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David G. Watterson, C.F.A., President
The Financial Analysts Research Foundation

THE DECADE 1965-1974: ITS SIGNIFICANCE FOR FINANCIAL ANALYSTS

Benjamin Graham

The title of this seminar—"The Renaissance of Value"—implies that the concept of value had previously been in eclipse in Wall Street. This eclipse may be identified with the virtual disappearance of the once well-established distinction between investment and speculation. In the last decade everyone became an investor—including buyers of stock options and odd-lot short-sellers. In my own thinking the concept of value, along with that of margin of safety, has always lain at the heart of true investment, while price expectations have been at the center of speculation.

Let me list some of the questions relating to the value approach that confront the financial analyst now in the light of the 1965-1974 experience:

1. Is the value approach a useful one in terms of
   (a) what it can accomplish on its own, and
   (b) by comparison of its results with those of other analytical methods and practices?

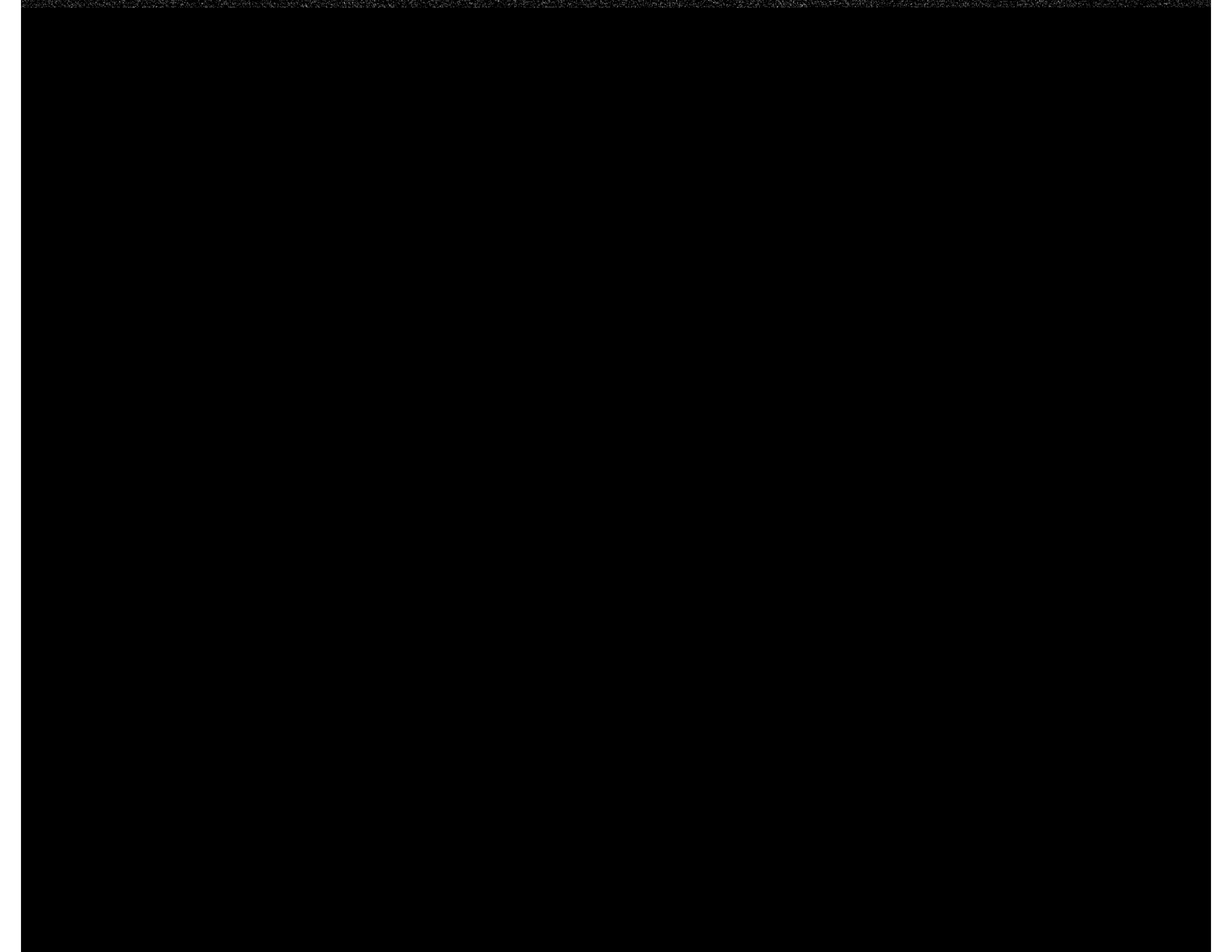
2. To what degree should the techniques of valuation as presented, say, in Graham, Dodd and Cottle, 1962—be modified by more recent developments, including theoretical thinking?

