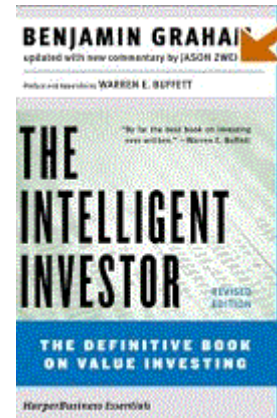


Benjamin Graham: The Intelligent Investor

Warren Buffett read the first edition of *The Intelligent Investor* by Benjamin Graham in 1950 when he was 19. At the time he thought that it was by far the best book ever written. Writing in the introduction to this recent edition, he states that still thinks that it is.

This is reinforced by his comment in the 2003 annual report of Berkshire Hathaway where he declared that it is his favorite book. Since it was first published in 1949, Graham's investment guide has sold over a million copies. In its new form—with commentary on each chapter and extensive footnotes prepared by senior *Money* editor, Jason Zweig—the classic is now updated in light of changes in investment vehicles and market activities since 1972. You can purchase the book at [Amazon.com](https://www.amazon.com/dp/0007117691).



The following summary notes were prepared by Jim Butler and kindly made available by him to subscribers of [Conscious Investor](https://www.consciousinvestor.com).

I. Core principles [p xiii]

- A. A stock represents an ownership interest in an actual business with an underlying value that does not depend on its share price.
- B. The market is a pendulum that swings between optimism (making stock too expensive) and pessimism (too cheap).
- C. The future value of every investment is a function of its present price. The higher the price you pay, the lower your return.
- D. No matter how careful you are, you need a margin of safety--never overpaying after considering all risks.
- E. The secret of financial success is inside yourself.
 1. be a critical thinker
 2. invest with patient confidence

II. Introduction [p 1]

- A. The underlying principles of sound investment should not alter from decade to decade, but the application of these principles must be adapted to significant changes in the financial mechanisms and climate. [p 4]
- B. Two types of investor [p 6]:
 1. Defensive
 - a) *chief aim is avoiding losses*
 - b) *secondary is low effort & annoyance and infrequent decisions*

2. Enterprising (active or aggressive)
 - a) *determining trait is willingness to devote time and care to selection of securities*
 - b) seeking a slightly better return (because expecting significantly better returns is probably unrealistic)
- C. MYTH of promising industries [p 6-8]
 1. Concept: locate the industries that are most promising, and then pick best companies in those industries
 2. computers and IBM are examples
 3. airlines and computers both show the fallacy of this approach
 - a) *obvious prospects for physical growth in a business do not translate into obvious profits for investors*
 - b) *experts do not have dependable ways to select the most promising companies in the most promising industries [This may not consider the consistent history of profits, ROI, growth, etc. reflected in John Price's STAEGR concept.]*
 - c) *By the time that everyone has decided on the best company, the prices have been bid so high that future returns have no upside.. [p 16-17]*
- D. Value investing -- Graham says that "For 99 issues out of 100 we could say that at some price they are cheap enough to buy and at some other price they would be so dear that they should be sold." p 8]
- E. Stocks become riskier as the prices rise, not less. Stocks become less risky as their prices fall. [p 17]
- F. The bear market is good news with buying opportunities.
- G. *Stock market predictions of brokerage firms are somewhat less reliable than flipping a coin. [p 10]*
- H. Isaac Newton, the timing expert [p 13-14]
 1. In 1720, he bought stock in the South Sea Company, which was then the hottest stock in England.
 2. He sold it for a 7,000 pound profit (almost \$1 million in today's money), saying that he "could calculate the motions of the heavenly bodies, but not the madness of the people." (referring to the market frenzy).
 3. Several months later as wild enthusiasm carried the stock higher, Newton jumped back in but at a much higher price, and then lost more than 20,000 pounds (\$3 million in today's money).

III. Investment vs. Speculation [p 18]

- A. "An investment operation is one which, upon thorough analysis, promises

safety of principal and adequate return. Operations not meeting these requirements are speculative." [p 18]

B. Note the components of investing [p 35]:

1. thoroughly analyze a company and the underlying business
2. deliberately protect yourself against serious losses
3. **aspire to "adequate" and not extraordinary, performance.**

C. Everyone who buys the so-called "hot" common stock issues is either speculating or gambling. [p 21]

1. An investor calculates what a stock is worth based on the value of the underlying business. [p 36]
2. A speculator gambles that a stock will go up in price because somebody else will pay even more for it. [p 36]

