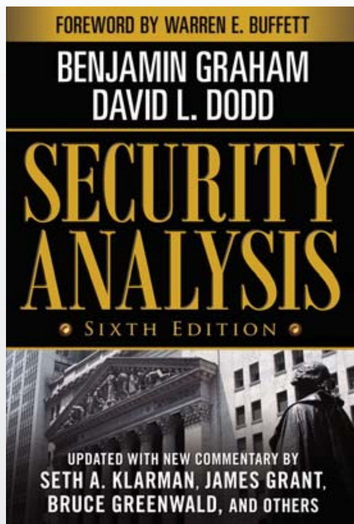
Timeless Wisdom for Troubled Times

In the new edition of Graham and Dodd's Security Analysis, several of today's most accomplished investors update what Warren Buffett calls the "roadmap for investing that I have now been following for 57 years."

Early in the process of defining how to update Graham and Dodd's *Security Analysis*, the acknowledged "bible of value investing," lead editor Seth Klarman and his assembled team abandoned any notion of editing the text of 1940's second edition. "It would have taken a decade to rewrite, with absolutely no assurance we could have improved upon it anyway," he says.



Instead, Klarman assembled a who's who of prominent value investors – including Glenn Greenberg, David Abrams, Howard Marks and Thomas Russo – to write introductory commentary to each of the book's sections, drawing out the timeless wisdom in the original text and combining it with additional insight and examples relevant to today's market. In the book's preface, Klarman himself describes the intellectual debt value investors owe to Graham and Dodd – for their focus on such things as margin of safety and limiting risk, in-depth fundamental analysis, a disciplined long-term approach, and the importance of resisting crowd psychology.

Klarman also addresses modern-day developments that have both aided and complicated the value investor's task. Among several he cites:

- More sophisticated business analysis, made possible by readily available information and advances in computer technology. While promoting far more useful analysis of industries and business models, Klarman cautions that such new tools can also "lead to a spurious precision of which Graham would have been quite dubious."
- A shift in focus from corporate earnings and dividend payments as barometers of a company's health to free cash flow. "Investors have rightly concluded that following the cash – as the manager of a business must do – is the most reliable and revealing means of assessing a company," he writes.
- The balance sheet's diminished importance – when most stocks trade far above book value – in arriving at estimates of intrinsic value, but it's critical role in assessing downside risk. Says Klarman: "Astute observers of corporate balance sheets are often the first to see business vulnerability as inventories and receivables build, debt grows, and cash evaporates."
- The increasingly global nature of investing, for which he argues Graham and Dodd's principles fully apply, and where he sees greater opportunity to take advantage of them: "International markets are even more subject to the vicissitudes of investor sentiment – and thus more inefficiently priced – than the U.S. market is today."
- The growing propensity of the Federal Reserve to intervene in financial markets, which he argues encourages speculation and prolongs periods of overvaluation – but which can also cause market dislocations that the disciplined value investor can capitalize upon.
- Cable television's "cheerleading pundits" who do viewers a disservice, Klarman argues, by giving "the impression that up is the only rational market direction and that selling or sitting on the sidelines is almost unpatriotic. Graham would have been appalled."

In honor of the release later this week of the new *Security Analysis* edition, Klarman spoke with us about his participation in the book project, how Graham and Dodd have most influenced him as an investor and how he believes their philosophy sheds light on today's precarious market environment. He also allowed us to excerpt a passage from the book's preface in which he discusses the key questions investors face today that haven't changed much from Graham and Dodd's time. *Plus ça change* ….

Channeling Graham and Dodd

A Conversation with Seth Klarman

Why take on what was surely a time-consuming role with this book?

Seth Klarman: First of all, it was an honor to be asked and I don't think one says "no" lightly to something like that. But on top of that, I feel a huge amount of loyalty to Graham and Dodd. Their thinking has influenced mine right from the beginning, so what could be more of an honor – and more of a responsibility – than to contribute to updating their work?

