

THE REDISCOVERED BENJAMIN GRAHAM *Lectures*

Lecture Number Five

This is a transcript of a lecture from the series *Current Problems in Security Analysis* presented by **Benjamin Graham** at the **New York Institute of Finance** from **September 1946 to February 1947**. This content is found in abridged form in *The Rediscovered Benjamin Graham: Selected Writings of the Wall Street Legend* (Wiley, April 1999) by Janet Lowe. Alternatively, full html versions for all ten lectures are available on the [publisher's website](#).



As a preliminary perhaps I might answer any questions that are in your mind growing out of the last lecture, which ended rather precipitously. Does anyone have anything on his mind? We were discussing the Childs' valuation by the Securities and Exchange Commission. At that time, you will recall, we had indicated that the SEC had valued the Childs Company primarily on the basis of its future earning power, which was the thing that interested us, but had added a certain amount for excess working capital -- actually \$1.3 million net after paying the bonds. Let me make the point here that a security analyst would not be inclined to add in the excess working capital to the valuation of the property unless he believed that the money was to be returned in some way or other to security holders. As a matter of fact, some part of the excess working capital was to be used to pay off the old debt of Childs, and that portion, of course, represented an addition to the earning-power value of the old company. Thus our own "practical" valuation would tend to be \$9 million rather than the \$10 million found by the SEC.

Since we discussed the matter two weeks ago, the Federal Court has approved the Childs plan, based upon the modified proposals of the trustee; and it has apparently placed the stock equity at \$9.98 million, which is \$300,000 less than the amount that the SEC found.

It may be interesting to look a bit at the prices of the securities, to see what they indicate as of now. The preferred and common together were selling for about \$8.4 million yesterday, preferred at 155 and the common at 7 1/8. This is less than the valuations that we have been talking about. There is nothing surprising about that, of course; because it is a normal experience to have the securities of a company in trusteeship sell at less than the valuations that an analyst would find for the property on a reorganized basis. It would be expected that the value would normally increase over a period of time -- such as one year or two years, following trusteeship, -- as the enterprise gains its proper position in the public's esteem. That is almost an invariable experience.

*** Here we have a five page discussion of American Radiator, in which a great deal of information is supplied on the industry, -- not only its past, but future calculations, based upon somebody else's estimates for the year 1947; and also some other estimates for the years running between 1946 and 1951, on the demand and supply of new houses.

Then they take up the earning power of American Radiator Company; and for the first time in this group of analyses that we are speaking of they actually endeavor to determine what the value of the company would be, based on assumptions as to earning power and as to multipliers. Their method is as follows: They project sales at the rate of \$10 million; and this, you see, is our now familiar Childs Company method. Then they apply a profit margin, which they expect to be fifteen per cent. Then they say, "Net per stock: \$1.40 per share." They do not give you the arithmetic of that, but here it is: Net before taxes would be \$24 million, less taxes at about 40 per cent, brings it down to about 14 million-odd, and that is about \$1.40 on ten million shares of stock. Then they add: "Foreign earnings, estimated 25 cents" -- and that is a very rough estimate. So they get \$1.60 to \$1.70 per share, total. Further, they state that the relatively near future, -- and because these favorable earnings should continue over a considerable period of time, the stock of this

company should prove to be relatively attractive even at its present level, the “present level” being about 20, in February, 1946.

That analysis was later used by a stock exchange house, which concluded, without needing quite as much courage, that the stock looks relatively attractive at 15, which was the price on October 23, 1946.

Now before I attempt a criticism, not necessarily unfavorable, of this analysis, I may as well go on to the last one that reached my desk, which is headed “Active Years Ahead for the Building Industry.” It gives a great deal of information on the building industry, and information about the companies in the industry, including American Radiator, which is the first one. There they make a calculation of the earning power of the company in what they call year 194x, which they figure at \$1.75 per share. They use an expected profit margin of 12 per cent. There is a little discrepancy between the 12 per cent and their final result. It can be explained, if you want to go to the trouble, partly because they take into account foreign earnings to a greater extent than did the research company analysis. Now, the interesting thing about this analysis is two-fold: First they get earnings of about \$1.75, which is not so different from the other projection. But they describe that estimate as follows: “A rough guess of potential earning power under optimum conditions over the next few years is shown by the line designated 194x.” In the rest of the circular, while not too specific, they imply that these stocks are attractive, the ones that they have listed, because of the expected earnings in the 194x year. That is particularly true because the price of American Radiator was only 13 1/2 on that date, and the estimated earnings of \$1.75 would make the price of 13 1/2 look quite reasonable if that represented future earning power.

