clients. The Wall Street brokerage fraternity has probably the highest ethical standards of any *business,* but it is still feeling its way toward the standards and standing of a true profession.*

In the past Wall Street has thrived mainly on speculation, and stock-market speculators as a class were almost certain to lose money. Hence it has been logically impossible for brokerage houses to operate on a thoroughly professional basis. To do that would have required them to direct their efforts toward reducing rather than increasing their business.

The farthest that certain brokerage houses have gone in that direction—and could have been expected to go—is to refrain from inducing or encouraging anyone to speculate. Such houses have confined themselves to executing orders given them, to supplying financial information and analyses, and to rendering opinions on the investment merits of securities. Thus, in theory at least, they are devoid of all responsibility for either the profits or the losses of their speculative customers.†

Most stock-exchange houses, however, still adhere to the old-time slogans that they are in business to make commissions and that the way to succeed in business is to give the customers what they want. Since the most profitable customers want speculative advice and suggestions, the thinking and activities of the typical firm are pretty closely geared to day-to-day trading in the market. Thus it tries hard to help its customers make money in a field where they are condemned almost by mathematical law to lose in the end.‡ By this we mean that the speculative part of their operations cannot be profitable over the long run for most brokerage-

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* Overall, Graham was as tough and cynical an observer as Wall Street has ever seen. In this rare case, however, he was not nearly cynical enough. Wall Street may have higher ethical standards than *some* businesses (smuggling, prostitution, Congressional lobbying, and journalism come to mind) but the investment world nevertheless has enough liars, cheaters, and thieves to keep Satan's check-in clerks frantically busy for decades to come.

† The thousands of people who bought stocks in the late 1990s in the belief that Wall Street analysts were providing unbiased and valuable advice have learned, in a painful way, how right Graham is on this point.

‡ Interestingly, this stinging criticism, which in his day Graham was directing at full-service brokers, ended up applying to discount Internet brokers in the

house customers. But to the extent that their operations resemble true investing they may produce investment gains that more than offset the speculative losses.

The investor obtains advice and information from stock-exchange houses through two types of employees, now known officially as "customers' brokers" (or "account executives") and financial analysts.

The customer's broker, also called a "registered representative," formerly bore the less dignified title of "customer's man." Today he is for the most part an individual of good character and considerable knowledge of securities, who operates under a rigid code of right conduct. Nevertheless, since his business is to earn commissions, he can hardly avoid being speculation-minded. Thus the security buyer who wants to avoid being influenced by speculative considerations will ordinarily have to be careful and explicit in his dealing with his customer's broker; he will have to show clearly, by word and deed, that he is not interested in anything faintly resembling a stock-market "tip." Once the customer's broker understands clearly that he has a real investor on his hands, he will respect this point of view and cooperate with it.

The financial analyst, formerly known chiefly as security analyst, is a person of particular concern to the author, who has been one himself for more than five decades and has helped educate countless others. At this stage we refer only to the financial analysts employed by brokerage houses. The function of the security analyst is clear enough from his title. It is he who works up the detailed studies of individual securities, develops careful comparisons of various issues in the same field, and forms an expert opinion of the safety or attractiveness or intrinsic value of all the different kinds of stocks and bonds.

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late 1990s. These firms spent millions of dollars on flashy advertising that goaded their customers into trading more and trading faster. Most of those customers ended up picking their own pockets, instead of paying someone else to do it for them—and the cheap commissions on that kind of transaction are a poor consolation for the result. More traditional brokerage firms, meanwhile, began emphasizing financial planning and "integrated asset management," instead of compensating their brokers only on the basis of how many commissions they could generate.

By what must seem a quirk to the outsider there are no formal requirements for being a security analyst. Contrast with this the facts that a customer's broker must pass an examination, meet the required character tests, and be duly accepted and registered by the New York Stock Exchange. As a practical matter, nearly all the younger analysts have had extensive business-school training, and the oldsters have acquired at least the equivalent in the school of long experience. In the great majority of cases, the employing brokerage house can be counted on to assure itself of the qualifications and competence of its analysts.*

The customer of the brokerage firm may deal with the security analysts directly, or his contact may be an indirect one via the customer's broker. In either case the analyst is available to the client for a considerable amount of information and advice. Let us make an emphatic statement here. The value of the security analyst to the investor depends largely on the investor's own attitude. If the investor asks the analyst the right questions, he is likely to get the right—or at least valuable—answers. The analysts hired by brokerage houses, we are convinced, are greatly handicapped by the general feeling that they are supposed to be market analysts as well. When they are asked whether a given common stock is "sound," the question often means, "Is this stock likely to advance during the next few months?" As a result many of them are com-

* This remains true, although many of Wall Street's best analysts hold the title of chartered financial analyst. The CFA certification is awarded by the Association of Investment Management & Research (formerly the Financial Analysts Federation) only after the candidate has completed years of rigorous study and passed a series of difficult exams. More than 50,000 analysts worldwide have been certified as CFAs. Sadly, a recent survey by Professor Stanley Block found that most CFAs ignore Graham's teachings: Growth potential ranks higher than quality of earnings, risks, and dividend policy in determining P/E ratios, while far more analysts base their buy ratings on recent price than on the long-term outlook for the company. See Stanley Block, "A Study of Financial Analysts: Practice and Theory," *Financial Analysts Journal*, July/August, 1999, at www.aimrpubs.org. As Graham was fond of saying, his own books have been read by–and ignored by–more people than any other books in finance.

