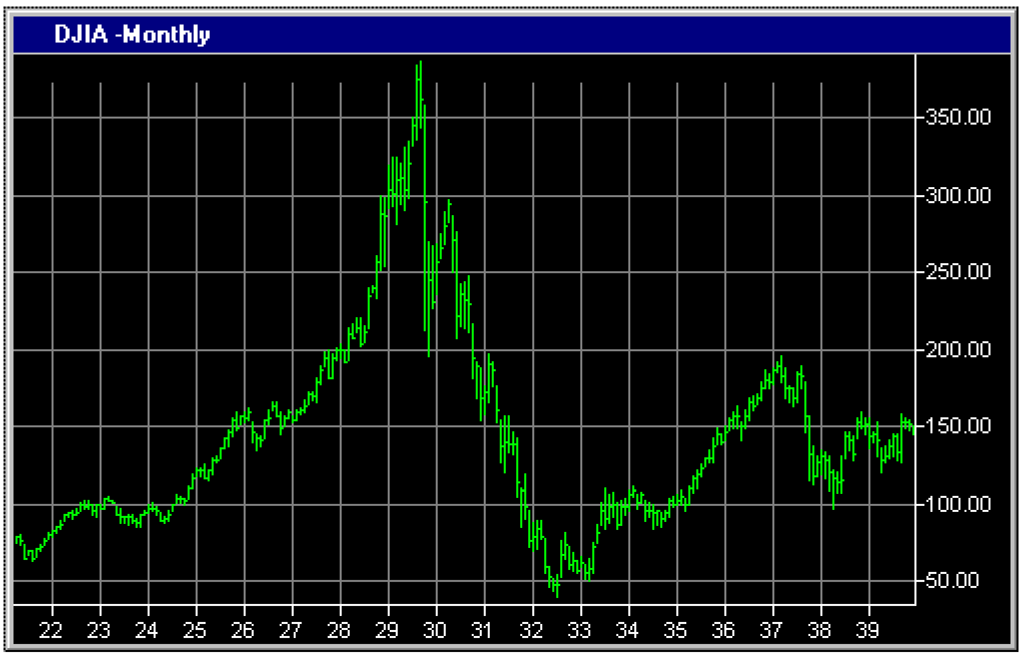
When Ben Graham's three part series, "Is American Business Worth More Dead than Alive?" was published in *Forbes* magazine, America, and indeed the world, had gone through the punishing stock market crashes of 1929 and 1930 and was in the depths of the Great Depression. Though the Depression continued until nearly the end of the decade, Graham's articles signaled to investors that it was now safe to return to the stock market. At that time, Graham pointed out, more than 30 percent of the companies listed on the NYSE were selling at less than what they would be worth if they were broken up and sold. In this series of articles, Graham took corporate management to task for taking advantage of investors and putting their own welfare ahead of that of the shareholders.

FORBES published a series of three articles by Benjamin Graham written at the bottom of the Great Crash. This is the first, ***Are Corporations Milking Their Owners?***

At its worst level, the Dow dropped to 40.56 in July, 1932. That is a drop of **89%**.



Inflated Treasuries and Deflated Stockholders (Article 1) by Benjamin Graham on June 01, 1932

SELLING AMERICA FOR 50 CENTS ON THE DOLLAR

More than one-third of all industrial stocks are selling in the open market for less than the companies' net quick assets[1].

Scores of common stocks are selling for less than their pro-rata cash in the company's treasury.

[1] **Net Quick Assets**: cash, marketable securities, and accounts receivable *minus* current liabilities. Inventory is excluded in order to determine whether, if sales evaporate, a business could meet its current liabilities with the readily convertible (to cash) assets on hand.

Corporations who are good risks for commercial loans do not need to borrow. They still have large unused cash balances furnished by their stockholders in the New Era days.

Corporation treasurers sleep soundly while stockholders walk the floor.

Banks no longer lend directly to big corporations. They lend to stockholders who have over-financed the companies through rights to buy stock at inflated prices.

What the responsibilities of the corporation, its directors, its stockholders? What is the proper way out? Are stockholders part-owners of their companies, or just suckers?

Shall companies reverse the 1929 method—give the stockholder rights to sell back the stock he bought, reduce capitalization, and equalize the burden between the corporations and the stockholder?

If market quotations discount huge cash reserves due to probable long continued future losses then should not the stockholder demand liquidation before his money is thus dissipated?

Are corporation playing fair with their stockholders?

Suppose you were the owner of a large manufacturing business. Like many others, you lost money in 1931; the immediate prospects are not encouraging; you feel pessimistic and willing to sell out--*cheap*. A prospective purchaser asks you for your statement. You show him a very healthy balance sheet, indeed. It shapes up something like this:

Cash and U.S. Gov. Bonds	$8,500,000
Receivables and Merchandise	$15,000,000
Factories, Real Estate, etc	+ $14,000,000
	$37,500,000
Less owing for current accts	-$1,300,000
Net Worth	**$36,200,000**

The purchaser looks it over casually, and then makes you a bid of $5,000,000 for your business--the cash, Liberty Bonds and everything else included. **Would you sell?** The question seems like a joke, we admit. No one in his right mind would exchange 8 1-2 millions in cash for five million dollars, to say nothing of the $28 millions *more* in other assets. But preposterous as such a transaction sounds, the many owners of *White Motors* stock who sold out between $7 and $8 per share did that very thing--or as close to it as they could come.

The figures given above represent *White Motors* condition on December 31st last year. At $7 3/8 per share, the low price, the company's 650,000 shares were selling for $4,800,000--about 60 per cent of the cash and equivalent alone, and *only one-fifth of the net quick assets*. There were no capital obligations ahead of the common stock, and the only liabilities were those shown above for current accounts payable.

The spectacle of a large and old established company selling in the market for such a small fraction of its quick assets is undoubtedly a startling one. But the picture becomes more impressive when we observe that there are literally dozens of other companies which also have a **quoted value less than their cash in bank**. And more significant still is the fact that an amazingly large percentage of all industrial companies are selling for less than their quick assets alone--leaving out their plant and other fixed assets entirely.

