income and increase his capital as much as possible from his investments. It is assumed that the individual following this plan has ample life-insurance protection to cover the possible needs of his dependents. It is also assumed that his income will continue in spite of temporary illnesses or that he has adequate accident-and-health insurance. Moreover, he should have adequate cash reserves or the equivalent of accumulated cash surrender value of life-insurance policies, which could be used in the event of a serious illness or other emergency requiring unusual expenditures.

In the Speculative-Investment Plan, the important objective is to increase the fund by means of the income from securities and some appreciation. A moderate degree of risk may be assumed in attempting to accumulate the funds that will later provide an income when the investor has retired from active business. Because this investor has other regular income, he may follow a less conservative course than the individual who is entirely dependent on the income from his investments.

The following indicates the approximate percentage of total speculative-investment funds (including cash reserves) that, in our opinion, should be allocated tc the various groups at this time (September 1963):

Cash or equivalent	35%	
Bonds:		
Medium-grade bonds	10	
Total fixed income		45%
Gold stocks and other foreign holdings		25%

Common stocks:		
Transportation	3%	
Public utilities	15	
Natural-resource industries	5	
Special industries	7	
Total variable income		30%
Total		100%

Security of principal is an important aspect of the Speculative-Investment Plan. However, in order to obtain capital appreciation, the speculative investor takes greater risks. These risks necessarily reduce the security of the principal, and there will be some danger that portions of the principal may be lost entirely. Furthermore, there probably will be times when the entire original principal will not be available because of changes in market prices.

Stability of income, although desirable, is not particularly important to the speculative investor. In view of the fact that he desires to augment his capital and has other income adequate for his basic needs, fairly wide variations in the income from investments can be permitted.

Appreciation of capital is a feature that is desirable in this instance. The speculative investor presumably is prepared to take the risks involved in attempting to obtain some capital gains.

Marketability in the sense of full-time availability of the entire principal, is unnecessary for this fund. Moreover, substantially all of the funds allocated for the cash-or-equivalent section of the fund would be invested in savings-and-loan shares or U. S. Savings bonds. Only persons who may be called upon to meet large demands for cash should give serious consideration to holding uninvested any appreciable portion of his fund. The prices of some securities fluctuate more than others merely because the amount issued is small or for some other reason is not freely marketable. However, if the securities are otherwise sound, they may be attractive for the speculative investor.

Freedom from care is a desirable attribute to those interested in this plan. The speculative investor has other interests that are his primary sources of income, and he has neither the time nor the inclination to devote all of his efforts to an investment policy requiring a great deal of thought and analysis. In general, the aim should be to purchase income-yielding securities that, for special reasons, have a favorable outlook. For careful selection and frequent appraisal of securities of this type, the follower of the Speculative-Investment Plan may find helpful the services of a competent investment counsel.

Speculative Plan

The Speculative Plan is intended to meet the needs of the investor who desires to augment his capital in spite of the fact that speculation necessarily involves a greater risk of loss than is incurred by followers of the Investment and Speculative-Investment Plans. The individual for whom the Speculative Plan has been prepared is assumed to have adequate and certain income, which is largely independent of the state of business activity and his own business capacity. Employees of Federal, State, and municipal governments and various others whose incomes are almost equally well assured should be included in this group. Of course, other individuals who might not have such a definitely assured income but who have a large capital might well use a portion of it in accordance with this plan. The speculator for whom this plan is prepared should have ample life insurance, accident-and-health insurance, or the equivalent in cash reserves; he should have provided for his retirement, and he should have adequate cash reserves to carry him through any period when his securities could be liquidated only at great loss.

The following table indicates the approximate percentage distribution of total speculative funds including cash reserves that, in our opinion, should be allocated to the various groups at this time (September 1963):

Cash or equivalent	40%	
Bonds:		
Medium-grade bonds	0	
Total fixed income		40%
Gold stocks and other foreign holdings		30%
Common stocks:		
Transportation	2%	
Public utilities	12	
Natural-resource industries	7	
Special industries	9	
Total variable income		30%
Total		100%

Security of principal and appreciation of capital are never found together. Because the value of the securities purchased will fluctuate to a considerable extent over a period of time, insecurity of principal is unavoidable in the Speculative Plan.

Stability of income is not considered in connection with this plan. Whether or not the individual securities recommended yield an income is likewise not considered of great importance.

Appreciation of capital is the objective that is given primary attention in connection with the Speculative Plan. An attempt should be made to select issues that will increase in value during the long term and that will provide the maximum degree of protection against the effects of inflation.

Marketability is much more important in connection with this plan than for either the Investment or the Speculative-Investment Plans. Occasionally the speculator will have to shift his holdings rapidly, and a ready market is a prerequisite to such action. The speculator may be justified in holding a portion of his fund in cash or equivalent in order to take advantage of special situations offering unusual investment prospects.

Freedom from care is out of the question when one embarks on a speculative course, and every individual must decide on his own ability to carry the burden without undue worry about his financial problems. However, this plan does not involve frequent trading, either on a week-to-week or month-to-month basis; therefore, the degree of care and attention required should not be such as to divert attention from one's primary source of income.

Plan for Small Funds

The three plans discussed above are designed for investors whose funds total more than $40,000. For smaller funds, adequate diversification cannot be obtained by direct investments in securities of individual companies. Each of the plans calls for the purchase of a dozen or more common stocks, at least; and the purchase of even the minimum number of issues required in sufficient amounts would be impossible with a relatively small fund. Therefore, we recommend that investors who have funds less than $40,000 purchase shares in appropriate investment companies and savings-and-loan associations.

The allocation of funds may be made on the basis of the investor's circumstances as described above in connection with the three typical programs. That portion of the fund that would be placed in common stocks should be invested in investment-company shares. The remainder of the fund should be invested in shares of savings-and-loan associations.

In general, the investment objectives for small funds will depend on individual circumstances previously discussed. In addition, the following comments are particularly appropriate for such investors.

Security of principal is an important objective of the small investor. For this reason, a substantial portion of his fund is held in the form of cash or equivalent and would be available on short notice. The fluctuations of the portion of the fund invested in investment-company shares will be determined by the nature of the stocks and bonds held by the trust.

Stability of income may be obtained by the small investor by means of his cash-or-equivalent type of investments. Investment-company shares invariably provide a fluctuating income and may, therefore, be helpful in protecting the investor's purchasing power during inflationary periods.

Appreciation of capital may or may not be an important objective of the small investor. Some capital enhancement may be sought by followers of the Speculative-Investment and Speculative Plan. Appreciation usually is obtained by careful selection of investment companies that have had the most favorable performance records.

Marketability is an important objective for the small investor. Fortunately, a high degree of marketability is obtainable by individuals holding savings-and-loan shares, United States Savings bonds, and investment-company shares.

Freedom from care is a desirable feature of this plan. The small investor who purchases shares of reputable investment companies thereby obtains management and supervision.

Whenever a fund reaches a total of about $40,000 to $50,000, the investor should switch to a plan of direct investment in securities suitable for his circumstances. The fund then is large enough to obtain adequate diversification, and annual management fees of as much as 1 percent of the net-asset value of investment-company shares may thereby be avoided. A more complete discussion of the nature of investment companies and the basis for selection of investment-company shares is presented in the Institute publication *Investment Trusts and Funds From the Investor's Point of View.* Price $1.00.

Investment Policy

After the investor has established an investment program, he should adopt a policy with regard to this program that will enable him to cope with the changes in personal circumstances and business conditions that he may encounter. This investment policy includes provisions for flexibility and permits a realistic reappraisal by the investor of the management of his funds.

Many investors lose sight of the purposes and objectives of their investment funds. In the hopes of greater gains in the form of income or appreciation, investors sometimes underestimate the risks involved in some securities and for that reason assume greater risks of loss than is appropriate for their circumstances or experience.

The investor should bear in mind that none of the plans described above is intended for traders or in-and-out-of-the-market speculators. Investment according to the plans should be in securities that will be purchased and held, ordinarily, for long periods of years. (The basis for selection of securities is discussed in section V.) Moreover, substantial

and rapid changes in the percentage allocations of funds usually are not desirable.

We are convinced that margin trading and short selling should not be undertaken by the average man of modest means. We believe that no inexperienced individual should engage in such operations with the expectation that his capital will be larger at the end of the process. We are also convinced that frequent trading is one of the most certain sources of loss. The record of attempts that have been made to make money by outguessing the short-term fluctuations of the stock market prove conclusively that the odds are overwhelming against the inexperienced trader.

However, the percentage allocations among various types of investments in each of the three plans may be changed from time to time as changes in business and other conditions require. In allocating funds among the various types of securities consideration should be given to the present degree of inflation, the chances of long-term depreciation of the dollar, and the possibility of deflation. Whenever the situation changes substantially, the percentages of funds allocated to the various types of securities should be modified.[1]

The percentage allocation of funds should be based on market value rather than cost prices, because the price paid for a security is only an historical incident of no fundamental significance as far as the value of the security at future times is concerned. From time to time, market fluctuations may cause a distortion of the percentage allocation of funds. Although minor variations from the recommended allocations of funds are not serious, investors should make readjustments in order to restore the recommended percentage distribution whenever there are large fluctuations in market values that seriously distort the allocation of funds.

Ordinarily, there is a gradual turn-over of funds, even in the portfolio of an individual following the Investment Plan. From time to time, bonds are called or mature; and it may be desirable occasionally to replace particular securities for various reasons. Investors should use the funds that thus become available and any new funds for those investments that will tend to restore the percentage allocation of funds indicated for the plan appropriate to their circumstances.

In addition to deviations from the recommended percentage distribution resulting from business-cycle and other market fluctuations, variations in the desirable percentage allocation may be made in order to fit particular circumstances. For example, a follower of the Speculative Plan or Speculative-Investment Plan who has permanent life insurance

[1]A "Quarterly List of Recommended Securities" may be obtained upon request from American Institute Counselors, Incorporated, Great Barrington, Massachusetts.

should list the cash value under high-grade bonds and should reduce correspondingly the percentage allocation to the cash-or-equivalent section or the medium-grade-bond section.

One of the most perplexing problems that investors face is the advisability of selling a stock for less than its purchase price. It should be emphasized that, except for the tax problem of balancing capital gains and losses, the price at which a security was purchased has no bearing on whether or not it should be retained. The question is not whether the purchase price has been regained or exceeded, but whether the funds obtainable by selling can be better invested elsewhere. The purchase price has no effect whatsoever on the progress of either the company concerned or other companies that may be considered as alternatives. By attempting to retain an investment until the purchase price has been regained, the investor often incurs greater losses that otherwise might have been avoided. Moreover, such action prevents the use of funds to greater advantage elsewhere. Obviously, a person who insists on retaining all the securities on which he has losses and sells only those on which he has profits will, within a few years, have a choice collection of "lemons." *In the long run,* losses indicate errors of judgment; profits indicate that the selection was wise. How foolish it would be to abandon commitments that confirmed one's wisdom and insist on retaining the investments that proved the fallibility of human judgment. Of course, the foregoing advice does not mean that any security that is selling at less than the purchase price should be sold for that reason alone. What is meant is that, if the investor is convinced that a mistake in judgment has been made, the fact that the security is selling at less than the purchase price should not influence his decision whether or not to sell it.

Tax problems encountered by the investor in relation to his program require different solutions in almost every instance. Except as discussed in the preceding paragraph, we have given weight to the tax aspects of investment policy only to a limited degree. We caution investors having large holdings to consult competent advisers experienced in taxation matters.

An important but frequently neglected aspect of an investor's program is the need for adequate record keeping and competent supervision. The maintenance of an accurate accounting record of all transactions is essential not only for the computation of various taxes but for the periodic evaluation of the individual's program as well. The following information regarding each investment is the minimum that should be recorded: principal amounts or number of shares purchased, dates of purchase, costs of purchases and expenses incurred, dates of sales, proceeds and expenses of sales, and capital gains or losses. An accurate record also should be

kept of all cash dividends, interest, and of all capital changes such as rights and stock dividends, which may require adjustment of the original cost basis for tax purposes.

The task of record keeping can be simplified greatly by using a custodian account with a bank or brokerage firm that will act as the investor's agent in carrying out all instructions given and safeguarding his securities. The securities ordinarily are registered or recorded in the name of the custodian's nominee, so that no legal complications delay any purchases or sales of securities. (Investors who desire to exercise voting rights themselves can have the custodian send them proxies for any meeting of stockholders).

