Benjamin Graham: The grandfather of investment value is still concerned

by John Quirt

In a television talk show back in the 1960s, one of the young gunslingers of the day was chattering on about aggressive investing when someone brought up the name of Ben Graham. Although he knew Graham only by reputation, the go-go fund manager remarked brashly that "the trouble with old Ben is that he just does not understand this market." Today, more than half a decade later, the question is: Who didn't understand what? That gunslinger, along with his once-exuberant peers, has long since been ambushed by the excesses of the performance cult he represented. But "old Ben" Graham is still very much around, preaching the gospel of true investment value, of margin-of-safety, and saying unnervingly critical things about institutional investing that all of a sudden many people seem to be hearing once again.

Benjamin Graham, now a vigorous 79, can be found these days at his La Jolla condominium overlooking the California shoreline, busily putting the finishing touches on the soon-to-be-published Fifth Edition of his perennial best seller, *Security Analysis* (by Benjamin Graham and David L. Dodd, McGraw-Hill, 778 pages, in cooperation with Sidney Cottle). A classical scholar and translator — he's brought into English works ranging from Ovid to a relatively recent Spanish novel — Graham is still widely acknowledged as the dean of the investment profession. Indeed, before Graham, security analysis wasn't a profession at all; he called for it to be made so in a speech during the mid-1940s, which eventually led to the designation of "Chartered Financial Analyst." Meanwhile, he also put his ideas into practice, amassing a substantial fortune, and translated them for the layman, in *The Intelligent Investor*, another best seller that has gone through several editions. "Roughly speaking" says one usually cynical member of the investment fraternity, "Ben Graham has written half the good stuff that's ever been written about investment management."

An accounting

"Just call me Ben," he tells a visitor, setting aside a sheaf of papers that represents a day's work on the update of his book — at an age when most people prefer reminiscing, he's still revising his thinking. Then, he asks in a courtly, soft-spoken manner: "Would you care for some afternoon tea?" It is a cool, clear winter afternoon and Graham is attired in a plaid shirt, dark suit and red bow tie. He moves slowly now, sometimes with the help of a cane, but speaks surely and irrefragably about developments in the investment business.

"In the past ten years Wall Street has given a poorer account of itself than at any time in its history," he asserts, adding parenthetically that "perhaps I shouldn't say anything like that, but, hell, if I am going to be 80 I guess I can say what I want to. You can almost despair of expecting any rationality if you look back over what has happened. First, a virtual collapse of the whole Wall Street system following a period of irrationality, but with extra factors added in that I've never heard of in my lifetime, including brokerage firms going broke for having *too much* business to handle. That's important to mention because it's an indication that the desire to make a lot of money fast took precedence over the most ordinary, elementary business considerations."

After new highs were made for the indexes at the end of 1972 and the beginning of 1973, he continues, we saw "another kind of collapse very similar in terms of the figures to what we saw in '70. How people could have had the lack of prudence to reestablish those late '72 and early '73 values is something I don't think I'll ever understand."

When Graham refers to "people," he is, of course, directing his disapprobation

Graham: No matter how low it starts, it won't rise forever

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largely at the institutional investors who led the ill-fated 1972 upsurge, including large pension funds that eschewed their usual conservatism to swing more aggressively into equities. He doubts the wisdom of any large fund striving for 12 per cent compounded returns at a time when bonds yield 8 per cent. And he continues to have grave misgivings about consanguine practices still in use, albeit less extensively, since the toppling of the two-tier market: The reliance on projected future earnings to buy relatively high multiples, measurements of short-term and comparative performance, employment of standard rates of turnover to give the appearance of trying for better results and weighing of risk through beta or price fluctuation analysis.

Socratic dialogue

Graham's views, which have been variously summarized as "the first step in making money is not losing money" and "you have to protect yourself against great adversity," got an unusual airing last year at a conference of money managers organized by Donaldson, Lufkin and Jenrette in Rancho La Costa. It was a meeting called to discuss some of the critical issues confronting the industry, and one of the participants, Charles D. Ellis, a frequent contributor to these pages, has since likened Graham's contribution there to that of Socrates addressing the Athenian youth.

The analogy is an extremely apt one. Graham is fluent in the language and actually called "Adam Smith's" attention to an error in a Greek quotation in *The Money Game*. But more important, as Ellis points out, Graham's co-discussants were mostly fourth generation investment managers who have long since considered "Graham and Dodd," which was first published in 1934, as out of date as "Currier and Ives." For them, the confrontation with the grandfather of their profession was undoubtedly an unnerving experience; some of them didn't even seem to understand his message. And it was also pretty unnerving for Graham.