D. The portfolio [p 22-23]

1. **Bonds should never be less than 25% of the portfolio nor more than 75% of it.**
2. Simplest solution for the Defensive Investor is 50-50 common stocks and bonds.
3. Adjust portfolio
 - a) *whenever shifts of 5% or more*
 - b) *at regular intervals (i.e. 6 months) -- suggestion of Jason Zweig*
4. Alternative approach is to reduce common stock percentage to 25% when common stocks seem very speculatively high, or to increase stock percentage to 75% when common stocks seem very low.
5. "The future of security prices is never predictable." [p 24]
6. The Defensive Investor must confine himself to the shares of important companies with a long record of profitable operations and in strong financial condition." [p 28]
7. If you look at a large quantity of data long enough, a huge number of patterns will emerge, if only by chance. [p 45]
8. Stocks do well or poorly in the future because the businesses behind them do well or poorly--nothing more, and nothing less. [p 45]
9. For most of us, 10% of our overall wealth is the maximum permissible amount to put at speculative risk. [p 46]

IV. **The Investor and Inflation** [p 47]

- A. There is no close time connection between inflationary (or deflationary) conditions and the movement of common stock earnings and prices. [p 51]

- B. Study of earnings rate on capital shown by American Business [p 51-52]:
 - 1. No general tendency to advance with wholesale prices or cost of living.
 - 2. Conclusion: the investor cannot count on much above the recent 5-year rate earned on the DJIA group.
 - 3. Cold figures demonstrate that ALL large gains in earnings of the DJIA in the past 20 years was due to a proportional large growth of invested capital coming from reinvested profits. [p 52]
 - 4. "The only way that inflation can add to common stock values is by raising the rate of earnings on capital investment. **On the basis of the past record this has not been the case.**" [p 52]
- C. Conclusion: An investor has no sound basis for expecting more than an average overall return of, say, 8% on a portfolio of DJIA-type common stocks purchased at the late 1971 price level....If there is one thing guaranteed for the future, it is that the earnings and average annual market value of a stock portfolio will *not* grow at the uniform rate of 4%, or any other figure. In the memorable words of the elder J.P. Morgan, "They will fluctuate." [p 54]
- D. It took 25 years for GE and the DJIA itself to recover the ground lost in the 1929-1932 debacle. [p 55]
- E. Investor cannot afford to put all his funds into one basket--neither the bond basket, despite unprecedented high returns that bonds offer, nor in the stock basket, despite the prospect of continuing inflation. [p 56]
- F. Stocks are not a guarantee against inflation. The stock market lost money in 8 of the past 14 years in which inflation exceeded 6% per year. The average return for those 14 years was only 2.6%. Stocks have failed to keep up with inflation about 1/5 of the time. [p 61]
- V. **A Century of Stock Market History** [p 65]
 - A. The investor must never forecast the future exclusively by extrapolating the past.
 - 1. This includes the corollaries such as forecasters who argue that stocks have returned an annual average of 7% after inflation ever since 1802. Therefore, investors should expect the same in the future. [p 80]
 - 2. The value of any investment is and always must be a function of the price you pay for it. [p 83]
 - 3. Robert Shiller, a finance professor at Yale, was inspired by Graham's valuation approach. he studies historical records and found [p 85-86]
 - a) *when the PE ratio goes well above 20, the market usually*

- delivers poor returns afterward*
- b) *when the PE ratio drops well below 10, stocks typically produce handsome gains down the road.*
- c) *see chart of total return for next 10 years when PEs went over 20 [p 86].*

VI. General Portfolio Policy: The Defensive Investor [p 88]

- A. Reminder: The defensive investor is one who does not want much risk and does not want to work very hard, make a lot of decisions, etc.
- B. Minimum 25% bonds, maximum 75% stocks ... and minimum 25% stocks and 75% bonds.
- C. Once you set your proportions, change them only as your circumstances change.
- D. Zweig suggest re-balancing to your set proportions every 6 months and to pick dates that are easy to remember like New Years and July 4th. [p 105]
- E. Bond funds bring easy diversification.

VII. Defensive Investor and Common Stocks [p 112]

- A. The argument for common stocks--they offer
 - 1. a considerable degree of protection against inflation (bonds, at least before TIPS, offer none).
 - 2. higher average return to investors over the years (combination of dividend yield and appreciation in value).
- B. These two benefits of common stock investments are lost if too high a price is paid. [p 113]
- C. Rules for common stock investment [p 114]:
 - 1. There should be adequate but not excessive diversification. (minimum of 10, maximum of 30 different issues).
 - 2. Each company should be large, prominent and conservatively financed.
 - 3. Each company should have a long record of continuous dividend payments. [Zweig suggests 10 years continuous payments, or maybe even 20.]
 - 4. Investor should limit the price paid to not more than 25 times average earnings for the past 7 years and not more than 20 times the last 12 month period.
- D. These rules would eliminate many of the most important growth stocks.
 - 1. Growth stock is one that has increased its per share earnings in the past at a rate well over that for common stocks generally and which is expected to continue to do so in the future.