pelled to analyze with one eye on the stock ticker—a pose not conducive to sound thinking or worthwhile conclusions.*

In the next section of this book we shall deal with some of the concepts and possible achievements of security analysis. A great many analysts working for stock exchange firms could be of prime assistance to the bona fide investor who wants to be sure that he gets full value for his money, and possibly a little more. As in the case of the customers' brokers, what is needed at the beginning is a clear understanding by the analyst of the investor's attitude and objectives. Once the analyst is convinced that he is dealing with a man who is value-minded rather than quotation-minded, there is an excellent chance that his recommendations will prove of real overall benefit.

The CFA Certificate for Financial Analysts

An important step was taken in 1963 toward giving professional standing and responsibility to financial analysts. The official title of chartered financial analyst (CFA) is now awarded to those senior practitioners who pass required examinations and meet other tests of fitness.[1] The subjects covered include security analysis and portfolio management. The analogy with the long-established professional title of certified public accountant (CPA) is evident and intentional. This relatively new apparatus of recognition and control should serve to elevate the standards of financial analysts and eventually to place their work on a truly professional basis.†

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* It is highly unusual today for a security analyst to allow mere commoners to contact him directly. For the most part, only the nobility of institutional investors are permitted to approach the throne of the almighty Wall Street analyst. An individual investor might, perhaps, have some luck calling analysts who work at "regional" brokerage firms headquartered outside of New York City. The investor relations area at the websites of most publicly traded companies will provide a list of analysts who follow the stock. Websites like www.zacks.com and www.multex.com offer access to analysts' research reports—but the intelligent investor should remember that most analysts do not analyze businesses. Instead, they engage in guesswork about future stock prices.

† Benjamin Graham was the prime force behind the establishment of the CFA program, which he advocated for nearly two decades before it became a reality.

Dealings with Brokerage Houses

One of the most disquieting developments of the period in which we write this revision has been the financial embarrassment—in plain words, bankruptcy or near-bankruptcy—of quite a few New York Stock Exchange firms, including at least two of considerable size.* This is the first time in half a century or more that such a thing has happened, and it is startling for more than one reason. For many decades the New York Stock Exchange has been moving in the direction of closer and stricter controls over the operations and financial condition of its members—including minimum capital requirements, surprise audits, and the like. Besides this, we have had 37 years of control over the exchanges and their members by the Securities and Exchange Commission. Finally, the stock-brokerage industry itself has operated under favorable conditions—namely, a huge increase in volume, fixed minimum commission rates (largely eliminating competitive fees), and a limited number of member firms.

The first financial troubles of the brokerage houses (in 1969) were attributed to the increase in volume itself. This, it was claimed, overtaxed their facilities, increased their overhead, and produced many troubles in making financial settlements. It should be pointed out this was probably the first time in history that important enterprises have gone broke because they had more business than they could handle. In 1970, as brokerage failures increased, they were blamed chiefly on "the falling off in volume." A strange complaint when one reflects that the turnover of the

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* The two firms Graham had in mind were probably Du Pont, Glore, Forgan & Co. and Goodbody & Co. Du Pont (founded by the heirs to the chemical fortune) was saved from insolvency in 1970 only after Texas entrepreneur H. Ross Perot lent more than $50 million to the firm; Goodbody, the fifth-largest brokerage firm in the United States, would have failed in late 1970 had Merrill Lynch not acquired it. Hayden, Stone & Co. would also have gone under if it had not been acquired. In 1970, no fewer than seven brokerage firms went bust. The farcical story of Wall Street's frenzied overexpansion in the late 1960s is beautifully told in John Brooks's *The Go-Go Years* (John Wiley & Sons, New York, 1999).

NYSE in 1970 totaled 2,937 million shares, the *largest* volume in its history and well over twice as large as in any year before 1965. During the 15 years of the bull market ending in 1964 the annual volume had averaged "only" 712 million shares—one quarter of the 1970 figure—but the brokerage business had enjoyed the greatest prosperity in its history. If, as it appears, the member firms as a whole had allowed their overhead and other expenses to increase at a rate that could not sustain even a mild reduction in volume during part of a year, this does not speak well for either their business acumen or their financial conservatism.

A third explanation of the financial trouble finally emerged out of a mist of concealment, and we suspect that it is the most plausible and significant of the three. It seems that a good part of the capital of certain brokerage houses was held in the form of common stocks owned by the individual partners. Some of these seem to have been highly speculative and carried at inflated values. When the market declined in 1969 the quotations of such securities fell drastically and a substantial part of the capital of the firms vanished with them.[2] In effect the partners were speculating with the capital that was supposed to protect the customers against the ordinary financial hazards of the brokerage business, in order to make a double profit thereon. This was inexcusable; we refrain from saying more.

