

Inspirational Figures

Benjamin Graham

Financial Wisdom For All Ages

By Paul Orfalea, Lance Helfert, Atticus Lowe and Dean Zatkowsky

“If I have seen further, it is by standing on the shoulders of giants,” said Sir Isaac Newton, in praise of his predecessors. Today’s most successful investors, including Warren Buffett, pay similar homage to a man known as the father of value investing: **Benjamin Graham**.

Graham was the first to bring a grounded, rational sensibility to Wall Street, distinguishing speculation from investing. During his long career as an investor and educator, Graham sought to distill his findings into a clear and accessible method that would help anyone make better investment decisions. To the benefit of all who study his work, he achieved that goal. Unfortunately, and despite nearly constant praise from his famous followers, few people pay heed to Graham’s excellent advice. Fortunately, it is still very good advice.

A FINE MIND, WORKING HARD

Born in England in 1894, Graham immigrated with his family to the USA before his second birthday. After the death of his father when Graham was just nine years old, the family’s importing business fell on hard times, making Benjamin’s childhood one of privation and worry. Young Benjamin poured his energy and ambition into his schooling, and made his way to Columbia University, where he earned a Bachelor’s Degree.

An excellent student at Columbia, Graham was offered teaching positions in the Mathematics, Philosophy, and English departments. Perhaps owing to the financial insecurity of his youth, Graham instead chose a career on Wall Street, starting out in 1914 as a “chalker” for the firm of Newburger, Henderson and Loeb. Still an excellent student, by 1919 the twenty-five-year-old was a partner at the firm, and exceedingly prosperous.

ROARING TWENTIES

In 1926, Benjamin Graham entered into two relationships that would come to define his adult life. With Jerome Newman, he formed an investment partnership. He also began teaching a finance course at Columbia University. Students appreciated the fact that their professor spoke from experience about investing. But as we’ve often heard, experience is a harsh teacher, because the lesson comes after the test, as it did in 1929.

The stock market crash that began in October 1929 almost

wiped out Graham and Newman’s company, and did wipe out Graham’s personal fortune. But it also opened his eyes to a new way of thinking about investing. Graham’s rapid rise and more rapid fall in the 1920s set the stage for a classic American success story, in which a man of sturdy character and great ability achieves stunning victories after surviving horrific defeat.

GREAT INVESTOR, GREAT EDUCATOR

When Benjamin Graham bent his considerable intellectual abilities to divining a rational alternative to the prevailing speculative nature of stock market investing, he could have kept his methods to himself and profited handsomely. In fact, he did profit handsomely; between the crash of 1929 and his retirement in 1956, Graham’s partnership with Newman generated annualized returns of about 17%. But Graham was a teacher, in the highest sense of the word, and wanted to make his discoveries available to everybody.

In 1934, Graham and co-author David Dodd published *Security Analysis*, which to this day has never been out of print and has been a standard textbook for students of finance. The book provides, for the first time in history, a rational and systematic approach for measuring the value of a public company, clearly distinguishing what is knowable from what is mere assumption.

The current review on Amazon.com calls *Security Analysis* “hands-down the most influential investment book in history.”

While *Security Analysis* became part of the required canon for investment professionals, the book intimidated laymen. Moreover, Graham, like any truth-seeker, constantly reviewed and refined his beliefs, hoping to establish clear and simple explanations of complex relationships. He succeeded in 1949, publishing *The Intelligent Investor*, which Warren Buffett has called “the best book on investing ever written.”

Benjamin Graham continually updated his books, and published many articles in periodicals. Three of Graham’s ideas make up the core of the “value investing” philosophy and represent, in our opinion, the most important considerations for novice investors (and rational professionals).

BUY COMPANIES, NOT PIECES OF PAPER

One of the strongest points Graham repeated throughout his



career emphasized the importance of distinguishing investing from speculation, and choosing only to engage in the former. "Investing is most intelligent when it is most businesslike," wrote Graham. He insisted that stock not be viewed as a piece of paper bought and sold based on price, but as a share of ownership in a real company. Thus, as in our own entrepreneurial investing style, Graham focused on the company, not the stock; the value, not the price.

Value investors exercise more patience than speculative investors, heeding Graham's observation that "In the short run, the market is a voting machine but in the long run it is a weighing machine." In other words, day-to-day prices fluctuate according to opinion, but in the long-term, a company will be valued according to facts.

