Tony - In case you DIDN'T see this. Walter

A Conversation With Benjamin Graham

Benjamin Graham, senior author of *Security Analysis*, needs no introduction to the readers of this magazine. The Journal thanks Charles D. Ellis, a member of its Editorial Board, for making available this presentation, in question-and-answer format, to a recent Donaldson, Lufkin & Jenrette seminar.

▸ *In the light of your 60-odd years of experience in Wall Street what is your overall view of common stocks?*

▸ Common stocks have one important investment characteristic and one important speculative characteristic. Their investment value and average market price tend to increase irregularly but persistently over the decades, as their net worth builds up through the reinvestment of undistributed earnings—incidentally, with no clear-cut plus or minus response to inflation. However, most of the time common stocks are subject to irrational and excessive price fluctuations in both directions, as the consequence of the ingrained tendency of most people to speculate or gamble—i.e., to give way to hope, fear and greed.

▸ *What is your view of Wall Street as a financial institution?*

▸ A highly unfavorable—even a cynical—one. The Stock Exchanges appear to me chiefly as a John Bunyan type of Vanity Fair, or a Falstaffian joke, that frequently degenerates into a madhouse—"a tale full of sound and fury, signifying nothing." The stock market resembles a huge laundry in which institutions take in large blocks of each other's washing—nowadays to the tune of 30 million shares a day—without true rhyme or reason. But technologically it is remarkably well-organized.

▸ *What is your view of the financial community as a whole?*

▸ Most of the stockbrokers, financial analysts, investment advisers, etc., are above average in intelligence, business honesty and sincerity. But they lack adequate experience with all types of security markets and an overall understanding of common stocks—of what I call "the nature of the beast." They tend to take the market and themselves too seriously. They spend a large part of their time trying, valiantly and ineffectively, to do things they can't do well.

▸ *What sort of things, for example?*

▸ To forecast short- or long-term changes in the economy, and in the price level of common stocks, to select the most promising industry groups and individual issues—generally for the near-term future.

▸ *Can the average manager of institutional funds obtain better results than the Dow Jones Industrial Average or the Standard & Poor's Index over the years?*

▸ No. In effect, that would mean that the stock market experts as a whole could best themselves—a logical contradiction.

▸ *Do you think, therefore, that the average institutional client should be content with the DJIA results or the equivalent?*

▸ Yes. Not only that, but I think they should require approximately such results over, say, a moving five-year average period as a condition for paying standard management fees to advisers and the like.

▸ *What about the objection made against so-called index funds that different investors have different requirements?*

▸ At bottom that is only a convenient cliché or alibi to justify the mediocre record of the past. All investors want good results from their investments, and are entitled to them to the extent that they are actually obtainable. I see no reason why they should be content with results inferior to those of an indexed fund or pay standard fees for such inferior results.

▸ *Turning now to individual investors, do you think that they are at a disadvantage compared with the institutions, because of the latter's huge resources, superior facilities for obtaining information, etc.?*

▸ On the contrary, the typical individual investor has a great advantage over the large institutions.

▸ *Why?*

▸ Chiefly because these institutions have a relatively small field of common stocks to choose from—say 300 to 400 huge corporations—and they are constrained more or less to concentrate their research and decisions on this much over-analyzed group. By contrast, most individuals can choose at any time among some 3000 issues listed in the Standard & Poor's Monthly Stock Guide. Following a wide variety of approaches and preferences, the individual investor should at all times be able to locate at least one per cent of the total list—say, 30 issues or more—that offer attractive buying opportunities.

▸ *What general rules would you offer the individual investor for his investment policy over the years?*

▸ Let me suggest three such rules: (1) The individual investor should act consistently as an investor and not as a speculator. This means, in sum, that he should be able to justify every purchase he makes and each price he pays by impersonal, objective reasoning that satisfies him that he is getting more than his money's worth for his purchase—in other words that he has a margin of safety, in value terms, to protect his commitment. (2) The investor should have a definite selling policy for all his common stock commitments, corresponding to his buying techniques. Typically, he should set a reasonable profit objective on each purchase—say 50 to 100 per cent—and a maximum holding period for this objective to be realized—say, two to three years. Purchases not realizing the gain objective at the end of the holding period should be sold out at the market. (3) Finally, the investor should always have a minimum percentage of his total portfolio in common stocks and a minimum percentage in bond equivalents. I recommend at least 25 per cent of the total at all times in each category. A good case can be made for a consistent 50-50 division here, with adjustments for changes in the market level. This means the investor would switch some of his stocks into bonds on significant rises of the market level, and vice-versa when the market declines. I would suggest, in general, an average seven- or eight-year maturity for his bond holdings.