The custodian will provide a periodic statement of income receipts and disbursements together with detailed reports on all principal transactions including stock dividends, rights, etc. By simply filing these reports or turning them over to his tax accountant, the investor can minimize his own record keeping. In addition, the trouble of handling securities and of safeguarding them in a safe deposit box or otherwise is avoided.

Many banks throughout the country offer custodian- or agency-account service. The banks in New York City are conveniently located in relation to the principal security exchanges and corporate security transfer agents. As a result, in many instances the fees charged by New York banks are considerably lower than fees charged by banks outside New York that are not so well equipped to handle custodian accounts. Such custody services can be obtained for an average fee of about 0.1 to 0.2 percent of the total market value of the portfolio, and the minimum fee is about $50. However, the basis for such fees varies widely. For this reason, we suggest that anyone who is interested in such services obtain the specific fee for his fund from several New York banks, as well as his local bank, before he makes a final decision.

Periodically, every investor should carefully and critically reappraise his investment position. A complete list should be made of all investments showing the current market value and annual income. The list should be arranged according to type of investment and subdivided into industry components. With this tabulation before him the investor may evaluate his financial position with regard to his own particular circumstances.

Within the uncertain and changing economic environment of today and the indefinite future, the success of an investor in maximizing the benefits from his investment fund may well depend on his ability to apply the general features of an investment program as outlined in this section. The individual should consider his needs and resources in order to

ascertain the objectives of his investment program. He may then formulate a plan that embodies the objectives peculiar to his circumstances. A method of selection of securities appropriate for the plans is described in the next section.

V. SECURITY SELECTION

SELECTION of securities suitable for the investor's program is as important as the determination of an appropriate investment program. Even with proper allocation of funds and a sound general policy, the success or failure of an investment program ultimately may depend on the selection of individual securities. A thorough discussion of security analysis will not be attempted in this publication. Instead we shall describe a suitable method of classifying the desirable attributes of industries and companies and outline some of the criteria used in selecting individual securities. At the end of the section we have added a list of references that may be useful to the reader who desires to study this field more extensively.

The problem of selection is complicated by the vast extent of business enterprise, by the great number of companies that have securities outstanding, and by the wide variety of activities in which the companies are engaged. In order to assist the individual who is not familiar with industries in which investment is possible, business concerns found in the United States may be classified according to the product or service that they produce.

The following five major categories of enterprise may be distinguished: transportation, public utilities, natural-resource industries, financial companies, and miscellaneous special industries. The transportation section includes the railroad, air-transport, bus, truck, and shipping industries. The public utilities include communications, electric-light and power, and natural-gas pipe-line industries. The enterprises included under the classification of natural-resource industries are those engaged in the production of aluminum, copper, lead, silver, zinc and other nonferrous metals, iron and steel, petroleum, and coal. Insurance companies, banks, and loan companies constitute most of the financial companies.

The special-industries classification may be subdivided into groups of industries manufacturing producers' goods, industries supplying consumers' goods, and industries providing services. Producer-goods industries include companies manufacturing chemicals, aircraft, and office, plant, farm, electrical, railroad, and construction equipment. Consumer-goods industries are composed of those companies that produce automobiles and automobile accessories, beverages, various food products, household equipment, paper, drugs, textiles, and tobacco as well as those companies engaged in retail trade and amusement items. Among the

producers of services are the moving-picture companies, the radio-broadcasting companies, etc.

This classification of the major fields of enterprise indicates the wide diversification of industries available to the investor. However, such a classification of itself does not assist the investor in selecting suitable securities for his fund; and a more critical basis of classification must be sought.

Desirable Investment Characteristics

Industries and companies have certain common characteristics that have a bearing on the long-term investment prospects of the securities of particular companies. Some of these characteristics are not especially significant, but others provide a basis for the differentiation between securities that are unsuitable and those that are desirable for a fund. In view of the risk involved in the ownership of any security, we have concluded that an investment should not be made in a company unless that company or the industry of which the company is a part is aided by some of the favorable characteristics discussed below.

Growth

A favorable long-term growth is one of the more important attributes of a company in which an investment may be made. Businesses grow and decline at varying rates and for various reasons. However, a general pattern may be described in terms of which individual industries may be discussed.

In the early stages of an industry's development, expansion may not be rapid. After the invention of a new product and the formation of companies to produce it, certain difficulties may be encountered. Many experiments are required to test the uses of the product, and some of the products are defective. Because of the expense involved in improving and introducing the product in the market, its price is high and the company may lose money for several years.

However, the period of experimentation may have resulted in an improved product that can be manufactured in quantity by machines and mass-production techniques. Consequently, prices can be reduced; and the market for the product may expand. Modification of the basic product may permit and encourage its employment in a wider variety of uses. During this period the industry experiences a rapid growth that is characterized by increasing sales, lowered operating costs, expanding plant and equipment, and increasing profits.

Although the period of rapid growth may continue for many years, inevitably a time is reached when growth is not so rapid; and the industry enters a period of relative stability. Further improvements in the manu-

facturing process are difficult to make; costs, and therefore market prices of the products, cannot be reduced greatly. The characteristics of this period in the life of an industry are decreasing adaptation of the product to new uses, development of competitive products, and relative stability of sales and profits.

The total output of the product, as well as sales and profits, may continue to increase but usually at a diminishing rate. The companies in the industry will seek to develop newer products and may shift to the production of entirely new devices. The demand for the old product and the industry engaged in its manufacture will have reached maturity. Finally, in many instances, a period of retrogression is reached, characterized by declining sales, higher costs, and less efficient production as the industry's equipment ages and is not replaced. Profits decline, and the industry eventually may pass out of existence.

Of course, few industries have experienced growth patterns similar in all respects to that described in the preceding paragraphs. There is some evidence that consumer-goods industries, which often have a comparatively short growth cycle, follow this trend to some extent; for example, automobile production, radio sales, and mechanical-refrigerator sales seem to have followed this general pattern. On the other hand, the growth trends of natural-resource industries frequently extend over a century or more. Moreover, available data give no indication that their growth trends follow any particular pattern.

In one of the better books available on the subject of growth trends[1] the author has suggested several reasons for the divergence of production trends, including the following: invention of new commodities, development of new raw materials, and discovery of new mineral resources; changes in the methods of production, transformation of industrial equipment, recovery of waste products, and changes in the form of industrial organization; an increase in the number of uses to which raw materials are put; an emergence of a variety of luxury products and style goods.

The statistical evidence included in the cited book clearly demonstrates the differences in the rates of growth of various industries in the United States. Of interest also is the fact that the earlier stages of most industries are seldom marked by a gradually increasing rate of growth. On the contrary, production in the early stages usually is characterized by violent fluctuations. Many companies enter the field; changes in the product are rapid; competition for the new market is keen; failures and bankruptcies mark the departure of less successful companies. Only after competition has eliminated the weaker companies and several well-estab-

[1]Arthur F. Burns, *Production Trends in the United States Since 1870* (New York, National Bureau of Economic Research, Inc., 1934).

lished organizations dominate the field does a typical growth pattern become evident.

For example, although more than 800 different makes of automobiles have been manufactured since 1896, only 10 companies were producing cars at the outbreak of World War II; and the products of five companies dominate the field today. Television is a more recent example of an industry that experienced rapid expansion for about a decade following the end of World War II and then reached the stage of maturity characterized by a diminishing annual rate of growth.

A major conclusion justified by the statistical evidence available is that "an industry tends to grow at a declining rate, its rise being eventually followed by a decline."[2] However, the life cycles of various industries are not of equal length. A luxury good or a fad may experience a complete life cycle within a few years; on the other hand, the petroleum industry has not yet reached maturity after almost a century of growth.

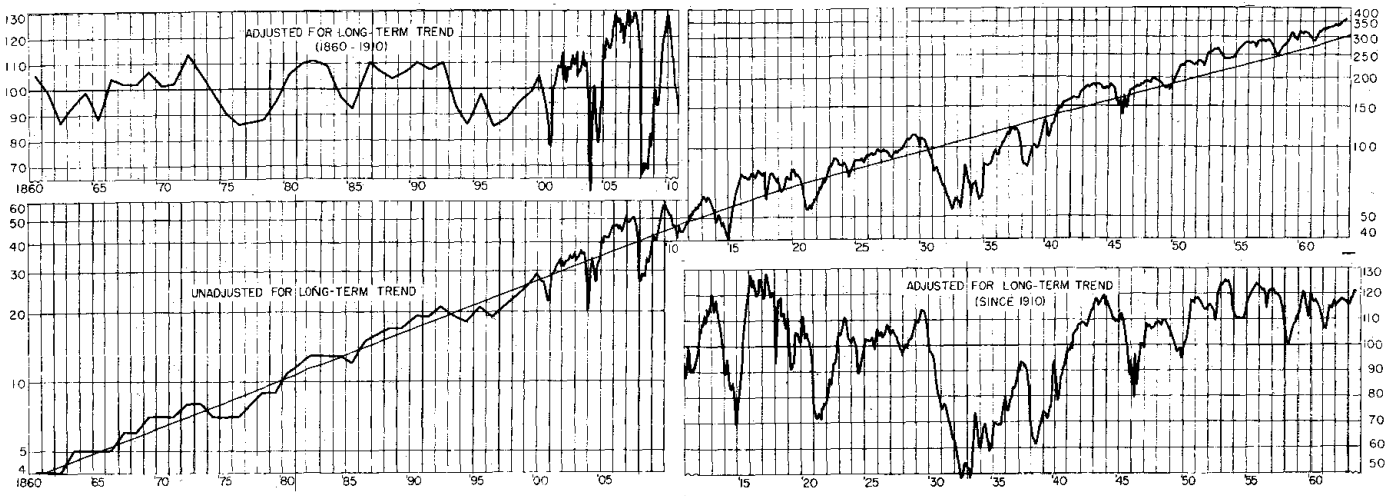
Some readers will be interested primarily in the growth rates of particular industries, but others may have reason to be more concerned with the composite growth rate of all industries in the United States. No one statistical measure can include all of the industries in the country; even if data were available, the task of compilation would be enormous. One indicator that may be useful, however, is the index of industrial production[3] shown on the chart on page 54. The long-term growth of industrial production as well as cyclical fluctuations is clearly shown. The data have been plotted on a ratio chart, which gives equal weight to equal percentage changes rather than to equal numerical changes.

Careful study of this chart may help readers to understand the importance of growth trends. In spite of cyclical recessions, the long-term trend of production has been upward and probably will so continue for a long time to come. Even a recession as severe as that of 1929-32 did not force production to a level below that of the depression immediately prior to World War I. The peak reached in 1937 was greater than that of 1929. During World War II, production was increased to levels never before reached. After a brief period of postwar readjustment, production increased to levels even higher than those of the war years. The brief business recession in 1949 interrupted the high level of output, as did the prolonged steel strike in 1952. However, except

[2] *Ibid.*, p. 173

[3] In the preparation of the index, the data from 1860 to 1899 were based on an index of production compiled by Edwin Frickey in his book *Production in the United States, 1860-1914;* the data from 1900 to 1918 were derived from Standard and Poor's index of industrial production. The data from 1919 to date are based in part on those provided by the Federal Reserve Board but include adjustments made in order to eliminate distortions in the index.

INDUSTRIAL PRODUCTION IN THE UNITED STATES



for these interruptions and the downturns in 1953-54, 1957-58, and 1960, production since 1946 has been at high levels.

