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# Lessons and Ideas from Benjamin Graham

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Benjamin Graham wrote his first book on investing in 1934, and although he refined these thoughts over time, his message (and the truth therein) has remained the same. Thus, Graham was not a man ahead of his time; he was a man for all time.

In June 2003, HarperCollins Publishers asked if I would be interested in updating Benjamin Graham's classic *The Intelligent Investor*.<sup>1</sup> After determining that the proposal was not somebody's idea of a practical joke, I agreed to take on the project. And as I worked on revising the book, I was reminded, once again, what a genius Graham was. So, in the course of this presentation, I will discuss the following:

- the things that made him famous,
- the factors that caused his reputation to drop out of fashion,
- the insights that make him relevant today, and
- the many ways in which he showed himself to be a man of brilliance.

## Becoming Reacquainted with Graham

My work on Graham's book took about five months. Before that, however, I spent several months throwing ideas back and forth with the HarperCollins editors to settle on an appropriate way to approach the project. What we decided on was this: I could not change the original text. After all, you do not rewrite the Bible. So, if I was not going to change the original text, we had to come up with something for me to do. As it turned out, my role was twofold.

One part of my job was to annotate the existing text (the 1972 edition, which was Graham's fourth revision)—the purpose being to make the book more comprehensible for contemporary readers, both

retail investors and investment professionals. For example, many of the businesses that Graham discussed in the last edition of the text had to be placed in their historical context, and some required more explanation than others. For instance, most investment professionals know that Studebaker was once a stock, but far fewer of them know much about the Northern Pipeline Company or the other companies that are integral to Graham's discussions.

The other part of my job was to write commentaries to accompany all of Graham's chapters. Each of my commentaries explains the basic principle that Graham addressed in the chapter, describes what has happened in recent years to the investors who did—and did not—listen to him, and suggests how Graham's principles might apply in the future.

As I worked on the project, one of the questions I kept asking myself was: Is Graham still relevant? After all, this was a man who was born in 1894, began working on Wall Street in 1914, wrote *Security Analysis* in 1934,<sup>2</sup> and wrote the first edition of *The Intelligent Investor* in 1949, primarily using ideas that were fully formed in his mind by the early 1930s. A lot has changed since then, and Graham came under a great deal of criticism in the late 1990s. For example, consider the following remark from Jim Cramer: "You have to throw out all of the matrices and formulas and texts that existed before the Web. . . . If we used any of what Graham or Dodd teach us, we wouldn't have a dime under management."<sup>3</sup>

But Graham anticipated comments such as this one. Graham knew that people were going to say such things about him someday, just as he seemed to

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<sup>1</sup>Benjamin Graham, *The Intelligent Investor*, rev. ed., updated with new commentary by Jason Zweig (New York: HarperBusiness, 2003). The first edition was published in 1949 by Harper, and a fourth revised edition was published in 1972 by Harper & Row. I will refer to these three editions throughout my presentation.

<sup>2</sup>Benjamin Graham and David L. Dodd, *Security Analysis* (New York: Whittlesey House, McGraw Hill Book Company, 1934).

<sup>3</sup>James J. Cramer, *thestreet.com* (29 February 2000).

know so many things before they happened. In fact, the 5 May 1974 edition of the *New York Times* quoted him as saying: “[My books] have probably been read and disregarded by more people than any book on finance that I know of.” Much as Mark Twain said about the weather, Graham understood that people would read the ideas in his books but that nobody would do anything about them. So, I struggled with this issue: How relevant is Graham’s book today?

I had read the book twice myself. It was the first book I read when I became a financial journalist in 1987, and I had read it again in the early 1990s. But when I started this project, I had not read the book from cover to cover in a decade, although I had always kept it on my shelf and frequently referred to individual chapters or specific passages. When I read it again at the beginning of this project, I could not believe how good it was—and how relevant.

## Why Graham Fell Out of Fashion and Why He Is Famous

Graham is often regarded as a kind of judgmental or formulaic market timer, not in the sense that Elliot Spitzer has made famous but in the sense that one should get out of stocks when they are overvalued and stay in cash or bonds until stocks get cheap again. A lot of the early chapters in Graham’s book are given over to his ruminations on when investors should be in the market and when they should be out. Such emphasis on market timing is largely out of fashion today. His basic formula is that when investors think stocks are cheap, they should have up to 75 percent of their assets in stock. When stocks are expensive, they should reduce their holdings to as low as 25 percent and keep the rest in bonds or cash. It is an interesting formula—and not all that different from the kind of tactical asset allocation that many pension funds currently use.