"I was shocked by what I heard at that meeting," he says. "I could not comprehend how the management of money by institutions has degenerated from the standpoint of sound investment to this rat race of trying to get the highest possible return in the shortest period of time. Those men gave me the impression of being prisoners of their own operations rather than controlling them. I say 'prisoners' in the sense that they have held themselves out as being able to do what their employers or contractors want them to do — which is to obtain a better-than-average return on the enormous amounts of money they handle. By definition, that's practically impossible to do. They are promising performance both on the upside and on the downside that is not practical to achieve."

Their efforts to do so, Graham continued, had led to an essentially speculative approach to the handling of the funds. As I listened to those fellows talk, I couldn't imagine how their approach could in the end ever produce anything but regrets, perhaps some very serious lawsuits and a general discrediting of the whole idea of money management."

At one point during the Rancho La Costa meeting, Graham asked one of the money managers if he were convinced that the market was due to drop severely, what effect would it have on his operations? "None," came the reply. "Relative performance is all that matters to me. If the market collapses and my funds collapse less, that's okay with me. I've done my job."

"That concerns me," Graham admonished him. "Doesn't it concern you?"

On another occasion a participant pleaded that he really couldn't distinguish between an investor and a speculator. Graham responded, almost inaudibly, "That's the sickness of the time."

At still another juncture he asked, "is there a standard rate of turnover for the kind of money you manage?".

"Yes," a participant replied, "about 25 to 30 per cent."

"Have you ever investigated to see what would happen if your turnover was less?" Graham inquired. Most of the participants conceded that they had not investigated. One who had, said "turnover seems to hurt performance most of the time."

"Then is there perhaps some self-interest reason for the high turnover?" Graham persisted.

"Well, we do get paid to manage the money," said a participant. "And our employers and clients expect us to be active managers. We're paid to try."

Bursting bubbles

Toward the close of the meeting the conversation turned to growth stocks and rate of return, and Graham raised his voice to challenge the group: "How can you talk seriously about a 7.3 per cent average annual rate of return that is based on stock prices that shoot up 40 per cent one year and go down 20 per cent the next?" he asked. "And how can the market be expected to outperform the underlying profits growth of publicly held corporations?"

Receiving no satisfactory answers to embarrassingly fundamental questions such as these, he drove home his feelings about growth stocks with a simple illustration. "Take a stock that has earnings growth of 15 per cent per year," Graham said. "That's rather remarkable, but let's take it as an example. So long as the p/e just stays at its present level, the buyer will get 15 per cent returns — plus dividends if any — which will be so attractive to other investors that they will want to own that stock too. So they will buy it and in doing so they will bid up the price and hence the p/e. This makes the price rise faster than 15 per cent so the security seems even more

become enamored with the promised rate of return, the price lifts free from underlying value and is enabled to float freely upward creating a bubble that will expand quite beautifully until finally and inevitably it *must* burst. In other words, if you start low, you'll have a rise, and if you have a rise you'll have satisfaction and that will bring a further rise, and so on. But it won't go on forever. It may go too far, but never forever."

Some time later, Graham was asked whether the participants at Rancho La Costa had given any evidence of having learned something from the discussion. "Not in any worthwhile way," he concluded, ruefully. Could he at least take some solace in the fact that his admonitions had proven on target twice in four years? "In a way that's an unfair question," he replied. "Human nature is human nature and naturally you can't help but feel vindicated to some degree after you've gone through a period where people say 'Graham was all right in his day, however' . . ."

Why then, when investment managers have seen overvalued bubbles burst twice since '70, can't more of them — indeed, why can't all of them — manage somehow to get back to something more closely approximating Graham and Dodd basics?

Graham smiled and adjusted his glasses. It was a question he had weighed many times before. "I myself think it's the consequence of the greater magnetism of the stock ticker," he said reproachfully. "These chaps start out reading Graham and Dodd and I'm sure most of them are quite impressed by it in business school. I take some malicious pleasure in saying it's the book on finance that's been read by more people and disregarded by more people than any other that I know of."

But after that, he continued, "when they come down to Wall Street, the principles and concepts they have learned seem only theoretical ones. My guess is that as they get into the work of finance where results are measured by what the stock ticker says rather than by the soundness of what's being done, they lose rather rapidly their theoretical viewpoint. They move over to what they would call a practical viewpoint and virtually turn their backs on what I consider sound approaches."

What's sound?

