Honoring Benjamin Graham: The Father of Value Investing

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by Albert L. Auxier, Ph.D.
Associate Professor of Finance
University of Tennessee, Knoxville

Few Wall Streeters have been more observant nor more influential than Benjamin Graham. Perhaps the greatest tribute to Ben Graham comes from legendary Omaha investor and businessman, Warren E. Buffett. According to Forbes magazine's latest tally, Buffett, our richest American and arguably the world's greatest investor, is worth $8.3 billion. Buffett, says Forbes, credits his father, a stock broker and former congressman, with influencing him most, and next he credits Benjamin Graham. As a young man, Buffett was Ben Graham's student at Columbia University, and he was so impressed by Graham that he offered to work for him for nothing. But the great man turned him down! Which suggests that investment genius isn't always apparent at an early age. Buffett later did work for Graham, and he developed a tremendous respect for him.

Benjamin Graham was born in London in 1894 of jewish parents, and his family emigrated to America when he was a year old. When he was nine years old, his father died. The father's death was apparently not only an emotional loss for the family but caused financial hardship as well, and this scarring experience at a young, impressionable age surely left a lasting imprint on him. Graham was attracted to beautiful women, and they to him. One can only surmise whether this mutual attraction was the source of much pain and sorrow or much happiness. Graham died in 1976, but had he lived he would have been 100 years old on May 9th. Moreover, 1994 year is the 60th anniversary of the publication of his great work, Security Analysis: Principles and Technique, of which he was the lead author and which was coauthored by David L. Dodd. (McGraw-Hill published the 5th and latest edition of this work in 1988 with new authors Sidney Cottle, Roger F. Murray, and Frank E. Block, and with the collaboration of Martin L. Leibowitz.) Graham and Dodd was the "bible" for serious students of investments for decades--and for many it still is.

Ben began his career on Wall Street in June, 1914, and near the end of his life, when he published the fourth revision of his investment philosophy in The Intelligent Investor: A Book of Practical Counsel, he had completed 57 years' experience on Wall Street. (Harper & Row, the publisher of The Intelligent Investor, has reissued this work with a new Preface and Appendix by Warren Buffett.) Ben Graham taught investments for 28 years at Columbia University, and perhaps his success as a professional investor is matched by his success as an academic, which is most unusual--most finance academicians are not noted investors. His published works have instructed many thousands of students and, indeed, his strength as an academic is derived from his many years experience on Wall Street.

We celebrate Benjamin Graham's 100th birthday--and the 60th anniversary of the publication of Security Analysis--by examining his investment philosophy. For this purpose, we rely heavily on The Intelligent Investor, which he considered more useful than Security Analysis to a young security analyst.

Father of Value Investing

Ben Graham is the Father of Value Investing. The essence of value investing is that any investment should be worth substantially more than an investor has to pay for it. This investment philosophy may seem like common sense, but strangely enough--as Ben might have put it--many investors are not careful to see that they receive good value for their money. Ben wasn't the first value investor. Bernard Baruch and other value investors predate him. In fact, the first value investor probably was a cave person. But Graham, among early Wall Streeters, did the most to invent a systemized body of investment knowledge. He built this body of knowledge through research and practice, and he disseminated it through his teaching and writings. Whereas, Ben Graham is considered the Father of Value Investing, he actually fathered the modern study of investments.

Margin of Safety Concept

Graham was most insistent that any security purchased should represent good value. He felt stocks should be bought like groceries, not like perfume, and he distilled his investment philosophy down to just three words, "MARGIN OF SAFETY".[1] By margin of safety, he meant that any stock bought should be worth considerably more than it costs. He sometimes suggested at least 50 percent more. Stocks bought with a margin of safety give some assurance that one has invested wisely. And stocks bought with a margin of safety should be low risk, high return investments--the kind we all want.

How do you find stocks with a margin of safety? In part, they are found by avoiding stocks which are unlikely to possess this margin. Popular stocks are avoided since they are likely to be fully priced, and growth stocks are avoided since they tend to be popular and since they tend to perform poorly in bad markets. And you follow rules pertaining to low price/earnings ratios, low price/book value ratios, etc., which are designed to exclude stocks without a margin of safety.

