Hi, just finished reading The Intelligent Investor by Benjamin Graham 5th time.
The idea he speaks of is becoming more clearer now.

Benjamin Graham, popularly known as Ben, was a great economist, investor, observer, thinker, writer and teacher (he taught at Columbia). Warren Buffett stated about Benjamin Graham - "I have never met anyone with a mind of similar scope. Virtually total recall, unending fascination with new knowledge, and an ability to recast it in a form applicable to seemingly unrelated problems made exposure to his thinking in any field a delight."

Ben died in Sep. 1976. He was an icon and his depth of understanding on security analysis would be difficult to match ever. His teachings on the subject would continue to enlighten the path of sincere seekers of knowledge and wisdom in the field of investments. Thanks to generosity, with which, he shared his invaluable thought process with all of us.

The Intelligent Investor – Summary

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The Intelligent Investor by Benjamin Graham

Introduction

Ben Graham, 'Dean of Wall Street' and father of 'Value Investing' wrote this classic in 1949. Though several editions of the book have come since then, fundamental texture of the book remains the same. Jason Jweig has added phenomenal value to the book through his commentaries with Grahams theories applied on recent events (in case of this book is Dot Com bubble of 2000), which are really thought provoking.

Objective of the book :

As honestly stated by Graham, is not to teach how to beat market but teach three powerful lessons:

• How to minimize the odds of suffering irreversible losses (33% fall in price calls for 50% rise just to break even!)

• How to maximize the chances of achieving sustainable gains (thought is protecting downside is beginning of rise!)

• How to control the self-defeating behaviour that keeps away most investors from reaching their full potential (emotional discipline is key!)

Jason states "Combining his extraordinary intellectual power with profound common sense and vast experience, Graham developed his core principles, which are at least as valid today as they were during his life time:

• A stock is not just a ticker symbol or an electronic blip; it is an ownership interest in an actual business, with an underlying value that does not depend on its share price.

• The market is a pendulum that forever swings between unsustainable optimism (which makes stocks too expensive) and unjustified pessimism (which makes them too cheap). The intelligent investor is a realist, who sells to optimists and buys from pessimists.

• The future value of every investment is a function of its present price. The higher the price you pay, the lower your return will be.

• No matter how careful you are, the one risk no investor can ever eliminate is the risk of being wrong. Only by insisting on what Graham called the margin of safety – never overpaying, no matter how exciting an investment seems to be – can you minimize your

odds of error.

• The secret to your financial success is inside yourself. If you become a critical thinker, who takes no Wall Street "fact" on faith, and you invest with patient confidence, you can take steady advantage of even the worst bear markets. By developing your discipline and courage, you can refuse to let other people's mood swings govern your financial destiny. In the end, how your investments behave is much less important than how you behave.

• An investment operation is one which, upon thorough analysis promises safety of principal and an adequate return. Operations not meeting these requirements are speculative."

Investment Operations

Investment operation :
Investing is a serious activity and needs to be run as business. As Graham said "Investing is most intelligent when it is businesslike."

Thorough analysis :
Buying a business is alternative to starting a business and would demand same kind of research and analysis on various dimensions of business – product, customers, inputs, outputs, bargaining power, competition, regulatory environment, potential opportunities, threats etc.

Principal protection :
First objective is to protect what we have. Only tool for principal protection is margin of safety – paying lower than what we think a business is worth. Also, investment activity as operation/business indicates that while there may be loss (es) on one or more investments, at business level, we should not have loss. Loss, as per Graham, is the 'permanent loss of capital' and not 'mark to market loss'.

Adequate return :
Do not expect extraordinary returns from investment in equity. Otherwise, this would push us to undertake risky bets.

People's behavior

• In Wall Street/Dalal Street language – everyone who buys/sells securities becomes an investor regardless of what he buys/sells, for what purpose, what price, whether for cash or on margin and with or without understanding.

• While enthusiasm may be necessary for great accomplishments elsewhere, on Wall Street it almost inevitably leads to disaster.

