COMMON STOCKS AND "SAFETY OF PRINCIPAL"

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WRITERS ON INVESTMENT theory and practice seem to be almost universally agreed on the fact that one of the crucial general tests of investment quality is "safety of principal." For instance, in their outstanding work on investment analysis, Graham and Dodd make "safety of principal" an essential element in their definition of an investment commitment; the proposition is advanced that unless a commitment to securities promises such safety it is not an investment but must be relegated to the rather dubious category of a "speculation."[1]

In view of the importance thus attached to "safety of principal," it might be expected that something very precise and distinct would be implied by this incontestably desirable attribute. However, one finds that the usual discussion of the safety concept does not lead to sharply defined conclusions that may be applied to specific investment decisions. This is true to some extent in the treatment of fixed income securities, but there is an especial lack of distinct implications in the field of common stocks.

In this article it is intended that attention will be concentrated on three major questions involved in the appraisal of common stocks relative to their safety elements. First, should a distinction be drawn between "safety of principal" and "recoverability of principal"? If there is such a distinction, what is the relationship between volatility of market price and safety? Second, is it always necessary to diversify commitments to common stocks in order to obtain even a modicum of safety? If so, why is it that a commitment to a single common stock does not have the "safety" essential to classify it as an investment? Third, should "safety of principal" be interpreted mainly in the light of dollar values or should greater specific emphasis be placed on so-called "real" values when this concept is discussed as a measure of investment quality? Some of these questions have been discussed by investment authorities under various topical headings, but to my knowledge they have never been specifically considered as a whole when the focus of attenton was on "safety of principal" as a general test of investment quality.

1. B. Graham and D. L. Dodd, *Security Analysis* (Second Edition, New York: McGraw-Hill Book Co., 1940), pp. 63–64.

On the whole it does not appear very enlightening to define a safe stock as one which in all probability will be "worth" the price paid for it.[2] To be very useful as either a theoretical or practical definition it would seem obvious that it is necessary to remove the ambiguities pertaining to the critical word in this definition: "worth." Without attempting to appear dogmatic on the subject it may be conjectured that the ordinary purchaser of securities would be inclined to identify "worth" and market price. This is not to say that minor variations in market price would have disturbing implications as to "worth" and resultant safety, but if any material depreciation ensued in the market price after purchase (say 30 per cent), then the average investor might be hard pressed to imagine that the stock was "worth" the price paid. The natural conclusion from this general identity: any stock having a volatile price history and therefore vulnerable marketwise could not properly be classified as an investment promising safety of principal. And as a large number of common stocks have been unstable pricewise, the field of investment in common stocks (requiring by definition "safety of principal") would thereby be drastically limited unless some method could be suggested to offset the possibility of unsatisfactory price experience.

It is probably fair to state that the most common technique introduced by investment practitioners to minimize variations in the market value of a portfolio is diversification. Orthodox practice involves investment operations in common stocks (as presumably contrasted to speculation) being limited to group operations involving industry and company diversification before even the semblance of safety is achieved. Along this line Graham and Dodd state that "instability" of common stocks requires the "investor" to commit funds to common stocks only if a diversified group can be obtained.[3] However, in fairness to the authors it must be pointed out that it is not entirely clear if cyclical "instability" is the crucial factor or if "instability" in "value" due to unpredictable secular developments is of prime importance.[4] The latter factor relates mainly to shortcomings in the valuation process which are discussed below rather than to variable cyclical prices with long-term "values" presumably remaining constant.

