

Ludwig von Mises, Meet Benjamin Graham: Value Investing from an Austrian Point of View

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DRAFT – COMMENTS WELCOME

Chairman: ... One other question and I will desist. When you find a special situation and you decide, just for illustration, that you can buy for 10 and it is worth 30, and you take a position, and then you cannot realise it until a lot of other people decide it is worth 30, how is that process brought about – by advertising, or what happens? (Rephrasing) What causes a cheap stock to find its value?

Graham: That is one of the mysteries of our business, and it is a mystery to me as well as to everybody else. [But] we know from experience that eventually the market catches up with value.

Benjamin Graham
Testimony to the Committee on Banking and Commerce
Sen. William Fulbright, Chairman
(11 March 1955)

What we do is look for extremes in markets: very undervalued or very overvalued. Austrian theory has certainly given us an edge. When you have a theory to work from, you avoid the problem that comes with stumbling around in the dark over chairs and nightstands. At least you can begin to visualise in the dark, which is where we all work. The future is always unlit. But with a body of theory, you can anticipate where the structures might lie. It allows you to step out of the way every once in a while.

James Grant
The Austrian Economics Newsletter (1996)

Introduction

Ludwig von Mises, one of the twentieth century's most influential Austrian School economists, migrated to the United States in 1940. Sixteen years later, Benjamin Graham, the founder of modern security analysis, disbanded his investment company, returned its assets to shareholders and retired to southern California. During these years they both lived and worked in Manhattan, but trod a circuit without direct reference to the other. Mr Graham commuted between his home at 91st Street and Central Park West, his office at Graham-Newman Corp. and his securities analysis class at Columbia University; and Prof Mises trekked from his flat in West End Avenue to the National Association of Manufacturers, The New York Public Library, Foundation for Economic Education in Irvington-on-Hudson and (beginning in 1949) his seminar at NYU's Graduate School of Business.¹

More generally, although Murray Rothbard (using a pseudonym) and Howard H. Buffett (a Congressman and the father of Graham's most famous student, colleague and standard-bearer, Warren Buffett) commiserated during the 1950s about the bitter fruits of America's interventionist foreign and domestic policies, no publicly available information suggests that during these years Grahamite investors and Misesian economists crossed paths and exchanged ideas.² Perhaps that is just as well. Had they met or corresponded, it is reasonable to suppose that a range of policy issues would have divided them. It is doubtful, for example, whether Graham's advocacy of a commodity-based reserve currency³ would have commanded Mises' assent; and it is still less likely that Graham's backing of the Employment Act of 1946 would have impressed Mises.

Yet Graham, Mises and their students and adherents would surely have agreed emphatically – and disagreed just as strongly with the mainstream in Wall Street and academia – with respect to several fundamental concepts and their interrelations. Perhaps most importantly, to a Grahamite investor and an Austrian School economist price and value are distinct things. Over extended periods of time they tend towards one another. But at any given moment they will likely differ from one another; and from one moment to the next they may diverge.

This paper shows that value investors⁴ and Austrians hold compatible views not only about the price and value, but also about other vital economic and financial phenomena. These include risk and arbitrage; capital and entrepreneurship; and time-preference and interest. Indeed, with respect to these matters each group may have more in common with the other than each has with the mainstream of its respective field. As background, the paper uses the investment results of Leithner & Co. Pty Ltd, and a few of the principles it has used to generate these results, to highlight and elaborate these compatibilities. A private and unlisted company established in 1999 and a Graham-style “value” investor, it views many financial and economic phenomena through Austrian

¹ See Benjamin Graham, *Benjamin Graham: Memoirs of the Dean of Wall Street* (McGraw-Hill, 1996, ed. and with an introduction by Seymour Chatman); and Margit von Mises, *My Years with Ludwig von Mises* (Center for Futures Education, 1984).

² See Justin Raimondo, *An Enemy of the State: The Life of Murray N. Rothbard* (Prometheus Books, 2000).

³ See Benjamin Graham, *World Commodities and World Currency* (McGraw-Hill, 1944, repr. ed. 1998).

⁴ This, alas, has become an ambiguous term. Practitioners of Graham's principles and methods are called value investors; but, judging from the loose usage of the phrase, not all – indeed, few – value investors follow Graham. This paper uses the phrase “value investor” in its restrictive (i.e., Grahamite) sense.

School spectacles.⁵ Its motto is its method: to undertake investment operations that are based upon thorough research; to provide reasonable safety of principal and offer an adequate return; and to inform its shareholders regularly, fully and in plain language about these investment operations. (A summary of Leithner & Co.'s results since inception appears in Appendix 1.)

Price, Value, Risk, Individualism and Scepticism About Maths

Benjamin Graham (1894-1976), author of *Security Analysis: Principles and Techniques* (co-authored by Prof David Dodd, five editions 1934-1962), *The Analysis of Financial Statements* (1937) and *The Intelligent Investor* (four editions 1949-2003) and director of Graham-Newman Corp. (1926-1956), is widely regarded as the founder of modern financial analysis.⁶ Graham's key insight is the premise that "investment is most successful when it is most businesslike. An investment operation is one that, upon thorough analysis, promises safety of principal and a satisfactory return. Operations not meeting these requirements are speculative."⁷

Graham maintained that price is what is paid and that value is what is received; observed that over time price and value gravitate towards one another but that at any given point in time they may diverge (sometimes by a wide margin and for an inconvenient length of time); and lamented that most people rarely recognise – and more than a few wilfully ignore – the fundamental distinction between value and price. Value investors thus reject the mainstream view that the price and value of a security (i.e., stock, bond or title to real estate) necessarily coincide at all times.⁸

Graham not only denied that price and value are synonyms;⁹ he also rejected the financial mainstream's conviction that the more volatile the price of a security the "riskier" it is.¹⁰ To the mainstream, the conception of risk is almost invariably applied to a perceived likelihood that a security's price will decline – even though the decline may be of a cyclical and temporary nature and even though the holder is unlikely under these circumstances to be forced to sell. Value investors, in contrast, "believe that what is here involved is not a true risk in the useful sense of the term ... The *bona fide* investor does not lose money merely because the market price of his holdings declines; hence the fact that a decline may occur does not mean that he is running the risk of a true loss ... This

⁵ See the Newsletters, circulars to shareholders and other materials at www.leithner.com.au. Leithner Investments Pty Ltd, an institutional funds manager using the same investment philosophy, was established in 2004.

⁶ Graham's major books, articles and speeches have been reprinted. See in particular *The Interpretation of Financial Statements: The Classic 1937 Edition* (HarperBusiness, 1998); *Security Analysis: The Classic 1940 Edition* (McGraw-Hill, 1996); *The Intelligent Investor: A Book of Practical Counsel* (rev. ed. Updated with commentary by Jason Zweig, Harper Business, 2003); and Janet Lowe, *The Rediscovered Benjamin Graham: Selected Writings of the Wall Street Legend* (John Wiley & Sons, 1999).

