AN HOUR WITH MR. GRAHAM

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HB: Mr. Graham, I do appreciate so much being able to come and visit with you this afternoon. When Bob Milne learned that Mrs. Butler and I would be in La Jolla, he suggested that I not only visit with you but also bring along my cassette tape recorder. We have much I would like to cover. First, could we start with a topical question—Government Employees Insurance Company—with GEICO being very much in the headlines.

Graham: Yes, what happened was the team came into our office and after some negotiating, we bought half the company for $720,000. It turned out later that we were worth—the whole company—over a billion dollars in the stock market. This was a very extraordinary thing. But we were forced by the SEC to distribute the stock among our stockholders because, according to a technicality in the law, an investment fund was not allowed more than 10 percent of an insurance company. Jerry Newman and I became active in the conduct of GEICO, although we both retired a number of years ago. I am glad I am not connected with it now because of the terrific losses.

HB: Do you think GEICO will survive?

Graham: Yes, I think it will survive. There is no basic reason why it won't survive, but naturally I ask myself whether the company did expand much too fast without taking into account the possibilities of these big losses. It makes me shudder to think of the amounts of money they were able to lose in one year. Incredible! It is surprising how many of the large companies have managed to turn in losses of $50 million or $100 million in one year, in these last few years. Something unheard of in the old days. You have to be a genius to lose that much money.

HB: Looking back at your own life in the investment field, what are some of the key developments or key happenings, would you say? You went to Wall Street in 1914?

Graham: Well, the first thing that happened was typical. As a special favor, I was paid $12 a week instead of $10 to begin. The next thing that happened was World War I broke out two months later and the stock exchange was closed. My salary was reduced to $10—that is one of the things more or less typical of any young man's beginnings. The next thing that was really important to me—outside of having made a rather continuous success for 15 years—was the market crash of 1929.

HB: Did you see that coming at all—were you scared?

Graham: No. All I knew was that prices were too high. I stayed away from the speculative favorites. I felt I had good investments. But I owed money, which was a mistake, and I had to sweat through the period 1929-1932. I didn't repeat that error after that.

HB: Did anybody really see this coming—the crash of 1929?

Graham: Babson did, but he started selling five years earlier.

HB: Then in 1932, you began to come back?

Graham: Well, we sweated through that period. By 1937, we had restored our financial position as it was in 1929. From then on, we went along pretty smoothly.

HB: The 1937-1938 decline, were you better prepared for that?

Graham: Well, that led us to make some changes in our procedures that one of our directors had suggested to us, which was sound, and we followed his advice. We gave up certain things we had been trying to do and concentrated more on others that had been more consistently successful. We went along fine. In 1948, we made our GEICO investment and from then on, we seemed to be very brilliant people.

HB: What happened in the only other interim bear market—1940-1941?

Graham: Oh, that was only a typical setback period. We earned money in those years.

HB: You earned money after World War II broke out?

Graham: Yes, we did. We had no real problems in running our business. That's why I kind of lost interest. We were no longer very challenged after 1950. About 1956, I decided to quit and to come out here to California to live.

I felt that I had established a way of doing business to a point where it no longer presented any basic problems to be solved. We were going along on what I thought was a satisfactory basis, and the things that presented themselves were typically repetitions of old problems which I found no special interest in solving.

About six years later, we decided to liquidate Graham-Newman Corporation—to end it primarily because the succession of management had not been satisfactorily established. We felt we had nothing special to look forward to that interested us. We could have built up an enormous business had we wanted to, but we limited ourselves to a maximum of $15 million of capital—only a drop in the bucket these days. The question of whether we could earn the maximum percentage per year was what interested us. It was not the question of total sums, but annual rates of return that we were able to accomplish.

HB: When did you decide to write your classic text, *Security Analysis*?

Graham: What happened was that in about 1925, I thought that I knew enough about Wall Street after 11 years to write a book about it. But fortunately, I had the inspiration instead to learn more on the subject before I wrote the book, so I decided I would start teaching if I could. I became a Lecturer at the Columbia School of Business for the extension courses. In 1928, we had a course in security analysis and finance—I think it was called Investments—and I had 150 students. That was the time Wall Street was really booming.

The result was it took until 1934 before I actually wrote the book with Dave Dodd. He was a student of mine in the first year. Dave was then Assistant Professor at Columbia and was anxious to learn more. Naturally, he was indispensable to me in writing the book. The First Edition appeared in 1934. Actually, it came out the same time as a play of mine which was produced on Broadway and lasted only one week.

HB: You had a play on Broadway?

