A Conversation with Benjamin Graham

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Common stocks have one important characteristics and one important speculative characteristic. Their investment value and average market price tend to increase irregularly but persistently over the decades, as their net worth builds up through the reinvestment of undistributed earnings--incidentally, with no clear-cut plus or minus response to inflation. However, most of the time common stocks are subject to irrational and excessive price fluctuations in both directions, as the consequence of the ingrained tendency of most people to speculate or gamble--i.e., to give way to hope, fear and greed.

A highly unfavorable--even a cynical--one. The Stock Exchanges appear to me chiefly as a John Bunyan type of Vanity Fair, or a Falstaffian joke, that frequently degenerates into a madhouse--"a tale full of sound and fury, signifying nothing." The stock market resembles a huge laundry in which institutions take in large blocks of each other's washing--nowadays to the tune of 30 million shares a day--without true rhyme or reason. But technologically it is remarkably well-organized.

Most of the stockbrokers, financial analysts, investment advisers, etc., are above average in intelligence, business honesty and sincerity. But they lack adequate experience with all types of security markets and an overall understanding of common stocks--of what I call "the nature of the beast." They tend to take the market and themselves too seriously. They spend a large part of their time trying, valiantly and ineffectively, to do things they can't do well.

To forecast short- and long-term changes in the economy, and in the price level of common stocks, to select the most promising industry groups and individual issues--generally for the near-term future.

No. In effect, that would mean that the stock market experts as a whole could beat themselves--a logical contradiction.

Yes. Not only that, but I think they should require approximately such results over, say, a moving five-year average period as a condition for paying standard management fees to advisors and the like.

At bottom that is only a convenient cliche or alibi to justify the mediocre record of the past. All investors want good results from their investments, and are entitled to them to the extent that they are actually obtainable. I see no reason why they should be content with results inferior to those of an indexed fund or pay standard fees for such inferior results.

On the contrary, the typical investor has a great advantage over the large institutions.

Chiefly because these institutions have a relatively small field of common stocks to choose from--say 300 to 400 huge corporations--and they are constrained more or less to concentrate their research and decisions on this much over-analyzed group. By contrast, most individuals can choose at any time among some 3000 issues listed in the Standard & Poor's Monthly Stock Guide. Following a wide variety of approaches and preferences, the individual investor should at all times be able to locate at least one per cent of the total list--say, 30 issues or more--that offer attractive buying opportunities.

Let me suggest three such rules: (1) The individual investor should act consistently as an investor and not as a speculator. This means, in sum, that he should be able to justify every purchase he makes and each price he pays by impersonal, objective reasoning that satisfies him that he is getting more than his money's worth for his purchase--in other words, that he has a margin of safety, in value terms, to protect his commitment. (2) The investor should have a definite selling policy for all his common stock commitments, corresponding to his buying techniques. Typically, he should set a reasonable profit objective on each purchase--say 50 to 100 per cent--and a maximum holding period for this objective to be realized--say, two to three years. Purchases not realizing the gain objective at the end of the holding period should be sold out at the market. (3) Finally, the investor should always have a minimum percentage of his total portfolio in common stocks and a minimum percentage in bond equivalents. I recommend at least 25 per cent of the total at all times in each category. A good case can be made for a consistent 50-50 division here, with adjustments for changes in the market level. This means the investor would switch some of his stocks into bonds on significant rises of the market level, and vice-versa when the market declines. I would suggest, in general, an average seven- or eight-year maturity for his bond holdings.

In general, no. 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, 40 years ago, when our textbook "Graham and Dodd" was first published; but the situation has changed a great 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 cost. To that very limited extent I'm on the side of the "efficient market" school of thought now generally accepted by the professors.

Essentially, a highly simplified one that applies a single criteria or perhaps two criteria to the price to assure that full value is present and that relies for its results on the performance of the portfolio as a whole--i.e., on the group results--rather than on the expectations for individual issues.

I can give two examples of my suggested approach to this problem. One appears severely limited in its application, but we found it almost unfailingly dependable and satisfactory in 30-odd years of managing moderate-sized investment funds. The second represents a great deal of new thinking and research on our part in recent years. It is much wider in its application than the first one, but it combines the three virtues of sound logic, simplicity of application, and an extraordinarily good performance record, assuming--contrary to fact--that it had actually been followed as now formulated over the past 50 years--from 1925 to 1975.

My first, more limited, technique confines itself to the purchase of common stocks at less than their working-capital value, or net-current-asset value, giving no weight to the plant and other fixed assets, and deducting all liabilities in full from the current assets. We used this approach extensively in managing investment funds, and over a 30-odd year period we must have earned an average of some 20 per cent per year from this source. For a while, however, after the mid-1950's, this brand of buying opportunity became very scarce because of the pervasive bull market. But it has returned in quantity since the 1973-74 decline. In January 1976 we counted over 300 such issues in the Standard & Poor's Stock Guide--about 10 per cent of the total. I consider it a foolproof method of systematic investment--once again, not on the basis of individual results but in terms of the expectable group outcome.

This is similar to the first in its underlying philosophy. It consists of buying groups of stocks at less than their current or intrinsic value as indicated by one or more simple criteria. The criterion I prefer is seven times the reported earnings for the past 12 months. You can use others--such as a current dividend return above seven per cent or book value more than 120 percent of price, etc. We are just finishing a performance study of these approaches over the past half-century--1925-1975. They consistently show results of 15 per cent or better per annum, or twice the record of the DJIA for this long period. I have every confidence in the threefold merit of this general method based on (a) sound logic, (b) simplicity of application, and (c) an excellent supporting record. At bottom it is a technique by which true investors can exploit the recurrent excessive optimism and excessive apprehension of the speculative public.