TALK GIVEN SEPT 1974 PLS RETURN WALTER

Dear Walter - Thanks for thinking about me and sending this. I had time to read it at leisure while on a trip to Texas last week. Graham continues to make sense to me, and I am especially interested in some of the changes in approach he suggests.

Don 2/6/75

cc: Dave
(return original to Walter)

THE DECADE 1965-1974; ITS SIGNIFICANCE FOR FINANCIAL ANALYSTS

Benjamin Graham

The title of this seminar—"The Renaissance of Value"—implies that the concept of value had previously been in eclipse in Wall Street. This eclipse may be identified with the virtual disappearance of the once well-established distinction between investment and speculation. In the last decade everyone became an investor—including buyers of stock options and odd-lot short-sellers. In my own thinking the concept of value, along with that of margin of safety, has always lain at the heart of true investment, while price expectations have been at the center of speculation.

Let me list some of the questions relating to the value approach that confront the financial analyst now in the light of the 1965-1974 experience:

1. Is the value approach a useful one in terms of
   (a) what it can accomplish on its own, and
   (b) by comparison of its results with those of other analytical methods and practices?
2. To what degree should the techniques of valuation—as presented, say, in Graham, Dodd and Cottle, 1962—be modified by more recent developments, including theoretical thinking?
3. What is the effect of institutional domination of the stock market on the valuation work of the security analyst and the decision-making procedures of the financial analyst?
4. To what extent does the sheer number of practicing analysts—some 14,000 F.A.F. members, including 3,800 C.F.A.s and over 2,000 active C.F.A. candidates—prevent the average or representative worker from achieving worthwhile results? This is indeed a delicate question.

The discussion that follows will not separate each of these questions from the others, but I will try to answer them as best I can.
The value approach has been founded on the premise that in many—but by no means in all—cases a dependable range of valuation can be established for a common stock by analytical techniques; that often this range differs substantially from the current price; and that

such differences offer rewarding opportunities for investment operations. The phrase "rewarding opportunities" implies that the stock market itself will vindicate the value-based operation, after an interval that averages not too long for human patience—say, three years or less.

Typically, the midpoint of the value range has been found by applying an appropriate multiplier to estimated future earnings. My present view is that this is not the best technique. Instead, the earnings figure taken should be what we call "normal current earnings", and all the future prospects—favorable or unfavorable, specific or general—should enter into the multiplier. This procedural change obviates the necessity of establishing a future value and then discounting same to its present worth.

Such a procedure would carry us very far from the method first suggested in 1938 in Dr. John Burr Williams' seminal book "The Theory of Investment Value". His technique required an estimate of the stream of dividends to be received over a very long future period, and the summation of the discounted worth of each dividend to arrive at present value. The various mathematical methods later developed for valuing growth stocks represent a sort of compromise between the Williams approach and what I now suggest. For they stop the estimated stream of dividends at a terminal year—say ten years hence—and then value the stock, usually on a conservative basis, in that terminal year. The resulting figures of dividends and terminal value would then be discounted at a uniform chosen rate to arrive at present value.

Those of you who have studied *Security Analysis* may recall that we tried to simplify the mathematical methods of several writers by suggesting a formula that employs a single variable G, representing the expected growth rate over the next seven to ten years. It read (at bottom of p. 537):

Value = current normal earnings times the sum of 8½ plus 2G.

This valuation formula—like those it purported to approximate—had the great defect of failing to allow for changes in the basic rate of interest. But the one development in the past decade that has had the greatest influence on stock values—and, somewhat belatedly, on stock prices—has been the phenomenal advance in interest rates. For the three years preceding the publication of our text the yield on AAA bonds averaged 4.4 percent, and that was also the figure just ten years ago. But for the three years 1971-1973 the average was 7.5 percent, and most recently 9½ percent.

It would seem logical to me to make common-stock valuations vary inversely with representative current interest rates corresponding to the analyst's use of representative current earnings. Suppose we restated our 1972 formula with that objective, making it reflect the then going AAA rate of 4.4 percent. The expression would then read:

> Value = Earnings times the sum of 37½ plus 8.8 G., divided by the AAA rate.

