

THE INTELLIGENT INVESTOR

A BOOK OF PRACTICAL COUNSEL

REVISED EDITION

BENJAMIN GRAHAM

Updated with New Commentary by Jason Zweig

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- Group 4: The Classified

To E.M.G.

if the investor had a given sum in the DJIA at its closing price of 874 in 1964 he would have had a small profit thereon in late 1971; even at the lowest level (631) in 1970 his indicated loss would have been less than that shown on good long-term bonds. On the other hand, if he had confined his bond-type investments to U.S. savings bonds, short-term corporate issues, or savings accounts, he would have had no loss in market value of his principal during this period and he would have enjoyed a higher income return than was offered by good stocks. It turned out, therefore, that true “cash equivalents” proved to be better investments in 1964 than common stocks—in spite of the inflation experience that in theory should have favored stocks over cash. The decline in quoted principal value of good longer-term bonds was due to developments in the money market, an abstruse area which ordinarily does not have an important bearing on the investment policy of individuals.

This is just another of an endless series of experiences over time that have demonstrated that the future of security prices is never predictable.* Almost always bonds have fluctuated much less than stock prices, and investors generally could buy good bonds of any maturity without having to worry about changes in their market value. There were a few exceptions to this rule, and the period after 1964 proved to be one of them. We shall have more to say about change in bond prices in a later chapter.

3. Expectations and Policy in Late 1971 and Early 1972

Toward the end of 1971 it was possible to obtain 8% taxable interest on good medium-term corporate bonds, and 5.7% tax-free on good state or municipal securities. In the shorter-term field the investor could realize about 6% on U.S. government issues due in five years. In the latter case the buyer need not be concerned about

* Read Graham's sentence again, and note what this greatest of investing experts is saying: The future of security prices is never predictable. And as you read ahead in the book, notice how everything else Graham tells you is designed to help you grapple with that truth. Since you cannot predict the behavior of the markets, you must learn how to predict and control your own behavior.

THE MONEY ILLUSION

There's another reason investors overlook the importance of inflation: what psychologists call the "money illusion." If you receive a 2% raise in a year when inflation runs at 4%, you will almost certainly feel better than you will if you take a 2% pay cut during a year when inflation is zero. Yet both changes in your salary leave you in a virtually identical position—2% worse off after inflation. So long as the *nominal* (or absolute) change is positive, we view it as a good thing—even if the *real* (or after-inflation) result is negative. And any change in your own salary is more vivid and specific than the generalized change of prices in the economy as a whole.³ Likewise, investors were delighted to earn 11% on bank certificates of deposit (CDs) in 1980 and are bitterly disappointed to be earning only around 2% in 2003—even though they were losing money after inflation back then but are keeping up with inflation now. The nominal rate we earn is printed in the bank's ads and posted in its window, where a high number makes us feel good. But inflation eats away at that high number in secret. Instead of taking out ads, inflation just takes away our wealth. That's why inflation is so easy to overlook—and why it's so important to measure your investing success not just by what you make, but by how much you keep after inflation.

More basically still, the intelligent investor must always be on guard against whatever is unexpected and underestimated. There are three good reasons to believe that inflation is not dead:

- As recently as 1973–1982, the United States went through one of the most painful bursts of inflation in our history. As measured by the Consumer Price Index, prices more than doubled over that period, rising at an annualized rate of nearly 9%. In 1979 alone, inflation raged at 13.3%, paralyzing the economy in what became known as "stagflation"—and leading many commentators to question whether America could compete in the global market-

³ For more insights into this behavioral pitfall, see Eldar Shafir, Peter Diamond, and Amos Tversky, "Money Illusion," in Daniel Kahneman and Amos Tversky, eds., *Choices, Values, and Frames* (Cambridge University Press, 2000), pp. 335–355.

switching their low-interest holdings into very-high-coupon issues on an even-money basis.

In our view the special advantages enjoyed by owners of savings bonds now will more than compensate for their lower current return as compared with other direct government obligations.

2. OTHER UNITED STATES BONDS. A profusion of these issues exists, covering a wide variety of coupon rates and maturity dates. All of them are completely safe with respect to payment of interest and principal. They are subject to Federal income taxes but free from state income tax. In late 1971 the long-term issues—over ten years—showed an average yield of 6.09%, intermediate issues (three to five years) returned 6.35%, and short issues returned 6.03%.

