PART

One

The Foundations of Modern Business and Security Analysis

COPYRIGHTED MATERIAL

CHAPTER 1

The Scope of Fundamental Finance, Investing, and the Investor Landscape

Investing versus Speculating
The OPMI Defined
Activists
Summary

Benjamin Graham and David Dodd (G&D) were prolific writers, publishing volumes in 1934, 1940, 1951 and 1962 and by Ben Graham alone in 1971. A principal problem with G&D is that almost everyone in finance talks about G&D, but very few seem to have actually read G&D.

Because so many have such a superficial understanding of G&D, their names have become synonymous with the term *value investing*. This, in turn, has led to some confusion about what it is that value investors do. Though we are influenced by G&D, our methods are basically different.

Value investing is one area of fundamental finance (FF). Value investing involves commitments in marketable securities by non-control outside passive minority investors (OPMIs).[1] A thorough discussion of how we integrate the individual components of fundamental finance investing, discussed

---

[1] Since most conventional approaches to investing, e.g., Graham and Dodd (discussed in Chapter 16), modern capital theory (discussed in Chapter 17), broker-dealer research departments and conventional money managers (discussed in Chapter 18), are centered on the OPMI, we provide a more detailed description of this type of investor later in this chapter.

in the first part of this book, into our safe and cheap approach to value investing is contained in Chapter 15.

The other areas of fundamental finance involve the following:

- Distress investing[2]
- Control investing
- Credit analysis
- First- and second-stage venture capital investing

Modern capital theory (MCT), like value investing, also focuses on investments by OPMIs. Unlike value investors, MCT focuses strictly on near-term changes in market prices and it is a top down approach rather than a bottom up approach. In a number of special cases the factors important in MCT are also important in value investing. MCT is discussed in Chapter 17.

INVESTING VERSUS SPECULATING

Since the five areas of fundamental finance involve different types of *investing* and value investing focuses on commitments in marketable securities by OPMIs, we need to be sure that the reader understands what we mean by the word *investing*.

In the first and subsequent editions of *Security Analysis,* G&D devoted an entire chapter to the problem of clearly defining the meaning of the word *investing*. Their goal was to come up with a definition that would serve as an objective benchmark that would allow people to distinguish between financial operations devoted to investing from those devoted to speculating. Although people seem to have a clear idea of what the differences between the two words are, G&D found that coming up with a precise definition of the terms ran into "perplexing" difficulties. We discuss a few of these difficulties or misconceptions that are still prevalent today later in this chapter.

The academic profession has not provided any guidance on this important matter, either. In fact, they have authoritatively contributed to the raging confusion that still exists today. For example, the prevailing view or conventional wisdom is that in order to achieve larger returns buying

[2] The reader is referred to a book written by the authors on this area of fundamental finance: Martin J. Whitman and Fernando Diz, *Distress Investing: Principles and Technique* (Hoboken, NJ: John Wiley & Sons, 2009).

securities, one must undertake larger amounts of market risk. Of the many implicit mistakes in this view, one of them is the academic belief that all purchases of securities are investments. Nothing could be more misleading than this belief.

Why a Definition for Investing?

Why is it worthwhile to have precise definitions for investing and speculating? First, without a precise definition, we cannot distinguish between speculative and investment operations. On Wall Street, every speculator is called an investor. This is bad and very misleading semantics. But why should we distinguish between investing and speculating? This leads us to the second and, perhaps, more important reason. We do agree with G&D that the failure to distinguish between investment and speculative operations was in large part responsible for the wipeout or near wipeout of market participants during the 1928–1929 market crash. This failure continued to play an important role in more recent examples of wipeouts or near wipeouts of market participants (OPMIs generally) that occurred in 1974, 1987, 1989, 2000, and 2008–2009.

