

Chapter 1

An Overview

THIS BOOK IS DIRECTED toward investors and creditors who hold, purchase or sell all types of securities and evidences of indebtedness, and who are aggressive because within their own contexts they expect a well-above-average return over the long term. For these investors, this book presents conservative methods of investment, especially equity investment, that the authors believe minimize risk for securities holders. It is our thesis that minimizing risk does not reduce profit potentials for investors in common stocks; rather, minimizing the downside tends to enhance the realistic upside potential, especially for noncontrol investors in common stocks.

Since many of the investors and creditors to whom this book is directed are financial institutions—for example, commercial banks, insurance companies and investment companies—it ought to be useful to those interested in what U.S. financial institutions as asset managers do and why they do what they do.

Some participants in these investment processes are outside, passive investors; others are activists. Outside investors are members of the public and are distinguishable from others in three respects. First, individually they have no control or influence over the businesses whose securities they hold or contemplate holding. Second, they do not have access to information other than that which is generally available to the public. Third, they are those whom the U.S. securities laws and regulations have been designed to protect.*

Throughout the book, we refer to them as outside investors and passivists, as well as noncontrol and unaffiliated security holders. The key is that they are inactive in management and not connected with the company issuing securities in any way other than as security holders.

Noncontrol investors are also supposed to be the beneficiaries of various state laws and regulations, including blue sky statutes governing terms and conditions under which new issues may be offered;† anti-takeover statutes; statutes aimed at controlling going-private transactions; more generalized common-law and state statutory requirements covering the fiduciary obligations of those in control of corporations to unaffiliated common stockholders; and statutes defining appraisal remedies when stockholders dissent from force-out mergers or similar force-out transactions. Outside investors are additionally protected by rules promulgated by quasi-public bodies, particularly the New York Stock Exchange, among other exchanges, and the National Association of Securities Dealers.

*The relevant laws and regulations are the federal securities laws administered by the Securities and Exchange Commission: the Federal Securities Act of 1933 as amended, the Securities Exchange Act of 1934 as amended, the Investment Company Act of 1940 as amended, the Investment Advisers Act of 1940 as amended, the Public Utility Holding Company Act of 1935, the Trust Indenture Act of 1939 and the Securities Investors Protection Act of 1970.

†“Blue sky statutes” refers to state statutes governing the terms and conditions on which offerings to sell securities to the public or to buy them from the public can be made in that jurisdiction. There is a further discussion in Appendix I of blue sky laws as they impact on the underwriting of new issues. The origin of the term “blue sky” is derived from the promises of promoters who foisted upon unsuspecting outside investors investments that had no substance, only blue sky.

We regard as activists those participants in U.S. financial processes who have elements of control or influence over the businesses in which they invest, who have or can obtain nonpublic information and whom federal securities regulation is intended to control rather than to protect. We believe the materials in this book are of interest to both activists and outside, passive investors.

We differ from most others writing about fundamental security analysis and corporate finance. It is our view that other fundamentalists have a tendency to apply to all companies tools of analysis that in fact are applicable only to that small minority of companies which are large, stable and seasoned enterprises engaged in continuous operations. Such businesses are strict going concerns—that is, they are engaged in a particular type of operation to be financed in the future in about the same way they have been in the past. It is our view that an analysis that is useful for evaluating stable going concerns is of limited help when applied to businesses involved, even partially, in what we call asset-conversion activities—that is, mergers, acquisitions, or the purchase, sale or distribution of assets in bulk; major financial restructurings or recapitalizations; sales of control or contests for control; or the creation of tax shelter. And most businesses seem to be engaged, at least to some extent, in asset conversion. We believe it is necessary to distinguish between asset-conversion analysis and going-concern analysis.

Our underlying thesis is that in both fundamental security analysis and corporate finance a key element to be emphasized is financial position, measured by a concern's ability to have and to create liquidity (either from surplus cash or from other assets readily convertible into cash, such as a portfolio of blue-chip corporate stocks and bonds whose resale is not restricted); by an ability to generate surplus cash from operations; by an ability to borrow; or by an ability to market new issues of equity securities.