Graham is probably most famous for the various valuation metrics that he spelled out in *Security Analysis* and *The Intelligent Investor*. Graham would roll over in his grave if he heard me use the word “metrics” in the sense that was made popular in the late 1990s, but it is good shorthand and, as rules of thumb, the formulas are familiar to many of us. For example, on the one hand, Graham said that investors should stay away from growth stocks when their normalized P/Es go above 25. On the other hand, when the product of a stock’s normalized P/E and its price-to-book ratio (price/book) is less than 22.5—Normalized P/E × (price/book) < 22.5—it is at least a good value. So, if the normalized P/E is below 15 and the price/book is below 1.5, the stock should be attractive. Another valuation metric that he made

famous is that when the price of a stock is less than 1.3 times the tangible book value, it should be a good value for the investor.

Graham is also well known for his idea of “net nets,” which means, in essence, that if investors can buy stocks for less than the value of net working capital, they will always do well. And historical evidence has shown this axiom to be true. Unfortunately, history also shows that the market provides such opportunities, on average, perhaps once every 27 years. One such opportunity occurred in the early 1970s and another occurred in the wake of the 1999 stock market bubble, but it appears to be gone already. Such windows open quickly and close just as fast.

Graham wrote a series of articles in *Forbes* in 1932 in which he talked extensively about the significance of buying stocks for less than net working capital and why no one was doing so but him. It is in these articles that he coined the phrase “those with the enterprise haven’t the money, and those with the money haven’t the enterprise,”<sup>4</sup> which is almost, by definition, why valuation can go so low: The people who could buy are too scared to make a move, and the ones who know they should buy do not have enough capital to do so.

## Why Graham Should Be Famous

I would not presume to tell an audience of CFA charterholders what Graham’s valuation formulas would be today. For one thing, they would not be the formulas for which he is well known because, as I will show, one of the things that Graham *should* be famous for is that he was a great American tinkerer. In the same tradition as Edison and the Wright Brothers, Graham was constantly experimenting and retesting his assumptions and seeking out what works—not what worked yesterday but what works today. In each revised edition of *The Intelligent Investor*, Graham discarded the formulas he presented in the previous edition and replaced them with new ones, declaring, in a sense, that “those do not work any more, or they do not work as well as they used to; these are the formulas that seem to work better now.”

One of the common criticisms made of Graham is that all the formulas in the 1972 edition are antiquated. The only proper response to this criticism is to say: “Of course they are! They are the ones he used to replace the formulas in the 1965 edition, which replaced the formulas in the 1954 edition, which, in turn, replaced the ones from the 1949 edition, which were used to augment the original formulas that he

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<sup>4</sup>*Forbes* (1 June 1932):11.

presented in *Security Analysis* in 1934.” Graham constantly retested his assumptions and tinkered with his formulas, so anyone who tries to follow them in any sort of slavish manner is not doing what Graham himself would do if he were alive today.

So, what *should* Graham be famous for? Well, perhaps he should be famous for being one of the most brilliant men who ever lived. And he shone not with just one kind of brilliance but with at least five kinds:

- intellectual brilliance,
- financial brilliance,
- prophetic brilliance,
- psychological brilliance, and
- explanatory brilliance.

**Intellectual Brilliance.** Let me begin by saying that Graham had an intellectual firepower that the stock market has probably seen only one time since—in the person of Warren Buffett. At the age of 20, Graham graduated from Columbia University second in his class. He had actually been admitted when he was 15, but because of an administrative error, he did not enter the university until he was 16. Otherwise, he would have graduated when he was 19.

Before the end of his senior year, he was offered faculty positions in three different departments. How many of us, I wonder, can imagine ourselves being asked to join the faculty of any college, much less an elite one, before we graduated? And consider the faculty positions that he was offered—one in the department of English, one in the department of philosophy with a specialty in Greek and Latin, and one in mathematics. If that does not define a renaissance man—or boy—I do not know what does.

