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The Intelligent Investor

Thechinamoorthy Subbiah Chettiar

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Benjamin Graham, the author of the book *The Intelligent Investor*, may not be as famed as the well-known investment guru Warren Buffett. Nevertheless, Benjamin Graham can be lionized as the grand master of value investing. He is also known as the "Dean of Wall Street". He outshined others, excelled and made money for himself and his clients from the stock market without taking big risks. Ben Graham developed his unique way of finding the right stocks, which made him a successful investor. His wisdom and principles of investing in the stock market are timeless masterpieces which every modern investor can draw on.

Warren Buffet himself describes the book *The Intelligent Investor* as "the best book on investing ever written" and I couldn't agree more with him. In my opinion, it is a book every investor should read before they invest. I would have done a lot of things differently if I had read this book years before investing. However, it has certainly has changed my perception of looking at a stock in recent years.

The book *The Intelligent Investor* comes in 20 chapters, followed by a commentary from Jason Zweig, a senior writer at *Money Magazine*. Jason is also an author of *Your Money and Your Brain* (Simon & Schuster, 2007). Many, including Warren Buffet, attribute their massive net worth to the principles and wisdom in this book.

As matter of fact, Ben Graham wrote another book earlier entitled *Security Analysis* and this book *The Intelligent Investor* is the watered down or a simpler version of the former. It is definitely geared to equip a common investor as opposed to a securities analyst or someone working professionally in a financial institution.

I would like to divide this book into four segments for the sake of the book review. So, we will look at Chapters 1 - 7 first, then Chapter 8, Chapters 9 to 19 and finally Chapter 20 by itself. I have

Correspondence: Thechina@moneymatters.com.my

heard Warren Buffet preaching that if you ever read *The Intelligent Investor*, read Chapter 8 and 20. Hence, my decision to divide the book review in such a manner.

The Intelligent Investor takes off with a very important discussion distinguishing between and an investor and a speculator. Graham says if you are an investor, you will not seek a massive amount of return in a short period of time. Therefore, an investor must seek to expect a reasonable return taking into consideration numerous things such as the holding time, options available at that time and risk or the margin of safety as Graham calls it in a particular investment proposition. The question I am asking right now is, what is the reasonable amount of return for an investor? However, Graham does not answer that question; instead, he leaves it to the readers to determine the expected return. He probably means if you are looking for a 50% return in a one-year period, you are probably getting into the realm of speculation. An investment with such excessive gain is most likely speculative in nature and if you are not sure or have some basis in your decision making, then you are probably speculating or gambling. He clearly cautions the readers to stay away from speculation if they want to be successful investors.

He then moves on to a discussion about promoting safety of the principal. Graham says an investor must pay attention to protection of the principal and expect a reasonable return. No investor will compromise losing the principal of the invested amount in any investment. Therefore, he emphasises resolutely that the protection of principal is of utmost importance. Conventionally, there is always a trade-off between risk and return and therefore most of us will condone losing the principal in the venture of getting higher gains.

In my opinion, Graham's investment approach example would be, if you are planning to invest in a large cap company, you probably want their revenues to be really steady. They will have all these consistent numbers and an expectation that they are going to continue to have this trend at least to the level of earning where they are today as they move forward into the future. There is not anything really that you can see on the horizon that would cause a major disruption in the next couple of years. That will probably be an example of investment.

However, if the revenue or the net income is not something you can project nor can you predict when a bad event is about to occur, that is where you get into more of a speculative approach as opposed to an investment approach.

In a nutshell, Graham postulates these two ideas: the protection of the investor's principal and to go after the things that will give that reasonable return. That is probably how he will be investing. Here is a direct quote from

the book that will reaffirm the statement above: *"Investing is promoting the safety of the principal with an adequate return".*

The first thing that came to my mind as I read the line above is the idea of risk-return trade-off. Investopedia defines risk-return trade-off as *"The risk-return tradeoff is the principle that potential return rises with an increase in risk. Low levels of uncertainty or risk are associated with low potential returns, whereas high levels of uncertainty or risk are associated with high potential returns. According to the risk-return tradeoff, invested money can render higher profits only if the investor is willing to accept the possibility of losses."*

When you read that definition, you will probably will believe that the principal must be exposed to risk or you must be willing to accept the risk of losing the capital for a potential higher return. You may now realise that you may be wrong if you had that sort of thinking. After reading about the idea of margin of safety in *The Intelligent Investor*, my paradigm as an investor has shifted. Investors should have the notion of safety at the back of their minds as the cardinal rule of investment.

