

THE INTELLIGENT INVESTOR: **WHAT CAN WE LEARN FROM GRAHAM** **THAT STILL MATTERS?**

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The Wall Street Journal

The Challenge

- **May 1894: Benjamin Graham born**
- **May 1949: *The Intelligent Investor* published**
- ***How can a 75-year-old book, written by someone born 130 years ago, still be relevant?***

Graham's Genius

- intellectual
 - student, scholar, teacher, inventor, author
- investor
 - 1936-1956:
 - S&P 500: 12.13%
 - Graham-Newman Corp.: 17.39%
 - outperformance “far more terrific” than that (Apr. 14, 2023)
 - does **not** count GEICO spinout for G-N investors!
- psychologist
 - Mr. Market
 - “The chief advantage, perhaps, is that such a formula will give him *something to do.*”
 - “You are neither right nor wrong because the crowd disagrees with you. You are right because your data and your reasoning are right.”

Formulaic Graham

Value = Current (Normal) Earnings \times (8.5 plus twice the expected annual growth rate)

The Intelligent Investor (2003 edition), p. 295.

Formulaic Graham

- $P/E * P/B \leq 22.5$
- “Net-nets”
 - $P = \frac{2}{3} * NCAV$
- “Earnings yield at least twice the high-grade bond yield”
 - $E/P \geq 2 * [\text{AAA-rated industrial-bond yield}]$