In contrast to our emphasis on financial position, conventional fundamental analysis rests on a primacy-of-earnings theory—that is, reported earnings are a principal determinant of common-stock prices. To us, the primacy-of-earnings approach is valid in special cases—that is, it is more applicable than a financial-position approach for those

common-stock traders whose one consuming interest is day-to-day stock market fluctuations. It seems reasonable to suppose that most of the time, accounting earnings as reported will have a more significant impact on immediate stock prices than will perceived changes in financial position. Yet, we view financial position as normally the more fundamental factor because it is a better aid in understanding a business than are reported earnings, especially since most enterprises are not strict going concerns. In addition, most securities holders, including creditors, are not stock traders. Primacy-of-earnings concepts therefore appear to be more limited in applicability than is popularly supposed.

We are concerned with fundamental analysis rather than technical analysis. Fundamental analysis involves the study of a business and the factors that the analyst believes will affect that business. Using his study of the enterprise and the terms of its outstanding securities, the fundamentalist arrives at judgments about those securities in the context of the prices at which they are selling. Technical analysts, on the other hand, are concerned solely with the behavior of securities prices; some technicians believe past securities price behavior has predictive value for future prices. Others—random walkers and efficient-market theorists, whose practices are examined in Chapter 4—are technicians who believe that past securities prices have no predictive value.

What is a “security,” at least as that term is used in this book? The key feature of a security is that it is an investment vehicle in which the holder can benefit from an inactive creditor or ownership role. The owner of a security does not, because of his holding, have to perform any managerial or other economic function, but he can anticipate benefits through someone else’s efforts. Where efforts by the holder are a necessary part of ownership, no security originates, either by our definition or by most legal definitions. Examples of securities under our definition include conventional instruments, such as common stocks, preferred stocks, bonds, leasehold interests and limited partnership participations, and instruments not normally thought of as securities, such as savings-bank deposits and commercial paper. One example of a nonsecurity is ownership of a

McDonald's fast-food franchise in which, as part of the transaction under which the investment is made, the franchisee is expected or required to manage the facility.

As far as technical analysis is concerned, the material in this book notes in Chapter 4 those aspects of modern capital theory that are involved with efficient-market and efficient-portfolio hypotheses. However, we place these theories in perspective. Even granting that efficient-market and efficient-portfolio assumptions may be valid, they are not particularly relevant to the main themes presented here. Indeed, we think that efficiency assumptions are, at best, of marginal relevance to real-world financial and corporate analyses of equities.

Our tools of analysis are applied to broad spectra of investors and securities. There are two reasons for this. First, while the standards of analysis tend to be different for different sorts of securities, the analytic concepts used and techniques involved are similar, whether the security to be evaluated is a \$500 million term loan from a commercial bank or 100 shares of Amterre Development common selling at around \$1 per share. For the \$500 million term loan, we think that understanding the business from an asset-conversion basis or a going-concern basis is essential; for the purchase of 100 Amterre Development common, such understanding is merely desirable. Understanding the business becomes increasingly important as larger amounts of funds or proportions of a person's or institution's resources are invested in a security. Understanding the business is also increasingly important as the quality of that security is diminished because of its lack of senior position as underlying or secured debt, and the lack of financial resources within the business issuing the security.

The second reason why this book covers a broad range of institutions and securities is that any type of security holder, including the outside, individual investor, is helped in his investment program if he has some understanding of why other types of investors, such as life insurance companies or deal promoters, do what they do. For example, the knowledge in 1976 and 1977 that life insurance companies were willing to lend funds to deal promoters to buy out companies such as Big Bear Stores and A. J. Industries at substantial premiums

above stock market prices would have been helpful to any investor making buy, hold or sell decisions about such securities.

Note that by “understanding the business,” we mean specifically understanding the finances and operations of a company, its problems and its potentials. Thus, we focus on the analysis of internal factors, especially financial position, that we believe affect the value of business. By “understanding the business,” we do not mean understanding stock-price movements, interest-rate fluctuations or even prognostications about the overall economy. This is not because we feel that predictions of general economic activity are unimportant, but rather because we believe that everyone, ourselves included, has limited abilities in macroeconomic forecasting. On the other hand, we believe that the “nitty-gritty” fundamentals we stress compensate for many errors that are bound to be made by all general economic crystal-ball gazers. In this sense, this book has a different emphasis from the other fundamentalist-school investment books of which we are aware.

