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Ben Graham approach

The Simplest Way to Select Bargain Stocks

You'd be hard pressed to find anyone more knowledgeable about the stock market and the secrets of latching on to real stock values than Benjamin Graham, a man generally regarded as the dean of security analysts. Not only did Graham co-author a book, *Security Analysis*, that's become the bible of the business, but his record of picking winning stocks is legendary on Wall Street.

A millionaire at 35, Graham retired to California some time ago. In recent years he's devoted himself to distilling the methods of stock selection he used successfully for nearly half a century into a few easily followed principles. Now 82, Graham has lately gone into association with investment counselor James B. Rea to establish a fund whose investment policy will be based on those principles. Graham believes that a doctor handling his own investments should be able to utilize those same principles to achieve an average return of 15 percent a year or better.

Sitting in the study of his La Jolla oceanfront apartment, Graham outlined the fundamentals of his approach for *Medical Economics* West Coast Editor Bart Sheridan. Here Senior Associate Editor Laton McCartney gives the highlights of their conversation:

Q. Would you start by telling us how you arrived at the simplified Graham technique?

A. Well, for the past few years I've been testing the results of selecting undervalued stocks according to a few simple criteria. My research shows that a portfolio put together using such an approach would have gained twice as much as the Dow Jones Industrial Average over the long run. The research period goes back 50 years, but the approach has proven successful when carried out over far shorter periods. I was so impressed by it, I felt it should be put into practice.

Q. Are you seeking out growth issues with this technique of yours?

A. No. To my mind the so-called growth-stock investor—or the average security analyst for that matter—has no idea of how much to pay for a growth stock, how many stocks to buy to obtain the desired return, or how their prices will behave. Yet these are basic questions. That's why I feel the growth-stock philosophy can't be applied with reasonably dependable results.

Q. What about the conventional yardsticks like a company's projected earnings or market share for evaluating stocks?

A. Those factors are significant in theory, but they turn out to be of little practical use in deciding what price to pay for particular stocks or when to sell them. The only thing you can be sure of is that there are times when large numbers of stocks are priced too high and other times when they're priced too low. My investigations have convinced me you can predetermine these logical "buy" and "sell" levels for a widely diversified portfolio without getting involved in weighing the fundamental factors affecting the prospects of specific companies or industries.

Q. That kind of thinking—ignoring fundamentals—would be branded as heresy by many analysts today . . .

A. Maybe so, but my research shows it works. What's needed is, first, a definite rule for purchasing which indicates *a priori* that you're acquiring stocks for less than they're worth. Second, you have to operate with a large enough number of stocks to make the approach effective. And finally you need a very definite guideline for selling.

Q. Can a doctor or any investor, like me, do all that?

A. Absolutely.

Q. How should I start?

A. By making as large a list as possible of common stocks currently selling at no more than seven times their latest—not projected—in the stock quotation columns of *The Wall Street Journal* or other major daily newspapers.

Q. Why a P-E ratio of seven instead of, say, nine or five?

A. One of the ways to determine what you should pay for stocks at any given time is to look at what quality bonds are yielding. If bond yields are high, you want to buy stocks cheaply, meaning you will look for relatively low P-Es. And if bond yields drop, then you can pay more for the stock and accept a higher P-E. As a rule of thumb in pricing stocks this way, I select only those issues whose earnings-to-price ratio—simply the P-E in reverse—is at least twice the average current yield on top-quality (triple-A) corporate bonds.

Q. Give me an example.

A. Sure. Just double the bond yield and divide the result into 100. Right now the average current yield of AAA bonds is something over 7 percent. Doubling that you get 14, and 14 goes into 100 roughly seven times. So in building a portfolio using my system, the top price you should be willing to pay for a stock today is seven times earnings. If a stock's P-E is higher than seven, you wouldn't include it.

Q. What if AAA bond yields go down to, say, 6 percent?

A. Then the acceptable P-E goes up. Twice six is 12; divide 12 into 100 and you get a maximum P-E of eight. However, in my opinion, you should never buy a stock with a P-E ratio over 10 no matter how low bond yields get. Conversely, in my system, a P-E of seven is always allowable no matter how high bond yields go.

Q. Okay. So, as of today, your formula says to consider only stocks with a P-E of seven or less. Is that all there is to it?

A. Well, that group alone should provide the basis for a pretty good portfolio, but by using an additional criterion you could do even better. You should select a portfolio of stocks that not only meet the P-E requirements but also are in companies with a satisfactory financial position.

Q. How do I determine that?

A. There are various tests you could apply, but I favor this simple rule: A company should own at least twice what it owes. An easy way to check on that is to look at the ratio of stockholders' equity to total assets; if the ratio is at least 50 percent, the company's financial condition can be considered sound.

Q. What's "stockholders' equity"?

A. Simply put, it's the company's net worth—the amount left over when you subtract its debts from its assets.

Q. Wouldn't I need an accountant to figure that out for me?

A. Not at all. You can easily obtain the figures for total assets and stockholders' equity from the company's annual report, or your broker can get them for you.

Q. Would you give me an example of how the rule works?

A. Say a company has stockholders' equity of $30 million and total assets of $50 million, a ratio of 60 percent. Since that's over 50, the company passes the test.