Graham's advice to avoid growth stocks may be surprising. The reason is that great wealth is seldom achieved without growth stock investment, and

[1]Benjamin Graham, The Intelligent Investor: A Book of Practical Counsel, 4th revised edition, with new Preface and Appendix by Warren E. Buffett (New York: Harper & Row Publishers, 1973), p. 277.

Graham himself apparently amassed much of his fortune, while considerably enhancing his reputation, from a single growth stock. However, when Graham and his investment partners violated this principle, they controlled the firm and thus possessed inside knowledge of its affairs. Graham and partners held on to this stocks, too, because it had become "family business."[2] In this case, they also violated Graham's often-stated admonition to be well diversified; 20 percent of their funds initially went into this one stock. Still, Graham's disdain for growth stocks--because they are often popular, tend to become overpriced in good markets, and tend to perform poorly in bad markets--is well founded.

Investment Performance Depends on Intelligent Effort

Graham disagreed with the usual postulated risk-return relationship, that is, to earn a higher return an investor must accept higher risk. To the contrary, he felt that the more intelligent effort one put into investing, the better the bargains bought. And the better the bargains, the lower the risk. Thus intelligent investing provides high yields and low risk. Finance academicians often fail to appreciate this point.

Investment Versus Speculation

The distinction between investment and speculation is central to Graham's investment philosophy. He defined these terms thusly: "An investment operation is one which, upon thorough analysis promises safety of principal and adequate return. Operations not meeting these requirements are speculative."[3] Based on this distinction, a speculator is either taking

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[2] Ibid., p. 289.

[3] Ibid., p. 1.

substantial risk or is not knowledgeable. While "speculation is always fascinating," Graham believed that for most speculators it is not "fattening to the pocketbook."[4] Speculation is akin to gambling, and Graham warned that one must be vigilant so as not to unconsciously slip into this mode.

Defensive Versus Enterprising Investors

Another distinction Graham makes is the difference between a defensive and an enterprising (aggressive) investor. A defensive investor is one who hasn't the time, knowledge or temperament to realistically seek superior investment returns. Since most investors do not possess these requirements, it is logical that most investors should be defensive investors. The defensive investor should follow simple, mechanistic rules, such as selecting a diversified portfolio of low price/earnings ratio stocks which are designed to produce a conservative portfolio with average or a little better performance. Conversely, the enterprising investor has a great deal of time and knowledge to devote to investing, and he or she possesses the requisite temperament. The enterprising investor is seeking superior performance, although Graham emphasized that it is difficult for even professionals to achieve superior results. The enterprising investor seeks superior performance through the application of rules similar to those applied by the defensive investor, but with greater flexibility in their application, through applying greater effort and knowledge, and perhaps through being more venturesome.

Bond Versus Stock Investment

Graham believed that the division of one's portfolio between stock and bonds is a basic policy decision. He advised the defensive investor always to have at least 25 percent of his or her assets in bonds and at least 25 percent in

[4] Ibid., pp. 3-4.

stock. But he obviously felt it preferable for defensive investors to shoot for a fifty-fifty split of their assets between high grade stock and high grade bonds.

Why always some stock and some bonds? Graham believed that stock cannot always offer better value than bonds. Especially when the stock market is dangerously high, bonds will offer better value than stock. Conversely, bonds cannot always offer better value than stock. In particular, Graham believed that stock offers better inflation protection than bonds. Implicit in these recommendations is Graham's belief that investors really don't have good ability at any given time to tell whether stocks or bonds are the better investment. So the intelligent thing to do is to be well represented in both types of investments.

Suppose that an investor wishes to add to bonds and reduce stocks as the stock market becomes overpriced, and to reverse these operations as the market becomes underpriced. As one consideration in making these decisions, Graham cautiously suggested comparing the earnings/price ratio for stock with the interest yield on high grade bonds. For example, if the earnings/price ratio for stock is about the same as the yield for bonds, then the stock market is probably high, and the enterprising investor might consider selling some stock and buying some bonds. But any investor should be cautious thinking he or she knows the market is high or low.

