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What Mr. Buffett Learned from Graham and Dodd

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Introduction

I've always been interested in how Mr. Warren Buffett, the legendary investor, formed the foundation of his investment philosophy. In this article I will cover what effect Mr. Graham's teachings may have had on Mr. Buffett and the development of his investment philosophies. I will present information gathered from the 1934 edition of *Security Analysis* by Benjamin Graham and David Dodd to show how the teachings of Graham & Dodd directly correlate to Mr. Buffett's position and attitudes concerning these same issues today. I hope anyone who has not read the writings of Mr. Graham will decide to do so after reading this article.

Investing vs. Speculation

On day one of Mr. Graham's investment class Mr. Buffett would have learned that speculation and investing were very different activities. This quote from page 3 of *Security Analysis* captures the meaning and futility of practicing a speculative approach towards investing: "…in speculation *when* to buy – and sell – is more important than *what* to buy, and also that almost by mathematical law more speculators must lose than can profit."

This telling quote from the 2000 Berkshire Hathaway Annual Report highlights Mr. Buffett's opinion of speculation in the investment process: "Now, speculation — in which the focus is not on what an asset will produce but rather on what the next fellow will pay for it — is neither illegal, immoral nor un-American. But it is not a game in which Charlie and I wish to play."

"The line separating investment and speculation, which is never bright and clear, becomes blurred still further when most market participants have recently enjoyed triumphs. Nothing sedates rationality like large doses of effortless money. After a heady experience of that kind, normally sensible people drift into behavior akin to that of Cinderella at the ball. They know that overstaying the festivities — that is, continuing to speculate in companies that have gigantic valuations relative to the cash they are likely to generate in the future — will eventually bring on pumpkins and mice. But they nevertheless hate to miss a single minute of what is one helluva party. Therefore, the giddy participants all plan to leave just seconds before midnight. There's a problem, though: They are dancing in a room in which the clocks have no hands."

The Psychology of the Market

He would also have learned that "New-Eras" were actually not new and any time that these words were used to describe the current market, the investor should head for shelter in the face of the coming storm. Understanding that "New-Eras" weren't in fact a new phenomenon would have been invaluable to individual investors if they had studied his writings before this latest period of market irrationality.

He would have learned from Mr. Graham that the "common-stock insanity" of the 1920s was much more a function of "…the nature of human beings than the nature of common stocks."
He may have heard for the first time what he would later adapt into one of his famous quotes: "…he is most optimistic when prices are highest and most despondent when they are at bottom."[1]

This information would serve him well when "temporary periods of insanity" struck the market again at various times during his investment career. The knowledge he gained from Mr. Graham helped him take advantage of situations when the stock market as a whole (or individual

[1] Page 12, Security Analysis (1934) by Benjamin Graham and David Dodd.

companies and/or industries) fell out of favor with speculators for no reasons related to fundamental business performance. For instance, think of the large gains that he made investing in American Express during the salad oil controversy, when its stock dropped in price by approximately 50%. He understood that short-term attitudes were governing the price of the stock but in the long term its franchise was still intact.

The Proper Mindset

Mr. Graham would have taught him the importance of investing in a rational, businesslike manner. He would have let the young Mr. Buffett know that "investment is by nature not an exact science" and that "it is a great mistake to imagine that intrinsic value is as definite and as determinable as is the market price [of a company]."[2] Mr. Graham always taught that security analysis involves analyzing a stock as a business and not as a piece of paper that can be traded on the stock exchange for whatever the current quote is.

Any student of Mr. Graham would have come to understand that the importance of the intrinsic value concept comes not from trying to determine the exact worth of the business in question but in trying to determine if "…the value is *adequate* – e.g., to protect a bond or justify a stock purchase."[3] In this manner Mr. Buffett would come to understand the importance of having a margin of safety. I'm sure he passed the test on this subject.

The teacher would have shown his student, Mr. Buffett, that the art of security analysis is "…more useful when applied to a business of inherently stable character than to one subject to wide variations."[4] The teacher would also form his opinion of the market itself by teaching that the "…market is not a *weighting machine …* the market is a *voting machine.*"[5] By this he meant that in the short-term the market is a voting machine influenced partially by the mood of the market and partially by the reasoned conclusions of market participants but in the long-term the market will price companies in accordance with their intrinsic values.