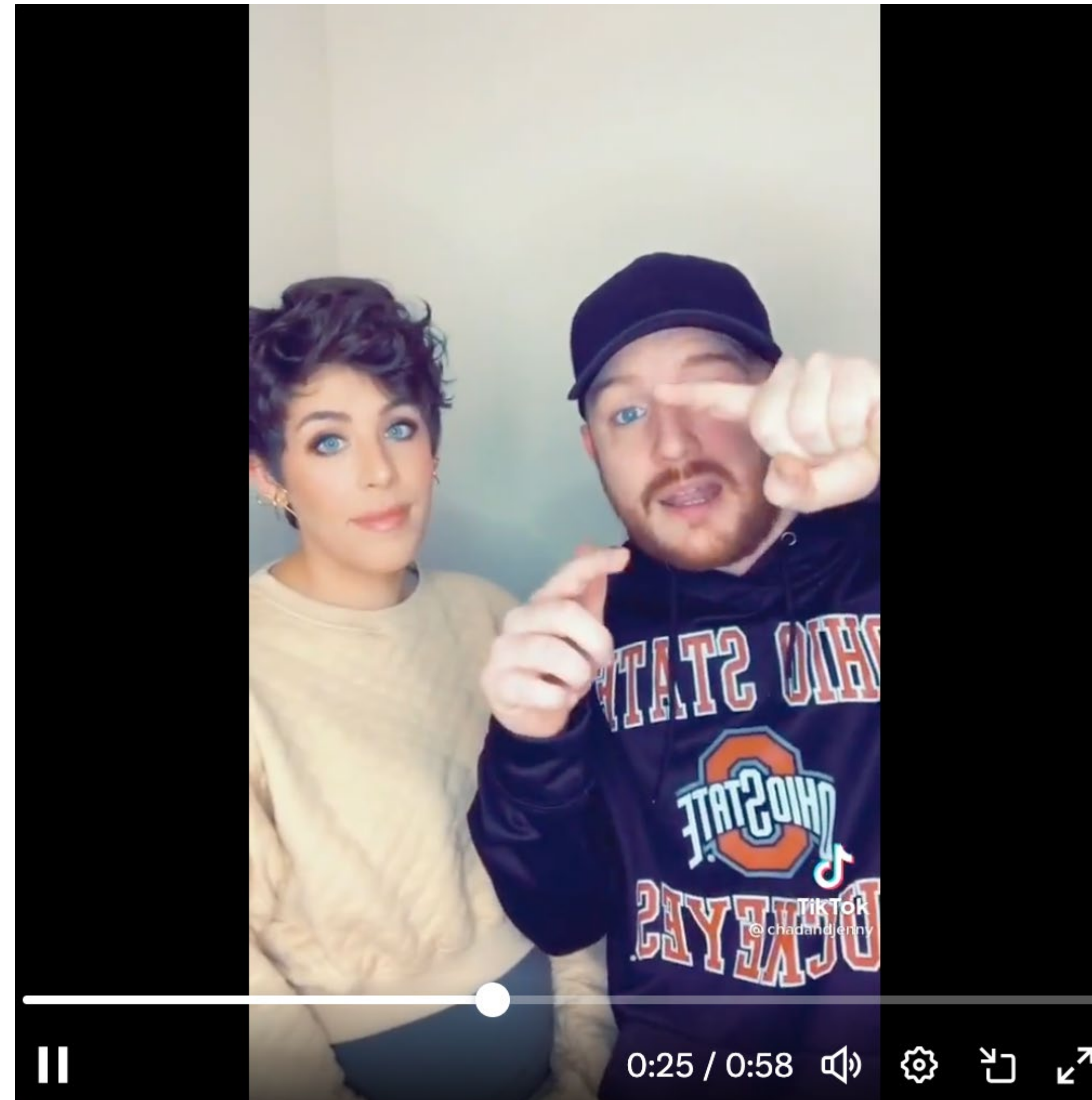
Why Graham Still Matters

- Graham's message is **not about formulas!**
- It is about **first principles!**
 - a stock is not a ticker symbol or a stream of price changes
 - Mr. Market
 - MOS
 - Above all: If you want to succeed, **organize for success**

Who /s Mr. Market?



Who /s Mr. Market?



[“I see a stock going up, and I buy it. And I just watch it until it stops going up, and then I sell it. And I do that over and over, and it pays for our whole lifestyle.”](#)

Meet Mr. Market

- Most of the time, “his idea of value appears plausible and justified by business developments and prospects as you know them.”
- Mr. Market is moody, but he is **not a moron**
- Most of the time, Mr. Market is an ETF:
 - patient (TO ~5%) → transaction costs almost nil
 - low cost ($\leq 5\text{bp}$)
 - tax efficient

Meet Mr. Market

- Mr. Market is an ETF, and **you are not**.
- Assume your expense ratio is only 75bp, your portfolio turnover rate is only 50%, and your total one-way transaction costs are only 50bp.
- Assume the expected return on equities is 10% and your objective is to outperform the market by 10%, i.e. = 11%.
- How much do you have to outperform before costs to meet your objective after costs?
- For a net return of 100 bp > a 10% market, you have to generate **225 bp** of gross outperformance
- The lower the market rate of return, the larger your frictional costs loom!

Source: Charles D. Ellis, "[The Loser's Game](#)" (FAJ, July-August 1975)

Flexible Graham

- “Unless structure follows strategy, inefficiency results” ([Alfred Chandler](#)).
- “At most asset managers, strategy follows structure instead. As a result, funds own too many stocks, trade too frequently and charge too much. No wonder most active managers underperform market-tracking index funds that charge a fraction of their fees.” (<https://on.wsj.com/3IZYEBI>)
- Benchmark the **performance**, not the **portfolio**
- Graham-Newman Corp.
 - open-end mutual fund permanently closed to new investors
 - small AUM (~\$6.5M max [1955] or ≈ \$200M today)
 - 10-for-1 reverse split to keep average NAV above \$1,000 per share!
 - loyal, supportive, informed **community** of investors
 - no procyclical cash flows pressuring the managers
 - mandate responsive to market conditions
 - the ability, not the pretense, to **be active!**

Where Do You Think Buffett Learned to Be Flexible?

- **Ben Graham 1.0 and 2.0:**
 - Benjamin Graham Joint Account (1926-36) and Graham-Newman Fund (1936-56):
 - fundamental analysis on single stocks
 - special situations
 - merger arbitrage
 - cash: defense and offense
- **Ben Graham 3.0:**
 - Graham's PA and the Graham-Rea Fund (1970s):
 - looking for statistical commonalities to identify “group undervaluation”
 - analyzed 50(!) years of data
 - net-nets, high earnings yields, high dividend yields
- In **every edition** of the book, he re-tested all his major formulas -- and threw many out
- He bent his own valuation rules to buy GEICO
- He admitted that GEICO may have been a “lucky break” rather than “shrewd”

Graham: On Portfolio Policy

Future Policy and Prospects.

Because of the large advance in the general market in the past three years, we have substantially changed the character of our security holdings during this period. The percentage held in "general portfolio common stocks" has been greatly reduced, and the percentage in arbitrages, hedging operations and convertible senior issues correspondingly increased. These changes are summarized in the accompanying percentage-analysis of our portfolio as at January 31st, 1943 and January 31st, 1946.

Percentage Distribution of Portfolio by Type of Operations

(Based on Market Value of Long Securities)

	<u>Jan. 31, 1943</u>	<u>Jan. 31, 1946</u>
	<u>% of Total</u>	<u>% of Total</u>
Cash and Government Securities	3.4%	10.7%
Arbitrages, Reorganizations, Guaranteed Issues	17.2	36.1
Liquidations	11.7	12.2
Hedges and Convertible Issues	-	20.0
Financial Companies	8.5	13.0
General Portfolio	<u>59.2</u>	<u>8.0</u>
	100.0%	100.0%

The sharp reduction in our general portfolio has not been based on an opinion that the rise in the market has now run its course, but on the fact that very few common stocks remain attractive holdings judged by our technical standards. Under our established policy, we do not participate in clearly speculative profit opportunities nor in the present rising market

Graham: On Capacity

Mr. GRAHAM. Ours is on the order of 6½ million.