⁷ Good secondary descriptions and analyses of value investing include Janet Lowe, *Benjamin Graham on Value Investing* (FT Pitman, 1995); Janet Lowe, *Value Investing Made Easy* (McGraw-Hill, 1996); and Bruce Greenwald et al., *Value Investing: from Graham to Buffett and Beyond* (John Wiley & Sons, 2001).

⁸ See in particular *Security Analysis: The Classic 1940 Edition*, Chap. 50 ("Discrepancies Between Price and Value") and Chap. 51 ("Discrepancies Between Price and Value Cont'd").

⁹ Graham did not reason from first principles towards this crucial conclusion, but the first generation of Austrians and Mises did (see in particular Chaps. 11 and 26 of *Human Action*). Leithner Letter No. 52 (26 April 2004) highlights the compatibility of the Grahamite to the Austrian conception of the distinction between price and value.

¹⁰ See also Chris Leithner, "Value Investing, Risk and Risk Management" and Leithner Letter 53 (26 May 2004).

confusion may be avoided if we apply the concept of risk solely to a loss which either is 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 [value] of the security ... Many common stocks do involve risks of such deterioration. But it is our thesis that a properly executed investment in common stocks does not carry any substantial risk of this sort and that therefore it should not be termed 'risky' merely because of the element of price fluctuation.”¹¹

In order better to appreciate the interplay of price, value and risk, Graham urged his students and directed his employees to focus not upon financial markets as a whole, or even upon the securities that comprise it, but rather upon the individual businesses that issue securities. For a Graham-style value investor, risk resides in the cumulative likelihood that one or more of four events occur. The first is that a thriving – on the basis of its past and current operations – business ceases in the future to prosper; the second is that an unreasonably high price is paid for such a business (or, equivalently, that the purchaser makes unduly optimistic assumptions about its prospects); the third is the possibility (perhaps as a result of mistaken or insufficiently thorough research) that what the investor believes to be a good business is actually a mediocre or poor one; and the fourth – and perhaps most dangerous – is the possibility that widely-accepted fallacies and falsehoods are received as facts. These possibilities, and not the volatility of individual prices or markets' overall levels, threaten the results of investment operations.

Graham therefore paid little day-to-day attention to “the market” (that is to say, the present or predicted level of aggregate market averages such as the S&P 500) and instead subjected individual companies to detailed and sustained scrutiny. Value investors regard (say) a stock as a share of a business whose value corresponds *pro rata* to the value of the entire enterprise. At any given moment, a stock's price will seldom equal the investor's estimate of its value. Over an extended period of time, however, its price and value will tend towards one another.¹² From this insight follow two others. First, under certain conditions a security may be purchased at a price less than that which emerges from a cautious estimate of its value; and the greater this disparity the greater the investment's “margin of safety.” Value investors, then, strive to become and remain dispassionate realists who sell selected securities to eager buyers (optimists) and purchase them from eager seller (pessimists). Second, to obscure the distinction between value and price – most notably, 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, embrace speculation and invite the impairment or loss of capital.

Because Graham-style value investors do not spend fruitless hours pondering either “the market” or myriad and esoteric economic aggregates, they can devote considerable time to a far more productive purpose: the search for individual businesses whose securities are available at reasonable or bargain prices. To these investors, it is important to emphasise, the allocation of capital is most successful when it is rational; and it is most rational when it is most businesslike. The most successful investor, then, is the one who thinks and acts like a shrewd businessman. Accordingly, with respect to a security under consideration value investors ask questions such as:

- is the underlying business understandable?

¹¹ *The Intelligent Investor*, pp. 121-122.

¹² Graham's parable of “Mr Market” on pp. 204-205, 212-225 of *The Intelligent Investor* is perhaps his simplest – and most engaging and profound – statement of this insight.

- does it have a consistently favourable operating history?
- are there any obvious and major factors which might favourably or adversely affect its prospects?
- is its management candid with shareholders? Does it recognise and correct its errors openly?
- do managers treat shareholders' funds as if they were their own?
- have managers invested their own money (as opposed to options leveraged against shareholders' funds) in the company? Do they own a significant percentage of it?

In answering these questions, value investors ground their analyses in simple arithmetic, plain verbal logic and commonsensical evidence. Like Austrians, they distrust the unrealistic assumptions, statistical models and aggregate data which contemporary financial analysis takes for granted. In Graham's words, written in 1958, "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 ... 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."¹³

Similarly, value investors place no credence upon "consensus" market, financial and economic views; and insofar as possible they exclude emotional considerations from their analyses. Accordingly, they take at face value little of what they read in mainstream newspapers and magazines; accept without careful consideration even less of what they hear on radio and television; run as fast as their legs can carry them from "tips" and never visit investment chat sites on the Internet.¹⁴ In short, the daily torrents of market news, data and opinion "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."

Prominent value investors, such as Mr Graham's students and employees Warren Buffett, Thomas Knapp and Walter Schloss, thus regard themselves not as traders of pieces of paper but as entrepreneurs and owners of tangible businesses. They seek to invest on the basis of realistic premises, valid logic and reliable evidence; reduce the risk of permanent loss of capital (as opposed to temporary quotational loss); be cautious when others are confident and decisive when others are fearful; and thereby to increase the enduring value (as opposed to the ephemeral market price) of their capital.

Grahamites as "Austrian" Entrepreneurs

An important sub-field of the Austrian School, the theory of entrepreneurial discovery, offers a superior explanation of how real-world markets work. Israel Kirzner is one of its most prominent contemporary exponents.¹⁵ The theory emphasises the very features of

¹³ See "The New Speculation in Common Stocks," in Lowe, *The Rediscovered Benjamin Graham*.

¹⁴ For details, see Leithner Letter No. 55 (26 July 2004).

¹⁵ See in particular Kirzner's *Competition and Entrepreneurship* (University of Chicago Press, 1973); *The Meaning of Market Process* (Routledge, 1996); *How Markets Work: Disequilibrium, Entrepreneurship and Discovery* (Institute of Economic Affairs, 1997); and *The Driving Force of the Market* (Routledge, 2000). [The Role of the Entrepreneur in the Economic System](#) (the Inaugural John Bonython Lecture delivered by Kirzner at

real-world markets that the mainstream model of perfect competition excises. Most importantly, disequilibrium, not equilibrium, characterises the interactions among buyers and sellers; and disequilibrium (and its associated cycle of error, detection, correction and renewed error) underlies entrepreneurial activity and discovery. Markets do indeed tend towards market-clearing prices: but they never attain equilibrium because numerous events – the constant change of plans, discovery of new information and technology, commission of errors and their discovery and rectification – intrude. Alert entrepreneurs, be they producers, consumers or investors, detect errors and, through a process of trial and error, learn how they can be remedied. Occasionally, disequilibrium also enables prescient entrepreneurs to anticipate changes in others' plans and decisions.