Finally, the big message for every investor in the first few chapters is that they must understand these basic fundamentals although they may sound really simple. If you are not doing that, then you are most likely speculating.

I often hear investors say, *"I feel like this is the direction it's going to go"*, throwing around that "feel" word as opposed to *"I have looked at the company's cash flows; they have been very consistent over the last 5 years and looking forward, I expect those cash flows to continue to remain consistent if not slightly grow, then, when we do a discount cash flow analysis by taking those future cash flows and discounting them back to today's present value, I expect the value of the company to be at a certain price a share at a certain discount rate."*

That's the kind of conversation investors need to have in their minds when determining the intrinsic value of the company. An investor must have gone through that sort of thought process in the decision making before picking the stock or making that important investment decision. If that's not your thought process, you are probably going into territory that you should not be venturing into.

When we really think about Graham's approach to investing, it could be a little mundane. Graham made his money by just waiting. So, we can talk about it the whole day, yet it's not going to be fun or easy to just wait. However, if you are looking for action and a lot of things to really happen fast, investing is probably not for you. If you really are "*The Intelligent Investor*", then there is no action at all. You would buy into a company and probably hold it for 10, 20 years or perhaps the rest of your life. Keep your money there and let it grow. That's is what Graham has been teaching to investors all his life.

After all, that is what value investing is all about.

An important point from Chapters 1 - 7 is that Graham divided investors into two categories:

1. Passive (defensive) investors.
2. Active (aggressive) investors.

Passive investors want "freedom from effort, annoyance, and the need for making frequent decisions." In other words, they value their time and freedom more than extra investment returns.

Active investors, on the other hand, are willing "to devote time and care to the selection of securities [investments] that are both sound and more attractive than the average."

Active investors make a job out of investing, whether part time or full time. They tend to love the details of the game of investing, and as a result they enjoy the sometimes tedious process of finding the best investments.

There is no right or wrong about active or passive investing. There are benefits and drawbacks to each. Graham also cautions that an aggressive investor will be expected to fare better than the passive equivalent but his result may well be worse.

He then gets into much discussion about defensive / aggressive investors, speculative trading, decision making based on information in hand and much more. I am now asking, how many types of investors are there? Probably there are only two types of investors and at times an investor can be both, depending on the choices they have based on their own research before investing.

As you progress to this part of the book, I must say it's not an easy read. It is dry and loaded with financial terminologies which have been used interchangeably and if you are not familiar with them, it can be brutal even though it's a simpler version of security analysis.

In Chapter, 8 Graham talks about Mr. Market. He illustrates that someone knocks on your door every day and that someone is Mr. Market. Mr. Market comes at the same time every day and he tells you, "I have these companies and I want to sell them to you." He goes on to say, "This XYZ Company is 35 dollars today and yesterday it was only 30 dollars. I have another company, ABC Company, which was 90 dollars yesterday and today it is a 100 dollars." Each day he goes back and comes back with different prices, sometimes higher and sometimes way less. This is how the market waves hit at us every day. Being the calm, competent, consistent, and balanced thinker that you are, you are going to listen to the offer and make a conscious decision of what something is worth.

Therefore, based on what Mr Market says of a company's worth, if you think it's a heck of a deal, maybe

an investor needs to buys some as he is offering it to you at a great price.

This is probably the kind of example, Graham would use in his classes which inspired and produced a prodigy like Warren Buffet. So, it's really about the choice you are making to determine whether you think it's a good offer or not. The price is just an offer; you don't get upset or angry with Mr Market. The Intelligent Investor must now get to work, using his or her own analysis and call the shots of what something is worth or valued i.e. the intrinsic value of a stock.

What Graham is trying educate the readers here is to really get back to the fundamentals of the content of the book. Are you speculating or are you investing? If you are investing, then you must do things that are necessary to protect the principal. He went on to say that as long as you find a good bargain, time will take care of the rest. Don't put your money into things that you have no idea of what could go wrong.