3. What is the effect of institutional domination of the stock market on the valuation work of the security analyst and the decision-making procedures of the financial analyst?

4. To what extent does the sheer number of practicing analysts—some 14,000 F.A.F. members, including 3,880 C.F.A.s and over 2,000 active C.F.A. candidates—prevent the average or representative one from accomplishing worthwhile results? This is indeed a delicate question.

The discussion that follows will not separate each of these questions from the others, but I will try to answer them as best I can.

The value approach has been founded on the premise that in many—but by no means in all—cases a dependable range of valuation can be established for a common stock by analytical techniques, that often this range differs substantially from the current price, and that



many of these may be in unsatisfactory financial condition, caused in part by inflation pressures and in good part also by the over-expansion of corporate debt in the past decade. (I consider the total figures for corporate debt since 1968, published in the June 1974 issue of the *Survey of Current Business*, to be most disquieting. [illegible] overall increase of 74 percent in only five years, with [illegible] 1974.)

I see no satisfactory way of reducing the multiplier to allow for a below-par debt position. My advice to analysts would be rather to avoid attempting a formal valuation of such companies. In other words, limit your appraisals to enterprises of investment quality, excluding from

meet criteria of value independent of the price record. A technique of this sort would have worked fine, according to my studies, up to and including the post-1970 market recovery. Under more recent conditions it would merely have added a price-decline criterion to the determination of buy points based on the valuation approach. For practically all issues of the Firestone type an acquisition price at two-thirds of analysts' valuation would be at less than half of the previous market high.

Let me pass on to a factor in the valuation process that in my thinking has taken on considerable importance under present conditions. This is the book value figure, to be viewed either as a point [illegible] for refined calculations or as a practically usable

stocks at less than their indicated value; the second is when with equal courtesy it permits him to sell at not more than one-half their former high quotation those that are of no importance to him. True, he may sometimes dispose of an investment at a loss. But that should not be because the market price went down; it should be because things went badly for the company and the true value of the shares declined below his purchase price. (Of course the investor may always use the stock market to switch out of issues he owns into others that offer more value at ruling prices.)

(You are now hearing some of the "old-time religion". You may not be converted, but it shouldn't do you any harm.)

At this point let me consider briefly an approach with which we were closely identified when managing the Graham-Newman fund. This was the purchase of shares at less than their working-capital value. That gave such good results for us over a forty-year period of decision-making that we eventually renounced all other common-stock choices based on the usual valuation procedures, and concentrated on these "sub-asset stocks". The "renaissance of value," which we are talking about today, involves the reappearance of this kind of investment opportunity. A Value-Line publication last month listed [illegible] such issues in the non-financial category. Their compilation suggests that there must be at least twice as many sub-working-capital choices in the Standard & Poor's Monthly Stock Guide. (However, don't waste $25 in sending for an advertised list of "1000 Stocks Priced at Less Than Working Capital." Those responsible inexcusably omitted to deduct the debt and preferred stock liabilities from the working capital in arriving at the amount available for the common.)

It seems no more than ordinary sense to conclude that if one can make up, say a 30-stock portfolio of issues obtainable at less than working capital, and if these issues meet other value criteria including the analysts's belief that the enterprise has reasonably good long-term prospects, why not limit one's selection to such issues and forget the more standard valuation methods and choices we have previously discussed? I think the question is a logical one, but it raises various practical issues: How long will such "fire-sale stocks"—as Value Line called them—continue to be given away; what would be the consequences if a large number of decision-makers began as of tomorrow to concentrate on that group; what should the analyst do when these are no longer available?