Accordingly, movements of prices, changes of methods of production and distribution, and choice of outputs stem ultimately from changes in consumers' plans and desires; and entrepreneurial error, discovery and correction set these market forces in motion and influence them in directions that serve consumers' wishes. Alert entrepreneurs reveal where and how the structure of production can be improved in order to serve consumers better. Entrepreneurial discovery is the oil that enables the market mechanism to operate so smoothly.

A deep chasm separates the theory of entrepreneurial discovery from the mainstream model of perfect competition. To mainstream economists, the decisions to buy and sell in the market are mere mathematical derivations. A decision, in other words, is "made" by a "given" model, probability distribution and data. The mainstream model thus eliminates the real-life, flesh-and-blood decision-maker – the heart of the Austrian economics and value investing – from the market. Market automatons do not err; accordingly, it is unthinkable that an opportunity for pure profit is not instantly noticed and grasped. The mainstream economist, goes the revealing joke, does not take the \$10 banknote lying on the floor because he believes that if it were really there then somebody would already have grabbed it.

In sharp contrast, Austrians recognise that decisions are taken by real people whose plans are imperfectly clear, indistinctly ranked, often internally-inconsistent and always subject to change. Further, at any given moment a market participant will be largely unaware of other market participants' present and future plans. It is participation in the market that makes buyers and sellers a bit more knowledgeable about their own plans and slightly less unaware of others' plans. Market participants will inevitably make mistakes; further, it is probable that they will not automatically notice them. Accordingly, it is not just possible – it is typical – that opportunities for gain ("pure profit") appear but are not instantly detected. Recognising the obvious – namely that he has possibly been the first to notice it – the Austrian will therefore take the \$10 note inadvertently dropped on the floor and ignored by his mainstream colleague. An "Austrian" act of entrepreneurial discovery, then, occurs when a market participant seeks and finds what others have overlooked.

Adelaide, South Australia on 30 July 1984) is an excellent five-page précis of this research. Leithner Letter No. 58 (26 October 2004) details the similarities between the behaviour of "Austrian" entrepreneurs and Grahamite investors.

In these respects, Grahamite value investors are “Austrian” entrepreneurs.¹⁶ To cite just one example, Warren Buffett discovered a lucrative opportunity (one of the first of many in his long and successful career) when he worked at Graham-Newman Corp. Mr Buffett recalls¹⁷ that “Rockwood & Co., a Brooklyn based chocolate products company of limited profitability, had adopted [Last In First Out] inventory valuation in 1941 when cocoa was selling for \$0.50 per pound. In 1954, a temporary shortage of cocoa caused the price to soar to over \$0.60. Consequently Rockwood wished to unload its valuable inventory quickly. But if the cocoa had simply been sold off, the company would have owed close to a 50% tax on the proceeds. The 1954 Tax Code came to the rescue. It contained an arcane provision that eliminated the tax otherwise due on LIFO profits if inventory was distributed to shareholders as part of a plan reducing the scope of a corporation’s business. Rockwood decided to terminate one of its businesses, the sale of cocoa butter, and said 13 million pounds of its cocoa bean inventory was attributable to that activity. Accordingly, the company offered to repurchase its stock in exchange for the cocoa beans it no longer needed, paying 80 pounds of beans for each share. For several weeks I busily bought shares, sold beans, and made periodic stops at Schroeder Trust to exchange stock certificates for warehouse receipts. The profits were good and my only expense was subway tokens.”

It is important to emphasise that this discovery, like Buffett’s and Graham’s many others, did not derive from information that other buyers and sellers could not possess. These acts of entrepreneurial discovery stemmed from the alert analysis of publicly available information and the superior detection of opportunities that others had simply overlooked. On numerous occasions, Graham and his students and followers have found promising places to look and have been the first, in effect, to detect the piles of notes that others have disregarded and left lying on the floor. Anybody, for example, could have bought parts of American Express, *The Washington Post*, GEICO (whose enormous potential Graham was the first to find) and Coca-Cola when Mr Buffett did; but few saw what he saw, ignored the irrelevancies and reasoned so clearly. Instead, most were distracted by myriad worries – and economic and financial fallacies – and so very few followed Buffett’s lead.

These examples are significant in another respect: they rightly imply that Grahamites are Kirznerian but not Schumpeterian entrepreneurs.¹⁸ Value investors, in other words, strive to discover “routine” discrepancies between price and value. By purchasing temporarily undervalued securities or selling overvalued securities, they encourage equilibrium (i.e., price and value to approximate one another more closely). But Graham and his followers have tended to eschew new firms or firms that produce radically new goods and services. Perhaps most notably, over the decades they have gone to great lengths to avoid “technology” firms. They have done so because these firms are difficult to value; and they are difficult to value partly because a few of these firms are “Schumpeterian” – that is to say, the goods and services they produce cause consumers to rearrange their preference scales in unforeseeable ways and thereby generate extended (but not permanent) disequilibrium in the market.

¹⁶ “Entrepreneurial judgment,” said Mises, “cannot be bought on the market. The entrepreneurial idea that carries on and brings profit is precisely that idea which did not occur to the majority. It is not correct foresight as such that yields profits, but foresight better than that of the rest. The prize goes only to the dissenters, who do not let themselves be misled by the errors accepted by the multitude. What makes profits emerge is the provision for future needs for which others have neglected to make adequate provision.”

¹⁷ See Mr Buffett’s 1988 letter to shareholders at www.berkshirehathaway.com.

¹⁸ I thank Robert Blumen for bringing this point to my attention.

As an example, personal computers, the various software programs they contain and the tasks they can accomplish have, since the 1980s, prompted many millions of consumers to purchase vast amounts of PC hardware and software. The consumers who have spent billions on these goods and services have declined to spend this money on the many other things that it can buy. Hence the advent of the PC, Internet and the like has prompted many of their users significantly and perhaps dramatically to adjust their preferences orderings; and this adjustment has necessitated corresponding recalibrations of many firms' capital structure. Accordingly, it is not sufficient to say that certain alert ("Kirznerian") entrepreneurs noticed that bits of metal, plastic and lines of code could be bought and assembled at place A for \$1.00 and sold at place B for (say) \$2.00; rather, it is more apt to say that the ideas of Silicon Valley and other "Schumpeterian" entrepreneurs introduced consumers to new sets of goods, services and choices.

