

Benjamin Graham in

By Dennis Butler

Perspective



Benjamin Graham (L), pictured here with General R.E. Wood, an official of Sears, Roebuck and Co., 1955.

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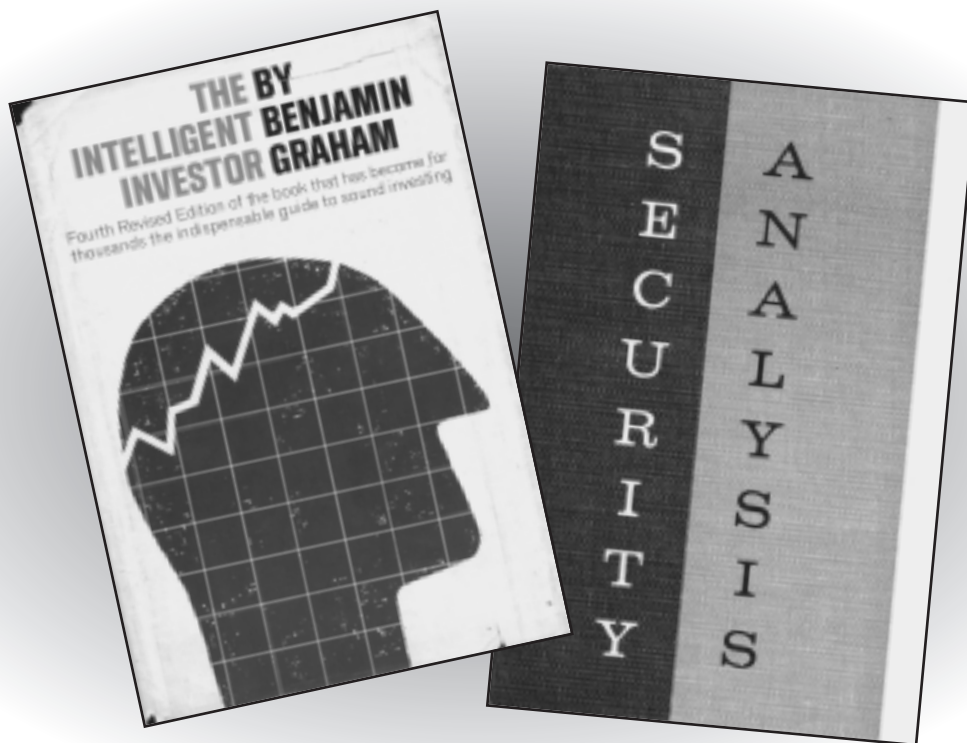
THE HISTORY OF INVESTMENT thinking is a neglected field, yet one of obvious value: our basic ways of approaching security analysis and investment, such as “growth” or “value,” are rooted in historical experience, practice, and ways of thinking. Names and instrumentalities change over time, but underlying issues, as well as the abilities and psychological makeup of investors, do not. A study of the craft’s past masters offers perspective and guidance to investors, much as politi-

cal history does to statesmen. There is, to be sure, an ongoing fascination with the market’s historical patterns and reactions to events. However, practitioners’ thinking about investment is a story lost to the majority of busy, practically-oriented investors.

Perhaps nowhere is the historical record less clearly understood than when it concerns Benjamin Graham, a central figure in 20th century investment practice and thought called the “father of financial analysis.” Graham

casts a long shadow over the field’s methods and professional structure, and his *Security Analysis* (1934) is known as the “Bible of Wall Street.” Terms such as “intrinsic value” and “margin of safety” are attributed to Graham. A school of investing—the “value approach”—views him as its patriarch. He helped to create professional organizations, including the New York Society of Security Analysts. Historical analysis reveals, however, that Graham’s contributions to investment *theory* were less significant for their originality than for their synthesizing quality. His actual contribution was to bring together and focus currents in investment thought already in existence. To appreciate that vital contribution and place his legacy in perspective, we must examine how conceptions of investing changed during the early 1900s.