It is certainly not my purpose to deplore diversification, which is obviously a desirable attribute of any security portfolio, but strictly interpreted it means that no individual can embark on an "investment"

2. *Ibid.*, pp. 63–64.
3. *Ibid.*, p. 362.
4. *Ibid.*, pp. 345–48. However, it might be noted that in this discussion the tendency for common stock prices to fluctuate more widely in recent years is used to indicate the increasing "instability" of common stocks.

in common stocks until sufficient funds are available to make possible the acquisition of a considerable number of issues.[5] It is thus implied that the investor will avoid common stocks until the funds at his disposal are relatively large, or possibly he may turn to the investment funds or perhaps to insurance companies which by themselves have diversified portfolios. But even a cursory review of the price histories of the shares of investment funds or insurance companies will reveal that price volatility is not avoided by purchasing a share in one diversified portfolio of such a company. In my opinion the divergent records of these companies make the case for diversification almost, if not equally, as strong when the shares of these companies are acquired.

Recently, however, Mr. Graham has convincingly argued that the "safety of principal" of funds intrusted to common stocks is not impaired by market fluctuations.[6] If we accept his argument, then "safety" should be carefully and completely divorced from "recoverability" or liquidity. In view of its importance brief attention might be devoted to the hypotheses underlying the logical separation of "safety" and market price. His conclusion seems to be based on two fundamental assumptions with respect to the nature of an investment operation. First, it is assumed that liquidity is not an integral feature of an investment in common stocks. It should be specifically recognized by the investor that if there is a reasonable possibility that he may have to recover a significant segment of his principal for use elsewhere at unpredictable times in the future, then an investment operation in common stocks is not advisable. But in lesser degree the same recommendation holds true for any commitment to securities outside of high-grade short-term bonds or government savings bonds.

Second, it is assumed that an investment in common stocks is made only after an intelligent and objective valuation has been formulated and that the price paid for a stock does not exceed the valuation so determined. Then so long as the investor's judgment regarding the valuation remains valid, the principal committed to the stock is "safe" irrespective of market aberrations. From this argument it follows that if stocks are bought without reference to a systematic valuation process or if the prices paid exceed the valuation estimates, then the principal committed to such stocks is "unsafe" by the difference between the valuation price and the purchase price.

5. See R. E. Badger and H. G. Guthmann, *Investment Principles and Practices* (New York: Prentice-Hall, 1941). Common stocks are held less suitable to the small investor because of the absolute need for diversification. It is also held that the "largest possibilities" of principal losses arise out of the cyclical price movements of common stocks (pp. 265–69).

6. B. Graham, *The Intelligent Investor* (New York: Harper and Bros., 1949), pp. 41–46, 78–80.

As a theoretical approach to "safety of principal" of common stocks, this argument seems to have considerable merit. It warns the investor that he may expect the market value of his portfolio to deteriorate below cost at any time. But it further makes clear that so long as no untoward event intervenes to vitiate his appraisal of the long-term prospects he has all the essential elements of "safety." The main difficulty which seems inherent in this approach is the assumption that objective and intelligent valuations of common stocks can actually be made in practice.

What are the obstacles to the valuation of common stocks? In the first place our economy is dynamic in character. This means that there are constant secular changes affecting industries and companies. New products and services are developed which render obsolete the demand for established products and services. There may be no public knowledge of these new products and services until they appear on the scene and modify or destroy the value of companies engaged in the production of competing goods. Obviously the valuation process cannot be expected to foresee all possibilities of secular decline in the positions of the companies analyzed. No matter how refined investment techniques become the valuation process may be vitiated by such developments.

But this source of "risk" leading to lack of safety should be appraised in its proper perspective and scope. As to perspective, it might be noted that other long-term "risks" might be equally significant relative to the real value of the principal and they cannot be ignored in any well-conceived investment operation. The risk involved in the long-term value of the unit of account has perhaps received the most attention in recent years. As to scope, it might be pointed out that many years ago Edgar L. Smith showed that such risks cannot be avoided by concentrating in high-grade corporate bonds.[7] If an industry encounters drastic secular adversity, bondholders of companies within that industry can expect losses almost commensurate with the stockholders of the same companies. Bankruptcies brought about by the obsolescence of products are hardly ever happy to the investors concerned regardless of the type of security held. In other words, no corporate security is immune to the secular risk as bondholders of the transit companies might testify.

