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BEN GRAHAM'S VALUE APPROACH: CAN IT STILL WORK?

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Price collapses in dotcoms and telecoms have fostered a comeback in the fundamental analysis identified with Benjamin Graham (1894–1976). Defining Graham's method is no simple task, however; his thinking evolved considerably over a 60 year career. Reducing Graham's approach to a quantitative formula does not produce superior performance. His most celebrated pupil, Warren Buffett, freely acknowledges buying entirely different stocks than Graham would. Graham's notion of paying less than breakup value remains a useful pricing concept. Investors must do hard analytical work, however, to separate the nuggets from the worthless overburden.

Getting back to basics is back in fashion among investors. Shaken by price collapses in dotcoms and telecoms, stock buyers have forsaken new paradigms in favor of old-fashioned asset values. Reacting against Wall Street analysts' drum-beating for companies' dubious business models, investors are demanding renewed focus on income statements and balance sheets.

Inevitably, fundamental analysis's comeback has put the spotlight on Benjamin Graham (1894–1976). A legendary money manager, writer, and teacher, "The Father of Security Analysis" has inspired generations of investors to search for stocks trading below their intrinsic value. Bargain-hunters can prosper, according to Graham, by ignoring fads and refusing to pay a premium for uncertain earnings growth.

Graham's continued relevance is ostensibly proved by a turnaround in the public perception of his most celebrated pupil, Warren Buffett. When shares of startup Internet ventures were soaring, Buffett was excoriated for refusing to jump on the high-tech bandwagon. After his conglomerate, Berkshire Hathaway, suffered a rare down year in 1999, one critic accused Buffett of holding "a stubborn and quirkily anti-growth belief" that constituted "not an investment opinion but a religious view."[1] Ultimately, though, the tech wreck and financial reporting scandals vindicated Buffett's unflagging devotion to value investing. Berkshire Hathaway's price skyrocketed by 35% in 2001, even as the Dow Jones Industrial Average fell by 8%. The "Sage of Omaha," declared one commentator, had been "right on his views about corporate governance, right about stock options and accounting reform, right about the demise of corporate ethics, uncannily right about the stock market."[2]

Clearly, it is once again respectable to be known as a follower of Ben Graham. Adopting his creed does not by itself guarantee superior results, however. Pledging allegiance to Graham is easy; profiting from his teachings is not.

1 What is the Graham approach, exactly?

To begin with, investors must define the Graham method before they can adopt it. The master's thinking evolved considerably over his 60 year career. It is no simple task to establish which of several distinct strains of his work represents the authentic Graham doctrine.

Some sources assert that the Graham method consists of buying stocks with (a) low price/earnings ratios and (b) current assets that exceed the sum of current liabilities and long-term debt.[3] This formulation derives from *Security Analysis*, a perennially popular textbook that Graham co-authored with finance professor David Dodd. Note, however, that a mere 23 out of 699 pages in the first (1934) edition deal with P/E ratios and net current assets. Additional factors that Graham and Dodd explicitly list as considerations in stock selection include the company's liquidation value, the percentage of earnings that it pays out in dividends, and the mix of debt and equity in its capital structure.

Graham, in short, does not suggest that investors can replicate his success by mechanically applying two rudimentary statistical measures, notwithstanding some empirical support for net current asset value as a valuation criterion.[4] Indeed, one of Graham's most successful disciples, Sequoia Fund founder Bill Ruane, maintains that the master's method cannot be reduced to a formula. Ruane instead describes Graham's approach as "a framework for making people think through what those numbers mean."[5]

Be that as it may, Graham endeavored in the final year of his life to replace the thoughtful fundamental analysis for which he was renowned with a purely mechanical formula. Examples of his strictly-by-the-numbers stock-picking criteria included a minimum dividend yield of two-thirds the AAA industrial bond yield and maximum total debt of twice the net current assets. Graham devised these statistical standards in collaboration with James Rea, an engineer and investment enthusiast.