This means that a great number of American businesses are quoted in **liquidating value**; that in the best recent judgment of Wall Street, *these businesses are worth more dead than alive.*

For most industrial companies should bring, in orderly liquidation, at least as much as their quick assets alone. Admitting that the factories, real estate, etc. could not fetch anywhere near their carrying price, they should still realize enough to make up the shrinkage in the proceeds of the receivables and merchandise below book figures. If this is not a reasonable assumption there must be something radically wrong about the accounting methods of our large corporations.

A study made at the *Columbia University School of Business* under the writer's direction, covering some 600 industrial companies listed on the New York Stock Exchange, disclosed that over 200 of them--or fully one out of three--have been selling at less than their net quick assets. Over fifty of them have sold for less than their cash and marketable securities alone. In the Appendix at the end of this document is given a partial list, comprising the more representative companies in the latter category. What is the meaning of this situation? The experienced financier is likely to answer that stocks always sell at unduly low prices after a boom collapses. As the president of the *New York Stock Exchange* testified, "in times like these frightened people give the United States of ours away." Or stated differently, it happens because those with enterprise haven't the money, and those with money haven't the enterprise, to buy stocks when they are cheap. Should we not find the same phenomenon existing in previous bear markets--for example, in 1921?

The facts are quite otherwise, however. **Stocks sold at low prices in the severe post-war depression, but very few of them could be bought on the Stock Exchange for less than quick assets, and not one for less than the company's available cash.**

The comparative figures for both periods, covering representative companies, are little short of astounding, especially when it is noted that they showed no materially poorer operating results in 1931 than in 1921. Today, these companies are selling in the aggregate for half their working capital; ten years ago working capital was only half the bottom prices. With respect to cash assets alone, present prices are relatively *six times* lower than in 1921.

We must recognize, therefore, that the situation existing today is not typical of all bear markets. Broadly speaking, **it is new and unprecedented.** It is a strange, ironical aftermath of the "new era" madness of 1921-1929. It reflects the extraordinary results of profound but little understood changes in the financial attitude of the people, and the financial fabric of the country.

Two plausible and seemingly innocent ideas, the first, that good stocks are good investments; the second, that values depend on earning power--were distorted and exploited into a frenzied financial gospel which ended by converting all our investors into speculators, by making our corporations rich and their stockholders poor, by reversing the relative importance of commercial loans and Wall Street loans, by producing topsy-turvy accounting policies and wholly irrational standards of value--and in no small measure was responsible for the paradoxical depression in which we find ourselves submerged.

Behind the simple fact that a great many stocks are selling for much less than their working capital lies a complex of causes, results and implications. The remainder of this article will deal with the causes of the present unique situation, while other ramified aspects will be developed in succeeding articles.

The current contrast between market prices and liquid assets is accounted for in large measure by the huge flood of new cash which stockholders in recent years have poured into the treasuries of their corporations by the exercise of **subscription rights**. This phenomenon, which was one of the distinguishing features of the 1928-1929 bull market, had two quite opposite consequences. On the one hand the additional funds received greatly improved the companies' cash and their working capital position; on the other hand the additional shares issued greatly increased the supply of stocks, weakened their technical position, and intensified their market decline. **The same circumstance, therefore, served both to improve the *values* behind a stock and to depress the *price*.** *(This circumstance occurs today (2003) with “Busted Initial Public Offerings or IPOs” when after raising substantial amounts of cash from investors when going public, the company has a hiccup in operations and/or markets turn down and the IPO’s price declines significantly).*

It is doubtful, however, **that the declines would have gone to the current extraordinary lengths if during the last decade investors had not lost the habit of looking at balance sheets.** Much of the past year's selling of stocks has been due to fear rather than necessity. If these timid holders were thoroughly aware that they were selling out at only a fraction of the liquid assets behind their shares, many of them might have acted differently.

But since value has come to be associated exclusively with earning power, the stockholder no longer pays any attention to what his company owns--not even its money in the bank.

It is undoubtedly true that the old-time investor laid too much stress upon book values and too little upon what the property could earn. It was a salutary step to ignore the figures at which the plants were carried on the books, unless they showed a commensurate earning power. *(The asset values should earn at least their cost of capital or Asset Value = Earnings Power Value at the cost of the firm’s capital.)*

But like most sound ideas in Wall Street, this one was carried too far. It resulted in excessive emphasis being laid on the reported earnings--which might only be temporary or even deceptive--and in a complete eclipse of what had always been regarded as a vital factor in security values, namely the company's working capital position.

Businesses have come to be valued in Wall Street on an entirely different basis from that applied to private enterprise. In good times the prices paid on the Stock Exchange were fantastically high, judged by ordinary business standards; and now, by the law of compensation, the assets of these same companies are suffering an equally fantastic undervaluation.

A third reason that stocks now sell below their liquid asset value is the <u>fear of future operating losses</u> *(thus, diminishing asset values).* Many readers will assert that this is the overshadowing cause of the present low market level. These quotations reflect not only the absence of earning power, but the existence of "losing power" which threatened to **dissipate the working capital behind the shares today**.

Is it true that one out of three American businesses is destined to continue losing money until the stockholders have no equity remaining? This is what the stock market says in no uncertain terms.

In all probability it is wrong, as it always has been wrong in its <u>major</u> judgments of the future. The logic of Wall Street is proverbially weak. It is hardly consistent, for example, to despair of the railroads because the trucks are going to take most of their business, and at the same time to be so despondent over the truck industry as to give away shares in its largest units for a small fraction of their liquid capital alone.

But since even in prosperous times many undertakings fall by the wayside, it is certain that the number of such ill--starred ventures must now be greatly increased. The weakly situated business will find it difficult, perhaps impossible, to survive. Hence in a number of individual cases the market's prophecy of extinction will be borne out. Nevertheless, there must still be a basic error in this <u>wholesale</u> dumping of shares at a small fraction of liquidating value.

