SUMMARY

Review & Analysis of
Graham's Book

The Intelligent Investor

BusinessNews Publishing

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Book Presentation
The Intelligent Investor by Benjamin Graham

Summary of ***The Intelligent Investor*** (Benjamin Graham)

BOOK PRESENTATION
THE INTELLIGENT INVESTOR
BY BENJAMIN GRAHAM

BOOK ABSTRACT

MAIN IDEA

An intelligent investor is “businesslike” – he or she approaches investing in just the same way as if one were to look at buying a business or a partnership in one. The sounder the investment principles you use, the better the results will be of your investment strategy. If you aspire to generate sizable returns by investing in the stock market or in other securities, run your activities in accordance with sound and sensible business principles.

The guiding principle of intelligent investing →

1. Know the business you’re investing.
2. Know who runs the business.
3. invest for profits overtime, not for quick buy and sell transactions.
4. Have confidence in your own reasoning.
5. Choose investments for their fundamental value, not for their popularity.
6. Always invest with a margin of safety.

> *“Successful investment may become substantially a matter of techniques and criteria that are learnable, rather than the product of unique and incommunicable mental powers. In 1900 none of us had any inkling of what the next fifty years were to do to the world. Through all its vicissitudes and casualties, as earth-shaking as they were unforeseen, it remained true that sound investment principles produced generally sound results. We must act on the assumption that they will continue to do so.”*
>
> *– Benjamin Graham*

ABOUT THE AUTHOR

BENJAMIN GRAHAM (1894-1976) is widely regarded as the father of value investing. He was born in London and his family migrated to America when he was very young. Graham graduated from Columbia University and took a job as a chalker for a Wall Street investment partnership. Before long, he was doing financial research for the firm and was made a full partner. At age 25, he was earning more than $500,000 a year. The Crash of 1929 meant Graham lost all of the wealth he had built up but he stayed in the investment business. In 1934, Benjamin Graham and David Dodd (another Columbia academic) coauthored *Security Analysis* which popularized the concept of intrinsic value. In 1949, Graham published *The Intelligent Investor* to encapsulate his thinking on how to be a successful investor. At the time of his death in 1976, Graham was still active in the investment community. He also taught at Columbia University for thirty years with one of his better known students being Warren Buffett.

IMPORTANT NOTE ABOUT THIS EBOOK

This is a summary and not a critique or a review of the book. It does not offer judgment or opinion on the content of the book. This summary may not be organized chapter-wise but is an overview of the main ideas, viewpoints and arguments from the book as a whole. This means that the organization of this summary is not a representation of the book.

SUMMARY OF *THE INTELLIGENT INVESTOR* (BENJAMIN GRAHAM)

PRINCIPLE #1: KNOW THE BUSINESS YOU'RE INVESTING IN.

Before you even consider investing in a business, get to know what it sells, how it operates and what it does to make money. Until you have a good feel for a firm's competitive environment, its challenges and opportunities and its strengths and weaknesses, you don't really know enough to be investing in that business. Get up to speed before you invest, not after.

> *"An investment operation is one which, upon thorough analysis, promises safety of principal and a satisfactory return. Operations not meeting these requirements are speculative."*
>
> *– Benjamin Graham and David Dodd, Security Analysis*

To invest in something rather than just speculating and hoping for the best, there needs to be a rational reason for your actions. There are a very large number of potential investments you can select from and it is only by careful and thorough analysis you can choose one investment over another logically and consistently.

Sound investments appreciate in value over time because of their long-term business operations rather than as a result of coming into market favor. The key is to accurately appraise the future possibilities of the company in question. You have to know enough to be able to make "an educated guess" about future financial results. This is only feasible if you understand in some detail what the company does and how it plans on generating profits in the future.

Note intelligent investors will be alert and businesslike as much after they become security owners as they were in making the decision to buy a particular stock. The bulk of the real money in any investment will be made by those who own and hold a security over time, receiving interest (in the case of bonds) or dividends (in the case of stock) therefrom combined with a share of the long-term increase in value. Investors need to think like owners rather than dealers or traders. Their major energies need to be focused towards assuring themselves of the best possible operating results by:

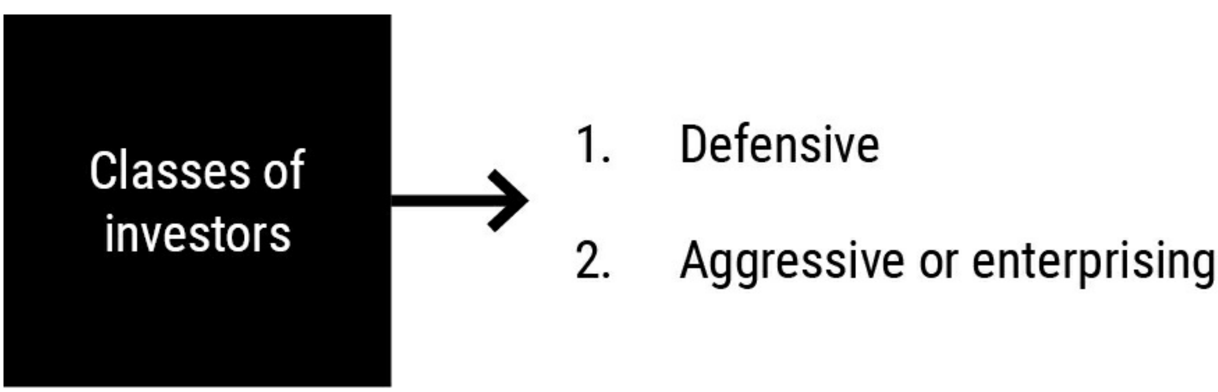
1. Appointing fully honest and competent managers.
2. Doing everything possible to improve bad management.
3. Actively participating in the stockholder - management relationship.