One of G&D's often unrecognized and perhaps most important contribution to fundamental finance was the clear articulation of a precise definition for the concept of investing that we reproduce below:[3]

> *An investing operation is one, which upon thorough analysis that can be justified on both quantitative and qualitative grounds, promises safety of principal and a satisfactory return. Operations not meeting these requirements are speculative.*

The difficulties encountered by G&D in coming up with a precise definition were rooted in common misconceptions about what an investment is. The above definition is helpful in the clarification of many of these misconceptions, a few of which we discuss below.

The Type of Security Does Not Define What an Investment Is

There is nothing inherent to a financial instrument that makes it either an investment or a speculation. This misconception is alive and well today.

[3] We thoroughly discuss the many substantive differences between our approach and Graham and Dodd's in Chapter 16 of this book.

EXAMPLE

Treasury securities are widely viewed as investment vehicles. This view notwithstanding, purchasing a 2 percent 10-year Treasury note priced at par in 2012 seems a sure loser. No credit instrument ever achieves a market price much above its call price no matter how much interest rates go down, so it is hard to foresee meaningful capital appreciation for the Treasury note. If interest rates go up (seems a reasonable possibility from 2 percent), the market prices of the Treasury note will decline. Purchases of 2 percent 10-year Treasury notes carry a large amount of investment risk and thus can hardly be considered an investment operation. We discuss investment risk at length in Chapter 8.

Inherent to a security are only the rights that its holders have. Ownership of a security gives its owners one of two benefits:

1. Contractual rights to receive cash payments in the form of interest, return of principal, and premium. These rights in the United Sates cannot be taken away from holders unless the holder so consents or in a court of competent jurisdiction, usually a bankruptcy court.
2. Ownership rights, which may or may not provide for payments to owners of dividends or share repurchases that are not contractually required, except for the case of preferred stocks where cash service is required before cash is paid out to junior securities. These ownership rights can be outright or contingent as in the case of options and warrants.

Hybrid securities give their owners both benefits but at different times. Owners of convertible notes, convertible preferred stocks may have contractual rights to cash payments until they convert those rights into ownership rights.

We discuss these substantive characteristics of securities in Chapter 4.

The Method of Purchase and the Holding Time Horizon

Purchasing a common stock outright does not *ispo facto* make it an investment. Neither does buying the stock of a strongly financed company on margin make it a speculation. Similarly, the distinction between a permanent holding or temporary holding cannot be used to differentiate between investment and speculation. For example, riskless arbitrage involves the simultaneous purchase and sale of related securities, on margin, and for

a short time period, but the transaction, properly executed, can be an investment operation, not a speculation. *Riskless arbitrage* is defined as a transaction that does not take any equity (or very little equity), guarantees safety of principal and a predetermined return in a fixed time period.

EXAMPLE

By September 2012 gold could be purchased in the cash market at $1,700 per ounce. Suppose a forward contract can be written to deliver physical gold in a year and get paid $1,800 per ounce. The cost of financing is 5 percent per year. An arbitrage transaction will involve:

- Borrow say $170,000 for a year at 5 percent.
- Use the proceeds of the loan to buy 100 ounces of gold in the cash market.
- Simultaneously enter into a forward agreement to deliver 100 ounces of gold in a year and get paid $1,800/oz.
- In one year, regardless of what the price of gold in the cash and forward markets is, you will deliver 100 oz. of gold and get paid $180,000 for it; and you will repay principal and interest on your loan of $178,500 and pocket a riskless profit of $1,500.

The above operation does not have any investment risk, involves purchasing gold on a fully margined basis, for a short time period, and provides more than an adequate return on no equity.

For Income or for Total Return

One common misconception is that purchases of issues for income or cash return purposes are also *ipso facto* investments. For market participants seeking satisfactory returns in mid-2012, it seems no longer possible to do so as a cash return investor. Interest rates are just too low. Rather the market participant has to focus on being a total return investor; that is, income plus capital gains. The futility of being a cash return investor is demonstrated by holding a 2 percent 10-year Treasury note priced at par. As we previously discussed, purchasing this instrument seems a sure loser. Thus, although it has become fashionable to talk about purchasing Treasury securities as a "return of capital" operation, the operation is fraught with investment risk and hardly compensates the purchaser with either an adequate cash or total return.

