Sleeping Dogs
That Investors
Shouldn’t Let Lie

Ignored by growth seekers, asset-rich stocks of lackluster companies often outperform growth stocks. by Patricia A. Dreyfus

"Here's a stock I think you should look at: Morpheus Mattress Spring. Sales have gone almost nowhere since 1967, and earnings have kept pace nicely. Management believes in old-fashioned values; there hasn’t been an innovation in years. Morpheus owns cool-bearing land but hasn’t done anything with it. At $6 a share we think it's a buy."

Most investors hearing this kind of advice would act quickly—to find another adviser. Wall Street calls such companies “dogs” and stays well away from the kennel. By doing so it passes up scores of sleepers about to arise.

For a generation, it has been the fashion among analysts to gauge a company’s investment value by its earnings growth instead of its balance sheet. Yet a handful of professionals have outperformed the performance-minded money managers by scanning financial statements for assets that add up to more than the market value of the company’s stock. Many asset-rich companies are as stodgy as Morpheus Mattress, but in the long run, say asset hunters, a stock’s price rarely fails to catch up with its intrinsic value.

Graham’s disciples

Intrinsic value can be defined in a number of ways, all set forth 42 years ago by Benjamin Graham and David L. Dodd in Security Analysis. One of the most common measures is book value, calculated by subtracting total liabilities from total assets. Because book value includes plant and equipment, whose market value is often a matter of opinion, many analysts consider it a less reliable test of value than net current assets, obtained by omitting plant and equipment from the equation.

Graham has recently simplified his techniques of analysis so that, as outlined in the box on the next two pages, any diligent investor can do his own research. Analysis as practiced by Graham's traditional disciples requires poring over scores of financial reports, a task too time consuming and complicated for most small investors.

Probably the largest and best...
known of the asset hunters is Pioneer Fund, a mutual fund in Boston. Its conservative investment approach seeks out stocks whose value, as measured by assets per share, clearly exceeds their market price. Since it started in 1928, the fund’s shares have appreciated an average of 7.16% a year, against 3.14% for the Dow Jones industrial average. Dividends are omitted in both cases.

Pioneer, sold through brokers at a maximum sales charge of 9.3%, has been one of the ten best performing mutual funds for more than 20 years. Yet Francis D. Cabour, the portfolio manager, is modest about its outstanding record. “There is absolutely nothing unique about what we do,” he says. “It’s the oldest, most conservative approach you can find. It’s also the only one that works.” Pioneer II, founded in 1969 to invest in asset-rich smaller companies, has a similar record. “Big sleepers, big fund; little sleepers, little fund,” says Cabour.

By concentrating on asset-rich stocks, TBK Partners Ltd., a private investment partnership in New York, has increased its asset value 20.4% a year since 1959. During the same period the Dow gained 5.7% annually. In 1975 the partnership started an investment advisory subsidiary, Tweedy, Browne Inc., for accounts of at least $50,000.

So confident is the firm of its performance that its prospectus brashly states: “Should results over the long term—a minimum of three years—not exceed the Dow, Tweedy, Browne believes clients should seek other investment advisors.”

**Investment analysis in two easy lessons**

Wall Street’s battle for investment profits is waged with a vast arsenal of data. Thousands of analysts grind out hundreds of pounds of research reports each month. Money managers vie for superior performance using techniques so complex they often require computers.

Taking all this with a grain of salt, or possibly a pinch of disdain, is Benjamin Graham, who pretty much launched the entire discipline of stock selection 42 years ago when he and co-author David L. Dodd published their classic book *Security Analysis*. At 82, after a lifetime of observing the stock market, Graham calls it “a Falstaffian joke that frequently degenerates into a madhouse.” He has come to believe that elaborate security analysis is of dubious value. And well it may be: about 75% of professional investors failed even to keep up with the stock market averages during the past ten years.