The investor should use his intelligence not only in formulating his financial policies but also in the associated details. These include the choice of a reputable broker to execute his orders. Up to now it was sufficient to counsel our readers to deal only with a member of the New York Stock Exchange, unless he had compelling reasons to use a nonmember firm. Reluctantly, we must add some further advice in this area. We think that people who do not carry margin accounts—and in our vocabulary this means *all* nonprofessional *investors*—should have the delivery and receipt of their securities handled by their bank. When giving a buying order to your brokers you can instruct them to deliver the securities bought to your bank against payment therefor by the bank; conversely, when selling you can instruct your bank to deliver the securities to the broker against payment of the proceeds. These services will cost a little extra but they should be well worth the expense in terms of safety and peace of mind. This advice may be disregarded, as no longer called for, after the investor is sure that all the problems of stock-exchange firms have been disposed of, but not before.*

Investment Bankers

The term "investment banker" is applied to a firm that engages to an important extent in originating, underwriting, and selling new issues of stocks and bonds. (To underwrite means to guarantee to the issuing corporation, or other issuer, that the security will be fully sold.) A number of the brokerage houses carry on a certain amount of underwriting activity. Generally this is confined to participating in underwriting groups formed by leading investment bankers. There is an additional tendency for brokerage firms to originate and sponsor a minor amount of new-issue financing, particularly in the form of smaller issues of common stocks when a bull market is in full swing.

Investment banking is perhaps the most respectable department of the Wall Street community, because it is here that finance plays its constructive role of supplying new capital for the expansion of industry. In fact, much of the theoretical justification for maintaining active stock markets, notwithstanding their frequent speculative excesses, lies in the fact that organized security exchanges facilitate the sale of new issues of bonds and stocks. If investors or speculators could not expect to see a ready market for a new security offered them, they might well refuse to buy it.

The relationship between the investment banker and the

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* Nearly all brokerage transactions are now conducted electronically, and securities are no longer physically "delivered." Thanks to the establishment of the Securities Investor Protection Corporation, or SIPC, in 1970, investors are generally assured of recovering their full account values if their brokerage firm becomes insolvent. SIPC is a government-mandated consortium of brokers; all the members agree to pool their assets to cover losses incurred by the customers of any firm that becomes insolvent. SIPC's protection eliminates the need for investors to make payment and take delivery through a bank intermediary, as Graham urges.

investor is basically that of the salesman to the prospective buyer. For many years past the great bulk of the new offerings in dollar value has consisted of bond issues that were purchased in the main by financial institutions such as banks and insurance companies. In this business the security salesmen have been dealing with shrewd and experienced buyers. Hence any recommendations made by the investment bankers to these customers have had to pass careful and skeptical scrutiny. Thus these transactions are almost always effected on a businesslike footing.

But a different situation obtains in a relationship between the *individual* security buyer and the investment banking firms, including the stockbrokers acting as underwriters. Here the purchaser is frequently inexperienced and seldom shrewd. He is easily influenced by what the salesman tells him, especially in the case of common-stock issues, since often his unconfessed desire in buying is chiefly to make a quick profit. The effect of all this is that the public investor's protection lies less in his own critical faculty than in the scruples and ethics of the offering houses.[3]

It is a tribute to the honesty and competence of the underwriting firms that they are able to combine fairly well the discordant roles of adviser and salesman. But it is imprudent for the buyer to trust himself to the judgment of the seller. In 1959 we stated at this point: "The bad results of this unsound attitude show themselves recurrently in the underwriting field and with notable effects in the sale of new common stock issues during periods of active speculation." Shortly thereafter this warning proved urgently needed. As already pointed out, the years 1960–61 and, again, 1968–69 were marked by an unprecedented outpouring of issues of lowest quality, sold to the public at absurdly high offering prices and in many cases pushed much higher by heedless speculation and some semi-manipulation. A number of the more important Wall Street houses have participated to some degree in these less than creditable activities, which demonstrates that the familiar combination of greed, folly, and irresponsibility has not been exorcized from the financial scene.

The intelligent investor will pay attention to the advice and recommendations received from investment banking houses, especially those known by him to have an excellent reputation; but he will be sure to bring sound and independent judgment to bear upon these suggestions—either his own, if he is competent, or that of some other type of adviser.*

Other Advisers

It is a good old custom, especially in the smaller towns, to consult one's local banker about investments. A commercial banker may not be a thoroughgoing expert on security values, but he is experienced and conservative. He is especially useful to the unskilled investor, who is often tempted to stray from the straight and unexciting path of a defensive policy and needs the steadying influence of a prudent mind. The more alert and aggressive investor, seeking counsel in the selection of security bargains, will not ordinarily find the commercial banker's viewpoint to be especially suited to his own objectives.†

We take a more critical attitude toward the widespread custom of asking investment advice from relatives or friends. The inquirer always thinks he has good reason for assuming that the person consulted has superior knowledge or experience. Our own observation indicates that it is almost as difficult to select satisfactory lay advisers as it is to select the proper securities unaided. Much bad advice is given free.

