LEITHNER & COMPANY
PTY LTD

Investment Philosophy

Confronted with a challenge to distil the secret of sound investment into three words, we venture the motto, Margin of Safety.

Benjamin Graham
The Intelligent Investor (1949)

To invest successfully, you need not understand beta, efficient markets, modern portfolio theory, option pricing or emerging markets. You may, in fact, be better off knowing nothing of these. That, of course, is not the prevailing view at most business schools, whose finance curriculum tends to be dominated by such subjects. In our view, though, investment students need only two well-taught courses – How to Value a Business, and How to Think About Market Prices.

Your goal as an investor should simply be to purchase, at a rational price, a part interest in an easily-understandable business whose earnings are virtually certain to be materially higher five, ten and twenty years from now. Over time, you will find only a few companies that meet these standards – so when you see one that qualifies, you should buy a meaningful amount of stock. You must also resist the temptation to stray from your guidelines: if you aren't willing to own a stock for ten years, don't even think about owning it for ten minutes. Put together a portfolio of companies whose aggregate earnings march upward over the years, and so also will the portfolio's market value.

Warren Buffett
Letter to Berkshire Hathaway Shareholders (1996)

Benjamin Graham (1894-1976), author of *Security Analysis* (1934) and *The Intelligent Investor* (1949), was a principal of Graham-Newman Corp. (1926-1955). He is also regarded as the founder of modern financial analysis. Leithner & Company (hereafter "LCO") is a Graham-style value investor.

Graham's key insight is that "investment is most successful when it is most businesslike. An investment operation is one which, upon thorough analysis, promises safety of principal and a satisfactory return." Operations that don't meet these requirements are speculative. Value investors recognise that price is what's paid and that value is what's received; they observe that over time price and value gravitate towards one another but that at any given point in time may diverge (sometimes by a wide margin); and they regret that most market participants apparently seldom recognise – and some willfully ignore – the fundamental distinction between value and price. Graham's followers emphatically reject the prevailing view that the price and value of a security (i.e., stock, bond, title to real estate) coincide at all times.

In order to appreciate the distinction between price and value, Graham urged market participants to ignore "the market" and to focus upon the individual business which issues a security such as a stock. The investor regards a stock as a share in the ownership of a business, and its value will over time correspond to that of the entire enterprise. From this insight follow two others:

1. Sometimes a security can be purchased at a price less than its value, and the greater this disparity the greater its "margin of safety."
2. To obscure the relationship of value to price – for example, to buy a security on the basis of its current popularity and in the hope that its price, reflecting this popularity, will shortly rise – is to forsake investment and embrace speculation. From the perspective of a Graham-style value investor, the vast majority of transactions occurring every day in financial markets are speculations rather than investments.[1]

Prominent value investors, such as Graham's one-time students and employees Warren Buffett, Thomas Knapp and Walter Schloss, regard

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[1] For details, see Chap. 1 of *The Intelligent Australian Investor: Timeless Principles and Fresh Applications*, John Wiley & Sons, 2005).

themselves not as traders of pieces of paper but as part-owners of tangible businesses. As such, they seek to allocate capital on the basis of justifiable premises, valid logic and hard evidence – not popularity or emotion; to reduce the risk of permanent loss of capital (as opposed to temporary "mark-to-market" loss); to be cautious when others are confident, calm when others are fearful and deliberate at all times; and to focus upon the value (as opposed to the market prices) of the securities which they own and seek to own. These insights imply ten principles that underpin LCO's operations.

Principle 1: Ignore "The Market" and "Market Experts"

> *Graham-style value investors ignore "market experts" and their predictions about the level of or movements in overall financial markets, prices of individual securities, etc.*

Commentators, strategists and other "experts" are human beings; *homo sapiens*, since time immemorial, has attempted to prophesy the future; today, although it's been dented, the confidence of the general public in the ability of experts to predict the future has vastly exceeded their ability to do so. The inability of alleged experts to prophesy the level of the All Ordinaries and other indices (as well the prices of particular securities, exchange rates, etc.) with any reasonable degree of accuracy is a specific instance of the basic human inability to foretell the future.

Graham didn't merely recognise this frailty: he noted that well-trained and otherwise-intelligent specialists are especially prone to it. "The farther one gets away from Wall Street," he observed in *The Intelligent Investor*, "the more scepticism one will find about the pretensions of stock-market forecasting or timing." Indeed,

> in our experience and observation, extending over 50 years, we have not known a single person who has consistently or lastingly made money by 'following the market.' We don't hesitate to declare that this approach is as fallacious as it is popular.[2]

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[2] In his 1980 Letter to Shareholders, Buffett added that "forecasts may tell you a great deal about the forecaster; [but] they tell you nothing about the future."