Since analysts have a weakness for figures, you might like to hear two or three results based on this revised formula. For the DJIA, taking G as its historic 4½ percent and the AAA rate of its 3-year average of 7½ percent, we get a multiplier of 10.2. Applying this to the 1971-73 average earnings of the Dow, its central value would be about 750. If instead of three-year average figures you took the recent bond rate of 9½ percent and the most recent inflation-aided annual earnings of about \$93 the indicated central value would be the same 750. (The higher earnings are offset by the higher interest divisor.)

These calculations, for what they are worth, suggest that the Dow at its recent low level of 627 was undervalued by about 15 percent. Whether this would presage a near or delayed end of the current bear market I leave to wiser or bolder heads than mine. However, this same method when applied to individual issues would indicate that many have been more significantly under-priced in the present market. Take Firestone as an example. Its earnings have grown at a better rate in the past decade than those of the Dow; the figures for 1971-73 show a 116 percent increase from 1961-63 for Firestone versus 66 percent for the DJIA. If we assume the same future G of 4½ percent for Firestone as for the Dow, and hence the same multiplier of 10.2 x 1971-73 earnings, our valuation would be 24 for the tire company shares, fully 90 percent above their 1974 low. Incidentally, this would just about equal the current book value of Firestone—a previously minor detail in the investment picture but one to which I am inclined to ascribe major importance under today's new conditions. Firestone is, of course, only one example of the discrepancy between the current level of the Dow—which includes several first-tier institutional favorites—and that of the current run-of-the-mine good sized company.

A multiplier based on expected growth and interest rates alone would imply that a company's financial structure and debt position do not enter into the valuation process. This might be the case if the formula were applied—as originally intended—only to high-growth companies, whose prospects are considered so good that they are assumed to face no financial problems. But if we seek to generalize our formula to apply to average-growth companies, we must recognize that many of these may be in unsatisfactory financial condition, caused in part by inflation pressures and in good part also by the over-expansion of corporate debt in the past decade. (I consider the total figures for corporate debt since 1968, published in the June 1974 issue of the *Survey of Current Business,* to be most disquieting. They show an overall increase of 74 percent in only five years, with more to come in 1974.)

I see no satisfactory way of reducing the multiplier to allow for a below-par debt position. My advice to analysts would be rather to avoid attempting a formal valuation of such companies. In other words, limit your appraisals to enterprises of investment quality, excluding from that category such as do not meet specific criteria of financial strength. This statement brings me back to our old position that speculative companies cannot be dealt with at all by the analyst with satisfactory overall results. By my own rather strict quantitative criteria, Firestone would pass the financial-strength test by a modest margin. Such tests might well exclude up to half of the NYSE list today from investment consideration, but there would remain enough qualifying issues to give the analysts and the investor an ample selection. It should be clear that I have faith in the valuation process as a guide to investment choices, but that I would limit this technique rather strictly to companies that meet criteria of financial soundness. Also, I should require that the buy-decisions based on this approach involve a margin-of-safety factor. This might well be a purchase price not over two-thirds of the central appraised value.

How would such a policy have worked out during the past decade? Several times the market price of Firestone fell below our formula value, but not by the one-third margin. (The indicated buying level in 1970 was 16 against its low of 17½, followed by the next year's high of 28½.) Other studies have led me to believe that a computer-type valuation job of this kind would have found a considerable number of cases where shares of sound companies could have been obtained for less than two-thirds of their formula-value. On the whole one would have done quite well over this period by buying on this basis and selling at a 50 percent profit when obtainable. I see no reason to think that a similar policy could not be followed with satisfactory results in the future. (It should be unnecessary for me to add that these results are not guaranteed.)