**Strong on cash**

Having published four editions of *Security Analysis* and an equal number of editions of a layman’s version called *The Intelligent Investor*, Graham has lately pared down all his guidelines to two separate and quite simple ways of picking stocks. Both lean toward companies with healthy cash positions and low-priced stocks; neither gives much weight to the industry a company is in or its growth prospects.

Graham’s first approach begins with the selection of stocks with low price/earnings ratios; that is, the price of the stock isn’t too much higher than the company’s earnings per share. Right now, he says, look for stocks selling at about seven times earnings. (Recently, the P/E ratio of Standard & Poor’s 500 stocks was 11.7.)

Having identified stocks selling at low P/Es, Graham looks at each company’s current assets—including inventory, cash on hand and accounts receivable. If these assets exceed liabilities—which he defines for this purpose as long-term debt and current liabilities—the stock passes his test. A quick run through the New York Stock Exchange listings last month turned up some examples of stocks meeting these tests: Colt Industries, a maker of machine tools, specialty steels and guns, selling around $50; Hoover Ball & Bearing, a car parts maker ($29); Maremont, also in car parts ($15.50); Stone & Webster, an engineering firm ($57); and Universal Leaf Tobacco ($23).

Graham’s alternative approach ignores P/E ratios and concentrates solely on cash positions. This time, from a company’s current assets he subtracts current liabilities, long-term debt and any outstanding preferred stock (at market value). He divides the result by the number of shares of common stock outstanding. If the asset value per share is higher than the price per share, he considers the stock attractive. Using this standard last month, an investor might have selected, among others, Marshall Foods, an egg processor and supermarket supplier that recently sold on the American Exchange at $4.50 a share and had an asset value of $7.80 per share; or Allyn & Bacon, a textbook publisher ($6 over the counter versus $7.28).

If possible, and he conceives it probably isn’t, Graham thinks beginning investors should limit their purchases for an entire year to pencils, paper and Standard & Poor’s monthly Stock Guide ($40 a year from Standard & Poor’s Corp., 345 Hudson Street, New York, N.Y. 10014). The guide contains all the data needed for his methods, except current share prices. After acquiring some discipline in buying and selling stocks on paper, investors can go ahead and put up actual cash.

**Room for error**

It’s perfectly all right to invest only a few hundred dollars a year, according to Graham. The important thing is practice. “The typical investor,” he says “is bound to make some mistakes, and it’s better to do this with small sums.
stitions and rich individuals for thousands of dollars a year.

Asset hunters may get impressive results, but they don't attract many followers. Proponents of growth-stock investing stick to the argument that rapidly rising earnings mean higher stock prices, higher dividends and more money reinvested in the company to ensure continued growth. "When you buy growth, you are really buying a rising asset base," says Cornelius C. Bond Jr., chief investment officer of the no-load T. Rowe Price Growth Stock Fund, which, like Pioneer, was among the top ten funds of the past 20 years.

Talk about growth companies still falls sweetly on investors' ears, even though these stocks are no longer market leaders. Talk about asset-rich stocks falls with the sound of lead clickers. In December 1974, Spencer Trask & Co., a New York brokerage house, used Ben Graham's techniques to compile a list of stocks selling either above or below their asset value. A follow-up study six months later showed an average gain of 50% for the high-asset stocks, compared with 41% for the Dow and 31% for stocks whose prices exceeded their asset value. Reviewed again last October, the high-asset stocks had slightly underperformed the Dow, while the stocks whose prices exceeded their asset value had done less than half as well as either. "We thought this was a handy, simple way to select stocks, but our customers' reaction was by and large 'So what?'—if they even paid that much attention," says Peter Smith, the analyst who did the study. "Customers thought Graham's formula was simplistic and wanted something more complicated." Spencer Trask dropped the project.

Practical considerations also disuade many professionals from siding with the ant instead of the grasshopper. Except in bear markets, when even a General Motors may sell below book value, asset-rich stocks are generally those of smallish companies.