In the language of modern capital theory, our focus is on unsystematic risk, factors that are peculiar to specific enterprises. In stark contrast to modern capital theorists, we believe that an outside investor can obtain excess returns if he is willing to apply himself so that he can benefit from the knowledge available in public documents and thus guard against unsystematic risk. Put simply, modern capital theorists believe it is practically impossible to guard against unsystematic risk because common-stock prices are almost always in equilibrium, neither too high nor too low. We are convinced that most common-stock prices are almost always in disequilibrium, certainly for activists and also for those outsiders willing to work and think like activists.

The views of modern capital theory about systematic risk—factors concerning general market and economic conditions—are similar to those held by us, namely, that such elements as overall stock market levels and interest rates are largely unpredictable. Modern capital theorists guard against systematic risk by diversifying into efficient portfolios—that is, portfolios whose risk is minimized for a given anticipated rate of return. Efficient portfolios assume

equilibrium prices. We believe there are elements of validity to such efficient-portfolio hypotheses for outside investors in limited situations where analysts are not prepared to investigate individual companies thoroughly and where portfolios are of a fixed size, without prospects for the investment of new funds in future years. Insofar as new funds for investment are created periodically, it becomes less and less important to diversify initially in order to achieve efficient portfolios.

Again, we are concerned with investing for the long term. We do not say that some may not have a legitimate interest in trying to predict short-term—even day-to-day, week-to-week or month-to-month—changes in the general level of stock prices and interest rates. Indeed, people or institutions who have borrowed heavily to carry securities or who engage in arbitrage activities almost always have to be vitally interested in market fluctuations. And, of course, anyone who does not understand the business in which he holds securities will have to be highly interested in market fluctuations if he owns any securities other than the highest-quality senior obligations. But that is not what this book is about. For us, markets are taken as given, something investors take advantage of because they understand a business.

If there is one thing that differentiates our approach from that of others writing on investments, it is our underlying conviction that the value of a business has no necessary relationship to the price of its common stock. Of course, business values are related to stock market prices: in some instances—for example, the going-concern analysis of electric utilities—virtually the same standards that seem to result in a price for the stock are used to value the business it represents. And it is also true that over time there probably is a tendency for stock prices to be equated with business values, though frankly it would be hard to demonstrate just how strong or how weak this tendency is. In a dynamic economy, moreover, disequilibrium, not equilibrium, is the rule.

Unlike many others, we believe that if there is any one factor that is crucial in determining most business value, it is the financial condition of a company—that is, the quality and quantity of its resources. According to our view, if a business has considerable financial strength

and if this flexibility is used reasonably, it should be able to create future wealth that will be manifested in tomorrow's reported earnings and common-stock prices. On the other hand, we believe that for the analysis of most businesses most of the time, the differences between business value and stock market prices are more important and more significant than their similarities. The analysis of a business entails understanding its key attributes and weighing its probable future operating and investment results as well as its ability to meet its debts and to pay dividends to its stockholders. Only in the case of a few stable businesses (such as utilities) will those things thought of as highly important to stock prices—current earnings as reported and current dividends—be sufficient to help any investor understand a business.

This book seems to us to be distinguishable from most other investment books of which we are aware, whether fundamental or technical, in that it offers no arithmetical formulas to noncontrol investors. Our "magic formula" for investment success—the understanding of a business—has to grow out of experience, insight and maturity of judgment. Nonetheless, we are hopeful that what we have to say ought to help investors in gaining these requisites.

We attempt to do this by covering three general topics. First, we try to educate the outside investor to think about investment questions the way insiders and deal promoters tend to. Second, we start the outsider onto the road to obtaining familiarity with the uses and limitations of the required disclosures, including accounting disclosures, of the Securities and Exchange Commission. Third, we attempt to impart understanding about who the various role players in the financial community are and how they each participate in the investment process.

There are many ways to invest in securities, some of which (such as short selling, option writing and arbitrage) are relatively esoteric. This book, insofar as it is directed to the non-insider, is directed toward unhedged investments in relatively conventional securities—say, commercial paper, corporate bonds, certain leases, preferred stock, limited partnership interests and common stocks, among others.

