It's a topsy-turvy era on Wall Street, with crazy valuations, volatile prices and a sense that this all may not last. But amid the turmoil, here is a set of durable investing principles.

BY THOMAS EASTON

It's a crazy world, as market averages vault ever higher, a gold-rush mentality has taken hold. Since June there have been ten initial public offerings that have climbed at least 1,000%. Upstarts you had no chance to own have produced a decade's good returns in a day.

But despite the rampant optimism, there's a sense of impermanence. How can all these highflyers stay aloft when they generate no profit? How can all the market's dot.com darlings ever make good on their promise to become dominant fixtures in cyberspace when there are so many of them? And turning to blue chips, what kind of climate is this when missing a penny on analysts' consensus earnings estimates can send solid performers into a tailspin that chops a third from their valuation?

In such a world you need grounding in reality, a guide to what will truly make you prosperous. So we've distilled eight lessons that a serious investor should diligently follow. No, we're not saying the stock market will melt down tomorrow—only that if and when a big correction occurs you must be equipped, financially and emotionally, to deal with it. We believe that you should stay with the market in good times and bad, and that if you do you will be amply rewarded.

We draw seven of our lessons from Benjamin Graham, the godfather of value investing. His teachings, first promulgated in the 1930s, had a run of popularity in the 1980s (thanks in no small part to the successes of his disciple Warren Buffett) but are out of fashion today, particularly among the day-trading set. They shouldn't be. His soberly analytical approach and disdain for faddish nonsense provide a sure compass in the most uncertain of times.

Our eighth lesson comes from an even more unlikely source: John J. Raskob, best remembered for his spectacularly mistimed advice on getting rich in the market, delivered two months before the 1929 crash. Despite this lollapalooza of a bad call, his thoughts on the virtue of steady investing perfectly complement Graham's practical philosophy. In Raskob's Lesson 8 (see p. 178) we do the math on exactly how everything we're saying will make you rich.

Of course if you'd followed FORBES' counsel in recent years, you wouldn't have made a killing on the Net. Not everyone, though, can be an Internet-stock millionaire, let alone stay one. That's why we stay committed to Graham's notion that you shouldn't buy a stock just because it's going up.

Graham, a lecturer at Columbia's business school and also a steadfast investor, cast a baleful eye on the giddy market of 70 years ago. A consummate realist who learned from failure as well as success, he had the intellectual honesty to put his own money at risk based on his theories. His first book, Security Analysis, appeared at the low point of the Depression, when a serious look at stocks had as much appeal as an undertaker's manual.

Undaunted, he said stocks should be bought because the odd psychology of investing had, at a time when no one wanted to buy stocks, made it possible to buy shares in corporations at valuations a small fraction of what those corporations would have been worth if sold as entire businesses. Forget upward
earnings or price trends. Forget breathtaking forecasts for the national economy’s bountiful future, heralded by promising technologies— in Graham’s time this meant radio, television, air-conditioning and universal telephone service.

History treated Graham’s pragmatism well. By the time he died in 1976 he had written a second book, The Intelligent Investor, made a modest fortune for himself and inspired others, such as Buffett, to make considerably greater fortunes.

So what would Graham say about today’s market? Another Graham devotee, Walter Schloss, thinks he’d be uneasy.

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, 20% versus 16% for the market), says: “He’d be asking, ‘When are you paying too much? Where is the margin of safety?’” After all, Graham taught that a stock’s price should be tied to its value.

Nevertheless, even in challenging markets Graham was no defeatist. Bulls and bears may squabble about what lies ahead (see debate, p. 182). Yet regardless of the background noise, a steadfast adherence to a set of beliefs should build the prosperity you seek. The time-tested lessons:

1. **Don’t trust the market to value a stock.** You’ve heard about the efficient market, where investors’ knowledge magically and correctly sets the best price for a stock? Baloney. Even when bales of information are available through the click of a mouse, the market is too often inefficient and prices don’t always reflect values. As Graham put it in the 1930s, “The market price is frequently out of line with the true value; there is an inherent tendency for these disparities to correct themselves.” Painfully, we might add.

Before the inevitable correction, he went on, “undervaluations may persist for an inconveniently long time, and the same applies to inflated prices.” In the short term, Graham wrote, in a frequently cited passage: “The market is not a weighing machine but a voting machine.”