Besides his sheer intellectual capacity, Graham displayed extraordinary skill in hypothesis testing. He observed the financial world through the eyes of a scientist and a classicist, someone who was trained in rhetoric and logic. Because of his training and intellect, Graham was profoundly skeptical of back-tested proofs and methodologies that promote the belief that a certain investing approach is superior while another is inferior. His writing is full of warnings about time-period dependency. By shifting the starting or ending date for data samples, he demonstrated that the results change dramatically. That is a lesson we should all keep in mind, both as consumers of investment analysis and as producers of investing arguments in presentations to clients. Graham argued for slicing data as many different ways as possible, across as many different periods as possible, to provide a picture that is likely to be more durable over time and out of sample.

Graham also wrote about survivorship bias before anyone ever used the term. In his discussion

of long-term stock returns, he apologized for the fact that he was using data from the late 19th century, saying essentially that he did not think the data sample was very good. That suggests that all of us need to be concerned about using any long-term data that go back generations. Unless we know what has fallen away from the dataset, we do not know how good the data actually are.

In contrast, in a particularly interesting passage (in Chapter 7), Graham apologized to the reader for having only 22 years of data to support a particular hypothesis (see the 2003 edition, p. 157). How many data providers today are going to offer such an apology? Yet, it is an apology (and a warning) that today’s investors should be hearing: We should always be suspicious of short-term data when formulating a hypothesis.

Finally, and this trait arises from his propensity for tinkering that I mentioned earlier, Graham displayed an exemplary intellectual honesty. Again and again, he pointed out where he was wrong in the past and how he had revised his thinking to improve the accuracy of his ideas.

**Financial Brilliance.** It is one thing to have an impressive intellect, but does that intellect necessarily translate into financial success? For all of his brilliant ideas, one might ask: Was Graham actually any good as an investor? The best way to answer that question is to consider the data.

He started investing independently in 1925, but performance numbers from that period are unreliable, so a discussion of his early investment career is not very fruitful. But in 1936, he started the Graham–Newman Corp., which was an open-end mutual fund, and his work with that fund is the financial work for which he is best known. He ran the fund for about 21 years, and during that period, the fund compounded at least 14.7 percent annually while the S&P 500 Index earned an annualized 12.2 percent. Most people will tell you that Graham–Newman did about 17 percent a year on a compound basis. That is the number that Buffett has often used, but when I went back and recalculated the numbers by hand, it was not clear to me whether the 17 percent was before fees or after fees. But even using the more conservative figure of 14.7 percent, Graham consistently beat the market by 250 bps a year for more than two decades. The answer to the question, then, is yes, Graham was an extraordinarily good investor.

**Prophetic Brilliance.** Graham was also a prophetic genius. He had an ability to see into the future—and not just the financial future—that was nothing short of phenomenal. Consider the following

passage from *Security Analysis*, published in 1934. Perhaps it will bring to mind a more recent period in financial history:

The notion that the desirability of a common stock was entirely independent of its price seems incredibly absurd. Yet the new era theory led directly to this thesis. If a stock was selling at 35 times its *maximum* recorded earnings instead of 10 times its *average* earnings, which was the pre-boom standard, the conclusion to be drawn was not that the stock was now too high, but merely that the standard of value had been raised. Instead of judging the market price by established standards of value, the new era based its standards of value upon the market price. Hence, all upper limits disappeared not only upon the price at which a stock *could* sell, but even upon the price at which it would *deserve* to sell. This fantastic reasoning actually led to the purchase for investment at \$100 per share of common stocks earning \$2.50 per share. The identical reasoning would support the purchase of these same shares at \$200, at \$1,000, or at any conceivable price.

An alluring corollary of this principle was that making money in the stock market was now the easiest thing in the world. It was only necessary to buy “good” stocks, regardless of price, and then to let nature take her upward course. The results of such a doctrine could not fail to be tragic. Countless people ask themselves, “Why work for a living when a fortune can be made in Wall Street without working?” The ensuing migration from business into the financial district resembled the famous gold rush to the Klondike, with the not unimportant difference that there really was gold in the Klondike. (p. 310)

This passage is one of the best descriptions of 1999 ever written, and Graham wrote it in 1934. Of course, in 1999, no one wanted to hear such thoughts, and it is unlikely that anyone would have listened if the passage had been read to them. But prophets are often ignored, especially by those who most need to listen.

