Security Analysis – What did Benjamin Graham Really Say?

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I believe *Security Analysis*, an investment textbook written by Benjamin Graham and David Dodd, should be on the required reading list for any serious investors. I also believe that the vast majority of practicing investors have not read any of its four editions. With this in mind I decided to write a couple of articles on what Benjamin Graham really had to say about investing in his seminal textbook.

In this article we will examine what he really had to say about the investing process in the 2nd edition of *Security Analysis* written in 1940. Why didn't I start by discussing what Mr. Graham had to say in the 1st edition of *Security Analysis*? The answer is that the information in the 2nd edition was largely unchanged from the 1st edition. What did change? The information was slightly revised, the examples were updated, and the effects of the creation of the SEC were noted. In other words, Mr. Graham presents a slightly more refined version of his approach in the 2nd edition.

Introduction

The first question to answer is what Mr. Graham's definition of common stock investing is. In the introduction to the 2nd edition he says common stock investing is "defined provisionally as purchases based upon analysis of value and controlled by definite standards and safety of principal."

He states that if the investor is trying to determine "definite investment standards" to create an investment program he might start by examining these four points:

1. The general future of corporation profits
2. The differential in quality between one type of company and another
3. The influence of interest rates on the dividends or earnings return that he shall demand
4. The extent to which his purchases and sales should be governed by the factor of timing as distinct from price.

What further comments did he give on each of the four points? Concerning the first point he stated that "in light of past experience, our most pronounced reaction is likely to be a wholesale skepticism as to the soundness of the stock market's judgment on all broad matters relating to the future."

On the second point he wrote words of caution, "…[that] stocks with good past trends and favorable prospects are worth more than others goes without saying. But is it not possible that Wall Street has carried its partiality too far – in this as in so many other cases?"

On the matter of timing he had a very definite point of view. This is unusual because Mr. Graham very seldom expressed himself so definitively on investing manners. He said, "It is our view that stock market timing cannot be done, with general success, unless the time to buy is related to an attractive price level, as measured by analytical standards. Similarly, the investor must take his cue to sell primarily not from so-called technical market signals but from an advance in the price level beyond a point justified by objective standards of value."

Price-Earnings Ratios for Common Stocks - Adjustments for Changes in Capitalization

Mr. Graham is famous for pioneering the use of the P/E Ratio. In *Security Analysis* he stated "a common stock is generally considered to be worth a certain number of times its current earnings." He elaborated on this statement by saying "in most instances he [the investor] will derive the investment value of a common stock from the average earnings of a period between five and ten years." He suggested, "…about 20 times average earnings is as high a price as can be paid in an investment purchase of a common stock."

Prices above 20 times average earnings were considered to be speculative investments with Graham stating "that people who habitually purchase common stocks at more than about 20 times their average earnings are likely to lose considerable money in the long run." I must note that he used this earnings multiple when long-term interest rates were approximately 4.5%.

Graham wrapped up this topic with the following statement, "We must emphasize also that a reasonable ratio of market price to average earnings is not the only requisite for a common stock investment. It is a necessary but not sufficient condition. The company must be satisfactory also in its financial set-up and management, and not unsatisfactory in its prospects."

The Theory of Common Stock Investing

In his opening comments of the section of the book entitled, The Theory of Common Stock Investing, he listed three realistic premises of common stock investing:

1. Common stocks of are basic importance in our financial scheme and are of fascinating interest to many people.
2. Buyers and sellers are generally anxious to arrive at an intelligent idea of their value.
3. Even when the underlying motive of purchase is mere speculative greed, human nature desires to conceal this unlovely impulse behind a screen of apparent logic and good sense.

Mr. Graham stated that common stock analysis permits "reasonably confident conclusions to be drawn from the process of analysis … only in the case of the exceptional common stock."

History

Also in the beginning of the chapter Mr. Graham covered historical methods of security analysis and had this to say on two historical valuation methodologies, "The older approach, centering upon the conception of a stable average earning power, appears to have been vitiated by the increasing instability of the typical business. As for the new-era view, which turned upon the earnings trend as the sole criterion of value, whatever truth may lurk in this generalization, its blind adoption as a basis for common-stock purchases, without calculation or restraint, was certain to end in an appalling debacle."

Canons of Common Stock Investing

After having discussed the historical methods of security analysis and their negative aspects he then develops several canons of common stock investment based on what he determined were the reasonable aspects of the historical analysis methods he had just examined and critiqued.

He listed the three possible canons of common stock investing as:

1. Investment is conceived as a group operation, in which diversification of risk is depended upon to yield a favorable average result.
2. The individual issues are selected by means of qualitative and quantitative tests corresponding to those employed in the choice of fixed-value investments.
3. A greater effort is made, than in the case of bond selection, to determine the future outlook of the issues considered.

Mr. Graham then compresses his three canons of common stock investing into a question. "May the ownership of a carefully selected, diversified group of common stocks, purchased at reasonable prices, be characterized as a sound investment policy?"

He went on to state that as long as the investor believed in that "(1) our national wealth and earning power will increase (2) that such increases will reflect itself in the increased resources and profits of our important corporations, and (3) that such increases will in the main take place through the normal process of investment of new capital and reinvestment of undistributed earnings." Based on this thought process "common stock selection is not a matter of purely of chance or guesswork but should be governed by an analysis of past records in relation to current market prices."

The instability of the market then was determined to have no long-term effects on common stock investing but it can have dramatic short-term effects due to economic cycle variations and in some cases it may have permanent dire effects upon individual companies and single industries. But Mr. Graham stated that "…of these two dangers the latter [single industry business model blowups] may be offset in part by careful selection and chiefly by wide diversification; the former [general business instability] may be guarded against by unvarying insistence upon the reasonableness of the price paid for each purchase."