> *"The genuine investor in common stocks does not need a great equipment of brains and knowledge, but he does need some unusual qualities of character."*
>
> *– Benjamin Graham*

> *"Do not try to make 'business profits' out of securities – that is, returns in excess of normal interest and dividend income – unless you know as much about security value as you would need to know about the value of merchandise that you proposed to deal in or manufacture."*
>
> *– Benjamin Graham*

> *"Since anyone – by just buying and holding a representative list – can equal the performance of the market averages, it would seem a comparatively simple matter to 'beat the averages'; but as a matter of fact the number of smart people who try this and fail is surprisingly large."*
>
> *– Benjamin Graham*

Investors come in two major classes:



1. Defensive investors want to conserve their investment capital first and foremost. They place a high premium on avoiding serious mistakes or losses. They also want to avoid having to make decisions too frequently and therefore will look for long-term investments that will grow and appreciate with minimal effort.

   Defensive investors will typically buy a mix of:

   1. United States Savings Bonds or other nontaxable securities
   2. A diversified list of leading common stocks
   3. Shares in leading investment funds
2. Aggressive or enterprising investors are willing to devote more time to managing their investments and making investment decisions. They will take the time to analyze everything about a business and get to know it thoroughly before deciding to invest.

   Aggressive or enterprising investors will buy a mix of:

   1. United States Savings Bonds or other nontaxable securities
   2. A diversified list of leading common stocks
   3. Shares in leading investment funds
   4. Growth stocks which will grow faster than everyone else
   5. Common stocks whenever the general market is low
   6. Corporate bonds and preferred stocks at bargain levels
   7. Some exceptional convertible issues

Note there are some types of investments intelligent investors will not buy, specifically:

- Low-yield corporate bonds or preferred stock.
- Foreign government issues.
- Leading common stocks whenever the market is at a historically high level.
- Secondary common stocks – unless they are offered at an exceptionally low price.
- New issues of common stocks – unless they offer as good a combination of income and safety as is obtainable by U.S. Savings Bonds and the

common stocks of leading corporations at normal market prices.

> *"Investors as a whole are not and cannot be dealers or traders in securities. They are owners of the country's larger enterprises. They make money not out of each other but out of those businesses. Hence their major energies and wisdom as investors should – in theory at least – be directed towards assuring themselves of the best operating results from their corporations. This in turn means assuring themselves of fully honest and competent managements."*
>
> *– Benjamin Graham*

> *"Though business conditions may change, corporations and securities may change, and financial institutions and regulations may change, human nature remains essentially the same. Thus the important and difficult part of sound investment, which hinges upon the investor's own temperament and attitude, is not much affected by the passing years."*
>
> *– Benjamin Graham*

PRINCIPLE #2: KNOW WHO RUNS THE BUSINESS.

You won't be able to operate the business yourself, so you need a manager who will run the business and hopefully make money for you. Look for companies that are being managed competently, efficiently and honestly. Find managers who will do those things which are in the best interests of shareholders. Never invest in anything until you have first looked very carefully at the strengths and competencies of the management team.

The relationship between a stockholder and the management of a corporation should be considered on three different levels:

- *In terms of legal rights* – stockholders as a class and acting as a majority can hire and fire managers and force them to do whatever the stockholders want.
- *In terms of common practice* – stockholders rarely if ever assert their legal rights over management. Instead, most stockholders vote in sheep like fashion for whatever the management recommends, even if their track record is abysmally poor. It is extremely rare for a proposition opposed by the management to be carried by the votes of rank-and-file

stockholders. It simply does not happen.

- *In terms of how managers commonly treat their stockholders*- and here companies on the whole are reasonably good. Most managers of public companies try and do the right thing, although it is easy for them to get away with the wrong thing if they are so inclined. Inefficient or dishonest managements usually get removed fairly promptly.