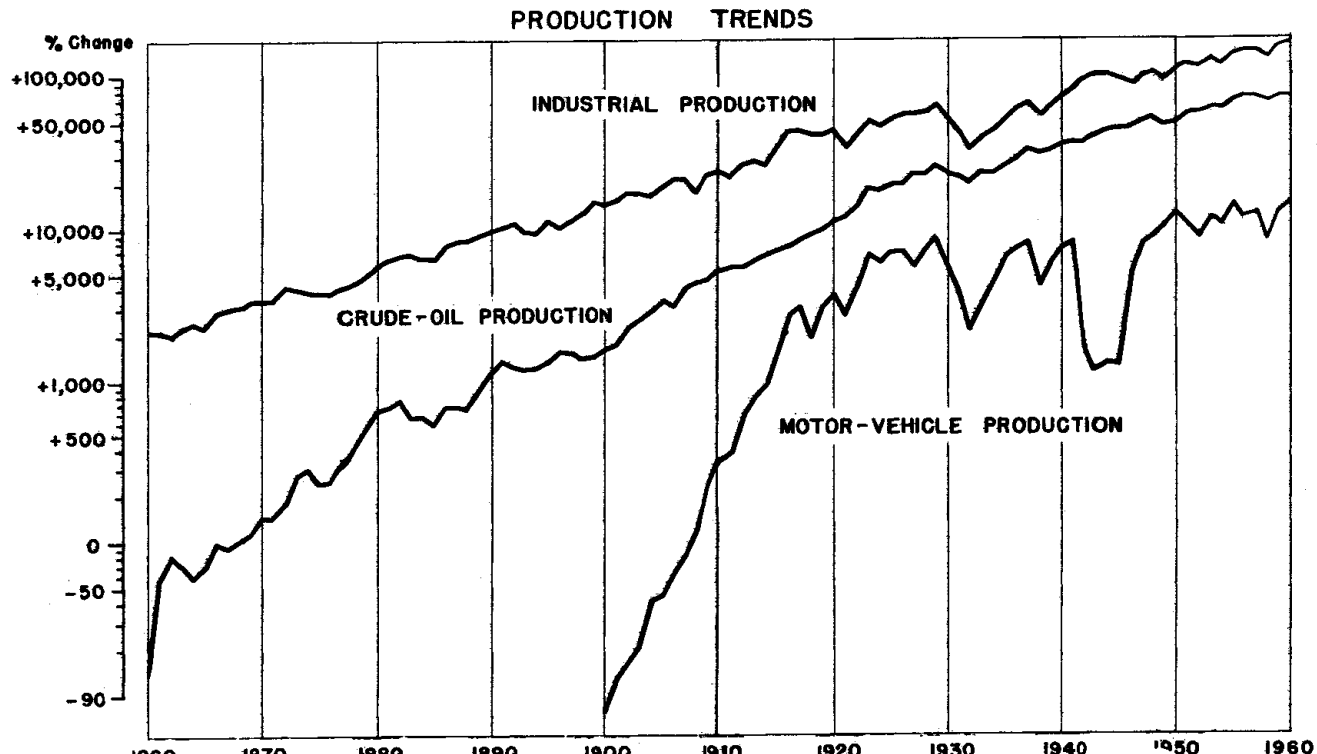
The full significance of the growth trend shown may not be apparent at first glance to readers unfamiliar with ratio charts. Production today is about six times the lowest level reached in 1932 and is nearly three times that at the peak of the 1929 boom. From the lowest point reached in the first year of this century, industrial production has multiplied nearly fourteen times.

The growth trend shown on the chart is a composite of the growth trends of many industries, some better than average, some poorer, and some so much poorer that the production in the industries concerned is decreasing in absolute amount as well as in relation to a theoretical national average. (In industries not engaged directly in manufacturing, growth may be measured by use of population or consumer-expenditure data.)

In his selection of individual corporations the investor must analyze first the growth prospects of the industry in relation to the industrial and population growth of the country as a whole, then endeavor to select companies that are expanding at a rate faster than the rest of the industry. Ordinarily, investments in the bonds and stocks of companies in industries with favorable growth trends will provide the greatest degree of safety and potentialities for appreciation. However, the ownership of bonds of corporations in industries whose growth is not superior is not necessarily undesirable. A company in an industry with a declining growth trend may not experience a decline if the processes and methods used can be shifted to production or manufacture of other products. Moeover, industries in the period of stability often provide adequate safety and relatively assured profits, which is desirable in bond investments. We caution investors to avoid investing in an industry that shows definite indications of retrogression. Even the high income return often available does not warrant taking the extreme risks involved in ownership of bonds or stocks of companies in such an industry.

In order to provide an illustration of comparative growth trends, we have prepared the chart on page 56 showing the long-term trend of two of the largest industries in the United States. Crude-oil production was begun in 1857, and the chart shows yearly production from 1860 to date. Although automobiles were manufactured as early as 1895, comprehensive production data are available only since 1900. The index of industrial production is included for comparative purposes.

A ratio chart has been used; consequently, rates of increase or decrease are comparable throughout. A scale is provided in the left margin of the chart so that the percentage increase of production in any one industry over a period of years may be ascertained. Perhaps the


PRODUCTION TRENDS
% Change
+100,000
+50,000
+10,000
+5,000
+1,000
+500
0
-50
-90
INDUSTRIAL PRODUCTION
CRUDE-OIL PRODUCTION
MOTOR-VEHICLE PRODUCTION
1860
1870
1880
1890
1900
1910
1920
1930
1940
1950
1960

easiest way for our readers to do this would be to mark on a card the vertical distance to be measured. They may then ascertain the percentage change by measuring the marked distance from the zero line on the scale.

Motor-vehicle production in 1929 reached a peak that was not exceeded until 1949. The production data reveal the pattern of an industry that apparently has reached a stage of maturity. The trend of production seems to have been downward at times. The totals in the peak years, 1937 and 1941, were both less than that of 1929, and output during recent years has been less than the alltime high reached in 1955.

On the other hand, the petroleum industry is an outstanding example of an industry that as yet shows no indication of having reached maturity. Although the rate of growth since 1900 has not been so rapid as that for the preceding 40 years, the trend of production still appears to be upward.

A closer examination of the growth trend will reveal two or perhaps three underlying trends. These trends reflect the different byproducts developed and new uses of the product. From 1860 to 1900 kerosene was the major refined product because the primary use of petroleum products was for illumination. Use of the electric light spread rapidly after 1900, and a leveling-off of petroleum production occurred about that time. However, automobile production began to increase after 1900. The upward trend of automobile production was paralleled by a renewed upward trend of petroleum production. Of course, gasoline replaced kerosene as the principal refined product.

When automobile production began to level off after 1923, petroleum production was affected also. Nevertheless, petroleum production has increased in the period since 1932 at a much faster rate than has automobile production. This development reflects the increasing use of petroleum products as a source of energy in place of coal. In 1920 crude oil and gas provided 26 percent of the total energy derived from fuels and water power, but the percentage has nearly doubled in the past 30 years. Furthermore, petroleum has become an increasingly important raw material for the chemical industry.

In addition to the petroleum industry, several other industries are in early stages of economic growth today. Natural gas is being used more widely as a fuel. The chemical industry has increased at a rate nearly twice that of industrial production as a whole since 1899. With the exception of 1929-32, electric-power production has increased at a rate of 10 percent, compounded annually, since 1920, a rate that has caused output to double every 7½ years.

Passenger travel by airplane has increased at a faster rate than passenger travel by railroad. In 1935 air-line traffic as measured in passenger-miles was less than one-fiftieth of railroad traffic. By 1955 the

corresponding figure was about two-thirds and there appears to be ample opportunity for future growth.

Perhaps television is the most recent example of the growth-to-maturity cycle in a major industry. Television-set production in the peak year of 1955 was 43 times that of 1947. However, by the end of 1958 it is estimated that 50,000,000 sets were in use in 46,000,000 homes. Although replacement demand and some further growth in new installations probably will require a large annual output, growth at a rate comparable with that from 1947 to 1955 seems unlikely.

Of course, growth does not insure that investments in an industry will be safe and profitable. Because other factors, such as a competitive situation in which no one company has any particular advantage, may make investment undesirable, careful selection of investments must be made on the basis of other attributes in addition to growth .

Superior Management

Superior management is a definite advantage to any corporation. When little differentiation can be made between the products or services, differences in management policy often are the decisive factors accounting for differences in profits among companies. An aggressive sales policy, intensive research in the development of new products, adaptation of old products to new uses, and continuous effort to improve production techniques are characteristics of superior management.

Criteria for measuring or judging the management of a corporation are difficult to formulate. Certain temporary advantages or circumstances may conceal the effects of poor management. However, to a large extent, the results of management are reflected in the long-term financial and economic development of a company.

Good management is often indicated by improvement in the profit margin of a company. As sales increase, the operating profits (that is, the profits derived directly from the primary operations of the business before deductions for taxes, interest, and other non-operating charges) may increase at a faster rate. Moreover, the profit margin may be maintained or improved in spite of a sales decrease if the percentage reduction in the operating profit is less than the percentage decrease in sales. The relative profit margins of companies in a particular industry will help to indicate the relative competitive strength of a company. Obviously, many other factors will have a bearing on the company's ability to make profits; but the ratio of profits to sales is useful as a measure of managerial ability.

Improved Technology

The technological advance of industry is a major feature in growth. Progress of this type consists of finding new relationships between re-

sources in the natural state or making use of relationships already discovered in the production of goods and services. Although the practical application of some of these relationships found by scientists in their laboratories or elsewhere may be postponed for years, some inventions and practical applications may precede the acquirement of more than elementary knowledge about physical relationships. Leadership in the technological advance of industry is an important and desirable characteristic of a good company. Although research in the development of new products and new production techniques is carried on today by most important companies, differences in the effectiveness of such research are difficult to measure. However, we can distinguish companies or industries that are active in the application of new technology or that are engaged in the production of equipment used in the application of these techniques.

One of the ways in which new technology is applied to production is by the introduction of new capital equipment or production techniques that replace or reduce manual operations. An outstanding example of application of technology of this type is provided by the automobile industry. Motor cars were offered for sale before the turn of the century, but quantity production with assembly-line techniques was not achieved until after 1908. The mechanization of agriculture offers another example of the substitution of machine for hand labor. In the four decades after 1899 the output of farm products increased about 50 percent; however, the agricultural labor force decreased nearly 10 percent during the same period. Much of the gain in productivity is attributable to the mechanization of farm work. Other remarkable improvements in productivity have been achieved as a result of improvements in office machinery, materials-handling equipment, and food-processing equipment. Companies engaged in the production of these types of machinery have exhibited favorable growth trends.

A second manner in which new technology is applied in industry is by the modification of the character of capital goods already in use. This type of progress results from research by companies or industries supplying equipment for other industries. The increased efficiency of steam-generating plants in the electric-light and power industry provides an illustration of the extensive research and development of improved equipment by the electrical-equipment industry. Much of the improvement in efficiency of the Nation's railroads has resulted from the use of more efficient motive power and equipment.

A third type of technological progress is the more effective use of raw materials. Included in this classification are the development of entirely new materials as well as the more effective utilization of materials already used.

The petroleum industry provides an example of the more effective use of a raw material found in nature, first to provide illumination and later to provide motive power. In the same industry better use is now made of materials previously wasted. Natural gas, formerly considered waste material and permitted to escape into the air, now is being conserved and used as a valuable fuel.

Many examples of the more effective use of materials also are evident in the metals industries. Substitution of low alloy steels for more costly alloys, substitution of aluminum for other metals, and the use of molten blast-furnace iron in the open hearth instead of cold pig iron are just a few of such instances.

Much of the chemical industry is concerned with developing new materials not ordinarily found in nature. Coal, petroleum, air, and water have become the basis for an increasing number of products such as nylon, cellophane, insecticides, and plastics.

One result of technological advance is an increasing diversity of products as well as improvement in items already available. The discovery of new products or improved methods of production make available new and cheaper consumer goods. Better goods at lower prices encourage the demand for these goods, which in turn encourages their future development. Therefore, the results of technological advance involve growth opportunities both for the companies that produce the improved equipment and for the companies that utilize this equipment.

Monopoly Privilege

Companies or industries that possess an artificial monopoly of a product or service often offer favorable investment opportunities. The possession of a monopoly privilege may offset to a limited degree some less desirable characteristics, such as a relatively moderate rate of growth or government regulation of operations and earnings.

Federal statutes forbid monopolies (except as specified by the patent laws) in the products of manufacturing companies; and, although examples exist of restricted competition in the production of some types of goods, the distribution of industrial products in general proceeds under conditions of active competition. The nature of services offered to the public by some other types of organizations limits the scope of competitive opportunity, so that monopoly conditions are the only ones practicable. For example, the conditions of their development originally gave the railroads of the country monopoly advantages; but truck and other competition has materially altered the situation in some sections of the country and for some types of traffic. Public utilities, including electric-light and power companies, gas-transmission companies, and telephone companies, also have monopoly characteristics.

The possession of a form of monopoly by enterprises carries both advantages and disadvantages. The privilege of providing a certain type of essential service to a given area does not assure that the service cannot be provided in other ways by competing industries. For example, the railroads are faced with increasing competition in the transportation of goods and passengers by trucks, busses, and air lines. Federally constructed or subsidized power projects may have adverse effects on public utilities operating in certain areas.

