The Intelligent Investor

Author: Benjamin Graham

The Intelligent Investor, written by Benjamin Graham in 1949, is possibly the most important and influential value investing book ever written. A bible for all investors, it made the concept of investing simple and easy to understand, so that even an ordinary individual could become an "intelligent investor". The book is also famous for introducing two concepts into the investing profession: the allegorical Mr. Market and the concept of "margin of safety." Warren Buffet described it as "by far the best book ever written on investing".

Key Take-Aways

- Investors are of two main types: the "enterprising investor" and the "defensive investor"
- It is important to understand the difference between speculation and investing
- Enterprising investors should treat investing like a business and commit their time and energy to the same
- Most investors don't have the time to see investing as a business. Hence, they must follow a defensive strategy
- There is no evidence to suggest that market timing and forecasting work
- Value investors must focus on the operating performance and dividends of the firm they own rather than the changing stock price
- When measuring value, check the firm's earning ability. Then multiply and adjust the asset values
- Shareholders must check the reliability of management
- Stockholders are responsible for ownership. They also have certain rights. Hence, stockholders must employ them seriously and consistently
- Always employ a margin of safety to limit your downside

Be an Intelligent Investor – Understand the difference between Investment and Speculation

The intelligent investor is one that is patient, disciplined and eager to learn. They are also able to harness their emotions and think for themselves.

"This kind of intelligence is a trait more of the character than of the brain."

The first step towards being an intelligent investor is understanding the difference between investing and speculating. Investing entails a thorough analysis of an investment that includes determining the risk/return characteristics of the asset. An investment has the ability to promise safety of principle and an adequate return. Speculation, on the other hand, involves taking investment decisions that are not made on a foundation of research and analysis and can consequently lead to a high probability of loss of capital. Investors should limit their allocation to speculative positions (also known as "mad money account") to no more than 10% of the investment funds. Never mingle the money in the speculative account with the money in the investment account.

"Stocks do well or poorly in the future because the businesses behind them do well or poorly - nothing more, and nothing less."

The intelligent investor will never exit a stock position purely in response to share price movement. He / she will always first ask whether the value of the company's underlying business has changed and then act accordingly. The intelligent investor only pays attention to the current stock price when it suits him. The investor who permits himself to be worried by unjustified market declines in his holdings is essentially transforming his basic advantage into a basic disadvantage. The speculator's main interest is to anticipate and profit from fluctuations in the market. The investor's primary interest is to acquire and hold suitable securities at suitable prices. Investing is not about beating others at their game, it's about controlling yourself at your own game. Most investors fail because they pay too much attention to what the stock market is doing currently.

Stock Market Volatility – An Introduction to Mr. Market Concept

Imagine that we own small shares in a private business that costs us $1,000. One of our partners is called Mr. Market. Mr. Market is a very obliging partner. Every day, he tells us what he thinks our interest is worth and furthermore, offers either to buy us out or to sell us an additional interest on that basis. Sometimes his idea of value appears justified and plausible by business *developments and prospects as we know them. Often, on the other hand, Mr. Market lets his enthusiasm or his fears run away with him, and the value he proposes seems to you a little short of silly.*

If we are a prudent investor or a sensible businessman, will we let Mr. Market's daily communication determine our view of the value of a $1000 interest in the enterprise? Only when we agree with him, or we want to trade with him. We may be happy to sell out to him when he quotes a ridiculously high price, and equally happy to buy from him when his price is low. But the rest of the time, we would be wiser to form our own views of the value of our holdings, based on full reports from the enterprise about its operations as well as its financial positions.

Inflation – The Silent Raider

Inflation is real and it erodes our purchasing power over time. A dollar 10 years ago is worth more as compared to A dollar today. What this means is that cash is a terrible investment. We need to make use of the cash, to get more cash. We need to invest cash to beat inflation. Investors often overlook the importance of inflation. Psychologists called this the "money illusion". For example, if we receive a 2% raise in salary in a year when inflation runs at 4%, we will most certainly feel better than if we take a 2% pay cut during a year when inflation is zero. Yet, both changes in the above mentioned scenarios leave us in a virtually identical position: Which is 2% worse after inflation. Investing in stocks for the long-term and REITs can help investors guard their earnings/investment returns from the ill effects of inflation.

