CHAPTER 1

Benjamin Graham

There Are No Iron-Clad Laws

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> In my nearly fifty years of experience in Wall Street I've found that I know less and less about what the stock market is going to do but I know more and more about what investors ought to do; and that's a pretty vital change in attitude.
>
> —Benjamin Graham

In 200 years, nobody will remember Bill Ackman's crusade against Herbalife. John Paulson's bet against the housing bubble will be long forgotten. Charlie's Mungerisms will be relegated to the dustbin of the twenty-first century. Great investors come and go, and most of the ones featured in this book will be lost on future generations. But if I had to put my money on one name that will stand the test of time, it's Benjamin Graham.

The Dean of Wall Street, as he was known, will be remembered forever because his teachings are timeless. The lessons he provided in his seminal work, *Security Analysis*, are just as relevant today as they were in 1934 and will be 200 years hence. The passage of time won't change human nature or the fact that "in applying analysis to the field of securities we encounter the serious obstacle that investment is by nature not an exact science."[1] As gifted as Graham was in mathematics, he understood that the laws of physics do not govern security analysis. It's difficult to overstate how many trails he blazed. Jason Zweig wrote, "Before Graham, money managers behaved much like a medieval guild, guided largely by superstition, guesswork, and arcane rituals."[2] Ben Graham is to investing what the Wright Brothers are to flight, and just as their names will be forever linked to the airplane, so will Graham's to finance.

Graham understood what few did at the time – that the stock prices quoted in the newspaper and the underlying value in the business are not equivalent. Sticking with the Wright brothers, Graham wrote:

> In the Wright Aeronautical example, the earlier situation presented a set of facts which demonstrated that the business was worth substantially more than $8 per share.... In the later year, the facts were equally conclusive that the business did not have a reasonable value of $280 per share.... It would have been difficult for the analyst to determine whether Wright Aeronautical was actually worth $20 or $40 a share ... or actually worth $50 or $80.... But fortunately it was not necessary to decide these points in order to conclude that the shares were attractive at $8 and unattractive, intrinsically, at $280.[3]

Security Analysis was written for the Wall Street professional. However it's *The Intelligent Investor* that will keep Graham's name alive forever. This is the first financial book that I ever read, and it left such a strong impression that I chose it as the namesake for my blog, *The Irrelevant Investor*. Unlike *Security Analysis, The Intelligent Investor* was intended for laymen, and, with more than a million copies sold, it reached its target. Warren Buffett said, "I read the first edition of this book early in 1950, when I was nineteen. I thought then that it was by far the best book about investing ever written. I still think it is."[4] As long as people want to learn about investing, they will find Graham, who translated an exotic language with terms like *net working capital* and *return on equity* into plain English with words like *price* and *value*.

Ben Graham invented the field of financial analysis. Roger Lowenstein said, "Investing without Graham would be like communism without Marx – the discipline would scarcely exist."[5] He was a polymath whom Charlie Munger called "a brilliant man" and "the only intellectual in the investing business at the time."[6] At just 20 years old, in his final semester at Columbia, he was offered three invitations, from the English, mathematics, and philosophy departments. Overwhelmed by these offers, he turned to Columbia's dean for advice. By a stroke of luck, a member of the New York Stock Exchange happened to come in to see the dean at the same time and asked him to recommend one of his strongest students. Without hesitation, he introduced him to Ben Graham.

Graham began his career on Wall Street in 1914, just before the New York Stock Exchange would close for four months, its longest shutdown ever, in light of the events surrounding the Great War. At 20 years old, without having taken any economics courses in college, he started at the bottom of the ladder, delivering securities and checks. After a month, he was promoted as an assistant to the bond department, and just six weeks later, with his advanced intellect, Graham was writing a daily market letter.

Ben Graham taught at Columbia Business School for 28 years, beginning in 1928, and simultaneously taught at the New York Stock Exchange's school, now known as the New York Institute of Finance, for a decade. He attracted students like Walter Schloss, Irving Kahn, and Bill Ruane. His most famous pupil, of course, is Warren Buffett, who became the richest man on the planet by using the principles that Ben Graham taught him.

Graham is on the Mount Rushmore of investing, and despite the enormous success he had managing money and teaching future generations

how to do the same, his career, like everybody else's, included some trying times. The lessons that Graham provided in the classroom, which he translated into books, will live forever. But we can also learn a lot from his failures. The most important lesson that investors should take from the person who taught us the difference between value and price is that value investing is not a panacea. Cheap can get cheaper. Rich can get richer. Margins of safety can be miscalculated, and value can fail to materialize.

Some investors search for companies that they expect will grow their earnings significantly faster than the broader market. Others prefer to look for companies whose future prospects aren't nearly as bad as their share prices reflect. Whether you consider yourself a growth investor, a value investor, something in between or entirely different, investors want stocks to be worth more than they pay for it. Value investing is the most effective way to determine whether the price you pay for a slice of the business is less than what the company is actually worth.