Stockholders should be focused primarily on determining the answers to just two key questions:

1. *Is the management reasonably efficient?*
    - There are really no rational tests by which this question can be answered, so it is really up to each individual investor to answer this question for themselves. There are, however, a few leading indicators of management competency:
    - Is the company performing as well as its peers?
    - Is the company increasing or losing its market share?
    - Does the company have a profit margin equal to its peers?
    - When none of these indicators are favorable, that's a reasonably good sign the management is not up to scratch. Stockholders should seek an explanation from the management whenever any of these three questions cannot be answered satisfactorily, or whenever the comparative statistics of performance point out a problem exists.
2. *Are the interests of the average outside stockholder receiving their proper recognition?*

    To determine this, find the answers to some key questions:

    - Are commensurate dividends being paid each year?
    - Are stockholder funds being used profitably?
    - Are stock buyback programs being run periodically?
    - Are operationally efficient decisions being made?

    How the management treats its outside stockholders – those who do not participate in the management of the corporation – is important. This is often illustrated by how a firm structures its business. If it sets up and runs holding companies which own business units, then the management can elevate or depress the market price of their stock almost at will by dissolving those holding companies whenever it suits them and reintegrating the various business units. Good management don't manipulate the share price in this way.

There is a general perception it is the job of the board of directors to ensure good management is in place. This is incorrect in practice because the board of directors is rarely independent of the management. It's far more usual for the officers of the corporation to choose the directors than it is for the directors to choose the management. Furthermore, many boards of directors are stacked with executives of the business. Under the strength of these personal and business ties, it is very unusual for a board of directors to do anything on its own initiative which runs counter to the wishes of the management.

So what can stockholders do to increase their influence over the management of a corporation? Some ideas:

- *Get to know the management of the company* – and express your opinions to them in whatever avenues arise. Attend all shareholder meetings, participate fully and do your homework so you can speak as an informed participant rather than just a shareholder.
- *Talk with the more substantial stockholders* – and get them on side to bring about any needed changes in management.
- *Always read all the material sent out with the annual report* – including the proxy statement. Know and weigh up the arguments on both sides of any issues facing the corporation. At the very least, determine for yourself whether the company is currently successful when compared to its peers.
- *If the corporate results are below expectations* -propose that outside business engineers be appointed to advise on the policies and competencies of the management. Make sure the firm selected to prepare this report is not engaged by the board of directors but by an independent committee of stockholders. The cost of the study should be borne by the company, even though the report would be submitted directly to the committee rather than to the management.
- *Lobby enthusiastically to have more independent directors appointed* –

ideally people with wide business experience who will be able to turn a fresh expert eye on the problems of the enterprise. These independent directors should submit a separate annual report addressed to stockholders and focused on the answer to one key question: “Is this business showing the results for stockholders which adequate management could provide, and if not, what should be done about it?”

> *“A company’s management may run the business well and yet not give the outside stockholders the right results for them, because its efficiency is confined to operations and does not extend to the best use of the capital. The objective of efficient operation is to produce low cost and to find the most profitable articles to sell. Efficient finance requires that the stockholders’ money be working in forms most suited to their interest. This is a question in which management, as such, has little interest. Actually, it almost always wants as much capital from the owners as it can possibly get, in order to minimize its own financial problems. Thus, the typical management will operate with more capital than is necessary, if the stockholders permit it – which they often do.”*
>
> *– Benjamin Graham*

> *“Good managements are rarely overcompensated. Poor managements are always overcompensated, because they are worth less than nothing to the owners.”*
>
> *– Benjamin Graham*

PRINCIPLE #3: INVEST FOR PROFITS OVER TIME, NOT FOR QUICK BUY-AND-SELL TRANSACTIONS.

Buy stock in companies which you believe will generate wealth over time through their ongoing business operations. Never buy shares in anticipation of being able to sell them for more at a later stage – that’s just attempting to make money off other stockholders.

Investors and speculators differ in their goals and approach to stock market investment in this way:

- Investors are attempting to acquire and then hold securities which they believe will appreciate in value over time as the company’s business operations move forward. Investors look to dividends and increases in

market value of their stock as the source of their investment gains.
- Speculators acquire shares at what they consider to be a favorable price and then sell them off as soon as possible at a profit. They try and anticipate what the market will value highly in the future and try to select stocks which will grow in market value faster than the general market does.

With this in mind, investors have a genuine sense of detachment about share price fluctuations. On the one hand, market-price changes combined with the dividend yield are a measure of investment success. This is especially true when the share price of stocks owned rise faster than the market as a whole. The investor may then feel he or she has made an excellent purchase decision. On the other hand, however, problems arise when investors make a genuine attempt to "time" the market – that is, to buy stocks when they are below their true market value in anticipation of being able to sell them at a higher price when they rise to their genuine market value in the future.

By attempting to time the market astutely, the speculator will gradually lose interest in the quality and value of the securities being purchased and focus instead solely on attempting to beat the market. The problem with this is the investor, along with his peers, constitutes the market. In effect, a share trader is really attempting to beat himself or herself.