The fact that a hot young technology company is trading at $280 a share does not make it worth $280 a share. Its price could reflect a small float of available shares and the temporary effect of momentum traders, the ones who buy simply because a stock is already moving.

2. **Don’t think it’s easy to beat the market.** You have to approach stock picking with a certain humility. It’s pretty hard to beat a broad-based index fund (like the Vanguard Stock Market Index) over a long period of time. Graham marveled at the poor long-term record of mutual funds and brokerage firm recommended lists. Nothing has changed in the intervening years.

After a lifetime of analyzing investment results, he wrote, “A

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**Net Value**

As we say in the main story, Ben Graham would have had a hard time liking any Internet stock. But what if you made one into a value play?

Here’s something Graham might have found intriguing: an Internet holding buried in something bigger. Our table shows several firms whose Net holdings are worth a lot, in some cases more than the parent.

Consider Lands’ End, the catalog retailing giant with $1.4 billion in 1999 revenues and a $1.75 billion market cap. Analysts expect landsend.com to generate $150 million in sales in 2000. Using valuations common to the Internet world, this dot.com division could be worth as much as $1.5 billion on its own. Take out the online division, and how much is Lands’ End really costing you? Not much. The same applies to Barnes & Noble. As a bonus to parent-company shareholders, its 40% stake in barnesandnoble.com is worth more than $200 million.

It has been years since airlines failed as high-flying growth stocks. (Which, by itself, may be a sign of value; AMR, holding company for American Airlines, sells for one-third the market multiple.) But look at this deal: AMR owns 82% of Sabre, the computerized reservation firm, and thus, indirectly, a stake in the successful Web site travelocity.com.

In some sense, then, the airline is available for free. We think Graham might have taken a flier on this AMR, particularly if he could have found some way to hedge the Net exposure.

—T. E. and Michael Malello

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**More Than Virtually Real**

Each of these companies produces real earnings and has valuable Internet affiliates. Buy the parent and you get a two-for-one play.

<table>
<thead>
<tr>
<th>Company</th>
<th>P/E</th>
<th>Earnings ($mil)</th>
<th>Market cap ($mil)</th>
<th>Value of Internet investment ($mil)</th>
<th>Internet investments</th>
</tr>
</thead>
<tbody>
<tr>
<td>AMR/American Airlines</td>
<td>12</td>
<td>$740</td>
<td>$9,000</td>
<td>$4,920</td>
<td>Sabre/Travelocity.com (52%)</td>
</tr>
<tr>
<td>Barnes &amp; Noble</td>
<td>22</td>
<td>84</td>
<td>1,680</td>
<td>207</td>
<td>barnesandnoble.com (40%)</td>
</tr>
<tr>
<td>Dell Computer¹</td>
<td>67</td>
<td>1,780</td>
<td>114,000</td>
<td>110,000</td>
<td>Dell.com (100%)</td>
</tr>
<tr>
<td>HNC Software</td>
<td>95</td>
<td>21</td>
<td>2,150</td>
<td>2,550</td>
<td>Retek (86%)</td>
</tr>
<tr>
<td>Lands’ End¹</td>
<td>35</td>
<td>60</td>
<td>1,750</td>
<td>1,500</td>
<td>landsend.com (100%)</td>
</tr>
<tr>
<td>Microsoft</td>
<td>64</td>
<td>8,400</td>
<td>492,000</td>
<td>1,580</td>
<td>Expedia (85%)</td>
</tr>
</tbody>
</table>

¹Estimates, based on ten times revenues.
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."

If you like Nasdaq stocks, you probably had a fabulous year in 1999. You might even have made more money in the market than you did from your salary. Before quitting your day job to trade, think about what Graham said.

3. Trend-following works over short periods, not long ones. Momentum investing—buying the stocks that have already had good runs in the past few months or so—has worked well recently. It can't keep working. At some point the stocks that are already expensive (in relation to their fundamental business value) become absurdly expensive. And then they crash.

Experience taught Graham that momentum investing was a sure way to be propelled off a cliff. In 50 years of investing, he wrote, "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."

