no return

Mr. Margin of Safety

A book on investment fundamentals

The year 1949 is a landmark in stock market history, for it was then that the indexes stopped tracing foothill patterns and began the long Himalayan climb that was eventually to become the great bull market of 1949-68. That year also marked a Wall Street event of another kind: the publication of the first edition of Benjamin Graham's The Intelligent Investor, which was to turn out to be even more durable than the bull market. Four revised editions have since been published, and the latest has just appeared. With good reason: although the book has never come out in paperback, it has sold about 200,000 copies.

All this is a bit surprising, since the post-1949 period has not generally been Ben Graham's kind of market, nor has he remained quite the folk hero he was in 1949. He was then a veteran of 35 years on Wall Street and was celebrated both as the co-author of Security Analysis (still the definitive work on the subject) and as a working analyst. He was also rich and getting richer, and in 1956 he moved into semiretirement. The last three editions of The Intelligent Investor have been produced out of his home in La Jolla, Calif., where this month he will turn 79.

From that lovely sunny spot a continent away from Wall Street's current gloom, Graham looks back with satisfaction on the timing of his first edition. The Dow Jones industrials were then at the 175 level and stocks had few admirers. Graham, however, considered them quite attractive, and the book was intended to get that message across. It did, though hardly in the manner of "Buy now! Last chance to stock up!" Graham's forecasts tend instead to be relentlessly low key, as in this muted 1949 opinion about the Dow Jones stocks: "The investor will be getting adequate long-term value at present levels."

He was considerably more emphatic, as he has remained in every edition since, about his investment philosophy. To begin with, there are "investors" and there are "speculators," and Graham has no use for the latter. "An investment operation," he writes, "is one which, upon thorough analysis, promises safety of principal and an adequate return. Operations not meeting those requirements are speculative."

His suggestions for picking stocks within that framework are naturally spelled out at length, but can be reduced to a few basics: choose stocks that have respectable earnings records, that have at least a fairly sturdy backing in assets and that can be bought at a price that is a moderate multiple of earnings. Specifically, never pay a price for a share of stock that is more than 20 times its annual earnings.

Twenty times earnings? Actually, that is Graham stretched to the fullest limit, for the latest edition recommends at one point a maximum of 15. Either standard suggests why Graham and the market began to part company in the 1950s. For it was then that Wall Street began to be gripped by growth stock fever. In that environment, 20 times earnings often came to seem rock-bottom cheap. And Graham came to seem plodding and old fashioned or, as one well-known analyst felt compelled to put it in the late 1950s, "a good man for his time, but not for today."

All this disdain pushed Graham into more than a bit of extra research at the La Jolla Public Library, resulting in a few pages of extra explanation in later editions of his book. He concedes the appeal of growth companies—those that have produced better-than-average financial results in the past and can be expected to do so in the future. But he sees their stocks as having two catches. The first is that they are usually available only at fancy prices. The second is that all those expectations about the future may turn out to be wrong; remember, for example, when the airlines were considered to have nothing but good times ahead? The combination of high prices and uncertainty, Graham says, acts to rob the investor of the margin of safety he needs.

The phrase "margin of safety" is Graham's trademark, and beyond that, it is the enormously sane concept around which his whole philosophy is built. But even a man who knows where he stands—and Graham undeniably does—must now and then tussle with a brand-new investment question. In his new edition, Graham comes to grips with one he obviously finds perplexing: how to react to the investment phenomenon of superyields on fixed-income securities. Yields on good-grade medium-term corporate bonds were about 8% at the time he was finishing his book in late 1971 and early 1972. That happened to be a bit better than the 7½% or so that Graham expected could be earned over the years (through dividends and market appreciation) on the high-grade stocks to which he normally steers so-called "passive" investors.

Given those bond yields and those expectations about stocks, it could be strongly argued that these investors should forgo stocks entirely and move 100% into bonds. Graham, in fact, dances all around this argument and at several points seems almost ready to embrace it. But he does not, declaring finally that the specter of inflation makes him unwilling to give up stocks completely. As conclusions go, that one would seem a little lacking in logic.

Another Graham conclusion of note concerns the current level of stock prices. Many market forecasters bill themselves as infallible, as blessed with a hot line to the Delphic oracle. Graham makes no such claim. His advice has not always worked out, and he admits this freely. Even his best guidance has sometimes seemed premature. In his fourth edition, written in late 1964, he allowed that the Dow Jones industrials, then very near 900, were "too high" and at a "dangerous" level. He was eventually to look very right, but not until 1970, when the market crumbled to a low of 632.

There was, of course, a recovery in prices from that level, and when Graham was wrapping up his latest edition in early 1972, the Dow once again stood in the neighborhood of 900. Once again, Graham did not like what he saw. "Our view of the market level would tend to be the same as it was some seven years ago—i.e., that it is an unattractive one from the standpoint of conservative investment." Everyone knows what has happened to stock prices since. They have gone way up, to a high of 1,051, and they have lately been going nowhere but down. From La Jolla, Graham said recently that the decline looked to him like a "perfectly natural thing." For a follow-up on that, we may have to wait for a sixth edition. —*Carol J. Loomis*

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The Intelligent Investor
by Benjamin Graham. Harper & Row, 1973. 318 pages. $7.95.