What tenets of Graham and Dodd have most influenced you as an investor?

SK: I think Graham and Dodd's writing is not actually about investing, but about thinking about investing. Any book can say, "Buy stocks that fit the following criteria," but Graham and Dodd go beyond that to fully explain why. It's like the difference between being able to divide two numbers using a calculator and actually knowing long division. A Graham and Dodd investor understands both the numbers and the concepts behind the numbers.

In a world in which most investors appear interested in figuring out how to make money every second and chase the idea *du jour*, there's also something validating about the message that it's okay to do nothing and wait for opportunities to present themselves or to pay off. That's lonely and contrary a lot of the time, but reminding yourself that that's what it takes is quite helpful.

Warren Buffett is right when he says you should invest as if the market is going to be closed for the next five years. That's particularly relevant right now – who knows, that might be the next thing the government does! The fundamental principles of value investing, if they make sense to you, can allow you to survive and prosper when everyone else is rudderless. We have a proven map with which to navigate. It sounds kind of crazy, but in times of turmoil in the market, I've felt a sort of serenity in knowing that if I've checked and re-checked my work, one plus one still equals two regardless of where a stock trades right after I buy it.

In your essay for the book you describe how the breadth of information available to investors has eroded one of the biggest market inefficiencies out there – namely, access to the best information. How can investors respond to that?

SK: Some people's way of dealing with a market in which information is more available and ubiquitous is to try to get better and better information. That's driving the growth in services providing broad access to industry experts or the hiring by money managers of lawyers and other specialists to address company- and industry-specific questions. That's not necessarily our approach at Baupost, because one of the things we worry about like crazy is when information is what I would consider unacceptably clever and comes too close to crossing an ethical or legal line.

An alternative way of dealing with information being more available is to stop playing the game and seek out securities or asset classes where there's less information or competition. Many firms have realized over the last ten years that it's harder to add value in equities.

Is that a permanent condition?

SK: I would actually stipulate that this might be about to change because of the way markets are evolving. You could argue that for the past 10 or even 20 years, equities haven't been allowed to get cheap. When it appeared the market was really going down – in 1987, 1998, 2000 – the government tended to intervene to prop it up. One of the pernicious problems of doing that when things are about to get cheap is that it creates the illusion that there isn't much downside risk, and also prevents the necessary creative destruction that happens when an asset gets incredibly cheap. When assets get cheap, people stop manufacturing it because you can buy the used ones cheaper. That's a healthy constraint on the market and gluts are prevented.

ON THE CURRENT CRISIS:

There's a higher probability fundamental value investors will be able to add value with specific stock selection.

With leverage being ever more available and the government not desiring the market to go down, that sowed the seeds for today's set of problems. It was as if risk wasn't out there, leading people to write ridiculous books about the Dow going to 36,000 as risk premiums went to zero. It changed financial institutions' behavior toward leverage, which in any number of ways has proven to be ruinous to many of those institutions. People say that what has happened recently was completely unpredictable and a god knows how many sigma event, but that's just not right. This was completely predictable and I could cite eight or ten people who in one way or another predicted it.

The result of risk being ignored was that everybody on the buy side started effectively using an LBO model, trading securities on some invisible grid, so that when a stock became the slightest bit inexpensive because the company missed earnings or something, the wise guys stepped in to buy because its buyout price in an LBO was higher. With nothing getting very cheap, it became very hard to add value with securities selection.

In the past fifteen months we've seen a complete breakdown of the private-equity model – since there is no available leverage – and we're starting to see stocks trade at whatever price. There's a much higher probability that fundamental value investors in this type of period will be able to add value with specific stock selection.

Has the federal intervention of the past two weeks changed your view on that?

