The Stock Market Is Like A Pendulum

If it's back to fundamentals in the stock market—as so many of the experts proclaim—then it's back to Benjamin Graham, the father of modern security analysis, the man who taught that what he defined as *value* would always—in the long run—prevail over panic and euphoria, over fad and fancy.

And, of course, over growth stock investing. Graham didn't go along with the types who believed in getting aboard a good growth stock and staying with it forever and forever, amen. Growth stock investing involves predicting the future, and Graham liked to point out that the future isn't predictable or measurable. Value, on the contrary, *is* measurable.

But when he interviewed the spry, 81-year-old sage last month, Forbes' Anthony Cook reminded Graham that he had once violated his own principles and gotten rich in the process. Back in 1948, his Graham-Newman fund invested heavily in a little-known company called Government Employees Insurance—GEICO. The stock soared to over 200 times its original offering price by 1973 and Graham hung on all the way. It was like finding another IBM or Xerox.

Graham

Graham, who looks younger than his years, conceded the point to Cook: "Our experience was contrary to everything we preached." Then he added: "But it was an exceptional experience. We were identified with GEICO, and we were more or less boxed into it."

In other words, Graham got very rich because he was virtually a founder of GEICO and also because he was lucky. But luck isn't something you can bank on. That's Graham's whole point. You can't count on luck or being in on the true ground floor, but you can pick undervalued stocks and aim for a 50% gain. If you hit one out of four, you get a 12.5% return—not riches, but a lot better than you can do at the banks (or at the racetrack).

Try consciously to do what Graham-Newman did with GEICO, he says, and you'll probably come a cropper. "Situations like this are almost impossible to identify. The ones that seemed the easiest to pinpoint in the Fifties, the airlines, the computer companies, turned out to be full of pitfalls as investments. Right now people still have great confidence in the future of the drug companies, but in the multiples we've seen you have to count on the continuation of growth for the next 20 years!"

That point cleared up, Cook asked for a market reading: "Are we in a new bull market? Or will the rally fizzle?"

"I haven't a notion," retorted Graham, showing his distaste for the question. "All you can bet on is fluctuations." But he answered obliquely by saying he didn't think the world was ending or that common stocks had ceased being a good investment.

"I refuse to attach a permanence to anything I see around me—including the pessimism I read today in *The Wall Street Journal.* With my 60 years of experience, I can't tell you that any of the enormous developments I've witnessed, including two world wars and the spread of communism, have had any identifiable long-term effect on common stock investment.

"When I started in the investment business, the first thing that happened was that World War I closed down the New York Stock Exchange for five months. It looked as if the end of the world had happened, but after a year and a half we were in the midst of a raging bull market.

"Six months ago all you needed was a minimum of intelligence and a maximum of courage to be bullish. That's changed, of course. Now it requires less courage but more intelligence to find the values."

Graham's idea of "value" was out of fashion during the growth fad of the Sixties. These days, however, it is making a comeback.

Last Year's Tests

How does he define value? It's all there in his book, *Security Analysis*, which is now in its fourth edition. But for those who want a capsule definition we can tell you about an exercise the old master worked last year. He looked for stocks selling at a multiple that was twice as attractive as prevailing interest rates; this came out to a price/earnings ratio of 5.2 times earnings—a yield on an earnings basis of just over 19%. (If you figure that the current interest rate figure is closer to 8%, presumably his attractive P/E today would be a bit better than six.) Furthermore, the stock had to sell at a discount of 20% or more from book value; book value is central in Graham's system, because it indicates the assets standing behind a stock. "Then," he said, "I took an arbitrary 6% dividend return, assuming that you could add a growth rate to the 6% dividend and match the high rate of return on bonds. Finally, I used a price that was one-half the previous high in the stock as a sort of buy signal."

In a random sample of 108 Big Board stocks last year, he found that 75% of them met his tough criteria—a clear "buy" signal for stocks as a whole. As of mid-May, 29% of those stocks still met his criteria—despite the rally. That's not a direct but an indirect answer to our question: Yes, there are still values around.

What about inflation? Doesn't it wipe out the growth value of common stocks? "I'm not willing to accept that after 100 years of being a bullish argument for stocks, inflation could turn out to be a bearish argument. Through inflation, businesses have tremendous assets selling at a discount from their replacement costs. I think it shows the shortsightedness of the financial community not to recognize it."

For a long time, it was fashionable to proclaim that the individual investor was finished. He couldn't compete with the institutions with their computers, fast information and professional management. A myth, says Graham. "The institutionalization of the market has produced very disappointing results. The institutions have proved as limited as anybody in their intelligence and skill. They have proved unlimited in their imaginations, which is a defect in investment."

One reason the Ben Graham approach hasn't been popular among institutions is that it preaches, essentially, that the market is a place to look for a good return on your money but not a place to get rich.

The best opportunity for the intelligent (as opposed to the lucky) investor, Graham insists, is in buying stocks that are temporarily selling below their basic value and selling them when they get above it, holding a diversified portfolio of such securities for up to two years. That stocks do indeed fluctuate around a basic value, Graham does not for a moment doubt. "The first time the Dow Jones sold at 100 was in 1906. The last time it sold at 100 was in 1942. For 36 years, from 1906 to 1942, you could say that the market made no real progress. But in 14 of those years it hit the 100 mark over and over. You have an analogy now with the 800 level. Since 1964 the Dow has been at 800 in ten out of 12 years. You get the clear feeling somehow that the stock market is like a pendulum swinging to and fro around that price." The market, then, is an excitable but basically rational creature.

Before the most recent market crash, a good many people were inclined to scoff at Ben Graham, with his talk of assets, central value and the futility of forecasting future earnings. They weren't interested in pendulums. They were looking for rockets. Right now, however, Graham looks pretty good. Don't try to forecast the market, Graham says, don't look for miracle stocks. Stick with value, and the stock market will always bail you out in the end. If you stumble on a GEICO, so much the better. ■