If a business is doomed to lose money, why continue it? If its future is so hopeless that it is worth much less as a going concern than if it were wound up, **why not wind it up?**

Surely the owners of a business have a better alternative than to give its present cash away, for fear that it is later going to be dissipated. We are back to the contrast between the *White Motors* stockholder and the individual factory owner, with which we started our article.

The issue is merely **one of simple logic.** Either *White Motors* is worth more as a going concern than its cash in bank, or it is not. If it is worth more, the stockholder is foolish to sell out for much less than this cash, unless he is compelled to do so. If it isn't, the business should be liquidated and each stockholder paid out his share of the cash plus whatever the other assets will bring.

Evidently stockholders have **forgotten more than to look at balance sheets.** They have forgotten also that they are ***owners of a business*** and not merely owners of a quotation on the stock ticker. It is time, and high time, that the millions of American shareholders turned their eyes from the daily market reports long enough to give some attention to the enterprises themselves of which they are the proprietors, and which exist for their benefit and at their pleasure.

The supervision of these businesses must, of course, be delegated to directors and their operation to paid officials. But whether the owners' money should be dissipated by operating losses, and whether it should be tied up unproductively in excessive cash balances while they themselves are in dire need of funds, are questions of major policy which each stockholder must ponder and decide for himself.

These are not management problems; these are ***ownership problems***. On these questions the management's opinion may be weighty but it is not controlling.

What stockholders need today is not alone to become "balance sheet conscious," but more than that, to become "ownership conscious." If they realized their rights as business owners, **we would not have before us the insane spectacle of treasuries bloated with cash and their proprietors in a wild scramble to give away their interests on any terms they can get.** Perhaps the corporation itself buys back the shares they throw out of irony, we see the stockholders' pitifully inadequate payment made to them *with their own cash*. *(Shareholders were desperately selling shares at prices below the net cash owned by their own companies to raise funds rather than have their management payout excess cash to them!)*

The waggish barber of the legend painted on his sign:

What, do you think --

We shave you for nothing and give you a drink!

That, without the saving comma, might well be blazoned as the motto of the stock seller of to-day, who hands over his share in inventories and receivables for less than nothing, and throws in real estate, buildings, machinery and what-not as a lagniappe or trading stamp.

The humor of the situation could be exploited further, but the need is not for witticism but for a straightforward presentation of the vitally important issues that face stockholders, managements, and bankers.

Should Rich Corporations Return Stockholders' Cash? (Article 2) by *Benjamin Graham*,

June 15, 1932

***FORBES* presents herewith the second in this spectacular series of articles on the maladjustment between finances of corporations and their owners.**

In our first article, the present disparity between the cash asset position of many companies and the price of their stocks was ascribed in part to the huge issues of additional shares which transferred money from stockholders' pockets into corporate treasuries. According to the *New York Stock Exchange's* compilation, the funds so absorbed by listed companies alone, between 1926 and 1930, amounted to no less than five billion dollars.

The total sale of corporate securities to the public in this period exceeded twenty-nine billions, of which a small part perhaps was turned over to private individuals, but the major portion was paid into the businesses, and either expended in plant additions or added to working capital.

It must not be forgotten that other enormous sums have also been accumulated in the form of undistributed earnings. After this tremendous influx of cash it is no wonder that corporate treasuries are still bulging, despite all the money that has been spent, or lost, or paid in dividends.

But what of the people who supplied the bulk of this money; the investor who bought new offerings; the stockholder who subscribed to additional shares? They are not rolling in wealth to-day, nor burdened with a plethora of idle funds. They stripped themselves of cash to enrich their corporations' treasuries; they borrowed heavily in order that these corporations might be able to pay off their debts.

The grotesque result is that the people who own these rich American businesses are themselves poor, that the typical stockholder is weighed down with financial problems while his corporation wallows in cash. *Treasurers are sleeping soundly these nights, while their stockholders walk the floor in worried desperation.*

True, the public has more stock certificates to represent the new shares which it paid for, and each certificate carries ownership in the cash held by the company. But somehow this doesn't help the stockholder very much. He can't borrow from the bank, or margin his existing loans, on the basis of the cash behind his shares. If he wants to sell he must accept the verdict of the ticker. If he should appeal to the officers of the company for a little of his own cash, they would probably wave him away with a pitying smile. Or perhaps they may be charitable enough to buy his stock back at the current market price--which means a small fraction of its fair value.

Meanwhile, the prodigal transfer of cash by the public to corporations in the new-era days has not only made infinite trouble for the security holder, but it has seriously demoralized our banking structure. Commercial loans have always been the heart and the bulwark of our credit system. Loans on securities have been secondary in volume and drastically subordinated in their standing.

But what have the corporations and the public done between them in recent years? They have paid off the cream of the country's commercial borrowings and substituted security loans in their place. Instead of lending directly to big business, the banks have been forced to lend to their stockholders against pledges of their shares, or to purchase securities on their own account.

Some idea of the extent of this shift of banking accommodation can be gleaned from the comparative figures of the reporting Member Banks of the Federal Reserve System:

Change in the Composition of Banking Resources--1920-1932 (In Millions)

	Commercial Loans	Loans on Securities	Total
Oct., 1920	$9,741	$7,451	$17,192
May, 1932	$6,779	$12,498	$19,277

The whole development has proved most disastrous to stockholders and most embarrassing to the banks. **The best form of borrowing has been replaced by the worst.** The safety of the loans, and to some extent the solvency of the banks making them, has been placed at the mercy of stock market fluctuations, instead of resting on the financial strength of our large corporations.

