All roads lead to Graham and Doddsville: the evolution of the modern value investor

‘Superinvestors’ such as Warren Buffet have adapted the basic principles of value investing, developed by Benjamin Graham and David Dodd in the 1930s, to invest successfully in all market conditions, including the recent volatility in financial markets.

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WITH HIGH LEVELS OF VOLATILITY in global equity markets and the collapse of several hedge funds, it is critical for investors to reassess the foundations of their investment strategies.

This article examines how the investment strategy known as ‘value investing’ has stood the test of time across all market conditions. It looks at how modern value investors (including the famous Warren Buffett) have adapted Benjamin Graham’s early investment framework to apply to competitive, modern investment markets.

Who is Benjamin Graham?

Benjamin Graham is the founding father of value investing. In 1928, Graham began teaching the course on security analysis at Columbia University. In 1934, Graham and colleague David Dodd wrote the book *Security analysis*, a recognised investment classic, which articulated the investment style known as value investing. Graham later refined his ideas in his 1949 book, *The intelligent investor*, which has sold more than one million copies and was praised by Warren Buffet as ‘the best book on investing ever written’.

Columbia University has continued this tradition of value investing, and many of its students have adapted and applied the foundations of Graham’s teachings in their professional investment careers with great success.

What is ‘value investing’?

The value investor seeks to buy assets for less than they’re worth – the proverbial exercise of buying one dollar for 60 cents. In finance parlance, value investors buy assets when they are priced at a discount to their intrinsic value.

Warren Buffett is probably the world’s best-known value investor. In March 2008, *Forbes* magazine ranked him the richest man in the world, with a net worth of US$62 billion. Unlike other mega-rich identities, Buffett accumulated his wealth largely through securities investment, so it’s worth listening to his opinions.

Buffett said that he learnt ‘the three cornerstones of sound investing from Ben Graham’. They are:

1. You should look at stocks as small pieces of the business.
2. Look at [stockmarket] fluctuations as your friend rather than your enemy – profit from folly rather than participate in it.
3. The three most important words of investing are: ‘margin of safety’.

First, Graham said that investors should analyse the business underlying any security. This might sound obvious, but some investment strategies pay no regard to the fact that a share represents part ownership of a business. For example, technical analysis is about responding to movements in price patterns of a security and doesn't analyse the fundamental performance of the underlying business.

Second, individual securities prices often fluctuate for reasons that have nothing to do with the intrinsic value of a business. Graham created the persona 'Mr Market' as a metaphor to explain stock market volatility. Mr Market is a bi-polar individual who represents the entire stock market. His personality fluctuates from wild euphoria to deep pessimism. His emotional volatility is reflected in stock market price volatility, with excessively optimistic prices at one extreme and stocks priced for disaster at the other extreme. The critical point is that every day Mr Market offers shares at prices that have nothing to do with the underlying intrinsic value of businesses. This creates the opportunity for an investor to buy shares for less than their value.

Third, investors should purchase shares in businesses at a price that represents a discount to the intrinsic value of that business. It doesn't have to be rock bottom, it just has to be selling for less than the value of the business. This discount is referred to as the 'margin of safety'. As Buffett said: 'Price is what you pay; value is what you get'.

The superinvestors of Graham and Doddsville: value investing stands the test of time

It is critical in any market condition for investors to understand the theoretical foundations of their investment strategy. It is even more critical in today's highly volatile market climate.

Some investment strategies are based on foundations that current market conditions are exposing as less than robust. Consider, for example, the flaws in 'momentum investing'. Momentum investing is a strategy where speculators buy stocks only because they have gone up in a chart pattern – based on the theory that 'the trend is your friend' – and cut losses quickly when the trend reverses. The flaw in this strategy is that when markets are highly volatile, share prices can 'gap down' in morning trade based on overnight Wall Street trading. A 'gap down' prevents traders from selling stock at a theoretical stop-loss position, and so exposes them to losses that exceed the stop-loss position.

A robust investment framework must be based on valid principles that are timeless and apply in all market conditions. Commenting on Ben Graham's three investment principles Buffett said: 'A hundred years from now they will still be the cornerstones of investing'.

Buffett made these comments in 1976. Since then, financial storms have come and gone. Hedge funds with new trading strategies and styles have come and gone. In 1998, the Long Term Capital Management hedge fund, complete with Nobel Economics Prize winners on its board, collapsed in spectacular fashion (losing US$4.6 billion). In this cycle, it is subprime mortgage funds, Bear Stearns, and commodity trading funds. Closer to home there have been a number of ailing companies including ABC, Allco, MFS and Centro. The apex of every bear market exposes new and improved losing strategies. However, despite continuous bear cycles, there is yet to be a spectacular collapse of an investment fund that has Ben Graham's investment framework as part of its core philosophy.