The Interstate Commerce Commission has for many years established the rates that the railroads may charge for their services and has gradually assumed dictation over many other affairs of these companies. Nevertheless, this quasi-judicial body recognizes the rights of the railroads to a reasonable return on invested capital in determining the establishment of rates for their services that will be fair to the public. All of the public utilities have the monopoly characteristics of the railroads and are subject to varying degrees of regulation by the Federal and State Governments as well as by policital subdivisions. Rate increases required to meet increased operating costs must be obtained from Federal, State, or local regulatory bodies, and in many instances relief has been refused or granted only after long delays.

For these reasons the advantages of the artificial monopoly characteristics of the railroads and public utilities are found only in certain companies that have superior growth trends and other offsetting features. The adverse effects of competition can be offset in many instances by increased efficiency. However, the railroads and utilities truly live from the territories they serve; and, other things being equal, companies that are located in sections of the country that enjoy economic growth trends better than the general average for the whole country are preferred investment risks. Regional considerations, therefore, are of great importance in the selection of railroad and public-utility investments.

Control of Basic Natural Resources

Another desirable attribute of an investment is control of a basic natural resource. Because of the common characteristics of companies engaged in providing the more important materials of the industry, the investor should establish a special classification for them in his portfolio. By "basic natural resources" we mean those essential to the present industrial civilization. Typical industries in this group are oil, copper, steel, lead, and aluminum. Many of the companies in these fields have greatly improved their production techniques. However, the significance of leadership in the technological advance is less important in considering the investment position of the natural-resource industries than that of manufacturing industries.

Natural-resource industries should be selected that produce commodities for which the trend is toward a greater per-capita use in the long run. Companies producing these commodities are favorably situated during periods when the general trend of commodity prices is upward. Because these companies control their sources of raw materials, the unfavorable effects of increased operating costs during an inflationary period are minimized. Increased labor and capital costs that do occur can be passed on to users of the products because of the essential nature of the raw material supplied. Therefore, increased earnings and dividends may be expected from these companies in an inflationary period.

Numerous large companies whose securities are widely held by investors are operating in the petroleum industry. In choosing companies in this department of the natural-resource group, selections should be made among those that control large crude-oil reserves and that are especially progressive in developing chemicals and byproducts. The latter characteristic seems destined to constitute a factor of growing importance in the industry.

Investments in the steel industry should be restricted to those well-managed, integrated steel companies whose production is largely in the light-steel classification. Demand in the postwar period has changed from the wartime emphasis on heavy steels to greater use of light steels. A sustained demand for light steels is practically assured. Light-steel-consuming industries (including the manufacturers of automobiles, refrigerators, washing machines, stoves, vacuum cleaners, and furniture) have been growing rapidly in recent decades and apparently will continue to grow rapidly for a long time.

Among the nonferrous metals, aluminum and copper have exhibited favorable growth trends. Improved methods of fabrication and the development of a wide variety of new uses have been reflected in increasing consumption of these metals. However, because of competitive conditions, investments should be limited to the strongest companies in the field.

Disadvantages of companies in the natural-resource-industries group include those that affect the manufacturing industries that they serve. In addition, competition among the industrial metals is keen; and variations in the price relationships determine in part the use of substitute metals. Moreover, consumption is affected by such factors as the fluctuating demand of manufacturing industries, technical improvements in the industrial use of metals, and the introduction of new metals. The industries included in this group are extractive ones, and profits are derived from the gradual liquidation of their assets. The depletion is, of course, taken into consideration in their financial accounts; but there is always the possibility of exhaustion of the company's natural resources that can be produced profitably.

Cyclical Characteristics

The cyclical nature of demand for products of various industries must also be considered by the investor, especially in the selection of common stocks. Various indices clearly demonstrate that production of consumer goods fluctuates less than that of durable producer goods. Therefore, the earnings of the capital-goods industries ordinarily are not so stable as those of companies producing goods for personal consumption. On the other hand, the long-term record of the less-stable industries in numerous instances has been more favorable than that of industries producing consumer goods. Moreover, in most instances, the earnings of capital-goods industries tend to increase faster and further during an inflationary boom than those of companies producing consumers' goods. Because one of the most important reasons for owning stock is for protection against inflation, the investor can take advantage of the relatively more favorable performance of the capital-goods industries during inflationary periods.

Several industries, notably those engaged in the building and railroad-equipment field, have cycles of activity that usually are longer in duration than the ordinary business cycle. Purchases of securities of companies in these industries, therefore, should not be made near the cyclical peaks of these particular industries. Even a favorable growth trend in the industry might be offset for years by a major cyclical decline in general business activity.

The investor seeking to take advantage of cyclical characteristics should select those companies that control their sources of raw materials or that will not be severely handicapped by rising costs of materials during an inflationary period.

Security Analysis

Numerous factors must be considered in the analysis of securities of individual companies. Various methods of analysis emphasize different factors, and there probably is no one generally accepted procedure. However, most methods include consideration of the general characteristics of the industry and the peculiar characteristics of the company, as well as financial factors.

The background analysis should include a consideration of the company's history and present status. The nature of the product or service produced, the territory or type of market served, management policies, and any other pertinent information concerning the actual nature of operations of the company should be considered. The physical plant or other facilities of the company and subsidiaries also are important. Some

of the important and desirable attributes of a company with respect to these background factors were discussed in the preceding paragraphs.

The important aspects of financial analysis of securities vary widely between bonds and stocks and among various types of issues. We shall attempt only to outline some of the factors that, in our opinion, should be considered in the financial analysis.

With reference to capital structure the distinction between bond analysis and stock analysis is significant. The capitalization of the corporation and the position in the capital structure of each security issue should be ascertained. (Capital structure refers to the stated dollar value of the various capital issues plus surplus items. The capital structure is found by adding the values of funded debt, preferred stock, common stock, and surplus items. The surplus should be reduced by the amount of any intangible items, such as good will or patents, which are listed as assets of the corporation.) In the discussion of any particular issue, consideration should be given to the proportion of senior issues and the percentage that the particular issue is of the capital structure.

The terms of various capital issues should be carefully analyzed. This is especially important for bonds. The nature of the property or assets securing any particular issue and the relationship of the lien of a particular bond issue to other issues should be considered. By deducting reserves for depreciation from the property value, one often can determine whether the book value of the property provides adequate security for bonds. In all cases the amount and number of issues having prior claim to assets or income should be determined. Sinking-fund provisions, restrictions on issuance of additional debt, and other provisions of the issue agreement must also be considered. The maturity of a bond issue and the yield basis on which the bond sells may also have an influence on whether the security is suitable for a particular investor.

The position of common stocks in the capitalization of a corporation may be seen by computing the percent of a total capital structure that is common stock and surplus. The percentage of issues having a claim on earnings prior to that of the common stocks will also be apparent. In this respect there is a relationship between the capital structure and the effects of changes in income on earnings available to stockholders. This relation is known as the leverage factor. A simple example will illustrate the effect of leverage on earnings.

A company has outstanding 100,000 shares of $5 preferred stock and 1,000,000 shares of common stock. If the net income available for all dividends in a certain year is $1,500,000, the amount available per share of common may be computed as follows:

Balance available for dividends	$1,500,000
Preferred dividend requirements	500,000
Balance for common	$1,000,000
Net income per share of common stock	$1.00

If we assume that in the following year the income available for dividends is doubled, the amount applicable per common share is as follows:

Balance available for dividends	$3,000,000
Preferred dividend requirements	500,000
Balance for common	$2,500,000
Net income per share of common stock	$2.50

Doubling the net income available for all dividends increases the amount available per share of common two and one-half times. Of course, this advantage when earnings increase becomes a disadvantage when earnings decrease. If we assume that, for the company discussed above, net income decreases to one-half of that reported in the first year considered, the result will be as follows:

Balance available for dividends	$750,000
Preferred dividend requirements	500,000
Balance for common	$250,000
Net income per share of common stock	$.25

In this instance a decrease of one-half in the balance available for all dividends reduces the amount available for the common stock to one-quarter of the first amount shown.

The analysis of earnings differs between bonds and stocks. The bondholder is concerned primarily with the ability of the corporation to meet the interest charges; the stockholder seeks earnings in increasing amounts. The ratio of the amount of earnings available for interest to the interest payments (usually called the "number of times interest earned") each year for a period of years will indicate the adequacy of interest coverage. Because interest is considered a debt payable to the creditors of a company, balance available for interest should be ascertained *before* payments for Federal income taxes. By substracting from earnings available for all interest payments the interest payments required on prior-lien securities, the interest coverage on a particular issue may be estimated. However, in the case of issues in which the priority of claims on earnings is not definite, the problem of computing interest coverage

on a particular issue is difficult. Moreover, the nature of a funded debt is usually such that the failure to meet interest on any particular issue may have serious financial consequences for all issues.

The common-stock holder will be interested in the long-term trend of earnings. For the purpose of year-to-year comparisons, the earnings record may be presented in terms of earnings per share of stock. The earnings available for the common-stock holders should be divided by the number of shares actually outstanding adjusted for stock dividends and stock splits. Long-term results should include significant years such as 1929, 1932, 1937, and 1938, which will indicate the earnings record of the company in both depression and boom years.

The trends of other influences on earnings also should be considered. This analysis includes gross revenues, sales, operating expenses, operating revenues, depreciation trends, and all factors affecting them. In view of the importance of trend factors in the selection of securities, investment in shares of a relatively new company should be avoided until the company has been in operation for a sufficiently long time to permit testing of the management in periods of severe business depression.

The financial position of a company is significant because the adequacy of a company's working capital with respect to current needs is indicated as well as the company's capacity to withstand sharp and unexpected drops in revenue and to meet current obligations in such an emergency. The current financial position may be classified as strong, satisfactory, fair, or unfavorable. If cash and marketable securities are equal to current liabilities, the financial position ordinarily is classified as strong. If current assets are about twice current liablities and cash is equal to about 25 percent of current debt, the position is satisfactory. If current assets are less than one and one-half times current liabilities but exceed the latter, the position is fair. Otherwise, the position is unfavorable. Of course, these classifications are generalities; and there will be companies whose position as measured by the ratios will not conform to the company's needs. For example a company's cash might substantially exceed current liabilities and still be small in relation to the company's working-capital requirements.

The dividend policy of companies is important to owners of common stock. Some companies pay a large proportion of earnings in the form of dividends; some companies pay a relatively small percentage and reinvest earnings in new plant and equipment; other companies attempt to maintain a steady dividend payment that is not geared to the earnings. Of course, dividend policy may change, but the past policy of a company may indicate the amount or change of dividend return that the common-stock holder of a company can expect under varying earning conditions. Investors to whom income-tax considerations are important

may prefer to invest in companies that are retaining a large portion of earnings for expansion.

The average investor ordinarily is not an experienced security analyst and does not have time to acquaint himself with all of the reference material used by the professional. However, he should become familiar with a few sources so that he can consult them with facility. There are numerous reference books and services that provide information regarding the earnings record, price record, and other pertinent facts concerning individual companies whose securities are owned by the public. The most widely accepted investment manuals are available in all of the larger public libraries and in institutional libraries that are open to the public. A list of some useful references that the investor may wish to consult is presented below.

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VI. INSURANCE AND INVESTMENTS

THE relationship of life insurance to an investment program may be shown by reviewing the functions of both programs during each phase of a man's lifetime. Before attempting to do this, however, a brief summary of the salient characteristics of insurance and annuity contracts may be helpful.

The fundamental principle of life insurance is the pooling or sharing of risks by many persons so that the financial loss of one individual will be covered when the loss insured against occurs. The annuity principle is similar in that it involves pooling the funds of many individuals, but an annuity assures an income during the lifetime of the annuitant rather than a sum payable after his death.

A policy other than term insurance does, of course, have a so-called investment element in that a cash surrender value accumulates while the policy is in force. This aspect of life insurance developed from the need for a method whereby insurance could be maintained in force for long periods without increases in the premiums as the policy holders grew older. For level-premium insurance, a reserve must be accumulated during the early years of each policy in order that death claims may be paid in later years when the mortality rates of the insured group are much greater. That the reserve thus accumulated is available to the insured as the cash value if the policy is discontinued is only incidental to the primary function that the life-insurance reserve performs.

The Earlier Working Years

Until his marriage, a man usually has no responsibility except his own support. However, this period usually is relatively short, because most men marry within a few years after they start to earn their living. During the earlier years of marriage, income and other assets in most instances are not large; but, especially after there are children, the family financial responsibilities in relation to income are great.