Growth Investing Approach

While examining the first part of his investment question "may the ownership of a carefully selected, diversified group of common stocks" he stated that some investors may prefer to focus "on the element of selectivity based on the premise that certain favored companies may be relied on to grow steadily."

This approach, he advised, could work very well for certain individuals when they could find shares available at reasonable prices. The caveat he added to this approach was that he didn't believe that most investors could practice this approach successfully.

He spoke of three issues surrounding the practice of growth investing. The first issue concerned what defines a growth company; he then asked if investors could determine what companies will become growth companies ahead of time, and finally he wondered how much the purchase price matters to an investor's return while investing in growth companies.

Let's examine these three issues in greater detail. His first issue is simple. What is a growth company? He described a growth company as one that is supposed to grow much faster than the economy in general for a significant period of time.

The second part of the issue, if investors can identify growth companies beforehand, is the key part of Mr. Graham's argument against this method of investing. After examining the topic at length he concludes that, "It cannot be accomplished solely by an examination of the statistics and records but requires a considerable supplement of special investigation and of business judgment."

The third part of the issue, how much the purchase price matters to an investment program's overall, return is thoroughly examined by Mr. Graham. The correct purchase price is the key to future returns. In *Security Analysis* Mr. Graham said the central issue to the growth investing issue was determining the correct price to pay for the expected future growth. Although he was never able to determine exactly what price the investor should pay, he did warn against paying a high price when he said "once the investor pays a substantial amount for the growth factor, he is inevitably assuming certain kinds of risk; viz., that the growth will be less than he anticipates, that over the long pull he will have paid too much for what he gets, that for a considerable period the market will value the stock less optimistically than he does."

While he does qualify the growth method of investing by saying that he has doubts that the average investor can successfully practice this approach and determining a correct purchase price is extremely difficult he does conclude that this approach could be successfully practiced. He attached two conditions that he thought had to be met to practice this investing style: 1. "Strong-minded, daring individuals who strive to avoid paying a high premium for future prospects by choosing companies about which he is personally optimistic, although they are not favorites of the stock market" and 2. "The price paid be not substantially different from what a prudent business man would be willing to pay for a similar opportunity presented to him to invest in a private undertaking over which he could exercise control."

<u>Margin of Safety Investing Approach</u>

Mr. Graham starts the discussion of margin of safety by stating, "If the analyst is convinced that a stock is worth more than he pays for it, and he is reasonably optimistic as to the company's future, he would regard the issue as a suitable component of a group investment in common stocks."

He further elaborated on two methods that he thought would be appropriate when practicing this type of investing discipline. He said investors could search for bargains when the overall market was low and/or they could search for bargains among undervalued individual stocks.

Before we discuss these two approaches to the margin of safety investing approach, let's examine how Mr. Graham defined the margin of safety. He said that the margin of safety "resides in the discount at which the stock is selling below its minimum intrinsic value…"

General Market Approach

Mr. Graham laid out three possible tenets that could be used to practice the margin of safety general market approach.

1. Select a diversified list of leading industrial common stocks.
2. Determine a base or "normal" value for the group by capitalizing their average earnings at some suitable figure, related to the going long-term interest rates.
3. Determine a buying point at some percentage below this normal value and a selling point above it.

Immediately after detailing these tenets Mr. Graham immediately highlighted three drawbacks to following this approach.

1. Although the general pattern of the market's behavior may be properly anticipated, the specific buying and selling points may turn out to be badly chosen and the operator may miss his opportunity at one extreme or the other.
2. There is always a chance that the character of the market's behavior may change significantly, so that a scheme of operation that would have worked well in the past will cease to be practical.
3. The method itself requires a considerable amount of human fortitude.

While acknowledging that these drawbacks are significant, he stated, "It is our view that this method has a good deal to commend it to those temperamentally qualified to follow it."

Undervalued Individual Common Stock Approach

Graham believed that investors should be able to find suitable investments looking for companies that aren't recognized growth companies or are thought to have just average growth characteristics. The key in his mind was to buy when the companies were selling for "considerably less than the business would be worth to a private owner." Obviously this would provide the investor with an adequate margin of safety.

In the next sentence Graham stated, "We incline strongly to the belief that this last criterion – a price far less than value to a private owner – will constitute a sound touchstone for the discovery of true investment opportunities in common stocks."

Summary of Investment Policies

In the closing chapter of the 2nd Edition of *Security Analysis* he reiterated the investing techniques for the "investor of small means." The one significant investment category that he added was the "purchases of securities selling below intrinsic value" category. This relates to the investment category of undervalued individual common stocks under the margin of safety investment approach.

He added that the term intrinsic value "takes into account not only past earnings and liquid asset values but also future earning power, conservatively estimated – in other words, qualitative as well as quantitative elements."

Conclusion

I hope that reading this article has enabled the reader to understand exactly what investment practices Mr. Graham believed could be practiced successfully. He believed that for the average investor an investment operation that consisted of buying at prices "far less than the value to a private owner" would be successful. He also believed that independent thinkers who purchased out of favor "growth companies" at reasonable prices could also be successful.

We have also determined what he decisively *excluded* from his definition of investing: "trading in the market, forecasting next year's results for various businesses, [and] selecting the best media for long-term expansion."

Stay tuned for the next article, which will cover what Mr. Graham had to say about investing in the 3rd edition of *Security Analysis*.