



AndersonGriggs

“Common Sense Investing for Intelligent Investors”

Monthly Letter to Our Clients and Friends The Forgotten Benjamin Graham

Complimentary Copy

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On February 16th I will be making a short trip to Atlanta to listen, critique, and judge the merits of student analyst teams from the University of Georgia, Georgia State University, Wofford College and Emory University. The teams from these four centers of higher learning are finalists in the Southern Classic Investment Research Challenge. The winners will be heading to New York for the next round of competition, and will find themselves one step closer to the ultimate goal of representing the Americas in Hong Kong, where they will be competing in the finals of this year’s Global Investment Research Challenge sponsored by the CFA Institute.

The Challenge gives the students real world experience in research, analysis, and report presentations of a public company in the role they will eventually play, securities analysts. Given that the pay and benefits package of a brokerage firm analyst exceeds that of the average practicing physician in this country, entry level positions in this field are highly competitive. Participating in the Challenge helps students show firms looking to fill positions that they are not only serious about the profession, but that they take the extra steps necessary to be the best. **Employers also understand that, as the CFA Institute says, “Where else but in our colleges and universities can you find the best and brightest minds of the next generation in the investment profession?”**

From what I have gathered, there will be five panelists. I am excited to participate in this, as the CFA Institute states that the schools are “evaluated by high-profile panels of heads of research, portfolio managers, and chief investment officers from the world’s top firms.” I am looking forward to meeting these high-profile individuals; however, I worry that they may be a bit disappointed when they find out a low-profile participant has snuck in amongst them. Here’s a hint at who that may be: his initials are KJA.

While I am excited about meeting these extraordinary individuals, I believe the real joy will come from seeing young people who are full of energy and the belief that they can change the world. It is this universal belief of youth that assures us the future will be better, and even this low-profile portfolio manager remembers his early years when ideas could cause stomach butterflies to spring into dance.

My initial foray into the world of financial analysis came by chance, when I happened to pick up a book written by Benjamin Graham. Unbeknownst to me at the time, Benjamin Graham had already earned the title, “Father of Security Analysis” and was instrumental in the creation of the National Federation of Financial Analysts Societies, the forerunner to this day’s CFA Institute. This little book, entitled *Interpretation of Financial Statements*, was published in 1937. I am sure you are wondering how a book about financial statements could actually be exciting, but it was to me. I had begun my pursuit of a college degree majoring in accounting, but economics pulled me away. The early classes emphasized the creation, not the use, of financial statements. This little book offered me the understanding I needed to bridge the gap between the use of a company’s past results in the science of accounting and the art of investing through expectations of the future.

Of course, once I was introduced to Benjamin Graham with this initial find, I had to read his other classic works, including *The Intelligent Investor*, as well as multiple editions of *Security Analysis*. Using these sources, I tried my hand at pure, long-only, deep-value investing in common stocks. After all, Warren Buffet, John Templeton, Walter Schloss, Seth Klarman and many others took lessons from Graham and became rich, famous, or both. However, my results were not that good. The securities ultimately worked out, but I discovered that the time frame required by most individuals for positive results is closer to about a month rather than a few years. I found myself with unhappy clients and with dashed hopes of becoming one of the rich and famous.

The Forgotten Benjamin Graham

When professional investors discuss Ben Graham, they note his expertise in finding opportunities within price discrepancies based on some method of arbitrage, in finding a bargain issue or special situation, and in benefiting from contrarian investing. They talk of his “margin of safety” and his quantitative investment methods, laid down in his “Last Will and Testament” article published in Forbes magazine way back in 1977. As Benjamin Graham himself states, the goal is “to obtain better than average investment results over a long pull.” There is no doubt that many investors have been able to do this well. **What is seldom discussed is the approach that Graham encouraged for defensive investors.**

Risk

It is Graham's work on behalf of the individual investor that I find pertinent to share with you. In order to relate accurately Graham's thoughts on risk and his guidance in common stock selection and portfolio policy, I have dusted off my fourth revised edition of *The Intelligent Investor*. **Let's start with his concept of risk which has long been abandoned by the majority of professional investors:**

...the bona fide investor does not lose money merely because the market price of his holdings declines; hence the fact that a decline may occur does not mean that he is running a true risk of loss. If a group of well-selected common-stock investments shows a satisfactory over-all return, as measured through a fair number of years, then this group of investments has proved to be "safe." During that period its market value is bound to fluctuate, and as likely as not it will sell for a while under the buyer's cost. If that fact makes the investment "risky," it would then have to be called both risky and safe at the same time. This confusion may be avoided if we apply the concept of risk solely to a loss of value which either is realized through actual sale, or is caused by a significant deterioration in the company's position—or, more frequently perhaps, is the result of the payment of an excessive price in relation to the intrinsic worth of the security."