The CHAIRMAN. On market value. That is not the original investment. That is the capital as now valued on the market; is that correct?

Mr. GRAHAM. That is right. We have paid back to our stockholders virtually all the earnings that have been made, so that in a sense our present value is very similar to the amount of money paid in.

The CHAIRMAN. You do not seek to increase the invested capital, I take it. Any particular reason for that?

Mr. GRAHAM. The basic reason, Senator, has been that we have not believed that we could get the same satisfactory results on very large capital as we can get on a moderate amount of capital.

The CHAIRMAN. Why is that?

Mr. GRAHAM. Because if you deal with special situations and undervalued securities, the markets in those for the most part are not very large. It is not possible to acquire an unlimited amount without affecting the market price, and if we had 10 times as much capital it would be very difficult for us to invest it the same way as our present capital.

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Graham: On Alignment

The CHAIRMAN. Is it public knowledge what you charge?

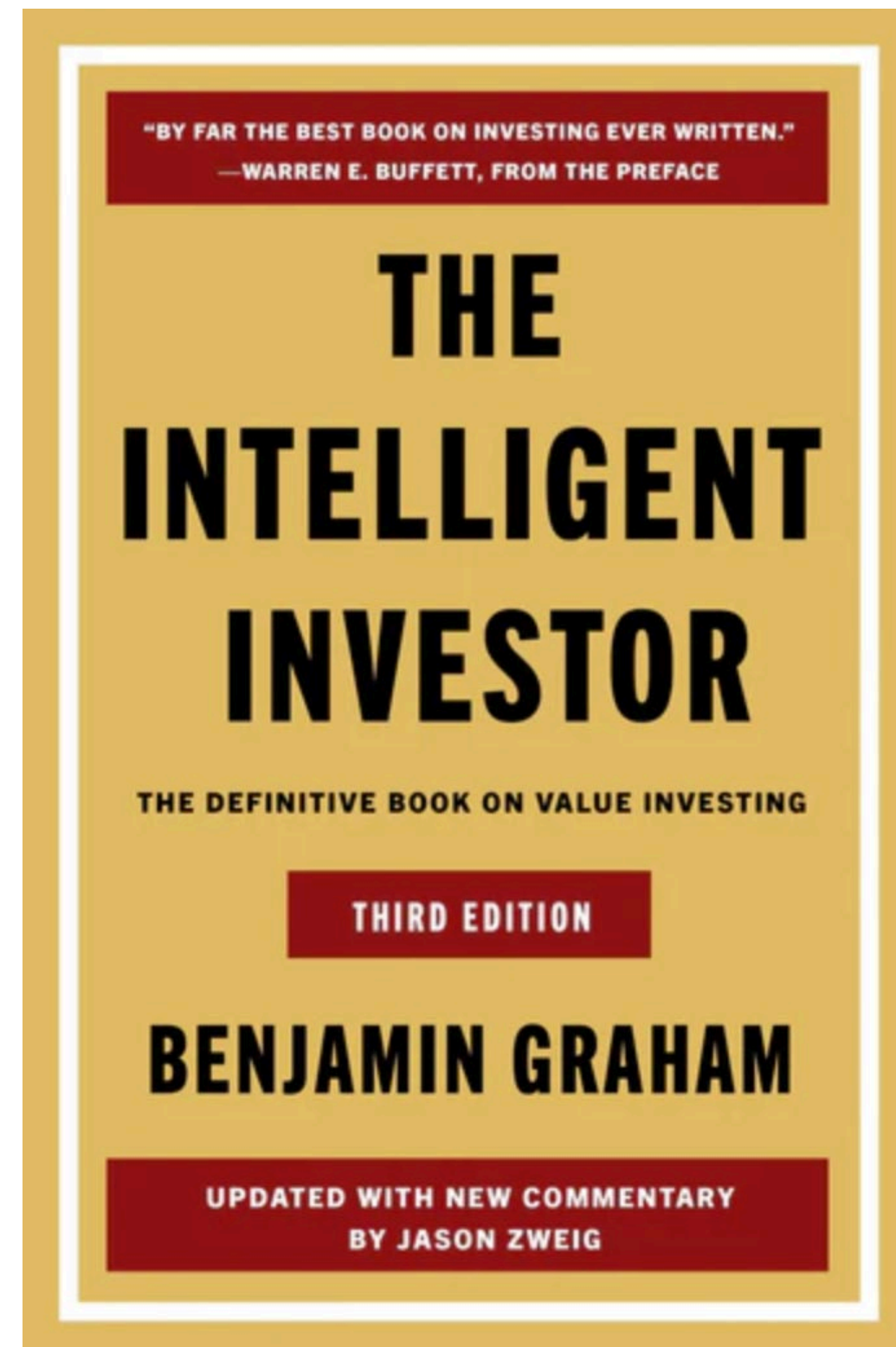
Mr. GRAHAM. Yes. We charge a great deal. We pay ourselves salaries on the order of \$25,000 and \$15,000, and we also have a profit-sharing plan under which after a \$40-a-share dividend is earned and paid in any year the management as a whole receives 20 percent of the additional amount earned and paid.