When *Security Analysis* was published, the Dow Jones Industrial Average was trading at 100. Today, 84 years later and hovering near 22,000, it's delivered 6.7% a year, not including dividends. Some of the best-known investors, devotees of value investing brought mainstream by Graham, have earned far greater returns by following a few simple rules. These rules all boil down to what Graham referred to as a "margin of safety." Graham defined this as "the discount at which the stock is selling below its minimum intrinsic value."[7] Yes, there were formulas involved, but they didn't need to be complicated. Graham liked stocks selling for one-third less than their net working capital. He once pointed out, "Some extraordinary results could have been obtained since 1933 by buying each year the shares of the six companies in the Dow Jones Industrial Average which sold at the lowest multiplier of their recent earnings."[8]

What made Graham so brilliant is not the calculations he performed to determine intrinsic value, but rather the understanding that determining exact values are both impossible and not a prerequisite for success. "It is quite possible to decide by inspection that a woman is old enough to vote without knowing her age or that a man is heavier than he should be without knowing his exact weight."[9]

Graham was far ahead of his time, writing about behavioral economics, the study of how psychology affects financial decision making, long before the term even existed. *Security Analysis* was published the same year that Nobel laureate Daniel Kahneman, who took this field mainstream, was born. Graham identified some of the cognitive and

emotional biases that caused investors to send a strong company diving 50% in 12 months. He examined the case of General Electric, which the stock market valued at $1.87 billion in 1937 and $784 million just one year later. Graham summarized it this way:

> Certainly nothing had happened within twelve months' time to destroy more than half the value of this powerful enterprise, nor did investors even pretend to claim that the falling off in earnings from 1937 to 1938 had any permanent significance for the future of the company. General Electric sold at 64 7/8 because the public was in an optimistic frame of mind and at 27 1/4 because the same people were pessimistic. To speak of these prices as representing "investment values" or the "appraisal of investors" is to do violence either to the English language or to common sense, or both.[10]

Graham taught his students and his readers that prices fluctuate more than value, because it is humans who set price, while businesses set value.

In *The Intelligent Investor*, he summed up the wild swings in price with a story he told about a hypothetical Mr. Market:

> Imagine that in some private business you own a small share that cost you $1,000. One of your partners, named Mr. Market, is very obliging indeed. Every day he tells you what he thinks your interest is worth and furthermore offers either to buy you out or to sell you an additional interest on that basis. Sometimes his idea of value appears plausible and justified by business developments and prospects as you know them. Often, on the other hand, Mr. Market lets his enthusiasm or his fears run away with him, and the value he proposes seems to you little short of silly.[11]

The financial world looks markedly different today than it did when Graham was practicing and teaching. In 1934, a total of 323 million shares were traded on the New York Stock Exchange.[12] As I write, on August 9, 2017, the total volume of shares traded on the NYSE was 3.2 billion. More than 10 times as many shares traded yesterday as all the shares traded during 1934! Today, supercomputers instantly parse the words contained in economic reports and company statements. Back in Graham's times, while quarterly statements were considered standard, they were not the law. And of the companies that made this information available,

there was no uniformity; the reports varied from only net earnings to a line itemed income statement and balance sheet. Graham looked for the income statement to contain a minimum of: sales, net earnings, depreciation, interest charges, nonoperating income, income taxes, dividends paid, and surplus adjustments. Prior to the Securities and Exchange Act, less than half of industrial corporations supplied this breakdown.

Graham's idea of value investing involves buying cigar butts, businesses with one final puff, as he called them. These companies controlled significant property, plant and equipment, inventory, and raw materials. It wasn't difficult to measure the tangible assets and calculate the intrinsic value. From there, he could determine whether there was a margin of safety. If Graham were still alive, he wouldn't understand how some companies are valued today. For example, over the last five years, Walmart has earned $75 billion on $2.4 trillion in revenue. Its net margins have been 3.15% and it's *lost* $3.6 billion in market capitalization. Amazon, on the other hand, has earned $3.5 billion on $490 billion of revenue. Its net margins have been 0.73%, and over this time it has added $350 billion in market capitalization.[13] While value investing intuitively makes a lot of sense, human emotions can overwhelm common sense. Prices can be driven both way below liquidating value and far past what any company can reasonably be expected to grow into. While Graham wouldn't recognize ETFs or high-frequency trading, he would feel right at home in today's market, which is still driven by investors' emotions. The way investors behave today, driven by fear and the fear of missing out would be very recognizable to him.