What Type of Investor should you be?

It is widely believed that the return you can expect from an investment is directly proportional to the risk that you are willing to take. This basically translates into the belief that high risk equals high return while low risk equals low return. However, the rate of return that an investor can expect is not only a function of risk but also of the amount of effort he/she is willing to invest in research.

To determine the amount of risk you can take, ask yourself:

- Are you single or married? What does your spouse or partner do for a living?
- Do you or will you have children? When will the tuition bills hit home?
- Will you inherit money, or will you end up financially responsible for aging, ailing parents?
- What factors might hurt your career? (If you work for a bank or a homebuilder, a jump in interest rates could put you out of a job. If you work for a chemical manufacturer, soaring oil prices could be bad news.)
- If you are self-employed, how long do businesses similar to yours tend to survive?
- Do you need your investments to supplement your cash income? (In general, bonds will; stocks won't.)
- Given your salary and your spending needs, how much money can you afford to lose on your investments?

For the defensive investor - high-grade bonds and common stocks

The defensive investor should divide his funds between high-grade bonds and high-grade common stocks. The standard division should be equal ones of 50-50 between stock and bonds. A sound reason to increase the percentage in common stocks is when there are more stocks in a bear market at a bargain price. Conversely, they should reduce common stock component to below 50% when the market level has become dangerously high. Investing in investment funds is more suitable for the defensive investor.

Stock selection for the defensive investor:

1. Adequate size of the enterprise - Exclude small companies that are more volatile
2. A sufficiently strong financial condition - Current assets should be at least twice of current liabilities for industrial firms. Long-term debt should not be more than net current assets. For public utilities, the debt should not exceed twice the equity
3. Earnings stability - Positive earnings for each of the past 10 years
4. Dividend record - Uninterrupted for the past 20 years
5. Earnings growth - A minimum increase of at least one-third in per-share earnings in the past ten years using three-year averages at the beginning and end
6. Moderate price to earnings ratio - No more than 15 times average earnings of the past 3 years
7. A moderate ratio of price to assets - Should not be more than 1.5 times the book value last reported. However, a low PE ratio below 15 can justify a higher price to book value. PE ratio x PB ratio should not be more than 22.5

Stock selection for the enterprising investor:

1. Financial condition: [1] Current assets at least 1.5 times current liabilities, and [2] debt not more than 110% of net current assets (for industrial companies)
2. Earnings stability: No deficit in the last five years
3. Dividend records: Some current dividend
4. Earnings growth: Consistent earnings growth
5. Price: Less than 120% net tangible assets

It is important to note that many of the best professional investors first get interested in a stock when its share price goes down, not up. Looking at the daily list of the new 52-week lows can be a great way to get started.

Investment Selection - How to Analyse Stocks and Bonds

When analysing bonds

The most important criteria to take note of is the number of times that total interest charges have been covered by available earnings. We should analyse for at least 7 years in the past.

For preferred stocks

It is the number of times the bond interest and preferred dividends combined have been covered by the available earnings for 7 years in the past.

For stocks

We have to compare our valuations of the company to the current price that the company is trading at in the stock market. We should always seek a margin of safety - purchasing the stock for less than its intrinsic value. The lesser the assumptions we have to make about the future during analysis, the lesser the possibility for error. Avoid making too many assumptions in your stock analysis.