• Intelligent investing has nothing to do with IQ. It means being patient, disciplined and eager to learn. Graham said "This intelligence is a trait of the character than of the brain."

• Sir Isaac Newton said "He could calculate the motions of the heavenly bodies, but not the madness of the people."

• Investors make money for themselves and speculators make money for brokers. And, that, in turn is why Wall Street downplays the durable virtues of investing and hypes speculation.

• For better or worse, the gambling instinct is part of human nature - so it is futile for most people even to try suppressing it. But, we must confine and restrain it.

• Investment decisions need to be rational and not emotional.

• During good times, quick profits shown by common stocks as a whole are sufficient to dull the public's critical faculty. Once intoxicated, they may jump the bandwagon without thinking appropriately.

• What we don't do is as important to our success as what we do.

• Wall Street's view is always either too optimistic (stocks are most overpriced) or too pessimistic (stocks are cheap/under priced). Behaviourally, we try to justify our actions (why stocks are there where they are).

• Speculative public is incorrigible – will buy anything at any price if there seems to be some action in progress.

• As warning on the cigarette pack doesn't prevent people from lighting up. Similarly, no regulatory warning would prevent investors from overdosing on their own greed.

• Risk is not in our stocks, but in ourselves.

• Graham states "Just as great athletes and musicians practice and rehearse before every actual performance, investors need to practice continuously.
Graham advises to start off by spending a year tracking and picking stocks (not with real money). It means mistakes without any actual loss. One would develop discipline and would learn what works and what does not. Also, learn from winners and losers.

Analyse experience and decide whether it is for you. Then, move slowly with small money and increase over a period of time."

Mr. Market

• Mr. Market theory – Mr. Market encourages us to buy, when prices have gone up (luring us with further upside potential!!) and encourages us to sell, when prices have gone down (creating fear that there is further downside!!) – But, decision lies with us.

• Mr. Market's behaviour is to fluctuate and we have to be financially and psychologically prepared for the same. Indeed, we should think of taking advantage of this fluctuation. This can be done either timing the market or pricing the market. Timing the market i.e. buying low and selling high is virtually impossibility. However pricing the market i.e. buying at price lower than value and selling at price higher than value is what can be done to take advantage of market fluctuations.

• Price fluctuations offer opportunity to buy wisely (when prices fall) and sell wisely (when prices rise). Other times, pay attention to dividend returns and operating results of the companies. Stock market often goes far wrong – alert and courageous investors can take advantage of this.

• Market does not impose the current quotation on an investor, who prefers to take his idea of value from some other source.

• "The sillier the market behaviour, the greater the opportunity for the business like investor" – W.B.

• Prices will fluctuate (that is the nature of the market); neither be concerned by sizeable declines nor become excited by sizeable advances. Never buy a stock after a substantial rise or sell one immediately after a substantial drop.

• Market offers us just an entry/exit route in a business at a price, which is always independent of the value of the underlying business. Market quotations are for our convenience – to be taken advantage of or to be ignored. We don't have to trade with him just because he constantly begs us to.

• Think of yourself and not the Mr. Market. Primary cause of investor's failure is that they pay too much attention to what Mr. Market is doing currently. A typical investor would be better off if his stocks had no market quotations at all for he would then be spared the mental anguish caused to him by other persons' mistakes of judgement. Exploit the speculative enthusiasm of the uninformed and greedy public.

• Do not think that overvalued stocks must drop purely because it is overpriced. A stock can remain overvalued for surprisingly long time.

• Mr. Market may price stock really fancy because of high profitability and high growth. Don't be carried away and look at long term history.

• Although there are good and bad companies, there is no such thing as a good stock; there are only good stock prices, which come and go.

• In the short run, market is a voting machine, but in the long run, it is weighing machine. In the end, only earnings and assets matter.

• Most of the times, market is accurate in pricing most stocks. But, sometimes, price is not right; occasionally, it is very wrong indeed.