In 1970 it was possible to buy a number of old issues at large discounts. Some of these are accepted at par in settlement of estate taxes. Example: The U.S. Treasury 3½s due 1990 are in this category; they sold at 60 in 1970, but closed 1970 above 77.

It is interesting to note also that in many cases the indirect obligations of the U.S. government yield appreciably more than its direct obligations of the same maturity. As we write, an offering appears of 7.05% of "Certificates Fully Guaranteed by the Secretary of Transportation of the Department of Transportation of the United States." The yield was fully 1% more than that on direct obligations of the U.S., maturing the same year (1986). The certificates were actually issued in the name of the Trustees of the Penn Central Transportation Co., but they were sold on the basis of a statement by the U.S. Attorney General that the guarantee "brings into being a general obligation of the United States, backed by its full faith and credit." Quite a number of indirect obligations of this sort have been assumed by the U.S. government in the past, and all of them have been scrupulously honored.

The reader may wonder why all this hocus-pocus, involving an apparently "personal guarantee" by our Secretary of Transportation, and a higher cost to the taxpayer in the end. The chief reason for the indirection has been the debt limit imposed on government borrowing by the Congress. Apparently guarantees by the government are not regarded as debts—a semantic windfall for shrewder investors. Perhaps the chief impact of this situation has been the creation of tax-free Housing Authority bonds, enjoying

You may often incur a variety of nuisance fees that can exceed \$25 per year. Even so, direct-stock purchase programs are usually cheaper than stockbrokers.

Be warned, however, that buying stocks in tiny increments for years on end can set off big tax headaches. If you are not prepared to keep a permanent and exhaustively detailed record of your purchases, do not buy in the first place. Finally, don't invest in only one stock—or even just a handful of different stocks. Unless you are not willing to spread your bets, you shouldn't bet at all. Graham's guideline of owning between 10 and 30 stocks remains a good starting point for investors who want to pick their own stocks, but you must make sure that you are not overexposed to one industry.⁶ (For more on how to pick the individual stocks that will make up your portfolio, see pp. 114–115 and Chapters 11, 14, and 15.)

If, after you set up such an online autopilot portfolio, you find yourself trading more than twice a year—or spending more than an hour or two per month, total, on your investments—then something has gone badly wrong. Do not let the ease and up-to-the-minute feel of the Internet seduce you into becoming a speculator. A defensive investor runs—and wins—the race by sitting still.

Get some help. A defensive investor can also own stocks through a discount broker, a financial planner, or a full-service stockbroker. At a discount brokerage, you'll need to do most of the stock-picking work yourself; Graham's guidelines will help you create a core portfolio requiring minimal maintenance and offering maximal odds of a steady return. On the other hand, if you cannot spare the time or summon the interest to do it yourself, there's no reason to feel any shame in hiring someone to pick stocks or mutual funds for you. But there's one responsibility that you must never delegate. You, and no one but you, must investigate (*before* you hand over your money) whether an adviser is trustworthy and charges reasonable fees. (For more pointers, see Chapter 10.)

Farm it out. Mutual funds are the ultimate way for a defensive investor to capture the upside of stock ownership without the down-

⁶ To help determine whether the stocks you own are sufficiently diversified across different industrial sectors, you can use the free "Instant X-Ray" function at www.morningstar.com or consult the sector information (Global Industry Classification Standard) at www.standardandpoors.com.

TABLE 7-2 Average Annual Percentage Gain or Loss on Test Issues, 1937–1969

<i>Period</i>	<i>10 Low-Multiplier Issues</i>	<i>10 High-Multiplier Issues</i>	<i>30 DJIA Stocks</i>
1937–1942	– 2.2	–10.0	– 6.3
1943–1947	17.3	8.3	14.9
1948–1952	16.4	4.6	9.9
1953–1957	20.9	10.0	13.7
1958–1962	10.2	– 3.3	3.6
1963–1969 (8 years)	8.0	4.6	4.0

made by Drexel & Company (now Drexel Firestone)* of one-year holding—from 1937 through 1969—the cheap stocks did definitely worse than the DJIA in only three instances; the results were about the same in six cases; and the cheap stocks clearly outperformed the average in 25 years. The consistently better performance of the low-multiplier stocks is shown (Table 7-2) by the average results for successive five-year periods, when compared with those of the DJIA and of the ten high-multipliers.

