Graham: the man who taught Wall Street the value of a good bargain.

Happy Birthday, Benjamin Graham

A century after his birth, his legacy lives on

BY ALBERT L. AUXIER • One hundred years ago today, one of the most influential individuals ever to adorn Wall Street was born in London. He was Benjamin Graham, whose family soon moved to America, where he was later to win fame for the great work for which he is best-known: *Security Analysis: Principles and Technique*. Graham was the book's lead author; the co-author was David L. Dodd. For decades, *Security Analysis*, which was published in 1934, was the Bible for serious investors. For many, it still is. (The most recent edition was issued in 1988 by McGraw-Hill.)

Graham began his career on Wall Street in 1914, and near the end of his life, when he published a revised version of *The Intelligent Investor: A Book of Practical Counsel*, he had worked 57 years on Wall Street. (Harper & Row has reissued this work, with a preface by Warren Buffett, one of Graham's most avid admirers.)

Graham is the father of value investing, a strategy whose basic tenet is that investors should buy only those investments that are worth substantially more than what they cost. Benjamin Graham wasn't the first value investor; Bernard Baruch (who once offered a junior partnership in his investment firm to Graham, who rejected it) and others predated him. But he did the most to systemize and promote this approach.

In fact, he distilled his investment philosophy to just three words: "margin of safety." Any security purchased should be worth not just more than it cost, but *much* more, perhaps at least 50% more. Stocks that met this standard offer both low risk and the potential for strong returns.

How can such stocks be found? In part, Graham said, by avoiding those unlikely to possess the crucial margin. Stocks with high price/earnings ratios, high price/book-value ratios, etc., usually are worse buys than those carrying lower valuations.

One bit of Graham's advice—that it's wise to avoid growth stocks—may seem surprising, particularly considering that he amassed a big chunk of his fortune from one company, GEICO, which was considered a growth company after he bought its stock in the late 'Forties. (However, when Graham and his investment partners violated his principle, they controlled the big insurer and thus possessed inside knowledge of its affairs.) Graham's disdain for growth stocks grew out of his conviction that they tend to become overpriced in good markets and to underperform in bad ones. ▶

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Graham disagreed with the theory hat, to earn more, an investor must accept iigher risk. On the contrary, he felt that ntelligent investing could uncover bargains. And the bigger the bargain, the ower the risk. Graham differentiates, iowever, between defensive and enterprising, or aggressive, investors.

A defensive investor doesn't have the ime, knowledge or temperament to realistically seek superior investment returns. Most people fall into this category. The defensive investor should follow simple, mechanistic rules, such as selecting a diversified portfolio of low P/E stocks designed to produce good but relatively modest returns.

Conversely, the enterprising investor has the time, knowledge and temperament needed to track down bargains. This investor should shoot for superior results, although Graham emphasized that even pros find these difficult to attain. The enterprising investor applies the same rules that the run-of-the-mill investor does. However, he uses them more flexibly, and he's often more venturesome.

Graham also viewed diversifying one's portfolio between stocks and bonds as a necessity. Defensive investors, he wrote, should always have at least 25% of their assets in bonds and at least 25% in equities.

The master investor believed that, when the stock market is dangerously high, debt securities offer better value than equities. On the other hand, he felt that stocks provide better inflation protection than bonds. And, since Graham believed that investors really don't have the ability at any given time to tell whether stocks or bonds are the better bet, both types of investments should be in their portfolios.

Parable of Mr. Market

As for price fluctuations, Graham came up with a famous parable to show how investors should regard them. Imagine, he said, owning a $1,000 interest in a business along with a partner called Mr. Market. Every day, Mr. Market offers either to buy your interest or to sell you a larger interest. Sometimes, his price is ridiculously high, giving you a perfect opportunity to sell. At other times, his price is ridiculously low, giving you a good opportunity to buy. On other days, his quotes are roughly justified by the business outlook. At such times, you should ignore him.

Graham's Mr. Market parable was related to his view of technical analysis, nearly all of which, he concluded, is based on buying shares when prices have risen and selling when they have fallen. This approach, he declared, "is as fallacious as it is popular."

In *The Intelligent Investor*, Graham evaluated the investment merit of several stocks, but not once did he predict earnings for those stocks. Why? He obviously didn't have much confidence in his ability to predict earnings—nor in others' predictions, especially long-term forecasts.

Indeed, Graham had serious doubts about the value of the security-valuation process in general. Its unreliability, he felt, was another reason to diversify one's investments.

One approach to investing is to choose the "best" industry, and then to invest in the "best" company in that industry, with little regard for the stock's price. Graham was wary of this strategy. Good business, he noted, doesn't always translate into good investment returns. Worst of all, this method could place an investor in popular, overvalued issues.

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How much should someone be willing to pay for a stock? In Benjamin Graham's view, not much more than book value. He advised conservative (defensive) investors not to pay above one-third more than book value, and aggressive (enterprising) investors not to pay above 20% more than book value.