Although these types of investments are frequently hybrids—that is, securities purchased in order to achieve a varied bag of investor objectives—we divide them into four types:

1. Trading investments
2. Investments in the securities of emerging companies or industries
3. Workout and special-situation investments
4. Cash-return investments

This book will be of little or no use to those whose *raison d'être* is to try to benefit from short-run market swings—that is, to trade. Indeed, there is a considerable dispute as to whether any outside investor using publicly available information can predict short-run movements for markets and particular stocks with sufficient consistency to make such activities profitable. Although we briefly discuss the random-walk theory in Chapter 4, we really do not have much to contribute to discussions of trading, either pro or con. It might be noted, though, that many who have trading accounts also have investment accounts, and much of the material of this book may be useful to those traders who also manage long-term money.

Since this book is about “how to” invest (and in a sense, “how to” promote), its emphasis is strictly financial; it becomes less useful as nonfinancial variables become more important. Nonfinancial variables tend to be of greatest importance in emerging security situations—that is, in enterprises based on new technologies, new inventions or ideas, and untried, untested managements. For example, a hypothetical bootstrap operation is described in Chapter 9. This was undertaken by Joe Promoter, who acquired control of a widget manufacturer. We think familiarity with these types of transactions is important for all kinds of investors as well as for promoters. However, a *sine qua non* for the transaction to be attractive to an investor—and to the legitimate promoter—is that the business be viable. And such viability probably would have to be determined not only by the availability of funds to finance the business, but also by whether the widgets are any good and can be manufactured and marketed profitably. These questions about widgets or similar nonfinancial variables are beyond the scope of this

book except for us to emphasize their importance in some, but far from all, investment situations.

Additionally, there are many industries where financial considerations are not of primary importance. For example, in the drug and chemical industry, the quality of a company's research and development activities will probably be a much more important determinant of future prosperity than will the firm's present balance sheet. That, however, does not mean that the balance sheet is unimportant; rather, it gives an investor clues as to whether the company can afford to do what it proposes to do. If this book can impart to a person who is knowledgeable about the economics of drug research an understanding of financial limitations and techniques, then we will have contributed to making that person a superior investor in the securities of companies in that industry.

The themes of this book seem most appropriate for the analysis of workouts and special situations as well as for cash-return investing. Investing in workout or other special situations involves buying securities in entities that have, first and foremost, financial strength, and that are available at prices the investor believes to be well below a conservative estimate of a realistic value. As we see it, the key to this kind of investing is a combination of strong financial position and price consciousness. Here, price of the issue assumes increasing importance, and the quality of the issuer (especially insofar as quality entails general recognition by others) is relatively less important than in other types of investing. The difference between emphasizing price of the issue and quality of the issuer is discussed in Chapter 5, "Risk and Uncertainty." The factors involved in an investment program based upon consideration of price and financial position are discussed in part in Chapter 2, "The Financial-Integrity Approach to Equity Investing."

Workout investing is a subgroup of special-situation investing. A workout investment is one in which a financially strong security is priced below a conservative estimate of a realistic value, and the investor has reason to believe that an asset-conversion event might

take place within a given time span. The asset-conversion event could be a merger or an acquisition, the sale of assets, a liquidation, a reorganization, a contest for control or a share-repurchase program.

The high interest rates of the 1970's made cash-return investing, in terms of percentage yield in fixed U.S. dollars, more attractive than it had been for a hundred years. In effect, cash equivalents such as savings deposits, commercial paper and treasury notes became securities affording not only flexibility and constant-dollar safety but also high return. But cash equivalents, like all other securities, have their problems: interest payments on most cash-equivalent securities are taxable as ordinary income, and in many contexts cash investing does not provide a satisfactory inflation hedge. Also, in investing for cash return there are many difficult questions: Should an investor purchase short, medium or long-term obligations? Should he purchase equity securities paying high dividends relative to price in order to obtain not only a high cash return but also a possible inflation hedge? Or should he purchase cash-return securities that also provide tax shelter? While many specific investment problems are beyond the purview of this book, the concepts discussed in it should help cash-return investors in dealing with these questions.

For many outside investors who are common stockholders, whether individuals, mutual funds or bank trust departments, the advice of Graham and Dodd in *Security Analysis* tends to be sound.¹ Their advice is that, with exceptions, such common-stock investments be restricted to choices from a basic portfolio list of one hundred primary common stocks, and that these be analyzed by emphasizing a going-concern approach. These issues should be generally recognized *by others* and *by the noncontrol investor* as high quality, based on sound capitalizations, long records of profitability and demonstrated dividend-paying ability.