There are, of course, many other approaches of the valuation type, and different analysts may favor different formulas with different parameters than the two I have been using. I have myself been intrigued by the idea of choosing stocks among those that are obtainable at not more than one-half their former high quotation, provided that they meet criteria of value independent of the price record. A technique of this sort would have worked fine, according to my studies, up to and including the post-1970 market recovery. Under more recent conditions it would merely have added a price-decline criterion to the determination of buy points based on the valuation approach. For practically all issues of the Firestone type an acquisition price at two-thirds of analysts' valuation would be at less than half of the previous market high.

Let me pass on to a factor in the valuation process that in my thinking has taken on considerable importance under present conditions. This is the book value figure, to be viewed either as a point of departure for more refined calculations or as a practically usable measure of a common stock's value. For years we have all pretty well disregarded asset values, except for financial enterprises and some special cases. But in recent markets a large number—perhaps a majority—of NYSE commons have actually fluctuated in price both above and below their asset values. Even Polaroid was recently obtainable at less than book value! This fact would seem to establish a realistic relationship in many cases between net worth and intrinsic or analysts' value. One might well speak today of "The Renaissance of Book Value."

You are all intelligent enough to appreciate that I am not now saying that Avon Products is only worth its book figure of $7.70 per share or that Chicago Milwaukee common is to be valued at the $149 per share shown on the balance sheet. In a substantial percentage of issues the book value figures have no worthwhile connection with the investment value of the shares. But the analyst has today perhaps a thousand stocks or more to choose from in which the asset value may actually fall within his range of appraised value. In many of these cases he could then settle for the net worth as his preferred specific figure of value, and base his buy-and-sell points on this convenient measure.

This approach can put the choice of marketable common stocks on a basis corresponding to that of investment in a private, non-quoted enterprise. If the commitment would be attractive as an ordinary business venture it should be even more attractive as part of a publicly-held enterprise, with the added advantages of diversification and ready marketability.

However, in my experience marketability has proved of dubious overall advantage. It has led investors astray at least as much as it has helped them. It has made them stock-market minded instead of value-minded. I have a puritanic vision of the true investor as someone who is entirely disinterested in what the stock market does except on two sorts of occasions that meet his convenience. The first occasion is when the market obligingly permits him to buy a group of common stocks at less than their indicated value; the second is when with equal courtesy it permits him to sell at not more than one-half their former high quotation those that are of no importance to him. True, he may sometimes dispose of an investment at a loss. But that should not be because the market price went down; it should be because things went badly for the company and the true value of the shares declined below the price he paid for them. (Of course the investor may also use the stock market to switch out of issues he owns into others that offer more value at ruling prices.)

(You are now hearing some of the "old-time religion". You may not be converted, but it shouldn't do you any harm.)

At this point let me consider briefly an approach with which we were closely identified when managing the Graham-Newman fund. This was the purchase of shares at less than their working-capital value. That gave such good results for us over a forty-year period of decision-making that we eventually renounced all other common-stock choices based on the usual valuation procedures, and concentrated on these "sub-asset stocks". The "renaissance of value," which we are talking about today, involves the reappearance of this kind of investment opportunity. A Value-Line publication last month listed 100 such issues in the non-financial category. Their compilation suggests that there must be at least twice as many sub-working-capital choices in the Standard & Poor's Monthly Stock Guide. (However, don't waste $25 in sending for an advertised list of "1000 Stocks Priced at Less Than Working Capital." Those responsible inexcusably omitted to deduct the debt and preferred stock liabilities from the working capital in arriving at the amount available for the common.)

It seems no more than ordinary sense to conclude that if one can make up, say a 30-stock portfolio of issues obtainable at less than working capital, and if these issues meet other value criteria including the analysts's belief that the enterprise has reasonably good long-term prospects, why not limit one's selection to such issues and forget the more standard valuation methods and choices we have previously discussed? I think the question is a logical one, but it raises various practical issues: How long will such "fire-sale stocks"—as Value Line called them—continue to be given away; what would be the consequences if a large number of decision-makers began as of tomorrow to concentrate on that group; what should the analyst do when these are no longer available?

