Rediscovering Benjamin Graham

A Learn & Earn Feature
by Janet Lowe

As most *Better Investing* readers know, NAIC believes in fundamental investing — building wealth and value over the long term by focusing on such basic investment fundamentals as sales and earnings growth, profit margins, price-earnings ratios, and so on. Although we have been espousing this approach to successful investing for more than four decades, we did not invent it. Perhaps the most well known fundamental investor of all time was Benjamin Graham, whose classic text on *Security Analysis* stands to this day as one of the best investment books ever written. Our thanks to Janet Lowe, who recently authored a book about Graham, for the following look at the man and his thinking. We believe it will be of interest to many of *BI's* "fundamental investors."

For decades, *Security Analysis* by Benjamin Graham and David A. Dodd was the "Bible" for professional investors. The book fell out of vogue briefly, but thanks to difficult market conditions and a new interest in value investing at Columbia University, where Graham and Dodd taught, that has reversed.

Benjamin Graham, who founded the highly successful Wall Street investment firm of Graham Newman in the 1920s, was the intellectual force behind *Security Analysis*. Graham's classic *The Intelligent Investor* was written in 1949, but it is still available in bookstores with a good investment section.

In a now celebrated speech at Columbia in 1984, "The Superinvestors of Graham-and-Doddsville," Warren Buffett described the spectacular success of the Graham disciples. In the speech Buffett refuted the so-called "efficient market" or "random walk" theory, the notion that every bit of knowledge on the market is so thoroughly known that no single investor has an advantage over another. He argued that the track record of Graham's students proved that the market is still dysfunctional enough to allow a skilled and enterprising investor to outperform the crowd.

The "superinvestors" such as Walter Schloss and Sequoia Fund founder William Ruane consistently earn 20 percent plus annual returns on the money they managed.

Most students of investments know Graham for his preference for stocks that sell below their net current asset value. While Graham's method of evaluation seemed to weigh heavily the assets, liabilities and other quantitative factors of a company to determine its appropriate share price and potential earning power (as opposed to cycles, management skills, industry outlook or other qualitative factors) his thinking was not as narrow or as methodical as some perceive it to be, claims William Ruane. Graham didn't simply produce a formula and doggedly follow it.

"Graham developed a framework for making people think through what those numbers really mean," explained Ruane.

Graham preached simple commandments that any investor can use as stars when navigating the expansive seas of the investment world, Buffett insisted. An individual investor, who isn't under pressure to shoot comets across the heavens but would like to earn a respectable and reliable return, especially can benefit from Graham's guidance.

In greatly simplified terms, here are the 14 main points Graham emphasized in his writing and speaking. Some of the counsel is technical, but much of it simply encourages the right attitude:

Be an Investor, Not a Speculator

"Let us define the speculator as one who seeks to profit from market movements, without primary regard to intrinsic values," Graham said. "The prudent stock investor is one who (a) buys only at prices amply supported by underlying value, and (b) who determinedly reduces his stock holdings when the market enters the speculative phase of a sustained advance."

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Speculation, Graham insisted, had a place in the securities markets, but a speculator must do more research, tracking of investments and be prepared for losses if they come.

Know the Asking Price

Multiply the company's share price by the number of total shares (undiluted) outstanding. Ask yourself, if I bought the whole company would it be worth this much money? Compare the asking price to that of other companies whose stocks seem suitable for purchase.

Rake the Market for Bargains

Graham is best known for using his "net current asset value" rule to decide if the company was worth its market price.

To figure the NCAV of a company, subtract all liabilities, including short-term debt and preferred stock, from current assets. Divide that number by the shares outstanding to get a per-share price.

By purchasing stocks below NCAV, the investor buys a bargain because nothing is paid for fixed assets. Research shows that buying stocks immediately after their price drops below NCAV per share and selling the shares by two years afterward, provides an average excess return of over 24 percent.

Yet even Graham recognized that NCAV stocks are increasingly difficult to find, and when one is located, this measure is only a starting point. "If the investor has occasion to be fearful of the future of such a company," he explained, "it is perfectly logical for him to obey his fears and pass on from that enterprise to some other security about which he is not so fearful."

Modern disciples of Graham look for hidden value in additional ways, but still probe the question, "what is this company actually worth?" Buffett modifies the Graham formula by looking at the quality of the business itself. Other apostles use the amount of cash flow generated by the company, the reliability and quality of dividends, and other factors.

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Buy the Formula

Ben devised another simple formula to tell if a stock is underpriced. Buy shares only if a company is selling near or below its intrinsic value. The concept has been tested in many different markets and works, though Buffett and Ruane agree that rigidly following a formula is unwise. *(Editor's Note: NAIC also believes that it is not prudent to rigidly follow any single formula. Personal judgment should always be added and oftentimes is the most crucial factor in an investment decision.)*

This formula takes into account the company's earnings per share (E), its expected earnings growth rate (R) and the current yield on AAA rated corporate bonds (Y).

The Intrinsic Value of a stock equals:
$E\ (2R + 8.5) \times Y/4$.

The number 8.5, Ben believed, was the appropriate price-earnings multiple (P/E) for a company with static growth. P/E ratios have risen, but a conservative investor will still use a low multiplier. At the time this formula was created, 4.4 percent was the average bond yield, or the Y factor.

