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“Common Sense Investing for Intelligent Investors”

Monthly Letter to Our Clients and Friends

The Southern Classic IRC - A Reason for Ben Graham to Smile Can Share Prices Diverge from Value?

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A Bit of History

Today in the field of investing, the glory is bestowed upon the salespeople of financial services, just as it was 85 years ago. Wealth, power and recognition go hand in hand with a firm’s ability to raise money from investors. Money and rewards are showered upon those individuals who can “market and sell,” which are integral to a successful financial services business. Yet the salespeople cannot make the business successful by themselves.

Two of the earliest societies of the Financial Analysts Federation began in Chicago and San Francisco back in the 1920’s. They were formed for two primary motives, the first being a purely social reason; the analysts wanted to get together with others who shared a passion for investing. The second motive, however, was a source for information and knowledge. As explained in Timothy Jacobson’s book *From Practice to Profession – A History of the Financial Analysts Federation and the Investment Profession*, published in 1997:

.....While the salesmen were unquestionably the glamour boys of the era, the essential scutwork belonged to the back-office moles whose job it was to keep the salesmen informed of what was what, and who probably knew the most about existing investment vehicles and increasingly numerous new issues. It could be a lonely, discouraging job. With much of the published material commonly out of date or incomplete (balance sheets typically showed no more than a comparison of current assets and current liabilities), these early practitioners relied naturally on personal contact with others in the same line of work to exchange ideas and information about bond and equity markets and the economy in general.

All these years later, the world has not changed all that much. The current societies of the CFA Institute still meet regularly to socialize with others of like mind. The glory is still bestowed upon salesman, while the majority of the back-office moles are hidden from view. The CFA society meetings are one of the best ways for us “back-office moles” to learn new ideas and to share information. Continuous learning is one of the hallmarks of any profession and academic institutions have shared and encouraged the teaching of financial analysis throughout its history. Benjamin Graham was the first to pursue an association between academia and the financial analysis profession when he began teaching an

investment course at Columbia University in the 1930's. However, The Boston Society was the first to formalize this relationship, in conjunction with Northeastern University and Boston University in 1947. From another passage of *From Practice to Profession – A History of the Financial Analysts Federation and the Investment Profession*

.....That first offering, which carried a full degree-credit, was titled “Applied Security Analysis – The Industrial Approach.” Though eventually supplanted by in-house programs, the early Boston liaison with academia foretold later engagements when the larger national organization sought to advance standards of practice effectively and conspicuously. It was also common in Boston, and in other societies, to try to enroll in their membership local academic specialists in business administration and economics who, it was hoped, would carry back to their students a practical understanding of what security analysis was all about and how analysts actually went about doing their work.

The Global Investment Research Challenge

The CFA Institute is working diligently to enhance this relationship with today's colleges and universities through its sponsorship of the Global Investment Research Challenge. Participation in the Global IRC exposes students to the profession of security analysis and the real world of equity research. Before I discuss the challenge in more detail, I would first like to share a few of my thoughts to the current educators and students of financial analysis.

For Educators

Over the past decade many universities and colleges have created a wealth management and/or personal financial planning focus within their Finance programs. This is understood given the perceived demand for personal financial planning and advice. In practice, the majority of wealth managers and financial planners of today are generalists, whose primary functions do not include the day to day management of investment portfolios. Many practicing planners may take offense at this statement, yet the majority of planners outsource investment management to a product provider: i.e. a mutual fund, a separately managed account, an insurance company, a hedge fund, a private equity fund of funds or any number of other devices. Given this use of products, it is easy for me to see why your investment training is directed towards the selection and monitoring of managers. But if your courses are designed to educate your students on the use of products for the implementation of a plan, should you not also consider training the “back-office moles” that are necessary for the construction and management of the products themselves? I advise you all to participate in the CFA Institutes Global Investment Research Challenge (Global IRC) as a starting point for the adoption of a curriculum focused for financial analysts.

In addition to the selection and monitoring of managers, you may also be offering courses that teach your students portfolio designs that are based on “modern portfolio theory.” MPT places emphasis on higher level mathematics and has very little to do with analyzing the merits of investing in an operating business. This brings up another question. Do you think it is wise to teach a concept based on the beliefs that the past predicts the future, that risk control can be eliminated through diversification, that there is such a thing as an “efficient market” and ignore the possibility that the price set by the market can diverge from business value? You can easily make a commitment to equalize MPT by participating in the Global IRC.