Summary

Investors who are prepared to pay a fee for the management of their funds may wisely select some well-established and well-recommended investment-counsel firm. Alternatively, they may use the investment department of a large trust company or the supervisory service supplied on a fee basis by a few of the leading New York Stock Exchange houses. The results to be expected are in no wise exceptional, but they are commensurate with those of the average well-informed and cautious investor.

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* Those who heeded Graham's advice would not have been suckered into buying Internet IPOs in 1999 and 2000.

† This traditional role of bankers has for the most part been supplanted by accountants, lawyers, or financial planners.

Most security buyers obtain advice without paying for it specifically. It stands to reason, therefore, that in the majority of cases they are not entitled to and should not expect better than average results. They should be wary of all persons, whether customers' brokers or security salesmen, who promise spectacular income or profits. This applies both to the selection of securities and to guidance in the elusive (and perhaps illusive) art of trading in the market.

Defensive investors, as we have defined them, will not ordinarily be equipped to pass independent judgment on the security recommendations made by their advisers. But they can be explicit—and even repetitiously so—in stating the kind of securities they want to buy. If they follow our prescription they will confine themselves to high-grade bonds and the common stocks of leading corporations, preferably those that can be purchased at individual price levels that are not high in the light of experience and analysis. The security analyst of any reputable stock-exchange house can make up a suitable list of such common stocks and can certify to the investor whether or not the existing price level therefor is a reasonably conservative one as judged by past experience.

The aggressive investor will ordinarily work in active cooperation with his advisers. He will want their recommendations explained in detail, and he will insist on passing his own judgment upon them. This means that the investor will gear his expectations and the character of his security operations to the development of his own knowledge and experience in the field. Only in the exceptional case, where the integrity and competence of the advisers have been thoroughly demonstrated, should the investor act upon the advice of others without understanding and approving the decision made.

There have always been unprincipled stock salesmen and fly-by-night stock brokers, and—as a matter of course—we have advised our readers to confine their dealings, if possible, to members of the New York Stock Exchange. But we are reluctantly compelled to add the extra-cautious counsel that security deliveries and payments be made through the intermediary of the investor's bank. The distressing Wall Street brokerage-house picture may have cleared up completely in a few years, but in late 1971 we still suggest, "Better safe than sorry."

COMMENTARY ON CHAPTER 10

> I feel grateful to the Milesian wench who, seeing the philosopher Thales continually spending his time in contemplation of the heavenly vault and always keeping his eyes raised upward, put something in his way to make him stumble, to warn him that it would be time to amuse his thoughts with things in the clouds when he had seen to those at his feet. Indeed she gave him or her good counsel, to look rather to himself than to the sky.
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> —*Michel de Montaigne*

DO YOU NEED HELP?

In the glory days of the late 1990s, many investors chose to go it alone. By doing their own research, picking stocks themselves, and placing their trades through an online broker, these investors bypassed Wall Street's costly infrastructure of research, advice, and trading. Unfortunately, many do-it-yourselfers asserted their independence right before the worst bear market since the Great Depression—making them feel, in the end, that they were fools for going it alone. That's not necessarily true, of course; people who delegated every decision to a traditional stockbroker lost money, too.

But many investors do take comfort from the experience, judgment, and second opinion that a good financial adviser can provide. Some investors may need an outsider to show them what rate of return they need to earn on their investments, or how much extra money they need to save, in order to meet their financial goals. Others may simply benefit from having someone else to blame when their investments go down; that way, instead of beating yourself up in an agony of self-doubt, you get to criticize someone who typically can defend him or herself and encourage you at the same time. That may provide just the psychological boost you need to keep investing steadily at a time when other investors' hearts may fail them. All in all, just as there's no reason you can't manage your own portfolio, so there's no shame in seeking professional help in managing it.[1]

How can you tell if you need a hand? Here are some signals:

Big losses. If your portfolio lost more than 40% of its value from the beginning of 2000 through the end of 2002, then you did even worse than the dismal performance of the stock market itself. It hardly matters whether you blew it by being lazy, reckless, or just unlucky; after such a giant loss, your portfolio is crying out for help.

Busted budgets. If you perennially struggle to make ends meet, have no idea where your money goes, find it impossible to save on a regular schedule, and chronically fail to pay your bills on time, then your finances are out of control. An adviser can help you get a grip on your money by designing a comprehensive financial plan that will outline how—and how much—you should spend, borrow, save, and invest.

Chaotic portfolios. All too many investors thought they were diversified in the late 1990s because they owned 39 "different" Internet stocks, or seven "different" U.S. growth-stock funds. But that's like thinking that an all-soprano chorus can handle singing "Old Man River" better than a soprano soloist can. No matter how many sopranos you add, that chorus will never be able to nail all those low notes until some baritones join the group. Likewise, if all your holdings go up and down together, you lack the investing harmony that true diversification brings. A professional "asset-allocation" plan can help.

Major changes. If you've become self-employed and need to set up a retirement plan, your aging parents don't have their finances in order, or college for your kids looks unaffordable, an adviser can not only provide peace of mind but help you make genuine improvements in the quality of your life. What's more, a qualified professional can ensure that you benefit from and comply with the staggering complexity of the tax laws and retirement rules.

