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In search of real value

If you've had real money, that is to say your money, in the market then you know what the record-setting averages don't show, that it's been a war zone. Leading companies like Amazon, Disney, Priceline, EBAY, E*Trade, Schwab, and Pfizer have lost more than a third of their value in a matter of months. Upstarts you had no chance to own have produced a decade's good return in a day. Here's our advice for surviving yet another new era: Read two old books.

up to 190 Before split

By Thomas Easton

Getting rich on paper this year has meant holding IPOs: 11 are up over 1000% (and the four zeros are not a typo). Getting rich for real is something else again. The actual float for these offerings has been tiny, just a sliver of companies not all that large to begin with. Only a few, Goldman Sachs, United Parcel, maybe Delphi Automotive, have the history and financial statements that lends itself to analysis, and they aren't the deals with the truly astronomical gains.

Is chasing screamers any way to get rich? Yes for a handful of exuberant sellers, and perhaps for the most astute, or luckiest, buyers, but aggressively betting on the hope of a distant profit, or a fortuitous trade, is a long-term recipe for going broke, not getting rich.

Be skeptical of any evidence to the contrary. Only one of the top 15 mutual funds over the past 12-month, for example, has even been around to have a five-year track record. None carried much in terms of assets. Their returns, in excess of 100%, made headlines; their results didn't make people money. Which do real investors care about?

WHAT DO

Benjamin Graham observed this kind of market in the early part of the century and repeatedly thereafter with an eye toward injecting reason and stability into an inherently chaotic and deceptive process. A Columbia Business School professor with the intellectual honesty to put his own money at risk based on his theories, he became a consummate realist who learned from failures as well as success.

His first book, titled simply Security Analysis, appeared in the depth of the Depression when a serious book about stocks and bonds had as much appeal as an undertaker's manual. Undaunted, he said stocks should be bought not because the "trend" of their share price or their earnings headed upwards, not because the future of the country looked brilliant, and not because of breathtaking new technology (though it was the dawn of radio, television, air conditioning and universal phone service, among other breakthrough development) but because the odd psychology of investing had, at a time when no one wanted to buy stocks, made it possible to pay a little cash and get back a stake in a company holding a great deal more. The strategy was a model of reason.

History treated Graham's pragmatism well. By the time he died in 1976, he had made a modest fortune for himself and inspired others to do so both directly, and through his two books Security Analysis (co-written with former instructor ~~student~~ and then professor ~~colleague~~ David Dodd) and the Intelligent Investor, each of which went through four editions. Would Graham have anything relevant to say about today?

We called up Walter Schloss, 83, who worked as a security analyst for Graham between 1946 and 1955 before opening a highly successful investment partnership of his own (compound return: tk% versus tk for the market) and asked him how Graham would deal with a market like this one.

"He never lived through a period like this, no one has," says Schloss. But he'd still maintain "the price of a stock is tied to its value. He'd be asking when are you paying too much? There is no question that investors have problems today, even if they don't understand that."

Even in challenging markets, Graham with no defeatist. "He always told me it was easier to make money than cut expenses," Schloss remarked. So in this spirit, with the idea there is always money to be made, we got copies of Graham's books and went back to school. The final 1973 edition of the Intelligent Investor remains in print; the original 1934 edition of Security Analysis was reissued last year.

What emerges is a core set of beliefs that are unarguably true, with others, deeply held, sure to be controversial in the current market but that are nonetheless likely to work out in the years ahead.

1) The market tends to go nuts.

"The market price (for a stock) is frequently out of line with the true value; there is an inherent tendency for these disparities to correct themselves," Graham wrote back in the 1930s. But then he added, "the second assumption is true in theory, but ... undervaluations may persist for an inconveniently long time, and the same applies to inflated prices.

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In the short term, he added, in passage frequently cited, "The market is not a weighing machine, but a voting machine."

Longer term? He believed that opportunities could be found, but not by everybody.

2) "To achieve satisfactory investment results is easier than most people realize; to achieve superior results is harder than it looks."

"Since anyone-by just buying and holding a representative list-can equal the performance of the market averages, it would seem a comparatively simple matter to "beat the average"; Graham wrote.

But as a matter of fact the proportion of smart people who try this and fail is surprisingly large.

His evidence: the poor long-term record of mutual funds and brokerage firm recommended lists. Nothing has changed in the intervening years.

"A creditable, if unspectacular, result can be achieved by the lay investor with a minimum of effort and capability; but to improve this easily attainable standard requires much application and more than a trace of wisdom," he concluded. "If you merely try to bring just a little extra knowledge and cleverness to bear upon your investment program, instead of realizing a little better than normal results, you may well find that you have done worse."