The young man with a family probably will have little or no funds left for investment after purchasing the insurance that he should have in order to provide protection for his dependents in the event of his untimely death. Term insurance should ordinarily be used. This low-premium type of insurance enables one to obtain a maximum of protection for the least expenditure. Term insurance is well suited for temporary responsibilities such as caring for children until they become independent; these policies may be discontinued from time to time as the children

grow older and the need for insurance therefore decreases. For permanent responsibilities such as protection for one's wife, ordinary life policies normally might be used, because they may be continued in force throughout the lifetime of the insured without any increase in premiums. However, continuing depreciation of the dollar has made such policies less attractive even for permanent responsibilities. Therefore, we suggest that 5-year renewable-term insurance be purchased and converted to ordinary life policies later *if* steps are taken to stabilize the dollar.

The Middle Working Years

At some time during the middle working years many men will begin to have surplus funds available for investment. Although current expenses probably will have increased, insurance needs will have decreased because (a) children will be older and therefore would be dependent for a shorter period after the father's death and (b) the life-income options of the insurance payable to the wife will have become more favorable because of her increased age. Therefore, the cost of the insurance program will be reduced. Also, during this period the incomes of most men are greater than their incomes during the earlier years.

Life insurance influences the investment program in several ways. First, as has been mentioned, a sufficiently comprehensive insurance program should be established before starting an investment program. This procedure postpones the beginning of the investment program for most men but is necessary in order that dependents may have means of support if the breadwinner dies prematurely. Second, the cash value of any insurance carried should be considered as part of the investment portfolio; this is the approximate amount that may be borrowed using the policies as collateral or, if the need for the protection passes, is the sum that the policyholder will receive when the insurance is discontinued. (As explained in Chapter III, the cash value of life insurance is, for planning purposes, considered the equivalent of high-grade bonds.) Finally, investments provide protection for dependents also; therefore, as the investment fund accumulates, the amount of insurance required is reduced accordingly.

The Later Working Years

Many men are unable to save substantial amounts until after their children become independent. From the standpoint of accumulating assets for retirement, the later working years may be the most important of a man's lifetime. During this period insurance needs are less than they were previously because the wife is the only dependent requiring insurance protection. Furthermore, because she also is older, the amount of insurance required to provide a specific life income for her will be less. Insurance that has been carried for the protection of the children

may be discontinued altogether. Because family expenses presumably will be lower and earning capacity ordinarily is large, the investment fund should be accumulated rapidly during this time.

If the investment fund becomes sufficiently large to provide an adequate income for the wife in the event of the husband's death, a man need not retain any life insurance during this period. However, funds will be needed immediately after his death for the payment of funeral expenses, expense of last illness, unpaid bills, taxes, etc. Also, if the estate must be administered, his widow will require funds for her living expenses until the estate is settled. For these purposes some insurance may be useful unless investments are more than sufficient for the wife's needs.

Another advantage of carrying some insurance during the later working years is that the life-income or annuity options become more favorable for the wife because of her increasing age; proceeds paid to her as a life income cannot be dissipated and will assure an income throughout her lifetime regardless of whether or not the investments are wisely chosen. For a man whose principal investment is in his private business, retaining a substantial amount of insurance is advisable because of the chances that the business will depreciate in value or perhaps fail after his death.

Retirement

Life insurance that has been carried sufficiently long to accumulate a substantial cash value also has important uses at retirement. Such policies in most instances can be converted to annuities payable to the insured at rates no longer obtainable elsewhere. Policies that are retained after retirement may be converted to paid-up insurance so that premium payments no longer will be required.

During one's later working years, the accumulation of savings may be accelerated, because children are no longer dependent. Moreover, for many men this is the period of maximum income. Therefore, preparation for retirement usually is easiest during this period.

Although he may no longer be responsible for the support of his children, a man in his later working years cannot afford to incur large risks in making his investments, because he may have neither the time nor the surplus energy required to reaccumulate funds to replace those lost. A man's older self is a dependent for whom provision must be made as definitely and as conservatively as for a wife and children. For this reason, one's program usually should become more conservative as the date of retirement approaches and as the details of the retirement plan are developed.

In planning for retirement, all available sources of income should be

considered in order that the maximum benefits may be derived from the available assets. The more common sources are discussed in the following section.

Sources of Retirement Income

Federal Old Age and Survivors Insurance (Social Security) is one source of retirement income. Briefly, the amount of the worker's pension beginning at age 65 depends on his "average monthly wage." Under present law, the maximum ultimate primary benefit possible is $127.00, and the maximum benefit that will be paid to one family is $254; the average benefits are much lower. Although income from this source may be relatively small in comparison with total needs, Social Security plays an important part in many retirement programs.

Pension plans have been established for their employees by many business organizations. Often a part if not all of the cost is borne by the employer (the funds thus accumulated are not taxable to the employee until he actually receives the income), and many plans are coordinated with Social Security in order to provide a minimum total income to the employee after his retirement. (Many pension plans also provide death benefits for dependents if a participating employee dies before retirement). Usually the amount of the pension is determined by length of service with the company and by the average salary during the period employed.

Life-insurance policies may provide another source of retirement income. By the time a policyholder retires, most of the needs for which the insurance was originally intended will have passed. If the rétirement plan otherwise provides for a continuing income for his wife in the event of his death, a policyholder will need little insurance after his retirement. Older policies often contain very favorable settlement options, and in most instances the insured is permitted to receive the cash surrender values under the stipulated installment or annuity options. Any policies continued ordinarily should be converted to paid-up insurance so that payment of premiums no longer will be required. The remainder of the insurance may be converted to annuities, if the options are favorable, or the surrender values may be taken in cash.

Investments normally will be of great importance in obtaining the desired retirement income. Accumulated assets in the form of savings deposits, bonds, mortages, stocks, real estate, and so on, should be considered in conjunction with other available retirement assets in order that the problem as a whole may be analyzed. This aspect of the problem will be discussed in greater detail later.

Annuities are suitable as a fixed retirement income. The funds receive excellent supervision and the return is large, especially for a

man age 65 or older. A portion of one's capital invested in annuities will provide as much assured income fixed in dollar amount as would be obtained from a much larger investment in bonds. Thus, more of one's remaining capital can be made available for investment in common stocks with a better prospect of offsetting further depreciation of the dollar.

Planning for Retirement

The first step in planning a retirement program is to ascertain the amount and nature of the assets available. For purposes of classification, investments may be considered under three basic categories: fixed-income and fixed-principal assets, such as United States Savings bonds, Federal savings-and-loan deposits, and, for all practical purposes, most high-grade bonds; assets that yield a fixed income but have fluctuating market values, such as medium and lower grade bonds; and assets that yield a variable income and have fluctuating market values, such as common stocks. Annuities as well as Social Security payments and pensions are a special type of fixed-income assets and may, for planning purposes, be considered the equivalent of high- or medium-grade bonds. Real estate is similar to common stocks in that the income and market value ordinarily fluctuate with general business conditions.

After the available assets have been classified, the next step is to ascertain what the income requirements will be after retirement. Usually an individual will wish to continue a standard of living similar to that attained prior to retirement. However, the income requirements often will be somewhat less, because many expenses that formerly were necessary for business reasons no longer will be incurred; moreover, many individuals will find that after retirement their activities are more restricted and their needs simpler than they may have expected. Therefore, when estimating retirement-income requirements, one should allow for the fact that his living expenses may be reduced, perhaps substantially, after he is no longer actively employed. However, special plans, such as for travel or some other activity requiring additional expenditures, also should be given consideration.

Comparison of available assets with the needs to be met should indicate whether the income desired can be achieved. Adjustments in the portfolio usually will be necessary. Income from Social Security, pension, or insurance policies converted to annuities will provide a fixed base for the program. Accumulated savings may be used to achieve the necessary balance among the different assets and to obtain the additional income needed.

The retirement program should be planned with the objective of assuring an income that will be relatively stable in purchasing power rather than an income fixed in dollar amount; this is necessary because

price levels fluctuate greatly over long periods. In most instances the Investment Plan probably will be most suitable, although, if funds are more than sufficient to care for probable needs, a modification of one of the other plans may be desirable. The examples that follow illustrate some of the more important principles to be observed when planning for retirement.

Example 1: A man age 65 wishes to retire with an income of $3,600 a year; in the event of his death, his wife, now age 62, would require $2,700 annually. Available assets include investments of $35,000, life insurance having a cash value of $15,000, and monthly Social Security benefits providing $91 for the husband and $34.20 for the wife (age 62) during their joint lifetimes. Moreover, if the wife survives her husband, she becomes entitled to the "widow's" benefit of $75.10 payable monthly for her remaining lifetime.

Four of the insurance policies having a total cash value of $12,000 have very favorable annuity-conversion options, and, if used to obtain a straight life (no refund) annuity for the man, will provide $1,175 annually. The remaining policy, having a cash value of $3,000, can be converted to a paid-up policy of $4,300, which would provide death expenses and some protection for the widow. The remainder of the assets could be distributed as follows:

	Annual Income
$10,000 Medium-grade bonds at 4½%	$ 450
$25,000 Common stocks at 3½%	875
Investment Income	$1,325

The total retirement income available under present circumstances therefore approximates $4,000. The investment in common stocks provides substantial protection against an increased cost of living resulting from further inflation.

If the wife survives her husband, the annual income then available to her is reduced to $2,225, or about $475 less than her needs. Life-insurance proceeds provide about one-half of the deficiency. Additionally, funds could be taken from the medium-grade-bond section and used to purchase an annuity for her, bringing her total income up to the amount required. If her husband's death should occur several years after retirement, less than the total funds in medium-grade bonds would be required for this purpose.

Example 2: A man and his wife, both age 66, have a fund of $68,000 available for retirement purposes. In addition, the man is to receive from his employer a pension of $100 a month, one-half of which would continue to his wife if she survives him. His primary benefit from

Social Security will be $116.00 monthly, and his wife's benefit will be one-half that amount. They can live comfortably on $4,800 annually, and the wife's requirements, if she were left alone, would be about $3,600 a year.

Assuming a conservative return of 3¼ percent on the funds invested, their income will be ample for their needs. Their primary task, therefore, is to adjust the security holdings in accordance with the Investment Plan, taking into consideration the annuity value of the pension and Social Security payments.

The value of the pension is $18,000 (this is computed on the basis of a joint-and-survivorship annuity of $50 monthly plus an annuity of $50 monthly on the life of the man), and the Social Security payments (computed on a similar basis) are valued at $24,000. These assets, therefore, comprise 38 percent of the total fund. In order to achieve the recommended allocation for the fund as a whole, about $13,000 of the remaining $68,000 might well be placed in fixed-income securities (cash or equivalent and medium-grade bonds), about $22,000 should be invested in gold stocks, and the remainder should be allocated to the various types of common stocks in the percentages indicated in section IV.

Life Insurance as an Investment

Some insurance agents may suggest that the insurance and savings programs be combined by purchasing limited-payment or endowment insurance. However, from the standpoint of both insurance protection and investment return, these policies have certain disadvantages.

Limited-payment insurance, such as a 20-payment and 30-payment life contract, involves a larger premium than does an ordinary life or term policy of the same face amount. The larger premium is necessary in order that the policy may become paid-up during the premium-payment period. Of course, the reserve and therefore the cash surrender value is greater than that of an ordinary life policy.

One advantage claimed for the limited-payment policy is that all premiums are paid during the years when the insured's earning capacity is greatest. However, any high-premium form of insurance necessarily reduces the amount of the insurance protection that may be obtained for a given expenditure. Because most young men cannot afford enough even of the lower-premium insurance to provide adequately for their dependents, the purchase of higher-premium policies usually is not justified for a man during his earlier working years. Moreover, ordinary life policies also accumulate cash surrender values, which may be converted to paid-up insurance at any time the policyholder chooses. The paid-up insurance value of an ordinary life policy that has been in force for 20 years is approximately 80 percent of the face amount of a 20-payment

life policy obtainable for the same premium. On the other hand, from 35 to 70 percent more insurance may be obtained for a given expenditure during the premium-paying years if an ordinary life policy is purchased.

Endowment insurance actually is a combination of term insurance and what may be termed "pure endowment." The term-insurance portion provides the death payment if the insured dies before the end of the endowment period. The "pure endowment" provides the face amount of the policy if the policyholder lives to the end of the endowment period; however, if he dies, his equity in the endowment fund is forfeited and is used to increase the equity of the other endowment policyholders. "Pure endowment" policies, when issued without the supplementary term insurance, proved to be unpopular because of the possibility that no return on the investment would be obtained; but, with the addition of the term-insurance element, endowment insurance has become very popular.