The Future Is Largely But Not Radically Uncertain

Grahamites recognise that the future is inherently uncertain. That is to say, there is no probability distribution and there are no data that can "model" it. The future is not radically uncertain, in the sense that Ludwig Lachmann maintained, but it is largely so. Like many Austrians, Grahamites accept that one can know some things (such as historical data, relationships of cause and effect and hence the laws of economics), and therefore that to some extent the past does project into the future.¹⁹ Grahamites do not agree, in other words, that anything can happen; but they are acutely aware – because they have learnt from unpleasant personal experience – that the unexpected can and often does happen. They also acknowledge that forecasting the future is the job of entrepreneurs, not economists or bureaucrats, and therefore that the entrepreneur-investor-forecaster must be cautious and humble.²⁰

Accordingly, Graham-style value investors pay no attention to the predictions of "market experts" and commentators about the level of or movements in overall financial markets, the prices of individual securities, etc. The vast majority of "market experts" and talking heads, it is important to recognise, are not Austrian entrepreneurs: they do not allocate their own or others' capital and their fortunes do not depend upon the correspondence of their plans to subsequent events. Mr Graham recognised this shortcoming and was therefore under no illusion about market prognosticators' abilities. "The further one gets away from Wall Street, the more scepticism one will find about the pretensions of stock-market forecasting or timing." Indeed, "in our [Graham and Dodd] 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 do not hesitate to declare that this approach is as fallacious as it is popular."

Mr Buffett has added²¹ "forecasts may tell you a great deal about the forecaster; but they tell you [precious little] about the future." In *The Intelligent Investor*, 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

¹⁹ I am grateful to Robert Blumen's particularly clear elucidation of this point.

²⁰ Reflecting upon his investment experience, which began in 1914 and ended in 1971, Graham concluded "through all vicissitudes and casualties, as earthshaking 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."

²¹ See Mr Buffett's 1980 letter to shareholders.

price will ‘do better’ than the rest over a fairly short period in the future ... We do not 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-neutralising and self-defeating over the years.”

A comprehensive study, published in the *Hulbert Financial Digest* in January 1994, corroborates this position. *HFD* found that, of the 108 market-timing and economic forecasting newsletters that were analysed during the preceding five years, the predictions of only two corresponded even crudely to subsequent events. This number is much smaller than the one that would be expected by pure chance. It demonstrates that “market experts” cannot systematically get things right – but that they do systematically get things wrong. Market timers, in other words, are seldom in doubt but virtually always in error. It is noteworthy that Warren Buffett and Peter Lynch (one of the most prominent and successful funds managers of the last four decades), disclaim any ability to predict financial markets’ overall level or direction. According to Lynch,²² “thousands of experts study overbought indicators, put-call ratios, the Fed’s policy on money supply ... and they can’t predict markets with any useful consistency, any more than gizzard squeezers could tell the Roman Emperors when the Huns would attack.”

Graham-style value investors also pay no heed to mainstream economists’ forecasts about macroeconomic aggregates such as inflation, exchange rates, joblessness, trade and budget deficits and the like. This is because the ability to forecast these things is at best tenuous. And even if they could be forecast reasonably accurately, they would distract rather than inform.²³ In Mr Buffett’s words, “if Fed Chairman Alan Greenspan were to whisper to me what his monetary policy was going to be over the next two years, it wouldn’t change one thing I do.” Subsuming and justifying this stance is William Sherden’s detailed review of research that tests the accuracy of macroeconomic forecasts.²⁴ He found that

- forecasters cannot predict turning points in the economy;
- their ability to forecast accurately is, on average, neither better nor worse than 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 prophesy, the less

²² Peter Lynch, *One Up on Wall Street* (Simon & Schuster, 1989), p. 85.

²³ Dr Greenspan, in unguarded moments, seems to agree. On 2 March 2004 he told the Economic Club of New York “despite extensive efforts on the part of analysts, to my knowledge, no model projecting directional movements in exchange rates is significantly superior to tossing a coin. I am aware that of the thousands who try, some are quite successful. So are winners of coin-tossing contests. The seeming ability of a number of banking organisations to make consistent profits from foreign-exchange trading likely derives not from their insight into future rate changes but from market making.”

²⁴ William Sherden, *The Fortune Sellers: The Big Business of Buying and Selling Predictions* (John Wiley & Sons, 1999).

- accurate their forecasts become;
- there are no individual forecasters who are consistently more accurate than their peers.

Given these disconcerting (for mainstream economists and investors!) results, Graham-style value investors keep firmly in mind two seemingly flippant but nonetheless very important “laws” of mainstream economics. The first is that, for every economist, there is an equal and opposite economist. The second law is that both are likely to be wrong. In the words of Philip Fisher: “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.”²⁵

Market timers, commentators and mainstream economists, then, cannot foresee economic events and developments with any useful degree of accuracy. And even if they could, the aggregate phenomena upon which they fixate are typically of little interest to Grahamites. Hence value investors ignore analysts, economists and others who claim that they possess clear crystal balls. But Grahamite investors do not ignore the future *per se*. Quite the contrary: they plan not by making particular predictions about what will happen but by considering general scenarios – particularly pessimistic scenarios – of what might conceivably happen. They then structure 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.

Grahamites also recognise that if markets tend towards but never attain a state of equilibrium, and if profit-seeking entrepreneurs constitute the “oil” that enables the market mechanism to operate and adapt so smoothly, then over time particularly talented and shrewd and lucky entrepreneurs will tend, more often than not and relatively consistently, to accumulate capital.²⁶ Less successful entrepreneurs, on the other hand, will consistently lose some – and eventually all – of their capital. It is for this reason that Grahamites search incessantly for businesses that possess consistently solid and relatively stable track records, and the demonstrated ability to surmount a variety of unexpected changes and vicissitudes.²⁷

Conceptions of Capital Goods and Capital

At the centre of the Grahamite approach to investment are two conceptions – capital goods and capital – that conform to Misesian conceptions.²⁸ Capital goods, according to Mises, are “tools and half-finished products, or goods ready for consumption that make it possible for man to substitute, without suffering want during the waiting period, a more time-absorbing process for another absorbing a shorter time.” Capital goods enable entrepreneurs to produce goods and services whose quantity, quality and price conform more closely to consumers’ demands. The variety of things demanded by consumers – to say nothing of their combinations of quantity, quality and price – is enormous;

²⁵ Phillip Fisher, *Common Stocks and Uncommon Profits* (John Wiley & Sons, 1996), p. 62.

²⁶ The greater the length of time, the more the stochastic element of luck and chance is removed. Buffett and coin-flipping in “the Superinvestors of Graham-and-Doddsville”

²⁷ See in particular *Security Analysis*, Chap. 27.

