Intelligent Investor

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Disclaimers

- I am not a registered investment advisor and I do not offer any investment advise
- No parts of this talk are suggestions to invest, not invest, buy or sell any kind of securities or other financial instruments

Intelligent Investor - Benjamin Graham

- Classic value investor's book
  - Timeless principles: margin of safety
- Drawbacks
  - Pretty negative (conservative?)
  - Unorganized
  - Time-specific (1971-72)
- We'll focus on the best parts of the book
  - but mention some negatives

Investor Types

- Avoidance of losses for both types
- Defensive investor
  - Little effort, few decisions
- Enterprising investor
  - Spends time and effort for security selection

Strategy for Defensive Investor

- 50% stocks (index fund), 50% high quality bonds (Treasuries/TIPS)
  - Rebalance from 25% stocks/75% bonds, to 75% stocks/25% bonds *if interested*
- Why not 100%?
  - Graham believes that past market patterns do not repeat
  - Impossible to know when top or bottom is
  - Impossible to know when bonds or stocks will outperform
  - 25% is a buffer for stock or bond outperformance when you do not believe in that category

Expect 6-7% annual return

- One of the very negative claims of the book
- 3-4% dividend return + 3-4% economy growth translating into business growth translating into stock growth
- Don't expect 10-12-15% per year!
  - Historic 10-12% market returns were due to PE expansion mostly
- Before inflation! – 3-4% after inflation
- Most people do not believe Graham – we are all overoptimistic!
  - Yet ~0% return on SP500 since 1997!
  - Of course, we all believe that we can do better than SP500…

Stock Selection (for Defensive Investor)

- Diversification: 10-30 stocks
- Each company: large, prominent, conservatively financed
  - <1 debt/equity
- Long record of dividend payments
- <25 PE over last 7 years average earnings

- Index fund is preferred – no such funds existed in Graham's time

Dollar Cost Averaging

- The only "formula investment" approach that (still) works
- Automatically buys more when stocks are cheap, and less when stocks are high
- Positive influence decreases as portfolio grows
  - $100 buys 100 shares, price drops 10%, $100 buys 111 = 211 shares - 5% share increase due to decreased prices
  - With 10000 share portfolio, price drops 10%, $100 buys 111 = 10111 shares – 0.1% share increase due to decreased prices

Enterprising Investor – What NOT to do

- No second-grade bonds or preffereds
- No foreign bonds
- No IPOs

Stock Selection Criteria

- Stocks in “relatively unpopular large companies”
- Over 10 years of positive earnings and dividends
  - At least 33% earnings growth through last 10 years (not annual!!!)
- At or below net current assets
  - Or at least <1.5 book value
- Low PE on average earnings – 7-10 years – PE 15 over average 3 year earnings
- Strong financial position
  - Current assets / current liabilities > 2
- Prospect that earnings will at least be maintained in coming years
- Very tough demands
  - Very few companies sell at such prices even now after 38% drop in SP500

Stock Selection Criteria for Enterprising Investor

- Arbitrages
- Liquidations
- Net Current Asset investments
  - <2/3 NCAV
  - Current assets / current liabilities > 1.5
  - Debt/equity < 1
  - No losses in 5 years
  - Some dividend
  - Some earnings growth
    - Growth calculation: 3 last years earnings to 3 years average 10 years ago
  - Not always available! When not available, do not buy "leftovers"

Industry Selection

- Graham does not believe in industry selection (growth investing)
  - Even for industries with very positive revenue growth prospects (air travel in 1940-1970…, Internet 1993-2005…), the earnings and stock prices are not guaranteed
  - Only 3% of companies have grown by 20% for 10 years. None have grown for 20% for 15 years
  - Concentration may improve your results, but may also lead to huge losses
    - Staying in Forbes 400 requires 4% annualized return, yet 84% percent of people drop out due to concentration and losses
  - Southwest Airlines, Worthington Steel, Dollar General, UST – top 30 best performing stocks of 1972-2002 – would you have guessed?
- Graham differs from Buffett!

Management Evaluation

- Graham gave up on management evaluation
  - Unlike Buffett, but he tried…
  - Have to read earlier editions for 34 pages on management evaluation
- Management should be reasonably efficient
- Management should recognize interests of outside shareholders
- Companies should pay dividends unless they clearly demonstrate that earnings reinvestment produces satisfactory earnings increase
  - Buffett!

General Advice

- Investor is never forced to sell shares
  - Ignore price quotation if it does not suit you to buy or sell
- Investment for protection instead of projection
- "The risk of paying too high price for good-quality stocks is NOT the chief hazard… Chief losses … come from purchase of low quality securities at times of favorable business conditions"
  - Even with aversion to growth companies… pure Buffett