SK: It just points to the fact that a paint-by-numbers value-investing approach probably isn't good enough anymore. For the first time since the 1930s, when Graham and Dodd first wrote *Security Analysis*, we're seeing the government intervene in an unimaginably large way in our markets and our lives. That has changed the rules in the financial sector, maybe for a year or two, maybe for good. We're facing the possibility, at least, of a rather severe economic downturn and who knows what else. That makes it a tough time for all investors, and it's more necessary than usual to have a view on the economy, on global markets, on debt markets, on derivative markets, on securitization markets. If you didn't see what other markets than the equity market were saying about the value of sub-prime mortgages and what they were implying about home-price depreciation, the traditional value investor might have been tempted by financials even a year ago. Having insight into only one market is likely not going to be sufficient.

You criticized in the book the "frenetic lunacy" of cable-television coverage of the stock market. How important has that been in the booms and busts we've been seeing?

SK: You can't blame the media for the sub-prime crisis or the out-of-control securitization that led to the financial crisis. What the media should be criticized for is the "cheerleader" aspect to its coverage. Champagne corks would pop with every new 1,000 points on the Dow, as if that was the natural state of things and that imagining that it could go down – or

even rooting for it to go down – was un-American. It's gotten better when you start to see people like Warren Buffett show up more on channels like CNBC, but I still find financial news as entertainment, with someone like Jim Cramer, sort of sad.

Coverage of the market is always about making money, when in fact sometimes you should be worried about preserving your money. Since you don't get advance warning about what kind of environment is coming next, you should always be concerned about preserving your money. The person just watching cable TV might never know that.

If Graham and Dodd were alive today, what advice do you think they'd offer to investors?

SK: I've thought a lot about that. Their focus would probably be on not worrying about where something trades tomorrow or next week. You need to worry about where the company and the stock will be in three to five years. If you can buy something today with little chance of permanent impairment and a high likelihood that you'll double your money over the next five years, you should go ahead and do it.

As always, they'd argue to be careful and make very sure nothing terminates your upside option, which would suggest staying away from highly leveraged situations. They'd probably tread very lightly with financials, although not ignore them, because some companies with clean books of business and great management are likely to take advantage of the lending environment today.

As Graham, Dodd and Buffett have all said, you should always remember that you don't have to swing at every pitch. You can wait for opportunities that fit your criteria and if you don't find them, patiently wait. Deciding not to panic is still a decision. VII

Excerpt from Seth Klarman's preface to Security Analysis, Sixth Edition

Unanswered Questions

Today's investors still wrestle, as Graham and Dodd did in their day, with a number of important investment questions. One is whether to focus on relative or absolute value. Relative value involves the assessment that one security is cheaper than another, that Microsoft is a better bargain than IBM. Relative value is easier to determine than absolute value, the two-dimensional assessment of whether a security is cheaper than other securities and cheap enough to be worth purchasing. The most intrepid investors in relative value manage hedge funds where they purchase the relatively less expensive securities and sell short the relatively more expensive ones. This enables them potentially to profit on both sides of the ledger, long and short. Of course, it also exposes them to double-barreled losses if they are wrong.

It is harder to think about absolute value than relative value. When is a stock cheap enough to buy and hold without a short sale as a hedge? One standard is to buy when a security trades at an appreciable – say, 30%, 40%, or greater – discount from its underlying value, calculated either as its liquidation value, going-concern value, or private-market value (the value a knowledgeable third party would reasonably pay for the business). Another standard is to invest when a security offers an acceptably attractive return to a long-term holder, such as a low-risk bond priced to yield 10% or more, or a stock with an 8% to 10% or higher free cash flow yield at a time when "risk-free" U.S. government bonds deliver 4% to 5% nominal and 2% to 3% real returns. Such demanding standards virtually ensure that absolute value will be quite scarce.

