JAN 10 1972

The Money Men

Take Your Dreams Elsewhere

BATTERED and frightened, whimpering after five years of being whipsawed by the stock market, the individual investor is seeking solace in bonds. If not bonds, then maybe burying his money in the back yard; buried money, after all, is better inflation protection than stocks that go down and down.

But look off on the horizon! Is that Benjamin Graham we see? Yes, it is Ben Graham, alive and sprightly at 77. After more than a year of saying "no" to us, this fundamentalist guru to whole generations of investment managers finally agreed to be interviewed by FORBES. Graham's living style is solid proof that his investment philosophy worked very well for him, however old-fashioned it may seem to the younger generation: We caught him by the swimming pool of a ranch-style house in La Jolla, Calif. where Graham lives when he's not staying in his other home in France's Aix-en-Provence.

Sitting in the sunshine with an unused cane in his lap, Graham spiced the FORBES interview with a witty mixture of anecdotes and well-honed aphorisms. We started with a zinger: "Are your ideas still relevant?" Graham replied with an anecdote: "About ten years ago my name came up during a television discussion among some security analysts, and one man said: 'Ben Graham was all right in his day. But he doesn't understand this market.'

"Later, when asked about it, I replied: 'It may be that I don't understand this market. But it is just as likely that the other man doesn't either.' That was just before the big 1961-62 decline."

The 1961-62 decline washed out one generation that laughed at Graham's belief in value and moderation as opposed to "concepts" and fast money. The 1969-70 crash took care of another. (In passing, Graham notes that many of these overrated investment managers "walked away rich men in spite of their failure to perform for their stockholders.")

No, Graham doesn't think his basic ideas are obsolete. He thinks far too many people bring their Walter Mitty dreams to the stock market, dreams of quick, easy money. When the same people manage a business for a living, pull teeth or practice law, they know that they have to work hard at it—and pay big taxes on what they earn. But the stock market looks like a place to make bigger money faster—and at capital gains rates.

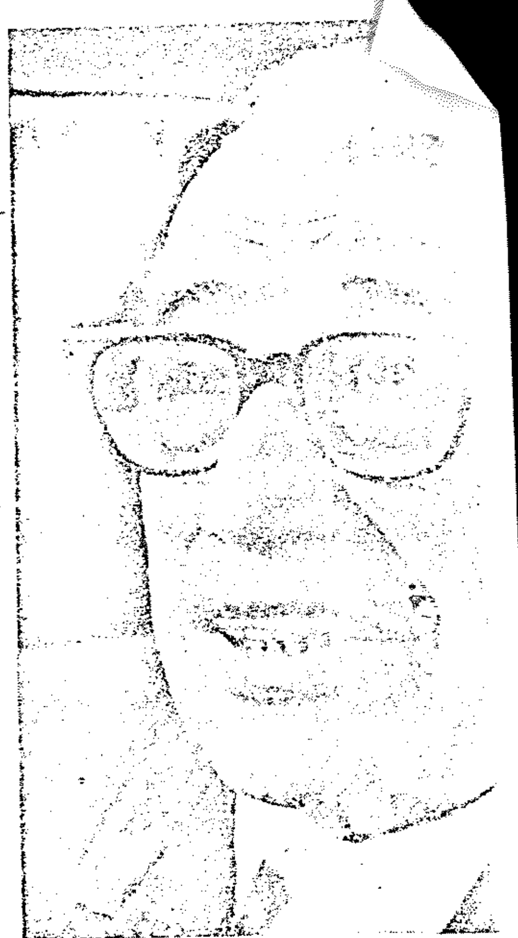
The average man who drives cautiously on the freeway wouldn't get into a racing car and rev it up to 150 miles an hour. But that's exactly what many of them do with their money in the stock market. They lack the patience and knowledge to analyze value. They fail to understand that every opportunity carries with it risks.

"If a man wants to make lots of money speculating," Graham says, "he must have a pretty good reason to believe he's smarter, and has a better feel for the market, than the next guy. Anybody that exceptional is in no great hurry. So first, any man should measure his abilities by speculating with money he can afford to lose in both bull and bear market cycles. And lucky he is if he actually turns out to be exceptional."

Graham's advice: "My basic rule is that the investor should always have a minimum of 25% in bonds, or bond equivalents, and another minimum of 25% in common stocks. He can divide the other 50% between the two, according to the varying stock and bond prices. The easiest course—and by no means the worst—would be to aim at a constant 50/50 division. When his stocks advanced substantially above his cost level he would sell some of his shares and reinvest the proceeds in bonds—and vice versa when the stocks declined. In this way he would be actively participating in price movement. That would be good for him psychologically. Also, his participation would be in the opposite direction from the general public's, which, in the end, should be good for him financially."

If an investor adopted Graham's rule using 25% minimums rather than a 50/50 split, he would own more stock when the market was low and less when it was high. But how would he know when the market was low enough or too high?