> *"A great deal of brain power goes into the pros and cons of market forecasting, and undoubtedly some people can make good money by being good stock-market analysts. But it is absurd to think the general public can ever make money out of market forecasts. For who will buy when the general public, at a given signal, rushes to sell out at a profit? If you expect to get rich over the years by following some system or leadership in market forecasting, you must be expecting (a) to try to do something countless others are aiming at and (b) to be able to do it better than your numerous competitors in the market. There is no basis either in logic or in experience for assuming that any typical or average investor can anticipate market movements more successfully than the general public, of which he himself is a part."*
>
> *– Benjamin Graham*

Market timing is of great importance to a speculator as he or she wants to make their profits in a hurry. For an investor, however, a waiting period of a year or even a number of years is of no consequence. His or her emphasis is not so much on price movements but on advancements in the value of the company itself. The investor can seize opportunities to buy more stock when the market is overly low and sell if the market is excessively high with a view to repurchasing when the market levels return to normal. Astute investors are not attempting to be smarter than others but simply to be less irrational than the mass of speculators who will only buy when the general market is advancing and sell when the overall market is declining.

The investor is also keenly aware it's not as easy to take advantage of the market movements as it always looks in hindsight. This is because of two inbuilt difficulties:

1. *The market's swings are generally more random than they appear on a chart* -and it is easy to devise various formulas which match historical fluctuations very well but which end up being of no use whatsoever in accurately forecasting the future movements of the market. There is no simple or foolproof formula which can guarantee to deliver guaranteed profits all the time.
2. *To buy when others are selling and sell when they are buying requires you to go against the prevailing sentiment* -which is very difficult to do over the long haul. It requires you to consistently believe you're right and everyone else is wrong. You have to become immune from the same market conditions which are causing everyone else to feel optimistic or pessimistic. If you can do this, you elevate yourself from being a member of the public into a specialized and self-disciplined group of investors. You can't allow yourself to grow impatient while waiting for the next buying opportunity to arise while you watch all the missed opportunities to earn dividend income. That's very difficult to do.

Naturally enough everyone wants to buy-low-sell-high. This principle can best be applied to individual stocks rather than to the general market. Astute investors should be permanently on the lookout for individual bargains. Base your purchase decisions on your own analysis of the company's business prospects rather than whether there has been significant movement upwards or downwards in the share price.

The good thing about a stock being publicly quoted is its liquidity – you can increase or decrease your shareholding at any time with minimal fuss. The daily quotation of a fluctuating share price is of less practical value because in reality, the underlying value of an enterprise doesn't vary that dramatically from day to day. If you base your investment decisions on the movement of the share price rather than the value of the underlying business assets, your investment decisions will bounce all over the place. Look to the market movements to give you buy and sell options, not to specify the value of an individual stock. Only you can determine that intrinsic value by your own careful and deliberate analysis.

> *"The most realistic distinction between the investor and the speculator is found in their attitude towards stock-market movements. The speculator's primary interest lies in anticipating and profiting from market fluctuations. The investor's primary interest lies in acquiring and holding suitable securities at suitable prices. Market movements are important to him in a practical sense, because they alternatively create low price levels at which he would be wise to buy and high price levels at which he certainly would refrain from buying and probably would be wise to sell. On the whole, it might be better for the investor to do his stock buying whenever he has money to put in stocks, except when the general market level is higher than can be justified by well-established standards of value."*
>
> *– Benjamin Graham*

PRINCIPLE #4: HAVE CONFIDENCE IN YOUR OWN REASONING.

When you've done your homework, act on it. Don't worry about what others are saying about your investment – you can never tell whether they've done their own analysis or are just repeating what they heard someone else say. As long as your data and your reasoning is sound, it doesn't matter in the slightest whether the crowd agrees with you or disagrees. Don't expect the marketplace to do your investment thinking for you.

The investment of money in securities is unique among business operations in that it is almost always based in some degree on advice received from others. The great bulk of investors are amateurs who welcome some guidance on where to invest.

> *"If the reason people invest is to make money, then in seeking advice they are asking others to tell them how to make money. That idea has some degree of naiveté. Businessmen seek professional advice on various elements of their business, but they do not expect to be told how to make a profit. That is their own bailiwick. When they, or non-business people, rely upon others to make investment profits for them, they are expecting a kind of result for which there is*

no counterpart in ordinary business affairs."

– Benjamin Graham

It stands to reason therefore an investor should make up his or her own mind on the desirability of an investment first and foremost on the strength of their own analysis and research. If an above average return is sought, do an above average amount of research. Above all, don't expect someone else to give some hot insider tips that will save doing all the basic research for yourself. The best way to look at and think about the recommendations put forward by the various investment advisers is as follows:

- *Professional investment advisers* – who will give you counsel and charge substantial annual fees. The best firms to align with are those which make no extravagant claims to brilliance but who are instead careful, conservative and competent. Their aim is usually to conserve your principal value and make a conservative return each year. Their main value is they will help shield you from costly mistakes.
- *Financial services firms* – who will send out bulletins on market developments and forecasts of the overall market direction developed by "technical" methods. The problem is few of these firms ever explain in detail how they reach their conclusions because this is proprietary information. Almost always, they recommend a stock be purchased on the strength of favorable near-term prospects regardless of the current price. This is very superficial and shows the lack of a sound analytical methodology. The intelligent investor will never buy or sell on the basis of these recommendations but will take their ideas as suggestions for a starting point of detailed analysis only.
- *Advice from brokerage houses* – who supply a wealth of information to their customers gratis. Never forget these firms make their money from brokerage commissions. Therefore, it is in their interests to get you to buy and sell often. An intelligent investor will readily see brokerage houses are too closely aligned with day-to-day marketplace trading to be able to offer any viable investment suggestions.
- *Advice from investment bankers* – who bring new share issues to the market. Always look at these firms for what they really are – salespeople for the firms which want to go public. Treat any of their recommendations with skepticism and scrutinize what they suggest for

yourself.