How long should the bond maturities be? Graham felt that this decision is largely a personal one. Longer maturity bonds tend to yield more than shorter maturity bonds. But if an investor does not wish the value of his or her bond portfolio to fluctuate much with interest rate changes, then he or she should select bonds with a maturity of seven years or less.

Famous Mr. Market Parable

Stocks will fluctuate substantially in value. For a true investor, the only significant meaning of price fluctuations is that they offer ". . . an opportunity to buy wisely when prices fall sharply and to sell wisely when they advance a great deal."[5]

Using his famous Mr. Market parable, Graham suggests the attitude one should adopt toward fluctuations in prices. Imagine owning a $1,000 interest in a business along with a partner, Mr. Market. Every day the accommodating Mr. Market offers either to buy your interest or to sell you a larger interest. Sometimes his price is ridiculously high, allowing you a good opportunity to sell. At other times his price is ridiculously low, allowing you a good opportunity to buy. Still at other times, his quotes are roughly justified by the business outlook, and you can ignore them.

The point is that the market is there for your convenience and profit. And market valuations are often wrong. Price fluctuations, Graham believes ". . . bear no relationship to underlying conditions and values."[6] It is a mistake, he argued, to let the market determine what stocks are worth. "In an astonishingly large proportion of the trading in common stocks," Graham stated, "those engaged therein don't appear to know--in polite terms--one part of their anatomy from another."[7] Generally an investor will be wiser to form independent stock valuations, and then to exploit divergences between those valuations and the market's prices.

Graham's Mr. Market parable is related to his view of technical analysis. According to Graham, nearly all of technical analysis is based on buying stock when prices have risen and selling when they have fallen. Based on over 50 years' experience, he had ". . . not known a single person who had

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[5] Ibid., p. 109.

[6] Ibid., p. 110.

[7] Ibid., p. 13.

consistently or lastingly made money by thus 'following the market.'"[8] This approach, he declared, ". . . is as fallacious as it is popular."[9]

Graham Declines to Predict Earnings

In The Intelligent Investor, Graham evaluated the investment merit of several stocks, but not once did he predict earnings for those stocks. (On other occasions, however, he did venture to predict earnings.) For instance, at the conclusion of his analyses of ELTRA and Emhart stocks, he concluded, "We make no predictions about the future earnings performance. . ."[10]

That Graham, an eminent security analyst, should decline to predict earnings is intriguing. He obviously did not have much confidence in his ability to predict earnings--nor in others' predictions, especially long-term predictions. Sophisticated investors have always been aware of this difficulty. For instance, John Maynard Keynes, the brilliant British economist, more than a half-century ago emphasized the great difficulty involved in forecasting investment returns. In regard to this difficulty, Keynes said:

> The outstanding fact is the extreme precariousness of the basis of knowledge on which our estimates of prospective yield have to be made. Our knowledge of the factors which will govern the yield of an investment some years hence is usually very slight and often negligible. If we speak frankly, we have to admit that our basis of knowledge for estimating the yield ten years hence of a railway, a copper mine, a textile factory, the goodwill of a patent medicine, an Atlantic liner, a building in the City of London amounts to little and sometimes to nothing; or even five years hence. In fact, those who seriously attempt to make such estimates are often so much in the minority that their behavior does not govern the market.[11]

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[8]Ibid., p. x.

[9]Ibid.

[10]Ibid., p. 182.

[11]John Maynard Keynes, The General Theory of Employment, Interest and Money, (New York: Harcourt, Brace & World, Inc., 1935), pp. 149-150.

Graham apparently felt that earnings forecasting is too inaccurate to be useful, given that the market already incorporates the consensus estimate. There also is danger of double counting for good earnings prospects. When this occurs, the market price allows for the good prospects but the investor counts them again.