²⁸ For details, see Leithner Letter No. 41 (26 May 2003).

accordingly, capital goods and the individual firms that use them are heterogeneous. Further, consumers' demands constantly change; for this reason, entrepreneurs incessantly amass and disassemble capital goods. Graham concurred, and throughout *The Intelligent Investor*, for example, he sought "to bring home in a concrete and vivid manner some of the many varieties of character, financial structure, policies, performance and vicissitudes of corporate enterprise ..."²⁹

From the point of view of a value investor, it makes sense to distinguish the notion of capital goods from the concept of capital. According to Mises, "the concept of capital is the fundamental concept of economic calculation, the foremost mental tool of the conduct of affairs in the market economy ... Capital is the sum of the money equivalent of all assets minus the sum of the money equivalent of all liabilities as dedicated at a definite date to the conduct of the operations of a definite business unit. It does not matter in what these assets may consist, whether they are pieces of land, buildings, equipment, tools, goods of any kind and order, claims, receivables, cash or whatever." A firm's capital, then, corresponds to its base of net assets as revealed by entrepreneurs in the market. Similarly, to a Grahamite a firm's capital is its base of net assets (or, more conservatively, its working capital).³⁰

Grahamites, like Misesians, acknowledge a rough but nonetheless systematic linkage between markets and capital structure. If, as Austrians have demonstrated from first principles and value investors have observed over the decades, entrepreneurs acting in markets can attract, deploy and redeploy capital goods and value capital such that they increase production, consumption and standards of living, then at most times (and setting aside the effects of government and central bank intervention into the market) capital goods will be priced ("capitalised") at least roughly rationally.³¹ To be sure, value is not a synonym of price; equally importantly, however – and precisely because they tend towards one another – value and price are not unrelated. To investors who err on the side of caution, prices will often be somewhat, occasionally significantly but seldom dramatically above judicious assessments of value. Similarly, prices will occasionally be significantly but rarely dramatically below businesslike assessments of value. To Grahamites and Misesians alike, in other words, markets are imperfectly but still reasonably "efficient." Mr Buffett once told his shareholders "correctly observing that the market was frequently efficient, [the efficient markets enthusiasts] went on to conclude incorrectly that the market was always efficient. The difference between the propositions is night and day."

According to Graham, the value of a business to an investor stems ultimately from an assessment of the quality of its capital; and that assessment depends upon the ability of that capital consistently to produce goods and services desired by consumers. The enterprise's financial statements provide the best means to ascertain this quality. How, then, does a Grahamite reason towards an opinion about a given security's value? By

²⁹ p. 446. See also his comparison of pairs of companies in Chaps. 13, 17 and 18.

³⁰ See *Human Action* p. 262; and *Security Analysis* pp. 181-183, 335-338, 611-616 and 672-674.

³¹ I am indebted to Robert Blumen for the gist of these two sentences. Blumen adds that if prices were typically irrational, then over time no accumulation of capital could occur. Under those circumstances, entrepreneurs would be just as likely to deplete as to increase accumulated capital. Indeed, assuming that the ways to waste capital are far more numerous than profitable business and investment ideas, if prices were irrational than the depletion of capital would be the rule. Yet during the past several centuries in Anglo-American and other countries, capital has clearly accumulated and standards of living have risen. Hence the rough but nonetheless systematic link between markets and capital structure. Over time, in other words, entrepreneurs are able to allocate capital to productive uses and thereby to accumulate it.

analysing the financial statements (i.e., its statement of profit-and-loss and balance sheet) of the business that underlies it. In Graham's words,³² "my reputation – such as it is, or perhaps as recently revived – seems to be associated chiefly with the concept of 'value.' But I have been truly interested solely in such aspects of value as present themselves in a clear and convincing manner, derived from the basic elements of earning power and balance-sheet position."

Capital and the Balance Sheet

The nature and quality of a firm's assets say much about its desirability as an investment. The cash net of debt on its balance sheet is usually easiest to analyse. "When the cash holdings [on the balance sheet] are exceptionally large in relation to the market price of the securities, this factor usually deserves a favourable investment attention. In such cases, the stock may be worth more than the earnings record indicates because a good part of the value is represented by cash holdings that contribute little to the income account. Eventually the stockholders are likely to get the benefit of these cash assets, either through their distribution or their more productive use in the business."³³

The analysis of other categories of asset and liability is much less straightforward. Cash assets can be accepted at face value; but buildings, machinery, non-marketable securities and so on may fetch as little as half (or less) of their stated value in a liquidation. Conversely, the balance sheet may contain diamonds in the rough. Real estate whose stated value is (say) \$50m may, in the hands of another entrepreneur, be worth \$100m. More generally, and as Graham was acutely aware, the value of assets on the balance sheet is subjective in the sense that these values often correspond only roughly to their original purchase price, the price at which they could presently be sold or their future replacement cost. Accordingly, and absent firm grounds to the contrary, when analysing firms Graham routinely discounted current assets such as receivables by as much as 10-25%, current assets such as fungible inventories by at least 10% (and non-fungible inventories by 25-50%) and fixed and miscellaneous assets such as specialised machinery, equipment and non-marketable securities by as much as 50-100%.

The most difficult assets to assess, as Graham recognised, are intangible assets such as accounting goodwill, patents and trademarks, licenses and mastheads, capitalised R&D and any other non-physical resources that give (or purport to give) a company some competitive advantage in the marketplace. At the same time, however, he also knew that the earnings generated by intangibles are typically less vulnerable to competition than assets that require repeated cash investments. Indeed, his attitude was a half-century ahead of its time: "under modern conditions, so-called 'intangibles,' goodwill or even a highly efficient organisation are every whit as real from a dollars and cents standpoint as are buildings and machinery. Furthermore, when conditions are favourable the enterprise with the relatively small capital investment is likely to show a more rapid rate of growth. Ordinarily it can expand its sales and profits at slight expense and therefore grow more rapidly and profitably for its stockholders than a business requiring a large plant investment per dollar of sales."³⁴

When asked about the importance of net assets at Berkshire Hathaway's 1995 AGM, Mr Buffett noted that it measures historical input; investment value, on the other hand,

³² Uttered in a speech delivered in 1975 and entitled "Three Simple Methods of Common Stock Selection."

³³ *The Interpretation of Financial Statements*, p. 20.

³⁴ *Security Analysis*, p. 577.

discounts future output. Book value, when it is stated such that it reasonably accurately reflects economic reality, provides a floor through which price not normally fall. In Graham's words, "we do not think that any [hard] rules may reasonably be laid down on the subject of book value in relation to market price, except the strong recommendation already made that the purchaser know what he is doing on this score and be satisfied in his own mind that he is acting sensibly."³⁵

Capital and the Income Statement

"The whole complex of goods destined for acquisition is evaluated in money terms," said Mises, "and this sum – the capital – is the starting point of economic calculation. The immediate end of acquisitive action is to increase or, at least, to preserve the capital. The amount that can be consumed within a definite period without lowering the capital is called income. If consumption exceeds the income available, the difference is called capital consumption. If the income available is greater than the amount consumed, the difference is called saving. Among the main tasks of economic calculation are those of establishing the magnitudes of income, saving and capital consumption."³⁶

Grahamites applaud and strive to implement this point. Quality assets tend to generate steady earnings; and earnings are vital because "stocks sell [on the basis of] earnings and dividends and not on cash-asset values."³⁷ Quality assets, in other words, tend to produce enough revenue to pay cash and non-cash expenses (including amortisation and depreciation), repay debt (and thereby generate net income), pay a reasonable dividend and still retain resources sufficient to maintain and perhaps increase a stream of earnings into the future. Graham assumed, and decades of experience have affirmed, that the greater the quality and stability of past earnings, the more reasonable the assumption – in the absence of other evidence to the contrary – that steady earnings would continue into the near future. By his reckoning, a company's earnings were stable when (1) earnings doubled during the most recent ten years and (2) they declined by no more than 5% two or fewer times during that interval.