Now, consider what Graham wrote in the 1972 revision of *The Intelligent Investor*, his last revision:

Can such heedlessness go unpunished? We think the investor must be prepared for difficult times ahead—perhaps in the form of a fairly quick replay of the 1969–1970 decline, or perhaps in the form of another bull market fling, to be followed by another catastrophic collapse. (p. 39)

What he foresaw was the crash of 1973–74, and certainly it turned out to be a catastrophic collapse.

What made Graham such a prophetic thinker? In my opinion, he was able to foresee what the future held because he saw the present so clearly and understood the past so comprehensively. Graham was an amazing historian and a great psychological thinker.

**Psychological Brilliance.** Considering he died only four years after the field that we now recognize as behavioral finance was first conceived, Graham’s insights into human behavior are remarkable. He made quite clear that the central difficulty of investing, both for retail and for professional investors, is that we are all our own worst enemy. We buy high; we sell low. We do the worst possible thing at the worst possible time because we are most certain that we are right just when we are most likely to be wrong. And Graham understood that we act this way because of the way we are designed.

Graham also understood an important and subtle point for investment professionals who are assisting individual investors—the importance of focusing not on what people ought to do to get optimal results but, rather, on what they *can* do. The best investing advice is not theoretically ideal but psychologically practical.

Throughout the book, he made similar points that are psychologically insightful. For example, when he was talking about his market-timing formula, he admitted that the formula was not all that good. He admitted how difficult it is for an investor to know with any degree of certainty that stocks are indeed overpriced. But he also knew that an investor would never go broke using the formula, and as he put it: “The chief advantage, perhaps, is that such a formula will give [the investor] something to do” (2003 edition, p. 197). Graham understood that investors *need* something to do. Psychologists refer to it as the “illusion of control.” It is why we blow on the dice when we are playing craps. It is why we push the elevator button nine times after we have pushed it the first time; we think we can make the elevator arrive more quickly if we keep pushing that button.

In Chapter 1 of *The Intelligent Investor*, Graham introduced the concept of mad money—the notion that people should invest the bulk of their assets carefully and speculate only with a segregated subset of their assets (their mad money), just as one might do in a casino, leaving most of the money in the hotel safe while taking two \$50 bills or two \$100 bills down to the casino floor. When the mad money is gone, the gambler stops betting and the investor stops speculating. I am not aware of any investment writer who presented that idea before Graham.

Graham also introduced the idea of the margin of safety in Chapter 20—the belief that an investor should not focus exclusively on how much money can be made but on how much money can be lost, because even the best investors are wrong 45 percent of the time.

Finally, in a truly modern insight, Graham said: “The speculative public is incorrigible. In financial terms it cannot count beyond 3. It will buy anything,

at any price, if there seems to be some ‘action’ in progress” (2003 edition, pp. 436–437). This is a wonderful line, and as I was working on the book, I was curious as to why he picked three. Then, it occurred to me that in the research I had done for an article I wrote last year about the neuroscience of investing, neuroscientists have found that three really is a magic number.

■ *Huettel’s study.* In the late 1990s, a neuropsychologist at Duke University, Scott Huettel, was puzzled by an old finding in psychology that people seem incapable of accepting that anything is random. For example, if people are approached in the right way, they can be quickly persuaded to bet on whether a coin flip will be heads or tails. Furthermore, it will not take long to get a betting pool started because people think that if they watch the coin long enough, they can get the hang of its behavior. Come to think of it, this may explain why there are so many active managers in the investment management industry.

To further understand this human propensity, Huettel designed an experiment to test whether brains respond differently to random sequences. He asked his subjects to look at a computer monitor. If a circle appeared on the screen, the subject was told to click a mouse with the right index finger; if a square appeared, the subject was told to click a mouse with the left index finger. Huettel advised his subjects to click the mouse as soon as they perceived the image as either a circle or a square. The hypothesis he was testing was that if people anticipate that a random sequence actually has a predictable pattern embedded in it, a slight but measurable difference in the speed of their response will occur.