Thousands of stockholders--*the owners of their company's business*--find themselves today in an absurd position. The market value of their stock may be, for instance, only ten $ millions, its borrowing value at best eight millions. Yet not only may the company have fifteen $ millions in the treasury, but it could borrow large additional amounts against its many millions of other quick assets. **If the owners of the business really controlled such a company, they could draw out not only the fifteen millions in cash but another five millions from bank loans, and still have a business in sound condition with substantial equities. (***Graham illustrates the absurd prices—the value of a company can not be worth <u>less</u> than what a lender would be willing to lend against it.)*

The very banks which hesitate to lend ten dollars per share on a stock would probably be glad to lend the company itself enough to **enable it to <u>pay-out</u> fifteen dollars per share to the stockholders.**

Consider on the one hand a typical standard business with its enormous cash and credit resources; and then consider the people who own this business and who poured millions into its treasury, unable to realize or borrow more than a miserable fraction of the cash value of their <u>own</u> property.

This is the result of undue generosity by stockholders towards their corporations in good times--and of undue parsimony by the corporations towards the stockholders today.

The banks may seem like co-villains in such a situation, but in fact they, too, are victims of circumstance--handicapped by a soundly conceived system which is out of harmony with the actualities of the present situation. They have been educated, and they are directed, to give first consideration to commercial loans.

But who now are the commercial borrowers? Strong corporations with good past (if not recent) records, requiring money for seasonal requirements? Not at all. Such corporations don't need the banks; they raised all the money they could use from the stockholders when the raising was good. *(The 1922-1928 Bull Market.)*

There are left three classes of bank borrowers: (a) Small or privately owned enterprises--maybe good, maybe not; (b) Large industrial corporations with poor records even in the late prosperity; (c) Railroads and utilities needing temporary (?) accommodation, to be paid off by permanent financing--a fruitful source of trouble for all concerned.

It must be recognized, therefore, that the replacement of good commercial loans by vulnerable loans on stock collateral has been harmful alike to our banking system and to the vast army of stockholders. Is there a remedy for this condition? There certainly is, and a very simple one.

Let corporations return to their stockholders the surplus cash holdings not needed for the normal conduct of their business.

The immediate result of such a movement would be to benefit the individual stockholder by placing funds in his hands to meet his urgent needs or to use as he sees fit. The secondary result would be to improve the price of the shares affected and the stock market generally, as the public is made aware in this forceful fashion of the **enormous cash values** behind American business today. The third result would be to improve the balance of our banking structure, making for a larger proportion of sound commercial loans (especially when business again expands) and permitting the repayment of a certain quantity of frozen security loans.

How should this return of cash be accomplished? Preferably by the direct retracing of the financial steps which have led to the present predicament. Instead of rights to buy stocks, let companies offer their stockholders the right to sell stock in a fixed proportion and at a stated price. This price should be above the current market but in most cases below the net quick assets per share and therefore far below the book value. From the corporation's point of view the result of such <u>repurchases at a discount</u> will be an increase both in the surplus and in the net current assets per share of stock remaining.

A few corporations have followed this procedure, one of the earliest being *Simms Petroleum.* Recently *Hamilton Woolen* has offered to buy one-sixth of the outstanding shares pro rata at $65, which is about equal to the net quick assets and considerably above the previous market price. This represents the return of a large portion of the new money paid in by stockholders in 1929.

Other companies have returned surplus cash to stockholders in the form of special distributions without cancellation of stock. *Peerless Motors* is a case in point, and another is *Eureka Vacuum Cleaner*, which accompanied its action by a statement recommending a similar move to other corporations as an aid in relieving the depression. A few companies, notably the *Standard Oil* pipe lines and some New England mills, **have returned surplus cash capital to shareholders by reducing the par value of the stock.**

All these methods accomplish the same purpose and the differences between them are largely technical. The repurchase of shares pro rata, which we recommend, is more practical in most cases than a reduction in par value, and it has certain bookkeeping advantages over a straight special dividend. Furthermore, as a direct reversal of the process of taking money from stockholders by issuing subscription rights, this method undoubtedly has a strong logical appeal.

A sizable number of enterprises have been employing surplus funds to acquire stock by purchase in the open market. This also represents a transfer of corporate funds to stockholders. It is undoubtedly helpful to the market price and hence to those constrained to sell, and **the repurchase of shares at bargain prices presumably benefits the surviving stockholders.** Certainly corporations using excess cash in this manner are acting more liberally than those who hold on like grim death to every dollar in bank.

But this form of procedure is open to objections of various kinds. If the price paid turns out to have been too high, the directors are subject to criticism from those whom they still represent, while those they have benefited are no longer interested in them or in the company. If, to avoid this danger, they buy only when the price is exceedingly low, they cannot avoid the appearance of having taken unfair advantage of the necessities of their stockholders. Furthermore, such undisclosed market operations may afford opportunities for questionable profit by directors and insiders.

The *Bendix Aviation Company* recently passed its dividend and concurrently announced its intention of purchasing a large block of shares in the open market. Other companies rich in cash have followed the same policy, though generally without even this saving grace of revealing their plan to buy in stock. Such a procedure contains possibilities of grave injustice to the shareholders. **When there is an accumulated surplus and excess cash on hand, the directors' <u>first duty</u> is to**

use the free cash to maintain a reasonable dividend. *(Today—2009--paying dividends vs. buying back stock below intrinsic value may or may not be a good choice depending upon circumstances. Graham puts a premium on paying out cash directly to shareholders because he says that corporate managements may be taking advantage of selling shareholders by repurchasing their stock at low prices).*

The prime reason for accumulating the surplus in good years was to make possible the continuance of dividends in bad years. Hence the absence of earnings is in itself no justification for stopping all payments to shareholders. To withhold the owners' money from them by suspending dividends, and then to use this same money to buy back their stock at the abnormally low price thus created, comes perilously close to sharp practice.

Such considerations should make it clear why the writer does not regard open-market purchases as the best method of returning corporate cash to stockholders. Retirement of stock pro rata involves no conflict of interest between those selling out and those staying in; and it provides no opportunity for errors in judgment or unfair tactics on the part of the management.