In the preface of this book, Warren Buffet states explicitly to pay attention to the valuable advice provided in Chapters 8 and 20. This is why Chapter 8 is so important. It shifts your behaviour, attitude and thoughts about the price movement of stock. Therefore, I urge readers not to miss the story of Mr Market and the other inestimable thoughts in Chapter 8.

Now let us move on to Chapters 9 to 19 of *The Intelligent Investor* and hit some of the high points in these chapters. I would probably label these chapters as *how to find the right stocks.*

Graham was more specific in these chapters regarding the criteria an investor should set before investing. He gets into much discussion about what discount rates and normalised earnings are and why they are important in determining the intrinsic value of a stock.

One of the shortcomings of *The Intelligent Investor* is that it really does not tell us how an investor can determine the intrinsic value of a stock. However, it does talk about discount rate and multiples of earning to price.

The intrinsic value of a security tells us whether it is higher or lower than its current market price - allowing them to categorize it as "overvalued" or "undervalued." Typically, when calculating a stock's intrinsic value, investors can determine an appropriate margin of safety, where the market price is below the estimated intrinsic value. By leaving a 'cushion' between the lower market price and the price you believe it's worth, you limit the amount of downside that you would incur if the stock ends up being worth less than your estimate.

For beginners getting to know the markets, intrinsic value is a vital concept to remember when researching firms and finding bargains that fit within their investment objectives. Though not a perfect indicator of the

success of a company, applying models that focus on fundamentals provides a sobering perspective of the price of its shares.

Graham speaks briefly about discounted cash flow, which could be a good indication of what its worth of investment proposition is in today's value based on the estimated potential cash flows of business.

A discounted cash flow (DCF) is a valuation method used to estimate the attractiveness of an investment opportunity. DCF analysis uses future free cash flow projections and discounts them to arrive at a present value estimate, which is used to evaluate the potential for investment

Graham does not get into details in this book although he mentions discount analysis. That is my frustration about the book as it does not tell me how I do it. There is more than just science in finding out the real value of a business.

The other thing is when there is high inflation, everything demands a high return on our capital. When we compare risk and the discount rate that we are using, there is no finite number that is the perfect measure of risk. So how do we come up with the valuation of a company with all these facts, graphs and future earnings? They may all look good but they may be risky due to the uncertainty in the cash flows.
Therefore, when an investor discounts that to the appropriate discount rate, it may turn out to out to be a risky company for a start-up as it is reflected in the intrinsic value.

I would rather look at the current yield of the KLCI when comparing an individual stock picking. Graham uses the Treasury Bill to measure the opportunity cost. In today's example, a 10-Year Treasury Bill is probably going to give a much higher intrinsic value due to a lower yield. Hence, the KLCI would be a better bet as it will give you better margin of safety. Furthermore, why in the world would I use a 10-Year Treasury Bill when I could be using the KLCI which will give me a more matched and conservative risk assessment? I am comparing an apple to apple simply because I am using equities to compare and it's so much safer to do so in today's context. If an investor cannot beat the KLCI, why take the risk on an individual stock? An investor should not be taking action with emotional attachment but should be doing with some science at the back of that decision. So, the calculation of the intrinsic value is not as easy as it may seem and can be misunderstood easily, which may result in financial losses.

The question that we should be asking ourselves is, how do I find undervalued shares? The answer to that question is often not as easy as we think. However, the criteria provided by

Graham in *The Intelligent Investor* could serve as a gauge for one to become a better investor. Graham's criteria for a stock pick are:

I. Look for a company that has a quality rating that is average or better. An investor need not find the best quality companies. He recommends using Standard & Poor's rating system and requires companies to have an S&P Earnings and Dividends Rating of B or better.

II. Buy into companies with Total Debt to Current Asset ratios of less than 1.0. In value investing, it is important at all times to invest in companies with a low debt load.

III. Check the Current Ratio (current assets divided by current liabilities) to find companies with ratios over 1.50 to make sure a company has enough cash and other current assets to weather stormy economic conditions.

IV. Find companies with positive earnings per share growth during the past five years with no earnings deficits. Earnings need to be higher in the most recent year than five years ago. Avoiding companies with earnings deficits during the past five years will help you stay clear of high-risk companies.