Such questions are actually related to broader aspects of the value approach, involving the availability of attractive investment opportunities if and when most investors and their advisers followed its doctrine. I shall return to that problem later.

Some interesting questions relating to intrinsic value vs. market price are raised by the take-over bids that are now part of our daily financial fare. The most spectacular such event occurred a few weeks ago, when two large companies actively competed to buy a third, with the result that within a single month the price of ESB Inc. advanced from 17½ to over 41. We have always considered the value of the business to a private owner as a significant element in appraising a stock issue. We have [illegible] for security analysts to think about the price that might be offered for a given company by a would-be acquirer. In that respect the ESB transaction and the Marcor one that followed it offer much encouragement to those who believe that the real value of most common stocks is well above their present market level.

There is another aspect of take-overs that I want to bring up here, on a somewhat personal basis, because it relates to an old and losing battle that I have long fought to make stockholders less sheeplike vis-a-vis their managements. You will recall that the first bid of INCO was termed a "hostile act" by the ESB management, who vowed to fight it tooth and nail. Several managements have recently asked stockholders to vote charter changes that would make such acquisitions more difficult to accomplish against their opposition—in other words, make it more difficult to deprive present officers of their jobs and more difficult for stockholders to obtain an attractive price for their shares. The stockholders, still sheeplike, generally approve such proposals. If this movement becomes widespread it could really harm investors' interests. I hope that financial analysts will form a sound judgment about what is involved here and do what they can to dissuade stockholders from cutting their own throats in such a foolish and reckless fashion. This might well be a subject for the FAF to discuss and take an official stand on.

There is at least a superficial similarity between the prices offered in takeovers and those formerly ruling in the market for the first-tier issues, as represented by "the favorite fifty". The large institutions have acted somewhat in the role of conglomerates extending their empires by extravagant acquisitions. The P/E ratio of Avon Products averaged 55 in 1972, and reached 65 at the high of 140. This multiplier could not have been justified by any conservative valuation formulae such as those we have been discussing. It was not made by speculators in a runaway bull market; it had the active or passive support of the institutions that have been large holders of Avon.

As I see it, institutions were persuaded to pay outlandish multipliers for shares of the Avon type by a combination of three influences: First, the huge amounts of money they have to administer,

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most of which they decided to place in equities. Second, the comparatively small number of issues to which their operations were confined, in part because they had to choose multi-million-share companies for their block transactions, and partly by their insistence on high-growth prospects. The third influence was the cult of performance, especially in pension-fund management. The arithmetic here is deceptively simple. If a company's earnings will increase 15 percent this year, and if the P/E ratio remains unchanged, then presto! the "investment" shows a 15 percent performance, plus the small dividend. If the P/E ratio advances—as it did for Avon in almost every year—the performance becomes that much better. These results are entirely independent of the price levels at which these issues are bought. Of course, in this fantasia the institutions were pulling themselves up by their own bootstraps—something not hard to do in Wall Street, but impossible to maintain forever.

These institutional policies raise two implications of importance for financial analysts. First, what should a *conservative* analyst have done in the heady area and era of high-growth, high-multiplier companies? I must say mournfully that he would have to do the near-impossible—namely, turn his back on them and let them alone. The institutions themselves had gradually transformed these investment-type *companies* into speculative *stocks*. I repeat that the ordinary analyst cannot expect long-term satisfactory results in the field of speculative issues, whether they are speculative by the company's circumstances or by the high price levels at which they habitually sell.

My second inference is a positive one for the investing public and for the analyst who may advise a non-institutional clientele. We have many complaints that institutional dominance of the stock market has put the small investor at a disadvantage because he can't compete with the trust companies' huge resources, etc. The facts are quite the opposite. It may be that the institutions are better equipped than the individual to speculate in the market; I'm not competent to pass on that. But I am convinced that an individual *investor* with sound principles, and soundly advised, can do distinctly better over the long pull than a large institution. Where the trust company may have to confine its operations to 300 concerns or less, the individual has up to 3000 issues for his investigations and choice. Most true bargains are not available in large blocks; by this very fact the institutions are well-nigh eliminated as competitors of the bargain hunter.