The Drexel computation shows further that an original investment of \$10,000 made in the low-multiplier issues in 1936, and switched each year in accordance with the principle, would have grown to \$66,900 by 1962. The same operations in high-multiplier stocks would have ended with a value of only \$25,300; while an operation in all thirty stocks would have increased the original fund to \$44,000.†

The concept of buying “unpopular large companies” and its

* Drexel Firestone, a Philadelphia investment bank, merged in 1973 with Burnham & Co. and later became Drexel Burnham Lambert, famous for its junk-bond financing of the 1980s takeover boom.

† This strategy of buying the cheapest stocks in the Dow Jones Industrial Average is now nicknamed the “Dogs of the Dow” approach. Information on the “Dow 10” is available at www.djindexes.com/jsp/dow510Faq.jsp.

quality of a common stock, the more *speculative* it is likely to be—at least as compared with the unspectacular middle-grade issues.* (What we have said applies to a comparison of the leading growth companies with the bulk of well-established concerns; we exclude from our purview here those issues which are highly speculative because the businesses themselves are speculative.)

The argument made above should explain the often erratic price behavior of our most successful and impressive enterprises. Our favorite example is the monarch of them all—International Business Machines. The price of its shares fell from 607 to 300 in seven months in 1962–63; after two splits its price fell from 387 to 219 in 1970. Similarly, Xerox—an even more impressive earnings gainer in recent decades—fell from 171 to 87 in 1962–63, and from 116 to 65 in 1970. These striking losses did not indicate any doubt about the future long-term growth of IBM or Xerox; they reflected instead a lack of confidence in the premium valuation that the stock market itself had placed on these excellent prospects.

The previous discussion leads us to a conclusion of practical importance to the conservative investor in common stocks. If he is to pay some special attention to the selection of his portfolio, it might be best for him to concentrate on issues selling at a reasonably close approximation to their tangible-asset value—say, at not more than one-third above that figure. Purchases made at such levels, or lower, may with logic be regarded as related to the

* Graham's use of the word "paradox" is probably an allusion to a classic article by David Durand, "Growth Stocks and the Petersburg Paradox," *The Journal of Finance*, vol. XII, no. 3, September, 1957, pp. 348–363, which compares investing in high-priced growth stocks to betting on a series of coin flips in which the payoff escalates with each flip of the coin. Durand points out that if a growth stock could continue to grow at a high rate for an indefinite period of time, an investor should (in theory) be willing to pay an infinite price for its shares. Why, then, has no stock ever sold for a price of infinity dollars per share? Because 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 miscalculation becomes. Graham discusses this problem further in Appendix 4 (p. 570).

TABLE 9-2 A Performance-Fund Portfolio and Performance
 (Larger Holdings of Manhattan Fund, December 31, 1969)

<i>Shares Held (thousands)</i>	<i>Issue</i>	<i>Price</i>	<i>Earned 1969</i>	<i>Dividend 1969</i>	<i>Market Value (millions)</i>
60	Teleprompter	99	\$.99	none	\$ 6.0
190	Deltona	60½	2.32	none	11.5
280	Fedders	34	1.28	\$.35	9.5
105	Horizon Corp.	53½	2.68	none	5.6
150	Rouse Co.	34	.07	none	5.1
130	Mattel Inc.	64¼	1.11	.20	8.4
120	Polaroid	125	1.90	.32	15.0
244 ^a	Nat'l Student Mkt'g	28½	.32	none	6.1
56	Telex Corp.	90½	.68	none	5.0
100	Bausch & Lomb	77¾	1.92	.80	7.8
190	Four Seasons Nursing	66	.80	none	12.3 ^b
20	Int. Bus. Machines	365	8.21	3.60	7.3
41.5	Nat'l Cash Register	160	1.95	1.20	6.7
100	Saxon Ind.	109	3.81	none	10.9
105	Career Academy	50	.43	none	5.3
285	King Resources	28	.69	none	8.1
					\$130.6
Other common stocks					93.8
Other holdings					19.6
Total investments ^c					\$244.0

^a After 2-for-1 split.