The facts add up to "intrinsic value," which lies at the heart of value investing. Value investors are bargain hunters, seeking

advanced by Benjamin Graham, and empowers Warren Buffett's first rule of investing: "Never Lose Money." After all, if making money is the goal of investing, losing money is, to say the least, counterproductive. Thus, intelligent investors seek an adequate margin of safety through very conservative valuation of a company's assets.

In effect, the ultimate margin of safety would exist when a company's market capitalization added up to less than the value of its net assets. In other words, if you could buy the company for \$1,000,000, but it held \$1,200,000 in cash and real estate and carried no debt, it would be pretty hard to lose money. Of course, a margin of safety could also include secure cash flow sources, such as long-term contracts.

Margin of safety answers the investor's question, "what is the worst that could happen?" By basing margin of safety on knowable values, such as tangible assets, rather than on

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— Benjamin Graham

companies that trade at a discount to their intrinsic value, buying when the market misunderstands the value, and profiting when the market eventually recognizes it.

PROFITING FROM MR. MARKET'S FOLLY

Value based on fact, rather than opinion, brings us to Graham's most beloved metaphor, the parable of Mr. Market. To illustrate the proper attitude toward the stock market, Graham asks us to imagine that we are business partners with a slightly unhinged gentleman named Mr. Market. Mr. Market is a moody fellow, and every day, depending on how he feels, he offers either to buy our interest in the company, or sell us his.

The prices offered by Mr. Market might be absurdly high or low, or they might be a fair value, based on our understanding of the business. One of the nice things about Mr. Market is that he doesn't mind being ignored; he'll come right back tomorrow with another offer. So we are in the driver's seat. If Mr. Market offers to buy our share of the company for a ridiculously high price, we may take his money. If he offers to sell his share for a ridiculously low price, we can take advantage of the bargain. If, on the other hand, he wants to sell for too high a price, or buy too low, we may ignore him. After all, he'll be back tomorrow.

The point is this: if we know the actual value of the company, we need only buy or sell when the act benefits us. If we do not understand the value of the company, Mr. Market, foolish though he may be, holds sway over us, and this is trouble.

Warren Buffett, citing Graham's parable, reminds us of the old poker axiom, "If you've been in the game thirty minutes and you don't know who the patsy is, you're the patsy." The story of Mr. Market is meant to remind us that the stock market exists to serve us, not to guide us. Our knowledge of business allows us to profit from others' folly, rather than participate in it. Value investors make volatility their friend.

MARGIN OF SAFETY

In our opinion, "margin of safety" is the most important concept

speculative concepts, such as "goodwill," one can build a very secure portfolio. Moreover, because we seek bargain opportunities to "buy a dollar for fifty cents," a portfolio with strong margin-of-safety companies also offers strong opportunity for asset appreciation.

ON THE SHOULDERS OF GIANTS

Benjamin Graham died in 1976, shortly after completing the fourth revision of *The Intelligent Investor*. In 1994, at a tribute to Graham celebrating the 100th anniversary of his birth, Graham's most famous student, Warren Buffett, spoke about the ideas mentioned above: investment as ownership of a company, Mr. Market, and margin of safety.

"I think those three ideas 100 years from now will still be regarded as the three cornerstones, essentially, of sound investment. And that's what Ben was all about. He wasn't about brilliant investing. He wasn't about fads or fashion. He was about sound investing. And what's nice is that sound investing can make you very wealthy if you're not in too big a hurry. And it never makes you poor, which is even better."

Benjamin Graham, despite a financially insecure childhood and severe reversals of fortune as a young man, applied his curiosity, keen observation skills, and analytical mind to the discovery of a rational approach to investing. That he succeeded is impressive. That he chose to share his findings for the benefit of all is more impressive. Columbia University still offers Graham's class on value investing, now taught by Bruce Greenwald, whose *Value Investing: From Graham to Buffett and Beyond* is a worthy companion to *The Intelligent Investor*.

Many investing methodologies derive from Graham's approach, including our own entrepreneurial style. Obsessed as we are with intrinsic value, margin of safety, and resistance to the disadvantageous entreaties of Mr. Market, we owe much of our success, as do many of our peers, to the teachings of Benjamin Graham.