Plainly, Ben Graham's would-be followers must decide which Ben Graham they intend to follow. Three investors, respectively employing the (alleged) 1934 Graham-and-Dodd formula, Graham's broader principles, and the Graham-and-Rea 1976 pushbutton model will probably wind up owning widely dissimilar portfolios. To complicate matters further, some self-described adherents of Graham give weight to cash flow, a concept addressed neither in *Security Analysis* nor in Graham's 1949 classic, *The Intelligent Investor*. Other professed acolytes attach significance to earnings growth, a factor that *Security Analysis* portrayed as having been discredited by the 1929 Crash.[6] Even Graham himself sometimes deviated from the principles laid out in his writings. Most famously, he achieved his greatest single success with GEICO, a company that according to his avowed standards paid an inadequate dividend. Moreover, Graham invested nearly 25% of his fund's assets in GEICO, an action difficult to reconcile with the consistent emphasis that his writings placed on portfolio diversification. Unfortunately, for aspiring converts to "Grahamism," there is no self-evidently correct basis for determining which of its many versions represents the true vine.

2 Do Graham's methods still work?

Pragmatic investors will sidestep the definitional thicket surrounding the Graham method. Instead, they will try to determine whether *some* incarnation has stood the test of time and if so, adopt it. They run the risk, however, that an approach that has worked throughout the quarter-century since Graham's death will lose its effectiveness as a consequence of improved information availability and analytical technology.

Some readers may dismiss this risk out of hand, arguing that history repeats itself and nothing really changes over time. A remark that Graham made late in his career, though, should raise a caution: "I am no longer an advocate of elaborate techniques of security analysis in order to find superior value opportunities."[7] Such activity had been rewarding 40 years earlier, Graham explained, but he now put himself (albeit to a "limited extent") on the side of academics who maintain that the market prices stocks correctly. Because other authorities continue to challenge this doctrine (the Efficient Market Hypothesis), however, it remains worthwhile to investigate whether some form of Grahamism produces superior results.

A cursory inspection of the data produces one useful conclusion: Loading up on value stocks, which many consider synonymous with "Ben Graham," does not assure investors of outperforming the averages. In some periods, the market simply does not like the value sector. During 1999, for example, small-capitalization value stocks (as measured by the Dow Jones US Style Indexes) fell by 7% as their growth counterparts rose by 61%.

Hardcore value investors will reflexively reply that their style requires patience. Long-run Bloomberg figures, however, show that from the beginning of 1970 through the third quarter of 2000, mutual funds specializing in large-capitalization value stocks produced an average quarterly total return of 2.74%. That was slightly *less* than the 2.95% achieved by large-capitalization growth funds.

To be fair, Graham's definition of value is not identical to the definitions used by contemporary fund managers and index-compilers. Therefore, a more precise test of his method is to measure the performance of the specific stocks that investors would pick by applying one of his formulas. As it turns out, stocks selected by Graham and Rea's quantitative criteria of 1976 achieve better-than-market returns, according to several academic studies published between 1981 and 1993.[8]

Investors should treat these "paper portfolio" results with caution, however. To replicate the performance reported in a 1993 study, for example, an investor would have had to own 148 different issues. Such exhaustive exploitation of the law of large numbers is feasible for a large mutual fund, but impractical for most individual investors. In addition, a 1984 study showed less-than-compelling results for stocks selected solely from the New York Stock Exchange, which generally lists large, liquid issues. Graham and Rea's formula produced conspicuously superior performance only when the researcher added smaller issues from the American Stock Exchange to his sample. Seasoned investors recognize that, in the real world, it is often difficult to buy small-capitalization stocks at officially quoted prices.

Rea attempted to bridge the gap between theory and practice, but did not inscribe a proud chapter in the annals of investing. In 1976, with some help from the ailing Graham, he launched an investment partnership designed to own only stocks meeting certain of the duo's criteria. (Few issues satisfied all ten.)

From the time of its 1982 conversion to a mutual fund until it was sold to a German investor in 1998, the Rea–Graham Fund underperformed index funds by 12 percentage points a year.[9] Graham spoke more truly than he knew when he said that the 1976 formula's promise of achieving good results with minimal work seemed "too good to be true."[10]

Some Graham loyalists contend that Rea performed poorly because he failed to follow the master's principles closely enough.[11] It may be, however, that Rea's struggles arose from the "out-of-sample" problem endemic to investment analysis. Many strategies perform well in tests against historical data, but not when subsequently put into practice.

3 Forget about formulas?

An alternative way to evaluate Graham's teachings is to regard them, as Bill Ruane does, as a framework rather than a formula. *A propos*, a 1984 article[12] by Warren Buffett discusses several Graham disciples who trounced the averages over long periods. Although they all chose stocks on the basis of disparities between price and value, there was little overlap in the names that they bought. Ruane, for example, preferred large companies, while Walter Schloss invested in such obscure stocks as Jeddo Highland Coal and New York Trap Rock Company.