Later, when he has more money, he won't make the same mistakes," Graham cracks a smile, then adds: "He'll make different ones.

Aim for a portfolio of at least 30 stocks, Graham says, even if you own only ten shares of each. This flies in the face of standard wisdom, which holds that a portfolio should contain no more stocks than you can carefully monitor—generally about ten.

"Investors should set a profit objective of between 50% and 100% and a holding period of no more than three years," Graham advises. Any stock that does not reach its objective by then should be sold out. Graham's intelligent investor keeps at least 25% of his capital in stocks and 25% in bonds, switching the rest back and forth as the stock market goes up and down. In a rising market Graham recommends shifting money into bonds, preferably those maturing in seven or eight years.

The dean's idea

Graham's investment techniques made him a millionaire before he was 35, but the wonder is that he found his way to Wall Street at all. At Columbia University, he dropped his only economics course after a few weeks and concentrated on English, math and philosophy. After he graduated Phi Beta Kappa in 1914, all three departments offered him teaching jobs. The dean had a better idea: a business career. He introduced Graham to a broker, who hired him at $12 a week as a board boy, chalk- ing prices on a blackboard. Graham soon moved up to selling bonds but did not do well at it. "I was too shy," he recalls. "I didn't have the quality they de- scribe today as chutzpah."

He did not give up university life: he spent 25 years teaching finance part time at Columbia and 15 years at UCLA. To this day his conversation, studded with offhand quotes from Milton and Descartes, seems better suited to a professor than to a money manager. He and his French-born third wife, Marie-Louse, speak French almost exclusively. Even their gray cat is cajoled with phrases from Baudelairean sonnets.

Since publication in 1972 of the latest edition of The Intelligent Investor, Graham has been diligently studying stock performance. After breakfast every morning, he goes into the cluttered study in his La Jolla, Calif. apartment, sets a yellow plastic kitchen timer for 60 minutes and pulls out his sheets of numbers. After lunch and supper, he puts in more work—all told, about five hours a day.

Like the bilingual French and English Scrabble he and his wife play every night, he says stock research gives him pleasure. But the hypothetical results of the stocks that pass his tests have been so impressive—an average gain of 19.7% a year, not counting dividends or commissions—that Graham recently decided to come out of retirement with a new investment fund. To be called the Rea, Graham-Plan Fund, it is a limited partnership sold in minimum units of $50,000. Yet, says Graham, the underlyng ideas—those two approaches of his—are so simple that investors with little money or experience can get good results on their own. "Nine out of ten so-called investors—and this includes the big institutions—are really speculators," says Graham. "This is fortunate, because it means the tenth can make a decent profit."

To be successful investors, Graham says, "people don't need extraordinary insight or intelligence. What they need most is the character to adopt simple rules and stick to them. They have to avoid greediness and overenthusiasm—that's a silly thing to say, because I know they won't do it; it's not human nature."

After a moment's pause, Graham continues: "To be a successful investor, you can't be a real human being. I probably fell short to some degree. A niece of mine likes to say that I'm a very humane person but not a very hu-

A successful balance

For a millionaire, Graham lives in a remarkably modest fashion. His second-floor condominium is comfortable and welcoming, yet the space is small, only three rooms, with a flower-filled terrace affording, as he says, "a glimpse, not a view" of the Pacific. The Grahams have a second, almost identical apartment in Aix-en-Provence in southern France, where they spend the summer and fall.

Wealth has meant money to give rather than money to spend. "With four children and ten grandchildren, giving is more or less continuous," says Gra- ham, who has also made generous char- itable contributions. His emphasis on bargain prices and values applies only to in- vestments. Whenever he decides he wants something, like his present apart- ment, he buys it even though he may think the price too high. With so few temptations, it probably isn't difficult for Graham to live up to his own def- inition of financial success: "Never hav- ing to balance your checkbook."