Benjamin Graham

JOHN TRAIN

Benjamin Graham set an example of professional diligence and skill, and contributed more than any other person to the development of security analysis and investment management. Two of his great books, *The Intelligent Investor* and *Security Analysis*, continue to be "must reads" a full half-century after their initial publication dates. Most of his fortune was made through an investment in GEICO. It was an investment made at a P/E multiple well beyond anything sanctioned by his investment philosophy but one to which he felt he had obligated himself—even as others in his investor group shied away.

Benjamin Graham ranks as this century's (and perhaps history's) most important thinker on applied portfolio investment, taking it from an art, based on impressions, inside information, and flair, to a proto-science, an orderly discipline. He applied great astuteness, hard experience, and infinitely detailed labor to a field full of superstition, tips, and guesswork, one in which most people who have something to say also have an incentive to deceive the listener. Employing analysis of published records, Graham explained and demolished fallacy after fallacy—often as neatly as if opening a letter.

Graham's *summa*, after more than 50 years still the basic text of the profession, is his *Security Analysis*. More useful for most readers, however, and indeed the best book ever written for the stockholder, is *The Intelligent Investor*. One is ill advised to the point of folly to buy a bond or a share of stock without having read its three hundred pages. Many people, including experienced businessmen and professionals, have been financially shipwrecked because they trustingly set forth in a leaky craft captained by an incompetent. *The Intelligent Investor* would be unlikely to suffer this fate. . . .

Benjamin Graham . . . came to New York from England with his parents in 1895 when he was a year old. His father represented the family chinaware firm, Grossbaum & Sons. (The family name was changed to Graham during World War I.) He grew up in Manhattan and Brooklyn, the youngest of three boys. After the death of his father, when Ben was nine, the family was greatly reduced in circumstances. His mother never adjusted to the change, and her anxieties undoubtedly contributed to Ben's subsequent preoccupation with achieving financial security.

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school years, when he took jobs to help support his family, he studied Greek and Latin, which became a lasting joy to him. After graduating from Columbia in the class of 1914, Ben was offered teaching fellowships in English and mathematics; instead he went to work as a messenger in Wall Street for Newburger, Henderson & Loeb. He soon progressed to doing write-ups and analyses, and during this period he married the first of three wives. By 1917 he was earning respect as an analyst, and started publishing in financial magazines. He became a partner of the firm in 1920.

Graham was a small, stocky man who became thinner as he aged. He had an odd round face, with heavy lips and light blue eyes. A complex person of boundless energy, he loved literature—Proust, Virgil, Chateaubriand, Victor Hugo, the German poets—and was a fountain of apposite quotations.

By Wall Street standards he had unusually wide interests: the Greek and Latin classics, philosophy, languages. He translated a book from the Portuguese, wrote several books himself, admired Marcus Aurelius, and identified himself with Tennyson's free spirit, Ulysses, a wily and thoughtful adventurer who traveled far, leaving his wife lonely.

Once at a family gathering for his birthday he delivered this remarkable and revealing piece of self-analysis:

> One of the great heroes of my childhood reading was Ulysses, or Odysseus. In spite of the great praise heaped on the *Iliad* as the world's foremost poem, I must confess that I have never been able to read it through—although some passages, such as Hector's farewell to Andromache, have long been my favorites. But the *Odyssey* has fascinated me from the beginning, nor has that fascination diminished through the years. The wiliness and the courage, the sufferings and the triumphs, of its protagonist carried an appeal which I never could quite understand. At first I thought it was the attraction of opposites—Ulysses enthralled me because both his character and his fate were so different from my own. Only after I had long passed my maturity did I begin to realize that there were quite a bit of the typically Odyssean faults and virtues in my own makeup. . . .

While Graham sought women, he was not suited to marriage. His second wife was a secretary, and his third, Estelle, worked for him. The French . . . [woman, Malov,] with whom he spent his final years he took over from one of his own sons. He developed a passion for dancing and signed up for several thousand dollars' worth of lessons, eventually giving it up and offering the unused time to his brother, Victor.