What he found was that when his subjects saw a circle appear twice in a row, they would anticipate that a circle would appear next and the quickness of the right click would increase. If two squares appeared in a row, then they would anticipate another square and the quickness of the left click would increase. Even though the subjects had been told that the sequence was random, their brains perceived a pattern and acted on it. This is not a new finding in psychology, but it is new proof from the field of neuroscience that the human brain cannot accept that so many of the stimuli in the world are genuinely random. In other words, after a stimulus repeats twice, people compulsively expect a third repetition—the precise phenomenon Graham had pinpointed so long ago.

■ *The 80–20 probability experiment.* For almost 40 years, psychologists have replicated a similar experiment. It is called the “probability matching experiment.” The subjects are presented with a randomly generated red or green square but with a

known probability. The probability of getting a green square is 80 percent, and the probability of getting a red square is 20 percent. The subjects are told explicitly that the order is random and thus cannot be predicted. But they are also told that if they want to try predicting the pattern, they are welcome to try.

Given these parameters, what is the optimal strategy? The optimal strategy is to choose green 100 percent of the time because it leads to a guaranteed 80 percent success rate. If subjects choose red only 20 percent of the time (and thus green 80 percent of the time), their accuracy drops to 68 percent.

The longer the subjects participated in this study, the more convinced they became that a pattern existed, even though they had been told that the probability was fixed and that no pattern existed. Rats and pigeons can easily be trained to guess green 100 percent of the time and thus score 80 percent consistently. But humans will persist in guessing both green and red for hundreds, if not thousands, of trials. Humans seem to have an inborn need to see patterns—and act on them—even when they have been assured that such patterns do not exist.

Graham warned constantly against the human compulsion to see patterns in fundamentally random data. In a quote that any chief investment strategist can relate to, Graham said in Chapter 10 of *The Intelligent Investor*: “Nearly everyone interested in common stocks wants to be told by someone else what he thinks the market is going to do. The demand being there, it must be supplied” (2003 edition, p. 260). And that is why we have people on CNBC telling everybody who will listen how the stock market will behave tomorrow.

**Explanatory Brilliance.** *The Intelligent Investor* has a contrapuntal structure, very fugue-like, in which Graham compared and contrasted various concepts and made many insightful distinctions. His classic distinction is between speculating and investing. In Chapter 1, there is a wonderful passage by Graham that should be engraved on the front door of every management firm: “An investment operation is one which, upon thorough analysis, promises safety of principal and an adequate return. Operations not meeting these requirements are speculative” (2003 edition, p. 18).

For the investment process to be true investing and not speculation, (1) the investor must analyze the investment, and the analysis must be thorough; (2) the investment must provide reasonable assurance that the investor will not lose everything; and (3) it cannot promise that anyone will get rich quickly. If the process fails *any one* of these criteria, it is speculation. Virtually everyone who got carried away in 1999 forgot these criteria.

Two other important distinctions that Graham emphasized for the reader are between stocks and companies and between price and value. Stocks, he reminded us, have prices; companies have value. The reason people end up coming to grief in the stock market is that they tend to mistake a change in price for a change in value (and much of the buzz in the financial world encourages them to do so). Furthermore, they forget that when they buy a stock, they end up owning a company. If the price of the stock does not reflect the value of the company, then the investment outcome is almost certain to be bad.

Another valuable insight is Graham's classification of investor types. Current wisdom, with which we are all familiar, states that there are three kinds of investors: defensive, moderate, and aggressive. What places people along this spectrum is their propensity to take risk. The entire financial planning community endorses this view, and the assumption is that someone's tolerance for risk is knowable and static. But according to Graham, it is neither. It is not knowable because people who put 100 percent of their money in the Jacob Internet Fund in January 2000 are the same people who now have all their money in a government bond fund. They thought they had a high tolerance for risk, and they were wrong. What they had was a high tolerance for making money.

At the time they invested in the Jacob Internet Fund, what did risk mean? Risk meant that their buddy Fred might make more money than they would, and they did not want to take that risk. So, they bought the Jacob Internet Fund before Fred did. That way, they lowered their risk of underperforming Fred. But when market conditions changed, so did the definition of risk. Now, risk has come to mean that they might lose their shirts. And Fred, surprisingly, is no longer in the picture because once investors start losing money, relativity goes out the window. Thus, risk tolerance changes over time.