Apparently because of such problems, Graham believed that the security valuation process is not very reliable. After discussing some problems valuing ALCOA, Graham said, "ALCOA is surely a representative industrial company of huge size. . .[it] supports to some degree, the doubts we expressed [earlier] as to the dependability of the appraisal process when applied to the typical industrial company."[12] Because the appraisal process is unreliable, it is prudent to diversify one's investments. Perhaps it is enough, Graham thought, for an investor to be assured that he or she is getting good value, even if an accurate valuation is impossible.

Finally, the inherent inaccuracy of this valuation process may explain Graham's observation that he had never ". . . seen dependable calculations made about common-stock values . . . that went beyond simple arithmetic or the most elementary algebra."[13] In valuing stock, crude, simple calculations often are as good as you can do.

The Prevalent Approach to Investing Often Does Not Work

The prevalent approach to investing is first to choose the best industry, and then to invest in the best company in that industry, regardless of the stock's price. Graham did not think well of this approach because he believed it was too unreliable. Good business does not always translate into good investment

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[12]Graham, The Intelligent Investor, op. cit., p. 174.

[13]Ibid., p. 321.

returns, and even the experts have difficulty selecting and concentrating on those issues which will become winners. Finally, the application of this method may place an investor in popular, overvalued stocks.

Select Low Price/Book Value Stocks

Graham felt rather strongly that an investor should not pay much more than book value for a stock. In his word, "Strangely enough we shall suggest as one of our chief requirements . . . that our readers limit themselves to issues selling not far above their tangible-asset value."[14] He advised conservative (defensive) investors not to pay above one-third more than book value, and aggressive (enterprising) investors not to pay above 20 percent more than book value.

Graham's bias against high price-to-book value stocks is simply explained: These stocks tend to be popular, speculative, overpriced and more risky. Often, popular growth stocks fall into this category and should be avoided. It is paradoxical, Graham thought, that our most successful companies should be avoided for investment purposes.

Selecting Unpopular Stocks

If an investor is to do better than average, Graham argued that his or her investment policies should not be popular. He believed that most Wall Street professionals tend to seek out stocks with the best growth prospects and to ignore other stocks. This bias causes unpopular stocks to become undervalued and good buys. "It would be rather strange", Graham suggested, "if--with all the brains at work professionally in the stock market--there could be approaches which are both sound and relatively unpopular. Yet our career and

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[14] Ibid., p. xvi.

reputation have been based on this unlikely fact."[15] An investor who follows the crowd is unlikely to experience even average results, if for no other reason because of transactions costs.

Still, profiting by buying an unpopular or neglected stock, or selling short a popular, overvalued stock is no easy road to riches.[16] "Buying a neglected and therefore undervalued issue for profit," Graham cautioned, "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."[17] Graham's thoughts here are reminiscent of the famed Gerald Loeb's view that "Successful investment is a battle for financial survival."[18]

Investment in Secondary Stocks

Investors have a distinct preference for the more successful, large (primary) firm stocks. Therefore, Graham reasoned, bargains are more likely to be discovered among the comparatively unpopular, neglected smaller (secondary) firm stocks. Today, a rather arbitrary dividing line between large and small firms is $400 million of outstanding common stock value. Often the large company stocks are referred to as large capitalization ("cap" for short) stocks and the small company stocks as small cap stocks. A carefully

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[15]Ibid., pp. 204-5.

[16]Selling short is a method for profiting in a situation where the investor believes that a stock will decline in price. The stock is borrowed from another investor and sold on the open market. Later the stock must be bought back, hopefully at a lower price, and returned to the party from whom it was borrowed. Selling short is usually risky and only performed by professionals.

[17]Graham, The Intelligent Investor, op. cit., p. 13.

[18]Gerald M. Loeb, The Battle for Investment Survival, rev. ed., (New York: Simon and Schuster, 1965), p. 19.

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. Graham's rationale can be summarized as follows: secondary stocks sell for less than primary stocks except during the later stages of a bull market. If bought at a bargain price, they often later can be sold at or near their full market value.