Q. Are there stocks around today that meet this requirement and have P-Es of seven or lower?

A. Oh, yes. Not nearly as many as in the market decline of 1973 and 1974, but there are still plenty; the box on page 49 [Table 9] lists some of them.

Q. Once I've gone through the screening process and settled on my "buy" candidates, how do I go about structuring a portfolio?

A. To give yourself the best odds statistically, the more stocks you have to play with, the better. A portfolio of 30 would probably be an ideal minimum. If your capital is limited, you can deal in "odd lots"—less than 100 shares of stock.

Q. How long should I hold onto these stocks?

A. First you set a profit objective for yourself. An objective of 50 percent of cost should give good results.

Q. You mean that I should aim for a 50 percent profit on every stock I buy?

(See T) A, Yes. As soon as a stock goes up that much

Q. What if it doesn't reach that objective?

A. You have to set a limit on your holding period in advance. My research shows that two to three years works out best. So I recommend this rule: If a stock hasn't met your objective by the end of the second calendar year from the time of purchase, sell it regardless of price. For example, if you bought a stock in September 1976, you'd sell it no later than the end of 1978.

Q. What do I do with the money when I sell off a stock? Reinvest it in other issues that meet your requirements?

A. Usually, yes, with some flexibility dictated by market conditions. In times like the 1974 drop, when you find many good companies whose stocks are selling at low P-E levels, you should take advantage of the situations and put up to 75 percent of your investment capital into common stocks. Conversely, in periods when the market as a whole is overpriced you'd have trouble finding stocks to reinvest in that meet my criteria. In such periods you should have no more than 25 percent of your funds in stocks and the rest in, say, U.S. Government bonds.

Q. Using your strategy what kind of results can I expect?

A. Obviously you're not going to get a 50 percent gain on every stock you buy. If your holding-period limit on a stock expires, you'll have to sell it at a smaller profit or even take a loss. But in the long run, you should average a return of 15 percent a year or better on your total investment, plus dividends and minus commissions. Over all, dividends should amount to more than commissions.

Q. This is the return you'd have gotten over 50 years according to your research?

A. Yes, and the results have been very consistent for successive periods as short as five years. I don't think a shorter period gives the strategy a really fair chance to prove itself. In applying the approach every investor should be prepared financially and psychologically for the possibility of poor short-term results. For example, in the 1973–1974 decline the investor would have lost money on paper,

but if he'd held on and stuck with the approach, he would have re-
couped in 1975–1976 and gotten his 15 percent average return for
the five-year period. If we get a repeat of that situation, the investor
should be prepared to ride out the downturn.

Q. With the Dow around 1000 and many issues at their five-year highs, is there a danger of the kind of drop that followed the overpriced markets of the late 1960s and early 1970s?

A. I have no particular confidence in my powers—or anyone else's—
to predict what will happen with the market, but I do know that if
the price level is dangerously high, chances are you will get a seri-
ous correction. In my own tests there were a number of periods of
overvaluation, and the number of stocks available at attractive
prices was very small; that proved a warning that the market as a
whole was too high.

Q. Can you summarize the key to making your approach work?

A. The investor needs the patience to apply these simple criteria con-
sistently over a long enough stretch so that the statistical probabili-
ties will operate in his favor.

A SAMPLING OF BARGAIN STOCKS

The following stocks meet the selection criteria recommended by Benjamin Graham in the accompanying article—a P-E ratio of seven or less and an equity-asset ratio of 50 percent or more. All are listed on the New York Stock Exchange. [See Table 9.]

A Sampling of Bargain Stocks

Company	*Stockholders' Equity (millions)*	*Total Assets (millions)*	*Equity-Asset Ratio (%)*	*P-E Ratio (8/16/76)*	*Recent Price (8/16/76)*
Amalgamated Sugar	$ 92	$120	77	3	36⅞
Ampco-Pittsburgh	50	65	77	7	10
Amstar	230	441	52	6	44¼
Blue Bell	164	302	54	5	39⅞
Federal Co.	81	124	65	4	25⅝
Federal Paper Board	153	291	53	5	37¾
Gordon Jewelry	82	147	55	5	10¾
Graniteville Co.	80	117	69	4	13¾
Harsco Corp.	206	358	58	6	22⅞
Houdaille Industries	126	190	66	6	16⅛
Houghton Mifflin	54	87	62	6	12
Hughes & Hatcher	26	47	54	6	7
Jantzen	40	65	62	5	18¼
Jorgensen (Earle M.)	78	122	64	5	37
Lane Bryant	76	137	55	6	11¾
Leslie Fay	31	62	50	6	8
McCord Corp.	48	68	71	6	16
Michigan Seamless Tube	42	65	65	6	20½
Murray Ohio	47	78	60	7	20¼
Norris Industries	119	196	61	6	37¾
Omark Industries	78	129	60	6	11¾
Reeves Brothers	73	108	68	6	30
Riegel Textile	82	148	56	5	16¾
Russ Togs	48	64	75	6	10⅝
Sparton Corp.	23	35	66	6	8¼
Uarco	57	87	66	6	21
Wallace-Murray	105	209	50	7	18⅜
Western Publishing	103	163	63	6	16⅜
Weyenberg Shoe Mfg.	23	40	57	7	23
Zale Corp.	292	181	61	7	17

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