2. Some authorities say that a growth stock is one that is expected to double its earnings in 10 years. Using the Rule of 72, this means, it will take a 7.1% compounded annual growth rate to double earnings in 10.1 years. [Rule of 72 tells you how long to double something if you divide the expected rate of return into 72. So, in this example, $72 / 7.1 = 10.1$ years.]
3. The problem is that on many growth stocks, the prices advanced many times faster than the rate of growth in earnings.
4. Graham says that "we regard growth stocks as a whole as too uncertain and risky a vehicle for the defensive investor ... In contrast we think that the group of large companies that are relatively unpopular and therefore obtainable at reasonable earnings multipliers, offers a second if unspectacular area of choice by the general public."
5. Note on the Category of "Large, Prominent and Conservatively Financed Corporations" [p 122-123]
 - a) *Finances are not conservative unless book value is at least half of the total capitalization, including bank debt*
 - b) *Large and prominent relate to size and leading position*
 - (1) large means at least \$50 million [Zweig says that today that means at least \$10 billion]
 - (2) prominent means that the company should be in top 1/4 or 1/3 of its industry by size

E. Commentary

1. Decision about investing in common stocks has nothing to do with how much you might have lost in the past. When stocks are priced reasonably enough to give you future growth, then you should own them, regardless of the losses that you have had before. [p 124]
2. Peter Lynch says "buy what you know."
 - a) *amateur investors can get important information this way -- personal insight into what is working*
 - b) *but this is ONLY the FIRST STEP!*
 - c) *then you have to do the financial analysis*
 - (1) study the financial statements
 - (2) otherwise, the "invest in what you know" approach is dangerous
 - (3) causes over confidence -- familiarity breeds complacency

VIII. Portfolio Policy for the Enterprising Investor: Negative Approach (i.e. the Don'ts) [p 133]

- A. The aggressive investor starts from the same base as the defensive investor

1. division of funds between high grade bonds and common stocks bought at reasonable prices

B. Junk bonds [p 145-147]

1. Graham gave them a big thumbs down.
2. Today however there funds that offer diversification that concerned Graham, and have much lower cost.
3. However most junk bond funds have higher costs and do not do a good job of preserving principal.

C. **The more you trade, the less you keep.** [p 149]

IX. **Portfolio Policy for the Enterprising Investor: The Positive Side (i.e. the Dos)**
[p 155]

A. The Enterprising Investor does all the work he does to obtain a *slightly better* investment result

1. Many would think that you just buy when the market is down and sell when it is up. But thorough analysis shows that attempts to do this just don't work.
2. The best way for dealing with ups and downs in the market is through allocation of stock and bond investment proportions. The general allocation suggested for defensive investor applies here [p 156]
 - a) *50-50 is best for most*
 - b) *wide leeway to go 75/25 or 25/75*
 - c) *rebalance*

B. Growth Stock approach [p 157]

1. Every investor would like to select the stocks of companies that will do better than the average over a period of years.
2. A growth stock may be defined as one that has done this in the past and is expected to do so in the future.
3. It is just a statistical chore to identify companies that have outperformed the averages in the past.
4. There are 2 problems with just picking some of these stocks that have outperformed in the *past*.
 - a) *stocks with good records and apparently good prospects in the future sell at correspondingly high prices -- so you could be right about the good future prospects but might not do well with the investment because you overpaid.*
 - b) *judgment about future performance may prove wrong; rapid growth cannot continue forever and at some point it will flatten out.*

5. Graham thinks that it is not likely anyone can pick the growth companies that will succeed. He bases this on [p 158-159]
 - a) *A study of the investment results achieved by investment funds specializing in growth stock approaches*
 - b) *120 growth funds' results were studied over a period of years. 45 had 10-years of experience or more. They generally did no better and sometimes worse than the DJIA or S&P.*
6. The implication is that no outstanding rewards came from diversified investment in growth companies as compared with that in common stocks generally. [p 158-159]
 - a) *Over 10 years ending December 31, 2002, funds investing in large growth companies earned an annual average of 5.6%, underperforming the overall stock market by an average of 4.7% points per year.*
 - b) *However, "large value" funds investing in more reasonably priced big companies also under performed the market over the same period by a full percentage point per year.*
 - c) *Zweig asks if the problem is that the growth funds cannot reliably select stocks that will outperform, or if the problem is a high cost structure.*
7. Graham advises against "the usual type of growth stock commitment" for the enterprising investor.
 - a) *There is no reason at all for thinking that the average intelligent investor, even with much devoted effort, can derive better results over the years from the purchase of growth stocks than the investment companies specializing in this area.*
 - b) *The professionals have more brains and better research facilities.*
 - c) *But the "usual type of growth stock commitment" is one where the excellent prospects are fully recognized in the market and already reflected in a current price earnings ratio of, say, higher than 20.*
 - d) *For the defensive investor we suggest an upper limit of purchase price at 25 times average earnings of the past 7 years.*
8. Comments: [fn at p 158-159]
 - a) *Graham reminds that an "Enterprising Investor" is not one who takes more risk than the average or who buys aggressive growth--but is simply one who is willing to put in extra time and effort in researching his or her portfolio*
 - b) *Graham insists on calculating the PE ratio based on a multi-year average of past earnings. That way you lower the odds that you will overestimate a company's value based on a*