The second main difficulty encountered in the valuation of common stocks lies in the fact that the value of a common stock is dependent largely upon an estimate of "earning power." It is at this point that there is a fundamental difference between the approach to fixed income securities and common stocks which makes the analysis of common

7. E. L. Smith, *Common Stocks as Long-Term Investments* (New York: Macmillan Co., 1924), pp. 94–98.

stocks immeasurably more difficult than bonds or preferred stocks. With the latter it is only necessary to be reasonably convinced that the earnings protection afforded the interest or dividend coupon is going to be *adequate* in the future. In a great many cases the analyst can be reasonably convinced of this adequacy from an inspection of the past record. But in the case of common stock it is not sufficient to conclude that future earnings are reasonably certain to be adequate. It is necessary in addition to attempt the derivation of some estimate of the actual future *level* of earnings.[8]

For example, if a company has $2 million of interest charges and if "earnings available for fixed charges" has varied over the past decade or so between $10 million and $20 million, a conclusion might well be reached that the bonds of this company deserve a high-grade rating and a resultant value as a "money" bond. It makes little difference whether future earnings average $10 million or $20 million so far as the status of these bonds is concerned; in either case they would merit their high-grade rating. However, it makes a great deal of difference to the value of the common stock. If earnings are expected to average $10 million then a much lower value would be placed on the common equity than if the estimate was set at $20 million.

Various analytical techniques have been suggested to estimate "earning power." Perhaps the most widely used is that of the arithmetic average of past earnings over at least one complete business cycle. Such a solution might be the best available expedient, but implicit in this technique is the assumption that the pattern of cyclical fluctuations in business in the future is going to resemble the pattern of the decade or so covered by these average figures. This crucial assumption is of course one which is very tenuous and can be supported only by references to historical precedents. The use of the simple arithmetic average of past earnings as the quantitative indication of earning power also ignores the factors of trend and possible structural changes in the company and in the economy as a whole. To give effect to those matters more emphasis may be placed on more recent earnings or additional refinements of technique may be adopted. But no matter how elaborate the statistical technique, the "earning power" estimate in many cases cannot be resolved with any degree of confidence.

Thus while in theory common stock investors can obtain safety of principal by purchasing stocks at prices at or below their reasonable values, in practice such safety is difficult to obtain because of the uncertainties involved in many cases in the valuation process. But at this

8. See G. W. Dowrie and D. R. Fuller, *Investments* (New York: John Wiley and Sons, 1950), p. 270.

point the principles of diversification are again introduced. Here we are not attempting to protect the investor against cyclical movements in stock prices resulting from variations in the business outlook or from short-term changes in the relative positions of various industries. Instead, the main objective of diversification is to protect the investor against the possible errors inherent in the valuation process. A rather crude "law of averages" is applied. Presumably the possibility of overestimating a single company's future earning potential will not be disastrous to the over-all principal value, and besides, favorable results may accrue from underestimating the potential of other companies. In this way the over-all principal value of the portfolio may be regarded as reasonably safe.

But it would also seem to follow that if the investor can be unusually confident of his earning-power estimate and resultant value, there is a lessened need for diversification to obtain safety of principal. Also the suggestion might be offered that if the price of a stock is materially below any conservatively estimated value, there is less need for diversification because the estimate of earning power has a very large "margin of safety." Let us examine each of these possibilities in turn.

While admittedly not typical, it is possible that the analyst may have a very high degree of confidence in the earning-power estimates of certain companies. The required characteristic of such companies would be the indication of exceptional prospects of stability both in a cyclical and secular sense. From a quantitative standpoint earnings should vary in a relatively narrow range about the average, and the secular trend (if any) should not be unfavorable. From a qualitative standpoint the company's products should appear to have an inelastic demand in both a price and income sense, and competitive conditions should be orderly. Conservative financing and reasonable control of costs should be indicated. Specifically certain enterprises engaged in industries such as banking, food production and distribution, tobacco, and electric power might well meet these requirements among others.

