INVESTMENT STRATEGY IN A MODERN WORLD

Remarks by Bosworth M. Todd, Jr., President
of Todd-Boston Company, Inc., to the Lexington
Kiwanis Club on May 16, 1968.

The typical investor today is worried about the economy, disturbed by the lacklustre performance of his portfolio and confused as to how to solve this problem. I hope to share with you some of the observations of the investment scene today in the hope that it will be of some benefit to you in investing for the future.

First, I would like to discuss some of the problems our economy faces; second, discuss why, in spite of our economic problems it's misleading to be necessarily bearish on the stock market, and finally discuss what investment strategy all this implies.

We can find disturbing signs in our economy. It's not important to look at the rapid growth in GNP and FRB index, etc., we all expect these figures to rise. We are living in an economic euphoria, as Pierre Rinfret puts it; we face the most grave economic period of the postwar, basically for five reasons:

1) Our balance of payments situation is worse. Our trade surplus formerly offset much of our government deficit in our balance of payments deficit. Now that the trade surplus has vanished, in fact the fourth quarter 1967 rate was a $2.1 billion trade deficit, our total of balance of payments deficit is likely to exceed last year's $3.5 billion red figure. The problem is I don't think Europe will give us much over another six months to begin solving our balance of payments problems before she begins cashing in dollars for gold once again.

Inflation is getting worse. The 4-5% rise in the consumer price index currently compares with a 2% annual gain in the postwar period thru 1965. 1967 labor agreements averaged 6% wage increases plus a cost of living improvement, which gets it up over 8% a year.

Tight money is getting worse. Since we have had no restraint on Government spending, and no tax increase to pay for the rising government deficit, the burden has fallen on the federal reserve to cope, as best as possible, with the above problems. So now we have 6% governments and negative reserves in the banking system. We have a $25 billion federal deficit coming up next year but since no central bank has ever refused to allow its country to finance a war, it's being financed and it's inflationary. We now have a combination of rising interest rates and disintermediation is resulting - this is do it yourself saving. The Savings and Loan Association, for example, were taking in deposits at a $28 million annual rate last October, and their deposit gain is down to a $16 billion annual rate. So it's only a matter of time before housing will be hurt, and in time, capital spending will also slow down.

So the lag effect of the recent monetary policies will hurt us later. it takes a few months for a monetary policy to take effect. We are still riding on the benefits of the relatively easy money policies of 1967. The impact of the

recent tighter money policies will not be felt until the end of this year. Since we'll have a new President in '69, he'll have to deal with the problems of rising Government spending and the problems of the lag effect on the economy of tight money.

The problem is simply that we have piled onto a full employment economy in 1965 a major war escalation in Vietnam without making decisions on re-allocation of our priorities. We cannot, by definition, get anything more from the economy. Something has to give. We are paying the tax of this war, an inflation tax, cruelest of all, and it creates another bill later, a recession with unemployment and lower corporate profits. A partial remedy, tight money, which we have also, has an economic impact but coming with a lag, there is no free lunch; we can't have both guns and butter unless we have un-utilized resources of men, money, and materials to draw upon. It's a problem we can solve, and in fact, did solve in the late 50's, and it's time we began once again to recapture lost ground.

<u>In spite of these economic problems surprisingly enough it's misleading to be bearish on the stock market</u>. The economy and the stock market are two different things. There will be a continuing struggle between our desire to own stocks and the confused economic fears we face. In a way we are having a schizoid market in a highly illogical economic climate but I think it will continue. I'm not as worried about the stock market as perhaps I should be for one very important reason: There is a huge demand for stocks and a very limited supply. The productivity of capital as an investment motive is more important today then preservation of capital. Growth, rather than income, is the main investment objective of investors now. It is interesting to note that the total market value of a recently offered Kentucky nursing home chain is greater than the market value of the outstanding stock of the second largest bank in the state. There is more interest in stocks of smaller companies than in the large, well known names. Bonds have fallen into disfavor. 60% of the analysts and 40% of the security salesmen on Wall Street today, according to Bill Grant of Smith Barney, were not even in the securities business in the 1962 market. Aggressive investment policies are being followed by many institutions today - not only the mutual funds and hedge funds but also the large banks and pension funds. Insurance companies, not content to lose their share of the market for the saver's dollar, are getting into the mutual fund business and investment counsel business in a big way. Continental Casualty, now known as CNA financial, has just acquired the TSAI Management Company, which manages the $500 million Manhattan Fund.