Such questions are actually related to broader aspects of the value approach, involving the availability of attractive investment opportunities if and when most investors and their advisers followed this doctrine. I shall return to that problem later.

Some interesting questions relating to intrinsic value vs. market price are raised by the take-over bids that are now part of our daily financial fare. The most spectacular such event occurred a few weeks ago, when two large companies actively competed to buy a third, with the result that within a single month the price of ESB Inc. advanced from 17½ to over 41. We have always considered the value of the business to a private owner as a significant element in appraising a stock issue. We now have a parallel figure for security analysts to think about: the price that might be offered for a given company by a would-be acquirer. In that respect the ESB transaction and the Marcor one that followed it offer much encouragement to those who believe that the real value of most common stocks is well above their present market level.

There is another aspect of take-overs that I want to bring up here, on a somewhat personal basis, because it relates to an old and losing battle that I have long fought to make stockholders less sheeplike vis-a-vis their managements. You will recall that the first bid of INCO was termed a "hostile act" by the ESB management, who vowed to fight it tooth and nail. Several managements have recently asked stockholders to vote charter changes that would make such acquisitions more difficult to accomplish against their opposition—in other words, make it more difficult to deprive present officers of their jobs and more difficult for stockholders to obtain an attractive price for their shares. The stockholders, still sheeplike, generally approve such proposals. If this movement becomes widespread it could really harm investors' interests. I hope that financial analysts will form a sound judgment about what is involved here and do what they can to dissuade stockholders from cutting their own throats in such a foolish and reckless fashion. This might well be a subject for the FAF to discuss and take an official stand on.

There is at least a superficial similarity between the prices offered in takeovers and those formerly ruling in the market for the first-tier issues, as represented by "the favorite fifty". The large institutions have acted somewhat in the role of conglomerates extending their empires by extravagant acquisitions. The P/E ratio of Avon Products averaged 55 in 1972, and reached 65 at the high of 140. This multiplier could not have been justified by any conservative valuation formulae such as those we have been discussing. It was not made by speculators in a runaway bull market; it had the active or passive support of the institutions that have been large holders of Avon.

As I see it, institutions were persuaded to pay outlandish multipliers for shares of the Avon type by a combination of three influences: First, the huge amounts of money they have to administer, most of which they decided to place in equities. Second, the comparatively small number of issues to which their operations were confined, in part because they had to choose multi-million-share companies for their block transactions, and partly by their insistence on high-growth prospects. The third influence was the cult of performance, especially in pension-fund management. The arithmetic here is deceptively simple. If a company's earnings will increase 15 percent this year, and if the P/E ratio remains unchanged, then presto! the "investment" shows a 15 percent performance, plus the small dividend. If the P/E ratio advances—as it did for Avon in almost every year—the performance becomes that much better. These results are entirely independent of the price levels at which these issues are bought. Of course, in this fantasia the institutions were pulling themselves up by their own bootstraps—something not hard to do in Wall Street, but impossible to maintain forever.

These institutional policies raise two implications of importance for financial analysts. First, what should a conservative analyst have done in the heady area and era of high-growth, high-multiplier companies? I must say mournfully that he would have to do the near-impossible—namely, turn his back on them and let them alone. The institutions themselves had gradually transformed these investment-type *companies* into speculative *stocks*. I repeat that the ordinary analyst cannot expect long-term satisfactory results in the field of speculative issues, whether they are speculative by the company's circumstances or by the high price levels at which they habitually sell.

My second inference is a positive one for the investing public and for the analyst who may advise a non-institutional clientele. We have many complaints that institutional dominance of the stock market has put the small investor at a disadvantage because he can't compete with the trust companies' huge resources, etc. The facts are quite the opposite. It may be that the institutions are better equipped than the individual to speculate in the market; I'm not competent to pass on that. But I am convinced that an individual *investor* with sound principles, and soundly advised, can do distinctly better over the long pull than a large institution. Where the trust company may have to confine its operations to 300 concerns or less, the individual has up to 3000 issues for his investigations and choice. Most true bargains are not available in large blocks; by this very fact the institutions are well-nigh eliminated as competitors of the bargain hunter.