Examination of the partial list in Table 1 on page 16 of companies selling in the market for less than their net current assets, as well as reference to the table offered in our first article last issue, will disclose many instances in which the **cash holdings are clearly *excessive*.** If stockholders will bring sufficiently strong pressure upon their managements, they can secure the return of a good part of such surplus cash, with great benefit to their own position, to stock market sentiment, and to the general banking situation.

In order to obtain these desirable results, stockholders must first be aware that surplus cash exists; and therefore they must direct at least a fleeting glance to their company's balance sheet. In recent years financial writers have been unanimous in pointing out how unimportant are asset values as compared with earning power; but no one seems to have realized that both the ignoring of assets and the emphasis on earnings can be--and have been--carried too far, with results of the most disastrous kind.

The whole "new-era" and "blue chip" madness derived from this exclusive preoccupation with the earnings trend. *(Oh, the dangers of high growth or momentum investing)* A mere $1 increase in profits, from $4 to $5 per share, raised the value of a stock from 40 to 75, on the joyous assumption that an upward trend had been established which justified a multiple of 15 instead of 10. **The basis of calculating values thus became arbitrary and mainly psychological**, with the result that everyone felt free to gamble unrestrainedly under the respectable title of "investment." *(Confusing investment with speculation).*

It was this enticement of investors into rampant speculation which made possible the unexampled duration and extent of the 1928-1929 advance, which also made the ensuing collapse correspondingly disastrous, and which--as later appeared--carried the business structure down into ruin with the stock market. *(As Rothbard shows in **America's Great Depression**, massive credit expansion/easy money certainly fueled the mania.)*

A peculiar offshoot of the obsession with earnings is the new practice of writing fixed assets down to $1, in order to eliminate depreciation charges and thus report larger profits. The theory is that by destroying asset values we can increase earning power and therefore enhance the market value. Since no one pays any attention to assets, why carry any assets on the books? This is another example of *Alice in Wonderland* financial logic.

It is in amusing contrast with the much berated *stock watering*[2] practice of a generation ago. In those days fixed assets were arbitrarily written-up, in order to enlarge the book values, and thus facilitate a fictitious market price. In place of watering of assets, we now have watering of earnings. The procedures are directly opposite, but the object and the underlying deception are exactly the same. *(Here Graham describes the misuse of accounting rules by promoters to obscure economic reality and fleece the public.)*

Because of the superstitious reverence now accorded the earnings statement by both investors and speculators, wide variations in market prices can be occasioned by purely arbitrary differences in accounting methods. The opportunities for downright crookedness are legion, nor are they ignored.

One company, listed on the *New York Stock Exchange*, recently turned an operating loss into a profit by the simple expedient of marking up its goodwill and adding the difference to earnings, **without bothering to mention** this little detail. The management apparently relied, and not unreasonably, on the fact that stockholders would not examine the balance sheets closely enough to detect their charming artifice.

The disregard of assets has also introduced some new wrinkles into reorganizations and mergers. Creditors are no longer permitted to receive the cash directly available to pay off their claims; stockholders are forced into consolidations which give other securities a prior claim on cash which formerly was theirs.

The *Fisk Rubber Co.*, for example, showed around $400 in cash on hand for each $1,000 of overdue debt, and nearly $900 in net quick assets, excluding the extensive factories, etc. Yet the proposed reorganization plan offers these creditors no cash at all, but only stock in a new company.

Similarly, while *Prairie Pipe Line* stockholders were taking comfort from the fact that there had lately appeared to be $12 per share in cash equivalent behind their stock, they suddenly found themselves owners of shares in another company which had no cash at all directly applicable to their holdings, this new stock, moreover, having a total market value equal to less than half the cash equivalent alone which they formerly owned.

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[2] This term came from the activities of *Daniel Drew* in the 1870s during his early life as a cattle drover--his discovery of the profit to be gained from **"watered" cattle** which he later used in watering the stock in the famed Erie Railroad operation. After driving them to the stockyards for sale *Drew* would feed salt to his cattle and his cattle would drink lots of water. Obviously, watering cattle artificially boosted the weight of his cattle and thus his profits.

In the writer's view, all these strange happenings flow from the failure of the stockholder to realize that he occupies the same fundamental position and enjoys **the same legal rights as the part-owner in a private business.** The panoply and pyrotechnics of Wall Street have obscured this simple fact. If it only could be brought home to the millions of investors the country over, a long step would be taken in the direction of sounder corporate practices and a saner attitude towards stock values.

Treasurers Sleep Soundly While Stockholders Walk the Floor!

Why is the stockholder poor today?

Because he borrowed from the banks in 1929 to put more cash into the companies he owns. Where is that cash now? Much of it is still held intact by his company. Does the stockholder need that money more than his company? You bet he does. Has he done anything to get it? No. **He thinks his company is broke because stock prices say so.** He has forgotten asset value. He has forgotten that his officers and directors are supposed to be his own representatives, working for his own best good. **He has forgotten that he is a part-owner and manager of the company in which he owns stock.**

Should Rich But Losing Corporations Be Liquidated by Benjamin graham, July 01, 1932

Which is Right--the Stock Market or Corporation Management?

Another aspect of the current maladjustment between corporation and their stockholders is the question of possible liquidation. Many stocks sell for less than their cash value because the market judges that future operating losses will dissipate this cash.

If that is the case, then should not the stockholder demand liquidation before his cash is used up? The management says "No"--naturally, but the stock market says "Yes,"—emphatically. Which is right? What are the salient factors on both sides of the question?

Forbes presents herewith the third, and last, article in this series by Mr. Graham, which reaches down to the very roots of the present troublesome situation.

The unprecedented spectacle confronts us of more than one industrial company in three selling for *less than* its net current assets, with a large number quoted at less than their unencumbered cash. For this situation we have pointed out, in our previous articles, three possible causes:

(a) Ignorance of the facts;

(b) Compulsion to sell and inability to buy;

(c) Unwillingness to buy from fear that the present liquid assets will be dissipated.