temporarily high burst of profitability

9. The striking thing about growth stocks as a class is wide swings in market price.
 - a) *This is true for even the largest and longest-established companies like GE and IBM.*
 - b) *The investment caliber of such a company may not change over a long span of years, but the risk characteristics of its stock will depend on what happens to it in the stock market.*

C. A recommended approach for Enterprising Investors [p 163]

1. To obtain better than average investment results over a long pull requires a policy of selection or operation possessing a twofold merit:
 - a) *it must meet objective or rational tests of underlying soundness*
 - b) *it must be different from the policy followed by most investors or speculators*
2. This leads Graham to recommend 3 approaches which include the "relatively unpopular large company"
 - a) *The market tends to over value good companies and undervalue those out of favor because of unsatisfactory developments of a temporary nature.*
 - b) *Key is to concentrate on larger companies going through a temporary unpopularity*
 - c) *Large companies are good*
 - (1) *have capital and brainpower to get through adversity and back to satisfactory earnings*
 - (2) *the market is likely to respond with reasonable speed to any improvement*
 - d) *Companies with widely varying earnings tend to sell at relatively high prices and low multipliers in their good years, and at low prices and high multipliers in bad years*
 - e) *Graham likes using low PE ratio based on average earnings to eliminate anomalous earnings companies with erratic swings*
 - f) *Start with low multiplier idea, but add other quantitative and qualitative requirements.*
3. Special Situations
 - a) *The securities markets tend to undervalue issues that are involved in any sort of complicated legal proceedings. following the Wall Street adage to "never buy into a lawsuit."*
 - b) *not buying into a lawsuit may be sound advice for speculators but it creates bargain opportunities*

D. Commentary by Zweig [p 179]

1. Timing: For most investors, timing is a practical and emotional

impossibility.

2. When stocks grow faster than companies, investors always lose.
3. Growth stocks are worth buying when their prices are reasonable, but when their PE ratios go much above 25 or 30, the odds get ugly.
4. Unsustainable Growth [p 181-182]
 - a) *In a study covering 1960-1999, only 8 of the largest 150 companies on the Fortune 500 list managed to raise their earnings by an annual average of at least 15% for two decades. Carol J. Loomis, "The 15% Delusion," Fortune, February 5, 2001. p 181]*
 - b) *Sanford Bernstein studied 5 decades of data and found that only 10% of large US companies had increased their earnings by 20% for at least 5 consecutive years; only 3% had grown by 20% for at least 10 years; and not a single one did it for 15 years in a row.*
 - c) *An academic study of thousands of US stocks from 1951 - 1998 found that over all 10-year periods:*
 - (1) net earnings grew by an average of 9.7% annually
 - (2) for the largest, 20% of the companies, earnings grew by an annual average of just 9.3%
5. The intelligent investor gets interested in big growth companies, not when they are most popular, but when something goes wrong. [p 183]
 - a) *JNJ lost 16% of its stock price in a single day when federal regulators announced they were looking into accusations of false record keeping. This took the PE ratio down from 24 to 20 times the prior 12 months earnings.*
 - b) *JNJ suffered similar price hits 20 years earlier over the Tylenol tampering scare.*
6. The bargain bin -- *WSJ* for companies hitting 52 week lows.
7. Consider up to 1/3 of investments in foreign stocks (mutual funds that hold foreign stocks) [p 187]

X. The Investor and Market Fluctuations [p 188]

- A. Market price fluctuations is minimal on bonds of 7 years or less.
- B. Common stocks--there are two possible ways to profit from wide fluctuations in price:
 1. Timing -- does not work
 2. Pricing -- can yield satisfactory results. Don't pay too much.
- C. Timing issues
 1. "It is absurd to think that the general public can ever make money out of market forecasts." [p 190]