One of the chief arguments used to sell endowment insurance is that it provides a convenient method of saving in combination with the insurance program. However, an endowment policy provides much less insurance protection for a given expenditure than does either term or ordinary life insurance. In addition to the hidden gamble mentioned in the preceding paragraph, endowment insurance has the disadvantage of providing a relatively low yield on that part of the cost that may properly be considered an "investment." Moreover, continuing depreciation of the dollar probably will cheat the policyholder far more than most people seem to understand.

In summary, the investment element inherent in the life insurance policies discussed herein is not especially attractive under current economic conditions. Moreover, until sound money-credit conditions are again restored in this country, we suggest that most individuals may provide better and more economical protection for their dependents by purchasing 5-year renewable term insurance to cover their total needs. (Readers desiring more detailed information regarding the influence of life insurance on their savings and investment programs will find our publication *Life Insurance and Annuities from the Buyer's Point of View* helpful.)

VII. INVESTMENT COMPANIES

FROM the investor's viewpoint the principal advantages offered by investment companies are broad diversification, professional management, continuous supervision, and provision of the administrative functions of custody, buying and selling, and record keeping.

We strongly recommend the use of suitable investment company shares in lieu of direct holdings of common stocks for investment funds of less than about $40,000. Under existing conditions, we also believe that shares of certain investment companies may be attractive for larger funds.

Our recommendation of investment company shares for the investor of modest means contemplates that the amount allocated to common stocks in accordance with the percentage allocations shown in section IV should be invested in two or three of the outstanding investment companies. Because shares of investment companies provide the owner with an interest in a well diversified portfolio of common stocks, as much as 20 to 30 percent of a fund properly may be invested in a single investment company. On the other hand, we should not recommend concentrating all of one's common stock holdings in a single investment company.

Closed-end Companies vs. Open-end Funds

Among the several types of investment companies, the shares of open-end and closed-end management type companies are by far the most widely held.

Open-end companies, popularly referred to as mutual funds, continuously offer their shares to the public and agree to repurchase their shares at any time. In the instance of open-end companies the investor purchases his shares directly from the company, or its agent. The price paid is the net-asset-value per share at the time of purchase plus the applicable loading charge, which usually is about 7½ percent of the net asset value. Sales are made by submitting the shares to the company (or its agent) for redemption at the then current net-asset value. Some, but relatively few, companies charge a small redemption fee.

In contrast to the open-end funds, closed-end companies do not ordinarily buy or sell their own shares. The number of shares is relatively fixed and they are traded in the open market. Shares of most of the major closed-end companies are listed on the New York Stock Exchange or are traded in the over-the-counter market. Purchases and sales are made through any stock broker and the usual brokerage commissions are charged.

Shares are traded at the current market price, which may be more or less than the existing net-asset value.

As a result of our continuing study of investment companies during the past 30 years we have reached 2 conclusions that are of primary importance to investment-company shareholders.

First, over a span of more than 2 decades, encompassing 4 major cyclical movements, representative closed-end investment companies have provided consistently more favorable investment results than those obtained by the better open-end funds.

Second, the ordinary income earned and distributed by representative closed-end companies has consistently exceeded, by a substantial margin, that available from a similar investment in open-end shares.

Apparently the purchase premium (loading charge) assessed by most open-end companies represents a substantial handicap to ultimate investment success. On the other hand, the discount from net-asset value at which the shares of several of the better closed-end companies are available represents an advantage that may contribute markedly to the success of a long-range investment program.

A detailed study of investment companies including analyses of performance records and specific recommendations, is presented in the Institute publication *Investment Trusts and Funds From the Investor's Point of View.* Price $1.

VIII. AN INVESTMENT VIEWPOINT

IN the preceding sections we have developed what may be considered a basic investment philosophy as well as a specific outline of the manner in which this philosophy should be applied. We have described the savings-investment process and the operations and abuses of the money-credit system of the United States in section I. In section II the principal types of investment were discussed, and in section III suggestions were made for classifying these investments so that their effectiveness in an investor's program could be analyzed.

The next four sections were concerned more specifically with the problems faced by most investors. In section IV we discussed the programs applicable in various circumstances and in section V described the methods used for selection of bonds and stocks. The use of investment trusts and life insurance in an investment fund were discussed in the next two sections.

Readers who have followed the analysis presented in the book thus far may realize that our suggested approach to investments differs substantially from that recommended by many investor-advisory services. Many advisory services appear to regard securities much as a storekeeper considers merchandise, that is, as articles to be bought low and sold high in order to obtain a profit. In fact, the trite statement, "No one ever went broke taking profits," may be considered the byword of this particular group.

Based on our study of economic and investment problems during the past three decades, we believe that any investment policy that considers securities as merchandise to bought at low prices and sold at high prices is fundamentally unsound and may easily lead to unnecessary waste of assets. An analysis of what we believe are the fallacies involved is presented in succeeding sections of this section.

Economic Analysis

Two general theories are applied by those who believe that securities should be regarded as merchandise. The first bases its actions on conclusions derived from economic analyses of business conditions, industries, companies, and security prices. The underlying thought is that such analyses make possible the selection of securities that are undervalued at prevailing marget prices and that purchase of these investments when undervalued will result in price appreciation and profits to be taken later.

The second approach is concerned primarily with a technical analysis of price trends on the assumption that all factors (except "acts of God") that influence security values are reflected in their market prices.

We have no quarrel with the selection of securities by economic analysis. However, we do disagree with the idea that the purpose of the analysis should be the selection of investments that may be bought at low prices and sold at higher prices in the near future.

The first objection to this procedure is that too much emphasis is placed on particular investments. As was pointed out in the chapter on "The Individual's Program," we believe that the selection of securities should be the last step in any investment program. The investor should first examine all of his assets and the responsibilities that they must meet and then select an investment program designed to meet those responsibilities in the light of prevailing economic conditions. This program should involve first the allocation of funds to fixed- and variable-income securities in the proportions desirable according to the program selected and *finally* the selection of suitable securities. If this procedure is not followed and individual investments are selected primarily because they are considered undervalued, over a period of years the investor will have collected a miscellaneous group of securities that probably will have no relation to a well-planned investment program designed for his particular circumstances.

The second objection to the idea of buying investments low in order to sell them high is the difficulty of deciding *when* to "take profits." Price appreciation in relation to the general trend of market prices ordinarily indicates that good judgment has been exercised in selecting the security. "Taking profits" may well result in withdrawing funds from what has been *and may continue to be* a most successful enterprise. The greater the profits, the greater the compulsion to sell and the greater the danger that the amount of the profits rather than the soundness of the investment will be the determining influence.

The final criticism of buying investments at low prices in order to sell them at high prices is that the present Federal tax law penalizes this procedure. Every time profits are taken, a portion of the profits must be given to the Federal Government. As a result, the investor is faced with the necessity of investing the proceeds of the sale less the tax in another investment that can be purchased at a relatively lower price than the one sold and that will have equal or better chances of appreciation. We believe that this alternative selection is much more difficult than most investors believe; over a long period of years, continuing the process of "taking profits" may well result in a dissipation of capital. Losses will be experienced when errors in judgment are made, and every time "profits" are taken a tax liability will be incurred.

Technical Analysis

Technical analysis assumes that price movements reflect all the information, hopes, and fears of investors everywhere. In fact, one proponent of this type of analysis has stated that the decision to buy or sell a security can be based on a chart of plotted market prices; no further information, not even the name of the company involved, is necessary. In essence, technical analysis is concerned with predicting future trends in security prices as well as identifying present trends.

The discussions in the preceding section on economic analysis are equally applicable to the technical approach. However, a more detailed analysis of other aspects may be helpful.

Dow Theory

One of the most widely publicized theories for predicting future price fluctuations is the so-called Dow Theory. This theory is based on fluctuations of prices of a relatively small group of common stocks comprising the Dow-Jones Industrial Average and the Dow-Jones Railroad Average. These averages are computed daily and are published in *The Wall Street Journal, Barron's*, and other financial publications.

We do not deny that the Dow-Jones averages are useful statistical indicators that may reflect the past trend of the price movements of securities. However, the effectiveness of these averages in predicting future price fluctuations is open to question.

Briefly, security-price fluctuations under Dow Theory are considered to be comprised of three movements. The first is the primary trend, the so-called bull and bear markets, which may last for a year or more. Within the primary trend are the so-called secondary trends lasting only a few months, during which prices may move contrary to the primary trend. The daily fluctuations are the third type of movements described, but they are not considered important in the interpretation of the theory.

Dow Theory is not a clear-cut and easily read guide. The various experts who interpret the movements of the Dow-Jones Industrial and Rail Averages often disagree as to the meaning of particular changes. Of course, with the help of hindsight it is easy to differentiate between the various types of market movements. However, while secondary reactions are in progress, any sharp dividing line between them and the less important changes extending over only a few days or weeks cannot easily be established. Moreover, indications of changes in trend invariably come late. During periods of marked changes in security prices or trends that extend over a period of years, the delay may not be too important. However, if prices do not fluctuate substantially or if primary trends are not continued for long periods of time, little advantage can be obtained.

In addition to the problem of distinguishing between types of movements, the long-term record of Dow Theory application has not been impressive. One of the leading interpreters of Dow Theory has pointed out that funds invested and reinvested in the Dow-Jones industrials, in accordance with Dow Theory, from 1897 to 1937 would have multiplied 36 times. Similarly, funds invested in the railroad issues would have multiplied 5⅓ times. At first thought, these increases may seem to be very great; in fact, the profits obtained from investing in the industrial issues seem to be astounding. However, the results are not so extraordinary as many have supposed, because a 3,600-percent gain during a period of 40 years is equivalent to only about 9½-percent compound interest. Furthermore, the 530-percent gain from speculation in the railroad issues is equivalent to only about 4¼-percent compound interest, somewhat less than savings banks were paying during most of the 40-year period.

Dow Theory results are substantially less favorable when those for the first 26 years (that is, from 1897 to 1923) are considered. The return to the speculator who confined his operations to the Dow-Jones industrial stocks was the equivalent of 6¾ percent compounded annually; and the return to the speculator who dealt only in the railroad issues was the equivalent of 3¼ percent compounded annually.

The results assumed to have been attained by following Dow Theory include neither dividends received (and presumably reinvested) nor taxes paid on either capital gains or income. Because the first of these factors is a plus and the second a minus item, to some extent at least they probably offset each other. Presumably, the large taxes payable as the result of profits taken in 1929 and again in 1937 would be much greater than the dividends received during the immediately preceding years. Moreover, one of the leading Dow Theory interpreters has stated that his personal profits have been much below those apparently available to anyone following Dow Theory, because taxes have taken an important portion of profits, thereby preventing their cumulative reinvestment.

For the first 26 of the 40 years, taxes probably would not have been very great. Therefore, a more accurate picture of the result obtained can be derived by making some allowance for the dividends that a follower of Dow Theory presumably received. If he had followed the signals given, he would have held stocks for approximately 24 of the 40 years. Presumably from 50 to 60 percent of the approximately 6-percent dividends paid on the securities involved could have been received and reinvested by the follower of Dow Theory. If this had been done, the annual rate of gain would have been increased by approximately 3½ percent. Therefore, the rate of gain for the speculator who dealt in the industrial issues only would have been somewhat more than 10 percent

compounded annually; and that for the Dow Theory follower who purchased only the railroad issues would have been about 6¾ percent compounded annually. These rates seem the most comparable with those obtainable by following other investment procedures.

Fortunately, a comprehensive statistical analysis of investment results has been made by the Cowles Commission for Research in Economics. The findings were published in the book *Common Stock Indexes, 1871-1937* by Alfred Cowles 3rd and Associates. The results of the study are highly important, and we strongly recommend that investors consult this reference. Mr. Cowles and his associates have computed stock-price indices for various groups of common stocks and have included the effects of reinvesting cash dividends when such dividends were paid. In other words, they have shown the results of investment experience in common stocks in a manner similar to that used by us in testing the records of investment companies.

The Cowles Commission's studies show that an investor or speculator who purchased a representative group of industrial common stocks listed in the New York Stock Exchange would have received the equivalent of 8.4 percent compounded annually from 1871 to 1937. The rate of return shown by the Cowles studies was somewhat greater during the 40-year period mentioned above; and during the 26-year period from 1897 to 1923, the rate of return was approximately 10 percent annually. The investor who simply selected industrial common stocks at random and held them regardless of what happened in individual instances would have obtained about as good results as might have been obtained by a follower of Dow Theory, in spite of the better selection of securities involved in the Dow-Jones Averages, compared with the general lot of listed industrials. We believe that such a comparison is the fairest that can be made with Dow Theory results.

