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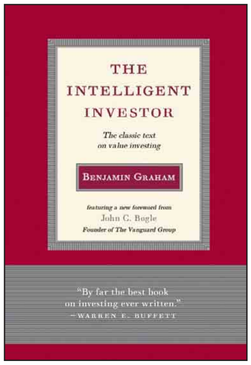

The Intelligent Investor

The Classic Text on Value Investing

by Benjamin Graham
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with Collins Business, an imprint of HarperCollins Publishers
304 pages

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Take-Aways

- Investors fall into two broad categories: the "defensive" and the "enterprising."
- Speculation is not investing.
- To succeed, enterprising investors must treat investing as they would treat any other business they entered.
- Because most investors do not have the time to treat investing as a business, they should adopt a defensive strategy.
- No evidence suggests that market forecasting and market timing work.
- Value investors should pay more attention to the dividends and operating performance of the companies they own than to the movement of their stock prices.
- As a preliminary to calculating value, estimate the company's earning ability, multiply appropriately and adjust for the value of assets.
- Every investor wants to be better than average.
- Stockholders need to take an interest in the fidelity of management, and the confidence it inspires.
- Stockholders have the rights and responsibilities of ownership, and should exercise them consistently and seriously.

Rating (10 is best)

Overall	Applicability	Innovation	Style
10	**10**	**9**	**9**

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Relevance

What You Will Learn

In this Abstract, you will learn: How to understand the fundamental principles of value investing as propounded by its founder Benjamin Graham, the man who literally taught Warren Buffett how to invest.

Recommendation

This classic book on investing belongs on the bookshelf of every investor. The principles that Benjamin Graham outlines are the very precepts that guided such great investors as Warren Buffett, and such mutual fund innovators as John Bogle, the noted Vanguard Group founder, who wrote this edition's foreword. First published in 1949, the text shows a few signs of age, most notably in its discussion of interest rates, investment vehicles such as savings bonds and other time-sensitive subjects. However, those are minor issues. When Benjamin Graham writes about categories of investors, approaches to security analysis, the proper disposition investors should have toward market moves, and other fundamental investment subjects, his advice is timeless. *getAbstract* highly recommends this seminal book.

Abstract

Foreword by John Bogle

Financial markets are far different today than the markets were in 1949 when Benjamin Graham wrote *The Intelligent Investor*. Stock valuations are much higher and the savings bonds that Graham praised are no longer attractive investments. Graham described the markets using the metaphor of a character he called "Mr. Market," a mythical fellow who offered investors a daily price at which he would buy their stock or sell them more. Generally speaking, Graham advised investors to ignore Mr. Market. However, today's investors are doing "1500 times as much business with him as they did a near-half-century ago," so many investors must have ignored this good advice.

"The genuine investor in common stocks does not need a great equipment of brains and knowledge, but he does need some unusual qualities of character."

Graham would probably have cocked a skeptical eye at today's volume of speculative trading. He certainly would have criticized the shift from owning stocks to renting them, because short-term stock ownership gives investors little incentive to exercise responsible oversight. However, Graham's words about "defensive" and "enterprising" investors are still true. He was also prescient about the inability of fund managers to earn a return superior to the market average. His emphasis on long-term ownership suggests that he would have endorsed the idea of an index mutual fund. In an interview shortly before he died, he said investors should insist on earning at least the average market return from a fund. Of course, only index funds guarantee such returns. Graham conceded that his ideas might not pass the test of time, however, some of his principles remain valid, including:

"Investment is most intelligent when it is most businesslike."

- Speculation usually leads to losses.
- Buy when others are eager to sell and sell when others are eager to buy.
- Do your homework before you invest – investigate carefully.

The Intelligent Investor

Investors – as opposed to speculators – come in two broad categories:

1. Defensive – This investor intends to preserve capital, make as few mistakes as possible, enjoy a good return and hedge against inflation. Defensive investors want safety and freedom, so they are well-advised to put up to 40% of their money in savings bonds and a good portion in common stocks, both as an inflation hedge, and as an opportunity to earn dividend income and profit from the stocks' appreciation.
2. Enterprising (or aggressive) – This investor wants to buy securities at less than their intrinsic value. Enterprising investors may try to profit by trading on the market averages, picking market-beating stocks, selecting growth stocks, purchasing bargains, and, overall, buying when the market is pessimistic and selling when it is optimistic. Attempts to beat the market average and pick winning stocks are more akin to speculation than investing. The other techniques, however, are genuine investment strategies. Purchasing undervalued securities may be the most certain route to riches, if the investor devotes enough time and effort to becoming an investment expert.