^b Also \$1.1 million of affiliated stocks.

^c Excluding cash equivalents.

Annual Performance Compared with S & P Composite Index

	1966	1967	1968	1969	1970	1971
Manhattan Fund	- 6 %	+38.6%	- 7.3%	-13.3%	-36.9%	+ 9.6%
S & P Composite	-10.1%	+23.0%	+10.4%	- 8.3%	+ 3.5%	+13.5%

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

- The company is a Johnny-One-Note, relying on one customer (or a handful) for most of its revenues. In October 1999, fiber-optics maker Sycamore Networks, Inc. sold stock to the public for the first time. The prospectus revealed that one customer, Williams Communications, accounted for 100% of Sycamore's \$11 million in total revenues. Traders blithely valued Sycamore's shares at \$15 billion. Unfortunately, Williams went bankrupt just over two years later. Although Sycamore picked up other customers, its stock lost 97% between 2000 and 2002.

As you study the sources of growth and profit, stay on the lookout for positives as well as negatives. Among the good signs:

- The company has a wide “moat,” or competitive advantage. Like castles, some companies can easily be stormed by marauding competitors, while others are almost impregnable. Several forces can widen a company's moat: a strong *brand identity* (think of Harley Davidson, whose buyers tattoo the company's logo onto their bodies); a *monopoly* or near-monopoly on the market; *economies of scale*, or the ability to supply huge amounts of goods or services cheaply (consider Gillette, which churns out razor blades by the billion); a unique *intangible asset* (think of Coca-Cola, whose secret formula for flavored syrup has no real physical value but maintains a priceless hold on consumers); a *resistance to substitution* (most businesses have no alternative to electricity, so utility companies are unlikely to be supplanted any time soon).⁵

company's cash inflows and outflows into “operating activities,” “investing activities,” and “financing activities.” If cash from operating activities is consistently negative, while cash from financing activities is consistently positive, the company has a habit of craving more cash than its own businesses can produce—and you should not join the “enablers” of that habitual abuse. For more on Global Crossing, see the commentary on Chapter 12. For more on WorldCom, see the sidebar in the commentary on Chapter 6.

⁵ For more insight into “moats,” see the classic book *Competitive Strategy* by Harvard Business School professor Michael E. Porter (Free Press, New York, 1998).

COMMENTARY ON CHAPTER 13

In the Air Force we have a rule: check six. A guy is flying along, looking in all directions, and feeling very safe. Another guy flies up behind him (at “6 o’clock”—“12 o’clock” is directly in front) and shoots. Most airplanes are shot down that way. Thinking that you’re safe is very dangerous! Somewhere, there’s a weakness you’ve got to find. You must always check six o’clock.

—U.S. Air Force Gen. Donald Kutyna

E - BUSINESS

As Graham did, let’s compare and contrast four stocks, using their reported numbers as of December 31, 1999—a time that will enable us to view some of the most drastic extremes of valuation ever recorded in the stock market.

Emerson Electric Co. (ticker symbol: EMR) was founded in 1890 and is the only surviving member of Graham’s original quartet; it makes a wide array of products, including power tools, air-conditioning equipment, and electrical motors.

EMC Corp. (ticker symbol: EMC) dates back to 1979 and enables companies to automate the storage of electronic information over computer networks.

Expeditors International of Washington, Inc. (ticker symbol: EXPD), founded in Seattle in 1979, helps shippers organize and track the movement of goods around the world.

Exodus Communications, Inc. (ticker symbol: EXDS) hosts and manages websites for corporate customers, along with other Internet services; it first sold shares to the public in March 1998.

This table summarizes the price, performance, and valuation of these companies as of year-end 1999:

fewer than 245 companies in the S & P 500 index met that criterion as of early 2003, leaving the defensive investor an ample list to choose from. (If you double the cumulative growth hurdle to 100%, or 7% average annual growth, then 198 companies make the cutoff.)

