

# THE REDISCOVERED BENJAMIN GRAHAM *Lectures*

## Lecture Number Seven

---

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](#).



MR. GRAHAM: Good evening. You have all had a month's rest since the last lecture. I hope you had a pleasant vacation during that period and you are now ready to absorb some more punishment.

If you recall as far back as the last lecture, we dealt there mainly with the prospective earning power of the Dow-Jones list considered as a unit, and with its prospective central market value.

You might now ask the question: What about the earnings of the individual components of the Dow-Jones list? How would one go about evaluating them, and what results would you get?

As it happens, that job was done -- at least from the standpoint of expected earnings power -- in an article that appeared in the Analyst Journal in July 1945. It is called "Estimating Earnings of an Active Post-War Year," and it is by Charles J. Collins. There he gives his estimate of the post-war earnings of all the companies in the Dow-Jones unit, together with the sum of these earnings.

His total figure varies from \$15.96 to \$17.58 per unit. You may recall that my rather rough calculation gave a figure of \$13.60, and it may thus appear that my figure is rather definitely lower than Collins'. Actually that may not be true, because Collins identifies his earnings as those of an active post-war year, whereas the earnings that I had used in the last lecture are supposed to represent the average future earning power of the Dow-Jones unit -- which would include some allowance for poor years as well as good ones.

It is interesting to note that Collins' estimates for individual companies show considerable variation from their pre-war earnings, say their 1940 figures. I might read off a few to you to show how different are his expectations for different companies. Here are four that show large expected increases, taking 1940 as against the future years: American Smelting, from \$4.21 to \$9.50; Chrysler, from \$8.69 to \$17.75; Johns Manville, from \$6.34 to \$14.75; Goodyear, from \$3.44 to \$8.60.

Here are four others that show very small increases, if any: ( I am using here, the average of his range of figures) American Tel and Tel, from \$10.80 to \$10.50; American Tobacco from \$5.59 to \$5.90; National Distillers, from \$3.28 to \$3.35; and Woolworth, from \$2.48, in 1940, to \$2.62 in the postwar year.

Collins does not give his method of calculation in detail, but he does give you a description which you can follow through fairly well.

He starts from industry sales projections which have been made by the Committee for Economic Development of the Department of Commerce, and he adjusts them to an expected national income of \$112-billion. That happens to be quite a conservative figure, because the national income for the year 1946 was about \$165-billion.

He does not apply the exact percentage increase in each industry to the particular company; but he allows for its better or poorer trend than that of the industry as a whole over the period from 1929 to 1940. He assumes, in other words, that a company which did better than its industry from 1929 to 1940 will do proportionately better in the increase that is to be seen from pre-war; and correspondingly for those that may have done worse.

From the estimated sales he then calculates net before taxes based on pre-war ratios; he takes taxes of 40 per cent; and that gives him his figure, with a small range that he allows for possible adjustments.

You will recall that the profit margin that we used was distinctly lower than the pre-war; but on the other hand we took a considerably higher national income, and we also took a lower expected tax.

These variations in method suggest that there is no single way of dealing with a projection of future earnings and that individual judgment will have to play a considerable part. But the variations in this technique are not likely to be as great as the variations in the market's response to what it thinks are the possibilities of different companies.

I would not criticize the Collins' method, except in one respect which I think it is rather significant to consider. He assumes that the trends shown from 1929 to 1940 will continue in the future, and that seems a natural assumption to make. But I would like to warn you against placing too much reliance on that supposition.

Some years ago we made a rather intensive study on the subject of whether earnings trends did or did not continue. We tried to find out what happened to companies showing an improvement in their earnings from 1926 to 1930, comparing them further with 1936???, and also those that had failed to show improvement in the period. We found that there were at least as many cases of companies failing to maintain their trend as there were of those that did continue their trends. And that is a very vital consideration in all future projections.

As a matter of fact, Collins himself says that, when he accepts the trends, in some cases he finds he gets such large earnings that he felt constrained to reduce them in the interests of conservatism; and I imagine he was probably right.

\*\*\* Now I would like to return for a moment to the analyst's view of Wall Street as a whole -- that is, the scope of his own activities in the securities markets and his approach to his function of analyzing securities and drawing conclusions from his analysis.

I suggest that there are two fundamentally different approaches that the analyst may take to securities as a whole.

The first I call the conventional one, and that is based primarily on quality and on prospects.

The second I call, in complimentary fashion, the penetrating one, and that is based upon value.

Let us first attempt a brief description of these different approaches as they relate themselves to actual activities of the analyst.

The conventional approach can be divided into three separate ways of dealing with securities. The first is the identification of “good stocks” -- that is “strong stocks,” “strong companies,” “well-entrenched companies,” or “high quality companies.” Those companies presumably can be bought with safety at reasonable prices. That seems like a simple enough activity.