In the preceding articles Inflated Treasuries And Deflated Stockholders (Article 1) and Should Rich Corporations Return Stockholders' Cash? (Article 2) we discussed the first two causes and their numerous implications. But neither the ignorance nor the financial straits of the public could fully account for the current market levels.

If *gold dollars without any strings attached* could actually be purchased for 50 cents, plenty of publicity and plenty of buying power would quickly be marshaled to take advantage of the bargain. **Corporate gold dollars are now available in quantity at 50 cents and less--but they *do* have strings attached. Although they belong to the stockholder, he doesn't control them.** He may have to sit back and watch them dwindle and disappear as operating losses take their toll. For that reason the public refuses to accept even the cash holdings of corporations at their face value.

In fact, the hardhearted reader may well ask impatiently: "Why all this talk about liquidating values, *when companies are not going to liquidate?* As far as the stockholders are concerned, their interest in the corporation's cash account is just as theoretical as their interest in the plant account. *If* the business were wound up, the stockholders would get the cash; *if* the enterprise were profitable, the plants would be worth their book value. "*If* we had some ham, etc., etc."

This criticism has force, but there is an answer to it. **The stockholders do not have it in their power to make a business profitable, but they do have it in their power to liquidate it.** At bottom it is not a theoretical question at all; the issue is both very practical and very pressing.

It is also a highly <u>controversial</u> one. It includes an undoubted conflict of *judgment* between corporate managements and the stock market, and a probable conflict of *interest* between corporate managements and their stockholders.

In its simplest terms the question comes down to this: Are these managements wrong or is the market wrong? Are these low prices merely the product of unreasoning fear, or do they convey a stern warning to liquidate while there is yet time?

Today stockholders are leaving the answer to this problem, as to all other corporate problems, in the <u>hands of their management</u>. But when the latter's judgment is violently challenged by the verdict of the open market, it seems childish to let the management decide whether itself or the market is right. This is especially true when the issue involves a strong <u>conflict of interest</u> between the officials who draw salaries from the business and the owners whose capital is at stake. **If you owned a grocery store that was doing badly, you wouldn't leave it to the paid manager to decide whether to keep it going or to shut up shop.**

The innate helplessness of the public in the face of this critical problem is aggravated by its acceptance of two pernicious doctrines in the field of corporate administration. The first is that directors have no responsibility for, or interest in, the market price of their securities. The second is that outside stockholders know nothing about the business, and hence their views deserve no consideration unless sponsored by the management.

By virtue of dictum number one, directors succeed in evading all issues based upon the market price of their stock. Principle number two is invoked to excellent advantage in order to squelch any stockholder (not in control) who has the temerity to suggest that those in charge may not be proceeding wisely or in the best interests of their employers. The two together afford management perfect <u>protection</u> against the necessity of justifying to their stockholders the continuance of the business when the weight of sound opinion points to better results for the owners through <u>liquidation</u>.

The accepted notion that directors have no concern with the market price of their stock is as fallacious as it is hypocritical. Needless to say, managements are not responsible for market fluctuations, but they should take cognizance of excessively high or unduly low price levels for the shares. They have a duty to protect their stockholders against avoidable depreciation in market value--as far as is reasonable in their power--equal to the duty to protect them against avoidable losses of earnings or assets.

If this duty were admitted and insisted upon, the present absurd relationship between quoted prices and liquidating values would never have come into existence. Directors and stockholders both would recognize that the true value of their stock should under no circumstances be less than the realizable value of the business, which amount in turn would ordinarily be not less than the net quick assets.

They would recognize further that *if the business is not worth its realizable value as a going concern it should be wound up.* Finally, directors would acknowledge their responsibility to conserve the realizable value of the business against shrinkage and to prevent, as far as is reasonably possible, the establishment of a price level continuously and substantially below the reasonable value.

Hence, instead of viewing with philosophic indifference the collapse of their stock to abysmally low levels, directors would take these declines as a challenge to constructive action. In the first place, they would make every effort to maintain a dividend at least commensurate with the minimum real value of the stock. For this purpose they would draw freely on accumulated surplus, provided the company's financial position remained unimpaired. Secondly, they would not hesitate to direct the stockholders' attention to the existence of minimum liquidating values in excess of the market price, and to assert their confidence in the reality of these values. In the third place, wherever possible, they would aid the stock-holders by returning to them surplus cash capital through retirement of shares pro rata at a fair price, as advocated in our previous article.

Finally, they would study carefully the company's situation and outlook, to make sure that the realizable value of the shares is not likely to suffer a substantial shrinkage. If they find there is danger of serious future loss, they would give earnest and fair-minded consideration to the question whether the stockholders' interest might not best be served by sale or liquidation.

However forcibly the stock market may be asserting the desirability of liquidation, there are no signs that managements are giving serious consideration to the issue. In fact, the infrequency of voluntary dissolution by companies with diversified ownership may well be a subject of wonder, or of cynicism. In the case of privately owned enterprises, withdrawing from business is an everyday occurrence. But with companies whose stock is widely held, it is the rarest of corporate developments.

Liquidation *after* insolvency is, of course, more frequent, but the idea of shutting up shop *before* the sheriff steps in seems repugnant to the canons of Wall Street. One thing can be said for our corporate managements--they are not quitters. Like *Josh Billings*, who in patriotic zeal stood ready to sacrifice all his wife's relations on the altar of his country, officials are willing to sacrifice their stockholders' last dollar to keep the business going.

But is it not true that the paid officials are subject to the decisions of the board of directors, who represent the stockholders, and whose duty it is to champion the owners' interests--if necessary, against the interests of the operating management? In theory this cannot be gain-said, but it doesn't work out in practice.