As for the railroad issues, the investor who purchased all listed railroad stocks in 1897 and simply held them until 1923, without any change other than reinvesting dividends received, would have profited by an amount equivalent to 7¼ percent compounded annually. This profit compares with the slightly less than 7 percent obtainable by followers of Dow Theory.

The Cowles Commission study also reveals that the trends of various groups of stocks were widely divergent, a fact that suggests the greater importance of growth trends in selecting securities. For example, the shipping and shipbuilding group showed no gain at all from 1871 to 1937 in spite of the reinvestment of dividends received. On the other hand, capital invested in the railroad equipment group was multiplied 500 times during the period from 1871 to 1937, after allowing for the reinvestment of dividends received. Equally startling returns were ob-

tained by investments in the chemical, automobile, and electrical-equipment groups during the periods when such investments could have been made.

Our conclusions may be summarized as follows:

1. From the viewpoint of the average investor and even the average speculator, adequate diversification of holdings and the selection of securities from those industries having the best growth possibilities are more important factors than application of Dow Theory.

2. Occasionally, following a great speculative boom or after an exceptionally severe depression, Dow Theory may provide a useful clue for the average investor, but one should not expect that such opportunities will occur more than a few times during any individual's lifetime.

3. The interpretation of trends based on a correct appraisal of secondary movement is often difficult until hindsight helps to solve the problem, at which time the opportunity to take advantage of the situation usually is past.

Trading Results

The price fluctuations that are recorded during the market's secondary movements frequently are so extensive within a relatively short period that the average investor is tempted to try his skill at taking advantage of them. Many people believe that such great changes can be foreseen, and hindsight is so crystal clear that many are willing to believe that their own or someone's foresight should be good enough to make trading on the secondary trends profitable.

The Cowles Commission has conducted a substantial amount of research in the field of predicting stock-market prices. The results of this research have been published in pamphlet form and may be obtained from the Commission, University of Chicago, Chicago 37, Illinois. The pamphlets are *Can Stock Market Forecasters Forecast?* by Alfred Cowles, 3rd, (1933) and *Stock Market Forecasting* by Alfred Cowles, 3rd, (1944).

The first pamphlet reports the results of a study of the investment advice for periods of 4 to 20 years given by 16 financial services, 20 fire-insurance companies, William Peter Hamilton's forecasts based on Dow Theory, and 25 financial publications. The second pamphlet reports on a study of the record of 11 leading financial periodicals from 1927 to 1943. The conclusion reached was that, of the many financial services studied, *none* disclosed evidence of ability to predict successfully over a period of time the future course of the stock market.

Although our studies of this field have not been so extensive as those of the Cowles Commission, we have not discovered in our work any investment service that has been successful in this field. Professional

traders or those who devote all of their time to investments may be able to operate profitably by successfully outguessing the market, but for the average investor such a procedure is unwise.

Formula-Timing Plans

Formula-timing plans are partly mechanical methods of determining the apportionment of funds in a portfolio, that is, the distribution of funds among cash, bonds, and stocks at any one time. Followers of these plans assert that the purpose of adopting them is to remove guesswork in the determination of the apportionment of funds. However, these plans, in fact, are based primarily on security price fluctuations. Little or no consideration is given to other factors in determining the apportionment of funds.

The use of these plans is not recommended for the average investor. In the first place, the operation of such a plan does not become mechanical until the investor has selected a "normal" distribution for his portfolio or "normal" levels for market averages. Determination of the so-called "normal" level is no less difficult and involves as much guesswork as would be required in *knowing* that prices are at peaks or trough levels at any given time. What appeared to be normal in the past may be below or above normal in the present or the future. Because the average or normal for the next several years cannot be determined in advance, the whole procedure is based on assumptions that may be seriously in error.

Another criticism of this type of investment procedure is even more important than that outlined in the preceding paragraph. As security prices increase, formula-timing plans call for progressive decreases in the common-stock portion of a fund and similar increases in the bond portion. Such action contemplates that when the trend of the market is reversed, most of the funds will be invested in fixed-income securities that are subject to relatively little price fluctuation, so that the investor will be protected against severe declines. However, during an inflationary period such as that from say 1949 to 1959, the investor would have progressively decreased his holdings of the type of security that provides some protection against the effects of inflation. Common stocks usually pay increased dividends during an inflationary period, so that the income of an investor is augmented and some protection against the increased cost of living is provided.

The third and most convincing argument against the use of mechanical formulas is found in the basic reasons for assuming the risk of common-stock ownership in the first place. The preservation of the purchasing power of both capital and income during a progressive inflation can be a major problem. Application of the mechanical formula-timing plans will remove from the investor's portfolio the type of security

that can protect his capital and, in some degree, his income during a prolonged inflationary progression (such as that which lasted three decades in France and which has virtually destroyed the capital of bondholders in several nations during the present century). We consider unwise the adoption of a plan that disregards the changes actually in progress and is based, fundamentally, on the hope that the average of security prices for the next decade will be nearly the same as that for the last.

Dollar Averaging

In contrast to the Dow Theory, formula timing, and other investment theories that stress the timing of security purchases, dollar averaging is an investment method designed to eliminate not only timing but also most other factors from consideration by the investor.

If strictly followed dollar averaging requires that a predetermined specific amount be invested periodically (usually monthly or quarterly) in a selected security or small group of securities and that these periodic purchases be continued over a prolonged period.

The theoretical advantage claimed for this type of program is that more shares will be acquired at a low cost per share during periods of depressed stock prices and few shares will be acquired at a high cost per share during periods when security prices are at high levels, thus assuring the investor a favorable (low) average cost per share over the long term.

The Monthly Investment Plan initiated by the New York Stock Exchange and widely publicized by its member firms as well as the periodic investment programs now offered by many open-end mutual funds both represent the dollar-averaging type of investment program.

We have three primary objections to this method of investing.

First, in order to obtain the desired results an investor must continue the program without interruption for a long period, at least throughout an entire major business cycle. Many investors may find it extremely difficult if not impossible to accumulate the necessary savings during periods of business depression and therefore lack investable funds at the time when security prices are depressed and purchases are most desirable. In other instances, the confidence of the individual involved may become shaken to such an extent during periods of depression that further investment becomes psychologically impossible.

Second, such a program is relatively inflexible. Most individuals are able to increase their rate of savings during periods of great prosperity. Yet to increase the amount invested during such periods may tend to defeat the fundamental aim of such plans by increasing the number of high-cost shares purchased.

Finally, in most instances the costs involved in making several small investments are more than those that would be incurred in connection with fewer but larger investments. For example, if $50 per month is invested in any security listed on the New York Stock Exchange, the commission involved is 6 percent ($3) on each purchase. By accumulating a similar amount for 6 months and making a single purchase amounting to $300, the commission involved would be only 3⅓ percent ($10).

The Recommended Approach to Investment

At the beginning of this section, we mentioned that two approaches to investment could be distinguished. Up to this point we have discussed some theories that consider securities as merchandise to be bought at low prices and sold at high prices, and a method of periodic investment without regard to economic conditions. The alternative that we recommend for the average investor has been described at length in earlier sections of this book. Essentially, we believe that the investor should consider securities purchased not as merchandise but as an investment in a business in which he will participate. This investment is not for a short period in order to make a quick profit but for the long term in order to participate in the success of a profitable enterprise.

(Our concept of "long term" investment may vary substantially from the meaning of the term when used by many advisory services. "Long term" to others usually involves investment for a period of 2 or 3 years; we prefer to consider "long term" as meaning many years, perhaps a few decades.)

The fundamental distinction between the plans recommended in this book and those suggested elsewhere is that the securities purchased ordinarily will be held for long periods of time. How, then, can the investor be sure he is not paying too much for his purchases? Two protections are afforded. In the first place, securities selected will be those of companies with outstanding growth trends over long periods. Therefore, the profitability of the enterprise over a period of years should result in a favorable long-term price trend for the security involved.

Second, the percentage distribution of the funds should be adjusted between fixed- and variable-income investments as changes in business and economic conditions warrant. Increases in the allocation of funds to common stocks ordinarily will be made during periods of depressed business conditions. As business recovers and security prices increase to higher levels, particularly if these events are accompanied by an inflationary boom, the less desirable securities should be weeded out. In the later stages of the boom, the proceeds from these sales should be invested not in additional stocks but in fixed-income securities, thus effecting a change in the percentage distribution of funds. As a result

of this procedure, most common stocks will be purchased at below-average prices; and sufficient fixed-income investments will be available in the event of a major depression.

Adaptation to Individual Requirements

An investment portfolio should be planned in the light of the circumstances of the individual owner, with a view to attaining his objectives. Presumably, each investor hopes to maintain or increase his purchasing power through income and capital gains. For some individuals the investment fund must provide a major share of living expenses. This group should avoid undue risk of loss. For this reason, adequate diversification is essential, and developments affecting specific securities should be followed closely.

Other individuals who are not dependent on income from their securities are able to assume greater risks of loss. Usually their long range objective is to accumulate a capital fund that will provide an income for themselves or their dependents at some later date. Most investors fall either within one of these two groups or in some intermediate position. Therefore, we believe that one of the three plans described in section IV, with perhaps minor variations in individual instances, will be found suitable to meet the needs of most investors. However, the amount of investment advice required properly to manage a portfolio depends entirely on the individual concerned. Those who have adequate time and sufficient experience with investment problems may well manage their funds with a minimum of outside assistance. On the other hand, those whose business, professional or other activities leave them with little time to devote to the management of their personal financial affairs probably will find it advantageous to obtain periodic or continuous advice from a competent investment advisor. Services that may be helpful to individuals who wish supplementary advice are described on page 92.

Adaptation to Changing Conditions

Because business and monetary conditions change continually, the position of an investment portfolio should be reviewed frequently and revisions should be made whenever the economic outlook changes significantly. Therefore, we believe that a thorough and broad knowledge of economic developments is essential in formulating investment decisions. Factors that should be considered include private and governmental money-credit developments, the trends of prices, production and trade, and many others. For the guidance of readers we present the following summary of our appraisal of existing economic conditions and the outlook for the future.

Existing Conditions and Outlook for the Future

This is written at a time (September 1963) when most stock price averages are at record highs, a situation that presumably reflects a generally high degree of optimism among investors. Nevertheless, the experience of the preceding 20 months clearly indicates that wide and, in our opinion, unpredictable fluctuations in stock prices still are a phenomenon to be reckoned with in the formulation of a sound investment policy. Even with the help of hindsight no one can ascertain with certainty what cause or causes were responsible for the severe contraction of stock prices during the first half of 1962. Neither can it be known why stock prices turned upward in June of that year, and, during the following 14 months, regained all of the ground lost during the preceding decline.

However, apparently the recent upward trend of stock prices has been attributable in part, at least, to general acceptance by investors of the belief that more government-sponsored inflating is assured and that common stocks again will fulfill their traditional role as an inflation hedge.

We question the wisdom of basing investment decisions on either or both of these assumptions at present, and we believe that those who do so are undertaking greater risks than they realize.

The inflation panacea is not an invention of present-day money managers. It has been tried on countless occasions during the centuries for which monetary history has been recorded. Unfortunately, every country that has experimented with inflation has found that, although exhilarating effects are experienced for a short period after each successive injection of inflationary purchasing media into the monetary system, painful and demoralizing deflation invariably comes at the conclusion of the experiment.

We do not know, and we do not see how anyone can know how much longer the United States might be able to continue inflating before being confronted with the painful aftermath; severe deflation and depression. We do know, however, that the Nation has experienced almost continuous inflating for more than 25 years and that the end of the road, therefore, is nearer than it was before. Moreover, there are unmistakable signs that some of the maladjustments attributable to prolonged inflating have become acute. For example, the international balance-of-payments deficits and the gold outflow are clear indications that the Federal Government is perilously close to insolvency, at least in relation to its international obligations. The financial crises in some States and municipalities reveal how seriously their financial positions have been impaired. The large amount of private installment, mortgage, and business debt now

outstanding suggests that repayment in full would be doubtful in the event of any significant reduction in the incomes of individuals and businesses. Also, much of the purchasing media created to help finance World War II has been put into circulation gradually during the postwar years. This supply of reserve funds has been so greatly reduced that little is left to help cushion the effects of a contracting money supply in the future. Finally, prices for many stocks are higher than they ever have been before, and they are unusually high in relation to recent earnings and dividends. Substantially increased earnings and dividends for several years in the future already appear to be reflected in the present price level.