Yet Graham was very wary about any automatic assumption that a trend of earnings observed in the past would continue into the future. Whilst "a trend shown in the past is a fact, a 'future trend' is only an assumption. The past, or even careful projections, can be seen as only a 'rough index' to the future."³⁸ Mr Buffett agrees: "I have no use whatever for projections or forecasts. They create an impression of apparent precision. The more meticulous they are, the more concerned you should be. We never look at projections but we care very much about, and look very deeply, at track records. If a company has a lousy track record but a very bright future, we will miss the opportunity."³⁹ More specifically, when examining a firm's track record Grahamites seek clear evidence of its ability to expand the margin between its revenue and cash and non-cash expenses. This can entail actions such as the reduction of costs, increase of prices, expansion into new markets, and revitalisation or disposal of unprofitable or insufficiently profitable operations. To do these things consistently over time is, in effect, successfully to reinvest retained earnings and to increase the company's capital (and, more often than not, capitalisation).

³⁵ *Ibid.*

³⁶ *Human Action*, p. 261.

³⁷ *Security Analysis*, p. 608.

³⁸ *Ibid.*, p. 41.

³⁹ Berkshire Hathaway, Inc., 1995 Annual General Meeting.

Time Preference, Interest and Rate of Return

On what bases, then, do Grahamites reason towards an assessment of a given security's value? First, they assess the structure of the underlying firm's capital and the stability of its earnings. Second, they ascertain their time preference (i.e., the extent to which they are prepared forego consumption today in order to consume more in the future) and thus their desired rate of return. Although value investors have never used the term "time preference," embedded within the Grahamite approach to the valuation of securities is a notion of time preference and interest that is compatible with Austrian understandings of these concepts.⁴⁰

As a useful mental exercise, value investors tend to consider these abstract points by comparing whether the ownership of a given and relatively "risky" investment, such as a particular company's shares, is preferable to that of a "risk free" (i.e., AAA-rated corporate or government) bond.⁴¹ As a rough rule that admits many caveats and exceptions, Grahamites decide that the share is preferable to the bond when its yield is and is likely to remain significantly greater than that of a comparable bond; conversely, a bond is more attractive than the share when its yield is equal to or greater than that of a comparable stock. As a simple illustration, consider Telstra Corp. Ltd (one of Australia's largest corporations, presently 51% owned by the Commonwealth Parliament) and Australian Government debt. Assume that you can buy either one share at \$8.20 (its average closing price in October 1999) or a hypothetical five-year Commonwealth Government bond at a price of \$8.20 and a yield of 6.35% (the average yield prevailing in October 1999 for Commonwealth bonds maturing in September 2004). Further, assume that whichever you chose you are a "long term" investor; that is, you will hold your investment for five years. If you purchased the bond then by late 2004 it was virtually certain that you would earn \$2.57 (i.e., 51.4 cents per year for five years) in coupons and upon redemption would collect total proceeds of \$10.77 (i.e., \$8.20 of principal plus \$2.57 of coupons).

Alas, because they are not fixed and are subject to wide variation from one year to the next, a share's "coupons" are very difficult to predict with any reasonable degree of accuracy. Because the investor must make assumptions about its coupons, the analysis of the share is (relative to that of the bond) less straightforward and more prone to error. Clearly, however, and whatever our assumptions, if the Telstra share purchased late in 1999 at \$8.20 is going to be a better investment than the bond then it must return at least \$10.77 by late 2004. Given the general euphoria prevailing in Australia late in 1999 – and the virtually-unanimously enthusiastic statements about Telstra by government ministers, brokers, analysts and market commentators – this seemed to be an easy hurdle for Telstra to jump. But if one had applied reason rather than emotion to one's decision, then one would have quickly realised that this hurdle was considerably higher than the vast majority of market participants recognised.

⁴⁰ For details, see "Risk and Return: Restating Some Fundamentals for Value Investors" and Leithner Letter No. 51 (26 March 2004).

⁴¹ These bonds, particularly government bonds, are typically dubbed "risk-free" because their probability of default is regarded as miniscule. Clearly, however, and judging from the historical record, to own long-dated bonds for extended periods of time is to bear the harmful consequences of a virtually-inevitable shrinkage of the purchasing power of the \$A, £, \$US, etc. In this sense, these bonds are hardly "risk free."

Table 1 shows Telstra’s actual coupon in 1999 (27 cents). It also shows its projected coupons for the next five years under the then-uncontroversial (considering analysts’ statements and “consensus”) assumption that they would grow without interruption and at a compound rate of 17% per year. At the end of five years, cumulative coupons of \$2.50 – *slightly less than the bond’s cumulative coupons* – would accrue to the Telstra shareholder as dividends, retained earnings or some combination of the two. Further, note that only in the fifth year of ownership (i.e., in 2004) does Telstra’s yield exceed that of a “risk free” Commonwealth bond (7.2% versus the bond’s 6.35%). Under these assumptions, then, Telstra would generate a somewhat smaller cumulative coupon than the bond. Further, unlike the bond there was no guarantee that one would be able to redeem one’s initial investment at exactly \$8.20 after five years.

Table 1: A Simple (1999 Vintage) Evaluation of Telstra Corp. Ltd

	Coupon	Cumulative Coupon	Yield on \$8.20
1999	\$0.27	\$0.27	3.3%
2000	\$0.32	\$0.59	3.9%
2001	\$0.37	\$0.96	4.5%
2002	\$0.43	\$1.39	5.2%
2003	\$0.51	\$1.90	6.2%
2004	\$0.59	\$2.50	7.2%

Even when aided by these very ambitious assumptions, in other words, and regardless of the nearly-unanimous assurances and recommendations of brokers, financial planners, funds managers and commentators, the purchase of Telstra was riskier than the purchase of the bond; the bond, in other words, seemed to be more attractive than the share. He who purchased the Telstra share late in 1999 committed himself to a wait of five years before its projected yield matched the “guaranteed” yield available immediately from the bond. Whether he recognised it or not – and in retrospect it is apparent that very few recognised it – Telstra’s fortunes had to unfold exactly according to these very rosy projections and for the full five-year period in order in the fifth year to provide a cumulative coupon that would not exceed the coupon guaranteed from the first day of ownership by the five-year Commonwealth bond.