Graham: Yes. "Baby Pompadour" or "True to the Marines." It was produced twice under two titles. It was not successful. Fortunately, *Security Analysis* was much more successful.

HB: That was *the* book, wasn't it?

Graham: They called it the "Bible of Graham and Dodd." Yes, well now I have lost most of the interest I had in the details of security analysis which I devoted myself to so strenuously for many years. I feel that they are relatively unimportant, which, in a sense, has put me opposed to developments in the whole profession. I think we can do it successfully with a few techniques and simple principles. The main point is to have the right general principles and the character to stick to them.

HB: My own experience is that you have to be a student of industries to realize the great differences in managements. I think that this is one thing an analyst can bring to the solution.

Graham: Well, I would not deny that. But I have a considerable amount of doubt on the question of how successful analysts can be overall when applying these selectivity approaches. The thing that I have been emphasizing in my own work for the last few years has been the group approach. To try to buy groups of stocks that meet some simple criterion for being undervalued—regardless of the industry and with very little attention to the individual company. My recent article on three simple methods applied to common stocks was published in one of your Seminar Proceedings.

I am just finishing a 50-year study—the application of these simple methods to groups of stocks, actually, to all the stocks in the Moody's Industrial Stock Group. I found the results were very good for 50 years. They certainly did twice as well as the Dow Jones. And so my enthusiasm has been transferred from the selective to the group approach. What I want is an earnings ratio twice as good as the bond interest ratio typically for most years. One can also apply a dividend criterion or an asset value criterion and get good results. My research indicates the best results come from simple earnings criterions.

HB: I have always thought it was too bad that we use the price/earnings ratio rather than the earnings yield measurement. It would be so much easier to realize that a stock is selling at a 2.5 percent earnings yield rather than 40 times earnings.

Graham: Yes. The earnings yield would be more scientific and a more logical approach.

HB: Then with roughly a 50 percent dividend payout, you can take half of the earnings yield to estimate a substainable dividend yield.

Graham: Yes. Basically, I want to double the interest rate in terms of earnings return. However, in most years the interest rate was less than five percent on AAA bonds. Consequently, I have set two limits. A maximum multiple of 10 even when interest rates are under five percent, and a maximum multiple of 7 times even when interest rates are above seven percent as they are now. So typically my buying point would be double the current AAA interest rate with a maximum multiplier between 10 and 7. My research has been based on that.

I received in Chicago last year the Molodovsky Award.

HB: I understand that you have about completed this research.

Graham: Imagine—there seems to be practically a foolproof way of getting good results out of common stock investment with a minimum of work. It seems too good to be true. But all I can tell you after 60 years of experience, it seems to stand up under any of the tests that I would make up. I would try to get other people to criticize it.

HB: By some coincidence as you were becoming less active as a writer, a number of professors started to work on the random walk. What do you think about this?

Graham: Well, I am sure they are all very hardworking and serious. It's hard for me to find a good connection between what they do and practical investment results. In fact, they say that the market is efficient in the sense that there is no particular point in getting more information than people already have. That might be true, but the idea of saying that the fact that the information is so widely spread that the resulting prices are logical prices—that is all wrong. I don't see how you can say that the prices made in Wall Street are the right prices in any intelligent definition of what right prices would be.

HB: It is too bad there have not been more contributions from practicing analysts to provide some balance to the brilliant work of the academic community.

Graham: Well, when we talk about buying stocks, as I do, I am talking very practically in terms of dollars and cents, profits and losses, mainly profits. I would say that if a stock with \$50 working capital sells at \$32, that would be an interesting stock. If you buy 30 companies of that sort, you're bound to make money. You can't lose when you do that. There are two questions about this approach. One is, am I right in saying if you buy stocks at two-thirds of the working capital value, you have a dependable indication of group undervaluation? That's what our own business experience proved to us. The second question, are there other ways of doing this?

HB: Are there any other ways?

Graham: Well, naturally, the thing that I have been talking about so much this afternoon is applying a simple criterion of the value of a security. But what everybody else is trying to do pretty much is pick out the "Xerox" companies, the "3M's", because of their long-term futures or to decide that next year the semiconductor industry would be a good industry. These don't seem to be dependable ways to do it. There are certainly a lot of ways to keep busy.

HB: Would you have said that 30 years ago?

Graham: Well, no, I would not have taken as negative an attitude 30 years ago. But my positive attitude would have been to say, rather, that you could have found sufficient examples of individual companies that were undervalued.

HB: The efficient market people have kind of muddied the waters, haven't they, in a way?