His interest in his own children only really started when they became concerned with ideas; then he became their walking encyclopedia. A born teacher, he liked to invent stories for them and answer their questions on any subject.

Generous and kind . . . he was liked by the people he came in contact with, but had few intimate friends. In a self-description he quoted Estelle's judgment that he was "humane, but not human." Although an agnostic who held for no organized faith, he was interested in religious philosophy. He became a skier when that was an unusual skill, and a keen tennis player. As a friend says, he had no *minor* faults: he didn't smoke or drink, and ate sparingly. He was absentminded and did not like to drive a car. He lived modestly but comfortably, and after he achieved financial security he was little concerned with money. Late in life he moved from New York to La Jolla, California, but in his very last years preferred the south of France.

Graham loved mathematics, and his approach to investment is mathematical, quantitative. In fact, he may well have been concerned with security analysis primarily as a branch of mathematics. Certainly no earlier investment thinker approached the subject solely through figures, without concern for the quality of the business or the character of management.

In 1926 he formed a pool, the Benjamin Graham Joint Account, which grew to $2.5 million within three years and which he managed in return for a share of the profits. During the first year he was joined by Jerome Newman, with whom he remained associated throughout his business career.

During this period Graham encountered Bernard Baruch, and was instrumental in his making a number of investments. A person close to the situation adds, "Baruch was lavish with praise privately but that was all; the relationship was all take and no give on the part of Baruch." Baruch is believed to have offered Graham a profit-sharing association, but not on a basis that Graham found attractive.

When the market collapsed in 1929 and 1930, the Joint Account sustained severe losses; from 1929 to 1932 it declined 70 percent as compared to 74 percent for the Dow Jones Industrials and 64 percent for the Standard & Poor's 500. But since the Joint Account had been using substantial margin at the beginning of the period Graham's stock-picking record was better than it seemed. Nevertheless, he personally was wiped out in the Crash. Having ducked the 1929 cataclysm, he was enticed back into the market before the final bottom.

From 1928 to 1956 Graham taught a popular evening course at Columbia Business School. In 1934, with Professor David L. Dodd, he published the monumental *Security Analysis*, the basic text for all serious students of investing, which has sold over 100,000 copies so far and seems likely to sell forever. (As a curiosity, and an indication of Graham's skill, the value of the list of undervalued special situations in the 1940 edition advanced over 250 percent in the next eight years, compared to a one-third increase in the Standard & Poor's Industrials.)

In 1944, Graham published *Storage and Stability*, offering a plan to stabilize food surpluses, world commodities, and world currencies. *The*

Interpretation of Financial Statements appeared in 1947, and in 1949 *The Intelligent Investor*.

Graham's greatness as an investor may well have consisted in knowing how to say no. One of his assistants in Graham-Newman has described to me ruefully what it was like proposing a list of carefully selected and researched opportunities for Graham's consideration, only to have him find something substantive to object to in every one. He felt no compulsion to invest at all unless everything was in his favor.

When he finally did buy he was sure of what he was doing. His idea of a good, safe investment was simply buying a dollar for 50 cents over and over again. In any specific case something may go wrong, but if you do it dozens of times the procedure is virtually infallible. Diversification—a multiplicity of transactions—is thus a key to the method, just as in insurance.

And even as he bought, Graham always kept one foot out the door, ready to run if his calculations went awry. But this intrinsic caution robbed him of the flair necessary to catch major market moves. Besides reentering the market too soon in the thirties and getting cleaned out, he missed the great bull move beginning in 1950, even advising one of his protégés not to go to work in Wall Street in 1951 because the market was so high.

However, in the 1973 edition of *The Intelligent Investor* he was right: "We think the investor must be prepared for difficult times ahead—perhaps in the form of a fairly quick replay of the 1969–1970 decline, or perhaps in the form of another bull market fling, to be followed by a more catastrophic collapse." And indeed, the 1973–1974 collapse was the most severe since the great crash of 1929–1932—creating the best buying opportunity since that time.