In 1920, Graham issued a report stating, “if a common stock is a good investment, it is also an attractive speculation.” Although Graham (who in six years had risen from “gofer” to analyst at a brokerage firm) later claimed his assertion had been revolutionary, he was not alone. In 1917, Albert Atwood, in *The Exchanges and Speculation*, had similarly argued that “For a stock to be a good investment



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Benjamin Graham's two most notable works are *The Intelligent Investor* (1949) and *Security Analysis* (1934).

it must be a good speculation.” The language of these statements, familiar to market participants of the day, is somewhat puzzling to the modern reader, as is the reason why such pronouncements were controversial.

The “traditional view” held that securities transactions could be distinguished by the intentions and knowledge of the “operator.” An *investor* aimed for secure income, with absolute safety of principal. Only bonds, protected by legal covenants and issuer assets, met these requirements. If your interest was to benefit from a change in market value—to buy “for the rise” or sell “for the fall”—then you were a *speculator*. Common stocks, with volatile prices and no secure income, were the primary focus, and speculators battled on the “fields of speculation,”—the stock exchanges. Investing had an aura of permanence, speculation, of opportunism. Finally, those who traded stocks recklessly, with little

experience or knowledge of the issuing companies, and usually on thin margins, were *gamblers*.

These distinctions were taken seriously. “Are common stocks investments?” was a legitimate, if quaint-sounding, question subject to stormy debate into the 1930s. Other observations appear equally odd or comical to the modern reader. For example, a speculator forced to hold a position longer than anticipated “became an investor” inadvertently. Conversely, investors with substantial profits would sometimes realize them, thereby “becoming speculators.” People were surprised at the number of “speculations”—what we would now refer to as alternative, private equity, and venture capital holdings, or simply stocks—held in the estates of some of the era's great financiers, including the banker George F. Baker.

The investment-speculation distinction permeates the financial literature of the time. It was codified in the legal

system—in the “prudent man rule,” and in state laws regulating savings institutions. Nevertheless, the traditional view was not universally held, and the line demarcating investments and speculations had always been fuzzy. The idea that one could only *invest* in fixed-income instruments or that investment was indifferent to appreciation came increasingly into question at the time Graham entered Wall Street.

Contemporary observations reveal this tension. In 1911 Thomas Conway claimed in *Investment and Speculation* that the investment-speculation issue was “an academic question to which we need give but little attention.” Speculators and investors alike were alert to price trends. The speculator was an opportunist. The investor, although seeing himself as a long-term business partner, still was happy to see gains, and was inclined to sell if prices rose sufficiently. Edward Jones (*Investment*, 1918) said the *investor* must take

advantage of long-term price swings, weighing price and “intrinsic value,” and selling when securities were most profitable. David Jordan, author of *Jordan on Investments* (1919), a college text, wrote (employing a theme that figures prominently in Graham’s book) that “the name of a security has little to do with its investment status.” While not an “ideal investment,” a stock’s investment status lay in the issuer’s financial status (the ability to pay its dividend was crucial). Even Lawrence Chamberlain, author of the standard text *The Principles of Bond Investment*, acknowledged that investment and speculation were “inseparably related” and that appreciation was “properly and studiously sought for in an investment.” Investors were *obliged to speculate* to “obtain the greatest possible security for an investment.”

Around 1920 a new “profession of investment,”—investment counseling—came into its own. Investment counselors were professionals dedicated to the intelligent deployment of client capital based on research and experience, independent and free of the conflicts plaguing brokers and bankers. The work of these counselors expresses that era’s evolving thought about the nature of investing.