For Students

There is a great opportunity for you in the world of investment advice and portfolio management.

Many of you have what it takes to be an analyst or portfolio manager, but are at a loss as to how to pursue the career. If you are interested in becoming a financial analyst, in lieu of wealth management or financial planning, my advice to you is to participate in the Global IRC. It will be the most valuable real world applicable training available to you. If your school is not a sponsor of the Global IRC, then approach someone at the school and request your schools participation. If this leads to rejection, then locate a local CFA society and seek some help. A financial analyst position is by far a more difficult and challenging roll in investment management, but it is also one of the most rewarding in the field.

The Southern Classic Investment Research Challenge

On February 26th I took a trip to the campus of Georgia State University in Alpharetta, Georgia to judge the finals of this year's Southern Classic Investment Research Challenge, the regional administration of the Global Investment Research Challenge.

This year teams came from The Citadel, Clark Atlanta University, Coastal Carolina University, Furman University, Georgia Institute of Technology, Georgia State University, the University of Georgia, the University of South Carolina and Wofford College. Each prepared an analysis of Global Payments, Inc and worked for an entire semester to create a written analysis and an oral presentation with a buy, sell or hold recommendation on the company. The team members were aided by a faculty advisor and a CFA credentialed investment professional.

The University of Georgia was our regional winner, and will take a trip to Omaha, Nebraska to compete for champion of the Americas. If they win there, then they would compete the following day in the Global finals. Congratulations to P.J. Bullock, Jeremy Wilson, Tim Ludwick and Stephen Price, members of this year's winning team from all of us at Anderson Griggs. I know you will do a great job. And please remember to give Warren my regards.

I was simply amazed at the knowledge and professionalism of all the students. Although I only had an opportunity to judge the three finalists, The University of Georgia, Georgia State University and our home team from South Carolina, Wofford College, I got a chance earlier in the day to hear the presentations of a couple others. The ability and skill these young people possess are exemplary, and Justin should consider hiring one or two of them when needed. It would be a much wiser approach than having to compete with them in the future.

I found myself proud of the students and their presentations, as well as their advisors and mentors, but my fellow judges just intimidated me. My Mom use to tell me that I was as good as everyone else. Well Mom, I know that maybe I am as good as everyone else in your mind, but I just met with a few individuals that would give you some thoughts to the contrary. They included talented professionals from GLOBALT Investments, INVESCO Global Strategies, Montag & Caldwell , Wilmington Trust Investment Management, Ridgeworth Investment, Iron Capital Advisors, Sun Trust Bank, Wells Fargo Securities, ZWJ Investment Counsel and Barclays Capital, and could just about buy the States of Georgia and South Carolina combined with their personal check books. The CFA Societies in South Carolina and Atlanta must have pulled in some markers to get these individuals to spend a day with a group of students.

The Reason Ben Graham is Smiling

Bernard Baruch, a native South Carolinian, was the world's most famous investor in the first half of the twentieth century. Baruch was at that time one of the richest men in the world. He tried with all his power and influence to make young Ben Graham (at the time 35 years old) his partner. Dr. Graham turned him down. Just think about this for a minute. It would be the same as you or me receiving an invitation from Mr. Warren Buffett to be his partner. How many of you could turn that offer down, whether you know anything about investing or not?

Well, it is a good thing Dr. Graham turned down the great man, as he went on to teach his views on the opportunities that markets create to Mr. Buffett and others: John Templeton, Walter Schloss, Irving Kahn, Sr. to name just a few. His writing influenced an all-star cast of portfolio managers including Michael Price, Seth Klarman and their mentor Max Heine. The folks at Tweedy Browne, Longview Partners and the group at Sequoia including the 2010 Morningstar Domestic-Stock Fund Managers of the Year Bob Goldfarb and David Poppe, count Dr. Graham as a major contributor to their work. There are so many more that the club Mr. Buffett started many years ago, The Superinvestors of Graham-and – Doddsville just continues to grow.