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All his professional life Graham sought explainable, specific techniques that he could teach to others to enable them to select safe and profitable investments. He wanted a method that was entirely *quantitative*, that did not depend on things one couldn't be sure about, such as social trends, a company's future success in bringing out new products, or quality of management.

He also wanted a method that could be used by anybody, and which therefore depended entirely on readily available published material, particularly the company's own reports.

He and his associates, after working for years, finally, in that prodigious compendium, *Security Analysis*, did give the investor the tools he needed.

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Graham constantly underlines the distinction between "investment" and "speculation." Investment must be based upon *thorough analysis*, and must promise *safety of principal* and a *satisfactory return*. A holding may fail to be

an investment, and thus be a mere speculation, because the analysis, the safety or the return is lacking.

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In 1948 Graham-Newman Corporation and Newman & Graham, a companion partnership, put $720,000, one-quarter of their assets, into buying a half-interest in Government Employees Insurance Company. GEICO . . . sells automobile insurance to government employees, but always directly, by mail. It has no agency force. It can offer unusually attractive rates, since its costs are low, and experience shows that this class of driver has relatively few accidents.

Although, for SEC reasons, most of this investment had to be spun off to the Graham-Newman Corporation shareholders, the value in GEICO stock received by Graham's group eventually reached half a billion dollars! GEICO then fell on very hard times, and at the dead low in 1977 lost 95 percent of its value; but it has made a considerable recovery since.

Excluding the GEICO stock received by his investors, Graham was never managing more than $20 million at any one time—an inconsiderable sum by today's institutional investment standards, since there are now hundreds of portfolios worth over $1 billion. By distributing to his shareholders the cash received from holdings that were liquidated, he kept his company from growing. That was because he was not confident of being able to discover more than $20 million of grossly undervalued situations at a time. If he had allowed the money to build up in the company, it would have grown to a very considerable sum—on the order of $100 million—and the results would probably have been affected.

Graham's explicit followers have always managed a limited amount of money. I would guess that even today it amounts to less than $100 million, and quite possibly much less. With the availability of computer readouts on demand, the game will become much easier to play, and thus more competitive and less profitable.

David L. Babson

EVERETT MATTLIN

David Babson is a folk hero to investment people of a certain age. He developed a concept of investing with which he built a respected firm. He also understood profoundly the concept of professionalism, for which he provided leadership to a generation. Along the way, he wrote some of the best-ever commentary about investing, and also had some fun. This piece dates from 1970, immediately following collapse of the "go-go years" bubble.

As the gunslingers were shot down en masse at the corner of Broad and Wall over the past year, the few left to swagger into Oscar's to celebrate were some of the old boys who had almost been forgotten in all the excitement of the past few years. Leading them was David L. Babson, whose fund ranked fifth in 1969 for U.S. funds with assets of over $10 million, with a slight gain in a year when minuses prevailed. Babson, 58, a dogged, somewhat stooped, pipe-smoking New Englander, has for years been wagging his finger at the performance boys and what he calls their "speculative orgy." It was as if old-fashioned virtue had finally triumphed in the marketplace.

Babson is a gentle man, but he has never been shy about speaking up against what he considers evil. In articles and speeches he has railed against what he has called at times "the performance fad" and at other, more emotional times, the "performance psychosis." He has blasted mutual funds that indulge in "outright gambling with other people's money" and who have turned the market into a "national crap game." Repeatedly he has condemned professional investors who behave like tape-watching speculators, the churning of fund portfolios, the analysts who substitute stories and chart reading for solid research, the liquidity problems that the continuous shifting of huge blocks of stocks is bringing about, the unlikelihood of "hundreds and thousands of smart guys trying to outsmart other smart guys as coming out anything but a draw," the questionable tactics of funds pushing up the price of thin stocks, the disreputability of "managing earnings" by accounting gimmicks, the possible decline of public confidence in the free enterprise system and

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the probability of eventual government intervention if the whole "gigantic pari-mutuel operation" doesn't stop.