Net Current Asset Bargain Stocks

Net current assets as defined by Graham are current assets less all the firm's debt (both long-term and short-term) divided by the number of shares outstanding. This net current asset figure assumes zero value to long-term assets (plant and equipment, etc.) and goodwill, such as valuable brand names. No sensible business owner would sell his or her business so cheaply, Graham declared, and yet historically these investments were plentiful. Graham's experience with these investments was almost universally good. "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."[19] While Graham prized a diversified group of these investments, the patience required can be considerable, he warned, in one case for him taking three and one-half years to work well. Furthermore, in modern markets, apparently only in the lower reaches of a protracted bear market can enough of these investments be found for proper diversification.

Did Graham Insist on a Sure Thing?

[19]Graham, The Intelligent Investor, op. cit., p. 216. (Emphasis in the original).

It is too strong to say that Graham insisted on a sure thing, but he clearly wasn't much of a risk taker. In his own words, "From the first we wanted to make sure that we were getting ample value for our money in concrete, demonstrable terms. We were unwilling to accept the prospects and promises of the future as compensation for a lack of sufficient value in hand."[20] Graham is proof that successful investment need not be risky investment

Enthusiasm on Wall Street Is Dangerous

Graham warned ". . . that while enthusiasm may be necessary for great accomplishments elsewhere, in Wall Street it almost invariable leads to disaster."[21] He didn't explain his rationale for this view, but enthusiasm destroys our critical faculties and leads us to believe we have a "sure thing". Coupled with greed, thinking an investment is a sure thing is most dangerous. We tend to bet heavily on the stock, forgetting the legendary Bernard Baruch's warning that every investment is something of a gamble.[22] Moreover, enthusiasm leads a person into speculation, which Graham greatly deplored.

Investment Experience and Stock Market History Are Important

Ben Graham's 57 years on Wall Street were most instructive, and he expressed his appreciation to them when he alluded to his "old ally, experience". To an important extent, you learn to invest by investing. Too often we have to make the same mistake as others before the lesson is instructive. All of us, it

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[20]Ibid., p. 199.

[21]Ibid., p. xii.

[22]Bernard Baruch, My Own Story, (New York: Holt, Rinehart and Winston Publishing Co., 1957), p. 247.

seems, must learn through the school of hard knocks. We would do better to learn from the likes of Ben Graham.

Graham was a careful student of stock market history, and he placed great emphasis on it. He thought that "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.'"[23] Graham could ridicule investors grasp of stock market history, referring to their "proverbial short memories".[24]

It was Graham's knowledge of the long sweep of stock market history that prompted his view that ". . . the investor may as well 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 5 years."[25] Historical insight is critical to successful investing. It is only through knowledge of the past that we can tell anything about the future.

Using an Investment Advisor

A great majority of investors are amateurs, and naturally many of these investors turn to professionals for advice. Yet there is something naive, Graham cautioned, about asking others how to make money. Unless an investor has an intimate and favorable knowledge of the advisor, Graham suggested the investor limit his or her investments to "conservative and even unimaginative forms".[26] The main benefit of a professional advisor, Graham argued, is to protect the investor from costly mistakes, not to beat the averages.

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[23]Graham, The Intelligent Investor, op. cit., p. ix.

[24]Ibid., p. 87.

[25]Ibid., p. 101.

[26]Ibid., p. 132.

Wall street historically has prospered from speculation, according to Graham, but he believed that speculators themselves on the whole lose money. "Hence," he stated, "it has been logically impossible for brokerage houses to operate on a thoroughly professional basis."[27]What is in the best interests of brokers--that is, maximizing commissions--is not in the best interests of investors.

Mutual Fund Investment

Despite mutual funds on average not performing as well as the popular stock indices, Ben Graham believed most individuals who have invested in mutual funds have fared better than they otherwise would have fared. If an investor does not opt for a mutual fund, Graham thought that "untoward influences" often incline him or her in the direction of speculation.[28]

For those interested in mutual funds, Graham recommended buying a group of closed-end investment company shares selling at a discount to their net asset values. These funds, he argued, have an advantage over even no-load funds because the investor purchases them for less than what the funds' underlying stock is worth in the market.