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Warren Buffett delivered a speech to students at Columbia Business School in 1984, called 'The Superinvestors of Graham-and-Doddsville'. Buffett rejected the academic position that beating the overall market index S&P 500 was 'pure chance'. He highlighted the outstanding investment records of a small group of superinvestors who had beaten the S&P 500, 'year in and year out', over long periods. Buffett named nine superinvestors, including himself, Walter J. Schloss, Ed Anderson (Tweedy, Brown Inc.), Bill Ruane (Sequoia Fund, Inc.), Charles Munger and Rick Guerin (Pacific Partners, Ltd.). Emphasising the point, Buffett said that each of the superinvestors had 'gone to different places and bought and sold different stocks and companies, yet they have a combined record that simply can't be explained by random chance'.

What these investors have in common is that they come 'from a very small intellectual village that could be called Graham-and-Doddsville' – they are all value investors.

Ben Graham as investor

So if value investors have been shown to outperform the market, how do they do it? The obvious short answer is that they follow Ben Graham's three cornerstone investment principles.

The long answer is a little more complicated – the challenge is how value investors quantify intrinsic value. Ben Graham himself applied his own principles, and invested with his own particular view on how to define value. However, as in any evolving field of endeavour, the students have adapted and modernised the work of the teacher.

Graham mostly invested during the years following the Great Wall Street Crash. The initial crash occurred on Black Thursday, 24 October 1929. The Dow Jones Industrial Average did not return to its pre-1929 levels until late 1954. Many investors remained shell-shocked and were distrustful of equities, so they avoided them altogether. This created ideal conditions for Graham to hunt for value bargains. There were plenty. In 1932, Graham wrote an article for *Forbes* magazine in which he pointed out that 30% of the companies listed on the NYSE sold for less than their net quick assets. The cycle had gone full circle – stocks that had been clearly overpriced in 1929 were now undervalued.

Graham generally did not care what the company actually did to generate revenue or whether it had capable management. He only cared about buying stocks whose price was less than intrinsic value.

As the memory of the Great Crash was forgotten and the next generation emerged, investors returned to the equity market. New money had bought the obvious bargains. Consequently, subsequent generations of value investors had to find new ways of discovering bargains in the equity market. Value investing had to adapt to new market conditions.

The evolution of the value investor: the building blocks of value

The strength of Graham's three cornerstones of investment is that value investors can use the framework to select their own definition of intrinsic value. This does not represent a loss of investment discipline, merely recognition that there are different components of the total value of a company, and some investors will choose to pay for these components and others will not.

To help understand the components of total value, a simple analogy is a six-storey apartment block, with each level representing a discrete layer of value. Each level of the building adds value to the previous levels beneath it; the total value of the building is the sum of all six levels. The most 'deep value' investor will only look to buy the building when Mr Market offers it at the price representing the value of one floor. He will want the other five levels for free. This is how Graham valued an investment. A modern value investor may value all six levels of the building and pay a fair price for them with the knowledge that the property is well located, has great tenants and will provide solid capital growth over time. This is the approach Warren Buffett has taken.

The six components of value of a company are listed below. Each of the components adds some extra value to the whole company. A more conservative value investor will only recognise and pay for the first one and/or two layers of value. A more aggressive investor will pay for the last few items of value.

The first component is the 'net–net' valuation method. This is the most conservative valuation approach. It attributes value only to the net current assets (current assets minus current liabilities) of the company and attributes zero value to property, plant and equipment, or any other long-term assets.

Graham's preferred technique was to buy stocks selling for two-thirds of their net–net value. These opportunities are rare in modern markets. However, there may be hidden opportunities, for example, in companies whose status as a going concern is in doubt.

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The second component is the 'liquidation value of assets'. This determines the worth of the company if it no longer operated as a going concern, and all its assets were sold on the open market. The value that can be achieved through asset sales in this scenario depends on such factors as the overall health of the company's industry (which determines the number of buyers), and how specialised the company's assets are. Typically, in this scenario, assets will be liquidated for a fraction of their true worth given that purchasers know they are buying from a distressed seller.

Third, the 'book value of assets' – which assumes the business continues as a going concern – is the total assets less the total liabilities on the company's balance sheet.

Few successful businesses will be available for sale at book value, and even fewer provide a margin of safety discount to book value. There are, however, some elements of hidden value that may not be immediately apparent in book valuations. For example, accounting standards require long-term assets to be recorded on the balance sheet at their historical cost, and then be depreciated over time. This accounting treatment can depart from real market values in some circumstances, for example, where a property has appreciated considerably over time. The book value of intangible assets such as brands or goodwill may have a value materially different to the balance sheet.