Elements to determine how much the enterprising investor should pay for a stock:

1. Long-term prospects of the company - Gather evidence in the financial statements that answer two questions: What makes this company grow? Where do (and where will) its profits come from? Look for companies that:
   a. Have a wide "moat" or competitive advantage
   b. Prefer to run marathons and not sprints
   c. Focuses on what it is sowing

2. Management competency - Look for management that says what they will do, and does what they have said. A good management will admit failures and take responsibility for them
3. Financial strength & capital structure - A good business generates more cash than it consumes. See in the statement of cash flows whether cash from operations has grown steadily over the past 10 years
4. Dividend record - One of the most persuasive tests of high-quality companies is an uninterrupted record of dividend payments going back over many years (20 years is preferred)
5. Current dividend rate
6. Be a long-term thinker - Looking at the longer term provides a better indicator of the future health of the company.
7. Look into the footnotes - Be wary of aggressive revenue recognition practices. It is a sign of dangers that run deep and large. Also be wary of companies that do not charge expenses against revenues when it is suitable to. Instead, they treat these expenses as a capital expenditure that increases the company's total assets instead of decreasing net income.

Margin of Safety – The Most Important Concept

Margin of safety in stock investing is the difference between the intrinsic value of the company and the price we pay to purchase it. The amount of price paid is the most important factor in investment.

Determining the purchase price, and having the discipline to only buy at or below the price is where the true test lies at. A sufficiently low price, relative to the actual value, can turn even a mediocre quality stock in to a great investment opportunity. The greater the margin of safety, the more leeway we have for things to go bad - before we lose money. If the future is as we expect it to be, the profits generated from that investment will also be much higher.

Unfortunately, not many people in the world can make an accurate forecast into the future of a company. There is always a risk of paying too high. The reason for having a margin of safety is essentially to make an accurate forecast of the future less necessary. There is a buffer for inaccurate forecasts. One of the main reasons for investor's loss is that they buy low-quality stocks at times of favourable business conditions, without a margin of safety.

Diversification is a key component of “margin of safety”

The odds would be with us when we only invest in individual stocks with a large enough margin of safety. While some stocks will live up to our expectations, many others will not. Diversification can amplify the benefits of margin of safety. A diversified portfolio has a higher probability of generating above average returns.

Eleven rules that can help both analysts and investors:

- Estimate the earning capacity of a company to measure value. Multiply this correctly and take into account asset value
- Earning capacity is an estimate of the firm's earnings over the next five years
- Guess a firm's average earnings over this period. You can do this by averaging past performance. Then estimate margins and revenues for the future
- Adjust previous years' numbers to reflect any changes in capitalization
- You should use a maximum multiplier of 20 and a minimum of 8. This allows for changes in earnings in the long-run
- If the value arrived at from earning power is higher than the fixed assets' value, subtract from the earnings value change. Suggested: subtract a quarter of the sum by which the earning-power value is higher than two-times the asset value. This allows for a 100% premium on tangible assets sans penalty
- If such value is lower than the net current assets' value, add 50% of the variance to the value measured on earning-power
- In unusual events, like war, short-term royalties or rentals, adjust the value accordingly
- Assign value among bondholders, stockholders or preferred shareholders. Before this step, compute the company value as though its capital structure had only common stock
- The more debt and preferred stock in the capital structure, the less you need to rely on the appraised value. Decisions should not be taken based on this value
- When the appraisal is one-third greater or less than the current market value, you can base your decision on this. If the difference is less, then the appraisal is just a factor to consider in the assessment

And always remember, investment is most intelligent when it is most business-like. **When we buy a stock, we become an owner of the company.**

Value investing is definitely a great approach to creating long-term wealth. However, value investing also requires a significant amount of commitment from your end. You need to study a company, arrive at its true or accurate intrinsic value, and then identify the best opportunity to buy that stock, i.e., when its price is below its intrinsic value. If you already have a full-time job or don't have the inclination to invest your time and energy in such analysis, then you might be better off investing in mutual funds. Basically, mutual funds are investment vehicles that pool investor money and then invest it in different asset classes like equity, debt, gold, etc. Within equity investing, certain mutual fund schemes follow the value investing approach wherein the fund manager along with the investment team uses the value investing methodology to identify stocks that are trading at the deep discount to their market price and thus, have a good margin of safety. An additional benefit of investing through mutual funds is that they also give you an opportunity to diversify your portfolio, thereby reducing overall portfolio risk. From that perspective, they can help you become value investors without having to make the effort to analyse a stock, determine the buy price, and track it till you reach the best sell price.