What is important to understand from this passage is that risk is independent of market volatility. For a conservative investor, the three primary things to consider before investing in common stocks are the time our funds can be invested before they are needed, the quality and safety of each individual company's financial position, and the price paid for the ownership interest itself. **Contrast this with your own thoughts on risk and the overpowering influence that market volatility may play in your decisions to buy, sell or hold.**

On Portfolio Policy for Conservative Investors

How much of our funds should we put in common stocks, bonds, cash or the multitude of other "alternatives?" This is a question each of us must answer, and the result is our own personal portfolio policy. **With the cheap computing power available today, company after company offers you the "right" mix of stocks, bonds, and cash for free.** All you have to do is answer a few questions such as: "How would you feel if the market declined 20%? What are your thoughts on inflation? What is your goal?" I'll give my answers to these questions, and we'll see how closely they mirror your own. If the market declined 20%, I would feel absolutely rotten. I don't like inflation, but a little of it is okay. My goal is to have enough money to live on. The fact is, no one wants to lose money, whether they can afford it or not. If we could accurately determine what the inflation rate will be, then we would be in Washington DC advising the

President on economic policy. And without knowing what the cost of living will be or how long we will live, setting a monetary goal of “enough money” is not possible.

Market timing has always been a popular investment approach for many individuals. After all, anyone can look at a chart of the Dow Jones Industrial Average and see that buying when the market is low and selling when it is high can result in high returns with very little risk. The problem is that no one has determined how to do this yet, but this has not stopped people from trying. However, end results are often far worse than they would have been if the investments had been kept over time. Benjamin Graham understood the appeal of market timing, and also believed that markets become both overvalued and undervalued. However, markets can stay overvalued or undervalued much longer than any of us can imagine. **His approach was as simple as it is logical: never be completely out of stocks, or completely out of bonds. Once again from *The Intelligent Investor*:**

“We have suggested as a fundamental guiding rule that the investor should never have less than 25% or more than 75% of his funds in common stocks, with a consequent inverse range of between 75% and 25% in bonds. There is an implication here that the standard division should be an equal, or 50-50, between the two major investment mediums. According to tradition the sound reason for increasing the percentage in common stocks would be the appearance of the “bargain price” levels created in a protracted bear market. Conversely, sound procedure would call for reducing the common-stock component below 50% when in the judgment of the investor the market level has become dangerously high”.

This simple policy, if applied with, say, an annual rebalancing, would serve most of us better than 90% of the computer generated allocations we may get our hands on. Yet in order to serve us well, we would have to continue to follow it, and often, human nature gets in the way. This is how Ben described it:

“These copybook maxims have always been easy to enunciate and always difficult to follow—because they go against that very human nature which produces the excess of bull and bear markets. It is almost a contradiction in terms to suggest as a feasible policy for the average stockowner that he lighten his holdings when the market advances beyond a certain point and add to them after a corresponding decline. It is because the average man operates, and apparently must operate; in opposite fashion that we have had the great advances and collapses of the past; and this writer believes we are likely to have them in the future.”

How right he was, as the market crashed in 1973 just one year after this edition was published. And how can we forget the market crash of 1987, 2000 or, fresh in our memories, the bear

market of 2007 through the spring of 2009? **Buying during times of stress isn't something the average person can do, yet how much better off would each of us be if we had sold some bonds and bought some stock in 1974, 1988, 2001, or last year?**

On Common Stocks for Conservative Investors

For many of us, common stock and the word “conservative” seems to be a contradiction. But given Benjamin Graham’s definition of risk, common stocks can be conservative. Not all common stocks, but those companies large and powerful enough to dominate an industry. Ben described these companies using the words large and prominent. Here is what he said:

“The words “large” and “prominent” carry the notion of substantial size combined with a leading position in the industry. Such companies are often referred to as “primary”; all other common stocks are then called “secondary,” except that growth stocks are ordinarily placed in a separate class by those who buy them as such. “

He does recommend a minimum size, based on assets and revenue, of \$50 million. Of course times have changed since 1972. We would recommend a minimum of \$5 billion in assets and revenues today. However, Graham adds this comment concerning his recommendations:

“It would be foolish, however, to insist upon such arbitrary criteria. They are offered merely as guides to those who may ask for criteria. They are offered merely as guides to those who may ask for guidance. But any rule which the investor may set for himself and which does no violence to the common-sense meanings of “large” and “prominent” should be acceptable. By the very nature of the case there must be a large group of companies that some will and others will not include among those suitable for defensive investment. There is no harm in such diversity of opinion and action. In fact, it has a salutary effect upon stock-market conditions, because it permits a gradual differentiation or transition between the categories of primary and secondary stock issues.”

Some final thoughts

In 1928, Benjamin Graham began a 28-year stint as a lecturer at Columbia’s School of Business Administration. One day each week, he taught a two-hour night course. He believed that a teacher should never supply an answer to a question. Instead, a teacher should encourage students to search for the answer, which would aide in creating a memory that could be useful for years to come. This style of teaching seemed to have worked, at least according to his most famous student, Warren Buffett. **Today, *Security Analysis* is no longer a required textbook for individuals seeking a career in financial services. Although updates, new commentary, and**

case studies have been added to the book, it seems to have lost its appeal in higher education.

In a short time, I will take my place on a panel to pass judgment on the analytical abilities of a group of eager youth. I am sure they will be well prepared with presentations that will bring respect to both themselves and their schools. If and when they become practicing analysts, I hope that they will stumble across a copy of Security Analysis and reap the benefits that are contained in its pages. The sixth edition sits on my bookshelf, its first couple of pages devoted to praise for its latest edition. I wanted to share this one with you:

“No book empowers you with better tools for intelligent investing than Security Analysis. Seth Klarman and his fabulous team have produced a nonpareil edition of Ben Graham’s classic for the new millennium.”
-Mason Hawkins, Chairman, Longleaf Partners, Southeastern Asset Management

Until next time,

Kendall J. Anderson, CFA

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