Graham also noted that "aside from forecasting the movement of the general market, much effort and ability are directed in Wall Street toward selecting stocks or industrial groups that in matter of price will 'do better' than the rest over a fairly short period in the future." He concluded

> we don't believe [this endeavour] is suited to the needs and temperament of the true investor. As in all other activities that emphasise price movements first and underlying values second, the work of many intelligent minds constantly engaged in this field tends to be self-neutralizing and self-defeating over the years.

A comprehensive study published in the *Hulbert Financial Digest* in January 1994 corroborates this position.[3] Of the 108 market timing and economic forecasting newsletters it analysed during the preceding five years, the predictions of only two corresponded even crudely to subsequent events. *This number is much smaller than would be expected by pure chance, and thereby suggests that although experts cannot get things systematically right they can and do get things comprehensively wrong.* Market strategists, commentators and gurus, it seems, are seldom in doubt but virtually always in error. It is noteworthy that Warren Buffett and Peter Lynch, two of the most successful investors of the last four decades, expressly disclaim any ability to predict markets' level. In Lynch's words, market timers "can't predict markets with any useful consistency, any more than gizzard squeezers could tell the Roman Emperors when the Huns would attack."[4]

So-called market experts encapsulate and disseminate the prevailing conventional wisdom of the moment. They tell us what is presently exciting, depressing or otherwise attracting the herd's attention. Experts don't *influence* mass expectations, and still less do they *create* them. Instead, they *reflect* them. During booms, the crowd expects – nay, *demands* – above-average results, and during busts it fears subpar ones. Hence the crowd extrapolates the immediate past into the indefinite future. Consciously or not, strategists strive to give the punters what they want (when they're upbeat) or what they fear

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[3] See also William Sherden, *The Fortune Sellers: The Big Business of Buying and Selling Predictions* (John Wiley & Sons, 1998).

[4] For a demonstration from first principles of the folly of market timing, see Chap. 2 of Chris Leithner, *The Intelligent Australian Investor* (John Wiley & Sons, 2005).

(when they're despondent), and incorporate these extrapolations into their oracular utterances.

Principle 2: Don't Try to Predict – and Ignore Those Who Do

> *Graham-style value investors pay little attention to forecasts about "the economy," the level and direction of interest rates, the Consumer Price Index, the exchange rate of the Australian dollar vis-à-vis other currencies, unemployment, the balance of payments and who-knows-what-else.*

Human beings, experts or otherwise, cannot prophesy with any useful degree of accuracy; economists are purportedly experts; therefore economists, however confident and seemingly convincing they might be, cannot foresee economic and financial phenomena with any useful degree of accuracy. Their prognostications distract rather than inform. Hence value investors devote little time to the relentless torrent of economic, financial and market prophesies.

William Sherden reviewed research about the accuracy of economic forecasts that has been conducted since the 1970s. He found that

- economists cannot predict turning points (i.e., when a growing economy falls into recession, when a recession ends, etc.) in the economy;
- their ability to forecast accurately is, on average, neither better nor worse than flipping a coin or simply guessing;
- increased sophistication (i.e., more powerful computers, more complicated econometric models and greater amounts of data) has not improved the accuracy of forecasts;
- there is no evidence that forecasters' skill has increased since the 1970s – if anything, their "skill," such as it is, has deteriorated over time;
- "consensus" forecasts (i.e., the combination of individual forecasts into a single, average forecast) are no more accurate than the individual forecasts which comprise them;
- the further into the future that economists attempt to forecast, the less accurate their forecasts become;
- no individual forecasters are reliably more accurate than their peers.

Given this disconcerting – for mainstream economists, strategists and the like – reality, value investors keep firmly in mind two seemingly flippant but nonetheless vital laws. The first is that, for every fortune-teller, there is likely to be an equal and opposite prophet. (This one says market up, that one says market down, etc.) The second law is that mainstream economists are irrelevant. In the words of influential investor Philip Fisher (*Common Stocks and Uncommon Profits*, John Wiley & Sons Investment Classics, 1996),

> I believe that the economics which deals with forecasting business trends may be considered to be about as far along as was the science of chemistry during the Middle Ages. The amount of mental effort the financial community puts into this constant attempt to guess the economic future makes one wonder what might have been accomplished if only a fraction of such mental effort had been applied to something with a better chance of proving useful.[5]

Buffett agrees. "We'll continue to ignore political and economic forecasts, which are an expensive distraction for many investors and businessmen," he said in his letter to Berkshire's shareholders in 1994. He continued:

> Thirty years ago, no one could have foreseen the huge expansion of the Vietnam War, wage and price controls, two oil shocks, the resignation of a president, the dissolution of the Soviet Union, a one-day drop in the Dow of 508 points, or treasury bill yields fluctuating between 2.8% and 17.4%.
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> But, surprise – none of these blockbuster events made the slightest dent in Ben Graham's investment principles. Nor did they render unsound the negotiated purchases of fine businesses at sensible prices. Imagine the cost to us, then, if we had let a fear of unknowns cause us to defer or alter the deployment of capital. Indeed, we have usually made our best purchases when apprehensions about some macro event were at a peak. Fear is the foe of the faddist, but the friend of the fundamentalist. A different set of major shocks is sure to occur in the next 30 years. We will neither try to predict these nor to profit from them. If we can identify businesses similar to those we

[5] A more detailed discussion and analysis of these points appears in Chap. 7 of *The Intelligent Australian Investor*.

> have purchased in the past, external surprises will have little effect on our long-term results.

On the eve of the Global Financial Crisis, the International Monetary Fund provided a revealing – and, if it weren't so pathetic, highly amusing – example of the delusional belief that mainstream economists can foresee the future.[6] On 12 April 2007, in its *World Economic Outlook*, the IMF stated that "rapid growth in the world economy is set to continue for years and will not be upset by financial instability." Indeed, it reckoned that the outlook for robust growth and low inflation "is better now than at any time since at least the 1960s, and growth prospects are more balanced around the world now than they were then." At a news conference celebrating the release of the WEO – and, more generally, of the IMF's alleged wisdom – its chief economist added

> I think we can sustain growth at around 5% a year for some time to come … You will have some ups and downs in financial markets, but as long as the macroeconomic policies are sound the issues in finance will not be of first order importance.

That prophesy, to put it mildly, was wildly incorrect. But no matter: if your forecasts don't at first succeed, forecast again. Little more than a year later (in its *World Economic Outlook* released on 8 October 2008), the IMF suddenly realised that the world was poised for a "major [economic] downturn" and that the U.S. and Europe were "either in or on the brink of recession." Indeed, "the world economy is now entering a major downturn in the face of the most dangerous shock in mature financial markets since the 1930s."

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[6] Economists of the Austrian School knew from the start that the IMF and like organisations were gangs of destructive jokes. "The destruction of the monetary order," wrote Ludwig von Mises in the 1952 edition of *The Theory of Money and Credit*, "was the result of deliberate actions on the part of various governments. The government-controlled central banks and, in the United States, the government-controlled Federal Reserve System were the instruments applied in this process of disorganisation and demolition. Yet without exception all drafts for an improvement of currency systems assign to the governments unrestricted supremacy in matters of currency and design fantastic images of super-privileged super-banks. Even the manifest futility of the International Monetary Fund does not deter authors from indulging in dreams about a world bank fertilising mankind with floods of cheap credit."

In a press conference, the IMF's chief economist conceded that "leaders in Europe" were encountering "some difficulty" agreeing how to tackle the crisis. If they succeed (and of course governments always succeed, on time and on budget, and their actions never spawn negative and unintended consequences), "the risk of a 'Great Depression' is nearly nil." *In neither its news conference nor in its WEO of October 2007 did the IMF utter a syllable about its failure to foresee this severe global recession. As for an apology or a note of humility, or some recognition that it had failed to do its job and would strive to do better next time – well, you've got to be joking.*

Forgetting its rosy assessment of 2007 and utterly oblivious to its utter inability to foresee the eruption of crisis in 2008, the confidence with which the IMF continued to predict remained undimmed. "Intensifying solvency concerns about a number of the largest U.S.-based and European financial institutions have pushed the global financial system to the brink of systemic meltdown," said its managing director on the weekend of 11-12 October. But don't worry, its chief economist added: "at the worst, governments will need another few weeks to make the right assessment and the stock exchanges could fall by another 20%. Then there will be a turnaround."

If on your second try you don't succeed, you guessed it – forecast again! On 12 February 2009, *The Australian* reported:

> International Monetary Fund chief Dominque Strauss-Kahn says the world's most advanced economies – the U.S., Western Europe and Japan – are already in depression, and that the IMF could slash its global growth forecasts further. "The worst cannot be ruled out," he said yesterday. The IMF managing director's comments … represent the most dire estimate so far of the state of the global economy by a major political figure, and were far more pessimistic than forecasts released as recently as 28 January.