Business and Management Quality

Another area where investors struggle is trying to define what constitutes a good business. Someone once defined the best possible business as a post office box to which people send money. That idea has certainly been eclipsed by the creation of subscription Web sites that accept credit cards. Today's most profitable businesses are those in which you sell a fixed amount of work product – say, a piece of software or a hit recording – millions and millions of times at very low marginal cost. Good businesses are generally considered those with strong barriers to entry, limited capital requirements, reliable customers, low risk of technological obsolescence, abundant growth possibilities, and thus significant and growing free cash flow.

Businesses are also subject to changes in the technological and competitive landscape. Because of the Internet, the competitive moat surrounding the newspaper business – which was considered a very good business only a decade ago – has eroded faster than almost anyone anticipated. In an era of rapid technological change, investors must be ever vigilant, even with regard to companies that are not involved in technology but are simply affected by it. In short, today's good businesses may not be tomorrow's.

Investors also expend considerable effort attempting to assess the quality of a company's management. Some managers are more capable or scrupulous than others, and some may be able to manage certain businesses and environments better than others. Yet, as Graham and Dodd noted, "Objective tests of managerial ability are few and far from scientific." (*p. 84*) Make no mistake about it: a management's acumen, foresight, integrity, and motivation all make a huge difference in shareholder returns. In the present era of aggressive corporate financial engineering, managers have many levers at their disposal to positively impact returns, including share repurchases, prudent use of leverage, and a valuation-based approach to acquisitions.

Managers who are unwilling to make shareholder-friendly decisions risk their companies becoming perceived as "value traps": inexpensively valued, but ultimately poor investments, because the assets are underutilized. Such companies often attract activist investors seeking to unlock this trapped value. Even more difficult, investors must decide whether to take the risk of investing – at any price – with management teams that have not always done right by shareholders. Shares of such companies may sell at steeply discounted levels, but perhaps the discount is warranted; value that today belongs to the equity holders may tomorrow have been spirited away or squandered.

The Value of Growth

An age-old difficulty for investors is ascertaining the value of future growth. In the preface to the first edition of *Security Analysis*, the authors said as much: "Some matters of vital significance, e.g., the determination of the future prospects of an enterprise, have received little space, because little of definite value can be said on the subject." (*p. xliii*)

Clearly, a company that will earn (or have free cash flow of) $1 per share today and $2 per share in five years is worth considerably more than a company with identical current per share earnings and no growth. This is especially true if the growth of the first company is likely to continue and is not subject to great variability. Another complication is that companies can grow in many different ways – for example, selling the same number of units at higher prices; selling more units at the same (or even lower) prices; changing the product mix (selling proportionately more of the higher-profit-margin products); or developing an entirely new product line. Obviously, some forms of growth are worth more than others.

There is a significant downside to paying up for growth or, worse, to obsessing over it. Graham and Dodd astutely observed that "analysis is concerned primarily with values which are supported by the facts and not with those which depend largely upon expectations." (*p. 86*) Strongly preferring the actual to the possible, they regarded the "future as a hazard which his [the analyst's] conclusions must encounter rather than as the source of his vindication." (*p. 86*) Investors should be especially vigilant against focusing on growth to the exclusion of all else, including the risk of overpaying. Again, Graham and Dodd were spot on, warning that "carried to its logical extreme, . . . [there is no price] too high for a good stock, and that such an issue was equally 'safe' after it had advanced to 200 as it had been at 25." (*p. 105*) Precisely this mistake was made when stock prices surged skyward during the Nifty Fifty era of the early 1970s and the dot-com bubble of 1999 to 2000.

ON SELLING:

Value investors should exit a security by the time it reaches full value. Owning overvalued securities is the realm of speculators.

The flaw in such a growth-at-any-price approach becomes obvious when the anticipated growth fails to materialize. When the future disappoints, what should investors do? Hope growth resumes? Or give up and sell? Indeed, failed growth stocks are often so aggressively dumped by disappointed holders that their price falls to levels at which value investors, who stubbornly pay little or nothing for growth characteristics, become major holders. This was the case with many technology stocks that suffered huge declines after the dot-com bubble burst in the spring of 2000. By 2002, hundreds of fallen tech stocks traded for less than the cash on their balance sheets, a value investor's dream. One such company was Radvision, an Israeli provider of voice, video, and data products whose stock subsequently rose from under $5 to the mid-$20s after the urgent selling abated and investors refocused on fundamentals.