Roger Lowenstein said, "It took Graham 20 years – which is to say, a complete cycle from the bull market of the Roaring Twenties through the dark, nearly ruinous days of the early 1930s – to refine his investment philosophy into a discipline that was as rigorous as the Euclidean theorems he had studied in college."[14] Let's return to the beginning.

Graham first started an investment partnership in 1923, the Graham Corporation, where he would apply arbitrage techniques, the simultaneous purchase of undervalued securities, and short sale of overvalued securities. This operation lasted for two years, and in 1926, he set up the Benjamin Graham Joint Account. In this structure, he would receive 20% of the first 20% return, 30% of the next 30%, and 50% of the balance. In 1926, he earned 32% while the Dow Jones Industrial Average gained just 0.34%. Word of his success spread throughout Wall Street and the famous financier Bernard Baruch asked Graham to become his partner.

Graham was flattered, but having made $600,000 the previous year, he had no reason to accept the invitation.[15] He began with $450,000, which ballooned to $2,500,000 in just three years. But this is a book about lessons we can learn from the failures of the best investors ever. Graham's was right around the corner.

In the final year of the great bull market of the 1920s, the Joint Account gained 60%, outpacing the 49.47% advance in the Dow. In the final months of 1929 when the market turned violently lower, Graham covered his shorts and held onto his convertible preferred securities, thinking that prices were too low and that Mr. Market was talking crazy. He finished the year down 20%, while the Dow fell 17%. Graham was about to learn that margins of safety don't matter when the baby is getting thrown out with the proverbial bathwater.

In 1930, thinking the worst was over, Graham went all in and then some. He used margin to leverage what he thought would be terrific returns. But the worst was not over, and when the Dow collapsed, Graham had his worst year ever, losing 50%. "He personally was wiped out in the crash. Having ducked the 1929 cataclysm, he was enticed back into the market before the final bottom."[16] In the four years from 1929 to the bottom in 1932, Graham lost 70%. If such a careful and thoughtful analyst can lose 70% of his money, we should be very careful to understand that while value investing is a wonderful option over the long term, it is not immune to the short-term vicissitudes of the market.

In 1932, just weeks before stocks bottomed, Graham wrote three articles in *Forbes*. In one, "Inflated Treasuries and Deflated Stockholders," he wrote:

> There are literally dozens of other companies which also have a quoted value less than their cash in bank. . . . This means that a great number of American businesses are quoted in liquidating value; that in the best recent judgment of Wall Street, these businesses are worth more dead than alive.[17]

In this article, Ben Graham was a voice of reason in a mob of financially depressed zombies:

> It is time, and high time, that the millions of American shareholders turned their eyes from the daily market reports long enough to give some attention to the enterprises themselves of which they are the proprietors, and which exist for their benefit and at their pleasure.[18]

After an 89% peak-to-trough decline in the Dow Jones Industrial Average, it was understandable why people would behave this way, and why a generation of investors would never return to the market. The fact that he remained steadfast in his conviction that security analysis was a worthwhile endeavor is nothing short of remarkable.

The partnership earned 6% a year from 1926 to 1935, compared to 5.8% for the S&P 500 and 3.8% for the Dow.[19] Despite the hard times and enormous drawdown, Graham would continue to operate under the assumption that value investing is the most intelligent way to achieve superior results. Believing that stocks eventually find their true value, the prospectus of Graham-Newman Corporation's stated that its investment policy is "To purchase securities at less than their intrinsic value as determined by careful analysis, with particular emphasis on purchase of securities at less than their liquidating value."[20] When asked what causes a stock to find its value, Graham answered, "That is one of the mysteries of our business, and it is a mystery to me as well as to everybody else. We know from experience that eventually the market catches up with value. It realizes it in one way or another."[21] Graham was proven right; over the long, long term, buying cheap stocks is a great strategy. Graham-Newman would outperform the market by nearly 3% a year for 20 years, a record that very few people have ever achieved.[22]

The fact that investors are willing to pay as little as five times for the prior 12 months' worth of earnings, and as much as 34, shows that relying on valuation alone is not enough. If you're not a dyed-in-the-wool value investor, and even if you are, surviving the long periods of time when the market separates price from value, on the upside and on the downside, can be mentally exhausting. You have the right to pay whatever you feel is fair value for stocks. Think 25 times trailing 12-month earnings is too high a price? Want to go all in at 10 times? Okay, but understand that waiting for valuations to "normalize" has stained the legacy of some of the greatest value investors to ever live. You can read all about the mood swings of Mr. Market, but that doesn't make you Dr. Freud.