2. There is no basis, either in logic or experience, to assume that any average investor can anticipate market movements more successfully than the general public, of which he is himself a part.
 3. We are convinced that the average investor cannot deal successfully with price movements by endeavoring to forecast them. It does not work any better in trying to work on major market movements after they have occurred than trying to guess when they will occur. Thus there is no success in trying to buy in a bear market (after a major decline) and sell in a bull market (after a major advance) than generally trying to forecast a stock. [p 192-193]
- D. The best way to deal with market fluctuations is to use the proportion of common stocks to bonds (i.e. the 50-50, 25-75 or 75-25 ratios) to put money into the common stocks or take it out and put it into bonds through re-balancing.
- E. Easy theories don't work for long--there have been many theories, formulas or approaches (such as dogs of the Dow, formula investment plans, etc), but none seem to work consistently or don't work once others start using the approach.
1. The moral seems to be that any approach to moneymaking in the stock market which can be easily described and followed by a lot of people is by its terms too easy and too simple to last.
 2. All things excellent are as difficult as they are rare." Spinoza
- F. It is probable (not just possible) that your portfolio will gain at least 50% from its lowest point and lose at least 33% from its highest point regardless of what stocks you own.
- G. Note that when a stock goes up 50% a decline of 33% is an equivalent amount (or an "*equivalent third*" as Graham calls it. Take a \$10 stock and if it goes up 50%, it goes to \$15. A decline of 1/3 (or \$5) is equivalent to the 50% on the increase), and takes it down \$5 to \$10 again.
- H. The stock market gives the investor liquidity, but an intelligent investor will value his investment based on the performance of the underlying business--like a silent partner in the business.
1. The greater the premium of stock price to book value, the less certain is the basis of determining the intrinsic value of the investment. **Look at price to book ratio.**
 2. Final paradox: The greater the quality of the common stock, the more speculative it is likely to be, at least as compared to unspectacular middle grade issues (i.e. because of premium pricing)
 - a) *This causes some of the most successful and impressive enterprises to have most erratic price behavior.*
 - b) *The foregoing suggest: **Concentrate on issues selling at a***

reasonably close approximation to their tangible asset value--say at not more than 1/3 above that figure.

- c) *The problem with high priced growth stocks: "The higher the assumed future growth rate, and the longer the time period over which it is expected, the wider the margin for error grows, and the higher the cost of even a tiny miscalculations becomes." [p 199]*
 - d) *But low book value is not enough. You want [p 200]:*
 - (1) low book value
 - (2) low PE ratio
 - (3) strong financial position
 - (4) prospect that earnings will be maintained over the years
 - e) *"Once the investor is willing to forego brilliant prospects--i.e., better than average expected growth--he will have no difficulty in finding a wide selection of issues meeting these criteria." [p 200]*
3. Mr. Market [p 205]
- a) *his job is to provide you with prices.*
 - b) *your job is to decide whether it is to your advantage to act on them.*
4. Distinction between speculator and investor
- a) *speculator's primary interest lies in anticipating and profiting from market fluctuations.*
 - b) *investor's primary interest lies in acquiring and holding suitable securities at suitable prices.*

I. Comments

- 1. Some advantages of individual investors may have over funds:
 - a) *Funds must invest billions and so they have to buy the biggest companies with huge float.*
 - b) *When investors pour money into funds, managers must invest it, usually fueling a price rise (which is when most people start pouring money even more money into a fund to catch the rising market).*
 - c) *Funds have to sell stocks into falling markets to cash out investors (instead of investing cash as prices become cheap), and this can fuel further sales and declines.*
- 2. Best vehicle for many people is a total stock market index fund.
- 3. Humans are pattern-seeking animals, looking for patterns even if there are none [p 220].
 - a) *there is a part of the brain that releases dopamine when an event occurs several times in a row and then recurs again*
 - b) *this actually makes you addicted to your predictions*

- c) *the pain of financial loss is more than twice as intense as the pleasure of an equivalent gain*

4. **Think of price declines as buying opportunities.**

XI. Investing in Investment Funds [p 226]

- A. Investment funds have tended to do better than the average individual investor
- B. Funds have generally done no better than common stocks as a whole (and the cost of the funds hits their performance for the investor).
- C. The overall results of 10 funds from 1961-1970 were about the same as the S&P 500 and a little better than the DJIA.
- D. Performance funds significantly under performed the market.
- E. Comments by Zweig [p 242]
 - 1. Most funds under perform the market, overcharge their investors, create tax headaches and suffer erratic swings in performance.
 - 2. "Buying funds based purely on their past performance is one of the stupidest things and investor can do."
 - 3. Conclusions of 50 year study [p 243]:
 - a) *average fund does not pick stocks well enough to overcome the costs of research and trading*
 - b) **the higher a fund's expenses, the lower its returns**
 - c) *the more frequently a fund trades its stocks, the less it tends to earn*
 - d) *highly volatile funds are likely to stay volatile*
 - e) **funds with high past returns are unlikely to remain winners for long**
 - 4. What should an intelligent investor do?
 - a) **Buy an index fund which owns all the market all the time [particularly for a 401(k)]**
 - b) *find one with rock bottom costs*
 - (1) **operating costs of .2% or less per year**
 - (2) **trading costs of .1% or less per year**
 - 5. **Warren Buffett and Benjamin Graham both think a low cost index fund is the best choice for individual investors. [p 249]**
 - 6. How to pick the best fund. Look for Funds and Managers where:
 - a) *They are cheap. Funds with higher fees earn lower returns.*
 - b) *Managers are the biggest shareholders (Longleaf, Davis and FPA)*
 - c) *They dare to be different*
 - d) *They shut the door*
 - e) *They don't advertise*