But bonds should be bought directly and not through a fund, according to Graham. Presumably he felt that most investors can obtain satisfactory bond diversification without paying a fee to the mutual fund management firm. Furthermore, diversification, while still important, may be less critical in the case of high grade bonds, which is the type he generally recommended. Nevertheless, many financial advisors will argue that for less knowledgeable, smaller investors, no-load, low-fee high grade bond funds offer sound diversification for a reasonable fee.

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[27]Ibid., p. 135.

[28]Ibid, p.118

Sampling Ben Graham's Writing

Ben Graham wrote well. The following quotes are suggestive of his writing and further reveal his investment philosophy.

In regard to market fluctuations: "Everyone knows that speculative stock movements are carried too far in both directions, frequently in the general market and at all times in at least some of the individual issues."[29]

Why bargains occur: "The market is fond of making mountains of molehills and exaggerating ordinary vicissitudes into major setbacks. Even a mere lack of interest or enthusiasm may impel a price decline to absurdly low levels."[30]

On stock market forecasts: "(I)t is absurd to think that the general public can ever make money out of market forecasts."[31]

A classic definition of a shrewd investor: "(O)ne who bought in a bear market when everyone else was selling and sold out in a bull market when everyone else was buying."[32]

The powerful pull of the crowd: "(E)ven the intelligent investor is likely to need considerable willpower to keep from following the crowd.:[33]

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[29] Ibid., p. 13.

[30] Ibid., p. 83.

[31] Ibid., p. 96.

[32] Ibid., p. 98.

[33] Ibid., p. 101.

Difficulty predicting security price movements: "If it is virtually impossible to make worthwhile predictions about the price movements of stocks, it is completely impossible to do so for bonds."[34]

The rationale for diversification: "It appears to be almost impossible to distinguish in advance between those individual [stock] forecasts which can be relied upon and those which are subject to a large chance of error. At bottom, this is the reason for . . . diversification . . ."[35]

Long-term forecasts are unreliable: "No one really knows anything about what will happen in the distant future, but analysts and investors have strong feelings on the subject just the same."[36]

Difficulty evaluating management: "Until objective, quantifiable, and reasonably reliable tests of managerial competence are devised and applied, this factor will continue to be looked at through a fog."[37]

Money managers promising miracles: "Bright, energetic people--usually quite young--have promised to perform miracles with 'other people's money' since time immemorial . . . they have inevitably brought losses to their public in the end."[38]

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[34] Ibid., p. 110.

[35] Ibid., p. 154.

[36] Ibid.

[37] Ibid., p. 155.

[38] Ibid., p. 124.

Safety with a security residing in earnings--not collateral: "Experience has shown that in most cases safety resides in the earning power, and if this is deficient the assets lose most of their reputed value."[39]

Will Graham Make You Rich?

Few investors--except in old age--will get rich adhering strictly to Graham's investment philosophy. His conservative, diversified approach for most practitioners is likely to yield investment results only a little better than average. His aim is to assist investors to obtain good value for their money--not to make them rich quick. Graham believed that this is the only legitimate function for an investment advisor. Most investors would do well to achieve such results because professional investors on average do not fare so well. Still, it would be good to remember Graham`s caution that:

> (A)ny approach to moneymaking in the stock market which can be easily described and followed by a lot of people is by its terms too simple and too easy to last. Spinoza`s concluding remark applies to Wall Street as well as to philosophy: "All things excellent are as difficult as they are rare."[40]

Ben Graham offers a keen insight into moneymaking and a wise philosophy. The investment principles he enunciated are timeless. The seeker of investment truth will discover in the old sage a gold mine of wisdom, one who creditably promises a "fattening of the pocketbook", and a fine companion as well. We would do well before we make our next commitment to think his motto, MARGIN OF SAFETY.

[39] Ibid., p. 149.

[40] Ibid., p. 100.