TRUST, THEN VERIFY

Remember that financial con artists thrive by talking you into trusting them and by talking you out of investigating them. Before you place

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[1] For a particularly thoughtful discussion of these issues, see Walter Updegrave, "Advice on Advice," *Money,* January, 2003, pp. 53–55.

your financial future in the hands of an adviser, it's imperative that you find someone who not only makes you comfortable but whose honesty is beyond reproach. As Ronald Reagan used to say, "Trust, then verify." Start off by thinking of the handful of people you know best and trust the most. Then ask if they can refer you to an adviser whom *they* trust and who, they feel, delivers good value for his fees. A vote of confidence from someone you admire is a good start.[2]

Once you have the name of the adviser and his firm, as well as his specialty—is he a stockbroker? financial planner? accountant? insurance agent?—you can begin your due diligence. Enter the name of the adviser and his or her firm into an Internet search engine like Google to see if anything comes up (watch for terms like "fine," "complaint," "lawsuit," "disciplinary action," or "suspension"). If the adviser is a stockbroker or insurance agent, contact the office of your state's securities commissioner (a convenient directory of online links is at www.nasaa.org) to ask whether any disciplinary actions or customer complaints have been filed against the adviser.[3] If you're considering an accountant who also functions as a financial adviser, your state's accounting regulators (whom you can find through the National Association of State Boards of Accountancy at www.nasba.org) will tell you whether his or her record is clean.

Financial planners (or their firms) must register with either the U.S. Securities and Exchange Commission or securities regulators in the state where their practice is based. As part of that registration, the adviser must file a two-part document called Form ADV. You should be able to view and download it at www.advisorinfo.sec.gov, www.iard.com, or the website of your state securities regulator. Pay special attention to the Disclosure Reporting Pages, where the adviser must disclose any disciplinary actions by regulators. (Because unscrupu-

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[2] If you're unable to get a referral from someone you trust, you may be able to find a fee-only financial planner through www.napfa.org (or www.feeonly.org), whose members are generally held to high standards of service and integrity.

[3] By itself, a customer complaint is not enough to disqualify an adviser from your consideration; but a persistent pattern of complaints is. And a disciplinary action by state or Federal regulators usually tells you to find another adviser. Another source for checking a broker's record is http://pdpi.nasdr.com/PDPI.

lous advisers have been known to remove those pages before handing an ADV to a prospective client, you should independently obtain your own complete copy.) It's a good idea to cross-check a financial planner's record at www.cfp-board.org, since some planners who have been disciplined outside their home state can fall through the regulatory cracks. For more tips on due diligence, see the sidebar below.

WORDS OF WARNING

The need for due diligence doesn't stop once you hire an adviser. Melanie Senter Lubin, securities commissioner for the State of Maryland, suggests being on guard for words and phrases that can spell trouble. If your adviser keeps saying them—or twisting your arm to do anything that makes you uncomfortable—"then get in touch with the authorities very quickly," warns Lubin. Here's the kind of lingo that should set off warning bells:

- "offshore"
- "the opportunity of a lifetime"
- "prime bank"
- "This baby's gonna move."
- "guaranteed"
- "You need to hurry."
- "It's a sure thing."
- "our proprietary computer model"
- "The smart money is buying it."
- "options strategy"
- "It's a no-brainer."
- "You can't afford not to own it."
- "We can beat the market."
- "You'll be sorry if you don't . . ."
- "exclusive"
- "You should focus on performance, not fees."
- "Don't you want to be rich?"
- "can't lose"
- "The upside is huge."
- "There's no downside."
- "I'm putting my mother in it."
- "Trust me."
- "commodities trading"
- "monthly returns"
- "active asset-allocation strategy"
- "We can cap your downside."
- "No one else knows how to do this."

GETTING TO KNOW YOU

A leading financial-planning newsletter recently canvassed dozens of advisers to get their thoughts on how you should go about interviewing them.[4] In screening an adviser, your goals should be to:

- determine whether he or she cares about helping clients, or just goes through the motions
- establish whether he or she understands the fundamental principles of investing as they are outlined in this book
- assess whether he or she is sufficiently educated, trained, and experienced to help you.

Here are some of the questions that prominent financial planners recommended any prospective client should ask:

Why are you in this business? What is the mission statement of your firm? Besides your alarm clock, what makes you get up in the morning?

What is your investing philosophy? Do you use stocks or mutual funds? Do you use technical analysis? Do you use market timing? (A "yes" to either of the last two questions is a "no" signal to you.)

Do you focus solely on asset management, or do you also advise on taxes, estate and retirement planning, budgeting and debt management, and insurance? How do your education, experience, and credentials qualify you to give those kinds of financial advice?[5]

What needs do your clients typically have in common? How can you help me achieve my goals? How will you track and report my progress? Do you provide a checklist that I can use to monitor the implementation of any financial plan we develop?

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[4] Robert Veres, editor and publisher of the *Inside Information* newsletter, generously shared these responses for this book. Other checklists of questions can be found at www.cfp-board.org and www.napfa.org.

