# ❖ Horizon Research Group ❖

## November 2008

*<u>Supplemental Musings</u>*

# *Essay – Benjamin Graham: Investor and Person*


**<u>Horizon Research Group</u>**

Steven Bregman
Thérèse Byars
Peter Doyle
Michael Gallant
Matthew Houk
Naveen Kumar
David Leibowitz
Eric Sites
Fredrik Tjernstrom
Steven Tuen
Murray Stahl

*PCS Research Services*
*125 Maiden Lane 6th Floor New York, NY 10038*
*(212) 233-0100*
*www.pcsresearchservices.com*

# *Essay – Benjamin Graham: Investor and Person*

Many value investors are acquainted with Benjamin Graham through the various editions of his classic investment textbook entitled *Security Analysis*. Far fewer are acquainted with Benjamin Graham via his autobiography. The textbook relates the truly timeless principles of value investing in their margin of safety dimension. Much as a physician is exhorted above all else to do no harm, the first mission of the value investor is to lose no capital. The autobiography relates how these principles were applied in the investment live of Benjamin Graham.

Although inference has been made thus far to the autobiography of Benjamin Graham, it is important to note that the editor has entitled the work as *Benjamin Graham: The Memoirs of the Dean of Wall Street*. In the introduction the editor makes great effort to delineate the difference between autobiography and memoirs. Autobiography requires extensive fact checking whereas memoirs are merely recollections as remembered by the author. Benjamin Graham's works are stated to be the latter. It is worthy of note that no scholar has ever published a biography of Mr. Graham despite his obvious importance to the evolution of investment thought. Yet, the investment community has never evidenced very much interest in the interests of Benjamin Graham. For instance, among many other accomplishments, Benjamin Graham was fluent in Spanish. He translated a novel entitled *La Trequa* (The Truce) into English. *La Trequa* is authored by the Uruguayan novelist Mario Benedetti. Mr. Benedetti is one of the most renowned Latin American writers, although he is essentially unknown in the English-speaking world.

Mr. Bennedetti was born in 1920. *La Trequa* was not published in Spanish until 1960 and this was Mr. Bennedetti's first novel. Benjamin Graham died in 1976. Thus, as an Anglophone, Graham must have been extremely well versed in then contemporary Latin American literature to appreciate Benedetti even before the Latin American reading public.

*La Trequa* is not considered Benedetti's best work. It is remarkable that Benjamin Graham encountered Benedetti's work late in life and was able to recognize the literary promise of the author. If one undertakes to understand the scope of Benjamin Graham's interests it is arguably easier to understand his view of the world. *La Trequa* is a novel that tells the story of how a middle-aged man with children expands his otherwise bland existence by commencing an extra-marital affair with a vibrant woman. In the novel, the protagonist views the affair as his last chance to enjoy happiness before he is overtaken by old age and solitude. Interestingly, the novel parallels certain portions of the Graham memoirs. In fact, according to the memoirs, Graham himself experienced similar encounters at a comparable age.

The memoirs are quite candid, although it is difficult for some readers to resist the conclusion that perhaps certain paragraphs were expurgated. Nevertheless, as a generalization, the memoirs are written in the confessional style practiced by such autobiographies as those of Rousseau, Cellini, or the Goncourt Brothers. Indeed, the journals of those last cited are referenced in the Graham memoirs with admiration.

If Graham was willing to be quite candid with regard to his personal life, there is no reason to doubt the veracity of those passages that relate to his investment life. The first investment item of note is that Graham executed a very expensive ten-year lease on a new duplex apartment on 81st Street and Central Park West in New York City. It was undertaken in the fall of 1928. The rent was $11,000 per annum.[1] In contemporary dollars, this would be equivalent to in excess of $172,000 or $14,369 per month. Such a sum would command a splendid apartment in 2008 New York City. The Graham family took possession in 1929. Benjamin Graham was 35 years old. His 1928 pre-tax income was in excess of $600,000.

The apartment expense does not appear to be extravagant in relation to Graham's income in 1928. Of course, in relation to real estate values, this was rather extravagant. Ultimately, Graham found that he could not afford the apartment and needed to lease a smaller dwelling.