Therefore, because tolerance for risk is neither static nor knowable, Graham said there are two kinds of investors. And the difference between them has nothing to do with risk tolerance. In fact, he specifically rejected that notion. So, what causes the difference between the two types of investors? It is their level of interest. People who are obsessed with investing and really enjoy the work of researching and monitoring investments are what Graham called "enterprising investors." People who would rather do something else with their time are "defensive investors." That is the difference—end of story. People who hire money managers as an act of delegation and who do not call those managers every Wednesday afternoon to pester them about why they have been underperforming the S&P 500 for the past 36

hours are genuinely defensive. The people who torture their managers with constant questions are enterprising. And I can almost guarantee that investment managers would much rather have defensive investors for clients than enterprising investors.

Graham also drew a distinction between what he called "projection" and "protection," which he believed are the two ways of thinking about the future in the financial market. Basically, the investor who uses the projection approach is a growth stock investor. Projection investors want to find the next Microsoft Corporation. If they can find "the next Microsoft," they do not care how many 3Coms or Quarterdeck Softwares or Ashford.coms they end up with. As long as they get one Microsoft, they will achieve their goals.

In contrast, protection investors want to make certain that they do not get wiped out. They are not concerned about being right only once. They want to minimize the number of times and the consequences of being wrong.

Paradoxically, it seems to me that diversification is probably more important for projection investors than they might realize: The odds of missing the next Microsoft are high, and a growth portfolio with only a few stocks has a high likelihood of being wiped out.

Finally, Graham discussed the differences between institutional and individual investors. He believed strongly that individual retail investors can outperform professionals, not because they are smarter but because professional investors have a handicap that can reduce their effectiveness—namely, benchmarking. No one cares about an individual investor's information ratio, but investors do care about their investment manager's information ratio, and they will fire that manager if the ratio is not high enough.

Graham set out this philosophy in a simple passage:

The true investor scarcely ever *is forced to sell* his shares, and at all other times he is free to disregard the current price quotation. He need pay attention to it and act upon it only to the extent that it suits his book and no more. Thus the investor who permits himself to be stampeded or unduly worried by unjustified market declines in his holdings is perversely transforming his basic advantage into a basic disadvantage. That man would be better off if his stocks had no market quotation at all, for he would then be spared the mental anguish caused by *other persons'* mistakes of judgment. (2003 edition, p. 203)

Graham's main point here is the importance of independent thinking. In the first edition of the book, he talked extensively about what he meant. Unfortunately, such explanations were edited out of the later

editions, although I restored some of his original discussion in the introduction to the latest edition (see the 2003 edition, p. 13).

## What Is an Intelligent Investor?

Why did Graham entitle his book *“The Intelligent Investor”*? It has nothing to do with what most people associate with intelligence: It is not IQ, and it is not SAT or GMAT scores. Investors do not need any letters after their names—not MBA or PhD, nor even any credentials, such as the CFA charter, even though Graham himself first raised the idea of a certification program that eventually became the CFA Program.

“The word ‘intelligent’ in our title,” he wrote in the first edition in 1949:

will be used throughout the book in its common and dictionary sense as meaning “endowed with the capacity for knowledge and understanding.” It will not be taken to mean “smart” or “shrewd,” or gifted with unusual foresight or insight. Actually the intelligence here presupposed is a trait more of the character than the brain. (p. 4)

That last sentence is the key. Graham was talking about personality, not IQ. The components that are needed in the character of an intelligent investor are patience, independent thinking, discipline, eagerness to learn, self-control, and self-knowledge.

Graham wrote a wonderful passage on independent thinking that, like all Graham junkies, I have more or less memorized. Graham said that “you are neither right nor wrong because the crowd disagrees with you. You are right because your data and your reasoning are right” (2003 edition, p. 524).

Warren Buffett quotes these words nearly every year at his annual meeting because he wants his investors to understand not only Graham’s point but also the philosophy he has learned from Graham: Investment managers must be *independent*. They must tell their clients that worrying about the information ratio and tracking error is not part of their process. If they do not establish the independence of their thinking, managers (and independent investors) will end up turning a basic advantage into a basic disadvantage. They will become trapped in the measurement and benchmarking game, which pretends that managers can outperform the market while maintaining portfolios and strategies that look exactly like the market. Such thinking, Graham would have said, fails the basic test of logic. And I think we have seen in the marketplace that such thinking does not work very well.