Yes if Ben was still with us he would surely be smiling as he thinks about the students participating in the Global IRC. The reason is that he had a common bond with these students. Long before he entered the teaching arena, long before he became rich and famous as an investor, he was like these students, curious about financial analysis and sought out ways to learn the profession. After his retirement in 1963, there was a bit of a squabble over which financial analyst society was the first in the country. He joined into the fracas with these remarks:

“My memory carries me back to the New York Society of Financial Statisticians. It was formed in 1916 under the aegis of Professor Gertenberg of NYU, then a leader in the general field of finance.

“I attended the organization meeting and was chagrined to learn that it was proposed to restrict membership to those over the age of 24. This would have excluded me. So I made a rather impassioned appeal on behalf of those whose ‘only crime was their youth.’ The proposed by-laws were then changed amid some laughter and I was allowed to become a member. (It is difficult to believe now that I was ever so young.)”

Can Share Price Diverge from Value?

The belief that share prices can at times diverge from underlying business value is the driving force behind security analysis as practiced by active investment managers. My example is not to lay out a case to buy or sell shares of IBM. Instead, it is to look at the value the market has placed on IBM over many years and let you decide if the price has diverged from the value of IBM as a business. To be fair, and to honor the many professional investors and students of investing who do not believe in active management, I at least need to give you their beliefs. This view is 180° from our example and is based on the belief that markets are efficient. The Efficient Market Hypothesis has three forms, which are weak, semi-strong and strong. The weak form states that the market sets the prices for stocks, bonds and property accurately as the current price reflects all known information. The semi-strong form adds all

past information and states that new information is immediately reflected in the current share price. The strong form says that the price the market sets is always right because it contains all known and unknown information. In simple terms, the market sets prices accurately; therefore, prices will not or cannot diverge from value.

A short description of IBM:

International Business Machines (IBM) is one of the world's largest suppliers of advanced information processing technology, communication systems, services and program products. IBM's expertise is used to find customized solutions for business within its major segments – Global Technology Services, Global Business Services, Systems & Technology, Software, and Global Financing.

A Few Facts About IBM's Share Price and Business Results

Calendar Year	Low Price	High Price	%Change in Share Price from Low	\$ Change in Market Value of Equity (Billions)	Dividends paid per share	Earnings Per Share	Sales Per Share
2000	80.1	134.9	68.4%	\$96.6	\$0.51	\$4.44	\$50.14
2001	83.8	124.7	48.8%	\$70.4	\$0.55	\$4.35	\$49.83
2002	54.0	126.4	134.1%	\$124.7	\$0.59	\$3.95	\$47.14
2003	73.2	94.5	29.1%	\$36.1	\$0.63	\$4.34	\$52.60
2004	81.9	100.4	22.6%	\$30.4	\$0.70	\$5.05	\$58.52
2005	71.9	99.1	37.8%	\$42.8	\$1.10	\$6.01	\$60.69
2006	72.7	97.9	34.7%	\$38.0	\$1.50	\$7.18	\$71.31
2007	88.8	121.5	36.8%	\$45.3	\$1.50	\$7.18	\$71.31
2008	69.5	130.9	88.4%	\$82.2	\$1.90	\$8.93	\$77.39
2009	81.8	132.9	62.5%	\$66.7	\$2.15	\$10.01	\$73.36
2010	116.0	147.5	27.2%	\$38.8	\$2.50	\$11.52	\$81.19
Selected Averages			53.7%	\$61.1			

You Decide – Can an Individual Company's Price Diverge from Value?

Maybe I'm a bit naive in my views. Many PhDs along with a number of Nobel Prize Winners would surely believe that I am. What they would tell me is that I spend my time looking at individual companies and disregard the market. If I took the time to look at the overall market I would see that prices are set properly.

Maybe they are right, yet my response is, so what! I do not have enough money to buy all the stocks in the world. I suppose I could buy a mutual fund that states they are representative of the entire market. Buy why should I expose my clients' wealth, or my own, to the ultimate risk of buying something I cannot begin to analyze? Especially when I can see very clearly that the market is constantly making mistakes on the value of individual companies.

Looking at the above facts concerning IBM the question I put forward is; Why would the market value of one of the most powerful and necessary companies in the world, IBM, change on average every year by over 50%?

The fact is that company after company experiences this same amount of divergence of value from price year after year. This is why I can state with certainty that prices at the individual company level do diverge from value. This is why we concentrate the majority of our research efforts on individual companies. This is where the opportunity exists.

Until next time,

Kendall J. Anderson, CFA

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