Until it struck, the IMF had no inkling that an economic tidal wave would shortly engulf the world. Similarly, until it occurred it was utterly oblivious to the economic crisis in Asia in 1997-1998. Like any and every other similar organisation (including central banks, the Treasuries of national governments, private sector forecasters, etc.) the IMF poses, postures, pontificates and pretends. *It and other organisations of "experts" desperately want you to believe that they can, but they simply can't foresee the future. More generally, such organisations* *strive to give the impression that they know what they're doing, but they clearly don't.* Humans' (including value investors') inability to prognosticate economic events and developments with any useful degree of accuracy means that they should discount or ignore economists or others who claim that they have a crystal ball.

Value investors, then, ignore forecasters. This does NOT mean that they ignore the future. Quite the contrary: they plan for tomorrow not by making particular predictions about what will happen but by considering general scenarios – and particularly pessimistic ones – of what might conceivably happen. They then adapt their actions and investments in order to reduce the risk of permanent loss of capital in the event that undesirable events and developments actually occur (see also LCO's conception of risk and framework for risk management). In this context it's significant that "psychologists have found that people who are mildly depressed tend to have the most realistic outlook" (quoted in *The Wall Street Journal* 22 September 1998).

Principle 3: Don't Attempt to Predict "the Market" or "the Economy" – Analyse Businesses

> *Because Graham-style value investors don't spend fruitless hours obsessing about "the market" or worrying about "the economy", they can devote considerable time to a far more productive purpose: the search for businesses whose securities are available at reasonable or bargain prices.*

To followers of Graham, it bears repeating, investing is most successful when it is rational; and it's most rational when it's most businesslike. "An investment operation is one which, upon thorough analysis, promises safety of principal and a satisfactory return. Operations not meeting these requirements are speculative." Accordingly, with respect to any security under consideration they ask, investigate and answer questions such as:

- is the underlying business understandable and sensible?
- does it have a consistently favourable operating history? Are there any obvious and major factors which might affect its prospects?
- is management candid with shareholders? Does it recognise and correct its errors? Do managers treat shareholders' funds as if it were theirs?
- do managers eat their own cooking? Have they invested own money in the company? Do they own a significant percentage of it?

In answering these questions, followers of Graham ground their analysis in simple maths, clear logic and hard evidence. As the preface of *Security Analysis* put it, "we are concerned chiefly with concepts, methods, standards, principles, and above all with logical reasoning." The investor-businessman distrusts the advanced mathematics, statistical models and computations which underlie contemporary finance. Graham's views were unequivocal:

> In 44 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, you could take it as a warning signal that the operator is trying to substitute theory for experience, and usually also to give speculation the deceptive guise of investment.[7]

Value investors don't heed others' optimism and wishful thinking (or despondency); insofar as possible they exclude emotional considerations from their analyses. Accordingly, they accept at face value little of what they encounter in mainstream media – and accept without careful consideration even less of what they hear on non-mainstream media. In particular, they run as fast as their legs can carry them from "tips" and never visit investment chat sites on the internet.

Principle 4: Buy Only When the Price Is Right

> *When research can derive a justifiable estimate of a business's value (it often can't); when hard evidence indicates that it possesses solid long-term investment value (often it doesn't or is inconclusive); and when there's a "margin of safety" (i.e., the business is selling at a price which is significantly less than a conservative estimate of its value, which it usually*

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7 See Benjamin Graham, "The New Speculation in Common Stocks," *The Analysts Journal* (June 1958). Warren Buffett has uttered similar sentiments. If they're correct, then a firm that combines Nobel Laureates, extremely sophisticated computer algorithms, mountains of data and tens and perhaps hundreds of billions of borrowed dollars speculates on an unprecedented scale – and will generate epochal losses. And so it has transpired: for details, see Roger Lowenstein, *When Genius Failed: The Rise and Fall of Long-Term Capital Management* (Random House, 2000) and James Grant, *Mr Market Miscalculates: The Bubble Years and Beyond* (Axios, 2008).

> *doesn't), Graham-style value investors ask themselves a hypothetical question. "If financial markets were to close for the next five years, would I still be happy to own this business's securities?" Only if the answer is "yes" and there exists no other opportunity that is more compelling do they act. When they act, they act decisively.*

If this sounds extraordinary, remember that estate agents don't quote to you on a daily basis the market price of your house. Further, reflect that despite the absence of such daily price quotations you probably don't – unless you bought it in 2004-2007 – lose sleep over its worth (see also Chris Leithner, *The Intelligent Australian Investor*, Chaps. 3-6 and 10-11).