Moderate P/E ratio. Graham recommends limiting yourself to stocks whose current price is no more than 15 times average earnings over the past three years. Incredibly, the prevailing practice on Wall Street today is to value stocks by dividing their current price by something called “next year’s earnings.” That gives what is sometimes called “the forward P/E ratio.” But it’s nonsensical to derive a price/earnings ratio by dividing the known current price by unknown future earnings. Over the long run, money manager David Dreman has shown, 59% of Wall Street’s “consensus” earnings forecasts miss the mark by a mortifyingly wide margin—either underestimating or overestimating the actual reported earnings by at least 15%.² Investing your money on the basis of what these myopic soothsayers predict for the coming year is as risky as volunteering to hold up the bulls-eye at an archery tournament for the legally blind. Instead, calculate a stock’s price/earnings ratio yourself, using Graham’s formula of current price divided by average earnings over the past three years.³

As of early 2003, how many stocks in the Standard & Poor’s 500 index were valued at no more than 15 times their average earnings of 2000 through 2002? According to Morgan Stanley, a generous total of 185 companies passed Graham’s test.

Moderate price-to-book ratio. Graham recommends a “ratio of price to assets” (or price-to-book-value ratio) of no more than 1.5. In recent years, an increasing proportion of the value of companies has come from intangible assets like franchises, brand names, and patents and trademarks. Since these factors (along with goodwill from acquisitions) are excluded from the standard definition of book value, most companies today are priced at higher price-to-book multiples than in Graham’s day. According to Morgan Stanley, 123 of the companies in the S & P 500 (or one in four) are priced below 1.5 times book value.

² David Dreman, “Bubbles and the Role of Analysts’ Forecasts,” *The Journal of Psychology and Financial Markets*, vol. 3, no. 1 (2002), pp. 4–14.

³ You can calculate this ratio by hand from a company’s annual reports or obtain the data at websites like www.morningstar.com or <http://finance.yahoo.com>.

problem of "what to do" with a convertible when it goes up. We believe it still merits inclusion here. Like several of our references it is based on our own investment operations. We were members of a "select group," mainly of investment funds, who participated in a private offering of convertible 4½% debentures of Eversharp Co. at par, convertible into common stock at \$40 per share. The stock advanced rapidly to 65%, and then (after a three-for-two split) to the equivalent of 88. The latter price made the convertible debentures worth no less than 220. During this period the two issues were called at a small premium; hence they were practically all converted into common stock, which was retained by a number of the original investment-fund buyers of the debentures. The price promptly began a severe decline, and in March 1948 the stock sold as low as 7%. This represented a value of only 27 for the debenture issues, or a loss of 75% of the original price instead of a profit of over 100%.

The real point of this story is that some of the original purchasers converted their bonds into the stock and held the stock through its great decline. In so doing they ran counter to an old maxim of Wall Street, which runs: "Never convert a convertible bond." Why this advice? Because once you convert you have lost your strategic combination of prior claimant to interest plus a chance for an attractive profit. You have probably turned from investor into speculator, and quite often at an unpropitious time (because the stock has already had a large advance). If "Never convert a convertible" is a good rule, how came it that these experienced fund managers exchanged their Eversharp bonds for stock, to their subsequent embarrassing loss? The answer, no doubt, is that they let themselves be carried away by enthusiasm for the company's prospects as well as by the "favorable market action" of the shares. Wall Street has a few prudent principles; the trouble is that they are always forgotten when they are most needed.* Hence that other famous dictum of the old-timers: "Do as I say, not as I do."

Our general attitude toward new convertible issues is thus a mistrustful one. We mean here, as in other similar observations,

* This sentence could serve as the epitaph for the bull market of the 1990s. Among the "few prudent principles" that investors forgot were such market clichés as "Trees don't grow to the sky" and "Bulls make money, bears make money, but pigs get slaughtered."

What kind of business did buyers get for that price? eToys' sales had risen 4,261% in the previous year, and it had added 75,000 customers in the last quarter alone. But, in its 20 months in business, eToys had produced total sales of \$30.6 million, on which it had run a net loss of \$30.8 million—meaning that eToys was spending \$2 to sell every dollar's worth of toys.

The IPO prospectus also disclosed that eToys would use some proceeds of the offering to acquire another online operation, BabyCenter, Inc., which had lost \$4.5 million on \$4.8 million in sales over the previous year. (To land this prize, eToys would pay a mere \$205 million.) And eToys would “reserve” 40.6 million shares of common stock for future issuance to its management. So, if eToys ever made money, its net income would have to be divided not among 102 million shares, but among 143 million—diluting any future earnings per share by nearly one-third.