Think about that next time you are tempted to put through a couple quick day trades.

"The real choice of the average individual has been between succumbing to the wiles of the doorbell ringing mutual-fund salesman on the one had as against succumbing to the even wilier and much more dangerous peddlers of second and third rate new offerings."

Funds charged too much for sub-par performance, Graham believed, but, despite his rueful observations to the contrary, he believed professional managers were less likely to be duped by worthless stocks. Moreover he endorsed a structure that provided easy diversification. No one

Today we're talking [illegible] Dollars invested [illegible] over/so stocks is not unreasonable

should hold fewer than 10 stocks, he believed, and 30 would be a better number. No doubt he'd approve of cheaply managed indexes for most people.

3) "Expectations for returns should be based not on optimism but on arithmetic."

Consider the following statement "The new theory or principle may be summed up in the sentence, 'the value of a common stock depends entirely upon what it will earn in the future'"

Dividends? Irrelevant, because they reflect past, not future, wealth. Assets? Irrelevant again "because no relationship exists between assets and earnings". Past earnings? Only important in terms of how they indicate change in future results.

what ? [illegible] Assets can affect market price

This passage could pass as the investment mantra of our times. It is why the deviation by a single penny of a company's results from analyst expectations can cause giant moves in its stock price, even though the number is really meaningless by itself.

In fact, Graham wrote this description in 1934 to characterize the prevailing ethos before the 1929 crash. Technological change was everywhere. Railroads and streetcar companies, the growth issues of the early century, were being decimated. The future was all about cars and electronics and yet when the crash came, the future came to a halt.

Buying on the premise of far better times to come was ludicrous to Graham, as was buying merely based on projecting forward past market performance. He explicitly mocked the faith displayed by John Raskob (see box) whose investment recommendations rested on his faith in the growth of the country and first class business operations.

His disappointing results "show how little reliance can be place on such optimistic forecasts and assurances," Graham wrote.

In Graham's view, a good investment begins with real evidence of return. High quality bonds and preferred stocks had real virtues because their income streams were visible. A stock was good value if a similar bond could had it been issued against a company's assets and potential earnings.

Sound complicated? In essence, Graham was a "show me the money" kind of investor. He wanted an investment that could benefit from an economic expansion but also survive a real crunch. For all investors but the ones willing to do the most extensive spade work, he recommended companies with strong balance sheets, a track record of earnings extending back seven years (the average earnings over this period was more important than the trend in earnings) and a dividend.

The last item, dividends, makes no sense in theory. They are taxed at the higher ordinary income rate than the one for capital gains. Companies with unusually high returns on capital can make better returns merely by reinvesting profits.

But before dismissing those tiny quarterly payments, look at the chart on page tk for the returns of the Massachusetts Investment Trust from a $15 monthly investment beginning at the eve of the 1929 crash. Principal of $37,000 would have been transformed into a $3 million portfolio. One-quarter of that return came directly from income, far more because of it being reinvested. More strikingly, a study of the Dow Jones industrial average concluded that had dividends been included from its inception in 1894, its current level would not be 12,000, not be 120,000, but 650,000.

Dividends tend to grow over time and, growth aside, they are a real return that, unlike retained earnings, can't be subsequently written off in an accounting white wash as is increasingly common.

"Experience would confirm the established verdict of the stock market that a dollar of earnings is worth more to the stockholder if paid him in dividends than when carried to surplus," Graham wrote in 1934.

4) Don't follow the market

"In our own stock-market experience and observation, extending over 50 years, we have not known a single person who has consistently or lastingly made money by ...following the market. We do not hesitate to declare that this approach is as fallacious as it is popular."

It is an idea that would have worked well in the 1920s, in the 1930s, as recently as the 1980s. But what about a market like this one where the prevailing trend has been up and then up? It is a strong reason to consider selling but,

5) Timing the big trends is impossible

As someone with a mathematical bent, Graham spent much of his career trying to devise a good formula for when to get into, and out of, the stock market. All formulas, he concluded, failed. Stocks should be sold for valuation considerations, but the broad direction of the market is impossible to gauge. How to cope with this dilemma: build a portfolio of both stocks and bonds and never let either constitute more than 75%.

6) Buy OPOs (old public offerings) not IPOs

"We didn't buy what people like to OF AN IPO sell," says Schloss. The seller knows what it is worth. The underwriters want commission. The seller knows the price and won't sell unless he's getting ~~more."~~ A GOOD PRICE

The reasoning is unimpeachable. If the people running these IPOs are so clever about money, why would they like to share their participation in future profits?