Graham's bias against shares with high price-to-book values is easy to understand. Such issues tend to be popular, speculative, overpriced and relatively risky. He well understood the paradox of his convictions. Since many of the most successful companies had lofty market valuati[...] was suggesting that some of the w[...] top companies be avoided for investi[...] purposes.

Graham argued that most Wall Street pros seek stocks with the best growth prospects and ignore good stocks that appear to have somewhat less glowing futures. These, then, can become undervalued. An investor who follows the analytical crowd, he asserted, is unlikely to enjoy even average returns.

Still, there is no easy road to riches. "Buying a neglected and therefore undervalued issue for profit," Graham cautioned in *The Intelligent Investor* (which, inci-

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dentally, he felt was more valuable for young security analysts than his more famous *Security Analysis*), "generally proves a protracted and patience-trying experience. And selling short a too popular and therefore overvalued issue is apt to be a test not only of one's courage and stamina but also of the depth of one's pocketbook." Or, as Gerald Loeb once put it: "Successful investment is a battle for financial survival."

Most investors like to buy the shares of the most successful, large companies. Therefore, Graham reasoned, bargains are more likely to be discovered among the comparatively unpopular, neglected smaller (secondary) stocks.

A rather arbitrary dividing line between large and small is $400 million of outstanding common stock value. A carefully selected, diversified portfolio of secondary stocks is safe enough for an aggressive (enterprising) investor, but Graham suggested that these stocks are too risky for the conservative (defensive) investor.

One way in which Graham valued stocks was to look at their issuers' net current assets. He defined these as current assets less all the firm's debt (both long- and short-term), divided by the number of shares outstanding. This net current asset figure places zero value on long-term assets (plant and equipment, etc.) and goodwill items, such as brand names. No sensible business owner would sell his or her business so cheaply, Graham declared, and yet historically investments selling at attractive net current asset multiples were plentiful.

Patience Required

"Can one really make money in [these issues] without taking a serious risk?" Graham asked. "Yes indeed," he replied, "if you can find enough of them to make a diversified group, and if you don't lose patience if they fail to advance soon after you buy them." The patience required can be considerable, he warned, which means that the average investor won't have it. Furthermore, in modern markets, he theorized, apparently only in the lower reaches of a protracted bear market can enough of these investments be found for proper diversification.

Graham also warned against excessive bullishness: "While enthusiasm may be necessary for great accomplishments elsewhere, in Wall Street it almost invariably leads to disaster." Too much enthusiasm for a stock can destroy critical thinking, leading investors to believe they have a "sure thing" and encouraging them to forget Bernard Baruch's warning that "every investment is something of a gamble." Moreover, enthusiasm can be the first step on the road to speculation, which Graham deplored.

(If all this makes Graham seem rather glum, in reality, he wasn't. Having been ... family, his father Isaac ... man – he appreciated the things money could buy. And he knew how to have a good time and had a sense of style. In 1934, when *Security Analysis* was published, he also wrote and produced *Baby Pompadour*, a Broadway play that was panned by most of the press. Maybe the writers didn't like the plot, which showed a famous journalist's opinions being molded by a dimwitted chorus girl. Graham himself, while far from handsome, was notoriously fond of, and a favorite of, many beautiful women. He married three times and, when he died in France at age 82 in 1976, his longtime French mistress was present.)

Santayana's Caveat

Graham was a careful student of stock market history, on which he placed great emphasis. His knowledge led him to conclude that an investor should resign himself to the probability "that most of his holdings will advance, say, 50% or more from their low point and decline the equivalent one-third or more from their high point at various periods in the next five years." It also led him to comment: "No statement is more true and better applicable to Wall Street than the famous warning of Santayana: 'Those who do not remember the past are condemned to repeat it.' "

Most investors are amateurs, and naturally many turn to professionals for advice. Yet there is something naive, Graham cautioned, about asking others how to make money. The main benefit of having a professional adviser, Graham argued, is to protect the investor from costly mistakes, not to beat the averages. And, he pointed out, what is in the best interests of brokers—maximizing commissions—is not in the best interests of investors.

On the other hand, Graham believed that investing in mutual funds makes sense for most individuals. His favorites were closed-ends. These, he argued, have an advantage over even no-load open-end funds because they often can be purchased at a discount from their underlying net asset values.

However, Graham argued that bonds should be bought directly, rather than through a fund. Apparently, he felt that most investors can obtain satisfactory bond diversification without paying a fee to a mutual-fund management firm. Furthermore, diversification, while still important, may be less critical in the case of high-grade bonds, the type he generally recommended.

In conclusion, most of Graham's advice was simple, based on common sense. Those seeking arcane theories and promises of easy wealth needn't bother searching through his books. Graham's aim was not to help investors get rich quick, but to help them obtain good value for their money over the long haul. It's a simple goal that's hard to deliver. Perhaps that's why he was fond of Spinoza's remark: "All things excellent are as difficult as they are