Graham has a formula, but only



Reading But Not Heeding. With the publication in 1934 of Security Analysis (co-authored with David L. Dodd), Ben Graham's ideas spread beyond his immediate circle of customers and students (he went on to teach security analysis at Columbia University and UCLA). The book became—and it still is—the classic text on its subject. Basically, Graham taught that stock prices follow earnings and dividends, and that book value—physical assets—is a key figure. The trick was to buy good companies at or below book value and wait for better earnings to send the stock up.

To his critics in recent years, Graham was still living in a measurable, three-dimensional world, while they had moved on to a four-dimensional world of concepts and growth and excitement. What was the fourth dimension? Ah, you had to have a feel for it.

But to Benjamin Graham, earnings were still earnings, book value was still book value, and you couldn't take a concept to the bank and use it for collateral, could you? Interestingly, his books continued to sell to a generation who scorned his basic ideas; Harper & Row is to bring out a new edition of his The Intelligent Investor next month. People were reading Graham, even if they weren't heeding him. Now, after five years of whipsawing markets, people are heeding him again.

a rough one. And again, today's analysts would consider it very conservative. He says that the market is too high as long as the Dow Jones industrial average (or the Standard & Poor's composite index) returns less on an earnings-per-share basis than high-quality bonds return on a yield basis. "For example," says Graham, "if today's best-grade bonds are yielding 7.5%, then the DJI would be unattractively high at more than 13.3 times its average earnings for the last three years."

According to that measure, the market would start to look good to Graham when the DJI sank to around 733. He adds that the figure could be juggled slightly, depending on whether you think earnings are rising or bond yields are falling. "Bonds are a bargain right now, especially if I'm right about the inflation rate leveling at around 3% a year. I think high-grade bonds are worth buying at yields of anything above 6%."

That still leaves the question of what type of stocks to buy. And he has a characteristic answer: "I favor public utility stocks in good part because you can buy them at around book value. So you can consider yourself a part owner, which is a very sensible approach for sound investment. Ask yourself: If there was no market for these shares, would I be willing to have an investment in this company on these terms?"

Now, Graham got to the heart of his philosophy: "To the extent that Wall Street gets away from book value, it is headed into potentially dangerous areas of thinking. It then introduces factors—chiefly the notion of increasing future earnings—which are very difficult to measure and which therefore may be badly measured."

Graham tells a story, which illustrates why he regards book value, asset value, as so important. It's not that he isn't aware of the fortunes made from IBM and Xerox and Avon Products—stocks selling at ten, 20 times book. He thinks that the risk is high and the odds are overwhelming against achieving this kind of investment miracle. He has a story to illustrate the point.

"In 1915, while just a beginner on Wall Street, I suggested that the firm recommend a low-price stock, the Computing-Tabulating Recording Co. But my employer, a conservative fellow, pointed out that the company's bonds weren't covered by its assets. He said, 'How can you touch such a speculative stock?' And I returned to my desk a very chastised young man. Years later the public company changed its name to IBM."

His employer had brushed aside IBM when its common stock was valued at a mere $4 million. Think of the millions—indeed the *billions*—Graham and his colleagues could have made on that stock. Surely his boss was dead wrong, wasn't he?

"He was wrong about the stock," says Graham. "But he was right in terms of an overall *investment* policy. Look at what could happen. A man could buy a stock like that at, say, $40 a share, and it goes to $100. Then people would say, 'Don't be a fool. Take the profit. Trees don't grow to heaven, etc., etc.' So he sells out, and then spends the rest of his life watching IBM go up and up, while looking vainly for another IBM. To make a fortune in one stock you almost have to be an insider. For mere traders, there are very, very few IBMs. That's the vital point."

> *"In nearly 60 years of observing people in the market, I have found their mixture of greed and folly unbeatable. There's no way to put an end to it."*
>
> —Benjamin Graham

In seeking new IBMs, he points out, the investor gets away from measurable values. "You're introducing factors which may be real but which are very difficult to measure. A hot stock, like a hot stove, should be handled with care." Interestingly, Graham is not just warning against the trend to play hot stocks and concept stocks. That he regards as plain damned foolishness. The trend toward these grew out of a distortion of the original growth-stock principle, and is beyond the pale of any coherent investment philosophy. Rather, Graham is warning of the dangers involved in paying too high for even the best of stocks. He's talking about the man who thinks he is investing but actually is speculating.

"Probably the largest aggregate losses are suffered by people who invest overenthusiastically in a basically sound company. I favor companies selling at about ten times average earnings. And I would add that when the multiplier moves beyond, say, 35 times earnings—even for the best companies—I think the buyer is giving hostages to fortune. That is, he may be looking too far into the future to be on sound ground today. Take the fall of IBM from 387 to 219. The market didn't change its view of the company, nor even of its long-term prospects. It simply lost confidence in its own multiplier. But the fall was enormous, way over $10 billion in market value. Heavy, heavy losses for somebody."