Even though Graham pioneered security analysis, he was humble and open minded to the idea that what used to work no longer works, and what works today might not work as well in the future. He said:

> Unfortunately in this kind of work, where you are trying to determine relationships based upon past behavior, the almost invariable experience is that by the time you have had a long enough period to give

> you sufficient confidence in your form of measurement just then new conditions supersede and the measurement is no longer dependable in the future.[23]

Value investing still "works," but because it used to work so incredibly well, it has seen an influx of aspiring Warren Buffetts. This has made it much more challenging to identify undervalued opportunities. Graham recognized this dynamics long before this was a widely held belief. In a 1976 interview he said:

> I am no longer an advocate of elaborate techniques of security analysis in order to find superior value opportunities. This was a rewarding activity, say, forty years ago, when our textbook "Graham and Dodd" was first published; but the situation has changed a good deal since then. In the old days any well-trained security analyst could do a good professional job of selecting undervalued issues through detailed studies; but in the light of the enormous amount of research now being carried on, I doubt whether in most cases such extensive efforts will generate sufficiently superior selections to justify their costs. To that very limited extent I'm on the side of the "efficient market" school of thought now generally accepted by professors.[24]

He was asked whether "Wall Street professionals are usually more accurate in their near or long-term market trends, forecasts of stock market trends, if not, why not?" With a smile on his face, he answered:

> Well, we've been following that interesting question for a generation or more and I must say frankly our studies indicate you have your choice of tossing coins and taking the consensus of expert opinion, and the results are just about the same in each case. Your question is to why they are not more dependable is a very good one and an interesting one and my own explanation for that is this; that everybody in Wall Street is so smart that their brilliance offsets each other. And that whatever they know is already reflected in the level of stock prices pretty much and consequently what happens in the future represents what they don't know.[25]

It's critically important to be aware of value, but it's more important not to be a slave to it. Graham taught us that there are no iron-clad laws in finance and that cheap can get cheaper.

Like every lesson we'll come across in this book, the unfortunate reality is most of these have to be learned the hard way. Nobody can tell you that picking stocks is hard and that you're better off in an index fund. You'll never believe that a stock that falls 50% in a year might not necessarily be a bargain. You have to catch a few of these falling knives before scars develop and you learn that a falling price might not equate to better value. Many of the investors covered in this book began with Ben Graham's teachings, but they, like you, had to discover their own paths.

Notes

1. Benjamin Graham and David L. Dodd, *Security Analysis* (New York: McGraw-Hill Education, 2008), 61.
2. Jason Zweig, "A Note about Benjamin Graham," in *The Intelligent Investor* by Benjamin Graham (New York: HarperBusiness, 2003), xi.
3. Graham and Dodd, *Security Analysis*, 67.
4. Warren Buffett, "Preface to the Fourth Edition," in *The Intelligent Investor* by Benjamin Graham (New York: HarperBusiness, 2003), ix.
5. Quoted in Roger Lowenstein, *Buffett: The Making of an American Capitalist* (New York: Random House, 2008), 36.
6. Quoted in Rupert Hargreaves, "Why Charlie Munger Hates Value Investing," Nasdaq.com, April 13, 2017.
7. Graham and Dodd, *Security Analysis*, 373.
8. Benjamin Graham, "Securities in an Insecure World" (speech given at Town Hall at St. Francis Hotel, San Francisco, CA, November 15, 1963).
9. Graham and Dodd, *Security Analysis*, 66.
10. Ibid., 30.
11. Benjamin Graham, *The Intelligent Investor* (New York: HarperBusiness, 2003).
12. New York Stock Exchange, "Daily Share Volume 1930–1939."
13. Data provided by Ycharts, author's calculations.
14. Roger Lowenstein, "Introduction to Part I," in *Security Analysis*, 6th ed., by Benjamin Graham and David L. Dodd (New York: McGraw-Hill Education, 2008), 41.
15. Irving Kahn and Robert D. Milne, "Benjamin Graham: The Father of Financial Analysis" (Charlottesville, VA: Financial Analysts Research Foundation, 1977).
16. John Train, *Money Masters of Our Time* (New York: HarperBusiness, 2003).

17. Benjamin Graham, "Inflated Treasuries and Deflated Stockholders," *Forbes*, June 1, 1932.
18. Ibid.
19. Kahn and Milne, "Benjamin Graham," 42.
20. Benjamin Graham and Jerome A. Newton, Letter to Graham-Newton Corporation stockholders, January 31, 1946.
21. Ibid.
22. Roger Lowenstein, *Buffett: The Making of an American Capitalist* (New York: Random House, 2008), p. 58.
23. Jason Zweig, "A Rediscovered Masterpiece by Benjamin Graham," JasonZweig.com, March 31, 2015.
24. Benjamin Graham, "A Conversation with Benjamin Graham," *Financial Analysts Journal* 32, no. 5 (September/October 1976): 20–23.
25. "Legacy of Benjamin Graham: The Original Adjunct Professor," Heilbrunn Center for Graham and Dodd Investing, Columbia Business School, February 1, 2013.