Investment Operation Rather than an Issue

As we have already discussed, investment character does not inhere in an issue *per se*. Price is frequently an essential element, so that a common stock or preferred stock or bond may have investment merit at one price but not at another. Along the same lines, an investment may be justified in a group of issues that could not be justified individually. Moreover, certain types of arbitrage and hedging commitments can also be considered investments. As we saw in the riskless arbitrage example, the element of safety in these types of operations is provided by the purchase/sale transaction.

Safety of Principal as the Avoidance of Investment Risk

For analytical purposes *investment* risk for a security has three components:

1. Quality of the issuer
2. Terms of the issue
3. Price of the issue

Investment must always consider the *price* as well as the *terms* of the security and the *quality* of the issuer: there is no investment issue in the *absolute* sense; that is, implying that it remains an investment regardless of price. This is important to understand because semantics often obscure this fact. The purchase of a blue chip common stock is commonly considered as an investment at any price. Not so. An investment operation focuses on the appraisal and avoidance of investment risk as shown in the following example.

EXAMPLE

It is feasible today as a total return investor to buy into blue chip common stocks, which have the following characteristics and which in our opinion probably haven't been as attractively priced as they are now since the mid-1970s:

- Super-strong financial position (quality of issuer).
- Priced at a discount from net asset value of 25 percent or more (Wheelock and Company at a discount of about 50 percent) (price of the issue).

- Full comprehensive disclosures in English with audits by the Big Four (thorough analysis, based on both qualitative and quantitative grounds).
- Trading in markets where protections for OPMIs are strong (terms of the issue).
- Prospects seem good that over the next three to eight years net asset value (NAV) will grow by not less than 10 percent compounded annually after adding back dividends. If such growth is achieved, the investments seem very likely to be profitable because if not, the discounts from NAV would have widened to unconscionable levels.

THE OPMI DEFINED

Some participants in investment operations are OPMIs; others are activists having either control or elements of control over markets or corporate decision making. OPMIs are members of the public and are distinguishable from others in three respects:

1. Individually they have no control or influence over the businesses whose securities they hold or contemplate holding.
2. They do not have access to information other than that which is generally available to the public.
3. They are those whom the U.S. securities laws and regulations have been designed to protect.[4]

Throughout the book, we refer to them as OPMIs, as well as non-control 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. OPMIs run the gamut from day traders to most institutional investors to value investors who do not seek elements of control over the companies in which they hold securities positions. The reason for using the term OPMI rather than *investor* is that the word *investor*

[4] 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 Trust Indenture Act of 1939, and the Securities Investors Protection Act of 1970.

is one of the most misused and misunderstood words on Wall Street and is often used to describe what G&D and we would refer to as speculators.

Non-control 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;[5] 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. OPMIs are additionally protected by rules promulgated by quasi-public bodies, particularly the Financial Institutions Regulatory Authority (FINRA).

ACTIVISTS

We regard as activists those participants in U.S. financial operations who have either control or elements of control or influence over businesses, who have or can obtain nonpublic information and whom federal securities regulations are intended to control rather than to protect. We believe the materials in this book are of interest to both activists and OPMIs.

SUMMARY

The concept of value investing that is often associated with Graham and Dodd is only one form of fundamental finance investing that involves making commitments in marketable securities by non-control, outside, passive minority investors or OPMIs. The other forms of fundamental finance investing are distress investing, control investing, credit analysis and first- and second-stage venture capital investing. Clearly understanding what investing is as opposed to speculation is a *sine qua non* for running fundamental finance investing operations, and the definition of investing is one of Graham and Dodd's major contributions to the field of security analysis. We clearly define the concept of the OPMI but warn the reader that the concepts covered in this book can be used and are used by all those who run fundamental finance investing operations.

---

[5] *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.