- *Other advisers* – like bankers, relatives and friends. The inexperienced investor will ask everyone for their opinion, in the mistaken belief they have superior knowledge or experience. The intelligent investor will understand these people know very little about business outside their own areas of specialization, and will treat any such advice with caution.

> *"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 art of trading in the market."*
>
> *– Benjamin Graham*

> *"Let us say categorically that we do not consider that either general trading – anticipating moves in the market as a whole – or selective trading – picking out stocks which will do better than the market in the short term – has any place in investment practice. Both of them are essentially speculative in character because they depend for success not only on the ability to foretell specifically what is going to happen, but on the ability to do this more cleverly than a host of competitors in the field."*
>
> *– Benjamin Graham*

> *"If you have formed a conclusion from the facts and if you know your judgement is sound, act on it – even though others may hesitate or differ. You are neither right nor wrong because the crowd disagrees with you. You are right because your data and your reasoning are right. Similarly, in the world of securities, courage becomes the supreme virtue after adequate knowledge and a tested judgement are at hand."*
>
> *– Benjamin Graham*

> *"Nothing in finance is more fatuous and harmful, in our opinion, than the firmly established attitude of common stock investors and their Wall Street advisers regarding questions of corporate management. That attitude is summed up in the phrase: 'If you don't like the management, sell the stock'. Obviously such action does nothing at all to improve bad management; it only puts down the price of the stock and shifts the ownership to someone else. Investors as a whole seem to have abandoned all claim to control over the paid superintendents of their property. The best opportunity for demonstrating investor intelligence is in the field of stockholder-management relationships; for here investors can act as a class and not as individuals, a novel but important branch of the science of investment."*

– Benjamin Graham

"The art of investment has one characteristic which is not generally appreciated. A creditable, if unspectacular, result can be achieved by the lay investor with a minimum of effort and capability; but to improve this easily attainable standard requires much application and more than a trace of wisdom. If you merely try to bring a little extra knowledge and cleverness to bear upon your investment program, you may well find you have done worse."

– Benjamin graham

PRINCIPLE #5: CHOOSE INVESTMENTS FOR THEIR FUNDAMENTAL VALUE, NOT FOR THEIR POPULARITY.

Always remind yourself general market sentiment is driven more by mood swings and less by rational thought. Therefore, for most of the time, view the market fluctuations solely as indicators something may be going wrong or something may be going right with your investment. If prices fall sharply, this may be a great opportunity to buy more. And conversely, if the prices advance a great deal, this may be an opportune moment to sell wisely.

Consider this business parable:

- Imagine you own a share in a small business for which you paid $1,000.
- Every day, one of the other shareholders in the same business, Mr. Market, tells you what he thinks your share is worth. He then offers to either buy your share at that price or sell you his share at that same price.
- Mr. Market's moods vary – some days he is conservative in his valuation, on other days he is feeling optimistic and his valuation reflects that enthusiasm.

The question is: "Does the value of your $1,000 shareholding in that company really vary as much in value from day to day as Mr. Market would have you believe?" Obviously, an intelligent investor will say no, the value of the business doesn't vary, but it's Mr. Market that varies according to the feeling of the moment.

"The true investor is in that very position when he owns a listed common stock. He can take advantage of the daily market price or leave it alone, as dictated by his own judgement and inclination. He must take cognizance of important price movements, for otherwise his judgement will have nothing to work on. Conceivably they may give him a warning signal which he will do well to heed – this in plain English means that he is to sell his shares because the price has gone down, foreboding worse things to come. In our view such signals are misleading at least as often as they are helpful. Basically, price fluctuations have only one significant meaning for the true investor. They provide him with an opportunity to buy wisely when prices fall sharply and to sell wisely when they advance a great deal. At other times he will do better if he forgets about the stock market and pays attention to his dividend returns and to the operating results of his companies."

– Benjamin Graham

To succeed as an intelligent investor, you have to learn how to value companies on the basis of sound financial analysis. For common stock, a company's valuation is easy to define:

- Value = Average earnings x Capitalization rate

where: Value is the true valuation of the company.

Average earnings are projected a number of years into the future based on the company's historical earnings track record, the known economic factors which will have a likely impact on the company's future earnings and the informed expert opinions about how that company is likely to perform.