"The purchaser is frequently inexperienced and seldom shrewd," Graham wrote. "His unconfessed desire in buying is chiefly to make a quick profit.the investor's protection lies less in his own critical faculty than in the scruples and ethics of the offering house....it is imprudent for the buyer to trust himself to the judgment of the seller."

IPOs typically emerge in a pattern. "Somewhere in the middle of the bull market the first common stock floatations make their appearance. These are priced not unattractively, and some large profits are made by the buyers of the early issues. As the market rise continues, this brand of financing grows more frequent; the quality of the companies becomes steadily poorer; the price asked, and obtained verge on the exorbitant."

His predicted results:

"For every dollar you make in this way you will be lucky if you end up by losing only two," he wrote. "Some of these issues may prove excellent buys-a few years later when nobody wants them and they can be had a small fraction of their true worth."

7) What "metrics" matter

"Even when the underlying motive of purchase is mere speculative greed, human nature desires to conceal this unlovely impulse behind a screen of apparent logic and good sense," is how Graham described the rationalizations people used to justify buying hot stocks.

With this in mind, consider the lot of the person trying to provide a cogent argument for the valuations of a number of Internet companies. There are no dividends, earnings, or assets. A favored alter-

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native is revenues, though even these can be lacking.

In a series of recent speeches, Warren Buffett warned against valuing stocks based merely on how much money they churn through, citing the airline industry which has expanded unprofitably since its inception. The genesis of this observation could have been Buffett's own experience investing in USAir, or he might have just been reflecting on a passage Graham, his former professor and employer, wrote in 1949 shortly before Buffett began Graham's class.

"An investor may for example be a buyer of air-transport stocks because he believes their future is even more brilliant than the trend the market already reflects. For this class of investor the value of our book will lay more in its warnings against the pitfalls lurking in this favorite investment approach than in any positive technique that will help him along his path.

What was the problem? "The obvious prospects for physical growth in business do not translate into obvious profits for investors."

There was a second problem too.

8) Buy cold industries

"The experts do not have dependable ways of selecting and concentrating on the most promising companies in the most promising industries."

A new study by Ibbotson Associates going back to the Depth of the Depression shows that with very few exceptions buying companies selling at a low p/e provided significantly higher returns. The 1990s have been a different story largely because of the success of technology, a sector of the economy Graham was particularly skeptical of.

Does that mean that companies on the forefront of developments are bad investments? Absolutely not. "In investment theory there is no reason why carefully estimated future earnings should be a less reliable guide than the bare record of the past," he wrote.

The problem arose, he said, because typically projections have been too optimistic for winners, too dire for losers. Riding a wave was almost impossible.

"We regard growth stocks as a whole as too uncertain and risky a vehicle for the defensive investor," he concluded, voicing a thought that is at odds with everything going on today.

"Of course, wonders can be accomplished with the right individual selections, bought at the right levels, and later sold after a huge rise and before the probably decline. But the average investor can no more expect to accomplish this than to find money growing on trees

Clearly spending on technology continues to rise at a faster clip than for anything but perhaps health care. But does the growth justify their valuation?

9) "Any company is a good company, at the

right price"

"For 99 issues out of 100 we could say that at some price they are cheap enough to buy and at some other price they would be so dear that they should be sold. The habit of relating what is paid to what is being offered is an invaluable trait in investment. The really dreadful losses of the past few years (and on many similar occasions before) were realized in those common-stock issues where the buyer forgot to ask "how much?" Graham wrote in the 1970s.

[illegible]

Graham wasn't a total bottomfisher, at least in his recommendation. The biggest losses, he believed, came from buying bad companies in good times. Rather he liked loaded laggards; stock that sold cheap yet still had strong finances and the prospects that earnings could be maintained.

10) What the right price?

A price where you are unlikely to lose money, says Schloss, reflecting on his time with Graham. Graham voiced skepticism about any stock trading at in excess of 25 times earnings, a number slightly below the current market average. He also recommended stocks selling at no more than one-third above book value. That would have worked brilliantly over the past year in Japan, but it would leave a selection pool in the United States dominated by troubled companies.

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What then, to conclude? That the 4% return on an inflation adjusted bond, or the 8% effective return on a municipal if you live in a high tax state, is not a bad place to start. They do provide a real return with little risk. As for stocks, look at the companies getting crushed after they miss an earnings period. Their stock becomes more, not less, attractive, as its falls.

In an effort to provide a path to the Internet era, we include a table of established companies selling at low prices that have electronic operations that THE market seems to ignore. Ironically, the most compelling example is an airline. Years of disappointments have taken their toll on the industry. The price premium for growth Graham and others witnessed over prior decades is finally all gone. That's when to start looking.