As anyone who has ever read *Security Analysis* knows, Graham's conception of a sound investment approach stresses net asset value and low multiples as criteria, and evaluates prices in relation to interest rates. His detractors frequently criticize this approach as a couple of decades out of date and hopelessly cast in stone. But in reality it *has* been modified in an attempt to keep up with the times. In the Fourth Edition published twelve years ago, he added a full 50 per cent to the valuations in previous editions and justified the liberalization on the grounds of basic improvements in business plus the government's commit-

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ment to avert deep depressions. That line of reasoning, says Graham, "would have shown itself to be justified in practice except for the rise in interest rates in the late '60s, which is something we had no foresuspicion of."

Now, he says, assuming 7½ or 8 per cent instead of 4½ as the going interest rate and using four-thirds of that as a divisor, (reflecting his view that one ought to get at least a third more from equity investments than debt ones, "in view of the troubles they go through with them") "we're back pretty much to the multiples that we were accustomed to prior to World War II." And the market in 1973, he adds, was "making a belated adjustment" to the higher rate.

What do the numbers point to today? Assuming 60 as the DJI's ten-year average earnings and taking four-thirds times 7½ per cent, says Graham, "you get only about 600 for the Dow. And if you substitute the last twelve months' earnings for the ten-year average you arrive at somewhere around 750. So you can't get very enthusiastic on either basis," he cautions.

What Graham can and does get a little enthusiastic about these days is the preponderence of *undervalued* situations around. On a straight Graham & Dodd basis the market is, in his words, "filled with bargains." Are they concentrated in certain industries? Graham says no, that they cut across industry lines, and he adds that he has very little regard any longer for research that purports to single out attractive opportunities on the basis of judgments of an industry's past performance, subjunctive evaluations of management or any other factors that cannot be measured quantitatively. "The older and more experienced I get," he says, "the less confidence I have in judgmental choice as distinct from the figures themselves."

New combinations

To help identify the soundest buys among the undervalued situations around, Graham has been experimenting with new combinations of the figures. But his experiments do not entail any further liberalization of what constitutes sound value. In fact, as he prepares the upcoming Fifth Edition, Graham says he finds himself "going back to earlier notions of investment," and specifically to the notion that "if you want to be sure of your ground you probably should start with and stick to the net asset value area as a point of departure. That doesn't mean you should not pay attention to other considerations," he adds, "but it does mean that whatever other factors you include should be justified by conservative viewpoints."

This, he continues, "is a very important thing to me, and it should be important for investment generally. What it really means is that the typical good company today often fails to offer a *feasible* basis for sound investment. The very fact that it is a good company introduces a speculative element in the area of price."

The newest approach Graham has experimented with in his efforts to develop a system for locating mathematically justifiable investments in the post-1968 market is a formula which he says may or may not be introduced in the Fifth Edition. Basically an adaption of his central value method but geared to individual companies rather than the DJI, it calls for buying at the lowest of three criteria:

- A low multiple (e.g., 10) of the preceding year's earnings;
- A price equal to half the previous market high ("to indicate that there has been considerable shrinkage");
- Net asset value.

Under this formula, stocks would be sold after a 50 per cent profit and otherwise the operation would be closed out after a period of, say, three years.

Graham has been testing the formula and the results so far, he says, have been "quite satisfactory. If you look at the market since '68 — and I've actually done some tests back to '61 — you find that there were considerable buying opportunities along these lines. One study I made

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using 100 company samples in 1970 showed about 50 that could have been bought under these criteria with very good results." But actually, he confesses, "the results fascinate me a little too much right now, and of course I am going to have to study this a great deal more. But at least it is an example of the kind of approach that seems logical to look at today."

Investment managers who have begun to adopt longer perspectives and turn their attention more toward assets may take fairly kindly to Graham's latest approach. But those who are still under the gun to improve performance now or be fired are unlikely to embrace it any more eagerly than they have subscribed to his other conservative advice in the past. For one thing, it is a purely mechanical formula that gives no weight to fundamental research on a company or industry. Moreover, the investment opportunities it points to are largely unpopular companies with plenty of assets but little charisma — the kind of commitments that are not always easily explained to growth-minded clients. In addition, the considerable patience the system calls for obviously will not have very much appeal to customers who still believe results ought to be measured quarterly.

Finally, it perhaps is worth noting that issues depressed 50 per cent below their market highs often tend to get less than the best risk ratings when subjected to beta analysis, no matter how low their multiples or how substantial their assets. Not surprisingly, Graham says he finds beta analysis "absurd," arguing that "the investment manager's job is to *take advantage* of price fluctuations."