• When the price of a stock can be influenced by a 'herd' on Wall Street with prices set at the margin by the most emotional person, or the greediest person, or the most depressed person, it is hard to argue that the market always prices rationally. In fact, market prices are frequently nonsensical.

• In financial markets, the worse the future looks, the better it usually turns out to be and vice versa.

• Bull market characteristics are historical high prices, high P/E and P/BV ratios, low dividend yield against the bond yields, prices being justified based on growth potential, lots of IPOs, Lots of M&A transactions, lots of Private Equity Transactions, High earnings of Investment Bankers being reported, brokers hiring/ expanding operations etc. etc. Bear market has subdued activities in the market and stocks are available at thrown away prices – historically low prices, low P/E and P/BV ratios, high dividend yield, virtually no IPOs and M&A activities and downsizing across the financial markets.

• The intelligent investor realizes that the stocks become more risky, not less, as their prices rise-and less risky, not more, as their prices fall. The Intelligent investor dreads a bull market, since it makes stocks more costly to buy. And conversely welcomes a bear market, since it puts stocks back on sale.

• Longer the bull market, more severely investors will be afflicted with amnesia. In bull market, people forget… and do not believe that bear markets are even possible. All those who forget are doomed to be reminded. And, in the market, recovered memories are most of the times unpleasant – why did I buy, why didn't I buy, why did I sell, why didn't I sell etc.

Businesses to buy

• Obvious prospects for physical growth in a business do not translate into obvious profits for investors. Aviation and internet are two good examples of this thought.

• Graham said "investors should ask - would I be willing to have an investment in this company on these terms, if there was no market for these shares." – This is private equity mindset. Thought is originating from the point that we are buying businesses and not shares. Also, investing is a patient job.

• Stocks do well or poorly in the future because the business behind them do well or poorly – nothing more and nothing less.

• Most business change in character and quality over the years – sometimes for the better..perhaps, more often for the worse. Give a good hard look on your portfolio companies from time to time.

• Dependence on one or two customers (customer concentration) could be a large risk for corporate.

• Better to look at businesses with deep and sustainable "moat – competitive advantage" – strong brand identity, monopoly or near monopoly, economies of scale (low cost producer), resistance to substitute or no substitute.

• Business is a marathoner and not a sprinter – fast growing companies tend to overheat and flame out. Critical for success is a consistent speed with long term focus on target.

• Company should be consistently discovering new products, new markets and newer ways to serve customers.

• Management thinks like owners and not just business managers – communicate candidly about problems, clear plans for allocation of current and future cash flows and own sizeable stake in the business (preferably through cash and not ESOPs).

• Buffett's prefers franchise businesses – strong brands, easily understandable, robust financial health, near monopoly in their markets; buy them when there is a scandal, big loss or some other bad news; look for managers who set and meet realistic goals, build business through organic growth and not acquisitions, allocate capital wisely and do not pay themselves hundred million dollars jackpot of options.

• Look for goodwill component in any acquisition. Too large is an alarming bell.

Paying for Businesses

• Most of the street knows price of everything and value of nothing.

• Buy stocks as we buy grocery and not the perfume. Graham states “The really dreadful losses always occur after the buyer forgot to ask ‘How Much’. The investor’s chief problem and even his worst enemy-is likely to be himself.”

• Limit your investments to stocks selling not far above their Tangible Asset Value – conservative policy of paying less for what you receive is likely to work out better than exciting adventures into the glamorous and dangerous fields of anticipated growth (paying higher for anticipated growth – future is always uncertain.) Tangible Asset Value, Net Asset Value, Book Value, Balance Sheet Value are all synonyms for net worth – total value of a company’s physical and financial assets minus all liabilities and intangible assets such as goodwill, trademarks ,brands, copy rights, patents, franchise etc.

• Valuation based on anticipation of future is more vulnerable to possible miscalculations and errors. If they involve complex valuation models, higher algebra and several spread sheets one needs to become skeptical.

• Mathematics is ordinarily considered as producing precise and dependable results; but in the stock market the more elaborate and abstruse the mathematics the more uncertain and speculative are the conclusions we draw there-from. In forty-four 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, we 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.