Principle 5: Ignore Institutional and Bureaucratic Imperatives

> *LCO resists what Mr Buffett has called the "institutional imperative." This is the lemming-like tendency, which is particularly marked within large organisations, to imitate others' behaviour – no matter how silly or self-destructive that behaviour might be.*

John Maynard Keynes, the influential (and enormously destructive) British economist and keeper of the investments of King's College, Cambridge, described the institutional imperative in *The General Theory of Employment, Interest and Money* (1936): "[most] investors may be quite willing to take the risk of being wrong in the company of others, while being much more reluctant to take the risk of being right alone." Peer pressure, in other words, prompts us to do things as members of a group that we'd never countenance as individuals. "Groupthink," as Irving Janis showed in *Victims of Groupthink: A Psychological Study of Foreign Policy Decisions and Fiascos* (Houghton-Mifflin, 1972),[8] spawns a range of unintended negative consequences.

Unlike most market participants, who run in herds and follow the crowd, followers of Graham are individualists – and, at opportune times, contrarians. They work alone or with one or a handful of colleagues but virtually never within large organisations; they analyse primary data and sources of information but discount secondary sources (such as media reports, the assertions of mainstream economists, politicians, et al., and gossip and

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[8] See also Gary Belsky and Thomas Gilovich, *Why Smart People Make Big Money Mistakes* (Simon & Schuster, 1999), and *The Intelligent Australian Investor*, Chap. 9.

scuttlebutt); and they draw a sharp distinction between the veracity and the popularity of their actions. They endeavour to use justifiable premises, valid logic and reliable evidence to reach sound conclusions. They're not dissuaded from a course of action simply because alleged experts or "the market" disagree. Nor do they undertake an action simply because others are doing so. As Graham put it in *The Intelligent Investor*, "you are neither right nor wrong because the crowd disagrees with you." Rather, "you are right because your data and reasoning are right." Indeed, and as he also emphasised, "the right kind of investor [takes] added satisfaction from the thought that his operations are exactly opposite to those of the crowd."

Principle 6: Buy with the Intention of Holding Indefinitely

> *A strategy of buy-and-hold (i.e., buying parts of good businesses with the intention of holding these investments as long as these businesses remain good, thus achieving returns commensurate with their underlying economics) lies at the core of LCO's operations.*

Few market participants can resist the temptation constantly to buy and sell securities. They feel the need to buy and sell within short periods of time rather than wait for attractive opportunities, buy and then hold. "Churning" is costly. On each side of the transaction, brokers extract a commission. Warren Buffett has estimated that the sum of all commissions, fees, etc., generated by churning is vast. As he told *Fortune* (22 November 1999),

> my estimate is that investors in American stocks pay out well over $100 billion a year – say, $130 billion – to move around on those chairs or to buy advice as to whether they should! Perhaps $100 billion of that relates to the FORTUNE 500. In other words, investors are dissipating almost a third of everything that the FORTUNE 500 is earning for them by handing it over to various types of chair-changing and chair-advisory "helpers" … In my view, that's slim pickings."

It's not sufficiently recognised – but vital to understand – that the more frequently one trades the poorer one's results will tend to become (see in particular *The Intelligent Australian Investor*, Chap. 2). This point applies at least as much to major institutions as it does to retail investors and day traders. The greater is the frequency of trading, the greater is the amount paid in brokerage and commissions. As Charles Ellis[9] has demonstrated, the more frequently one trades the more profitable one's trades must be in order to counteract the "drag" imposed by commissions and other charges (see also Terrence Odean and Brad Barber, Trading is Hazardous to Your Wealth: The Common Stock Investment Performance of Individual Investors).

In sharp contrast, LCO attempts to locate and purchase a manageable number of securities whose values (at the time of purchase) exceed their prices. Once purchased, the intention is to retain these securities indefinitely. If their values do indeed exceed their prices, then over time such a portfolio will tend to generate reasonable returns for its owner. LCO has neither the talent nor the disposition to churn securities in anticipation of favourable short-term movements of their prices. Given the benefits of the buy-and-hold approach, it makes sense to devote time and energy to the identification of securities with a significant "margin of safety." And given the costs of churning, it makes sense to regard market prices not as signals to trade but rather as opportunities to acquire part-ownership of sound businesses at reasonable prices. Accordingly, with respect to the frequency of buying and selling (as opposed to the intensity of research) lethargy bordering upon sloth forms a cornerstone of its approach to investment.