[5] Credentials like the CFA, CFP, or CPA tell you that the adviser has taken and passed a rigorous course of study. (Most of the other "alphabet soup" of credentials brandished by financial planners, including the "CFM" or the "CMFC," signify very little.) More important, by contacting the organization that awards the credential, you can verify his record and check that he has not been disciplined for violations of rules or ethics.

How do you choose investments? What investing approach do you believe is most successful, and what evidence can you show me that you have achieved that kind of success for your clients? What do you do when an investment performs poorly for an entire year? (Any adviser who answers "sell" is not worth hiring.)

Do you, when recommending investments, accept any form of compensation from any third party? Why or why not? Under which circumstances? How much, in actual dollars, do you estimate I would pay for your services the first year? What would make that number go up or down over time? (If fees will consume more than 1% of your assets annually, you should probably shop for another adviser.[6])

How many clients do you have, and how often do you communicate with them? What has been your proudest achievement for a client? What characteristics do your favorite clients share? What's the worst experience you've had with a client, and how did you resolve it? What determines whether a client speaks to you or to your support staff? How long do clients typically stay with you?

Can I see a sample account statement? (If you can't understand it, ask the adviser to explain it. If you can't understand his explanation, he's not right for you.)

Do you consider yourself financially successful? Why? How do you define financial success?

How high an average annual return do you think is feasible on my investments? (Anything over 8% to10% is unrealistic.)

Will you provide me with your résumé, your Form ADV, and at least three references? (If the adviser or his firm is required to file an ADV, and he will not provide you a copy, get up and leave—and keep one hand on your wallet as you go.)

Have you ever had a formal complaint filed against you? Why did the last client who fired you do so?

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[6] If you have less than $100,000 to invest, you may not be able to find a financial adviser who will take your account. In that case, buy a diversified basket of low-cost index funds, follow the behavioral advice throughout this book, and your portfolio should eventually grow to the level at which you can afford an adviser.

DEFEATING YOUR OWN WORST ENEMY

Finally, bear in mind that great financial advisers do not grow on trees. Often, the best already have as many clients as they can handle—and may be willing to take you on only if you seem like a good match. So they will ask you some tough questions as well, which might include:

Why do you feel you need a financial adviser?

What are your long-term goals?

What has been your greatest frustration in dealing with other advisers (including yourself)?

Do you have a budget? Do you live within your means? What percentage of your assets do you spend each year?

When we look back a year from now, what will I need to have accomplished in order for you to be happy with your progress?

How do you handle conflicts or disagreements?

How did you respond emotionally to the bear market that began in 2000?

What are your worst financial fears? Your greatest financial hopes?

What rate of return on your investments do you consider reasonable? (Base your answer on Chapter 3.)

An adviser who doesn't ask questions like these—and who does not show enough interest in you to sense intuitively what other questions you consider to be the right ones—is not a good fit.

Above all else, you should trust your adviser enough to permit him or her to protect you from your worst enemy—yourself. "You hire an adviser," explains commentator Nick Murray, "not to manage money but to manage you."

"If the adviser is a line of defense between you and your worst impulsive tendencies," says financial-planning analyst Robert Veres, "then he or she should have systems in place that will help the two of you control them." Among those systems:

- a **comprehensive financial plan** that outlines how you will earn, save, spend, borrow, and invest your money;
- an **investment policy statement** that spells out your fundamental approach to investing;
- an **asset-allocation plan** that details how much money you will keep in different investment categories.

These are the building blocks on which good financial decisions must be founded, and they should be created mutually—by you and the adviser—rather than imposed unilaterally. You should not invest a dollar or make a decision until you are satisfied that these foundations are in place and in accordance with your wishes.

CHAPTER 11

Security Analysis for the Lay Investor: General Approach

Financial analysis is now a well-established and flourishing profession, or semiprofession. The various societies of analysts that make up the National Federation of Financial Analysts have over 13,000 members, most of whom make their living out of this branch of mental activity. Financial analysts have textbooks, a code of ethics, and a quarterly journal.* They also have their share of unresolved problems. In recent years there has been a tendency to replace the general concept of "security analysis" by that of "financial analysis." The latter phrase has a broader implication and is better suited to describe the work of most senior analysts on Wall Street. It would be useful to think of security analysis as limiting itself pretty much to the examination and evaluation of stocks and bonds, whereas financial analysis would comprise that work, plus the determination of investment policy (portfolio selection), plus a substantial amount of general economic analysis.[1] In this chapter we shall use whatever designation is most applicable, with chief emphasis on the work of the security analyst proper.

The security analyst deals with the past, the present, and the future of any given security issue. He describes the business; he summarizes its operating results and financial position; he sets forth its strong and weak points, its possibilities and risks; he estimates its future earning power under various assumptions, or as a

* The National Federation of Financial Analysts is now the Association for Investment Management and Research; its "quarterly" research publication, the *Financial Analysts Journal*, now appears every other month.