• “Investors judge the market price by established standards of value while speculators based their standards of value upon the market price” – For uninformed buyer of anything, higher the price, higher the quality. Higher price creates illusion/misconception of higher value.

• No intelligent investor, no matter how starved for yield, would ever buy a stock for its dividend income alone; the company and its businesses must be solid and its stock price must be reasonable.

• Remember ‘The higher the stocks go, the harder they fall.’ Would be good to ask questions:

- Are stocks sure shoot recipe to make money.

- Do most of the people believe that.

- If most believe so, won't the market end up being wildly overpriced.

- And, once that happens, how can future returns possibly be high.

• Stocks are not worth buying at any price. Objective should be to buy great businesses and buy them at great (bargain) price.

• In public markets, valuation becomes popularity contest – price of the stock seems more important than the value of the stock.

• A great business is not a great investment if we pay too much for the stock.

• We should look at not the absolute level of index or price but its comparison with underlying value i.e. earnings, book value etc.

• Capitalization rate viz. P/E should be a function of future earnings (general long term business prospects), management quality, financial strength and capital structure (good cash, low debt, good interest coverage) and uninterrupted record of dividend payout over many years.

• Pay no more than one and a half times of Net Asset Value and no more than 15 times of P/E based on average 3 years earning. And, multiplication of these two ratios not to exceed 22.5.

• Stock portfolio at acquisition should have an overall earning yield (E/P – reverse of P/E) at least as high as current yield of high grade bonds. Earning yield higher than bond yield would work as margin of safety.

• Function of margin if safety is to render unnecessary an accurate estimate of the future and accommodate our errors in valuation. If stocks are bought with margin of safety – we don't require high quality of insight/foresight into businesses for success.

• There is no reason to expect that, in a short period of time, low P/E would outperform high P/E stocks. High P/E stocks may have high momentum behind them and that may continue for a quite long. Question is one is chasing "Value type Investments" or "Glamour type investments".

• Don't pay high prices for a stock (in relation to earnings and assets) because of enthusiasm about the future prospects.

• Why do debt guys ask for interest coverage of 4/5 times over last several years – it provides cushion for future decline in earnings. As equity is the last in the pack of securities in a business, we need to apply same safety concepts and more to equity investments.

• Pay price always in relation to earnings and assets.

• Focus on paying for the present and getting the future for nothing.

• People often assign a mental value to stocks based largely on the emotional imagery the companies evoke.

• Speculative elements in stocks has two components –

a) uncertainty and fluctuating elements in company, industry and economy and

b) viewpoint and attitude of stock buying
public, their advisers and research analysts.

• Whatever is paid as enterprise value over the net assets is market's appraisal of "good will" – leading to superior expectations of increased profits in the future.

• Never overestimate your ability to understand an investment. Ask questions:

- My experience and track record with similar decisions in the past.
- Experience of others with similar decisions in the past.
- Someone is selling to me. Does he know more than I do.
- Someone is buying from me. Does he know more than I do.
- Do I understand consequences of my analysis going wrong – is too much at risk; am I well diversified. We have to protect ourselves against the consequences of going wrong.

Leverage

Markets may remain irrational longer than we may remain solvent. Better to avoid leverage from three perspective –

a) money is always made on exit and that is uncertain both in terms of price and time – so, how long to borrow for!;

b) if call goes wrong, leveraged positions would accelerate the depletion of owner's capital;

c) in case of sudden and drastic fall, owners' may have to lose control of position to creditors (if full owner's capital is already sunk, creditors may forcefully close the position irrespective of potential future gain possibility).

Inflation

• Inflation :
Erosion of value of money is a silent eater of capital. At 8% inflation rate, Rs 100 purchase today would demand Rs 108 at the end of the year. Therefore, to avoid the negative impact of inflation on our purchasing power, our money needs to at least earn at par with the inflation rate. If we are earning 8% interest when inflation is 12% vis a versa are earning 5% when inflation is 3% - obviously, we are better off in latter situation.