Principle 7: Diversify, but Don't Over-Diversify

> *The securities of well-managed and cautiously-financed businesses are not often available at attractive prices. It thus makes sense to research diligently and wait patiently until such opportunities present themselves; and when they do, to place significant sums in those businesses.*

Since its inception in 1999, LCO's investment portfolio has comprised a limited (10-20) number of securities. To diversify beyond this number is necessarily to lower one's buying standards and to buy less discriminately; to do this, in turn, and as justified in detail in Risk and Its Management, increases risk and reduces returns.

What's wrong with diversification? Up to a point, nothing: when a portfolio contains 10-20 securities, diversification is indeed very beneficial. Beyond this

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9 See The Loser's Game and *Winning the Loser's Game: Timeless Strategies for Successful Investing* (McGraw-Hill, 2002).

point, however, it greatly increases the chances that the buyer buys securities about which he knows (too) little. John Maynard Keynes outlined the rationale for focusing the portfolio in a limited number of investments. In a letter to a business associate dated 15 August 1934, he wrote:

> As time goes on, I get more and more convinced that the right method in investments is to put fairly large sums into enterprises which one thinks one knows something about and in management of which one thoroughly believes. It is a mistake to think that one limits one's risk by spreading too much between enterprises about which one knows little and has no reason for special confidence … one's knowledge and experience [are] definitely limited and there are seldom more than a handful of enterprises at any given time in which I personally feel myself entitled to put full confidence.

Philip Fisher lamented in *Common Stocks and Uncommon Profits* that far too few people consider the "evils" of extreme diversification. "This is the disadvantage of having eggs in so many baskets that a lot of the eggs don't end up in really attractive baskets, and it is impossible to keep watching all the baskets after the eggs get put into them." Diversification has been "so oversold" that the fear of having too many eggs in one basket has caused people to put far too few eggs into companies they thoroughly understand and far too many in others about which they know next to nothing. "It never seems to occur to them, much less their advisors, that buying a company without having sufficient knowledge of it may be even more dangerous than having inadequate diversification."

Similarly, Warren Buffett says "diversification serves as a protection against ignorance. [It] makes very little sense for those who know what they're doing." Further, "if you want to make sure that nothing bad happens to you relative to the market, you should own everything. There's nothing wrong with that. It's a perfectly sound approach for somebody who doesn't know how to analyse businesses." If, however, "you are a know-something investor, able to understand business economics and to find … sensibly priced companies that possess important long-term competitive advantages, [then] conventional diversification makes no sense for you."[10] If it raises both the

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[10] See Janet Lowe, *Warren Buffett Speaks: Wit and Wisdom from the World's Greatest Investor* (John Wiley & Sons, 1997), Robert Hagstrom, *The Warren Buffett Portfolio* (John Wiley & Sons, 1999) and particularly Frank Shostak, Diversification: An Austrian View.

intensity with which an investor thinks about a business and the comfort he must derive from its operations before becoming an owner or part-owner, then a strategy of mental and financial concentration may *lessen* the risk that accompanies any investment operation.

Principle 8: Remember That Risk Accompanies Any Investment

> *Mammoth and esoteric tomes have been written, and much popular ink has been spilt, about the concept of risk. Yet despite academics' strenuous – and mostly successful – attempts to complicate it unnecessarily, the concept is very simple: it is the probability that a bad thing might happen. Applied to investments, "risk" has nothing whatever to do with the volatility of the price of a security. Rather, it has everything to do with the likelihood that (i) one pays more for a security than a reasoned assessment of its worth justifies; and (ii) that a sound company ceases at some point in the future to exhibit this characteristic.*

Most market participants, including institutions, brokers, advisors and private investors, define investment risk in terms of the short-term ups-and-downs of a security's market price (relative either to comparable securities or that of 'the market' as a whole). As a result, the practice of investment risk management is conventionally understood as an attempt to reduce within acceptable bounds the short-term variability – particularly in a downward direction – of an investment portfolio's current market worth.

Graham-style value investors disregard both the conventional definition of risk and the standard practice of risk management (see Risk and Its Management). Their impertinence, and in some cases scorn, extends to the body of academic literature which underlies this definition and practice. In Mr Buffett's words, "for owners of a business – and that's the way we think of shareholders – the academics' definition of risk is way off the mark, so much so that it produces absurdities." Among the many examples: Berkshire Hathaway, Inc., which Mr Buffett chairs, bought a substantial stake in The Washington Post Company in 1974. The price paid implied that TWPC, considered as a whole, would fetch $80m. Yet "if you'd asked any one of 100 analysts how much the [entire] company was worth when we were buying [a portion of] it, no one would have argued with the fact that it was worth $400m."