Capitalization rate is a multiplier which reflects the "quality" of the company and is usually determined in comparison to the capitalization rates of a number of the company's peers.

Earning power estimates will fluctuate according to:

- Changes in relative prices and profit margins.
- General economic conditions and the vibrancy of markets.
- Any special conditions affecting an industry.
- The entry of new competitors.
- The availability of new technologies.
- The growth or contraction of markets served.
- The earnings of affiliates or subsidiaries.

- Money set aside in contingency funds.

The capitalization rate applicable for any specific company will also vary to reflect:

- The general long-term prospects of an industry.
- Changes in company management.
- Variations in financial strength including debt levels.
- Changes to the company's capital structure.
- A corporation's track record with regards to paying dividends.
- The company's standard dividend policy.
- Changes in accounting policies and procedures.

Note also that in determining the value of an enterprise, it will be necessary to strip out all non-recurrent profits and losses from the operating results used in these calculations. Non-recurrent items can significantly increase or decrease the financial results achieved in any one year without any flow-on impact on the equivalent results generated in future years. These items come in a wide variety of factors and may include:

- A profit or loss on the one-time sale of assets.
- A profit or loss on the sale of marketable securities.
- A discount or premium on the retirement of capital obligations.
- The proceeds from cashing in financial securities.
- Tax refunds and the interest thereon.
- Gains or losses as a result of litigation.
- Extraordinary write-downs of inventory.
- Extraordinary write-downs of receivables.
- The cost of maintaining non-operational assets.

The whole point is each investor must make his or her own calculation as to the value of the enterprise. This has to be made systematically and thoroughly if you hope to be in a position to compare the merits of investing in one company's stock rather than another. It is only when you have gone into these numbers in fine detail that you are in a position to evaluate whether the market price is a bargain or not. You have to make your own buy-or-sell decisions – nobody else can make these for you, not even those investment professionals who offer their recommendations to you.

"The investor with a portfolio of sound stocks should expect their prices to fluctuate and should neither be concerned by sizable declines nor become excited by sizable advances. He should always remember that market quotations are there for his convenience, either to be taken advantage of or to be ignored. He should never buy a stock because it has gone up or sell one because it has gone down. He would not be far wrong if this motto read more simply: 'Never buy a stock immediately after a substantial rise or sell one immediately after a substantial drop.'"

– Benjamin Graham

"United States Savings Bonds are by far the most important security ever issued in this country – or anywhere else, for that matter. Every non-professional investor should have a substantial portion of his funds in these issues. Investments in these bonds is a simple matter, whereas common stock investment is full of possible complexities and dangers."

– Benjamin Graham

PRINCIPLE #6: ALWAYS INVEST WITH A MARGIN-OF-SAFETY.

When investing, your margin of safety is built around the price at which you can buy a stock with minimal downside risk. Often, this will be below a company's intrinsic value because you've got to allow for the impact of unanticipated external events. Always build a margin of safety into the price you're willing to pay when buying stock in a company and then diversify over 20 or more different companies to generate satisfactory results over time.

"In the old legend the wise men boiled down the history of mortal affairs into the single phrase, 'This too will pass'. Confronted with a like challenge to distill the secret of sound investment into three words, we venture the motto, MARGIN OF SAFETY. This is the thread that runs through all investment policy. All experienced investors recognize that the margin-of-safety concept is essential to the choice of sound bonds and preferred stocks."

– Benjamin Graham

In the case of a bond, the margin-of-safety consists of the number of times the corporation has earned its total interest charges. If the company has for the past number of years earned four or five times as much as it is obligated to pay in interest on the bonds it proposes to issue, then there is a very sizable margin-of-safety. The company's business revenues will have to decline appreciably before it will be unable to meet its obligations. Or alternatively, the margin-of-safety might be calculated by comparing the total value of the enterprise with the amount of debt. This will give some idea how much the value's net worth can shrink before repaying the debt will become a major concern.

The same margin-of-safety concept also applies to investing in common stock in this way:

- You first calculate the intrinsic value of a share by whatever methodology makes sense to you. This needs to be consistently applied to be of value in making comparisons. Note that external events may affect the value of the share or your calculation methodology may turn out to be entirely wrong so you also need to build in a margin-of-safety into these calculations as well.
- Next you project what the expected earning power of that stock will be over the next ten years, taking into account the fact the business will most likely retain some of its future earnings for reinvestment rather than paying shareholders everything it earns in dividends.
- You then compare the expected earning rate of the stock with the going rate for bonds. Anything that is above the bond rate is your margin-of-safety. For example, if a stock is yielding 10-percent while government bonds are yielding 5-percent, then over a period of ten years the excess yield will total 50-percent-which should prevent or minimize a loss as long as the stocks were chosen well in the first place.
- You then invest in a diversified list of twenty or more stocks so as to further increase the probability of a favorable result. As long as the purchases are made at the average level of the market over a number of years and fairly normal conditions exist, you then have an assurance that an adequate margin-of-safety has been built in, and your investment program should yield satisfactory results.