V. Invest in companies with price to earnings per share (P/E) ratios of 9.0 or less. I am looking for companies that are selling at bargain prices. Finding companies with low P/Es usually eliminates high growth companies, which should be evaluated using growth investing techniques.

VI. Find companies with price to book value (P/BV) ratios less than 1.20. P/E ratios, mentioned in rule 5, can sometimes be misleading. P/BV ratios are calculated by dividing the current price by the most recent book value per share for a company. Book value provides a good indication of the underlying value of a company. Investing in stocks selling near or below their book value makes sense.

VII. Invest in companies that are currently paying dividends. Investing in undervalued companies requires waiting for other investors to discover the bargains you have already found. Sometimes your wait period will be long and tedious, but if the company pays a decent dividend, you can sit back and collect dividends while you wait patiently for your stock to go from undervalued to overvalued.

In Chapter 20, Graham talks about the Margin of Safety. Graham calls the margin of safety "the secret of sound investment" and "the central concept of investment".

He devotes the whole of the last chapter to this concept and places it last because it is the most important. In my opinion, Margin of Safety are probably the most important three words in *The Intelligent Investor.*

Investopedia defines Margin of Safety as *"a principle of investing in which*

an investor only purchases securities when the market price is significantly below its intrinsic value. In other words, when market price is significantly below your estimation of the intrinsic value, the difference is the margin of safety". Hence, the margin of safety for an investment is the difference between the real or fundamental value and the price you pay. The goal of the value investor is to pay less (hopefully, much less) than the real value.

Warren Buffett compares margin of safety to driving across a bridge. I love this analogy, and Warren Buffett has used it multiple times. If you're driving a truck across a bridge that says it holds 10,000 pounds and you've got a 9,800 pound vehicle, if the bridge is 6 inches above the crevice it covers, you may feel okay; but if it's over the Grand Canyon, you may feel you want a little larger margin of safety.

That is the same thing with businesses. If you understand a business perfectly and the future of the business, you will need very little in the way of a margin of safety. So, the more vulnerable the business is, and assuming you still want to invest in it, the larger the margin of safety you would need.

Finally, I shall leave you with these seven interesting quotes from *The Intelligent Investor* which may arouse your interest to get your hands on the book.

QUOTE 1

To invest successfully over a lifetime does not require a stratospheric IQ, unusual business insights, or inside information. What's needed is a sound intellectual framework for making decisions and the ability to keep emotions from corroding that framework. (pg. ix).

QUOTE 2

By developing your discipline and courage, you can refuse to let other people's mood swings govern your financial destiny. In the end, how your investments behave is much less important than how you behave. (pg. xiii).

QUOTE 3

Investing isn't about beating others at their game. It's about controlling yourself at your own game. (pg. 219)

QUOTE 4

The best way to measure your investing success is not by whether you're beating the market but by whether you've put in place a financial plan and a behavioural discipline that are likely to get you where you want to go. (pg. 220).

Quotes 1 - 4 inspired many to become better investors. One need not be a genius or smarter than others to invest in the stock market but what an intelligent investor needs is the discipline in investing. The intelligent

investor's decision making must take the fundamentals into consideration and not be swayed by popularity or mood swings.

QUOTE 5

The defensive (or passive) investor will place chief emphasis on the avoidance of serious mistakes or losses. His second aim will be freedom from effort, annoyance, and the need for making frequent decisions. (pg. 6).

QUOTE 6

Successful investing is about managing risk, not avoiding it.

Quotes 5 and 6 refer to what Graham emphasizes greatly: "Margin of Safety". I defer to agree to a common fact that we always speak of, that is, high return equals high risk although many may not agree with me. At times, we think that we must be prepared to lose money when we take high risk. If you read this book, you would probably know why I don't subscribe to this idea.

QUOTE 7

People who invest make money for themselves; people who speculate make money for their brokers. And that, in turn, is why Wall Street perennially downplays the durable virtues of investing and hypes the gaudy appeal of speculation. (pg. 36).

Quote 7 is derived from some of Graham's basic ideas. When I say this, I hope I am ridiculously wrong. I think most people are speculators. Many get into the market for a quick gain and not with a long-term plan. Speculators seek to make abnormally high returns from investments that can go either way in the short term. One needs to be that calm and competent investor to pick a stock that will grow over the years. ■