A comparison of eToys with Toys “R” Us, Inc.—its biggest rival—is shocking. In the preceding three months, Toys “R” Us had earned \$27 million in net income and had sold over 70 times more goods than eToys had sold in an entire year. And yet as Figure 17-3 shows, the stock market valued eToys at nearly \$2 billion *more* than Toys “R” Us.

CONCLUSION: On March 7, 2001, eToys filed for bankruptcy protection after racking up net losses of more than \$398 million in its brief life as a public company. The stock, which peaked at \$86 per share in October 1999, last traded for a penny.

buy tchotchkes for children at eToys than at a traditional toy store. As analyst Gail Bronson of IPO Monitor told the Associated Press on the day of eToys' stock offering, “eToys has very, very smartly managed the development of the company last year and positioned themselves to be the children's center of the Internet.” Added Bronson: “The key to a successful IPO, especially a dot-com IPO, is good marketing and branding.” Bronson was partly right: That's the key to a successful IPO for the issuing company and its bankers. Unfortunately, for *investors* the key to a successful IPO is earnings, which eToys didn't have.

default rates tend to jump in a recession—but its stock price reflected at least some risk of potential trouble.

What happened next? In 2001, Commerce One generated \$409 million in revenues. Unfortunately, it ran a net loss of \$2.6 billion—or \$10.30 of red ink per share—on those revenues. Capital One, on the other hand, earned nearly \$2 billion in net income in 2000 through 2002. Its stock lost 38% in those three years—no worse than the stock market as a whole. Commerce One, however, lost 99.7% of its value.⁸

Instead of listening to Hoffman and his lapdog analysts, traders should have heeded the honest warning in Commerce One's annual report for 1999: "We have never been profitable. We expect to incur net losses for the foreseeable future and we may never be profitable."

PAIR 4: PALM AND 3COM

On March 2, 2000, the data-networking company 3Com Corp. sold 5% of its Palm, Inc. subsidiary to the public. The remaining 95% of Palm's stock would be spun off to 3Com's shareholders in the next few months; for each share of 3Com they held, investors would receive 1.525 shares of Palm.

So there were two ways you could get 100 shares of Palm: By trying to elbow your way into the IPO, or by buying 66 shares of 3Com and waiting until the parent company distributed the rest of the Palm stock. Getting one-and-a-half shares of Palm for each 3Com share, you'd end up with 100 shares of the new company—and you'd still have 66 shares of 3Com.

But who wanted to wait a few months? While 3Com was struggling against giant rivals like Cisco, Palm was a leader in the hot "space" of handheld digital organizers. So Palm's stock shot up from its offering price of \$38 to close at \$95.06, a 150% first-day return. That valued Palm at more than 1,350 times its earnings over the previous 12 months.

That same day, 3Com's share price *dropped* from \$104.13 to \$81.81. Where should 3Com have closed that day, given the price of Palm? The arithmetic is easy:

⁸ In early 2003, Capital One's chief financial officer resigned after securities regulators revealed that they might charge him with violations of laws against insider trading.

host of strongly financed industrial companies at the low price levels of 1932–33. In such instances the investor can obtain the margin of safety associated with a bond, *plus* all the chances of larger income and principal appreciation inherent in a common stock. (The only thing he lacks is the legal power to insist on dividend payments “or else”—but this is a small drawback as compared with his advantages.) Common stocks bought under such circumstances will supply an ideal, though infrequent, combination of safety and profit opportunity. As a quite recent example of this condition, let us mention once more National Presto Industries stock, which sold for a total enterprise value of \$43 million in 1972. With its \$16 millions of recent earnings before taxes the company could easily have supported this amount of bonds.