The key things to watch out for when considering this margin-of-safety approach to investment are:

1. You may end up purchasing low-quality securities at times of favorable business conditions and find their anticipated earnings do not in fact turn

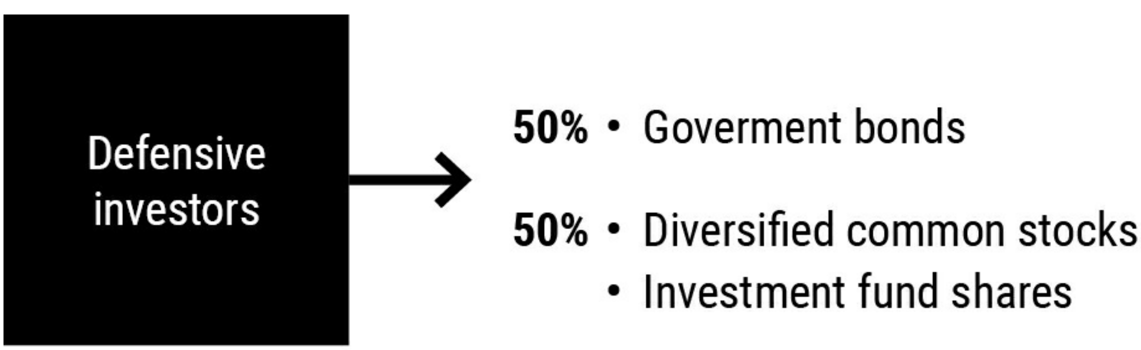
out to be as high as anticipated.

2. You may get tempted to purchase "growth stocks" which have no real earnings history and overly optimistic future earnings projections.
3. If you can purchase undervalued stocks, your margin-of-safety increases dramatically. If these stocks are bought on a bargain basis, even a moderate decline in the stock's earning power will still retain your margin-of-safety.

> *"There is a close logical connection between the concept of a safety margin and the principle of diversification. Even with a margin in the investor's favor, an individual security may work out badly. For the margin guarantees only that he has a better chance of profit than for loss – not that loss is impossible. Diversification is an established tenet of conservative investment."*
>
> *– Benjamin Graham*

The margin-of-safety concept differentiates investing from speculating. Speculators always believe the odds are in their favor, even when they do something which is outside normal investment practices. By contrast, investors do everything conceivable to increase their margin-of-safety. They calculate their margin-of-safety by figures, by reasoning and by reference to a body of factual data rather than to their own reasoning.

So how does this work out in practice for each type of investor? As previously stated, investors come in two natural groupings – defensive or aggressive and enterprising. An appropriate defensive investors would be:



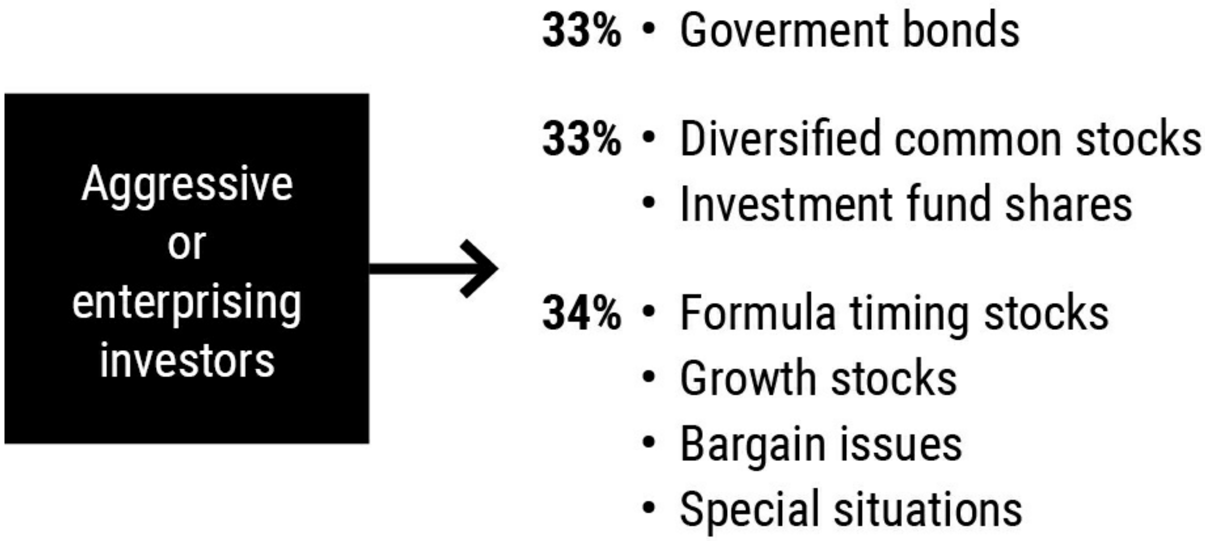
Defensive investors want to conserve their investment capital but at the same time generate an income. Their rate of return will be commensurate with the amount of effort they put into managing their investment program. The bond component might be lowered to 25-percent if the investor feels comfortable selecting more high-grade common stocks. Alternatively, if the investor has little or no time or interest in the investment field, the bond component might be raised to 75-percent.