Morrell Gaines’s *The Art of Investment* (1922) offers an interesting transition from the traditional view. “Constructive investment,” as he terms it, is neither speculation nor the commitment of funds solely for income. Enhancing principal value is a legitimate goal, as long as income is maintained securely. Henry Sturgis, in *Investment, A New Profession* (1924), argues that investment entails speculation to some degree, speculation being (in a phrase suggesting Graham’s later definition of investment) “a transaction engaged in after careful study and consideration of all the relevant facts.” Stocks, says Sturgis, were “less unconservative” than blindly buying supposedly safe bonds. Acquired carefully, stocks’ profits offset the *loss of*

purchasing power. Purchasing power was also an issue for Dwight Rose in *A Scientific Approach To Investment Management* (1928). He writes of the difficulty equating conservatism with bonds, and speculation with stocks, if the result is to erode purchasing power. “Total return” is the proper objective of investment: both income and appreciation of principal.

For the new investment advisers, the investment-speculation distinction as traditionally identified with *types of securities* was disintegrating. Stocks, no longer *ipso facto* speculations, were, instead, a legitimate part of an investor’s portfolio. Interestingly, these views predated the publication of Edgar Lawrence Smith’s *Common Stocks As Long Term Investments* (1925) and Kenneth Van Strum’s *Investing In Purchasing Power* (1926), works implying that stocks were superior to bonds as *investments*, precisely because of stocks’ inflation-protection qualities. Unfortunately, Smith and Van Strum provided a theoretical justification for the disastrous New Era of the late 1920s, whose ultimate outcome—the 1929 crash—for a time undermined the idea that stocks could be legitimate investments. To their credit, a few of the new investment counselors had warned of New Era excesses.

There were other indications that the investment-speculation dichotomy was becoming increasingly strained. John Durand, addressing the equivalent of today’s “momentum” traders, writes, in *The New Technique of Uncovering Security Bargains* of 1928, of the modern “spec-investor” looking for capital appreciation opportunities. *Common Stocks and the Average Man* (1930) by J. George Frederick encourages the average man to “regard himself as an investment-speculator,” owning some bonds—traditionally the only appropriate investments for people of limited means—as well as “good common stocks” in order to share in the nation’s growth.

Philip Carret’s *The Art of Speculation* (1930) carries the concept of speculation as far as it can go; for his subject is not really speculation, but *investment* in the same sense that Graham would articulate it four years later. “The investor must speculate,” says Carret. To protect wealth from inflation, the investor “must consciously purchase a portion of security holdings with an expectation of profit.” Carret emphasizes the study of businesses, not market forecasts, and advocates purchasing “out of favor” stocks that are undervalued based on their *earning power*. In a phrase pre-saging Graham: “The road to success in speculation is the study of values.”

A common thread in these writings is a stress on “value.” As Gaines noted: “In the abstract, the investor needs to know only two things—the value of his security and the price at which it is selling.” Likewise, in a line hinting at Graham’s later “Mr. Market” parable: “The habit must be formed of sitting as a court of independent review on prices, aloof from the enthusiasms and pessimisms of the market place itself.” For Sturgis, investing was a matter of common sense, “based on a knowledge of what constitutes security values.” Rose observed that stocks had an advantage over bonds when purchased at an earnings yield (the ratio of earnings to stock price) exceeding bond yields—a value yardstick often employed by Graham. The reinvestment of earnings gave stocks a long-term advantage, but in a Graham-like note of caution Rose says stocks could be purchased with confidence “so long as the major part of excess earnings is not discounted in a greatly inflated market value.”

Thus, the notion of investment “value” predated *Security Analysis*. Indeed, the idea that securities had “intrinsic value” had appeared in financial literature for centuries and was incorporated into investment practice. Around 1720, Daniel Defoe

wrote of the hazardous purchase of securities at prices exceeding “intrinsic values” (Defoe had been caught up in the South Sea Bubble). Stockbroker and journalist William Fowler, in *Inside Life In Wall Street* (1873), frequently refers to a stock’s intrinsic value and the significance of value to operators such as Cornelius Vanderbilt. Henry Clews, a prominent banker of the late 1800s, wrote of buying stocks below their intrinsic values in his *Twenty-Eight Years In Wall Street* (1888). Likewise, “margin of safety” was a well-worn phrase used most often in bond analysis to refer to an issuer’s coverage of interest expense by earnings (or of dividends in the case of “investment grade stocks”), although this is not how Graham uses it.