Intelligent investors are disciplined. They establish a consistent approach, and they stick with it. They are also eager to learn, not only about the market but also about themselves. By getting to know

themselves, they understand what their own strengths and weaknesses are and learn to harness the emotional aspects of investing, not just stifle them or suffer from them. Such self-knowledge and self-control also apply to the relationship between investment managers and their clients. Managers need to understand who their investors are. In Graham’s terms, are they projective or protective? Are they defensive or enterprising?

## Graham’s Thoughts on the Intelligent Owner

If I were asked to name the one significant contribution I made to the new edition, I would say that it was to put more of Graham’s words back into the book. These words are what I call the “lost Ben Graham.” For example, in the 1972 edition, Chapter 19 was eight pages of perfunctory remarks about dividend policy. When I went back to the 1949 edition (on the suggestion of a certain resident of Omaha), I discovered that one-third of the original book was given over to a discussion of what Graham called “the investor as stockholder.” In these passages, Graham explained the responsibilities that come with owning companies.

Where did those passages go? Why did Graham take them out? I think he removed them because he was disgusted that nobody had listened to him. But they illustrate an essential aspect of Graham’s thinking.

Graham was the original activist shareholder, long before people like Michael Price or Boone Pickens ever came along. Graham was shaking up companies throughout the 1920s and 1930s. He did it again and again. In the Northern Pipeline case, he even took on the Rockefeller family and prevailed. Graham had no use for the standard truism that investors should vote with their feet.

“Nothing in finance,” he wrote in 1949:

is more fatuous and harmful, in our opinion, than the firmly established attitude of common stock investors and their Wall Street advisers regarding questions of corporate management. That attitude is summed up in the phrase: “If you don’t like the management, sell the stock.” (pp. 19–20)

In the 1934 edition of *Security Analysis*, Graham reinforced this idea with the following classic formulation: “Certainly there is just as much reason to exercise care and judgment in *being* as in *becoming* a stockholder” (p. 508).

Unfortunately, most investors and investment managers put their effort into developing the perfect buy list. Then, once the stock is purchased, it goes into a manila folder or a PDF (portable document folder) on the desktop. But investors should devote at least

as much attention to a company once they own it as they did when they were considering buying it in the first place.

According to Graham, generating the proper amount of attention requires that the investor ask only two basic questions: “(1) Is the management reasonably efficient, and (2) are the interests of the average outside shareholder receiving proper recognition?” (see the 2003 edition, p. 499). Simple, and yet stockholders have not been asking these questions nearly enough in recent years.

Graham also wanted investors to consider the problems that cash can raise for companies and their shareholders. As Graham pointed out, companies that are superbly efficient, such as Microsoft, almost inevitably run into a paradoxical financial problem. They are so good at running their businesses, and at generating cash, that they end up generating too much cash. That is great for them because it gives management an immense margin for error, or as Graham would have put it, a margin of safety. But is it in the best interest of the outside stockholders to have managers sitting on \$40 billion of cash? Clearly, it is not. And Microsoft has finally recognized the problem and has started paying a dividend.

Related to the problem of too much cash is the question that Graham raised about whether a company should pay dividends. Consider the boom of the 1990s and how every single 10-K that came out of Silicon Valley had the same proviso in it—that the profits of the company, rather than being paid out to the shareholders in the form of dividends, would be retained for the foreseeable future and would be reinvested for the future growth of the business.

Graham would have seen the logical flaw in the situation: If every technology company is retaining every penny of cash flow and refusing to pay out any

dividends, how can they all be acting in the interest of the aggregate shareholders? Not all high-tech companies can be winners. Some of them have to be losers, and the losers clearly should not be retaining their cash for reinvestment. In fact, Graham would probably have argued that none of them should be keeping all the cash for their own purposes.

Graham spelled out several formulas for dealing with mismanagement. He proposed that independent directors should produce a separate annual report explaining why management had been compensated in the way it had been, in what ways the company had been managed in the best interest of the outside shareholders, and why the management of the company was indeed efficient. He also said that shareholders should band together and form communities to agitate and speak up to management. Later in his life, he lost hope that shareholders would do such things, at least on a regular enough basis to cause any systemic change in company management.<sup>5</sup>

## Conclusion

Did Benjamin Graham’s ideas ever lose their relevance? I would say no, and I have Warren Buffett’s words to back me up: “I read the first edition of this book early in 1950, when I was 19. I thought then that it was by far the best book about investing ever written. I still think it is” (preface by Warren Buffett, 2003 edition, p. ix).

