Ben Graham was right—again

BY DAVID DREMEN

BEN GRAHAM, the great stock market sage who counts Warren Buffett among his disciples, liked to buy companies at a discount from book value. If you followed Graham’s advice and pursued value stocks, you would not be unsettled by recent market volatility, which is likely to be temporary.

In his first edition of Security Analysis, back in 1933, Graham expressed disdain for Wall Street’s near-obsession with earnings in determining the value of a public company. For Graham, book value was a better guide. Yet, if anything, the emphasis on near-term earnings has increased dramatically over the years.

But Graham was right. Just look at the chart that I prepared in collaboration with Eric Lutkin of the Dreman Foundation. We took the largest 1,500 companies on the Compustat Tapes for the 25-year period ending Dec. 31, 1994. For each quarter during the period we divided the stocks into five equal groups strictly according to their price-to-book ratios. We then calculated returns for the 20% of stocks with the lowest and highest price-to-book ratios.

The chart demonstrates it was no contest. Low price-to-book stocks won in a breeze. If you had invested $10,000 in the lowest price-to-book group in 1970, it would have returned $864,000, or 36 times the original investment by the end of 1994 (all figures are dividend-adjusted, and are before taxes). This more than doubled the return for the market as a whole—$10,000 in an equally weighted market index provided the investor with $163,000.

And what if you had chosen the stocks that sold at the handsomest premiums to book value? You would have ended with a miserable $92,000, about 55% of the market’s return and only one-fourth as much as on the lowest price-to-book group.

Graham’s observation that investors pay too much for trendy, fashionable stocks and too little for companies that are out-of-favor, was on the money.

Given the poor relative performance of high price-to-book and the outstanding returns of low price-to-book stocks, why does the profitability discrepancy persist? And why do people keep flocking to growth and concept stocks selling at huge premiums to their physical assets?

Because emotion favors the premium-priced stocks. They are fashionable. They are hot. They make great cocktail party chatter. There is an impressive and growing body of evidence demonstrating that investors and speculators don’t necessarily learn from experience. Emotion overrides logic time after time.

Let’s face it: There’s a kind of thrill in owning the latest Internet stock. You don’t get that with it feeling from owning some regional bank stock, say, or an auto parts maker. So Ben Graham and his descendants could talk about the advantages of buying value until they were blue in the face and the mob would still chase hot stocks.

If you want to invest for results rather than for excitement, go for value, not for momentum and concept. Here are a number of reasonably priced stocks that should outperform in either up or down markets:

Community Psychiatric Centers (CPS) operates 52 psychiatric hospitals. Earnings have increased in the last three years and should be up again in 1996. The stock is priced at only an 11% premium to book value and a P/E of 12 on 1996 estimates.

Hudson’s Bay Co. (HBC) is Canada’s largest department store chain. Earnings after a number of poor retailing years should pick up in 1996. The stock trades at a discount of almost 40% to book value, a P/E of 16 on 1996 estimates and yields 3.2%.

National Bank of Canada (NA) is the eighth-largest bank in that country. Earnings should improve again in 1996. The stock trades at an 8% discount to book value, a P/E of 8 and yields 3.8%.

Shopko Stores (SKO) is a specialty retail discounter operating 129 stores, as well as a health care business. Earnings should be up about 10% in the current fiscal year (ending February 1997). The stock trades at a 12% discount to book, a P/E of 13 and yields 2.9%.

Standard Motor Products (SMP) is a maker of automotive replacement parts for the aftermarket. Earnings should be up 10% or more this year, with further improvements ahead. The stock trades at about a 6% discount to book, a P/E of 13 and yields 2%.

Even efficient market theorists now acknowledge that Ben Graham was right.