Assuming all this is true we must recur to the question we raised at the outset. How many financial analysts can earn a good living by locating undervalued issues and recommending them to individual

investors? In all honesty I cannot say *that there is room* for 14,000 analysts or a large proportion thereof, in this area of activity. But I can assert that the influx of analysts into the undervalued sphere in the past has never been so great as to cut down its profit possibilities through that kind of over-cultivation and over-competition. (The value-analyst was more likely to suffer from loneliness.) True, bargain issues have repeatedly become scarce in bull markets, but that was *not because* all the analysts became value-conscious, but because of the general upswing in prices. (Perhaps one could even have determined whether the market level was getting too high or too low by counting the number of issues selling below working-capital value. When such opportunities have virtually disappeared, past experience indicates that investors should have taken themselves out of the stock market and plunged up to their necks in U. S. Treasury bills.)

So far I have been talking about the virtues of the value approach as if I had never heard of such newer discoveries as "the random walk", "the efficient market", "efficient portfolios", the Beta coefficient, and others such. I have heard about them, and I want to talk first for a moment about Beta. This is a more or less useful measure of past price fluctuations of common stocks. What bothers me is that authorities now equate the Beta idea with the concept of "risk." Price variability yes; risk no. Real investment risk is measured not by the percent that a stock may decline in price in relation to the general market in a given period, but by the danger of a loss of quality and earning power through economic changes or deterioration in management. In the five editions of *The Intelligent Investor* I have used the example of A & P shares in 1936-1939 to illustrate the basic difference between fluctuations in price and changes in value. By contrast, in the last decade the price decline of A & P shares from 43 to 8 paralleled pretty well a corresponding loss of trade position, profitability, and intrinsic value. The idea of measuring investment risks by price fluctuations is repugnant to me, for the very reason that it confuses what the stock market says with what actually happens to the owners' stake in the business.

Let me pass now to the doctrine of the efficient market. I am particularly interested in this because of its negative implications for the work of security analysts generally. The subject is dealt with briefly in my current article in the *Financial Analysts Journal*, but it has such potential importance for this audience that I shall try another crack at it here.

Let me shorten slightly the definition of an efficient market that appears on p. 97 of *The Stock Market* by Lorie and Hamilton. "An efficient market is one in which a large number of buyers and sellers cause the prices to reflect fully what is knowable about the prospects

for the companies dealt in." The key phrase for me is "reflect fully." Let us assume first that it means only that the market has and uses all knowable information about *every* company's prospects, and hence that there is no point for analysts to spend their time trying to obtain *additional* information. I dissent from that statement to the extent that it would render meaningless the current controversy and concern on the use of "material information", particularly as obtained by security analysis from managements. If in all cases the market already knows and reflects all that is knowable about each enterprise then there should be no such thing as "material inside information."

But this is not my chief quarrel with the concept of the "efficient market." There is a strong implication in the Lorie and Hamilton book that because the market reflects fully all the knowable facts it thereby establishes correct or reasonably correct prices for common stocks. Hence, only the superior security analyst can successfully select the stocks that should be bought or sold. These exceptional people—in the authors' words—"have a *quicker* and more profound understanding of the economic consequences to individual firms of changes in the economic environment or changes within the firm itself." They have "a rare and *valuable talent*." I disagree completely with this viewpoint. To establish the right price for a stock the *market must have* adequate information, but it by no means follows that if the market has this information it will thereupon establish the right price. The market's evaluation of the same data can vary over a wide range, dependent on bullish *enthusiasm*, concentrated speculative interest and similar influences, or bearish disillusionment. Knowledge is only one ingredient on arriving at a stock's proper price. The other ingredient, fully as important as information is sound judgment. Take Avon Products, which sold at 140 early last year, or *$8 billion for the company*; and under 20—or a mere $1.2 billion—last month. Was the market for Avon "efficient" on both these dates, in the sense that the price reflected "fully and properly" (the latter my addition to the Lorie and Hamilton phrase) the knowable facts. Were the changes in the short period in the environment or the company's prospects sufficient to cut 85 percent from the true value of this highly profitable, well-managed, and strongly-financed enterprise?