Clearly, then, in 1999 the results of an investment in Telstra could not reasonably be expected to surpass by a wide margin that available from a “risk free” Commonwealth bond. To a Grahamite value investor, it therefore made little sense to purchase Telstra shares at prices remotely close to \$8.20.⁴² To buy at an exuberant price (i.e., one that reflects exuberant assumptions) is not to allocate capital on the basis of a sober assessment of a company’s operations: it is to gamble that the market price of the shares in question will continue to increase and become even more detached from the company’s operations, and that it will be possible to sell them to an ever greater fool at a still more inflated price. To buy Telstra under 1999 conditions prevailing in 1999, in other words, was clearly to speculate rather than invest. (And speculation inevitably ends in tears: in September-October 2004, Telstra’s average closing price was \$4.85. Including

⁴² Notice that Grahamites seldom attach a specific number to their assessment of a security’s value. Much more commonly, as in this instance, their analysis leads them to conclude that a rational value lies far below some reference point.

the dividends earned during the ensuing five years, the purchase of its shares at \$8.20 in late 1999 generated a five-year return on one's outlay of capital of minus 22.5%).

But did the purchase of the bond constitute an investment? In 1999, this particular bond was more attractive than the single given alternative. Was it more attractive in a general sense? Hitherto very little has been said about Grahamites' calculation of investment returns. Now, however, much can be said. Not surprisingly, little or none of it resonates with the mainstream. If time is money, as Ben Franklin quipped, and if lack of time is dearth of capital, as Mises demonstrated, then wealth is time. The return on an investment, in other words, can – indeed, should – be measured in terms of time.

The degree of investment risk that inheres in a given asset varies not only with the variability of its coupons: it differs as well according to the length of time one must wait (i.e., the “payback period”) in order to recoup the initial investment. The payback period of the Telstra share analysed in Table 1 is approximately 12 years, and that of the Commonwealth Government bond to which it was compared is slightly more than 16 years. Table 2 shows why. Given our assumptions (i.e., Telstra's purchase price of \$8.20, coupons grow at 17% per year), 12 years is required for the cumulative coupons to meet or exceed the asset's purchase price. Twelve years, in other words, is required – *assuming that the coupons eventuate according to this trajectory* – for the Telstra share to “pay for itself.” Analogously, the bond requires slightly more than 16 years to do so.

Table 2: Comparing Payback Periods of the “1999” Stock and Bond

	Telstra Share at \$8.20 With 17% Growth of Coupon		6.35% Government Bond With Fixed Coupon	
	Coupon	Cumulative Coupon	Coupon	Cumulative Coupon
Year 1	\$0.27	\$0.27	\$0.51	\$0.51
Year 2	.32	.59	.51	1.02
Year 3	.37	.96	.51	1.53
Year 4	.43	1.39	.51	2.04
Year 5	.51	1.90	.51	2.55
Year 6	.59	2.49	.51	3.05
Year 7	.69	3.18	.51	3.56
Year 8	.81	3.99	.51	4.07
Year 9	.95	4.94	.51	4.58
Year 10	1.11	6.05	.51	5.09
Year 11	1.29	7.34	.51	5.60
Year 12	\$1.52	\$8.86	.51	6.11
Year 13			.51	6.62
Year 14			.51	7.13
Year 15			.51	7.64
Year 16			\$0.51	\$8.15

What is an appropriate payback period? The answer depends upon one's time preference; and that, in turn, will vary from one investor to another. But a few general points can be made. First, a shorter payback period (i.e., a higher rate of return) is preferable to a

longer one (i.e., lower rate of return). This is because the longer the time required in order to recoup an investment, the riskier that investment becomes. The longer the payback period, the more a decision to invest depends upon the veracity of its underlying assumptions, i.e., the more imperative it becomes that those assumptions correspond to reality. With each additional year of waiting, the chances increase that unforeseen or uncontrollable factors – a recession, a decrease of the purchasing power of the currency, new competition, the loss of key contracts, employees and other innumerable and perhaps unimaginable factors – will decrease (or halt the rate of increase of) the size of the yearly coupon and hence prolong further the payback period. What, for example, are the chances that during the next dozen years the Australian telecommunications industry will change significantly in some unforeseeable way?

Second, a high natural rate of interest implies a large required rate of return and a more stringent hurdle for potential investments to surmount. For example, a natural rate of 12-15% (which Leithner & Co. uses to conduct its investment operations) and a constant stream of coupons imply a payback period of 6-8 years. By that criterion, both the Telstra stock's and the Commonwealth bond's payback period is unacceptably long; and by this absolute, more challenging – and, to mainstream investors, virtually unknown – yardstick, neither of these securities are compelling. Since the late 1990s, in other words, wide swaths of the investment universe (i.e., most equities, bonds and real estate) have been unacceptably dear; and the five-year investment results of most mainstream investors confirm the sad consequences of buying securities at inflated prices.

Mr Buffett concurs. At Berkshire Hathaway's 2003 AGM he stated "in our view, the same conclusion fits stocks generally. Despite three years of falling prices, which have significantly improved the attractiveness of common stocks, we still find very few that even mildly interest us. That dismal fact is testimony to the insanity of valuations reached during The Great Bubble. Unfortunately, the hangover may prove to be proportional to the binge. The aversion to equities that Charlie and I exhibit today is far from congenial. We love owning common stocks – if they can be purchased at attractive prices. In my 61 years of investing, 50 or so years have offered that kind of opportunity. There will be years like that again. [Until then] we will sit on the sidelines. With short-term money returning less than 1% after-tax, sitting it out is no fun. But occasionally successful investing requires inactivity."

Conclusion

Mainstream economics has not only become esoteric, incoherent and useless: it is creating increasing numbers of victims. It is therefore unsurprising that its reputation – which is built upon unrealistic and often absurd assumptions, arcane mathematics and data, privileges extended by governments and policies whose destructive consequences have become apparent to many members of the public – is suffering. Mainstream finance, which is effectively a sub-field of mainstream economics, finds itself in a similar pickle.⁴³

⁴³ Americans, Australians and Britons whose investments in mutual funds suffered sizable losses during The Great Bubble are correct to feel aggrieved: funds managers rather than "the market" were responsible for the loss. Tim Koller and Zane Williams of McKinsey & Co. drew these conclusions in a paper entitled "Anatomy of a Bear Market." According to Robert Gottlibsen (*The Australian* 7 May 2003), "the McKinsey research doesn't make judgements on the funds managers. But it is clear that many ... were simply caught in a mire of short-term forecasts and index worship. They blew their customers' money." Alas, this unpalatable result is not a temporary aberration: it applies to most points

In sharp contrast, Austrian School economists use realistic premises, simple (but not simplistic) verbal logic and commonsensical evidence to explain the actions of real, flesh-and-blood people. So too do Grahamite value investors,⁴⁴ and the results of this clan's most prominent members demonstrate the applicability of Graham's ideas over the decades and in many countries.⁴⁵ Hence (from a mainstream point of view) a paradox: there exists a philosophy and practical approach to investment that is both unpopular and profitable. In his "Superinvestors of Graham-and-Doddsville" speech, Mr Buffett concluded "the secret has been out for fifty years ever since Ben Graham and Dave Dodd wrote *Security Analysis*, yet I have seen no trend toward value investing in the thirty-five years I've practised it. There seems to be some perverse human characteristic that likes to make easy things difficult. The academic world, if anything, has actually backed away from the teaching of value investing over the last 30 years. It's likely to continue that way. Ships will sail around the world but the Flat Earth Society will flourish. There will continue to be wide discrepancies between price and value in the marketplace and those who read their Graham and Dodd will continue to prosper."