Walter Schloss is a noted value investor who buys shares based on margin on safety discounts to asset values. He was once an employee of Ben Graham at the Graham-Newman investment company. In 1955, he set up his own investment fund. He has one of the longest and best records in investment history. Over the entire 45-year period from 1956 to 2000, Schloss returned 15.3% p.a., compared to his S&P benchmark of 11.5%.

The fourth component of value is 'reproduction value of assets'. Reproduction valuation measures the cost of reproducing the market position of a particular company. Often, book value does not measure reproduction value because the value of intangible assets is not accurately reflected in the balance sheet. For example, the value of

Coca-Cola's distribution network is not included in its balance sheet. The costs of establishing and running its sales/distribution force would have been expensed long ago, but there is an intangible value attached to this network.

Similar analysis applies to the valuation of a brand, research and development and acquisition of licences and patents. Accounting standards require that many of these items be expensed, but the adventurous value investor can determine if these prior expenses have in fact created an enduring asset for the company that is not reflected in the company's balance sheet – another form of hidden value. A good example is Warren Buffett's purchase of Walt Disney shares in 1969. At that time, an investor could buy the whole company for US$80 million on the share market. This was when *Snow White*, *Swiss Family Robinson* and some other cartoons, which had been written off the balance sheet, were worth that much by themselves.

The fifth component is 'valuation of the earnings of the business'. This valuation will apply a multiple to what is considered to be sustainable future earnings of the business. This is a significant departure from the classic Ben Graham investing strategy of buying assets that sell at a price discount to 'net–net' value.

An estimate of the company's intrinsic value on this basis requires two steps. In the first step, reported earnings are adjusted to estimate the cash that investors can extract from the firm and still leave it functioning as a sustainable business. Adjustments that need to be made to reported earnings include removing the impact of one-off items (such as restructuring charges) and quantifying the average level of earnings across the business cycle.

In step two, a multiple is selected to reflect both the prevailing level of interest rates and the risk level of the firm relative to other investment alternatives.

Another article could be written on the types of adjustments that should be made and the appropriate discount rate. Often these judgements are subjective and based on the investor's knowledge of a particular company and its industry. But value investors compensate for these subjective considerations by demanding a margin of safety discount to the valuation that they calculate.

The sixth and final component is 'franchise value'. Franchise value has absolutely nothing to do with Domino's Pizza, Subway or Donut King. In the context of value investing, a 'franchise' refers to a business that has barriers to entry and sustainable competitive advantages. Barriers to entry are anything that make it difficult for a competitor to enter a company's market, such as licences, patents, copyrights, distribution networks, captive customers, economies of scale and high switching costs. Franchise value is the major source of any value that exceeds the asset reproduction value.

The challenge for investors is that a franchise can be difficult to identify. Part of the genius of Warren Buffett has been his ability to identify durable business franchises when the market has not been able to appropriately identify and/or value them. Buffett identified the value inherent in the franchise of businesses such as American Express, Walt Disney, Coca-Cola, Gillette and Wells Fargo at times when the rest of the market did not, and he invested accordingly. The rest is the stuff of investment legend.

Buffett evolved and adapted Ben Graham's principles to include recognising the value of a business franchise. In 1985, Buffet said that he would be 'willing to pay more for a good business and for good management than I would 20 years ago. Ben tended to look at the statistics alone. I've looked more and more at the intangibles'.

Bill Ruane, founder of the highly successful Sequoia Fund, commented on the connection between Buffet and Graham's investment styles: 'Graham wrote what we call the Bible, and Warren's thinking updated it. Warren wrote the New Testament'.

Conclusion

In today's highly volatile markets, it's worthwhile thinking about the foundation on which investment strategies are based. New hedge fund trading strategies come and go, but value investing has survived the test of time. Value investors have stayed true to Benjamin Graham's three cornerstone investment principles: a stock is a piece of a business; exploit rather than be led by Mr Market; and buy stocks at a margin of safety discount.

Buffett concluded his Superinvestors speech by saying that in his whole career of value investing, he had seen no trend towards it. For reasons of behavioural finance best left to another article, Buffett stated: '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'.

Buffett also said that he expected value investing would remain a valid philosophy through future business and investment cycles: 'In an area where much looks foolish within weeks or months after publication, Ben's principles have remained sound – their value often enhanced and better understood in the wake of financial storms that demolished flimsier structures'.

Although later generations of value investors have used different methods to quantify intrinsic value, Ben Graham's three cornerstone principles are common to all. In fact, it can be said that all value investors choose to take their own path, but aim for the same destination, the hallowed nirvana of stock market out-performance called Graham and Doddsville.