But even under conditions where substantial confidence can be placed in the estimates of earning power, there is a further requisite before safety of principal is obtained. The price of the stock must be in reasonable relationship to the estimated earnings. However, the question immediately arises as to what benchmark may be applied to determine whether the price is reasonable relative to earnings. In brief, the problem can be stated in terms of the orthodox and familiar "capitalization rate." Unless some guidepost exists to limit the "capitalization rate" to reasonable proportions, safety of principal cannot be obtained.

It is at this point that the "margin of safety" concept, developed by

Benjamin Graham in his most recent book, provides the basis for a solution. In brief, "margin of safety" relates the earnings yield (based on estimated earning power) of a common stock to the yield obtainable on high-grade bonds. Graham suggests that the earnings yield on a stock should be at least twice bond yields before the "margin of safety" is adequate.[9] In other words, if the bond yields are roughly 3 per cent, then safety of principal is obtainable only if the capitalization rate is 6 per cent or higher. Put in terms of the more familiar Price-Earnings ratio, the maximum P/E ratio which can prevail and still obtain safety of principal, when bonds are yielding 3 per cent, would be 16.6.[10] A theoretical definition of a "safe" stock is thus suggested: safety of principal is achieved when the earnings yield based on a conservative appraisal of earning power is at least two times high-grade bond yields.

Now, like any other investment standards or techniques, interminable debate could be devoted to the question as to whether or not a "margin of safety" of two is adequate or whether it should be less or more. But the same sort of debate is possible with respect to standards of bond selection, such as whether the "times charges earned" ratio should be two, three, or something else before reasonable safety is achieved. While the matter cannot be termed unimportant, it is obviously a moot question not subject to mathematical solution but dependent upon empirical judgments. Merely as a matter of judgment, it would seem that Graham's suggested "margin of safety" of two is reasonably conservative.

Actually the "margin of safety" approach seems to be an extension to common stock valuation of the "times fixed charges earned" technique used to appraise fixed-income securities. And because it applies quantitative limitations to the investment values of common stocks, this concept or something reasonably related thereto must necessarily be used in common stock valuations. But because of this apparent close relationship with an important technique of bond analysis, at least one important problem is raised which is pertinent to the question of safety of principal. In the case of bonds it seems eminently reasonable to hold that the safety of a bond is jeopardized when and if the average earnings coverage of fixed charges falls below say three times in the case of an industrial company. In this way a "safe" commitment may become "unsafe" *before* earnings have declined to a point where they are just equal to bond interest requirements.

Thus, only if the analyst felt that a *very* high degree of confidence could be placed in the estimate of earning power would a capitalization

9. Graham, *op. cit.*, p. 255.

10. Dowrie and Fuller, *op. cit.*, suggest a P/E ratio of 15 or an earnings yield of 6.6 per cent, but this figure is rather arbitrarily selected (p. 515).

rate of only two times the bond yield rate be justified. Presumably such a company should indicate on all counts either considerable stability (both from a cyclical and secular point of view) or a definite upward secular trend before the minimum "margin of safety" (two) could be held to promise safety of principal. But if the common stock of such a company could be bought at say twelve times the estimated earning potential or on an earnings yield basis of 8.3 per cent, which would give a "margin of safety" of almost three at the present time, it is my feeling that such a commitment alone would promise safety of principal sufficient to classify it as a true investment.

To make this discussion more concrete two examples might be cited of such stocks: Liggett and Myers Tobacco Company and Central Hanover Bank and Trust Company. The table below shows the earnings and dividends per share of these two companies for the years 1936–41 inclusive and 1946–49 inclusive, and the price range of the stocks over the years 1948–49. The range of earnings of the obviously less indicative war years is also shown.