The Selling Conundrum

Another conundrum for value investors is knowing when to sell. Buying bargains is the sweet spot of value investors, although how small a discount one might accept can be subject to debate. Selling is more difficult because it involves securities that are closer to fully priced. As with buying, investors need a discipline for selling. First, sell targets, once set, should be regularly adjusted to reflect all currently available information. Second, individual investors must consider tax consequences. Third, whether or not an investor is fully invested may influence the urgency of raising cash from a stockholding as it approaches full valuation. The availability of better bargains might also make one a more eager seller. Finally, value investors should completely exit a security by the time it reaches full value; owning overvalued securities is the realm of speculators. Value investors typically begin selling at a 10% to 20% discount to their assessment of underlying value – based on the liquidity of the security, the possible presence of a catalyst for value realization, the quality of management, the riskiness and leverage of the underlying business, and the investors' confidence level regarding the assumptions underlying the investment.

Assessing Risk

Finally, investors need to deal with the complex subject of risk. As mentioned earlier, academics and many professional investors have come to define risk in terms of the Greek letter beta, which they use as a measure of past share price volatility: a historically more volatile stock is seen as riskier. But value investors, who are inclined to think about risk as the probability and amount of potential loss, find such reasoning absurd. In fact, a volatile stock may become deeply undervalued, rendering it a very low-risk investment.

One of the most difficult questions for value investors is how much risk to incur. One facet of this question involves position size and its impact on portfolio diversification. How much can you comfortably own of even the most attractive opportuni-

ties? Naturally, investors desire to profit fully from their good ideas. Yet this tendency is tempered by the fear of being unlucky or wrong. Nonetheless, value investors should concentrate their holdings in their best ideas; if you can tell a good investment from a bad one, you can also distinguish a great one from a good one.

Going Abroad

Investors must also ponder the risks of investing in politically unstable countries, as well as the uncertainties involving currency, interest rate, and economic fluctuations. How much capital do you want tied up in Argentina or Thailand, or even France or Australia, no matter how undervalued the stocks may be in those markets?

Leverage

Another risk consideration for value investors, as with all investors, is whether or not to use leverage. While some value-oriented hedge funds and even endowments use leverage to enhance their returns, I side with those who are unwilling to incur the added risks that come with margin debt. Just as leverage enhances the return of successful investments, it magnifies the losses from unsuccessful ones. More importantly, nonrecourse (margin) debt raises risk to unacceptable levels because it places one's staying power in jeopardy. One risk-related consideration should be paramount above all others: the ability to sleep well at night, confident that your financial position is secure whatever the future may bring.

Final Thoughts

In a rising market, everyone makes money and a value philosophy is unnecessary. But because there is no certain way to predict what the market will do, one must follow a value philosophy at all times. By controlling risk and limiting loss through extensive fundamental analysis, strict discipline, and endless patience, value investors can expect good results with limited downside. You may not get rich quick, but you will keep what you have, and if the future of value investing resembles its past, you are likely to get rich slowly. As investment strategies go, this is the most that any reasonable investor can hope for.

The real secret to investing is that there is no secret to investing. Every important aspect of value investing has been made available to the public many times over, beginning with the first edition of *Security Analysis*. That so many people fail to follow this timeless and almost foolproof approach enables those who adopt it to remain successful. The foibles of human nature that result in the mass pursuit of instant wealth and effortless gain seem certain to be with us forever. So long as people succumb to this aspect of their natures, value investing will remain, as it has been for 75 years, a sound and low-risk approach to successful long-term investing. VII

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