All this leaves Graham wary—as he always has been—of paying too high a premium for a good record or even for apparently good prospects. "There is vulnerability in a high growth rate and in high returns on capital of, say, 15%—and the two normally go together." For one thing, such fat earnings sometimes attract competitors. But even more important, the market commonly overreacts with an unreasonably high multiple.

There are numerous examples of what Graham is talking about. In the mid-Fifties, aluminum had high returns and was considered a great growth industry. Aluminum Co. of America sold at 25 times earnings. As the years passed, its earnings continued to grow, and even in depressed 1971 they will exceed the peak years of the Fifties. But the price/earnings ratio has come down from 25 to 10. People who bought Alcoa around 100 are sitting with losses of 50% and more after 15 years of waiting.

What happened was that Alcoa's high profitability attracted competition and overexpansion, and profit margins came down. Its high growth and high rate of return proved to be a disadvantage as well as an advantage.

Graham feels much the same way about spectacular earnings gains. In recent years it hasn't been at all uncommon for a company to

(*Continued on page 193*)

Slit skirts and the classic look helped to lure women back to the store in droves.

Why do Kresge's K marts continue to flourish? Each one is identical, which helps in training and shifting management. Aggressive promotion and low prices help even more when the economy is off. And finally, K marts enjoy a considerably faster inventory turnover rate than that of their competitors.

just *say* we put emphasis on the quality of our products," says Penney's President Wright, "we do it. We show up better than others when things are slow. When the Boeing cutbacks came in Seattle with that high unemployment, our stores held their volume."

Value, not just price. Could that be why most of the pioneer discounters have run into profit problems? Ironically, latecomer Kresge with its K marts is the nation's largest discounter. By contrast, Korvettes, now part of Arlen Realty & Development, has been a disappointment, while discount pioneer Interstate Stores is still hurting. Clearly, it takes something besides low prices to keep volume profitable. Too many discount stores seem to have not only lower prices but lower efficiency, too.

The department stores followed the big chains' pattern. Federated, after a tiny 4.5% dip in 1970, was setting earnings records again, with its Christmas business 11% ahead of 1970. But Federated in a poor year outperforms Macy in a good one, just as Macy outranks Gimbel's and Allied.

It was, on the whole, a more difficult year for the food retailers: A&P's earnings have sagged again for the second year in succession, and Stop & Shop went into the red for the first half because of disrupted distribution following a warehouse fire.

Discounting has continued to replace trading stamps as the major competitive weapon in many parts of the country. Said President William Mitchell of Safeway, which again set earnings records last year, "We're on a discount program with 80% of our stores. Sales have been buoyant, and I see no drastic change for 1972. However, we operate on a very narrow margin and there is no room in our industry for cost absorption."

Was Safeway just lucky in its concentration on the booming West Coast? Hardly. For one thing, the West Coast wasn't booming very loudly anymore, as California's in-migration has all but ceased. And west coast companies like Arden-Mayfair, beset by years of internal strife and management changes, show the wretched results one might expect.

The contrast of success and failure in the same areas in the same year merely emphasizes once more the overriding importance of good management. Those distributors who have it are continuing to make a lot of money. For, as David Mahoney, chairman of Norton Simon, says, "The world has belonged to the man who can package, promote and distribute his product dramatically ever since Moses stepped down from the mountain with the stone tablets." ■

The Money Men

(Continued from page 90)

treble its price when it *doubles* its earnings; the market, assuming the rising trend will continue, puts a premium on the stock. In Graham's view, the market should regard the gain rather more skeptically: At most the stock should double—or maybe not even that until such time as the earnings gains look reasonably permanent. "The market's viewpoint in these things can be quite volatile," he says.

Indeed it can. Recently Wm. Wrigley stock dropped some $60 million, or 19%, in one day, when Wall Street chose to be disappointed with a 20% *gain* in earnings.

In spite of the rough bear markets of recent years, Graham is by no means convinced that the worst is over. It won't be, he says, until "price movements are justified by objective views of some kind and not simply by pure enthusiasm or obstinacy. The extraordinary recovery the market made from its 1970 low indicates that there has been no real impairment in the public's enthusiasm for stocks that seem to be moving best."

But the old game of premiums-for-growth isn't producing results, he says, and so, its days are numbered. "I don't think traders, and that includes the institutions, will maintain forever a stock market psychology that turns out to be relatively unprofitable.

"Take IBM again. It sold at 350 in 1968 and now is about 335. With a dividend return of under 2%, that means its shareholders got virtually no net return on their money. They become dependent on a market advance to justify the price they paid—but it should be the other way around."

In all this, Graham is not predicting "another 1929" or "500 on the Dow" or anything rash like that. But he does see ahead a repetition of the wild swings of the past few years.

There it is, Ben Graham updated, and it's not a very optimistic message. But it's sober and hardheaded and realistic and maybe more in tune with the new mood in America. When you think about it, a really rip-roaring stock market would seem terribly out of place in a nation which is questioning its basic values and in a world where the once almighty dollar cowers before the once-despised yen. ■