The common stock portfolio for a defensive investor must be:

1. Diversified over between ten and thirty different stocks.
2. Filled with large, prominent and conservatively financed stocks.
3. Stocks which have a continuous record of paying dividends.
4. Stocks which are reasonably priced.
5. Changed no more than once a year.

> *"The kind of securities to be purchased and the rate of return to be sought depend not on the investor's financial resources but on his financial equipment in terms of knowledge, experience and temperament. The minimum return goes to our passive investor, who wants both safety and freedom from concern. The maximum return would be realized by the alert and enterprising investor who exercises maximum intelligence and skill."*
>
> *– Benjamin Graham*

> *"The proportion of smart people who try this and fail is surprisingly large, including many of the investment funds which with all their experienced personnel have not performed as well over the years as the stock market. The real money in investing will have to be made – as it has in the past – not out of buying and selling, but out of owning and holding securities, receiving interest and dividends, and benefitting from their long-term increase in value."*
>
> *– Benjamin Graham*



Aggressive or enterprising investors are prepared to accept a higher degree of risk in order to attempt to generate a greater rate of return. They also have more time and energy to devote to their investment activities. Aggressive or enterprising investors have a clear concept of the difference between market price and the underlying value of the investments they make, and therefore can still base their selections on the margin-of-safety principle.

In addition to having part of their investment funds in government bonds and a portfolio of high-grade common stocks or investment fund shares, aggressive investors also invest in:

- Formula timing stocks – which are purchased when the market price is low and then resold at a profit when the market price moves higher. There are various plans which can be used here, but a simple and convenient approach is preferred.
- Growth stocks – securities which will hopefully appreciate in market price faster than the general market. This will require exceptional foresight and judgement on the part of the investor.
- Bargain issues – which are defined as situations where a stock is worth at least 50-percent more than its current market price. Again, this will require careful and astute analysis to determine.
- Special situations – purchasing stock in companies which are about to undergo a sale, merger, recapitalization, reorganization or liquidation. This is a very technical area of investment which will require specialist

knowledge on the part of the investor.

Note especially all of these additional investment activities are carried out on the basis of analysis of the underlying value of a security rather than technical analysis of stock market price movements. The entire emphasis is on investing where an appropriate margin-of-safety can be established. Aggressive or enterprising investors must have the know-how and the time to devote to making these investments successfully. There are no shortcuts to succeeding in this type of investment approach.

> *"The aggressive investor must have a considerable knowledge of security values – enough, in fact, to warrant viewing his security operations as equivalent to a business enterprise. It follows from this reasoning that the majority of security owners should elect the defensive classification. They do not have the time, or the determination, or the mental equipment to embark upon such investing as a quasi-business. They should therefore be satisfied with the reasonably good return obtainable from a defensive portfolio, and they should stoutly resist the current temptation to increase this return by delving into other paths."*
>
> *– Benjamin Graham*

> *"Investment is most intelligent when it is most businesslike. It is amazing to see how many capable businessmen try to operate in Wall Street with complete disregard of all the sound principles through which they have gained success in their own undertakings. Yet every corporate security may best be viewed, in the first instance, as an ownership interest in, or a claim against, a specific business enterprise. And, if a person sets out to make profits from security purchases and sales, he is embarking on a business venture of his own, which must be run in accordance with accepted business principles if it is to have a chance of success."*
>
> *– Benjamin Graham*

> *"I am no longer an advocate of elaborate techniques of security analysis in order to find superior value opportunities. This was a rewarding activity, say in the 1930s, but the situation has changed a great deal since then. In the old days, any well-trained security analyst could do a good professional job of selecting undervalued issues through detailed studies; but in light of the enormous amount of research now being carried on, I doubt whether in most cases such extensive effort will generate sufficiently superior selections to justify their cost. To that very limited extent, I'm on the side of the 'efficient market' school of thought now generally accepted by the professors."*
>
> *– Benjamin Graham*

> *"By periodically investing in an index fund, the know-nothing investor can actually outperform most investment professionals. Paradoxically, when 'dumb' money acknowledges its limitations, it ceases to be dumb. Those index funds that are very low cost are investor-friendly by definition*

and are the best selection for most of those who wish to own equities."

– Warren Buffett, CEO, Berkshire Hathaway

"It is Benjamin Graham's common sense, clear thinking, simplicity and sense of financial history – along with his willingness to hold fast to the sound principles of long-term investing even as he was willing to change with the times with respect to the types of securities employed – that constitute his lasting legacy. While the activities of investors, the investments of choice, and the ownership of stocks today bear little resemblance to those that characterized the world of investing when Graham wrote this original edition in 1949, the basic principles of intelligent investing that he set forth there have remained virtually intact and unassailable."

– John Bogle, founder, The Vanguard Group

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

– Benjamin Graham

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