Like Graham and Dodd, we recommend that outside investors in common stocks emphasize earnings and dividends of very large,

¹Benjamin Graham, David L. Dodd and Sidney Cottle, with Charles Tatham, *Security Analysis: Principles and Techniques*, 4th ed. (New York: McGraw-Hill, 1962).

seasoned, well-recognized issuers in a going-concern analysis where the investor lacks “know-how” (an ability or willingness to investigate in depth) or “know-who” (acquaintanceship with knowledgeable, helpful people). Here, earnings become more significant because the investor believes that no changes in the way resources are to be used by a company are likely, and that even if they were, he could exert no influence in making changes. Dividends, too, become crucially important. For one thing, they are tangible evidence that a business’s results are satisfactory, since a cash payment does not have the gimmickry potential of an earnings report. Moreover, for the unaffiliated security holder without much know-how, dividends are a hedge against the possibility of being wrong about either the market or the business; at least one can look forward to receiving a cash return. There are pitfalls to the Graham and Dodd approach to common-stock investment, and fortunes have been lost in recent years by investors who have restricted their holdings to generally recognized blue chips. But this does not invalidate the general rule that holding widely recognized blue-chip stocks is probably the least unsatisfactory form of equity investment for the outside investor who lacks know-how and know-who.

We depart from Graham and Dodd in two respects. First, we think public disclosures have become increasingly better in the years following the passage of securities acts amendments of 1964, and are now so good that diligent investors can, in increasing numbers of instances, analyze well enough to obtain reasonable results when they do not restrict their equity investments to securities that are generally recognized as high quality *by others*.

We also believe that satisfactory performance does not mean merely “beating the market” on a continual or relatively continual basis. Indeed, the only investor who attempts to outperform the market continually is the total-return investor, for whom results are measured both by income from dividends and interest and by the per-share or per-bond price of securities owned at any given moment. In our view, there are very few total-return, outside investors, nor should there be many, because they are unlikely to be successful at it for reasons discussed in Chapter 4.

We also differ from Graham and Dodd in that their advice seems directed to the outside investor who reacts to an environment where such things as general market levels and earnings per share are all-important. Our approach is geared toward activists and outside investors who want to think like activists. We believe that except for those who strive for total return, all intelligent investors willing to work hard can safely downgrade those principles that Graham and Dodd seem to believe are the lifeblood of successful investing—earnings, assessments of general market levels, and determination of the quality of the issuer by referring to opinions of others. In our view, all these elements are secondary to the financial approach discussed in the next chapter.

This book may be helpful not only for noncontrol investors, but also for promoters and would-be promoters. Almost all the outstandingly successful investors we have known have been long-term securities holders whose judgments have been based on the concepts expounded in this book. These concepts should be useful for all types of security analysts (including bank and insurance lenders), whether passive or activist, if for no other reason than that they serve as a reasonably accurate description of why such analysts do what they do. We suspect that for many, this book can provide at least a few useful new perspectives.

Other activists in the financial community—from investment bankers, arbitrageurs and venture capitalists, through company managements and control shareholders—should also find this book helpful as a description of an environment that some will recognize part of, but that others may not know at all.

Finally, we hope we have something to say to the two groups that have been crucial in making the investment environment in the United States the best that has ever existed anywhere for unaffiliated security holders: the accounting profession and the Securities and Exchange Commission. In our view, neither group seems to realize how well it has performed to date. As a consequence, there appear to be real dangers that the accountants and the SEC may change so much that they will kill the goose that is laying all those golden eggs for diligent investors. To the accountant, this book suggests that the

role of Generally Accepted Accounting Principles (or GAAP) in disclosure should be limited to giving security holders objective benchmarks, and that it is silly to attempt to equate accounting with Truth or Value. To the Securities and Exchange Commission, we suggest that the disclosure scheme built up, especially since 1964, is now extraordinarily good and extraordinarily valuable to all sorts of security holders. The SEC has no need to backtrack, and certainly is ill-advised if it believes that efficient-market economists who are neither practicing analysts nor investment bankers have much, if anything, to contribute to the implementation of a meaningful disclosure system.

Most of all, we think that this book, as a description of reality, ought to be useful to the many types of investors who make up the financial community by giving insights into what many of the professionals think and do.