The “study of values” implies principles and procedures. The first attempts to articulate fundamental investment principles began around 1900, and by Graham’s time, security analysis was playing an increasingly important and organized role. The evolution of investment thinking paralleled a transformation in American business. The early 1900s saw industrial corporations replace railroads as the dominant business entities. Large corporations, increasingly better financed and managed, gained greater political acceptance. Industrial stocks had become the “principal media of speculation” on the stock exchanges, taking over that role from railroad securities. With the growing capital needs of these organizations, Wall Street firms rose to the challenge. In demand were specialists trained to analyze the expanding number of issuers. Schools of business, such as those at New York University, Wharton, and Columbia, provided this training. Textbooks on industrial security analysis began to appear. Clinton Collver’s *How To Analyze Industrial Securities* was published in 1921; Walter Lagerquist’s *Investment Analysis*, the same year; Ralph Badger’s *Valuation of Industrial Securi-*

A Different Perspective on Graham

By Jason Zweig

As the editor of Graham’s book *The Intelligent Investor*, I thought I knew most of what there is to know about where Graham’s ideas came from. I was wrong. Dennis Butler’s article covers a great deal of ground that was new to me. I was particularly struck by Mr. Butler’s extensive citations of investing writers who came before Graham or were his contemporaries. This discussion is an important reminder that Graham was not a complete iconoclast but was also a product of his time.

However, the fact that most of Graham’s ideas came from somewhere else does not mean he was an unoriginal thinker. Graham had the genius to pull together strands of thought from many different sources and weave them into a precious new fabric that still bedazzles readers more than 70 years later. Graham blended insights from his mastery of mathematics, his decades of experience on Wall Street, his encyclopedic knowledge of classic literature and philosophy, and his profound understanding of human psychology – combining all these forms of learning into an analysis of investing no one has ever surpassed before or since. If Graham is not an original investing thinker, then who is?

King Solomon, in the Biblical book of Ecclesiastes, says that “There is nothing new under the sun.” Solomon was almost certainly restating an insight he got from some Hittite who, in turn, heard it from an Amalekite, who got it from a Babylonian, whose ancestors picked it up on the steppes

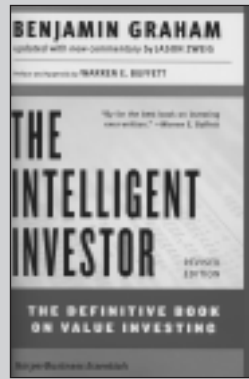
of central Asia. Does it matter how many people said it before Solomon?

The quality of ideas is not diminished merely because they have precedents. Anyone who has studied the history of innovation knows that even the most radical ideas do not come out of nowhere; they all depend on everything that has come before. The telegraph was “invented” several times before Morse came along, Leonardo da Vinci learned from Verrocchio and Pacioli, Beethoven built on Haydn, and the Wright brothers and Henry Ford benefited from the collective tinkering of several generations. When Sir Isaac Newton explained his own breakthroughs, he declared, “If I have seen further, it is by standing on the shoulders of giants.” That does not negate Newton’s achievement. Nor is Graham’s greatness dimmed by knowing that some of his ideas had already been expressed, in weaker form, by other people.

Graham lives on, while his predecessors have been forgotten, because he turned many small thoughts into a handful of huge thoughts. His legacy is not about borrowing ideas, but owning them. Other writers may have defined “value,” discussed the margin of safety, hinted at “Mr. Market,” or touched on the distinction between investing and speculating. But none of them unified all these ideas in a single masterpiece of writing and analysis. There’s a very simple reason Graham is immortal: While he may have had precedents, he has never had peers.