Promises, promises

What is needed to put the climate right for the kind of "sound value" investing Graham advocates, is, of course, a change in both client and investment management thinking. In Graham's view, one thing that is needed is a fundamental reform of the method by which money managers promote their wares. He would put an end to the practice of firms outpromising each other, even implicitly, and he would confine all promotion to "what can realistically be accomplished."

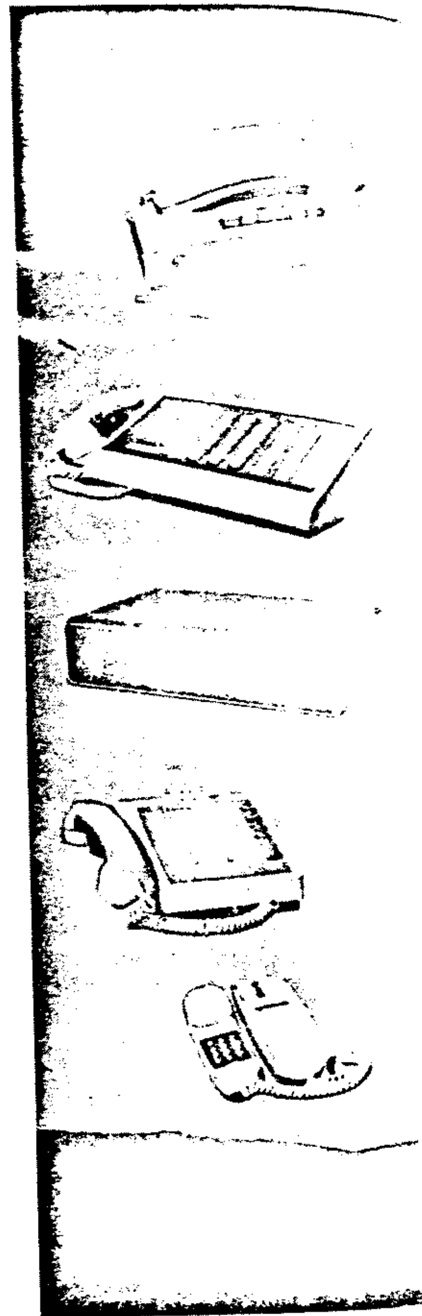
"The only way out of this mess is through some kind of joint or group action," Graham contends. "And investment managers will probably have to go through a wringer before they reach the point where they agree on limiting their promises to what is practical to achieve." That naturally raises a serious question, he admits. "Namely, if all that can be promised is an average result, how can managers expect to be paid large fees for providing that average result? I have not been able to figure out a solution or a new system of compensation though I've given it a great deal of thought," he admits. "But the whole issue is something that is going to have to be faced."

Graham's prescription for a radical change in the system of promoting competitive performance may very well draw a few guffaws along the Street. But that will be nothing new to a man who has been preaching more or less to deaf ears and going pretty much his own way in the investment world ever since his early days with Newburger Henderson and Loeb, starting 60 years ago. Graham then ran his own fund with Jerome Newman until he retired in 1956. One of his contemporaries recalls him as a "tough-minded guy who usually said and did what he felt was sound no matter which way the rest of the Wall Street mob was drifting." It is the sort of encomium that nearly everyone who has worked with Graham accords him today.

Younger critics who tend to dismiss Graham as too theoretical often overlook the fact that he *did* manage funds — and survived and prospered in the real world for three decades by putting his own theories to practice. That they should overlook this is probably unfortunate, though understandable enough, since it did not exactly happen yesterday. After all, it has been nearly two decades since Graham left his post as chairman of GEICO (which actually was one of his truly big winners) and ended his management of investment funds.

In fact, for quite a few years, Graham has been content to live a relatively quiet and private life, wintering in La Jolla and spending the summers at Aix-en-Provence in the south of France. He no longer invests in the market. ("Why should I try to get any richer?") And, other than updating *Security Analysis*, his only professional activity of late has been a rewrite of *The Intelligent Investor*. "It expresses what I feel about the period up to 1970," he says, "and I'm glad to hear that it's selling quite well."

Like this interview, Ben Graham's foray to the Rancho La Costa summit with the fourth generation last year was something of a rarity. But he remains sensitive to criticism that his comparative isolation of late has left him out of touch with the realities of modern institutional investing or made him unnecessarily critical of younger money managers. "I have the disadvantage of having a very good memory," he says. "And I try to distinguish between two aspects of being 80 next May — the subjective pessimism of an older individual, you know, and my objective pessimism from having observed stock market operations for many years. I'm not sanguine," the soon-to-be octogenarian says finally. "I am *concerned*." ■



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