"best guess." He makes elaborate comparisons of various companies, or of the same company at various times. Finally, he expresses an opinion as to the safety of the issue, if it is a bond or investment-grade preferred stock, or as to its attractiveness as a purchase, if it is a common stock.

In doing all these things the security analyst avails himself of a number of techniques, ranging from the elementary to the most abstruse. He may modify substantially the figures in the company's annual statements, even though they bear the sacred *imprimatur* of the certified public accountant. He is on the lookout particularly for items in these reports that may mean a good deal more or less than they say.

The security analyst develops and applies standards of safety by which we can conclude whether a given bond or preferred stock may be termed sound enough to justify purchase for investment. These standards relate primarily to past average earnings, but they are concerned also with capital structure, working capital, asset values, and other matters.

In dealing with common stocks the security analyst until recently has only rarely applied standards of value as well defined as were his standards of safety for bonds and preferred stocks. Most of the time he contended himself with a summary of past performances, a more or less general forecast of the future—with particular emphasis on the next 12 months—and a rather arbitrary conclusion. The latter was, and still is, often drawn with one eye on the stock ticker or the market charts. In the past few years, however, much attention has been given by practicing analysts to the problem of valuing growth stocks. Many of these have sold at such high prices in relation to past and current earnings that those recommending them have felt a special obligation to justify their purchase by fairly definite projections of expected earnings running fairly far into the future. Certain mathematical techniques of a rather sophisticated sort have perforce been invoked to support the valuations arrived at.

We shall deal with these techniques, in foreshortened form, a little later. However, we must point out a troublesome paradox here, which is that the mathematical valuations have become most prevalent precisely in those areas where one might consider them least reliable. For the more dependent the valuation becomes on anticipations of the future—and the less it is tied to a figure demonstrated by past performance—the more vulnerable it becomes to possible miscalculation and serious error. A large part of the value found for a high-multiplier growth stock is derived from future projections which differ markedly from past performance—except perhaps in the growth rate itself. Thus it may be said that security analysts today find themselves compelled to become most mathematical and "scientific" in the very situations which lend themselves least auspiciously to exact treatment.*

Let us proceed, nonetheless, with our discussion of the more important elements and techniques of security analysis. The present highly condensed treatment is directed to the needs of the nonprofessional investor. At the minimum he should understand what the security analyst is talking about and driving at; beyond that, he should be equipped, if possible, to distinguish between superficial and sound analysis.

Security analysis for the lay investor is thought of as beginning

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* The higher the growth rate you project, and the longer the future period over which you project it, the more sensitive your forecast becomes to the slightest error. If, for instance, you estimate that a company earning $1 per share can raise that profit by 15% a year for the next 15 years, its earnings would end up at $8.14. If the market values the company at 35 times earnings, the stock would finish the period at roughly $285. But if earnings grow at 14% instead of 15%, the company would earn $7.14 at the end of the period–and, in the shock of that shortfall, investors would no longer be willing to pay 35 times earnings. At, say, 20 times earnings, the stock would end up around $140 per share, or more than 50% less. Because advanced mathematics gives the appearance of precision to the inherently iffy process of foreseeing the future, investors must be highly skeptical of anyone who claims to hold any complex computational key to basic financial problems. As Graham put it: "In 44 years of Wall Street experience and study, I have never seen dependable calculations made about common-stock values, or related investment policies, that went beyond simple arithmetic or the most elementary algebra. Whenever calculus is brought in, or higher algebra, you could take it as a warning signal that the operator was trying to substitute theory for experience, and usually also to give to speculation the deceptive guise of investment." (See p. 570.)

with the interpretation of a company's annual financial report. This is a subject which we have covered for laymen in a separate book, entitled *The Interpretation of Financial Statements.*[2] We do not consider it necessary or appropriate to traverse the same ground in this chapter, especially since the emphasis in the present book is on principles and attitudes rather than on information and description. Let us pass on to two basic questions underlying the selection of investments. What are the primary tests of safety of a corporate bond or preferred stock? What are the chief factors entering into the valuation of a common stock?

Bond Analysis

The most dependable and hence the most respectable branch of security analysis concerns itself with the safety, or quality, of bond issues and investment-grade preferred stocks. The chief criterion used for corporate bonds is the number of times that total interest charges have been covered by available earnings for some years in the past. In the case of preferred stocks, it is the number of times that bond interest and preferred dividends combined have been covered.

The exact standards applied will vary with different authorities. Since the tests are at bottom arbitrary, there is no way to determine precisely the most suitable criteria. In the 1961 revision of our textbook, *Security Analysis,* we recommend certain "coverage" standards, which appear in Table 11-1.*

Our basic test is applied only to the *average* results for a period of years. Other authorities require also that a *minimum* coverage be shown for every year considered. We approve a "poorest-year" test

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* In 1972, an investor in corporate bonds had little choice but to assemble his or her own portfolio. Today, roughly 500 mutual funds invest in corporate bonds, creating a convenient, well-diversified bundle of securities. Since it is not feasible to build a diversified bond portfolio on your own unless you have at least $100,000, the typical intelligent investor will be best off simply buying a low-cost bond fund and leaving the painstaking labor of credit research to its managers. For more on bond funds, see the commentary on Chapter 4.