The second is the selection of companies which have better than average long-term prospects of growth in earnings. They are generally called “growth stocks.”

The third is an intermediate activity, which involves the selection of companies which are expected to do better business in the near term than the average company. All three of those activities I call conventional.

The second approach divides itself into two sub-classes of action, namely, first, the purchase of securities generally whenever the market is at a low level, as the market level may be judged by analysts. The second is the purchase of special or individual securities at almost any time when their price appears to be well below the appraised or analyzed value.

Let me try to do a little appraising of the appraisers or the analysts themselves, and embark on a brief evaluation of these five lines of action which I have briefly described to you. Of course, I am expressing, basically, a personal opinion, which is derived from experience and observation and a great deal of thought; but it should not be taken as in any sense representing the standard view of the work of the security analyst.

The first division, you recall, was the simple identification of good companies and good stock; and one is inclined to be rather patronizing about a job as easy and elementary as that. My experience leads me to another conclusion. I think that it is the most useful of the three conventional approaches; provided only that a conscientious effort is made to be sure that the “good stock” is not selling above the range of conservative value.

Investors do not make mistakes, or bad mistakes, in buying good stocks at fair prices. They make their serious mistakes by buying poor stocks, particularly the ones that are pushed for various reasons. And sometimes -- in fact, very frequently -- they make mistakes by buying good stocks in the upper reaches of bull markets.

Therefore, the very simple kind of advice which keeps the investor in the paths of righteousness, or rather of rightness, I would say is very worthwhile advice -- saying merely "These are good companies, and their prices are on the whole reasonable." I think also that is the key to the policy of the well-established investment-counsel firms; and it accounts for their ability to survive, in spite of the fact that they are not in a very easy kind of business.

When you move from that simple and yet valuable occupation, namely, telling an investor that General Motors and General Electric are safer things to buy than Barker Brothers at 25 3/4, for example -- when you move from that into the next activity, you are getting into much more difficult ground, although it seems to be much more interesting. And that is the selection of growth stocks, which for a long while was the most popular or rather the best-regarded type of activity by analysts.

The successful purchase of growth stocks requires two rather obvious conditions: First, that their prospect of growth be realized; and, second, that the market has not already pretty well discounted these growth prospects.

These conditions do obtain with regard to some growth stocks, as they are identified by analysts; and highly satisfactory profits are made from that work. But the results vary a great deal with the skill of the selector, and perhaps with "the luck of the draw." It is quite questionable to my mind whether you can establish a technique of a communicable sort -- that a good instructor can pass on to his pupil -- by which you will be enabled to identify those stocks not only which have good prospects of growth but which have not already discounted pretty much those prospects in the market.

Let us put it in this way: I think at bottom success in the identification of growth stocks comes from being smart or shrewd, but I do not consider it a standard quality of good security analysis to be smart or shrewd. Not that I have any objection to that, but it just doesn't seem to me to fit into the general pattern or canon of security analysis to require those rather rare qualities.

I might say rather that a security analyst should be required to be wise, in the sense that he is technically competent, that he is experienced, and that he is prudent. And I don't know that wisdom of that sort is particularly well adapted to the successful selection of growth stocks in a market that is so full of surprises and disappointments in that field as in many others. I have in mind many examples. If you take the chemical companies, which have been the standard example of growth stocks for as long back as I can remember, you will find that for a long period of years their market behavior was quite unsatisfactory as compared with other companies, merely because they had previously had a great deal of popularity at a time when other companies were not so popular. If you take the air transport stocks, the selection of those securities for investment, based upon the idea of growth, seems to me to have been an exceedingly speculative type of thing; and I don't know how it could have been properly handled under the techniques of well-established security analysis. As you know, there are many, many hazards which exist in

that kind of industry, and in many others that have been regarded as having unusual growth prospects.

Now let me pass on to the third activity of the conventional sort, which I think is done most constantly in day-by-day Wall Street organizations -- the trade investigation, which leads one to believe that this industry or this company is going to have unusually good results in the next 12 months, and therefore the stock should be bought.

Permit me to say that I am most skeptical of this Wall Street activity, probably because it is the most popular form of passing the time of the security analyst. I regard it as naive in the extreme. The thought that the security analyst, by determining that a certain business is going to do well next year has thereby found something really useful, judged by any serious standard of utility, and that he can translate his discovery into an unconditional suggestion that the stock be bought, seems to me to be only a parody of true security analysis.

Take a typical case. What reason is there to think that because U.S. Plywood, for example, is going to do better in 1947 than it did in 1946, and National Department Stores will probably do worse in 1947 than it did in 1946 -- what reason is there to believe that U.S. Plywood should be purchased at 34 rather than National Department Stores at 17? There is scarcely any serious relationship between these concepts of next year's operations and the purchase and sale of the securities at the going market price; because the price of 34 for U.S. Plywood might have discounted very good earnings for three years, and the price of National Department Stores might theoretically have discounted poor earnings for three years. And in many cases that is not only theoretically so, but is actually so.