> "Nothing in finance is more fatuous and harmful... than the firmly established attitude of common stock investors and their Wall Street advisers regarding questions of corporate management."

Investors need a sense of history, so they can put market moves in perspective. Because most investors lack such perspective, the market treats trends like they are permanent. Investing is a business and investors should treat it as such. Many business people who are quite prudent in their own work seem to lose this discipline when they encounter Mr. Market. Intelligent investors are not uncommonly smart, shrewd or insightful, but they understand the market as a business. Investing success is more a matter of character than brains. The investor must have the personal strength to resist urges to speculate, make quick money and follow the crowd.

> "That attitude is summed up in the phrase: 'If you don't like the management, sell your stocks'."

Market Movements

Speculators aim to make money on market moves. Investors, by contrast, intend to buy good stocks at good prices and hold them. Market movements matter only because they offer prices at which it becomes prudent for the investor to buy or sell. The average investor should not wait for the market to drop before buying stocks. As long as prices are not unreasonably high, you should work to build a portfolio of stocks through prudent purchasing patterns, such as averaging. Many investors attempt to identify stocks that will outperform the market in the short term. This is too close to speculation to be worth recommending. The stock price includes information about forecasts of higher or lower prices (both are always present in the market, for any stock) and reflects the net effect of these opinions. The value investor can ignore daily price fluctuations.

> "Good managements produce a good average market price, and bad managements produce bad market prices."

Portfolio Policies: Defensive, Aggressive and Enterprising

Investment advisors can be useful, but do not rely on them for advice on how to profit. Professionals can help you achieve a low level of risk and a conservative income, and financial services firms can provide economic and market information – but do not put much store in their market forecasts. Brokerages are more like businesses than like professional firms, such as law firms. Investment bankers are salespeople who see customers as potential buyers for the securities they underwrite.

> "Only in the exceptional case, where the integrity and competence of the advisors have been thoroughly demonstrated, should the investor act upon the advice of others without understanding and approving the decision made."

The way investors use advice and advisors depends on whether they are defensive or enterprising. Defensive investors should limit their securities purchases to relatively low risk, high-quality bonds and stocks. They need only relatively simple, straightforward advice about which stocks meet their requirements and whether prices are reasonably in line with past averages. Aggressive investors, however, work with advisors, and demand detailed explanations and recommendations. A well-constructed portfolio of stocks is not too risky for a defensive investor. Although stock prices fluctuate, the investor does not lose money merely because the market price declines. The investor only really loses value when selling at a price lower than the purchase price.

Aggressive investors should rely on their own judgment and look to advisors not for direction, but for knowledge to supplement their own expertise. Two portfolio management principles apply to the aggressive investor. First, avoid buying corporate bonds since U.S. savings bonds offer almost equal returns and much lower risk. Second, avoid high-quality preferred stocks. Lower-quality preferred stocks and corporate bonds may be good investments when prices are at least a third below par. Foreign bonds are best left alone, as are convertibles and common stocks with superior recent earnings performance. New issues are attractive investments only when they are out of favor and selling at less than intrinsic value.

"The intelligent investor (needs) an ability to resist the blandishments of salesmen offering new common-stock issues during bull markets."

The enterprising investor may seek to profit by:

- Market timing – Trying to buy when the market is down and sell when it is up is both attractive and dangerous. Future market fluctuations may not resemble past shifts. The one advantage of market timing formulas is that they may encourage investors to behave as contrarians, selling and buying against the crowd. This is a sound approach – but the rest of market timing has little merit.
- Growth stocks – Many investors want to pick stocks that will outperform the market in the future. Identifying stocks that have outperformed in the past is relatively easy, but forecasting future performance is difficult. Do not overpay for growth.
- Buying bargains – Bonds and preferred stocks may be bargains when their prices are below par. Common stocks may be bargains if their intrinsic value is higher than the market price. Some stocks, sometimes, sell for less than the value of their working capital. An industry's secondary stocks may also be bargains. The market tends to exaggerate the risk of stocks that are not industry leaders. However, those who buy bargain-priced stocks can profit from the high dividend returns, earnings reinvestment and price escalation that come in the course of time or as the result of a bull market.
- "Special situations" – Events such as bankruptcy, reorganization, mergers and the like offer profit opportunities for investors. The market often discounts stocks excessively in the face of such concerns as, for example, potential involvement in lawsuits.