Testimony, U.S. Senate Committee on Banking and Currency, March 11, 1955, bit.ly/4cAdtlp

What Would Ben Do?

- **Would Ben Graham be running a LCV mutual fund / SMA if he were around today?**
- **Cash flows from (and to!) clients: not just a blessing but a curse**
 - **Graham-Newman: closed to new investors for much of its history**
- **Whatever **can** be an ETF **will** be an ETF**
- **What can't be ETF'd?**
 - **Left tails: size, liquidity, marketability, popularity**
 - **Microcaps**
 - **Merger arbitrage**
 - **Community banks**
 - **Bankruptcies and spinoffs**
 - **Orphan stocks deleted from index funds**

Oct. 22, 2024



<https://amzn.to/43VEeDi>

Thank You!

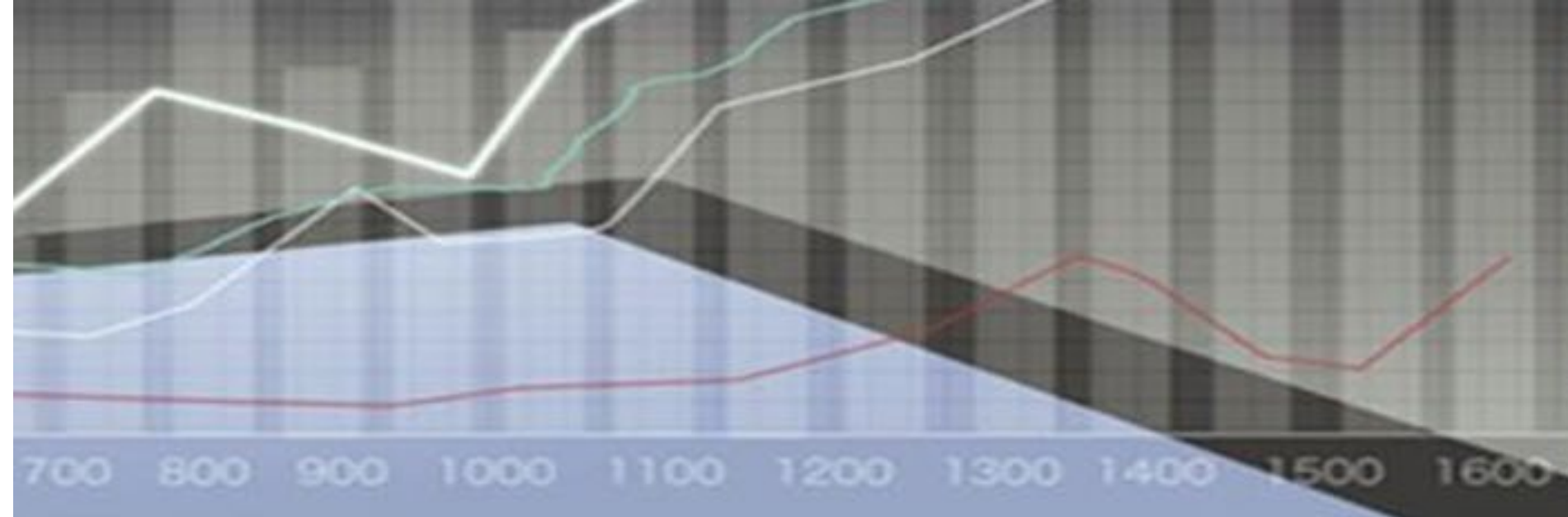
For Further Reading:

- [“Lessons and Ideas from Benjamin Graham”](#)
- [“A Rediscovered Masterpiece by Benjamin Graham”](#)
- [*Benjamin Graham: Building a Profession*](#)

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