7. Past performance is virtually the least important factor
 - a) *past performance is a pale pale predictor of future performance*
 - b) *today's winners often become the biggest losers for tomorrow (more investors pile in, etc)*
 - c) *also, today's losers rarely do better so avoid funds with poor performance record*
8. When to sell a fund
 - a) *sharp and unexpected change in strategy*
 - b) *increase in expenses*
 - c) *large and frequent tax bills generated by excessive trading*
 - d) *sudden erratic returns*

XII. Security Analysis for the Lay Investor [most of this is from Zweig Commentary starting at p 302]

A. How to determine the price for an investment--5 determinative factors

1. general long term prospects
 - a) *look at 5 years financial statements*
 - b) *look to avoid*
 - (1) serial acquirer
 - (2) OPM (look for cash from financing activities)
 - c) *look to find*
 - (1) a wide moat or competitive advantage, created by things like
 - (a) strong brand identity (Harley Davidson)
 - (b) monopoly or near monopoly (Gillette)
 - (c) unique intangible asset (like Coke)
 - (2) revenues and earnings that have grown smoothly and steadily over the past 10 years
 - (a) the fastest growing companies tend to overheat and flame out
 - (b) a pre tax growth rate of 10% may be sustainable over a long time (6% to 7% after tax) but 15% is not [p 305]
 - (3) effective research and development
 - (a) P&G spends about 4% on R&D
 - (b) JNJ spends 10% on R&D
 - (c) look for consistency in R&D expenditures (???)
2. quality of management
 - a) *what forecasts and how do they accomplish them*
 - b) *excuses of the economy and other matters*
 - c) *consistency of message in good times and bad*
 - d) *look to avoid*

- (1) big CEO salaries
 - (2) reissuing options
 - (3) big option overhang
 - (4) promoters (look to their spiel)
 - (5) use of accounting gimmicks, restatements, non recurring charges and extraordinary items
3. financial strength and capital structure
 - a) *Does it generate more cash than it consumes?*
 - b) *How steady is growth in cash from operations over the past 10 years*
 - c) *Look at amount and growth of Owner Earnings*
 - (1) net income plus
 - (2) amortization and depreciation
 - (3) less normal capital expenditures
 - (4) less costs of
 - (a) stock options
 - (b) unusual, nonrecurring or extraordinary charges
 - (c) income from pension fund
 - d) *Look for a owner earnings per share that have grown at a steady average annual growth of at least 6% or 7% over the past 10 years [p 308]*
 - e) *Look at capital structure*
 - (1) Long term debt should be less than 50% of total capital
 - (2) Look at ratio of earnings to fixed charges
4. dividend record
 - a) *if company has outperformed the competition in good times and bad, then it is probably making great use of capital, and it is less important that dividends are paid out*
 - b) *companies that buy back shares when they are cheap (not when they are expensive)*
5. current dividend rate

XIII. Things to Consider About Per Share Earnings [p 310]

- A. Two pieces of advice:
 1. Don't take a single year's earnings seriously
 2. Look out for booby traps in the per share figures (i.e. extraordinary items):
 - a) *special charges*
 - b) *dilution*
 - c) *special income tax situations (loss carry forwards, credits, etc.)*

- d) *depreciation (accelerated depreciation which distorts income?)*
 - e) *How R&D is handled (expensed or capitalized)*
 - f) *"pro forma" assumptions*
- B. Average earnings: Analysts used to use average earnings over a fairly long period of time (e.g. 7 to 10 years). This was thought to give a better idea of a company's earnings power than the results of a single year. This normally solves issues of special charges and distortions.
- C. Growth
 - 1. It is critical that the growth factor be taken adequately into account. Suggest comparing average growth of the last 3 years be compared to the corresponding figures 10 years earlier.
 - 2. Recent history and a mountain of financial data have shown that the market is unkindest to rapidly growing companies that suddenly report a fall in earnings. More moderate or stable growers tend to suffer somewhat milder stock declines if they report disappointing earnings. Great expectations lead to great disappointment if they are not met; a failure to meet moderate expectations leads to a much milder reactions. Thus one of the biggest risks in owning growth stocks is not that their growth will stop, but merely that it will slow down. And in the long run, that is not merely a risk, but a virtual certainty. [p 321]
- D. Commentary [p 322]
 - 1. The only thing that you should do with pro forma earnings is ignore them.
 - 2. Aggressive revenue recognition is often a warning sign of big problems.
 - 3. Look to see how often extra ordinary events happen. Inventory adjustments every 6 months begin to look like a regular event, and not an extraordinary one.
 - 4. Look for pension fund manipulation.
 - 5. Caveat investor
 - a) *Read financial statement notes backwards -- the damaging stuff is usually at the back*
 - b) *Read the Notes to the financials. NEVER BUY A STOCK WITHOUT READING THE NOTES TO THE FINANCIAL STATEMENTS.*