Now, for the first time in more than a quarter century there simply is no sound basis for predicting which of several possible future developments is the more probable. There is the threat of more and conceivably great inflating for a brief period if the President and the Congress accept the proposals of those who envision large Federal deficits as the cure for all of the Nation's ills and if such deficits are transformed into inflationary purchasing media by the banking system. Another possibility is that further expansion of the Nation's already overexpanded money-credit system may not be practicable and that severe deflation and depression soon may develop as part of the price that inevitably has to be paid for prolonged disregard of fiscal responsibility. Finally, there is the possibility that, in a desperate effort to escape the consequences of past follies, another devaluation of the dollar may be undertaken at some time within the next several years.

These diverse possible future developments present a serious problem for investors. Concentration of a large portion of one's funds in domestic common stocks involves not only acceptance of an undesirably low rate of return but also the risk of severe losses in the event of deflation and depression. Those who invest most of their funds in bonds and cash reserves might lose much of their purchasing media if more inflating or another devaluation of the dollar occurs. Shares of selected foreign gold mining companies and short-term bonds of countries that have demonstrated their determination to maintain a sound currency and to follow sound fiscal practices probably are the safest investments now available. However, such securities involve the risk that the income and principal might be unavailable to the investor when needed, if foreign exchange restrictions or excessive taxes are imposed.

In view of the foregoing we believe that the best an investor can do is to adopt a hedged position that will minimize the chances for severe losses during the critical period ahead. Therefore, we recommend that investment portfolios be adjusted to conform with the percentage allocation of funds shown in Section IV.

ASSISTANCE WITH PERSONAL INVESTMENT PROBLEMS

After functioning for nearly 30 years with tax exemption as an educational, scientific research organization, American Institute for Economic Research recently has been denied that exemption because of a revised Treasury ruling. The new ruling is based on the theory that the *Investment Bulletin* and other investment advisory services, which long have been offered by the Institute, are in the nature of a business activity and that, as such, they do not qualify for tax exemption.

We continue to believe that individuals are entitled to the benefit of unbiased information and advice that may be helpful to them in solving their personal financial problems and in formulating wise investment decisions. Therefore, a separate organization (American Institute Counselors, Incorporated) has been established to carry on the bulletin and investment advisory work.

American Institute Counselors, Incorporated, is registered with the Securities and Exchange Commission as an investment adviser, and its methods and practices will conform with long-standing policies of American Institute for Economic Research. The bylaws of American Institute Counselors provide that all net income after payment of any taxes required by law shall be held in trust and periodically paid over to American Institute for Economic Research for its scientific, educational, and charitable purposes.

The investment services offered by American Institute Counselors are described briefly on the following page.

AMERICAN INSTITUTE COUNSELORS, INC.

Great Barrington, Massachusetts

whose income shall be devoted to the purposes of supporting and advancing the scientific, educational, and charitable activities of

AMERICAN INSTITUTE FOR ECONOMIC RESEARCH

Offers the Following

SERVICES TO INVESTORS

The *Investment Bulletin* is intended to provide adequate advice for investors at the lowest possible cost. The Investment Plan, Speculative-Investment Plan, and Speculative Plan are covered in this single series of printed bulletins, which are published twice monthly. In addition to analyses of industries and individual securities on the approved list, general economic conditions and special factors that may have an influence on security values are discussed clearly and concisely. Four times each year subscribers receive the latest "Quarterly List of Recommended Securities," including the percentage allocation of funds currently recommended for each of the three plans.

The subscription rate for the bulletins is $10 per year including delivery by second-class mail. For first-class mail delivery, add $2; for docestic airmail, add $3. Foreign rates on request.

Because the subscription price for the bulletins is only $10 per year, this service cannot include detailed analyses of individual problems free of charge. It seems proper that only those who really need supplementary advice should be expected to pay for it. For those who wish personal advice the following services are available.

Continuous Supervisory Service is based on the same fundamental principles outlined in the *Investment Bulletin* and provides continuous supervision of the client's investment portfolio. Letters are sent to clients at least every other week, and specific sales and purchases are recommended whenever necessary. The investor whose time is limited by business or other interests may find it advantageous to use this service, which is adapted to his particular needs. The annual fee for this service approximates one-quarter of 1 percent of the value of the supervised assets, and will be quoted on application. Please note, however, that trading advice is not given.

List Appraisal and Revision provides a detailed analysis of an investment portfolio. The report includes four tabulations. The first lists the client's present holdings in their respective security classification. The second tabulation shows the recommended sales. The third tabulation gives the recommended purchases. The final tabulation shows the revised portfolio, assuming the recommendations are adopted. Reasons for the recommended changes are summarized, and the entire problem is presented in a manner that facilitates decision. Income and percentage distribution are shown in both the original and revised portfolios. If costs and purchase dates are given, the tax aspects of the portfolio will be considered in the recommendations. The charge for such a report is:

10 or fewer securities, $10; if more than $10, $1 each.

A *Personal Appraisal Form* is provided on the following pages. If the form is filled out and sent to American Institute Counselors, Incorporated, Great Barrington, Massachusetts, a preliminary study of the client's financial circumstances will be made *without obligation* and a brief report including suggestions regarding other services that should be helpful will be prepared. All information submitted will, of course, be considered confidential.

Further details concerning the foregoing services will be supplied on request. Requests for further information should be sent to American Institute Counselors, Incorporated, Great Barrington, Massachusetts.

A Personal Appraisal Form

The same principles that are used to test the soundness of a business enterprise will help to solve your personal financial problems. The first step is to appraise the assets in order to see whether or not they balance liabilities. This means checking *all* resources systematically to see if they balance *all* responsibilities. It is important to realize that *both the dollar amount and the nature of the assets* should be suitable for the responsibilities involved.

This form should be both interesting and helpful in studying your personal financial problems. Furthermore, if you wish to do so, you may complete and send the form to American Institute Counselors, Incorporated, who will make a preliminary survey of your problem in order to ascertain:

1. Whether or not the probable savings or other reasons would justify a complete report on your insurance or retirement program, and the cost of such a report.

2. Your need for special assistance in planning your estate so that income taxes and the estate and inheritance taxes payable at your death will be a minimum.

3. Whether an appraisal of your investment portfolio with recommendations as to which securities should be sold, retained, or added would be advisable, and the fees involved.

4. Whether other services such as the continuous supervision of investments would be helpful to you, and the cost of such services.

American Institute Counselors, Incorporated is a scientific and educational organization engaged in impartial research and has no connection with insurance companies, security-selling agencies, or other commercial organizations. Therefore, the cost of the work involved must be met by those benefited, insofar as that is practicable. The advantage is that your interests alone will determine the advice given concerning your problem. Moreover, you will not be obligated in any way until you authorize further study after a preliminary analysis has been made and an estimate of the cost of a complete report has been submitted to you.

PRESENT RESOURCES

1. Cash on hand and in checking account - $.....
2. Savings deposits $.....; maturity value U.S. Savings bonds, E $.....; F $.....; G $.....; postal savings $.....;
   Total - - -.....
3. Cash value of life-insurance policies* - - -.....
4. Cash value of annuities or other retirement contracts* - - - - - - - - - - - -.....Subtotal $.....
5. Securities:
   a. Bonds* - - - - - - - - - - - - -.....
   b. Common or preferred stocks* - - - -.....
   c. Notes held* - - - - - - - - - - - -.....
   d. Mortgages* - - - - - - - - - - - -.....Subtotal .....
6. Value of stock holdings or partnership in personal business.
   (A recent statement will clarify this item.)* .....
7. Real Estate:
   a. Home (mortgage $.....)
      present value - - - - - - - - - - -.....
   b. Business property (mortgage $.....)
      present value - - - - - - - - - - - -.....Subtotal .....
8. Car (present value) - - - - - - - - -.....
9. Household furniture and fixtures - - - -.....
10. Equipment owned personally and used for business or professional work - - - - -.....
11. All other present assets - - - - - - -.....Subtotal .....
    Total - - - - - - - - - - - - - .....

PROBABLE FUTURE RESOURCES

12. Approximate annual income from
    a. Salary and bonus (Subject to Social Security tax Yes.....No.....) - - -.....
    b. Profession or business - - - - - - -.....
    c. From investments - - - - - - - - -.....
    d. All other* - - - - - - - - - - - -.....Subtotal .....
13. Estimated annual savings* - - - - - - - - - - - - - .....
14. Pension plan to provide annually, beginning at age .....* - - - - - - - - - - - - - - - - - .....
    a. Social Security pension (estimated by Institute $.....)
15. Annuity contracts to provide annually* - - - - - - - - - ....
16. Value of property or other inheritance expected* - .....
17. Life insurance payable in event of death* - - - - - - - - .....
18. Health and accident insurance* - - - - - - - - - - - - .....
19. Owed to me that may be paid sometime* - - - - - - - - .....
20. Other probable future resources* - - - - - - - - - - - - .....

(Do not total)

*Please use the space on page 96 to describe these items in greater detail.

PRESENT RESPONSIBILITIES

21. Demand obligations; notes, I. O. U.'s - - - - - - - - - $.....
22. Accounts payable:
    a. Charge accounts - - - - - - - - $.....
    b. Doctor and dentist bills - - - - .....
    c. Other - - - - - - - - - - - .....Subtotal .....
23. Notes payable, unsecured - - - - - - - - - - - - - - - - .....
24. Secured liens:
    a. Borrowed on securities - - - - - - - -.....
    b. Borrowed on real estate, including mortgage - - - - - - - - - - - - -.....
    c. Owed on car, or other installment purchase.....
    d. Owed on life insurance - - - - - - -.....Subtotal .....
25. Other present obligations - - - - - - - - - - - - .....
26. All present responsibilities - - - - - - - - - -Total .....
27. Present personal net worth (total present resources minus total of present responsibilities) - .....

    Total (including personal net worth) - - - - .....

PROBABLE FUTURE OR CONTINUING RESPONSIBILITIES

28. Annual expenses of immediate family - - -.....
29. Annual contributions to expenses of other dependents - - - - - - - - - - - - - .....Subtotal .....
30. For college education of children - - - - - - - - - - - - .....
31. For acquirement of home or carrying out of other personal plans - - - - - - - - - - - - - - - - .....
32. For providing a capital fund for children - - - - - - - - .....
33. Annual retirement income desired to begin at age ..... - - - - - - - - - - - - .....
34. Estate and inheritance taxes - - - - - - - - - - - - - - .....
35. Annual income for wife in event of husband's death - - - - - - - - - - - - - - - -.....
36. Annual income for children in event of father's death - - - - - - - - - - - - -
    Ages 1-5, $.....; 6-11, $.....; 12-14, $.....
    15-17, $.....; 18-22, $.....
37. Other known responsibilities* - - - - - - - - - - - - - - .....
38. Possible emergencies (estimated) - - - - - - - - - - - - - .....

(Do not total)

If you desire to send this form for analysis please fill in the information requested below:†

Name ..... Street .....
City ..... Zone ..... State .....
Number of Dependents ..... Ages: Wife .... Children ..... Other .....
Own Age ..... Date of Birth ..... Occupation .....

*Please use the space on page 96 to describe these items in greater detail.
†All information given is of course considered confidential.

The space below may be used to describe securities, life-insurance policies, and other assets of which a more detailed description is desirable. Use as many lines as may be needed to describe each item. If more space is required, any blank sheet of paper will serve.

INVESTMENTS

Par value of bond; or number of shares of stock	Company	Details of bond issue; common or preferred stock, etc.	Original cost	Date of purchase

LIFE INSURANCE AND ANNUITIES

Face value of policy	Company	Type of policy	Premium	Age when taken out

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HOW TO AVOID FINANCIAL TANGLES by Kenneth C. Masteller	$1.00
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RESEARCH REPORTS, weekly analyses of economic developments, emphasizing their probable effects on future conditions. $9 per quarter, $35 per year.

ANNUAL SUSTAINING MEMBERS receive all the publications listed above, at $9 per quarter or $35 per year.

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At your request, the Institute will forward your subscription to, and payment for, the *Investment Bulletin,* published by American Institute Counselors, Incorporated. The bulletin is issued twice monthly at a price of $10 per year and includes three basic plans with specific recommendations of securities. It was formerly published by American Institute for Economic Research, but the Institute has divested itself of its direct investment and related advisory services in order to preserve its character as a scientific and educational institution. Those services are now rendered by American Institute Counselors, Incorporated, an independent organization, whose net income is devoted to the support of the purposes and objectives of American Institute for Economic Research.