



## Intelligent Investing

# Inflated Treasuries And Deflated Stockholders

Benjamin Graham 06.01.32, 6:00 AM ET

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
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	\$37,500,000
Less owing for current acct's	\$1,300,000
<b>Net Worth</b>	<b>\$36,200,000</b>

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. 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 appended table 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*.

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.

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 fear of future operating losses. 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 major 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 wholesale 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 to-day 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*.

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. These will be dealt with in succeeding articles.