The downward volatility of the price of TWPC's shares enabled Buffett, at a propitious moment, to buy a significant percentage of the company at a fraction of a cautious assessment of its value. In effect, he was buying assets worth $1.00 for only $0.20. According to academic conceptions of risk and the standard practice of investment risk management, the volatility of TWPC's shares made their purchase a risky proposition. Indeed, the greater the shares' price volatility and the lower their purchase price, the *riskier* is the investment. As Buffett concluded incredulously, "with that, [the academics] have lost me." Risk derives from the correspondence of one's premises and logic to reality – not from the ups and downs of the price of a security. The market capitalisation of Berkshire's stake in The Washington Post Company, for which it paid $10.6m in 1974, has subsequently fluctuated wildly – to $150m in 1984, $419m in 1994 and $1.4 billion in 2004.

Absent any change in a company's operations or prospects, then, any sudden or unanticipated fluctuation of the market price of its shares does not make an investment in the company "risky." Once he has acquired part-ownership of a company at a sensible price, the investor monitors its operations and prospects; and as long as these remain constant or improve he retains confidence in his judgement. If the price of its shares decreases after purchase – again, assuming no change in the business's operations or prospects – he will not be alarmed. On the contrary, in the absence of more favourable opportunities he will consider the purchase of more shares. As Graham put it in *The Intelligent Investor*,

> the bona fide investor does not lose money merely because the market price of his holdings declines, and the fact that a decline may occur does not mean that he is running a true risk of loss … we apply the concept of risk solely to a loss which is either realised through actual sale, or is caused by a significant deterioration in the company's position – or, more frequently perhaps, is the result of the payment of an excessive price in relation to the worth of the security.

Principle 9: Adopt a Sensible Criterion of Success

> *Graham-style value investing, it has been emphasised, builds upon the foundation that investment is most successful when it is most businesslike. Similarly, the measurement of the results of one's investment operations is most sensible when it too is businesslike. One's results, in other words,*

> *have everything to do with the earnings which one's businesses generate and nothing to do with the extent to which the prices of their shares fluctuate. As a business, LCO thus gauges its own results in the same way that it would gauge the progress of any other business, e.g., by its earnings, margins and return on equity.*

Academic conceptions of risk, the standard practice of investment risk management and the institutional imperative conspire to bastardise the criteria by which most market participants measure their results. They obsess about "the market" and its short-term "performance." They define the market in terms of a price index such as the All Ordinaries Index; they think about their own portfolios as an index, and compare the "performance" of that portfolio with that of the All Ord or some other index. Accordingly, the greater is an index's increase from one point in time to another, the more favourable is the evaluation of its performance. Conversely, the smaller is the rise (or the greater the decrease) the more negative is the interpretation. Further, if Index A (say, Jack's portfolio) increases relative to Index B (Jill's portfolio or some market index), then A has "outperformed" B.

Most market participants' obsession about markets leaves them little time to analyse individual businesses and securities. Let us assume that the economic bases, operations and prospects of a business change little from one day to the next; indeed, one might contend that the prospects of an established business with a history of sound results don't change significantly from one year to the next. If so, then the day-to-day ups-and-downs of its stock (if it is quoted on an exchange) tell us nothing about these fundamentals, operations and prospects. Clearly, some price changes stem directly from the appearance of genuinely new information. Equally clearly, however, the importance of new information is not often immediately apparent; and in any case most price fluctuations bear little or no direct relation to genuinely new information about operations and prospects. Accordingly, it is superficial influences, as opposed to fundamental changes to the business, which are reflected in day-to-day, week-to-week and month-to-month fluctuations of a stock's price. Hence the absurdity of defining the "performance" of a stock or a bundle of financial assets in terms of short-term price changes becomes apparent.

In *The Warren Buffett Portfolio*, Robert Hagstrom asks "if you owned a business and there was no daily quote to measure its performance, how would you determine your progress? Likely you would measure the growth in earnings, or perhaps the improvement in operating margins, or a reduction in capital expenditures. You would simply let the economics of the business dictate whether you are increasing or decreasing the value of your business." In order to buy or sell a security, one requires a price. In order to evaluate its worth, one does not: rather, one requires valid and reliable information about the business, its operations and prospects.

Principle 10: Explain Yourself Plainly and Remember the People Involved

> *Graham asked his students "have you ever seen a human being mentioned in a corporate business plan?" and beseeched them to "always remember that you are dealing with people and their hard-earned savings."*

Are financial markets falling, or is the sky? In the September-December quarter of 2008, the answer to this question, like much else, was uncertain. Comparisons with the early phases of the Great Depression filled the newspapers and airwaves; and in the year to 31 December, the All Ordinaries Index returned its worst-ever result (minus 45.7%). This loss exceeded those incurred during the Crash of 1987 and the recessions of the early 1990s, 1980s and 1970s, as well as the Great Depression; similarly, American financial markets plunged more in 2008 than at any time since the "Depression-Within-the-Depression" of 1937-1938.