The reasons will appear from a study of any typical directorate. Here we find: (a) The paid officials themselves, who are interested in their jobs first and the stockholders second; (b) Investment bankers, whose first interest is in underwriting profits; (c) Commercial bankers, whose first interest is in making and protecting loans; (d) Individuals who do business of various kinds with the company; and finally--and almost always in a scant minority--(e) Directors who are interested only in the welfare of the stockholders.

Even the latter are usually bound by ties of friendship to the officers (that is how they came to be nominated), so that the whole atmosphere of a board meeting is not conducive to any assertion of stockholders' rights against the desires of the operating management. Directors are not dishonest, but they are human. The writer, being himself a member of several boards, knows something of this subject from personal experience.

The conclusion stands out that liquidation is peculiarly an issue for the stockholders. Not only must it be decided by their independent judgment and preference, but in most cases the initiative and pressure to effect liquidation must emanate from stockholders not on the board of directors. In this connection we believe that the recognition of the following principle would be exceedingly helpful:

The fact that a company's shares sell persistently below their liquidating value should fairly raise the question whether liquidation is advisable.

Please note we do not suggest that the low price proves the desirability of liquidation. It merely justifies any stockholder in raising the issue, and entitles his views to respectful attention.

It means that stockholders should consider the issue with an open mind, and decide it on the basis of the facts presented and in accordance with their best individual judgment. No doubt in many of these cases--perhaps a majority--a fair minded study would show liquidation to be unjustified. The going concern value under normal conditions would be found so large, as compared with the sum realizable in liquidation, as to warrant seeing the depression through, despite current operating losses.

However, it is conceivable that under present difficult conditions the owners of a great many businesses might conclude that they would fare better by winding them up rather than continuing them. What would be the significance of such a movement to the economic situation as a whole?

Would it mean further deflation, further unemployment, further reduction of purchasing power? Would stockholders be harming the county while helping themselves? Superficially it might seem so, but powerful arguments can be advanced to the opposite effect.

The operation of unsoundly situated enterprises may be called a detriment, instead of an advantage, to the nation. We suffer not only from over-capacity, but still more from the disruptive competition of companies which have no chance to survive, but continue to exist none the less, to the loss of their stockholders and the unsettlement of their industry.

Without making any profits for themselves, they destroy the profit possibilities of other enterprises. Their removal might permit a better adjustment of supply to demand, and a larger output with consequent lower costs to the stronger companies which remain. An endeavor is now being made to accomplish this result in the cotton goods industry.

From the standpoint of employment, the demand for the product is not reduced by closing down unprofitable units. Hence, production is transferred elsewhere and employment in the aggregate may not be diminished. That great individual hardship would be involved cannot be denied, nor should it be minimized, but in any case the conditions for employment in a fundamentally unsound enterprise must be precarious in the extreme. Admitting that the employees must be given sympathetic consideration, it is only just to point out that our economic principles do not include the destruction of stockholders' capital for the sole purpose of providing employment.

We have not yet found any way to prevent depression from throttling us in the midst of our superabundance. But unquestioningly there *are* ways to relieve the plight of the **stockholders who today own so much and can realize so little.** A fresh viewpoint on these matters might work wonders for the sadly demoralized army of American stockholders.

Appendix:

Table 1: Some Stocks Which Are Selling for Less Than Their Cash Assets

Company	1932 Mkt. Low	($000s omitted) Mkt. Val. of Co. at L. Pr.	Mkt. Val. % Cash and Mkt. Secs.	($000s omitted) Cash Mkt. Secs.	MV %. Of CA -all Liabs.	($000s omitted) CA - All Liabs.	ML Pr. % of Cash A. /Sh.	Cash A. Per Share	MLP as % Net Quick A.	Net Quick Assets per sh.
Am. Car & Fdry Pref.	$20.25	$9,225	*61.71%*	$14,950	*46.23%*	$32,341	*40.5%*	$50.00	*18.8%*	$108.00
Am. Locomotive Pref.	30.25	14,709	*99.19%*	14,829	*65.53%*	22,630	*73.8%*	41.00	*48.0%*	63.00
Am Steel Fdry Pref	60.00	8,021	*99.69%*	8,046	*68.65%*	11,720	*46.9%*	128.00	*32.3%*	186.00
Am Woolen Pref.	15.25	8,354	*57.21%*	14,603	*35.82%*	40,769	*50.0%*	30.50	*17.9%*	85.00
Congoleum	7.00	10,078	*93.30%*	10,802	*66.32%*	16,288	*100.0%*	7.00	*58.3%*	12.00
Howe Sound	6.00	2,886	*58.78%*	4,910	*93.45%*	5,254	*60.0%*	10.00	*54.5%*	11.00
Hudson Motors	4.12	6,377	*75.36%*	8,462	*79.00%*	10,712	*74.9%*	5.50	*58.9%*	7.00
Hupp Motors	2.00	2,664	*36.82%*	7,236	*72.36%*	10,000	*36.4%*	5.50	*26.7%*	7.50
Lima Locomotive	8.50	1,581	*43.67%*	3,620	*53.46%*	6,772	*44.7%*	19.00	*23.6%*	36.00
Magna Copper	4.50	1,836	*48.69%*	3,771	*78.16%*	4,825	*50.0%*	9.00	*37.5%*	12.00
Marlin Rockwell	7.50	2,520	*65.73%*	3,834	*88.96%*	4,310	*65.2%*	11.50	*57.7%*	13.00
Motor Products	13.00	2,457	*83.29%*	2,950	*81.60%*	3,615	*83.9%*	15.50	*68.4%*	19.00
Munsingwear	10.87	1,805	*62.50%*	2,888	*50.06%*	5,769	*63.9%*	17.00	*32.0%*	34.00
Nash Motors	10.00	27,000	*73.85%*	36,560	*98.61%*	37,076	*74.1%*	13.50	*71.4%*	14.00
NY Air Brake	4.50	1,170	*79.38%*	1,474	*62.27%*	2,367	*90.0%*	5.00	*50.0%*	9.00
Opphm Collins	5.00	1,050	*52.08%*	2,016	*64.00%*	3,150	*52.6%*	9.50	*33.3%*	15.00
Reo Motors	1.50	2,716	*51.04%*	5,321	*51.50%*	10,332	*50.0%*	3.00	*27.3%*	5.50
S.O. of Kansas	7.00	2,240	*81.16%*	2,760	*61.65%*	4,477	*82.4%*	8.50	*50.0%*	14.00
Stewart Warner	2.38	3,023	*65.04%*	4,648	*55.98%*	8,303	*68.0%*	3.50	*34.0%*	7.00
White Motors	7.75	4,938	*57.29%*	8,620	*38.89%*	22,167	*59.6%*	13.00	*22.8%*	34.00