Don't Sweat the Math

Ben, who loved mathematics, said so himself: "In 44 years of Wall Street experience and study I have never seen dependable calculations made about common stock values, or related investment policies, that went beyond simple arithmetic or the most elementary algebra. Whenever excalculus is brought in, or higher algebra, you could take it as a warning signal that the operator was trying to substitute theory for experience, and usually also to give speculation the deceptive guise of investment."

Don't Stress Out

Realize you are unlikely to hit the precise "intrinsic value" of a stock or a stock market right on the mark. A margin of safety provides peace of mind. "Use an old Graham and Dodd guideline that you can't be that precise about a simple value," suggested former Columbia Professor Roger Murray. "Give yourself a band of 20 percent above or below, and say, 'That is the range of fair value.'"

Regard Corporate Figures with Suspicion

It is a company's future earnings that will drive its share price higher, but investors must be wary of estimates that are based on current numbers. Though regulations are tighter now than they were when Graham was investing, earnings still can be manipulated by creative accountancy. An investor is urged to pay special attention to reserves, accounting changes and footnotes when reading company documents.

As for estimates of future earnings, anything from false expectations to unexpected world events can repaint the picture. Nevertheless, an investor has to do the best evaluation possible, then go with the results.

Diversify, Rule # 1

"My basic rule," Graham said, "is that the investor should always have a minimum of 25 percent in bonds or bond equivalents, and another minimum of 25 percent in common stocks. He can divide the other 50 percent between the two, according to the varying stock and bond prices."

Using this rule, an investor would sell stocks when stock prices are high and buy bonds. When the stock market declines, the investor would sell bonds

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and buy bargain stocks. At all times, however, he would hold the minimum 25 percent of his assets either in stocks or bonds — retaining particularly those that offer some contrarian advantage.

As a rule of thumb, an investor should back away from the stock market when the earnings per share on leading indices (such as the Dow Jones Industrial Average or the Standard & Poor's composite index) is less than the yield on high quality bonds. When the reverse is true, lean toward bonds.

This is ho-hum advice to anyone in a hurry to get rich, but it helps preserve capital. Earnings cannot compound on lost money.

Diversify, Rule # 2

Have a large number of securities in your portfolio, if necessary, with a relatively small number of shares of each stock. While investors like Buffett may have fewer than a dozen or so carefully chosen companies, Graham usually held 75 or more. Graham suggested that individual investors try to have at least 30 different holdings, even if it is necessary to buy odd lots. The least expensive way for an individual investor to buy odd lots is through a company's dividend reinvestment program (DRP).

When in Doubt, Stick to Quality

Companies with good earnings, a solid dividend history, low debt and a reasonable price-earnings ratio serve best. "Investors do not make mistakes, or bad mistakes, in buying good stocks at fair prices," Graham said. "They make their serious mistakes by buying poor stocks, particularly the ones that are pushed for various reasons. And sometimes — in fact very frequently — they make mistakes by buying good stocks in the upper reaches of bull markets."

Don't follow the crowd. "There are two requirements for success in Wall Street," Ben once said. "One, you have to think correctly; and secondly, you have to think independently."

Dividends as a Clue

A long record of paying dividends, as long as 20 years, shows that a company has substance and is a limited risk. Chancy growth stocks seldom pay dividends. Furthermore, Ben contended that a stingy dividend policy harms investors in two ways. Not only are shareholders deprived of income from their investment, but when comparable companies are studied, the one with the lower dividend consistently sells for a lower share price.

"I believe that Wall Street experience shows clearly that the best treatment for stockholders," he said, "is the payment to them of fair and reasonable dividends in relation to the company's earnings and in relation to the true value of the security, as measured by any ordinary tests based on earning power or assets."

Defend Your Shareholder Rights

"I want to say a word about disgruntled shareholders," Graham said. "In my humble opinion, not enough of them are disgruntled. And one of the great troubles with Wall Street is that it cannot distinguish between a mere troublemaker or 'strike-suitor' in corporate affairs and a stockholder with a legitimate complaint which deserves attention from his management and from his fellow stockholders." If you object to a dividend policy, executive compensation package or golden parachutes, organize a shareholder's offensive.

Be Patient

"...every investor should be prepared financially and psychologically for the possibility of poor short-term results," Graham said. "For example, in the 1973-74 decline the investor would have lost money on paper, but if he'd held on and stuck with the approach, he would have recouped in 1975-76 and gotten his 15 percent average return for the five-year period."

Think for Yourself

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By Graham's own example, investors must keep an open mind and continue to search for better ways to ensure safety and maximize growth. Don't ever stop thinking.

Because of their focus on investment fundamentals and the long term, NAIC investors tend to follow many of the main points emphasized by Benjamin Graham. In fact, his name and his thinking are mentioned by featured speakers at most every major gathering, including last year's Portland Congress (photo above). NAIC's investment philosophy encourages individuals to invest regularly over a long period of time, to reinvest all earnings, and to invest in companies whose fundamentals suggest they could double in value over the next five years.

Janet Lowe's book Benjamin Graham on Value Investing: Lessons from the Dean of Wall Street was published this year by Dearborn Financial Publishing. Lowe is a San Diego-based author and business journalist.