"Some of these issues may prove excellent buys – a few years later, when nobody wants them and they can be had at a small fraction of their true worth."

Aggressive investors require a great deal of knowledge to conduct what is, in fact, an investing business. No middle ground exists between passive and active. Because relatively few investors have the expertise or the character attributes necessary to act like aggressive investors, most investors should adopt a defensive strategy.

"A prime test of the competent analyst is his power to distinguish between important and unimportant facts and figures in a given situation."

Rules for Appraising Stocks

The following 11 rules can guide investors and analysts:

1. As a preliminary to calculating value, estimate the company's earning ability, multiply appropriately and adjust for the value of assets.
2. Earning power is an estimate of the company's earnings over a five-year horizon.
3. Estimate a company's average earnings over this five-year horizon by averaging good and bad prior years, then projecting revenues and margins into the future.
4. Adjust prior years' figures to reflect any capitalization changes in the company.
5. Use a minimum multiplier of eight and a maximum of 20. The multiplier allows for earnings changes over the long term.

"This matter of choosing the 'best' stocks is at bottom a highly controversial one. Our advice to the defensive investor is that he let it alone."

“Insiders never suffer loss from an unduly low market price which it is in their power to correct. If by any chance they should want to sell, they can and will always correct the situation first.”

6. If the value calculated on the basis of earning power is greater than the value of tangible assets, deduct from the earnings value appraisal. “Our suggested factor is as follows: Deduct one-quarter of the amount by which the earning-power value exceeds twice the asset value. (This permits a 100% premium over tangible assets without penalty.)”
7. If the valuation based on earnings power is less than the value of net current assets, add 50% of the difference to the value calculated on earning power.
8. In unusual circumstances, such as those related to war, rentals or short-lived royalties, adjust the appraised value accordingly.
9. Allocate value among stockholders and bondholders or preferred stockholders. Before taking this step, calculate the enterprise value as if its capital structure consisted only of common stock.
10. The more aggressive the capital structure is (that is, the more debt and preferred stock in proportion to common stock), the less reliable the appraised value will be.
11. When a stock’s appraisal is a third higher or lower than its current market value, that can be the basis for a decision to buy or sell. When the differential is less, the appraisal is merely another fact to consider in the analysis.

Stockholders and Managers

Although stockholders have legal rights to control management, for practical purposes, stockholders are impotent. Stockholders tend to follow management regardless of its performance record. Although management is typically decent, there are enough cases of incompetent or dishonest management that stockholders should start getting serious about exercising their rights and responsibilities as owners. In particular, they should consider:

“It is amazing to see how many capable businessmen try to operate in Wall Street with complete disregard of all the sound principles through which they have gained success in their own undertakings.”

- Management efficiency – Although management is critically important in the performance of any stock investment, investors seem to have little interest in examining management quality, and less in removing or improving bad managers. Stockholders need to take an interest in the fidelity of management, and the confidence it inspires. Test the quality of management objectively. If shareholder return falters even when the industry prospers, margins lag the industry or the company does not sustain its market share, then stockholders should demand explanations. The information needed for this analysis is available. Stockholders may believe that elected directors will diligently protect their interests, but managers choose directors. Many ties, including ties of friendship, bias directors in favor of management.
- “Outside stockholders” – Stockholders who are not insiders are outsiders, and do not participate in management or control the company. Insiders often manage companies to serve their own interests, at the expense of outside shareholders. This discrimination has been most egregious in the case of holding companies, whose stocks have been “worth less than the value of the assets behind them.” Insiders could eliminate this difference by breaking up the holding company, although outside stockholders would profit. However, managers seldom do so willingly. Unconscionably, holding-company stockholders continue to acquiesce to management that acts against their interests.

Stockholders have the rights and responsibilities of ownership, and should exercise them consistently and seriously.

About The Author

Benjamin Graham (1894-1976), the father of value investing, was also the author of *Security Analysis* and *The Interpretation of Financial Statements.*