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It is ironic that Babson should now be labeled a conservative; when he opened his counseling office 25 years ago, the Boston investment community thought him rather far-out, and possibly unsound. Babson graduated from Harvard in 1932 on the day that the Dow-Jones hit its low mark of the century. "Steel mills were running at 8 percent of capacity that week," he recalls. But somehow the Depression and the War years didn't sour him on the stock market the way it did so many of his contemporaries. "After the War," he says, "I was the first, along with T. Rowe Price, to push growth stocks, when I might add, most of today's 'performance investors' were happily frolicking in their play pens."

That Babson could have a hard time convincing anyone to invest in stocks in the late 1940s now seems hard to believe, but he can remember those days clearly. "Everyone expected a big drop, like 1920–1921. Most people who had been through the 1920s were still thinking of a cyclical approach to the market. People were scared. There was no interest in stocks; they were selling four, five and six times earnings. I remember one day when only 130,000 shares were traded on the New York Stock Exchange. I stood on the floor of the Chicago Exchange and watched the boys playing ball on the floor. The ticker didn't move at all. Finally 200 shares of Armour crossed—at two dollars a share."

Investment counselors at other firms thought Babson irresponsible to recommend stocks in such a climate, but he kept writing in his weekly staff letters that "we are on the threshold of the greatest prosperity in our history." He argued that the stabilizers built into the economy since the Depression would really have an impact. He predicted that a sustained birth rate, inflationary pressures, government spending, higher standards of living, and great advances from new technology would assure an expanding economy. "Sure it's commonplace now, but they called me a radical then."

He was also an aggressive investor. "I never put money into bonds unless the account had to have them." He bought growth instead of dividends—3M, Honeywell, Merck, Pfizer, and Corning Glass—for his clients. "I bought Polaroid when it was running out of a garage in Cambridge. I bought IBM from 1948 on and I don't know as I ever told anyone to sell it. I've always believed in buying only stocks that you want to keep. There may be nothing very exciting about buying for the long pull," he says, "but it works."

Babson's approach to the market was probably inevitable, given his thoroughly New England heritage. He believes, as do a good many of the old-time Boston counselors and money managers, that those who handle money should function in the Boston prudent trustee tradition, and a

trustee doesn't fool around with someone else's money. Babson's ancestors settled in Massachusetts in 1630. He was born on a farm near Gloucester; his father was a veterinarian as well as a farmer. Babson went to grade and high school in Gloucester and worked summers on the farm. After skipping a couple of lower grades, he graduated from Harvard at the age of 20—with a major in history and a cum laude honors thesis pronounced the best in its division for that year. . . .

Babson is a facile expository writer, able to clarify and simplify complicated economic issues, and an inveterate communicator. Out of Harvard, he started writing at Babson's Reports for his cousin, the late Roger Babson. . . . He still writes a widely quoted weekly newsletter on economic and investment policy trends that is mailed to some 7,000 clients and interested parties. "I've been writing something once a week for 37 years now." . . .

In 1940, when he was 29, he left Roger to found his own firm. "Roger was tough to work for—and I was with him eight years. I really don't like to have anyone control me. Anyway, I was writing an investment newsletter when I thought what people really needed was personal attention. It's like reading a medical report in the paper instead of seeing a doctor. Counseling was still in its infancy then. There were only about a half dozen firms in the field. It was rough going at first. It's tough to come to a man and say, 'Mr. Smith, if you decided to become my client, you'll be the first.'"

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Investment decisions are based on the same principles that have applied since the firm began: to buy quality stocks for the long haul and not worry about short-term forecasting. But a Yankee is shrewd as well as cautious, and Babson has never played it super-safe by sticking to blue chips. He has always preached growth. His method of sniffing out growth situations is standard: his analysts look for a major industry, one growing faster than the economy, then seek the leaders in that industry, companies with progressive management, a low ratio of labor costs to sales, high profit margins, little government regulation and strong R&D which should result in new products and processes. . . .

Life is more relaxed for the man who buys for the long haul, who doesn't have to worry about daily portfolio switches, and there is no hurry about Babson—he even speaks slowly.