If but 1% of the bonds held by institutions today were switched into stocks this sum, $6 billion, is 3 times the $2.0 billion of the supply of new stocks offered in a year's time. In addition mutual funds have been net buyers of $1.6 billion of stocks in the past year and pension funds are investing $5.0 billion in a year in stocks.

Therefore while economic problems may post problems for corporate earnings for a year or so, it will not necessarily hurt the stock market. It could simply mean higher price earnings ratios in view of the chronic shortage of the supply of stocks.

So how does the prudent investor react to this changing environment? We have seen how the productivity of capital is of greater concern to the investor than is its safety. Higher rates of inflation and taxes exact their greatest toll from the investor of bonds and preferreds. A 6% preferred, for example, for a couple with a $12,000 taxable income, is but a 4 1/2% return

after taxes. With the purchasing power of the dollar declining 4% a year, this leaves practically zero in terms of real dollars after taxes.

Yet purchases of the traditional list of leading common stocks in basic industries will not necessarily prove rewarding in this changing economy. Slower growth rates, excess capacity, price erosion, rising labor costs, and higher interest rates have had their impact on these stocks. The Dow Jones industrial average, for example, is no higher now than it was four years ago. It's up 5% to be exact. The yield on these stocks is about 3 1/4%. Meanwhile the New York composite of all big board stocks has risen 17% in this same 4-year period. The American Stock Exchange index, comprised mainly of smaller companies, but it nevertheless encompasses all stocks on this exchange, has risen 155% in this same period. The over-the-counter stock index amazingly enough has shown no interruption in its uptrend in the past year, and, in fact, is up 70% since January 1967.

What the above figures indicate is the relative market strength of stocks in smaller companies, reflecting among other things a growing willingness on the part of institutions to sacrifice the liquidity in the hopes for greater than average gain by investments in small, though less marketable, companies.

This does not mean we abandon the American telephones, the Du Ponts, the Standard Oil of New Jerseys, although many investors wish they had a few years ago when they were selling 40-50% higher than they are now. It does mean, however, that we include in our portfolios stocks of smaller companies where an analysis of the record, an investigation of the management and an appraisal of their future demands suggest earnings per share should grow on the order of 15-20% a year. Unfortunately, many such issues have been bid up recently to very high levels but this does not nullify the concept, it just makes the task of selection that much harder.

How does the investor in Kentucky go about such a task of rearranging his portfolio? First of all there are 150,000 stockholders in Kentucky and 150 registered representatives of New York stock exchange firms - about 1,000 stockholders per broker if you will. The average investment per stockholder, according to the Department of Revenue in Frankfort, is about $50,000.

A mutual fund is an ideal investment vehicle for the person with a few thousand dollars. Investing money is a full-time job and should be done for you professionally. Incidentally, there are more new mutual funds now in registration with the SEC than there are mutual funds in existence. This is an amazing fact that I just learned recently. Mutual funds are a popular investment medium. Bill La Tourette, President of the Johnston Fund, a no-load fund affiliated with my parent company, told me last week that the number of HR-10 pension plans for self-employed being opened by his company is amazing.

Many substantial investors with the assistance of competent brokers achieve quite satisfactory results investing on their own. I'm afraid many others, however, if they take the time to measure the performance of their own account, say over the past three years, would find that they have a problem of sub-standard performance, as compared with the Dow Jones average.

Then too, many investors have, to their dismay, found that the losses which they have incurred in the bond portion of their portfolio have offset much of the gain in their stock account. High grade, long term, corporate and municipal bonds have declined about 20% in value since the end of 1964, reflecting the impact

of tight money. It wouldn't surprise me to see Kentucky Municipal Bonds offered on a 6 1/2% basis in the not too distant future. Some recent Kentucky Municipal issues offered on a 5 1/2% basis are not moving well. If we get the kind of yields I'm predicting this means the fair market value of your 3 1/2% school bonds, purchased at par a few years ago, will be worth about 65¢ on the dollar. The irony of this is that investors who have been buying bonds did so in an effort to maintain safety of principal as much as to obtain income.

In summary we favor common stocks over bonds, and we look favorably upon companies, particularly smaller companies, which demonstrate the ability to maintain or increase their profit margins as a per cent of sales. These are usually companies where because of their technological advances or unique management skills have been able to create markets for their products or services which to some extent insulates them from the rigors of price competition. In an inflationary period profit margins for the average company are squeezed by rising labor and raw material costs. There is only a limited number of companies providing a hedge against inflation - companies whose profits rise at least as fast as inflation. The emphasis is on the ability to raise profits.