Assuming all this is true we must recur to the question we raised at the outset. How many financial analysts can earn a good living by locating undervalued issues and recommending them to individual investors? In all honesty I cannot say that there is room for 14,000 analysts, or a large proportion thereof, in this area of activity. But I can assert that the influx of analysts into the undervalued sphere in the past has never been so great as to cut down its profit possibilities through that kind of over-cultivation and over-competition. (The value-analyst was more likely to suffer from loneliness.) True, bargain issues have repeatedly become scarce in bull markets, but that was not because all the analysts became value-conscious, but because of the general upswing in prices. (Perhaps one could even have determined whether the market level was getting too high or too low by counting the number of issues selling below working-capital value. When such opportunities have virtually disappeared, past experience indicates that investors should have taken themselves out of the stock market and plunged up to their necks in U. S. Treasury bills.)

So far I have been talking about the virtues of the value approach as if I had never heard of such newer discoveries as "the random walk", "the efficient market", "efficient portfolios", the Beta coefficient, and others such. I have heard about them, and I want to talk first for a moment about Beta. This is a more or less useful measure of past price fluctuations of common stocks. What bothers me is that authorities now equate the Beta idea with the concept of "risk." Price variability yes; risk no. Real investment risk is measured not by the percent that a stock may decline in price in relation to the general market in a given period, but by the danger of a loss of quality and earning power through economic changes or deterioration in management. In the five editions of *The Intelligent Investor* I have used the example of A & P shares in 1936-1939 to illustrate the basic difference between fluctuations in price and changes in value. By contrast, in the last decade the price decline of A & P shares from 43 to 8 paralleled pretty well a corresponding loss of trade position profitability, and intrinsic value. The idea of measuring investment risks by price fluctuations is repugnant to me, for the very reason that it confuses what the stock market says with what actually happens to the owners' stake in the business.

Let me pass now to the doctrine of the efficient market. I am particularly interested in this because of its negative implications for the work of security analysts generally. The subject is dealt with briefly in my current article in the *Financial Analysts Journal,* but it has such potential importance for this audience that I shall try another crack at it here.

Let me shorten slightly the definition of an efficient market that appears on p. 97 of *The Stock Market* by Lorie and Hamilton. "An efficient market is one in which a large number of buyers and sellers cause the prices to reflect fully what is knowable about the prospects for the companies dealt in." The key phrase for me is "reflect fully." Let us assume first that it means only that the market has and uses all knowable information about every company's prospects, and hence that there is no point for analysts to spend their time trying to obtain additional information. I dissent from that statement to the extent that it would render meaningless the current controversy and concern on the use of "material information", particularly as obtained by security analysts from managements. If in all cases the market already knows and reflects all that is knowable about each enterprise then there should be no such thing as "material inside information."

But that is not my chief quarrel with the concept of the "efficient market." There is a strong implication in the Lorie and Hamilton book that because the market reflects fully all the knowable facts it thereby establishes correct or reasonably correct prices for common stocks. Hence, only the superior security analyst can successfully select the stocks that should be bought or sold. These exceptional people—in the authors' words—"have a quicker and more profound understanding of the economic consequences to individual firms of changes in the economic environment or changes within the firm itself." They have "a rare and valuable talent." I disagree completely with this viewpoint. To establish the right price for a stock the market must have adequate information, but it by no means follows that if the market has this information it will thereupon establish the right price. The market's evaluation of the same data can vary over a wide range, dependent on bullish enthusiasm, concentrated speculative interest and similar influences, or bearish disillusionment. Knowledge is only one ingredient on arriving at a stock's proper price. The other ingredient, fully as important as information is sound judgment. Take Avon Products, which sold at 140 early last year, or $8 billion for the company and under 20—or a mere $1.2 billion—last month. Was the market for Avon "efficient" on both these dates, in the sense that the price reflected "fully and properly" (the latter my addition to the Lorie and Hamilton phrase) the knowable facts. Were the changes in the short period in the environment or the company's prospects sufficient to cut 85 percent from the true value of this highly profitable, well-managed, and strongly-financed enterprise?