TABLE 11-1 Recommended Minimum "Coverage" for Bonds and Preferred Stocks

A. For Investment-grade Bonds

Minimum Ratio of Earnings to Total Fixed Charges:

	Before Income Taxes		*After Income Taxes*	
Type of enterprise	Average of Past 7 Years	Alternative: Measured by "Poorest Year"	Average of Past 7 Years	Alternative: Measured by "Poorest Year"
Public-utility operating company	4 times	3 times	2.65 times	2.10 times
Railroad	5	4	3.20	2.65
Industrial	7	5	4.30	3.20
Retail concern	5	4	3.20	2.65

B. *For Investment-grade Preferred Stocks*

The same minimum figures as above are required to be shown by the ratio of earnings *before* income taxes to the sum of fixed charges plus twice preferred dividends.

NOTE: The inclusion of twice the preferred dividends allows for the fact that preferred dividends are not income-tax deductible, whereas interest charges are so deductible.

C. *Other Categories of Bonds and Preferreds*

The standards given above are not applicable to (1) public-utility holding companies, (2) financial companies, (3) real-estate companies. Requirements for these special groups are omitted here.

as an *alternative* to the seven-year-average test; it would be sufficient if the bond or preferred stock met either of these criteria.

It may be objected that the large increase in bond interest rates since 1961 would justify some offsetting reduction in the coverage of charges required. Obviously it would be much harder for an industrial company to show a seven-times coverage of interest charges at 8% than at 4½%. To meet this changed situation we now suggest an alternative requirement related to the percent earned on the *principal* amount of the debt. These figures might be 33% before taxes for an industrial company, 20% for a public utility, and 25% for a railroad. It should be borne in mind here that the rate actually paid by most companies on their total debt is considerably less than the current 8% figures, since they have the benefit of older issues bearing lower coupons. The "poorest year" requirement could be set at about two-thirds of the seven-year requirement.

In addition to the earnings-coverage test, a number of others are generally applied. These include the following:

1. *Size of Enterprise.* There is a minimum standard in terms of volume of business for a corporation—varying as between industrials, utilities, and railroads—and of population for a municipality.

2. *Stock/Equity Ratio.* This is the ratio of the market price of the junior stock issues* to the total face amount of the debt, or the debt plus preferred stock. It is a rough measure of the protection, or "cushion," afforded by the presence of a junior investment that must first bear the brunt of unfavorable developments. This factor includes the market's appraisal of the future prospects of the enterprise.

3. *Property Value.* The asset values, as shown on the balance sheet or as appraised, were formerly considered the chief security and protection for a bond issue. Experience has shown that in most cases safety resides in the earning power, and if this is deficient the assets lose most of their reputed value. Asset values, however, retain importance as a separate test of ample security for bonds and preferred stocks in three enterprise groups: public utilities (because rates may depend largely on the property investment), real-estate concerns, and investment companies.

At this point the alert investor should ask, "How dependable are tests of safety that are measured by past and present performance, in view of the fact that payment of interest and principal depends upon what the future will bring forth?" The answer can be founded

* By "junior stock issues" Graham means shares of common stock. Preferred stock is considered "senior" to common stock because the company must pay all dividends on the preferred before paying any dividends on the common.

only on experience. Investment history shows that bonds and preferred stocks that have met stringent tests of safety, based on the past, have in the great majority of cases been able to face the vicissitudes of the future successfully. This has been strikingly demonstrated in the major field of railroad bonds—a field that has been marked by a calamitous frequency of bankruptcies and serious losses. In nearly every case the roads that got into trouble had long been overbonded, had shown an inadequate coverage of fixed charges in periods of average prosperity, and would thus have been ruled out by investors who applied strict tests of safety. Conversely, practically every road that has met such tests has escaped financial embarrassment. Our premise was strikingly vindicated by the financial history of the numerous railroads reorganized in the 1940s and in 1950. All of these, with one exception, started their careers with fixed charges reduced to a point where the current coverage of fixed-interest requirements was ample, or at least respectable. The exception was the New Haven Railroad, which in its reorganization year, 1947, earned its new charges only about 1.1 times. In consequence, while all the other roads were able to come through rather difficult times with solvency unimpaired, the New Haven relapsed into trusteeship (for the third time) in 1961.

In Chapter 17 below we shall consider some aspects of the bankruptcy of the Penn Central Railroad, which shook the financial community in 1970. An elementary fact in this case was that the coverage of fixed charges did not meet conservative standards as early as 1965; hence a prudent bond investor would have avoided or disposed of the bond issues of the system long before its financial collapse.

Our observations on the adequacy of the past record to judge future safety apply, and to an even greater degree, to the public utilities, which constitute a major area for bond investment. Receivership of a soundly capitalized (electric) utility company or system is almost impossible. Since Securities and Exchange Commission control was instituted,* along with the breakup of most of

* After investors lost billions of dollars on the shares of recklessly assembled utility companies in 1929–1932, Congress authorized the SEC to regulate the issuance of utility stocks under the Public Utility Holding Company Act of 1935.