❖ Contrarian Research Report ❖
Compendium

November 2008

Featured Companies

Charles River Laboratories International (CRL)
Sotheby's (BID)
Forest City Enterprises (FCE)
Texas Pacific Land Trust (TPL)

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The Contrarian Research Report

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Murray's Musings

Allusions to the Great Depression

Readers of these *Musings* will observe that the *Contrarian Compendium* includes an essay written several days ago about Benjamin Graham and his investments during the time of the Great Depression. One of the interesting things is that Graham's fund, known as the Benjamin Graham Joint Account, actually declined during the course of the Depression by, roughly, 67%. There are more details in the essay that I won't pursue at this point, but what is interesting is that investments as a subject, several years before the Internet bubble, have been revolutionized in the following sense: the subject has become part of the mass media. When any subject becomes part of mass media, I would assert that the subject becomes necessarily distorted and perhaps greatly distorted.

I will cite an example. The year 1828 in American history represents a watershed. Very few people who are essentially conversant with American history understand why it represents a watershed. The 1828 election was the first election in which the franchise to vote was greatly extended. The number of people who voted in the 1828 election was 3½ times greater than the number of people who voted in the 1824 election. And as a consequence, the 1828 election was conducted in a manner that had never been seen before in American politics.

The protagonists in the 1828 election were John Quincy Adams and Andrew Jackson. Andrew Jackson actually received the endorsement for President by the Tennessee legislature immediately subsequent to the 1824 election, so the campaign began shortly after the 1824 election ended. That is very reminiscent of the modern era. And it was the first election in which genuinely exaggerated statements were made. For example, the Jackson camp questioned the integrity and the personal honor of John Quincy Adams. John Quincy Adams as a President, whatever his defects may have been, probably would rank as the most honest person ever to serve as American President. And of course Jackson won the election – not John Quincy Adams. The idea of conducting a debate on a subject with relatively unsophisticated people, who lack the time and means to generally understand the topic, results in a distortion. I would submit the same sort of thing occurs in the modern investment era today.

For example, in China the economy is growing at 9% per annum, and it's not very difficult to find Chinese companies that trade at a discount to book value and trade at single-digit P/E ratios that actually have growing earnings. In any kind of classical definition of value one would have to include many Chinese companies. In addition to that it is almost self-evident that the Chinese currency, the renminbi, is massively undervalued relative to the U.S. dollar. So when one buys a Chinese company whose earnings occur within the context of China itself and, therefore, its earnings represent a pure Chinese currency

stream, one is effectively buying a put option on the U.S. dollar relative to the renminbi and buying it for free. It's an extraordinary instance of value completely ignored by the financial media.

The estimates that are generally given by the financial media regarding subjects such as loan losses, ultimately realized either in the subprime sector or in the larger loan sector, are not merely unlikely – they're simply mathematically impossible. It is not very difficult to peruse newspapers and find statements like the following: "Ultimately, there will be $1.4 trillion of losses from subprime". This is simply impossible because $1.4 trillion is the total amount of subprime loans that were made at its high point. $1.4 trillion of subprime loans at face value does not exist at the moment. And, therefore, if each and every subprime loan were to default and the underlying collateral were to be absolutely worthless, there would not be $1.4 trillion of losses, nor could there ever be $1.4 trillion of losses. Indeed, there may well be substantial losses from subprime and those losses may well be sufficiently grievous to put in question the solvency of given banks, but, in any case there will not be $1.4 trillion of losses from subprime.

In sector after sector after sector, the popular understanding is, I think, enormously deficient. In the latter years of the Depression, that's ultimately the circumstance that Ben Graham felt. If one were to examine what we know about Ben Graham's portfolio at the onset of the Depression, one would find that he was buying classically undervalued companies in the sense generally understood when one reads *Security Analysis*. Ben Graham in his long positions was buying companies at a discount to net working capital. It was not readily conceivable to anyone that ultimately this net working capital would diminish by the depth of the financial crisis.

However, at the end of the financial crisis the following circumstance was the case: It was possible to purchase with margin, carrying an interest rate of 2%, a stock having a dividend yield of 8% and a very secure dividend. That was the exact reverse of what it was possible to do in 1929. In 1929, it was not unusual, because the broker call rate – the call money rate – had risen to 8%, for individuals to borrow money paying an interest rate of 8% to buy a stock with a 2% dividend. There actually is a passage in Benjamin Graham's memoirs where he relates a meeting that he had with Bernard Baruch in which they actually discussed that circumstance and how bizarre it really was. And that's a circumstance that actually required correction, so to speak. That was an instance of disequilibria in financial markets.

Once one element of markets is placed in disequilibrium there are occasions, and the Great Depression is one of them, when the resulting disruption to the lending market actually causes disequilibria in all sorts of other markets. So what is the lesson to be learned, if there is a lesson to be learned, from Benjamin Graham? Should he have ceased the practice of value investing even though we now know in retrospect his portfolio diminished in value during the course of the Great Depression by 67%? Should he have ceased investing and should he have forecasted that many of the companies that he thought

were undervalued would become even more enormously undervalued? Or should he have continued pursuing his principles as he thought it right to do, not realizing how deep and serious the Depression would become? And I think the only thing a reasonable person can do is the former, not the latter, because no one has the ability to forecast these massive disequilibria. Investing is done on the premise that these massive disequilibria will rarely occur. Of course they ultimately occur and they're usually a once in a generation event. Sometimes they're once in a century event. And the great irony in the life of Benjamin Graham was that at the end of 1932, he had a veritable cornucopia of remarkable investment opportunities. He ultimately managed to rebuild his wealth to a level that was probably unimaginable in 1929.