XIV. Stock Selection for the Defensive Investor [p 347]

- A. Two approaches
 - 1. Go with the DJIA type portfolio.

2. Apply standards for a minimum quality and minimum quantity in terms of earnings and assets per dollar of price.
- B. The Graham tests:
1. Adequate size of the company - not less than \$100 million of annual sales.
 2. Strong Financial Condition - current assets (and current asset ratio) should be 2 to 1.
 3. Earnings stability - some earnings for the common stock for each year in the past 10.
 4. Dividend record -- uninterrupted for 20 years.
 5. Earnings growth -- minimum increase of 1/3 in per-share earnings in the past 10 years using 3 year averages at the beginning and end.
 6. Moderate PE ratio -- current price should not be more than 15 times earnings of the past 3 years (Zweig thinks that today, Graham might go 17 times average of last 3 years).
 7. Moderate ratio of price to assets -- not more than 1.5 times the book value last reported.
- C. Two investment approaches
1. investment by prediction is a fool's errand.
 2. investment by protection is best -- protection from overpaying for a stock and overconfidence in your own judgment on quality of stock.
- D. Commentary [p 367]:
1. Low cost index fund is the best tool ever created for low-maintenance stock investing. Any effort to improve on it takes ore work and incurs more risk and higher costs than a truly defensive investor can justify. [p 367]
 2. If you won't be persuaded, then consider making it the foundation of your portfolio with 90% of your stock money in the index fund and only 10% for stock picking.
 3. An updated review of Graham's criteria for stock selection:
 - a) *Adequate Size -- more than \$2 billion in market capitalization* [Note: Above Zweig says \$10 billion is equivalent to Graham's "big companies"]
 - b) *Strong financial condition*
 - (1) 2 to 1 current ratio
 - (2) long term debt does not exceed working capital (isn't this a quick ratio of 1 to 1?)
 - c) *Earnings stability -- requirement for some earnings in each of*

- the last 10 years eliminates the chronic losers*
- d) *Dividend record -- no fewer than 255 companies in the S&P 500 had paid a dividend for 20 years in a row, and 57 had raised the dividend for 25 consecutive years.*
 - e) *Earnings growth -- Graham's test of increasing earnings by 1/3 over 10 years is a very modest 3% per year. Seems that cumulative growth over 10 years should be at least 50% over the 10 year period, or 4% average annual rise per year.*
 - f) *Moderate PE -- Graham likes 15 times average earnings for the past 3 years.*
 - g) *Moderate price to book -- Graham likes a price to book ratio of no more than 1.5. This is more problematic today as more companies have intangibles such as goodwill from acquisitions and most companies are priced higher than multiples of Graham's day.*
 - h) *Graham had an alternate test of multiplying PE ratio by the price to book ratio and seeing if the resulting number is below 22.5. If so, it passes the test.*

XV. Stock Selection for the Enterprising Investor [p 376]

- A. Goal: consider possibilities and means for the investor to make individual selections which are likely to prove profitable--above average.
- B. What are the prospects of this?
 - 1. Grave reservations about the ability to do it.
 - 2. Intuitively, it would seem that it should be easy to beat the DJIA average performance.
 - 3. But, there is considerable and impressive evidence that it is very hard to do this, even when the credentials of those trying are the highest.
 - 4. It is daunting that all common stock funds failed over a long span of years to earn quite as good a return as was shown on the Standard & Poor's 500 stock averages or the market as a whole. This conclusion has been substantiated by several comprehensive studies. [p 377]
 - 5. The failure of the funds to better the broad average is conclusive evidence that such an achievement is not easy, and is extremely difficult.
 - 6. Why such a lack of success?
 - a) *The work of the security analyst must be highly ineffective, because he is trying to predict the unpredictable.*
 - b) *Or, perhaps, the security analysts are handicapped by a flaw in their approach, They select industries with the best*

prospects for growth, and then those companies in those industries with the best management and other advantages. The implication is that they will buy into these companies at any price, and will avoid less promising companies and industries no matter how cheap. But this procedure only works if the projected earnings and growth is accurate and will continue indefinitely into the future.