Blue Chip Performance: 1929-1932
AT&T -76.9%
Bethlehem Steel -94.8%
General Electric -97.9%
Montgomery Ward -97.5%
Nat'l Cash Register -95.1%
Radio Corp of Amer. -97.5%

http://newsfrom1930.blogspot.com/2009/06/why-this-blog-socratic-monologue_3441.html

"I would get these newspapers from 1929. I couldn't get enough of it. I read everything - not just the business and stock-market stories. History is interesting, and there is something about history in a newspaper, just seeing a place, the stories, even the ads, everything. It takes you into a different world, told by someone who was an eyewitness, and you are really living in that time." - Warren Buffett
The Snowball, A. Schroeder (Bantam), p 148

June 1, 2009

Why this blog - A Socratic monologue

*Q. Okay, why **are** you doing this blog? Are you saying we're in for a replay of the 30's?*

A. How did I know you were going to ask me that? No, I don't think things are going to get as bad as in the 30's.

Q. So you're an optimist.

A. Well, that's only mildly optimistic. I mean things in the 30s got really, really bad. For example, between 1929 and 1932, the number of cars produced declined from 4.8 million to 1.2 million ...

Q. Okay - that's pretty bad, but it's only one industry ...

A. Looking at the economy as a whole, GDP went down by 40% and unemployment went from around 3% to 24% ...

*Q. Wow! That **is** really bad.*

A. It's actually even worse than that, because back then many more people worked on farms. When you take out farm workers, unemployment hit 37% - an almost unimaginable level for us today ...

Q. You must be a blast at parties ... Well then, if you don't think we'll repeat the 30's, are you saying, in Mark Twain's words, that history won't repeat but it will rhyme?

A. Hey! I wanted to use that line!

Q. Sorry. Well, do you think that?

A. Yes. I believe 1929-1930 has a couple of important similarities to 2008-2009. First and fundamentally, there was a big buildup of debt leading up to both. This was followed by a couple of major economic problems, including many banks running into trouble and a loss in perceived wealth by lots of people. These problems in turn have deflationary implications since they lead to less credit and spending ...

Q. Could you get to the second point before I fall asleep?

A. Second, for the technical stock people, the markets in the two periods do have interesting similarities. In both, the stock markets hit a high and then had a very scary, sharp crash where the panic level was high for a short time, followed by a nice relief rally when the immediate panic abated.

In the case of 1929 this market break is what is commonly known as the Great Crash, including Black Thursday on October 24,1929, quickly followed by Blacks Monday and Tuesday on October 28 and 29. The Dow began 1929 at about the 300 level, hit a peak of about 380, and the Crash cut it almost in half to 200.

What's not as commonly known about 1929 is that the Great Crash was followed by a nice rally with the Dow almost hitting 300 again in April 1930, and, at the point where we begin this blog in June 1930, still hovering in the 270's - not that far off where it was at the start of 1929. The real damage was done in the following two years when, following a spectacular series of further declines and rallies, the Dow bottomed out at 42 - almost 90% off its peak.

More recently, of course, we had a brief period of sheer panic in March 2009 when the Dow hit the 6500's, down from a high over 14000, then had the nice rally we're currently in ...

*Q. Zzzzzz ... *snort*! Ah yes, that's all very interesting, but are there any other similarities between the two times?*

A. Umm ... homina homina ... other similarities will be left as an exercise for the reader.

*Q. Well, have you noticed **anything** interesting yet?*

A. In histories of the Depression the leaders of the time are commonly portrayed as oblivious to what was going on, do-nothing, and stupidly optimistic. For example, every schoolkid has seen the much ridiculed pronouncement by Herbert Hoover that "prosperity is just around the corner." Even from my limited reading so far it's clear this criticism is mostly unfair. It appears that the people in charge at the time were well aware of what was happening, and did most of the things that we're doing now to alleviate it (with a couple of notable exceptions). And as for unjustified optimism, we will see that at least in mid-1930 there was a fair amount of good news coming out about the economy. And I mean actual good news where things were improving month-to-month, not the asinine stories we see today where bad numbers are interpreted as good because they were "better than expected," and declining numbers are called good because the rate of decline is slowing down (AKA second derivative stories).

Q. Anything else interesting?

A. Well, I'm a history buff, especially New York history, so it's interesting to me to see a day-by-day chronicle of a pretty eventful period. Or, as Warren Buffett said in *The Snowball* by Alice Schroeder (Bantam 2008, pg. 148):

"I would get these newspapers from 1929. I couldn't get enough of it. I read everything - not just the business and stock-market stories. History is interesting, and there is something about history in a newspaper, just seeing a place, the stories, even the ads, everything. It takes you into a different world, told by someone who was an eyewitness, and you are really living in that time."

Q. I knew you wouldn't be able to go the whole interview without sneaking a Buffett quote in. Does he have you on commission or something?

A. No comment. Seriously, though, I do think you get a different feel for history seeing it day-by-day like this - less tidy, but more real. And it just might give you a useful skepticism for some of the more Panglossian commentary we're seeing today when you see that similar things were said back then - and probably with more reason!

Q. Oooohhh ... Panglossian! Fancy Shmancy! You couldn't just say optimistic?

A. So – you want to suppress the truth just like the rest of the mainstream media! This interview is over!