Do Old Investing Rules No Longer Apply?

Do the old rules no longer apply? Can you live on corporate earnings alone? Is ignoring your margin of safety advisable?

It turns out, unsurprisingly that the answer to all these questions is no. Back in November of 1997 I wrote the following (my emphasis added in bold):

> ### *Ben Graham's Margin of Safety*
>
> *Graham died in 1976, yet his wisdom is as fresh as if he were standing before us today. Ben Graham & Co.'s advice to investors is to evaluate a stock as if you were considering buying the entire company. Graham's secret of sound investing can be distilled into three words—margin of safety.*
>
> *Why am I focusing on Graham's margin of safety? Because we are all happy as sin with the stock market advances of recent years, but I don't want you to lose perspective. When I was in the institutional brokerage business with Model Roland & Co. in the early 1970s, the Dow fell by 44% in just two years. As bad a year as 1973 was—the Dow fell over 16%—it was only a warm-up for 1974. In 1974, the floor caved in. The Dow plummeted over 27%.*
>
> ### *Sixteen Years of Falling Stock Prices*
>
> *Investors tend to be a little myopic. Many investors are terrific at extrapolating the past into the future. These misguided souls are not investors at all. Rather, they are speculators. Do you know that the Dow was actually down 10% over a 16-year period from its starting point in 1965 to year-end 1981? Do you realize that the yield on the Dow today is less than 40% of its historical average? Stocks are paying an*

average of only 1.7%, versus the historical average of 4-1/4%. ***But it’s a new era, you’re thinking. Things are different today. With the Dow at 8100, the old rules no longer apply.***

Well, I can tell you for sure, when you’re not getting paid to invest, you’re not getting paid. Pure and simple. Today’s common-stock investor is plunking down his hard-earned money and, in effect, saying, “I will take my gains on the come. Don’t worry about paying me anything today.” It’s the greater fool theory, not investing. I can give you lots of reasons why yield is low today. In the end, you can still say to me, reasons schmeasons, I’m not getting paid! And you would be right.

OK, it is clear that investors are not being paid, but what about corporate earning power? Don’t earnings control stock prices? ***As far as I know, you still can’t pay your telephone bill or mortgage payment with earnings. Dividends yes—earnings no.***

…

I invest my own money for the long term, and I do not trade or speculate. My portfolio turnover is lower than an index fund’s. The awesome power of compound interest, along with low turnover, taxes and commissions, and a lot of time do wonders for any portfolio. It’s exactly the strategy I write about and advise for you. But even if you are faithfully committed to the long-term power of compound interest, you need to tinker and prune. ***You want to invest newly available money with an eye toward current market conditions and Ben Graham’s concept of a margin of safety.***

All of what I wrote then applies today. Over the last few days investors have been shocked to see some of their favorite stocks getting hammered by events unrelated to earnings. Facebook is facing legal troubles. Amazon is looking down the barrel of federal regulation. Tesla has been rocked by the crash of one of its self-driving cars.

Prices of shares have dropped and could fall further in reaction to their troubles. What will investors be left with? Certainly not a steady stream of dividends.

In 1997, when I wrote the piece above on Ben Graham’s margin of safety, the P/E ratio of the Dow Industrials was 21.2, and its historical range had been from 6 to 24. It would eventually peak in 1999 at 44.2, before crashing back to earth in the dotcom bust. Today’s P/E of 24.75 is higher than the historic average for the Dow, but nothing like the dotcom era.

Higher valuations demand justification. If you can’t rely on your money ever being returned to you in the form of dividends, and instead you plan on selling shares to a greater fool in the future, that’s no justification at all. You need a margin of safety. A steady stream of dividends used to generate compound interest is that margin of safety. Invest accordingly.

Originally posted on March 30, 2018.