Chapter 13 of the Graham memoirs relates his experience as an investor during the Great Depression. The chapter begins by comparing these experiences to Dante's version of hell. As is well known, Graham was a conservative investor. He makes mention of selected long positions such as Plymouth Cordage. The shares were trading at a price of $70 with in excess of $100 of working capital.[2] Such investments are classic value stocks. Graham mentions others such as Pepperell Manufacturing and Heywood and Wakefield.

The Graham Fund, then known as the Benjamin Graham Join Account, had the following positions in the middle of 1929, just prior to the stock market collapse. The fund had $2.5 million of capital. It owned $2.5 million of convertible preferred shares offset by an equal amount of equivalent common stock short sales. This arbitrage position is fairly common today. In 1929, such undertakings were considered to be very conservative and required very little margin. This was the case in the Graham Account.[3] There were also $4.5 million of genuine long positions and $2 million of borrowings against these positions. According to Graham's then computations this amounted to 125% margin (i.e., 4.5 long on 2 of borrowings, or exposure of 2.25x, for 125% leverage).

In the modern era the exposure would be calculated as follows:

$2.5M long convertible preferred
2.5M short common stock

[1] *Benjamin Graham, the Memoirs of the Dean of Wall Street (edited and with introduction by Seymour Chatman)*. New York, McGraw Hill, 1996, p. 244
[2] Ibid p. 250
[3] Ibid p. 254

| | |
|---|---|
| | 4.5M long common stock |
| | 2.5M portfolio equity |
| | $9.5M total exposure |
| | $2.5M portfolio equity |
| | 380% total exposure |

The investment performance results as reported by Graham were as follows.

| | |
|---|---|
| 1929 | (20)% |
| 1930 | (50.5)% |
| 1931 | (16.0)% |
| 1932 | (3.0)% |
| 1929 – 1932 | (67.7)% [4] |

Of course, as is known, Graham managed, subsequent to the Great Depression, to rebuild his fortune and ultimately achieve a level of wealth that he probably could not have imagined in 1929. One factor in the recovery was that in January 1934 his investors generously consented to remove the high water mark and re-instate performance fees.[5] However, another important factor is that the application of the principles of value investing once again generated results in accord with the historical standard subsequent to the summer of 1932.

This brief summary of investment experience invites two questions. First, should Benjamin Graham have anticipated the investment calamity of the Great Depression? Second, does there exist an inherent flaw in the philosophy of value investing such that the application of margin of safety principles does not always produce a margin of safety?

In answer to the first question, it would have been necessary for Benjamin Graham to have conceived in 1929 that the next four years would witness a circumstance in which production of goods and services for which there was evident demand in 1929 would become remarkably diminished in the ensuing years. Scholars still debate the causes of this phenomenon nearly 80 years after its occurrence. If Benjamin Graham failed to foresee the Great Depression, one cannot find many contemporaries who managed to foresee the calamity. Indeed, luminaries such as John Maynard Keynes or Irving Fisher fared no better than Graham.

In answer to the second question, it is perhaps sufficient to say that value investing is a technique that merely seeks to assess the worth of a given enterprise against its trading price at a given moment. It makes no claim to see the diminutions of value that are caused by economic crises.

[4] Ibid p. 255-259
[5] Ibid p. 268

Perhaps the greatest lesson of the Benjamin Graham investment experience is that even a serious setback does not necessarily preclude success from the consistent application of investment principles. This was properly summarized by Bernard Baruch with the famous quote, “Don’t try to buy at the bottom and sell at the top. It can’t be done except by liars.”

The arithmetical consequence of the Great Depression was that it was easily possible on 1932 to purchase high quality companies with dividend yields of 8% with borrowed funds demanding interest at no more than 2%. Consequently, one might well wonder whether the Great Depression nearly destroyed Benjamin Graham or whether it made Benjamin Graham possible. The Depression so traumatized the investment public that it was possible to easily find incredibly undervalued securities as late as the mid 1950s. Ironically, value investing is not an investment technique that will not prevent loss in the event of a widespread panic. It is a technique that should produce investment success in the aftermath of a panic.