Imagine sitting through the lecture on Mr. Market (this is a parable that explains how the mood of the market can influence stock prices) taught by Mr. Graham himself! Mr. Buffett echoes these thoughts when he frequently cites those words of his mentor when speaking at colleges and at Berkshire Hathaway annual meetings.

Price vs. Value

Mr. Graham would certainly have spent at least one class period covering the difference between price and value. I'm sure Mr. Buffett learned a great deal from this paragraph on page 29 of *Security Analysis* when Mr. Graham covered it in class at Columbia: "In the field of common stocks … the danger of paying the wrong price is almost as great as that of buying the wrong issue … the new-era of investing left price out of the reckoning, and that omission was productive of the most disastrous consequences." On page 318 of *Security Analysis* he further elaborated on this important topic by adding that investors must practice "…unvarying insistence upon the reasonableness of the price paid for each purchase."

[2] Page 17, ibid.
[3] Page 18, ibid.
[4] Page 20, ibid.
[5] Page 23, ibid.

I'm sure Mr. Buffett went back to this basic idea when the Internet bubble was in full force and market prices paid for companies had no relation to their intrinsic worth. He has observed this principle work for him many times during periods of irrationality on Wall Street.

The Value of Independent Thinking

When Mr. Buffett espouses the importance of forming your own conclusion he might have been influenced by Mr. Graham when Mr. Graham wrote: "The analyst must pay respectful attention to the judgement of the market place … but he must retain an independent and critical viewpoint. Nor should he hesitate to condemn the popular and espouse the unpopular when reasons sufficiently weighty and convincing are at hand."[6]

This quote from the Berkshire Hathaway 2000 annual report highlights Mr. Buffett's thoughts on this subject: "To be sure, an investor needs some general understanding of business economics as well as the ability to think independently to reach a well-founded positive conclusion. But the investor does not need brilliance nor blinding insights."

Margin of Safety

Mr. Buffett would have discovered that the definition of investing is "…one which, on thorough analysis, promises safety of principal and a satisfactory return."[7] When Mr. Graham spoke of safety he meant, in respect to common stocks, those companies that "hold every prospect of being worth the price paid except under quite unlikely circumstances."

Mr. Buffett in a 1997 speech at Caltech had this to say about this concept: "…the concept of a Margin of Safety which he [Mr. Graham] said if you were driving a car or a truck that weighs 9,800 pounds and you see a bridge that says limit 10,000 pounds you go look for another bridge that says 20,000 pounds and you only buy securities when you think they are substantially below what you think they are worth."

Rule #1: Never Lose Money

Another fundamental theme that I'm sure Mr. Graham has covered in his classes is that true investors should emphasize loss avoidance. Mr. Graham stated that common stock investing is defined as "…purchases made with the intention and the reasonable expectation of securing safety of principal." [8]

Mr. Buffett also advocates the same theory by advising investors to only swing at the perfect investment pitches that present themselves. Mr. Buffett has often advised investors to approach investing as if they had a punch card with only 20 punches since they will then concentrate more on their investment selections and will be forced to invest in only those investment that have the highest probability of long-term success.

Don't forget this great quote of Mr. Buffett: "Rule No. 1: Never lose money. Rule No 2: Never forget Rule No. 1."[9]

[6] Page 33, ibid.
[7] Page 54, ibid.
[8] Page 321, ibid.
[9] The Forbes Four Hundred Billionaires, October 27, 1986.

Thoughts on EBITDA

When the investor examines the issues of how to account for depreciation and amortization charges we can see how Mr. Graham could have certainly influenced Mr. Buffett's thoughts on this matter. Mr. Graham observed that "Depreciation is not a mere bookkeeping conception, because for the most part it registers an actual diminution of capital values, for which adequate provision must be made if creditors or owners are to avoid deceiving themselves."[10] He further elaborated on this subject by stating: "…depreciation charges are eventually found to be related to actual cash outlays, and turn out to be as truly an expense of business as wages or rents."[11] Mr. Graham effectively debunked EBITDA (Earnings before interest, taxes, depreciation, and amortization) several decades before it came into vogue!