I would suggest, and this is a practical suggestion -- what I said before has been perhaps only a theoretical analysis in your eyes -- that if you want to carry on the conventional lines of activity as analysts, that you impose some fairly obvious but nonetheless rigorous conditions on your own thinking, and perhaps on your own writing and recommending. In that way you can make sure that you are discharging your responsibilities as analysts. If you want to select good stocks -- good, strong, respectable stocks -- for your clients, that's fine, I'm all for it. But determine and specify that the price is within the range of fair value when you make such a recommendation. And when you select growth stocks for yourself and your clients, determine and specify the round amount which the buyer at the current price is already paying for the growth factor, as compared with its reasonable price if the growth prospect were only average. And then determine and state whether, in the analyst's judgment, the growth prospects are such as to warrant the payment of the current price by a prudent investor.

I would like to see statements of that kind made in the security analyses and in circulars. It seems to me that you would then be getting some kind of defensible approach to this process of handing out recommendations.

And finally, in recommending a stock because of good near-term prospects, you should determine and state whether or not, in the analyst's judgment, the market price and its fairly recent market action has already reflected the expectations of the analyst. After you have determined that it hasn't, and that the thing has possibilities that have not been shown in the market action, then it would be at least a reasonable action on your part to recommend the stock because of its near-term prospects.

Have you any questions about this evaluation, perhaps somewhat biased, of the conventional activities of the security analyst?

QUESTION: Do you confine your near-term valuation, your Point Three, to just one year?

MR. GRAHAM: I am thinking more or less of between one and two years. Most people seem satisfied to talk about the next twelve months in this particular field. Let us spend the next five minutes on the unconventional or penetrating type of security analysis, which emphasizes value.

The first division represents buying into the market as a whole at low levels; and that, of course, is a copybook procedure. Everybody knows that is theoretically the right thing to do. It requires no explanation or defense; though there must be some catch to it, because so few people seem to do it continuously and successfully.

The first question you ask is, of course: "How do you know that the market price is low?" That can be answered pretty well, I think. The analyst identifies low market levels in relation to the past pattern of the market and by simple valuation methods such as those that we have been discussing. And bear in mind that the good analyst doesn't change his concept of what the earnings of the next five years are going to be just because the market happens to be pessimistic at one time, or optimistic at another. His views of average future earnings would change only because he is convinced that there has been some change of a very significant sort in the underlying factors.

Now he can also follow a mechanical system of operating in the market, if he wishes, like the Yale University method that many of you are familiar with. In this you sell a certain percentage of your stocks as they go up, or you convert a certain percentage of your bonds into stocks as they go down, from some median or average level.

I am sure that those policies are good policies, and they stand up in the light of experience. Of course, there is one very serious objection to them and that is that "it is a long time between drinks" in many cases. You have to wait too long for recurrent opportunities. You get tired and restless -- especially if you are an analyst on a payroll, for it is pretty hard to justify drawing your salary just by waiting for recurrent low markets to come around. And so obviously you want to do something else besides that.

The thing that you would naturally be led into, if you are value-minded, would be the purchase of individual securities that are undervalued at all stages of the security market.

That can be done successfully, and should be done -- with one proviso, which is that it is not wise to buy undervalued securities when the general market seems very high. That is a particularly difficult point to get across: For superficially it would seem that a high market is just the time to buy the undervalued securities, because their undervaluation seems most apparent then. If you could buy Mandel at 13, let us say, with a working capital so much larger when the general market is very high, it seems a better buy than when the general market is average or low. Peculiarly enough, experience shows that is not true. If the general market is very high and is going to have a serious decline, then your purchase of Mandel at 13 is not going to make you very happy or prosperous for the time being. In all probability the stock will also decline sharply in price in a break. Don't forget that if Mandel or some similar company sells at less than your idea of value, it sells so because it is not popular; and it is not going to get more popular during periods when the market as a whole is declining considerably. Its popularity tends to decrease along with the popularity of stocks generally.

QUESTION: Mr. Graham, isn't there what you might call a negative kind of popularity, such as the variations of Atchison? I mean, in a falling market, while it is perfectly true that an undervalued security will go down, would it go down as fast as some of the blue chips?

MR. GRAHAM: In terms of percentage I would say yes, on the whole. It will go down about as fast, because the undervalued security tends to be a lower-priced security; and the lower-priced securities tend to lose more percentagewise in any important recessions than the higher ones. Thus you have several technical reasons why it does not become really profitable to buy undervalued securities at statistically high levels of the securities market.

If you are pretty sure that the market is too high, it is a better policy to keep your money in cash or Government bonds than it is to put it in bargain stocks. However, at other times -- and that is most of the time, of course -- the field of undervalued securities is profitable and suitable for analysts' activities. We are going to talk about that at our next lecture.