Take at the other extreme the large group of stocks selling for less than their working capital. Is the market "efficient" in maintaining these "fire-sale" price levels? Surely it does not lack the essential information about companies. What it does lack is judgment, courage and patience. In situations of this kind lie the best opportunities for financial analysts to prove their mettle.

The value approach has always been more dependable when applied to senior issues than to common stocks. Its particular purpose in bond analysis is to determine whether the enterprise has a fair value so comfortably in excess of its debt as to provide an adequate margin of safety. The standard calculation of interest coverage has much the same function. There is much work of truly professional calibre that analysts can do in the vast area of bonds and preferred stocks—and, to some degree also, in that of convertible issues. The field has become an increasingly important one, especially since all well-rounded portfolios should have their bond component.

Any security analyst worth his salt should be able to decide whether a given senior issue has enough statistically-based protection to warrent its consideration for investment. This job has been neglected at times in the past ten years—most glaringly in the case of the Penn-Central debt structure. It is an unforgivable blot on the record of our profession that the Penn-Central bonds were allowed to sell in 1968 at the same prices as good public-utility issues. An examination of that system's record in previous years—noting inter alia, its peculiar accounting and the fact that it paid virtually no income taxes—would have clearly called for moving out of the bonds, to say nothing of the stock even at prices well below its high of 86. We now have a situation in which all bonds sell at high yields, but many companies have an overextended debt position. Also, many of them do not seem to have sufficiently strong protective provision in their bond indentures to prevent them from offering new debt in exchange for their own common stock. (A striking example is the current bond for stock operation of Caesar's World.) These widespread present maneuvers seem to me to be so many daggers thrust in the soft bodies of the poor creditors. Bondholders can and should take steps, legal if necessary, to protect their interests against such forms of invasion.

Thus security analysts could well advise a host of worthwhile switching in the bond field. Even in the Federal debt structure—where safety is not at issue—the multiplicity of indirect U. S. Government obligations of all sorts, including some tax exempts, suggest many opportunities for investors to improve their yields. Similarly, we have seen many convertible issues selling at close to a parity price with the common; in the typical case the senior issue has offered a higher yield than the junior shares. Thus a switch from the common stock into the senior issue in these cases would be a plain matter of common sense. (Examples: Studebaker-Worthington and Engelhard Mineral preferred vs. common.)

Let me close with a few words of counsel from an 80-year-old veteran of many a bull and many a bear market. Do those things as an analyst that you know you can do well, and only those things. If you can really beat the market by charts, by astrology, or by some rare and valuable gift of your own, then that's the row you should hoe. If you're really good at picking the stocks most likely to succeed in the next twelve months, base your work on the endeavor. If you can foretell the next important development in the economy, or in technology, or in consumers' preferences, and gauge its consequences for various equity values, then concentrate on that particular activity. But in each case you must prove to yourself by honest, no-bluffing self-examination, and by continuous testing of performance, that you have what it takes to produce worthwhile results.

If you believe—as I have always believed—that the value approach is inherently sound, workable, and profitable, then devote yourself to that principle. Stick to it, and don't be led astray by Wall Street's fashions, its illusions, and its constant chase after the fast dollar. Let me emphasize that it does not take a genius or even a superior talent to be successful as a value analyst. What it needs is, first, reasonable good intelligence; second, sound principles of operation; third, and most important, firmness of character.

But whatever path you follow as financial analysts, hold on to your moral and intellectual integrity. Wall Street in the past decade fell far short of its once praiseworthy ethical standards, to the great detriment of the public it serves and of the financial community itself. When I was in elementary school in this city, more than 70 years ago, we had to write various maxims in our copybooks. The first on the list was: "Honesty is the best policy." It is still the best policy, as our new President reminded us last month.