To value investors, Austrian economics is (or should be) compelling because it subsumes real economic and financial events within justifiable laws of human action. Unlike mainstream economic and finance, Austrians not only acknowledge but also emphasise the importance of entrepreneurship; indeed, Austrians acknowledge that sustained entrepreneurial acumen, whilst hardly widespread, is nonetheless likely to exist. In turn, value investing and the results achieved by prominent value investors may interest Austrians because Grahamites hold quasi-Austrian views – or, at any rate, views that are compatible to Austrian views – with respect to important economic and financial principles. Value investors also illustrate the positive results that entrepreneurial action can achieve. Despite the many follies of governments and mainstream economists and investors, which often prompt value investors and Austrians alike to adopt rather dour short-term outlooks, both Grahamites and Misesians are long-term optimists. To adopt their approaches to economics and investment is ultimately to affirm a basic faith in human nature, capitalism, one's country and a future that will be at least as prosperous as the present. The future envisaged by these economists and generated partly by these investors helps to vindicate this faith.

in time and to major institutional investors who conduct investment operations in a conventional manner. For details, see Chap. x of *The Fortune Sellers: The Big Business of Buying and Selling Predictions*.

⁴⁴ As the preface to the first edition of *Security Analysis* put it, "we are concerned chiefly with concepts, methods, standards, principles, and, above all, with logical reasoning. We have stressed theory not for itself alone but for its value in practice. We have tried to avoid prescribing standards which are too stringent to follow, or technical methods which are more trouble than they are worth." Both Graham and Buffett are rightly noted for the presentation of powerful ideas in plain and simple language. See also Buffett's preface to [A Plain English Handbook: How to Create Clear SEC Disclosure Documents](#) (Washington, DC: Securities and Exchange Commission, 1998), "Buffett Decodes Fund Prospectus" (*USA Today*, 14 October 1994) and The Leithner Letter (No. 44, 26 August 2003).

⁴⁵ An overview of the results achieved by Graham's most prominent followers, whom Warren Buffett has dubbed "the Superinvestors of Graham-and-Doddsville," appears as Appendix 1 in *The Intelligent Investor. What Has Worked In Investing* by Tweedy, Brown LLC sets out the results achieved by a Grahamite approach to investing in countries outside the U.S.

APPENDIX 1

Leithner & Company Pty. Ltd. is a private investment company and not a managed fund (unit trust). This structure has important implications for its operations and the measurement of its results. An investor exits (“cashes out”) a managed fund by selling its units back to the fund – which in extreme cases may oblige the fund to sell assets in order to meet requests for redemption. One can typically exit an Australian managed fund within a few working days. In sharp contrast, the shareholder of a private company sells his shares not to the company but to a third party that agrees to buy them. Like selling real estate, this process can take an extended period of time.

As a company, Leithner & Co.’s results derive from dividends and interest received and capital gains realised – and not from the fluctuations of the market prices of the businesses in its portfolio. A managed fund’s results, on the other hand, derive from dividends, interest and capital gains and losses – whether realised or unrealised. Given identical portfolios, over time a company’s results would tend to be steadier and the fund’s results more subject to the market’s up and downs. Accordingly, Leithner & Co.’s results, which are summarised in Table 3, have everything to do with the income received from the businesses of which it is a part-owner – and nothing to do with either the price volatility of these shares, bonds, etc., or their price level at a given point in time. (Since inception, the company’s portfolio has tended to consist in a roughly 50-50 split between cash, commercial paper and floating rate notes on the one hand and the shares of Australian and New Zealand companies on the other.)

**Table 3:
Leithner & Co.’s Cumulative Results
Half-Yearly Reporting Periods Since Inception**

Financial Year	Half	Total Beneficial Earnings Per Share	Grossed Up Dividend Per Class E Share	Annualised Return (Company)	Annualised Return (Class E Shareholders)
1999-2000	Jan-Jun	\$0.079	\$0.068		
2000-2001	Jul-Dec	\$0.087	\$0.071	16.6%	13.9%
	Jan-Jun	\$0.085	\$0.071	17.2%	14.2%
2001-2002	Jul-Dec	\$0.095	\$0.071	18.0%	14.2%
	Jan-Jun	\$0.086	\$0.071	18.1%	14.2%
2002-2003	Jul-Dec	\$0.097	\$0.071	18.3%	14.2%
	Jan-Jun	\$0.060	\$0.042	15.7%	11.3%
2003-2004	Jul-Dec	\$0.115	\$0.070	17.5%	11.2%
	Jan-Jun	\$0.095*	\$0.071*	21.0%*	14.1%*
2004-2005	Jul-Dec	\$0.098*	\$0.071*	19.3%*	14.2%*

The asterisks denote cautious estimates of results (whose degree of franking will be confirmed and finalised by October 2005). Under the Commonwealth's "Simplified Imputation System" effective 1 July 2002, changes were made to the way Australian private companies distribute dividend imputation (i.e., corporate tax) credits to their shareholders. Most importantly, they can frank retrospectively but must frank at a constant rate. This means that a company has the entire financial year and up to four months after the end of that year to make a decision on the extent to which it franks distributions made during the year. It is therefore expected that a decision about the franking of dividends for the 2004-2005 financial year will be taken by October 2005.

In the table's third column, *Total Beneficial Earnings Per Share* means all investment income per share. It is a conservative and "businesslike" measure in the sense that it does not include unrealised capital gains and is therefore not influenced by fluctuations in the market prices of investments; it also includes the franking credits associated with this income. In the fourth column, *Grossed Up Dividend Per Class E Share* means the dividend (including franking credits) paid per Class E share. In the fifth column, *Annualised Return (Company)* expresses the sum of T.B.E.P.S. for the current and immediately preceding half-year as a percentage of the Company's assets. And in the last column, *Annualised Return (Class E Shareholders)* expresses the sum of the G.U.D. per Class E share for the current and immediately preceding half-year as a percentage of the Company's assets.

Expressed in more conventional terms, each dollar invested on 30 June 1999, if reinvested in the Company's Class E shares, would by 30 October 2004 have grown to \$1.60, generated \$0.197 of franking credits and possessed unrealised capital gains of more than \$0.20 per share. This equates to a total gain of 99.7% and a compound rate of growth of 14.8% per annum.