My comment on these analyses -- the last two ones, which are the only ones that seriously attempt a projection of future earnings -- is this: They do not emphasize enough the fact that the earnings they are dealing with are earnings of a boom period; but the technique of analysis should take that carefully into account.

The earnings for the building boom should be evaluated pretty much in the same way as we were accustomed to evaluating war earnings, that is to say, by assuming that they were to last for a limited number of years. The excess earnings during that period should be added to what we would assume to be the normal valuation of the company based upon its average peacetime earnings. Thus, if you want to attempt a serious evaluation of a company like American Radiator, the only proper method is to take what you would assume to be its normal earning power, not its optimum earning power, evaluate that, and then add to it a fair allowance for the fact that it is facing some very good years.

I might say that if you want to be somewhat pessimistic you could criticize even that method; because you might argue that these boom years are simply part of a building cycle period, -- they are not really excess earnings; they are the good part of the normal earnings and will be offset by very low earnings when the building boom subsides. That comment may be justified; but in any event the method that I spoke of before seems to me to be as liberal a method as you could use.

You had a question about that?

QUESTION: What makes you say that in that estimate of \$160 million of sales, those factors were not considered?

MR. GRAHAM: You mean the fact that they were boom period sales?

QUESTION: Possibly they did consider that.

MR. GRAHAM: I can give you a specific reason for that. They say that the earnings are related closely to the residential building totals that will be expected. And over the period 1946-51 they have gone to the trouble of giving you a projection of the amount of buildings needed and the amount that will be supplied. During the years 1947-51 they are expecting a million units of building annually. At the end of that time the deficiency will be completely remedied; and, on the basis of their statistics, demand would be reduced to somewhere around 550,000 buildings a year, that is to say, about half a million new families plus demolition. Following through this calculation to the year 1952, you would find that the expectation of new units would be not more than half of the one on which they had based their \$160 million of sales.

Another reason, of course, is that the sales actually realized in 1939 were only \$80 million, and in 1938 \$68 million. Thus the volume of \$160 million, even allowing for some increase in prices, would obviously be on the high side.

Were there other questions about that? Questions of this kind are very good, because they help clarify the reasoning behind these evaluations.

It seems to me that the method of evaluation, then should be somewhat different for American Radiator than has been used. You ought to start, not with the optimum earnings, but what you would consider to be normal earnings for the company. The company had been earning on the order of about 50 cents a share in the period before the war; and I would assume that if you take earnings of a dollar a share after the war, you would be about as optimistic as you would have any right to be about this company's earnings after the building boom has subsided. I am inclined to think that is over-optimistic, as far as one can see now, for the very reason that when the building boom has subsided you are likely to go into a period of subnormal earnings if the building cycle behaves in the future as it has in the past. But if you accept the one dollar earnings -- and I really want to mark that as liberal, -- I think the multiplier would be somewhere between 12 and 15. That is higher than the company's past record would justify, -- but the American Radiator has some advantages in being a large and strong company, well thought of, and which many years ago was a very large earner. Consequently, I think you would get a valuation of \$12 to \$15 on a normal basis.

To that you would add an allowance for the boomtime earnings, which are 75 cents a share over expected normal. If you multiply this by four you are again pretty liberal; that will give you three dollars extra. The valuation, thus comes to about \$15 to \$18 a share

for the stock, giving the company the benefit of certain doubts that I would have in my own mind. This valuation, I think, could properly have been made for American Radiator at any time during the past year, and would have justified caution with regard to a purchase of that stock for investment at the prices of early 1946.