Take at the other extreme the large group of stocks selling *for less* than their working capital. Is the market "efficient" in maintaining these "fire-sale" price levels? Surely it does not lack the essential information about companies. What it does lack is judgment, courage and patience. In situations of this kind lie the best opportunities for financial analysts to prove their mettle.

The value approach has always been more dependable when applied to senior issues than to common stocks. Its particular purpose in bond analysis is to determine whether the enterprise has a fair value so comfortably in excess of its debt as to provide an adequate margin of safety. The standard calculation of interest coverage has much the same function. There is much work of truly professional calibre that analysts can do in the vast area of bonds and preferred stocks—and, to some degree also, in that of convertible issues. The field has become an increasingly important one, especially since all well-rounded portfolios should have their bond component.

Any security analyst worth his salt should be able to decide whether a given senior issue has enough statistically-based protection to warrent its consideration for investment. This job has been neglected at times in the past ten years—most glaringly in the case of the Penn-Central debt structure. It is an unforgivable blot on the record of our profession that the Penn-Central bonds were allowed to sell in 1968 at the same prices as good public-utility issues. An examination of that system's record in previous years—noting inter alia, its peculiar accounting and the fact that it paid virtually no income taxes—would have clearly called for moving out of the bonds, to say nothing of the stock *even at prices* well below its high of 86. We now have a situation in which all bonds sell at high yields, but many companies have an overextended debt position. Also, many of them do not seem to have sufficiently strong protective provision in their bond indentures to prevent them from offering new debt in exchange for their own common stock. (A striking example is the current *bond for stock* operation of Caesar's World.) These widespread present maneuvers seem to me to be so many daggers thrust in the soft bodies of the poor creditors. Bondholders can and should take steps, legal if necessary, to protect their interests against such forms of invasion.

Thus security analysts could well advise a host of worthwhile switching in the bond field. Even in the Federal debt structure—where safety is not at issue—the multiplicity of indirect U. S. Government obligations of all sorts, including some tax exempts, suggest many opportunities for investors to improve their yields. Similarly, we have seen many convertible issues selling at close to a parity price with the common; in the typical case the senior issue has offered a higher yield than the junior shares. Thus a switch from the common stock into the senior issue in these cases would be a plain matter of common sense. (*Examples:* Studebaker-Worthington and Engelhard Mineral preferred vs. common.)

Let me close with a few words of counsel from an 80-year-old veteran of many a bull and many a bear market. Do those things as an

analyst that you know you can do well, and only those things. If you can really beat the market by charts, by astrology, or by some rare and valuable gift of your own, then that's the row you should hoe. If you're really good at picking the stocks most likely to succeed in the next twelve months, base your work on the endeavor. If you can foretell the next important development in the economy, or in technology, or in consumers' preferences, and gauge its consequences for various equity values, then concentrate on that particular activity. But in each case you must prove to yourself by honest, no-bluffing self-examination, and by continuous testing of performance, that you have what it takes to produce worthwhile results.

If you believe—as I have always believed—that the value approach is inherently sound, workable, and profitable, then devote yourself to that principle. Stick to it, and don't be led astray by Wall Street's fashions, its illusions, and its constant chase after the fast dollar. Let me emphasize that it does not take a genius or even a superior talent to be successful as a value analyst. What it needs is, first, reasonable good intelligence; second, sound principles of operation; third, and most important, firmness of character.

But whatever path you follow as financial analysts, hold on to your moral and intellectual integrity. Wall Street in the past decade fell far short of its once praiseworthy ethical standards, to the great detriment of the public it serves and of the financial community itself. When I was in elementary school in this city, more than 70 years ago, we had to write various maxims in our copybooks. The first on the list was: "Honesty is the best policy." It is still the best policy, as our new President reminded us last month.