	Central Hanover Bank and Trust Company			Liggett and Myers		
Year	Earnings*	Dividends	Price	Earnings	Dividends	Price
1936.....	6.50	4.00	.....	7.25	7.00	.....
1937.....	7.50	4.00	.....	6.35	6.00	.....
1938.....	5.01	4.00	.....	6.09	5.00	.....
1939.....	5.15	4.00	.....	6.13	5.00	.....
1940.....	6.24	4.00	.....	6.02	5.00	.....
1941.....	6.31	4.00	.....	5.22	5.00	.....
1942–45....	5.76–8.79	4.00	.....	4.25–4.50	3.50	.....
1946.....	8.04	4.00	.....	5.40	4.00	.....
1947.....	6.68	4.00	.....	6.80	4.50	.....
1948.....	6.86	4.00	81 – 98	8.80	5.00	82–91
1949.....	6.52	4.00	82½–102	7.20	5.00	72–91

* Gains on sales of securities excluded.

The quantitative stability indicated by the reported earnings can be supported on qualitative grounds. Central Hanover, a large money market bank in New York, derives its earnings from government bonds and a diversified loan portfolio and its earnings are largely functions of the volume of deposits, money rates, and reserve requirements. However, as the first two of these factors are not subject to drastic change and as the reserve requirements in recent years have been relatively near the peak allowed by existing law, the risks associated with the earning power seem relatively negligible. It also might be pertinent to note that the book value of this stock was in excess of $125 per share at the end of 1948 and is still larger today. If this stock had been purchased about midway in the price ranges of 1948–49 or at about 90, the

earnings yield based on average earnings of $6.70 a share would have been 7.33 per cent and the dividend yield 4.4 per cent. The "margin of safety" thus indicated would have been about 2.5 times conservatively computed by estimating high grade bond yields as 3 per cent. Only to the extent that the earning power of Central Hanover might be materially less than about $5.50 per share in the future would the principal be unsafe at a price of 90, and the apparent remoteness of this possibility is a reflection of the safety of an investment in this stock at 90 or below.

Liggett and Myers occupies a strong position as one of the "Big Three" in the tobacco industry with its main revenues dependent upon the sale of a product which can be classified as a low-priced consumer good having an inelastic demand. Costs are largely a function of the price of raw tobacco and large inventories are required. Some risks are associated with the large inventory commitments and the resultant senior capital used to finance the inventories. However, as the *minimum* coverage of fixed charges over the past thirteen years has exceeded three times and as prices have been adjusted on an orderly industry-wide basis to rising costs of tobacco, the business and financial risks seem relatively moderate. At a price of about 80 or eight points above the 1949 low the stock would indicate an earnings yield of 8.1 per cent on average earnings over the years 1936–41 and 1946–49 inclusive. The "margin of safety" thus shown would be 2.7 times, and earning power would have to decline below $4.80 per share before the safety as defined above would be questioned. Outside of the war years earnings in every year from 1935 to date have exceeded $4.80 per share which roughly appraises the possibility of this contingency.

In addition special commitments might be made in less stable common stocks during periods of depressed market prices which can satisfy the foregoing definition of safety of principal without requiring diversification. At such times the current outlook for business would undoubtedly be dismal and the investor's liquid funds available for investment might well be limited. To hold that the investor should refrain from apparent bargains in common stocks unless he has sufficient funds to acquire a diversified portfolio would in many cases negate the opportunities presented by such markets. This observation, of course, rules out the possibility that a diversified portfolio is already held at the time the opportunities offered by the depressed market presents itself.

Under the conditions envisaged, the market prices of many stocks would be strongly influenced by transient emotional factors or by a large floating supply contributed by owners hard-pressed for liquidity. The market deterioration following the outbreak of the war with Japan

and Germany in 1942 might be offered as a specific case in point; the 1932 debacle is perhaps another instance. Under these circumstances seasoned stocks of large, well-established companies may be available at prices wherein the "margin of safety" based on an objective long-run appraisal of earning power is ridiculously large. In these cases it might even be apparent that the need to estimate the *actual* level of future earnings described above as a typical element in common stock valuation becomes less necessary. Here the investor-analyst might well reach the conclusion that while the absolute level of future earnings is most difficult to predict with any degree of confidence, it would be extremely unlikely for the company's average earnings to be less than that required to maintain an earnings yield of at least two times bond yields on the cost of the stock. Let us imagine a well-established company, conservatively financed, selling at only four or five times average earnings over a long-term period. At the time in question the current earnings of the company might be negligible, but the purchase of this stock in and of itself might well promise reasonable safety of principal as defined above and thus meet a basic test of an investment operation.