But on that subject let me add that it is perfectly proper to buy stocks for speculation. There is no crime in that. When you buy stocks for speculation it is perfectly proper to take speculative factors into account, which are different from investment factors. The normal expectancy would be that if this company is to earn \$1.75 a share for three or four years, the market will reflect those earnings in full on a speculative basis, without making allowance for the fact that they are temporary.

That hasn't always happened. For example, during the war the market certainly didn't reflect war earnings on the theory that they were permanent earnings. But the market does tend to do so with regard to cyclical earnings; it regards the boomtime earnings as permanent earnings. For that reason it is quite possible that American Radiator could sell, under good general market conditions and during its own boom period, at a price very much above our value of 15 to 18.

We must not forget that American Radiator as recently as 1942 sold at 3 3/4. What we are saying is that American Radiator is a speculative type of security by the nature of its business, as well as by the fact that it is a common stock. Just as it can sell at four dollars in bad year, it can easily sell at \$30 in a good year, and both prices would be fundamentally justified. Our own valuation represents the type of investment approach which tends pretty much to bring you what you would consider to be a central value for the stock. This interests the investor primarily; but second it may interest the intelligent speculator too. For he could then see how far he is getting away from central value when he is following up the speculative aspects of the situation.

I welcome questions about that, because I think that is very important.

QUESTION: If we are to estimate future earnings for just a period of five years, when you speak of a normal period for this industry, wouldn't your analysis go beyond that five-year period? The boom years might be the next five years. Then if you are striking for a normal level, that would go beyond the next five years; so as a result your earnings in the coming five years would be on a higher level and your normal period lower.

MR. GRAHAM: Yes, you are right in making that point. If my recollection is correct, I did make that point too, in my third lecture. I said that normally the earnings that you are trying to estimate are those of the next five years, -- perhaps five to seven years, -- but that there might be some exceptional cases. And I did have the building industry in mind, in which the next five years would not be regarded as a normal expectancy. The analyst is under a special disadvantage, then, because the normal earnings that you are thinking of lie so much further ahead in the future that your chance of being wrong in calculating what they are going to be is that much greater. But there is no help for it. You cannot

properly evaluate the boom earnings of the next few years as normal; so you must jump ahead to the later earnings.

QUESTION: But when the market regards the earnings of a company, if the company went along for five years at a high rate of earnings, then wouldn't the market place a higher valuation on those earnings, considering the length of time the earnings would be at that high level?

MR. GRAHAM: Yes; because the market would tend to multiply the earnings by your standard multiplier of 15 or thereabouts, instead of merely adding them in the way we suggest you do. (I am speaking, now, of the abnormal or excess component of those earnings.) The investor would then be out of step with the market in his attitude toward a stock like American Radiator.

The investor is very often out of step with the market, incidentally, and that would be no new experience for him. But I think it is useful for the investor to have some idea of what would seem to be the reasonable value, even if the current market may not reflect it at all.

*** A thing I would like to warn you against is spending a lot of time on over-detailed analyses of the company's and the industry's position, including counting the last bathtub that has been or will be produced; because you get yourself into the feeling that, since you have studied this thing so long and gathered together so many figures, your estimates are bound to be highly accurate. But they won't be. They are only very rough estimates, and I think I could have given, and probably you could have given me, these estimates in American Radiator in half an hour, without spending perhaps the days, or even weeks, of studying the industry.

*** I want to say finally on this question that an elaborate forecasting technique has been developed in recent years on the amount of dollar business and physical volumes that would be done in various industries at certain levels of employment, or certain levels of gross national product. The Committee for Economic Development has gotten out studies of that kind which gives you estimates of the industry totals under full employment conditions, and the same has been done by the Department of Commerce. Those of you who want to go into that aspect of analysis should start pretty much with these forecasts, and accept them or reflect them as far as your own judgment is concerned. If you accept them, then build your forecast of the individual company's sales in relation to the industry totals which you are starting with. You may make three different estimates, -- as is now done sometimes -- based upon full employment, moderate unemployment, and considerable employment; and make your estimate of sales accordingly. That is the new technique, and I think you will find it interesting as applied to security analysis.