• Statement that equities are best hedge against inflation may be misleading because of two reasons –

a) historically, it is not evident that during high inflation, equity returns are higher all the time and

b) Buying equity at any price may put our capital at risk in pursuit of protection against inflation.

Risk in investing

• Risk needs to be perceived in paying price higher than intrinsic value and not in terms of fluctuations in market prices. Industry practice of defining risk in terms of average price variation or "Volatility" is more harmful than useful for sound investing decisions – because it places too much emphasis on market fluctuations.

• Do home work on each business. Specialize in asking questions specifically on downsides/risks in/threats to the business. Investigate yourself (little to delegate here).

• Only risk for investors is 'loss of permanent capital'.

• Risk reward relationship in 'Value Investing' is negative. If we buy a dollar bill for 60 cents, it is riskier than if we buy a dollar bill for 40 cents (low money is at stake for loss), but expectation of reward is greater in the latter case for rise in price by each cent. Starting with lower risk point automatically improves the potential for reward.

• Investors do not like uncertainty. But it is most important fundamental of investing. Future is always uncertain.

• Graham and Dodd investors don't discuss Beta, CAPM, Correlations, Co-variance in return among asset classes or securities. No interest in any of these factors. Indeed, may find it difficult to define these terms. Their focus is only on two variables – Price and Value.

Prediction

• Our very refusal to be active (continuous buying and selling in the market), renunciation of any pretended ability to predict the future can become our most powerful weapon. Drop your self-delusion that you know where stocks are headed (fact is no one knows). Take away market's power to upset you.

• Our brains are designed to perceive trends even where they might not exist. Fight the prediction addiction, focus on your long term financial goals and tune out Mr. Market's mood swings.

• We note innumerable market predictions daily. Unfortunately, people pay attention to them and more unfortunately act on them. They think that it is important for them to form some opinion about future course of the market. And, they think that others forecast is more dependable than their own. Forecasts may become more influential (as more and more people act on them) but unfortunately not more accurate. It is absurd to think "General Public" can ever make money out of the market forecast.

• History proves "Expert" forecasters are inept at predicting future.

• Intelligent investors excel by making decisions which are not dependent on the accuracy of any body's forecast including their own.

• Future can be approached in two ways – way of prediction and the way of protection. We invest in the present, but we invest for the future; and unfortunately, future is always uncertain. Therefore, investing on the basis of projections could be dangerous and should be adopted carefully. Protection approach viz. investing with margin of safety appears better from risk point of view.

• Investment operations should be based not on optimism but on arithmetic. Believe in your knowledge and experience and take decisions based on facts and figures.

IPOs

IPO as – It is probably overpriced; Imaginary profits only; insider's private opportunity; idiotic, preposterous and outrageous.

• Investors need to be cautious with IPOs. Sellers of IPOs get high commissions to sell because they are to be pushed to investors, sold in favourable market conditions (favourable to seller and unfavourable to buyers), have no market track record. Graham advises – resist the blandishment of salesmen offering new shares during bull time; it is part of speculative business and better to leave for others; gives sense of easy money and you would be lucky, if you end up losing only $2 for each $ earned here; some of these issues may be owned later, when no one wants them and they are available at bargain prices.

• Bull market creates euphoria among the investing community as everyone seems to be making money. Some reasonably priced IPOs hit the street and investors make money. This builds their confidence and improves their appetite. Then starts the offerings of poor quality issues at unreasonable prices. Issuers push to sell anything at any price; foolishness of public to buy anything at any price and Investment Bankers make money while the sun shines. Clearly, these are the signs of the beginning of another fall.

• IPOs flow reflects regular recurrence of completely brainless, shockingly wide spread and inevitable catastrophic speculation.

Diversification

• Andrew Carnegie said "Do not scatter your shots… The great success in life is made by concentration." Graham said "The really big fortunes from common stocks have been made by people, who packed all their money into one investment they knew superbly well." The Forbes 400 list of the richest Americans has always been dominated by un-diversified fortunes ever since it was first compiled in 1982.