Mr. Buffett, who has commented on this subject frequently, has stated that: "The one figure we regards as utter nonsense is so-called EBITDA…Any business with significant fixed assets almost always has a concomitant requirement that major cash be reinvested simply to stay in the same place competitively in terms of unit sales. Therefore, to look at some figure that is stated before those cash requirements is absolutely folly. But that hasn't stopped EBITDA from being misused by lots of people to sell all manner of merchandise for years and years."

Dividends & Corporate Governance

Mr. Graham may also have influenced Mr. Buffett concerning the issue of retaining company earnings or paying dividends to the shareholders. Mr. Graham advocated that that "Withholding and reinvestment of a substantial part of the earnings must be clearly justified to the stockholders on the grounds of concrete benefits therefrom exceeding the value of the cash if paid to stockholders."[12] Mr. Buffett has maintained that Berkshire Hathaway will pay dividends only if he can find no opportunities to reinvest the earnings at an acceptable rate of return.

Mr. Buffett has often stated that he would like Berkshire Hathaway's stock to trade in close proximity to its intrinsic value. Mr. Graham would certainly agree with this conclusion as is evident in this quote: "…the responsibility of management … includes the obligation to prevent – in so far as they are able – the establishment of either absurdly high or unduly low prices for their securities." One great example of how Mr. Buffett practices this principle comes from the 1996 Berkshire Hathaway Annual Report:

"Additionally, we made two good-sized offerings through Salomon, both with interesting aspects. The first was our sale in May of 517,500 shares of Class B Common, which generated net proceeds of $565 million. As I have told you before, we made this sale in response to the threatened creation of unit trusts that would have marketed themselves as Berkshire look-alikes. In the process, they would have used our past, and definitely nonrepeatable, record to entice naive small investors and would have charged these innocents high fees and commissions."

"I think it would have been quite easy for such trusts to have sold many billions of dollars worth of units, and I also believe that early marketing successes by these trusts would have led to the formation of others. (In the securities business, whatever can be sold will be sold.) The trusts would have meanwhile indiscriminately poured the proceeds of their offerings into a supply of Berkshire shares that is fixed and limited. The likely result: a speculative bubble in our stock. For at least a time, the price jump would have been self-validating, in that it would have pulled new

[10] Page 387, ibid.
[11] Page 387, ibid.
[12] Page 349, ibid.

waves of naive and impressionable investors into the trusts and set off still more buying of Berkshire shares."

"Some Berkshire shareholders choosing to exit might have found that outcome ideal, since they could have profited at the expense of the buyers entering with false hopes. Continuing shareholders, however, would have suffered once reality set in, for at that point Berkshire would have been burdened with both hundreds of thousands of unhappy, indirect owners (trustholders, that is) and a stained reputation."

"Our issuance of the B shares not only arrested the sale of the trusts, but provided a low-cost way for people to invest in Berkshire if they still wished to after hearing the warnings we issued. To blunt the enthusiasm that brokers normally have for pushing new issues - because that's where the money is - we arranged for our offering to carry a commission of only 1.5%, the lowest payoff that we have ever seen in a common stock underwriting. Additionally, we made the amount of the offering open-ended, thereby repelling the typical IPO buyer who looks for a short-term price spurt arising from a combination of hype and scarcity."

Conclusion

As you can see, Mr. Graham's ideas seem to have heavily influenced Mr. Buffett's thoughts on investing and corporate responsibility. If Mr. Buffett benefited so highly from the teachings of Mr. Graham and Mr. Dodd I'm certain a close reading of *Security Analysis* and *The Intelligent Investor* would richly reward any investor who takes to time to read them both closely! Please feel free to visit the FocusInvestor.com message board at http://www.focusinvestor.com/cgi-bin/ib3/ikonboard.cgi to discuss any topics in this article in more detail or email me at focusinvestor@yahoo.com.

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