In the ordinary common stock, bought for investment under normal conditions, the margin of safety lies in an expected earning power considerably above the going rate for bonds. In former editions we elucidated this point with the following figures:

Assume in a typical case that the earning power is 9% on the price and that the bond rate is 4%; then the stockbuyer will have an average annual margin of 5% accruing in his favor. Some of the excess is paid to him in the dividend rate; even though spent by him, it enters into his overall investment result. The undistributed balance is reinvested in the business for his account. In many cases such reinvested earnings fail to add commensurately to the earning power and value of his stock. (That is why the market has a stubborn habit of valuing earnings disbursed in dividends more generously than the portion retained in the business.)* But, if the picture is viewed as a whole, there is a reasonably close connection

if the business conditions prevailing during the period were to continue unchanged” (*Security Analysis*, 1934 ed., p. 354). Some of his lectures make it clear that Graham intended the term to cover periods of five years or more. You can crudely but conveniently approximate a company’s earning power per share by taking the inverse of its price/earnings ratio; a stock with a P/E ratio of 11 can be said to have earning power of 9% (or 1 divided by 11). Today “earning power” is often called “earnings yield.”

* This problem is discussed extensively in the commentary on Chapter 19.

TABLE 1 Walter J. Schloss

Year	S&P Overall Gain, Including Dividends (%)	WJS Ltd Partners Overall Gain per year (%)	WJS Partnership Overall Gain per year (%)		
1956	7.5	5.1	6.8	Standard & Poor's 28¼ year compounded gain	887.2%
1957	-10.5	-4.7	-4.7		
1958	42.1	42.1	54.6	WJS Limited Partners 28¼ year compounded gain	6,678.8%
1959	12.7	17.5	23.3		
1960	-1.6	7.0	9.3	WJS Partnership 28¼ year compounded gain	23,104.7%
1961	26.4	21.6	28.8		
1962	-10.2	8.3	11.1	Standard & Poor's 28¼ year annual compounded rate	8.4%
1963	23.3	15.1	20.1		
1964	16.5	17.1	22.8	WJS Limited Partners 28¼ year annual compounded rate	16.1%
1965	13.1	26.8	35.7		
1966	-10.4	0.5	0.7	WJS Partnership 28¼ year annual compounded rate	21.3%
1967	26.8	25.8	34.4		
1968	10.6	26.6	35.5		

During the history of the Partnership it has owned over 800 issues and, at most times, has had at least 100 positions. Present assets under management approximate \$45 million. The difference between returns of the partnership and returns of the limited partners is due to allocations to the general partner for management.

of the data required usually makes the prospectus of prohibitive length. It is generally agreed that only a small percentage of *individuals* buying new issues read the prospectus with thoroughness. Thus they are still acting mainly not on their own judgment but on that of the house selling them the security or on the recommendation of the individual salesman or account executive.

Chapter 11. Security Analysis for the Lay Investor: General Approach

1. Our textbook, *Security Analysis* by Benjamin Graham, David L. Dodd, Sidney Cottle, and Charles Tatham (McGraw-Hill, 4th ed., 1962), retains the title originally chosen in 1934, but it covers much of the scope of financial analysis.
2. With Charles McGolrick, Harper & Row, 1964, reissued by Harper-Business, 1998.
3. These figures are from Salomon Bros., a large New York bond house.
4. At least not by the great body of security analysts and investors. Exceptional analysts, who can tell in advance what companies are likely to deserve intensive study and have the facilities and capability to make it, may have continued success with this work. For details of such an approach see Philip Fisher, *Common Stocks and Uncommon Profits*, Harper & Row, 1960.
5. On p. 295 we set forth a formula relating multipliers to the rate of expected growth.
6. Part of the fireworks in the price of Chrysler was undoubtedly inspired by two two-for-one stock splits taking place in the single year 1963—an unprecedented phenomenon for a major company. In the early 1980s, under Lee Iacocca, Chrysler did a three-peat, coming back from the brink of bankruptcy to become one of the best-performing stocks in America. However, identifying managers who can lead great corporate comebacks is not as easy as it seems. When Al Dunlap took over Sunbeam Corp. in 1996 after restructuring Scott Paper Co. (and driving its stock price up 225% in 18 months), Wall Street hailed him as little short of the Second Coming. Dunlap turned out to be a sham who used improper accounting and false financial statements to mislead Sunbeam's investors—including the revered money managers Michael Price and Michael Steinhardt, who had hired him. For a keen dissection of Dunlap's career, see John A. Byrne, *Chainsaw* (HarperCollins, New York, 1999).