To a Grahamite, a bracing bear market is a potential opportunity. Younger people benefit most from dramatically lower prices; hence they should rejoice when stocks and bonds go on sale – for they will enjoy the benefits in the years to come. For older people, this point is psychologically much more difficult to accept; cognitively, however, it's no less compelling. Yes, their retirement nest eggs have shrunk significantly. But part-and-parcel of older investors' wisdom is – or should be – a greater propensity to hold cash and other liquid assets to sustain them through the bust. Surplus liquid assets will also buy considerably more stocks and bonds towards the bottom than they did during the boom. Hence the family members (namely children and grandchildren) of older investors will enjoy the benefits.

But we mustn't forget – Graham never did – that we're talking about human beings and human nature. Not even the purest seeker of investment value is likely to welcome a bear market with calm in his breast and cash in his trouser pocket. Ordinarily, falling prices improve valuations. But they also mean mark-to-market losses for securities purchased at bullish prices. Objectively, that strains some investors' plans. And subjectively, rare is the investor who's immune to the nausea that tosses market participants during a storm. Just when the bargains are most compelling, the human heart is likely to develop an ardent fondness for cash under the mattress.

"Is American Business Worth More Dead Than Alive?" was the theme of Graham's three-part series of articles that were published in June and July 1932.[11] He noted that one-third of America's listed industrial stocks were priced at less than the pro rata share of their net current assets. Overall, the stock exchange ascribed to their property, plant and equipment, as well as intangibles such as goodwill, copyrights, trademarks and patents, a value of $0.00. The only way to explain the existence of so many ultra-cheap stocks, Graham proposed, was that buyers and sellers in the market had extrapolated the extreme present into the indefinite future: they had concluded that operating losses would continue for years and perhaps even decades.

In Graham's view, market participants had let their emotions overcome their brains. "Much of the past year's selling of stocks has been due to fear rather than necessity." Moreover,

> If these timid holders were thoroughly aware that they were selling out for only a fraction of the liquid assets behind their share, many of them might have acted differently. But since valuation has come to be associated exclusively with earning power, the stockholder no longer pays any attention to what his company owns – not even its money in the bank.

"Is it true," he asked, "that one out of three American businesses is destined to continue losing money until the stockholders have no equity remaining? That is what the stock market says in no uncertain terms." He answered:

> In all probability [the market] is wrong, as it has always been wrong in its major judgments of the future. The logic of Wall Street is proverbially weak. It is hardly consistent, for example, to despair of the railroads because the trucks are going to take most of their

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11 See Should Rich Corporations Return Stockholders' Cash? and Inflated Treasuries and Deflated Stockholders and Should Rich but Losing Corporations Be Liquidated?

> business, and at the same time to be so despondent over the truck industry as to give away shares in its largest units for a small fraction of their liquid capital alone.

The series in *Forbes* bracketed the Dow's 8 July absolute bottom. Graham had never made market calls or taken others' seriously; but on that occasion, and virtually alone, he possessed the fortitude as well as the intellect to be bullish when virtually everybody was despondent. His stance was soon rewarded: in 1933, his portfolio's valuation increased by 50%. That wasn't nearly enough to recoup his losses – that would have to wait until 1936 – but it was a start.

Graham was – like most people – a complex mixture of reason and emotion. Between 1929 and 1932 his investment partnership lost 70%; not until 1936 did it recoup all it had relinquished; and in 1937-1938 it suffered fresh losses. Yet for more than a decade he persevered and, with his partner, Jerry Newman, proceeded – notwithstanding those disastrous years – to achieve an excellent long-term record. Most people have heard the quip "The first rule of investing is not to lose money and the second rule is not to forget the first." Yet sometimes – and particularly on the downward leg of what might be a severe and extended bear market – that advice simply isn't helpful. What *is* useful is knowledge of Graham's mindset and philosophy. They demonstrate that a severe loss is no reason to capitulate.

To buy assets whose value exceeds their price, and to ignore (or at least endure stoically) short-term fluctuations and vicissitudes, is the essence of investing. In Graham's words,

> basically price fluctuations have only one significant meaning for the true investor. They provide him with an opportunity to buy 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.

And at all times, Graham concluded, fashion and conventional wisdom are no substitutes for clear premises, hard evidence and valid reasoning. In this manner "through chances various, through all vicissitudes, we make our way" (Virgil, *The Aeneid*).