For Further Reading:

- Benjamin Graham (with Jason Zweig), *The Intelligent Investor*, 2003.
- Robert K. Merton, *On the Shoulders of Giants*, 1965.



ties, 1925; and Carl Kraft and Louis Starkweather's *Analysis of Industrial Securities*, 1930. Other texts, such as Chamberlain's standard work on bonds, first published in 1911, went through several editions, as did Jordan's *Jordan on Investments* of 1919. The emphasis was on bond analysis—especially in the earlier volumes. Many analytical themes from these volumes, as well as an emphasis on careful analysis and the analyst's duty to make the accounting adjustments needed to reveal true earning power, later made their way into Graham's *Security Analysis*.

The preceding discussion should make the opening chapters of the 1934 text—encompassing Graham's remarks on investment and speculation, the breakdown of the traditional view, and the impact of the Great Crash on investment thinking—more understandable to the modern reader. Remaining to be considered is why the book is considered groundbreaking. There is, for example, no indication that Graham sought to invent a “value approach” (the term does not appear in his writings until years later): that way of examining securities was not new. Nor did *Security Analysis* make its chief author the “father of financial analysis”—an already flourishing field. Instead, *Security Analysis* occupies an important place in the history of investment thought due to its “proposed definition of investment,” namely: “An investment operation is one which, upon thorough analysis, promises safety of principal and a satisfactory return. Operations not meeting these requirements are speculative.”

This definition's basic elements—“thorough analysis,” “safety of principal,” and a “satisfactory return”—were not only familiar, but lay at the heart of the traditional view. They were also essential to advocates of “value” in security selection—to avoid “greatly inflated” market values. Graham's definition is, indeed, a culmination of the trends in investment

thought during the previous 20 years, and a synthesis of the traditional view and the ideas of the new investment professionals, forged after the 1929 debacle. The effect was to *operationalize* investing, making it a matter of procedure and *measurement*—and consequently no longer identified with any particular type of security. Hence, *Security Analysis* was not organized according to the system of security types customary in finance texts—“corporation loan,” “civil loan,” and so on—but according to the analytical procedure appropriate in any given case: for example, “fixed-value investments” or “senior securities with speculative features.” Investment dealt with the security's actual interest in, or claim upon, an economic entity. Stocks were investments if selected according to analytical procedures and safeguards relating to valuation and diversification. A bond could be a speculation—even a *gamble*—if purchased blindly, without proper analysis.

These philosophical matters do not account for the acceptance, popularity, and enduring influence of Graham's work. Denizens of Wall Street are of a more practical and materialistic bent, so we must look for more worldly explanations. Graham's prior experience probably had much to do with the success of *Security Analysis*. He had been a brilliant practitioner for two decades prior to becoming the author of Wall Street's “bible.” An established reputation brought credibility. He was an engaging writer. For readers of other texts of that period, his book stands out. It is laced with examples—some current at the time of publication. It is written with a clarity and ease of style, even humor, seldom found in such works. The text was a practical “how to” manual that explained the “study of values” in concrete terms. Its appeal to those seeking to divine the secrets of Wall Street was understandable.

Graham was also an outstanding teacher. By 1934 he was well estab-

lished at the Columbia Business School and was popular among Wall Streeters. His course offered a theoretical foundation and also an opportunity for practical application (students often attended just to get investment ideas). He developed a following that would carry his methods forward to the present day—an ongoing tribute to the master. These more practical considerations are what has really attracted attention to Graham and his writings over the years. More esoteric matters, including his role in the old debate over investment and speculation, are largely forgotten.

In *The Intelligent Investor*, Graham laments the loss of the investment-speculation distinction, arguing that its simple conceptions of motivation and risk facilitated clear thinking about securities. When investors bought bonds and speculators traded stocks, even mentally lazy “operators” knew where they stood. However, when investment became a matter of procedures instead of titles, everyone played with the same toys. The distinctions were less obvious, and the costs of laziness greater. Graham warned of the risks resulting from people not clearly understanding what they are doing, and of the danger to Wall Street's credibility and capital. Ironically, the fading away of the old investment terminology may very well be one of Graham's own legacies: his endeavor to more clearly define *investment* has helped to foster the belief that mere ownership of a few shares of stock makes one an *investor*—even when they were acquired as a *speculation*. ■■

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