- c) *"The truth is contrary. Very few companies have been able to show a high rate of uninterrupted growth for long periods of time."*
- d) *Conclusion: If the undertaking of beating the average can be successful, it must take specific methods that are contrary to what Wall Street does.*

7. The Graham-Newman methods:

- a) *Description of various value investment concepts such as arbitrages, hedges, purchase of companies for less than net current asset value, secondary companies etc.*
- b) *Winnowing stock guide [p 385]*

C. Commentary [p 396]

- 1. For most investors, selecting individual stocks is unnecessary--if not inadvisable. The fact that most professionals do a poor job of stock picking does not mean that most amateurs can do better.
- 2. See discussion of "From EPS to ROIC" at p 398.
 - a) *ROIC = Owner Earnings / Invested Capital*
 - b) *ROIC of at least 10% is attractive. Even 6-7% is tempting if the company has good brand names, focused management or is under a temporary cloud.*
 - c) *Owner Earnings is equal to:*
 - (1) operating profit
 - (2) plus depreciation
 - (3) plus amortization of goodwill and similar items
 - (4) minus federal income tax (paid at company's average rate)
 - (5) minus cost of stock options
 - (6) minus "maintenance" (or essential) capital expenditures
 - (7) minus income generated by unsustainable rates of return on pension funds (at 2003, anything in excess of 6.5%)
 - d) *Invested Capital is equal to*
 - (1) total assets
 - (2) minus cash (and short term investments and non-interest bearing current liabilities)
 - (3) plus past accounting charges that reduced invested

capital

3. Are the company's managers people who think like owners:
 - a) *Are the financials easy to understand or full of obfuscation?*
 - b) Are the nonrecurring or extraordinary or unusual charges just that or do they keep recurring?
 - c) *Does management act like a good partner with good communication?*
 - (1) what do they say? what do they do?
 - (2) do they focus on the business or are they focused on promotion?

XVI. "Margin of Safety" as the Central Concept of Investment

- A. "Confronted with the challenge to distill the secret of sound investment into three words, we venture the motto, MARGIN OF SAFETY."
- B. Applying the Margin of Safety to Stocks would seem to work with Growth Stocks.
 1. The growth stock buyer relies on expected earning power that is greater than that for the average shown in the past, and substitutes expected earnings for the past record in calculating his margin of safety expected earnings in excess of those projected. This could work if the calculation of the future is conservatively done, and it shows a satisfactory margin in relation to the price paid.
 2. The danger in the growth stock program is that such favored issues have a tendency to set prices that will not be adequately protected by a conservative projection of future earnings. The margin of safety is always dependent on the price paid. [p 317]
- C. Diversification is related to margin of safety but different.
 1. Even with a margin of safety in the investor's favor, the investment may go badly.
 2. A margin of safety is not a guaranty, it simply provides a better chance for profit than from loss.
 3. But as the number of investments increases, it becomes more likely that in the aggregate there will be a profit--the basis of insurance underwriting.
- D. A criterion of investment vs. speculation:
 1. many see no benefit in distinguishing the investor from the speculator.
 2. Graham disagrees -- he believes the margin of safety may be "the touchstone to distinguish an investment operation from a speculative one."
 3. The speculator believes the odds are in their favor when they take

their chance and they might claim a margin of safety as a result from a propitious time, skill in analysis, adviser or system, etc. But these claims are unconvincing.

4. The investor's concept of a margin of safety rests upon a simple and definite arithmetical reasoning from statistical data.
 - a) *There is no guarantee that the fundamental quantitative approach will be successful in the future, but no reason for pessimism.*
 - b) *"To have a true investment there must be present a true margin of safety."*
5. "It is our argument that a sufficiently low price can turn a security of mediocre quality into a sound investment opportunity--provided that the buyer is informed and experienced and that he practices adequate diversification. For if the price is low enough to create a substantial margin of safety, the security thereby meets our criterion of investment."

E. Summary

1. Investment is most intelligent when it is most businesslike.
2. Every corporate security may best be viewed as an ownership interest in, or a claim against a specific business enterprise ... and the investor seeking to make profits from his security purchases and sales, is embarking on a business venture which must be run in accordance with accepted business principles.
3. Principles of business
 - a) *know your business -- for the securities investor, this means do not try to make "business profits" out of securities--that is returns in excess of normal interest and dividend income.*
 - b) *do not let anyone else run your business unless you can adequately supervise, and you have unusually strong reason to have confidence in the integrity and ability of the person.*
 - c) *do not enter upon an operation unless a reliable calculation shows that it has a fair chance to profit-- not based on optimism, but on arithmetic.*
 - d) *have the courage of your knowledge and experience.*