My own involvement in the book notwithstanding, I believe Buffett’s words still apply. Graham is a financial advisor for the ages, and the wisdom in this book will endure as long as financial markets do.

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<sup>5</sup>For a restoration of most of Graham’s original arguments, see my commentary to Chapter 19 in the 2003 edition, pp. 497–511.



# Question and Answer Session

Jason Zweig

**Question:** What do you think Benjamin Graham was like?

**Zweig:** I think Graham was an extraordinary man on a lot of fronts. One of the things I admire most about him was that he had a genuinely interesting mind. He was not a linear thinker. Unlike most money managers I know, he did not eat, sleep, and think stocks all day and all night. He had a million hobbies. He was interested in science. He was interested in history. By the end of his life, he had studied and become fluent in seven languages.

In 1956, he quit the business and left the financial world. He said it was not interesting any more. He had figured out everything that he believed could be figured out in that field, and he wanted to move on. He essentially spent the rest of his life in the south of France and in San Diego, translating Homer into Latin and Virgil into Greek and teaching himself Spanish and having a very nice time.

In 1988, Charles Ellis gave a speech to the Empire Club in Toronto in which he described the three approaches that an investment manager can follow to achieve success: the physically difficult approach, the intellectually difficult approach, and the emotionally difficult approach.<sup>1</sup>

Graham seems to have taken the emotionally difficult approach, which is to say that he decided to maintain all his outside interests and thus obtain a more varied perspective on the markets. He assumed that the more widely one read and traveled and the more

<sup>1</sup>Charles D. Ellis, CFA, "Three Ways to Succeed as an Investor," in *Classics II: Another Investor's Anthology* (Charlottesville, VA: AIMR, 1991):587–588.

broadly one learned to think, the more open-minded and independent of thought one would be when dealing with the markets.

Unfortunately, it appears that all too many money managers take the physically difficult approach. They tell themselves that they will out-work everyone else. They say to themselves: "I will read every research paper, I will meet with every management team, I will sleep three hours a night, and that is how I will beat the market." I don't believe that approach is very effective.

**Question:** Do you think Graham was a long-term investor? And do you think that the level of interest rates affected his thinking in the book as it went through its various revisions?

**Zweig:** Yes to both questions. I think Graham would meet anyone's definition of a long-term investor. He wasn't as long term as Buffett is, but then again, Buffett isn't quite as long term as Buffett fans like to think he is. Even Buffett buys and sells when he thinks it is necessary. I would not want to give an actual number, but if I had to guess, I would think Graham's portfolio turnover rate was probably in the 10–15 percent range at a time when 15–20 percent was typical. But Graham would be bewildered by the 100–150 percent portfolio turnover rate that seems currently standard.

As for interest rates, he discussed them extensively in both books. But Graham would be skeptical of any simple dividend discount model and would always want to test alternative discounting rates to make sure that he was

comfortable that the rate he had selected would work.

**Question:** Do you think he would have been surprised by the current scandals in the financial markets, including the scandals surrounding Enron Corporation, Arthur Andersen, and several mutual funds?

**Zweig:** Graham was a hard man to surprise, so I do not think he would have been. *The Intelligent Investor* is filled with warnings that human nature never changes, and anybody who expects legislative reform or regulatory changes to change human behavior for any length of time is going to be disappointed. There is a wonderful passage in the book in which Graham reminded the reader that the major Wall Street firms are in business to sell securities. Anyone who buys securities from them on the basis of the research they generate is a fool. I am paraphrasing, of course, but only slightly.

**Question:** Was Graham interested in tax strategies?

**Zweig:** Graham did a few arbitrages that seemed to capitalize on tax rules and loopholes that existed at the time, but he did not talk about tax strategies to any great extent in *The Intelligent Investor*.

**Question:** Would you have liked to work for him?

**Zweig:** I would have liked to know him. I probably would not have liked to work for him. By all accounts, he was a kind and considerate boss, but anyone who worked for him needed a lot of intellectual firepower. And I am not sure I would have measured up.