What's the opposite of trend-following? The philosophy that price matters. Your objective as an investor is to pay less than a company is intrinsically worth as a business concern—worth being defined in terms of earnings, liquidating value or (perhaps) future prospects. Norfolk Southern is worth something because it owns locomotives and tracks and has demonstrated an ability to collect more cash from these assets than it consumes trying to keep them going. Microsoft is worth a lot because it generates far more revenue than it needs to pay in salaries to keep that revenue coming in. The software firm may be worth a higher multiple of its earnings than the railroad because its prospects are better, but it is not worth infinitely more, and the recent action in its stock price is irrelevant to the analysis.

"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," Graham wrote in the 1970s, just as a bull market was being punctured. "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 wasn't a blind bottom-fisher. The biggest losses, he believed, came from buying bad companies in good times. But he never let his eyes stray too far from the balance sheet or the company's ability to pay a reasonable price on a stock, if you can't evaluate its earnings and assets, you shouldn't buy it.

4. You can't time the market. 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 bought when they are available for comfortably less than your best estimate of their intrinsic value, and sold when you can collect comfortably more than that sum. But the broad direction of the market is impossible to gauge.

In Graham's view it was acceptable to let the apportionment of your wealth between stocks and bonds fluctuate somewhat, but he insisted that neither allocation ever exceed 75%. He also insisted on the wisdom of diversification—owning at least 10 stocks and preferably 30. In light of the larger number of issues available today, protégé Schloss says, 100 is not too many. The first index fund was just being cranked up when Graham died, so we don't have his opinion on this vehicle, but we can surmise that he would have approved of it heartily for investors without the time to do meticulous research.

5. Base your expectations not on optimism but on arithmetic. In 1934 Graham summarized the kind of investing that leads sooner or later to capital losses: the view that a company's assets are irrelevant and that past earnings don't mean anything because values are only a function of the future.

He was criticizing the prevailing frame of mind just before the 1929 crash. He could just as well have been describing today's day traders. In the Roaring Twenties technological change was everywhere, and that seemed to imply a new era, with new rules for business. The past was steel and railroads; the future was all about cars and electronics, and so it seemed that the old rules shouldn't apply.

The optimists were very right about the future of the economy—cars and electronics represent far more wealth today than do steel and railroads. But they were wrong about how to invest. Auto companies by the score went bankrupt in the Depression; the pioneers in electronics were usually not the ultimate investment winners.

Graham would have found the Internet sector problematic, to put it mildly. Collectively the companies in this sector have no dividends, earnings or tangible assets to speak of. A favored alternative is revenues (see p. 194). But even this measure raises the eyebrows of no less an investor than Warren Buffett. In a series of recent speeches he warned against valuing stocks...
based merely on how much money they churn through, citing the airline industry. It has expanded magnificently since its inception, but it has yet to make consistent money.

Graham wrote this in 1949, shortly before Buffett took a class from the master at Columbia: “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.” What was the problem? “The obvious prospects for physical growth in business do not translate into obvious profits for investors.”

Sound complicated? Graham 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 spadework, he recommended companies with strong balance sheets, a record of earnings extending back seven years (the average earnings over this period was more important than the trend in earnings) and a dividend.

Dividends! True, they make no sense to taxable investors, and Buffett’s own Berkshire Hathaway refuses to pay one. But not every business has someone as mindful as Buffett of shareholder value. For the majority of businesses, dividends remain the most convincing evidence that the reported earnings are real—and, unlike earnings in this day of rampant writedowns, dividends cannot be retracted.

The real (inflation-adjusted) return on stocks over most of this century has been 7% or so, with more than half of that from dividends. Take a look at the chart on page 179 for the returns of the Massachusetts Investors 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-third of that return came directly from income, far more because it was reinvested.

6. Buy OPOs, not IPOs. That is, buy old public offerings—not new ones. The problem with initial public offerings is that you’re buying what someone is trying too hard to sell. That should make you suspicious. Says Schloss: “The underwriters want commissions. The seller knows what his company is worth and won’t sell unless he’s getting more.” That is a bit of an overstatement; nowadays technology firms allow underwriters to deliberately undervalue their shares so that the shares will pop up on the first day of trading. But note that you usually can’t participate in the first-day runup unless you are a favored customer of the broker; and note, too, that firms leaving a little money on the table with their initial offerings are often just warming up to much larger share issues, in either secondary stock issues or the use of shares in acquisition sprees.