• Interestingly, this list changes dramatically every 5-10 years, which makes us believe not many big fortunes have been kept this way – "concentration also makes most of the great failures of life."

• Theoretically, better to concentrate on one stock, we know/understand well. But, unfortunately, as minority outside shareholders, we may never know the entire story in a business, hence, this can't be done with reasonable confidence. Think of… we parking our entire money in one business like Enron, World com, Satyam etc.. Therefore, it will always be prudent to diversify in a concentrated manner (hold 10-20 businesses). But, wide diversification dilutes/waters the concentrated force of a few great ideas.

• Diversification doesn't just minimize our odds of being wrong. It also maximizes the chances of being right – over long period of time.

Investing - A Competitive Game

- Investing is not about beating others at their game. It is about controlling yourself at your own game.

- Refuse to judge your success by how a bunch of total strangers are doing. No one’s gravestone reads “He Beat the Market or other investors”. Objective of investments is not to beat others but to make enough money to meet your own needs. Who cares..what others are making? You are not in competition with anyone.

- Achieving satisfactory investment results is easier than most people realize; to achieve superior results is harder than it looks.

Financial Experts

• Experts do not have dependable ways of selecting and concentrating on the most promising companies in the most promising industries.

• Experts in stock market are significantly different from experts in engineering and medical fields. These guys are awfully wrong most of the times (cover themselves up under the shelter of words like 'view/opinion')

• In this age of computerization and availability of data, academicians have learnt mathematical skills to manipulate them. It appears sinful not to use all that learning, even if usage has no utility or negative utility.

Funds Operations

• Funds are most of the times buying high and selling low - Buy when investors give them money. Investors give them money when markets are rising/already quite high. Funds invest and take stocks up to even more dangerous heights; Sell when investors withdraw money. Investors withdraw money when markets are down. Funds sell and take stocks further down.

• Their objective is to beat indices and not to earn absolute return. When a stock gets to index, many of them buy at any price (pay high). If they don't and stock goes up, they appear foolish but if they do and it does poorly, no one will blame them.

• Funds are compelled to take short term view as their performance is being measured on real time basis (NAV monitoring).

• Funds don't think that their mandate is to hold cash. If they do and stocks go up, they appear foolish; if they do and stocks go down, no one pats their back; however, if they invest and stocks go down, that is fine as market as a whole has gone down. They are not the exclusive lot – consolation is that we have lost along with lot others.

• Better a fund performs, everyone wants that fund manager and he may quit. Also, as fund size increases it becomes difficult to replicate the performance of small fund. More funds come at the higher level of market and under pressure to invest, funds invest at higher levels, which may result in poor performance if markets go against.

• Index funds could be a good option for lots of people – own the entire set of index stocks, no pretence of being able to select the best and avoid the worst, rock bottom overheads – operating expenses, management fees and trading fees, insurmountable competitive advantage over actively managed funds in a long run. Indeed, a boring way to create wealth.

• What to see in a fund: managers are biggest shareholders – interests are aligned, no moral hazard, no conflict of interest; cheap in cost; dare to be different – not chasing wall street crowd; shut the door – chasing performance and not AUM; don't advertise and/or push investors for investment. Plato stated in "The Republic" that "the ideal rulers are those who do not want to govern".

Investment Advisers

• Investment advisers should be modest in their promises, no claim of being brilliant, careful, conservative and competent. They should do no guesswork on future stock prices.

• Good investment advisers don’t do sales pitches like – opportunity of the life time, guaranteed, you need to hurry up, sure thing, our proprietary model, smart money is buying it, it is a no brainer, you can’t afford not to own it, beat the market, you will sorry later, trust me, active asset allocation strategies, no one else knows how to do this etc.

• “Look for integrity, intelligence and energy” – W.B.

• Let others run your business only if a) you can supervise his/her performance with adequate care and comprehension, and b) you have strong reasons for placing confidence in his/her integrity and ability.