The approach to situations of this kind might thus be somewhat negative in character: determine the lowest earning power that would give a "margin of safety" of two times bond yields and objectively inquire as to whether such a low earning power could reasonably be expected in the future. Let us adopt this approach in the analysis of two large companies as of 1942. Shown below are the earnings and dividends of Sears, Roebuck and Company and Firestone Tire and Rubber Company over twelve and thirteen years respectively prior to 1942.

Sears, Roebuck and Company		
Year	Earnings	Dividends
1929	6.62	2.50
1930	3.01	2.50
1931	2.47	2.50
1932–33	(d) 0.53*	1.25
1934	2.35	....
1935	3.13	....
1936	4.45	1.75
1937	5.60	6.25
1938	5.58	5.50
1939	4.18	3.00
1940	6.60	4.25
1941	6.32	4.25

*Fiscal year changed to January 31.

Firestone Tire and Rubber Company		
Year	Earnings	Dividends
1929	3.27	2.00
1930	(d) .65	1.45
1931	1.26	1.00
1932	1.07	1.00
1933	(d) .21	.55
1934	.71	.40
1935	1.53	.40
1936	3.28	1.40
1937	3.33	2.00
1938	1.27	1.25
1939	2.03	1.00
1940	3.02	1.25
1941	4.37	1.50

Both of these companies were well intrenched in their respective industries and showed no evidence of a secular decline; they both had a long record of profitable operation and no serious difficulties were en-

countered during the depression with respect to securities senior to the common stock. Dividends on Firestone common had been paid in every year since 1910 and while Sears had omitted payments in a few years, the interruptions were not of long duration. However, it is notable that the earnings of both these companies had varied over a relatively wide range. But, counting earnings in the years in which small deficits were incurred as zero, average earnings were about $4.20 per share for Sears and $1.93 for Firestone. Admittedly average earnings are less significant when the variation about the average is relatively great. However, as the years covered were weighted by the inclusion of the "Great Depression," the use of average earnings as a point of departure for the estimation of earning power may be regarded as eminently conservative.

In the latter part of 1941 and/or early 1942, Sears was selling at 43 and Firestone at 13. Such prices indicate an earnings yield on average earnings of almost 10 per cent on Sears and 15 per cent on Firestone. The "margin of safety" was thus more than three times bond yields on Sears and about five times on Firestone. Before the "margin of safety" would be less than two times bond yields on Sears the earning potential would have to be written down to about $2.50 or about what was earned in the depression years of 1931 and 1934. Logically it would seem very doubtful in spite of the war and the unknowns associated therewith if the future earning power of Sears could have reasonably been placed at no better than earnings realized during two years of extreme depression. The earning power necessary to produce a "margin of safety" on Firestone of only two times bond yields at a price of 13 would be about $0.80 per share. This was less than was actually earned in 1931 and 1932. Again while the actual prediction of the future earning power of Firestone would have been difficult in 1942, it would also be most difficult to imagine that it would be less than that required to give a "margin of safety" of at least two times bond yields. If this is true then reasonable safety would be achieved by a commitment to either stock by itself at prices then prevailing.

Market circumstances such as the foregoing are only infrequently encountered; and stocks possessing the necessary stability of earnings along with a price which will obtain the necessary "margin of safety" are admittedly not typical of the great majority of common stocks. But at the same time these cases might well be of sufficient importance to warrant a qualification of the generalization that *only* diversified group purchases of common stocks can qualify as "investment" commitments.