Graham: “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 ob-

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Raskob’s Folly

8. Hang in there. Poor John J. Raskob. In his infamous, ill-timed interview in the August 1929 Ladies’ Home Journal, he declared: “Everybody ought to be rich.” And the way to do it was to invest $15 a month in the market—on margin. He wasn’t an idiot: Raskob was the financier who helped create General Motors and DuPont, the Microsoft and Intel of their day. His fatal error was overconfidence. He forgot that stocks sometimes retreat. Minus the leverage, Raskob’s advice was sound.

By the time he appeared in the magazine Raskob had delivered 22% average annual returns on several investment trusts (akin to mutual funds) he put together in 1907. They would have made $180-a-year savers comfortably positioned for early retirement. Raskob’s return was more than the 18% averaged by the S&P 500 over the period 1978-99, but less than the 25% the market has averaged since 1994.

“The common stocks of this country have in the past ten years increased enormously in value because the business of the country has increased,” he said to a nation of listeners eager to get tips from a magnate. “It may be said that this is a phenomenal increase and that conditions are going to be different in the next ten years,” he continued. That is “is not founded on experience. In my opinion, the wealth of the country is bound to increase at a very rapid rate.” Sound familiar? It is the mantra of our times as well.

But there was a very important kernel of wisdom in Raskob’s plan. Today we call it dollar-cost averaging: a steady investment, month after month, year after year. Although the system is of dubious value in accumulating a single stock, which could go down and stay there forever, it makes perfect sense as a formula for investing in a diversified portfolio. Yes, the market could collapse to 5500 two years from now (and would still be at the high end of historical multiples of earnings, dividends and book value). If you are young and thrifty, you would be benefited, not hurt, by such a collapse. Your reinvested dividends would give...
tained, verge on the exorbitant.... For every dollar you make in this way you will be lucky if you end up losing only two. Some of these issues may prove excellent buys—a few years later, when nobody wants them and they can be had for a small fraction of their true worth.”

7.

Buy cold 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 were a stunning counter-example to this long-term principle. Okay, you wish you had bought Dell ten years ago. But what now?

Graham was skeptical of technology companies because the “experts do not have dependable ways of selecting and concentrating on the most promising companies in the most promising industries.” 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. “The better a company’s record and prospects, the less relationship the price of its shares will have to book value,” he wrote, but that comes at a cost. “The greater the premium above book value, the more this ‘value’ will depend on the changing moods and measurements of the stock market.”

Conclusion: The higher its price, the more speculative the stock. For Graham, growth stocks were too risky for a defensive investor, 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 probable 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 anything except, perhaps, health care. But does the growth justify their valuation? The top 100 companies in the Nasdaq average traded at a collective 164 times trailing earnings. Are they worth it? 

As the market steams ahead—up 240 points one day, down 61 the next—fans of the technology sector leave value players in the dust. For the moment anybody taking great risks is fabulously well-rewarded. But at some point the more exuberant sectors of the market take the look of the game show, Who Wants to Be A Millionaire, as the contestant moves nervously past $32,000 and then $64,000 and then higher. The pile of money mounts—but it could disappear in a flash.

Do you sincerely want to be rich? Don’t stake your future on a narrow bet. Invest, like that cautious-value player Graham, with a view to underlying business values, and with plenty of diversification. But also invest like that exuberant bull John Raskob, with steady additions to your portfolio. If you do, you will survive a crash—and even prosper from it.

You twice the additional shares that they give you now. Your new savings would go into the market at bargain prices.

The grand scheme Raskob envisioned in that magazine article had the frugal working man living on Easy Street by 1949. After 20 years of the returns that Raskob forecast, the saver would have $80,000. That was a princely sum in 1929—worth $800,000 of today’s money.

In fact, 1949 would have been a terrible year to cash out. Stocks sold for under ten times earnings, with dividend yields in excess of 7%. It was a time to buy, not sell. Yet even then the results for an unleveraged investor saving away $15 a month wouldn’t have been so bad. Put into Massachusetts Investors Trust, a leading fund of Raskob’s day, the $3,600 of savings would have grown to $8,000, a yearly return of 7%

As they say about the Cubs, anybody

Everybody a Millionaire

The epilogue for one of the worst market calls in history. If you put in $15 a month your portfolio would be worth more than $3 million today.

Everybody ought to be rich.” With caveats, Raskob’s declaration is true.