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## THE TEMPLETON LETTER

Thoughtful students of investment values may enjoy re-reading today this article we sent to all clients and others four years ago, because it discusses forces recently receiving more attention by Wall Street writers. (TD&V - August 8, 1958)

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### WHY HAVE STOCK PRICES RISEN?

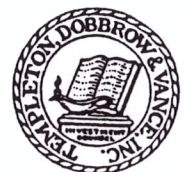
Several investors with whom I have talked seem to be baffled by the fact that stock prices have been going in the opposite direction from the trend of general business conditions. General business conditions as measured by the Index of Industrial Production declined from 137 in July of last year to 123 of April of this year. Many businessmen correctly foresaw this decline in general business conditions; and then assumed without much thought or study that this trend would also cause a decline in stock prices. Actually, as we all know, stock prices increased from a low of 257 on the Dow-Jones Industrial Average on September 17th of last year to a current level of 343 on that average.

Of course, those who have studied stock prices and business trends for many years realize that the trend of business is only one influence on stock prices. If all other factors were equal, stock prices might move in the same direction and in the same degree as industrial production. However, there is never a time when other factors are equal. To prove this fact you can inspect a chart of industrial production for the last 15 years and then compare this with a chart of stock prices for the same period. You will find that stock prices have gone in the opposite direction from industrial production more frequently than they have gone in the same direction.

The influences on stock prices are so numerous and so complex that no person has ever been able to predict the trend of stock prices with consistent success. In this short memorandum it is not possible to discuss all the influences. I simply want to point out one influence which may have been the major influence in causing stock prices to rise during the last ten months when industrial production was declining. This can be called the surplus of funds available for investment. It might be equally proper to call this influence the shortage of top-quality stocks available for new funds.

The amount of common stocks offered to the public for investment in recent years has been small. On the other hand, the funds becoming

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available for investment in common stocks have been great. The supply of good common stocks is relatively limited, whereas the funds available for purchases are increasing. This condition can lead to a great increase in the market prices for shares without having at the same time any increase in the real values of the shares. Perhaps you have heard about the wise Wall Street man whose client asked, "Why did stock prices go up?". He replied simply, "Because there were more buyers than sellers". This statement is not only humorous, but also it is literally true. There may be many reasons which cause a surplus of buyers, but possibly the greatest influence at present is the accumulation of idle cash.

Neither trustees nor individuals like to hold a very large part of their assets in liquid cash. They feel obliged to invest idle cash funds in order to get income. If high interest rates were available on top-quality bonds or good yields on high-grade preferred stocks, then these investors might use those means of investment. However, it is well known that the yields on bonds and preferreds are low now. Consequently, there is strong pressure for investors to put their idle cash into common stock.

No one knows how much new cash is flowing into common stocks each year. However, we do know enough to realize that the total is very large. We estimate, for example, that the new cash accumulating in pension funds and profit-sharing funds alone is now running in excess of one billion dollars annually. Not all of this is available for common stocks, but enough is available to have a great influence. Much of the new money is accumulating in the hands of institutions, such as trust companies, savings banks, life insurance companies, and investment trusts. The effect of this can be seen in the fact that the prices of top-quality common stocks have been bid up much more than the prices of medium and lower-quality common stocks. Of course, it is normal for high-quality stocks to sell at higher prices in relation to earnings than low-quality stocks. However, the interesting point is the fact that this disparity in price earnings has increased greatly in the last three years. To explain in part not only the premium price for high-grade stocks, but also the general rise in stock prices, I am quoting below figures compiled by Mr. Burton Crane showing that the total holdings of common and preferred stocks by institutions are probably now in excess of \$47 billion:

Institutional Holdings of  
Common & Preferred Stocks

Personal trusts in banks	\$25,900,000,000
Endowments	5,350,000,000
Investment Trusts	4,930,000,000
Fire & Casualty Ins. Cos.	4,700,000,000
Pension Funds	3,400,000,000
Life Insurance Companies	2,573,000,000
Mutual Savings Banks	400,000,000
Total	\$47,253,000,000

When selecting common stocks for purchase, we should bear in mind the fact that the top-quality stocks are already very high in price. A greater ultimate reward may be achieved by searching now for those

stocks which are not regarded as top-quality now, but may gain that reputation within a few years. Such stocks can be bought at much lower prices; and then later an improving reputation may lead to institutional preference and consequent improving prices. Another policy which may be successful in selecting stocks is to purchase those which have medium quality but increasing earnings. There are many good companies not widely known whose shares are still selling at low prices in relation to earnings. Of course, it would not be wise to buy such stocks if their earnings were likely to decline. By careful study it is possible to find many such stocks whose earnings will probably increase. A successful investment program can be built on buying stocks at low prices in relation to current earnings provided such companies have prospects for increasing earnings in the future.

Managers of investment funds are faced with the practical question of just how much should be held in common stocks at today's higher prices. When stock prices are very low, as they were five years ago, then of course it is wise to have a heavy proportion of common stocks. When stock prices are very high, as they were in 1929, then of course it is wise to hold only a minimum of common stocks. Today it is not wise to be completely out of stocks; and it is not wise to be completely in stocks. We are now near the middle-ground. We believe that each investor should have now close to his "normal" proportion in common stocks - certainly no more and in most cases no less - with the rest held in safer investments as a reserve.

John M. Templeton

July 29, 1954