Finally the question might be raised as to whether the safety of prin-

cipal test should give greater attention to "real" values as opposed to "dollar" values. Back in 1924 Smith pointed out that the safety of bond investments was largely illusory when allowance is made for possible erosion in the purchasing power of the dollar.[11] This is an incontestable theoretical concept. But possibly in order to avoid undue complications at the time when fundamental investment tests or policies are considered, many texts on investments seem to imply that dollar safety is the primary objective.[12] In later sections of some of these books the question of the "purchasing power risk" is introduced, sometimes rather reluctantly, as a matter of concern in the establishment of an investment policy. This treatment seems rather inconsistent. If an investor is conditioned to seek safety of principal in dollar terms as a basic objective of an investment operation, how logically can he be informed at a later point that this objective must be abandoned in part in formulating an intelligent investment program?

Unfortunately experience suggests that there is no known way whereby the investor can achieve assurance of safety of principal in real terms out of income-producing investments. But this fact does not reduce the importance of the problem. Furthermore, the principal of a bond portfolio is obviously not safe in real terms if there is any reasonable prospect that the value of the unit of account will be subject to future depreciation. In the case of common stocks this easy generality cannot be made, but it is also impossible to predict with any degree of assurance that the earning power of common stocks will have a direct correlation with price levels and thus that their dollar value (not necessarily price) will also be a partial function of the price level prevailing through time. Nevertheless without going into the matter in detail it has been alleged that the earning power of certain types of companies is likely to vary directly, although not necessarily proportionately, with variations in the price level. Thus if a significant and permanent depreciation was apparent in the value of the unit of account, there would be reason to establish a somewhat higher valuation on such stocks thereby increasing the dollar valuation of principal. Unfortunately the type of stocks which are usually thought of as having their earning power dependent upon price levels in part, i.e., "commodity" stocks such as oils and coppers, are also subject to wide cyclical variations in earnings and thus at the outset their valuations are more difficult to appraise. As a result, while safety of principal might be protected in real terms by such commitments, a larger "margin of safety" would be required because of

11. Smith, *op. cit.*, pp. 92–100.

12. See for example D. F. Jordan, *On Investments* (Fourth Edition, New York: Prentice-Hall, 1941), p. 251. Also Graham and Dodd, *op. cit.*, pp. 63–64; Badger and Guthmann, *op. cit.*, pp. 87–88.

the inability of the analyst to predict any level of earning power with confidence.

The assumption that there are companies whose earning power is a function of price levels has not been definitely proved; additional empirical research in this area undoubtedly is desirable. However, even if convincing proof is lacking on the subject, it might be suggested that a more consistent application of the purchasing-power theory to the safety concept would in general tend to reduce the difference ordinarily alleged to exist between bonds and stocks at this point.

In brief it is held that investment texts ought to give more emphatic recognition to the fact that principal losses in real values are suffered in bond investments when a structural change depreciates the value of the unit of account. It is further held that only if this qualification is specifically made does the safety of principal objective have any meaningful implications to the individual investor under conditions of recent years wherein the value of the dollar seems to be willingly sacrificed to various political and social objectives of the government.

To some extent it is unfortunate that "safety of principal" has become such a universally accepted cliché in discussions of investment principles and practices because it is quite likely that casual use of the phrase will have widely different meanings to various investors. Some might well regard "safety" as being synonomous with "recoverability," and thus limit their conception of "safe" investments to those promising dollar stability of market price. Others might think of "safety" strictly in dollar terms wherein it becomes more or less identifiable with assurance of continuity of income. Still others, taking a broader view, might well take the attitude that "safety" cannot possibly be achieved in any absolute sense in view of the wide range of risks that confront the investor in the real world. From this viewpoint "safety" becomes an illusion, and the investor is well advised to forget the phrase and spell out his objectives with a greater degree of precision. But inasmuch as "safety of principal" has become an integral part of the jargon of investment theory and practice, it is felt that various aspects of its meaning and implications deserve greater attention by writers on the subject of investments.