Graham: Well, they would claim that if they are correct in their basic contentions about the efficient market, the thing for people to do is to try to study the behavior of stock prices and try to profit from these interpretations. To me, that is not a very encouraging conclusion because if I have noticed anything over these 60 years on Wall Street, it is that people do not succeed in forecasting what's going to happen to the stock market.

HB: That is certainly true.

Graham: And all you have to do is to listen to "Wall Street Week" and you can see that none of them has any particular claim to authority or opinions as to what will happen in the stock market. They, and economists, all have opinions and they are willing to express them if you ask them. But I don't think they insist that their opinions are correct, though.

HB: What thoughts do you have on index funds?

Graham: I have very definite views on that. I have a feeling that the way in which institutional funds should be managed, at least a number of them, would be to start with the index concept—the equivalent of index results, say 100 or 150 stocks out of the *Standard & Poor's 500.* Then turn over to managers the privilege of making a variation, provided they would accept personal responsibility for the success of the variation that they introduced. I assume that basically the compensation ought to be measured by the results either in terms of equaling the index, say Standard & Poor's results, or to the extent by which you improve it. Now in the group discussions of this thing, the typical money managers don't accept the idea and the reason for non-acceptance is chiefly that they say—not that it isn't practical—but that it isn't sound because different investors have different requirements. They have never been able to convince me that that's true in any significant degree—that different investors have different requirements. All investments require satisfactory results, and I think satisfactory results are pretty much the same for everybody. So I think any experience of the last 20 years, let's say, would indicate that one could have done as well with Standard & Poor's than with a great deal of work, intelligence, and talk.

HB: Mr. Graham, what advice would you have to a young man or woman coming along now who wants to be a security analyst and a Chartered Financial Analyst?

Graham: I would tell them to study the past record of the stock market, study their own capabilities, and find out whether they can identify an approach to investment they feel would be satisfactory in their own case. And if they have done that, pursue that without any reference to what other people do or think or say. Stick to their own methods. That's what we did with our own business. We never followed the crowd, and I think that's favorable for the young analyst. If he or she reads *The Intelligent Investor*—which I feel would be more useful than *Security Analysis* of the two books—and selects from what we say some approach which one thinks would be profitable, then I say that one should do this and stick to it. I had a nephew who started in Wall Street a number of years ago and came to me for some advice. I said to him, "Dick, I have some practical advice to give you which is this. You can buy closed-end investment companies at 15 percent discounts on an average. Get your friends to put "x" amount of dollars a month in these closed-end companies at discounts and you will start ahead of the game and you will make out all right." Well, he did do that—he had no great difficulty in starting his business on that basis. It did work out all right and then the big bull market came along and, of course, he moved over to other fields and did an enormous amount of speculative business later. But at least he started, I think, on a sound basis. And if you start on a sound basis, you are half-way along.

HB: Do you think that Wall Street or the typical analyst or portfolio managers have learned their lessons of the "Go-Go" funds, the growth cult, the one-decision stocks, the two-tier market, and all?

Graham: No. They used to say about the Bourbons that they forgot nothing and they learned nothing, and I'll say about the Wall Street people, typically, is that they learn nothing, and they forget everything. I have no confidence whatever in the future behavior of the Wall Street people. I think this business of greed—the excessive hopes and fears and so on—will be with us as long as there will be people. There is a famous passage in Bagehot, the English economist, in which he describes how panics come about. Typically, if people have money, it is available to be lost and they speculate with it and they lose it—that's how panics are done. I am very cynical about Wall Street.

HB: But there are independent thinkers on Wall Street and throughout the country who do well, aren't there?

Graham: Yes. There are two requirements for success in Wall Street. One, you have to think correctly; and secondly, you have to think independently.

HB: Yes, correctly and independently. The sun is trying to come out now, literally, here in La Jolla. What do you see of the sunshine on Wall Street?

Graham: Well, there has been plenty of sunshine since the middle of 1974 when the bottom of the market was reached. And my guess is that Wall Street hasn't changed at all. The present optimism is going to be overdone, and the next pessimism will be overdone, and you are back on the Ferris Wheel—whatever you want to call it—Seesaw, Merry-Go-Round. You will be back on that. Right now, stocks as a whole are not overvalued, in my opinion. But nobody seems concerned with what are the possibilities that 1970 and 1973-1974 will be duplicated in the next five years. Apparently, nobody has given any thought to that question. But that such experiences will be duplicated in the next five years or so, you can bet your Dow Jones Average on that.

HB: This has been a most pleasant and stimulative visit. We will look forward to receiving in Charlottesville your memoirs manuscript. Thank you so much, Mr. Graham!