▸ *In selecting the common stock portfolio, do you advise careful study of and selectivity among individual issues?*

▸ In general, no. I am no longer an advocate of elaborate techniques of security analysis in order to find superior value opportunities. This was a rewarding activity, say, 40 years ago, when our textbook "Graham and Dodd" was first published; but the situation has changed a good deal since then. In the old days any well-trained security analyst could do a good professional job of selecting undervalued issues through detailed studies; but in the light of the enormous amount of research now being carried on, I doubt whether in most cases such extensive efforts will generate sufficiently superior selections to justify their cost. To that very limited extent I'm on the side of the "efficient market" school of thought now generally accepted by the professors.

▸ *What general approach to portfolio formation do you advocate?*

▸ Essentially, a highly simplified one that applies a single criterion or perhaps two criteria to the price to assure that full value is present and that relies for its results on the performance of the portfolio as a whole—i.e., on the group results—rather than on the expectations for individual issues.

▸ *Can you indicate concretely how an individual investor should create and maintain his common stock portfolio?*

▸ I can give two examples of my suggested approach to this problem. One appears severely limited in its application, but we found it almost unfailingly dependable and satisfactory in 30-odd years of managing moderate-sized investment funds. The second represents a great deal of new thinking and research on our part in recent years. It is much wider in its application than the first one, but it combines the three virtues of sound logic, simplicity of application, and an extraordinarily good performance record, assuming—contrary to fact—that it had actually been followed as now formulated over the past 50 years—from 1925 to 1975.

▸ *Some details, please, on your two recommended approaches.*

▸ My first, more limited, technique confines itself to the purchase of common stocks at less than their working-capital value, or net-current-asset value, giving no weight to the plant and other fixed assets, and deducting all liabilities in full from the current assets. We used this approach extensively in managing investment funds, and over a 30-odd year period we must have earned an average of some 20 per cent per year from this source. For a while, however, after the mid-1950's, this brand of buying opportunity became very scarce because of the pervasive bull market. But it has returned in quantity since the 1973-74 decline. In January 1976 we counted over 300 such issues in the Standard & Poor's Stock Guide—about 10 per cent of the total. I consider it a foolproof method of systematic investment—once again, not on the basis of individual results but in terms of the expectable group outcome.

▸ *Finally, what is your other approach?*

▸ This is similar to the first in its underlying philosophy. It consists of buying groups of stocks at less than their current or intrinsic value as indicated by one or more simple criteria. The criterion I prefer is seven times the reported earnings for the past 12 months. You can use others—such as a current dividend return above seven per cent or book value more than 120 per cent of price, etc. We are just finishing a performance study of these approaches over the past half-century—1925-75. They consistently show results of 15 per cent or better per annum, or twice the record of the DJIA for this long period. I have every confidence in the threefold merit of this general method based on (a) sound logic, (b) simplicity of application and (c) an excellent supporting record. At bottom it is a technique by which true investors can exploit the recurrent excessive optimism and excessive apprehension of the speculative public. ■

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The 1925-1960 portion of this study
is based largely on my work.  It, in
turn, was preceded by a "test" study
(1945-1974) I prepared for Mr. Graham
during spring/summer 1975.  The Cen-
tral Value models relate closely to
the dividend portion of this work.
                    ROBERT F. FARGO
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"It is fortunate for Wall Street as an institution that a small minority of people can trade successfully and that many others think they can. The accepted view holds that stock trading is like anything else; i.e., with intelligence and application, or with good professional guidance, profits can be realized. Our own opinion is skeptical, perhaps jaundiced. We think that, regardless of preparation and method, success in trading is either accidental and impermanent or else due to a highly uncommon talent."

". . . we must express some serious reservations and perhaps prejudices that we hold about the basic utility of industry analysis as it is practiced in Wall Street and as its results are exhibited in typical brokerage-house studies. Industry analysis relates to the past and the future. Insofar as it relates to the past, the elements dealt with have already influenced the results of the companies in the industry and the average market price of their shares. . . . When industry analysis addresses itself to the future it generally assumes that past characteristics and trends will continue. We find these forward projections of the past to be misleading at least as often as they are useful."

"If we could assume that the price of each of the leading issues already reflects the expectable developments of the next year or two, then a random selection should work out as well as one confined to those with the best near-term outlook."

— Security Analysis
Third Edition, 1951