"[T]hose who read their Graham & Dodd," Buffett concluded, "will continue to prosper."[13] An inference better supported by his evidence, however, is that certain *exceptionally talented and industrious* professionals can fare much better than thousands of other mortals operating within the same intellectual framework. Significantly, three of Buffett's showcase investors were individuals handpicked by Graham as research assistants.

Does not Buffett's own legendary performance, however, prove the power of Graham's methods? Not exactly. Although he is an unabashed admirer of Graham, Buffett cites investors Philip Fisher and Charlie Munger as additional shapers of his thinking. Reflecting their influence, Buffett favors well-managed companies, rather than those that are merely cheap on statistical grounds. He freely acknowledges buying entirely different stocks than Graham would.[14]

In any case, Buffett's experience has limited relevance to the vast majority of stock buyers. Most investors hope that the issues they pick will go up, but they have no means of influencing the outcomes. A key element in Buffett's success, by contrast, is investing in companies with unrealized potential, then persuading them to alter their strategies. Sometimes he institutes reforms by buying companies outright, as in the case of the *Buffalo Evening News*. In other instances Buffett initiates change through active board or executive involvement, as with the *Washington Post* and Salomon Brothers. (Contrary to popular belief, Buffett is no recent convert to proactive investing. In 1961, he used 20% of his partnership's assets to acquire a 70% controlling interest in a Nebraska farm implement manufacturer.) Unquestionably, Buffett has been a highly successful acquirer of assets. His career as an industrialist, however, by no means constitutes a pure test of Graham's approach to stock selection.

4 Conclusion

Empirical testing of Ben Graham's approach has focused mainly on a mechanical formula devised in his final year and not accountable for his outstanding investment record. In practice, Graham employed formulas only to eliminate patently overpriced stocks from consideration. He employed judgment to evaluate the remaining candidates. Moreover, it is exceedingly difficult nowadays to apply the 1976 Graham–Rea formula. Even with the Dow industrials down by almost 20% from their 2000 peak, few stocks satisfy its exacting standards.

Defined more broadly, though, Graham's approach retains its utility. Investment expert Victor Morris points out that recent research has found superior stock performance in companies adhering to the corporate governance policies that Graham espoused. Furthermore, his notion of acquiring a business at less than its breakup value remains a useful way of thinking about prices.

Graham's most successful followers did not excel through blind adherence to a formula. An investor cannot count on beating the averages by picking any random stock displaying a high net current asset value. Ben Graham continues to provide a map to the neglected nuggets, but investors must do the hard work of separating them from the worthless overburden.

Notes

1 Kedrovsky, P. (2000). "Warren Buffett's Vanishing Value: Tech Aversion Has Left Value Investor Behind the Curve." *National Post* (February 19), p. D4.

2 Serwer, A. (2002). "The Oracle of Everything." *Fortune* (November 11), pp. 68 ff.

3 See, for example, http://www.investment.com/glossary/gdefs/grahamanddodd.html

4 Vu, J. D. (1988). "An Empirical Analysis of Ben Graham's Net Current Asset Value Rule." *Financial Review* (May), pp. 215–225.

5 Lowe, J. (1994). *Benjamin Graham on Value Investing: Lessons from the Dean of Wall Street*. Chicago: Dearborn Financial Publishing, Inc., p. 5.

6 Lowe, p. 6.

7 Lowe, p. 225.

8 Oppenheimer, H. and Schlarbaum, G. G. (1981). "Investing with Ben Graham: An Ex Ante Test of the Efficient Market Hypothesis." *Journal of Financial and Quantitative Analysis* (September), pp. 341–360; Oppenheimer, H. (1984). "A Test of Ben Graham's Stock Selection Criteria." *Financial Analysts Journal* (September/October), pp. 68–74; and Rao, S. M. and Oliver, J. A. (1993). "Investing with Ben Graham." *American Business Review* (January), pp. 12–14.

9 Easton, T. (1999). "Graham, RIP." *Forbes* (March 8), p. 164.

10 Lowe, p. 217.

11 Lowe, p. 223.

12 Buffett, W. E. (1985)."The Superinvestors of Graham-and-Doddsville." In Benjamin Graham (ed.), *The Intelligent Investor*, Fourth Revised Edition, New York: Harper Business, pp. 291–313.

13 Buffett, p. 301.

14 Lowenstein, R. (1995). *Buffett: The Making of an American Capitalist*. New York: Random House, p. 201.

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