The interesting question to ask is – though we can't possibly know the answer – had the Great Depression never occurred, would Ben Graham at the end of his life have been a wealthier person or a poorer person? I think, ultimately, because of what happened in the Great Depression, Ben Graham ultimately became a wealthier person. The Great Depression was sufficiently severe such that it actually removed an entire generation of investors. And investors didn't begin to return to the marketplace for a quarter century subsequent to the Great Depression. So even as late as the 1950's, it was possible to find companies that were trading at low single-digit multiples, in many cases trading at a discount to working capital or even to cash on the balance sheet.

I believe that this is such an instance – that the decline in equity prices year-to-date is on a parallel with the Great Depression. But nothing else is. So, for example, in the Great Depression, the United States of America ultimately realized 25% unemployment. The market may well be forecasting 25% unemployment, but is it a reasonable forecast? When the United States government and state government spending represents a very substantial portion of the economy, and it did not represent that portion or anything close to that portion in the Great Depression, it is highly unlikely the United States government will make employees redundant. Similarly, the healthcare sector, which was an infinitesimally small segment of the American economy in 1929, is now 16% of the GDP. It's highly unlikely that persons in need of medical care as a generalization will not receive medical care irrespective of whatever might happen in the economy.

Similarly, there are other industries at least to date that have not suffered a severe diminution of activity, an example of which might be the entertainment industry. Perhaps in short order that industry will suffer a serious diminution of activity, but it has yet to happen. It is conceivable that the country might consume a diminished number of barrels of oil. The United States consumes somewhere between 22 and 23 million barrels of oil a day. It's hard to imagine the United States will consume, three years from now, 14 million barrels a day. It's hard to imagine the oil industry suffering a decline like it suffered in the Great Depression. One can reflect upon the various industries and see if it's reasonable.

In the Great Depression there was no unemployment insurance, there was no Social Security, there was no welfare. The savings rate may have been higher, but the savings

were concentrated largely among wealthy people. The vast bulk of the population had very little savings. And according to the figures of the Investment Company Institute, even though the savings rate in America is very low, there are tens of millions of people with large accounts in 401Ks. Many corporations have 401K or savings programs. This was essentially nonexistent during the Great Depression. Many persons own life insurance annuities. That existed during the Great Depression but only for a relatively select few. So the differences are enormous, but they're not remarked upon. I would conclude by saying that to compare this era to the Great Depression is not only ludicrous, it's actually irresponsible.

Industry Thoughts

The Gold Industry

The industry I'm going to talk about is reflective of a phenomenon that only happens during unique moments in history. First I'll give some numbers then I'll say what the industry is. On October 17, 2007, gold closed at $762.50 an ounce. On October 17, 2008, gold closed at $784.50 an ounce. So the price of gold increased modestly in that 12-month period. Any analyst following gold stocks on October 17, 2007 that was able to forecast the price of gold one year forward would probably have reasoned that the typical gold company would be unchanged in value. And the reason is that the only significant elements in calculating gold company profitability is the gold price and the quantity of production. They also need to take into account the cash production cost, but it doesn't radically change from year to year.

And production, generally speaking, doesn't radically change year to year. In most industries when production diminishes, earnings diminish. It's not entirely clear that this happens in the gold industry because when production diminishes, the price of the commodity might actually increase. So the gold industry is a little bit more complicated. But the most likely forecast would have been for the gold stocks to be more or less unchanged.

Now in that period of time, that year ending on October 17, 2008, Newmont Mining has declined by 40%. Barra Gold has declined by 40%. Goldcorp has declined by 40%. Kinross Gold has declined by 40%. Anglo Gold, which is a foreign company, has declined by 60%. The production figures, the replacement of reserves, the cash production prices and many other variables of all the five companies cited are actually different. In principle, apart from the gold price, these companies should have exhibited a wider spread of stock price performance. They did not because they trade as pieces of paper not unlike the commodity they mine. The actions of investors in the last year have really been the actions of individuals interested in controlling portfolio variability. One is more inclined to sell Anglo Gold as opposed to Newmont Mining simply because Anglo Gold, being a foreign company, is considered to have a greater range of variability. So Anglo Gold has declined more than Newmont Mining.

The P/E ratios using the best forecasts we can have of the companies in question are as follows: Newmont Mining trades at a P/E ratio of 10x 2009 earnings; Barra Gold trades at a P/E ratio of 9.7x; Goldcorp trades at 18x; Kinross at 11.9x; and Anglo Gold at 5x. Generally speaking, when gold companies trade at such low valuations, it's because the market expects a huge decline in the gold price. And the gold price is more or less at the level it attained in 1980. In the world of uncontrolled gold prices where the demand for gold is actually greater, where the formerly communist nations have actually become part

of the world monetary system, and considerable wealth is already being created in those nations in addition to various emerging markets – the demand for gold as an investment, the demand for gold in the form of jewelry, is clearly much greater than it was in 1980. It's hard to imagine that the gold price is on the verge of collapse, due to basic demand changes, save for the fact that gold is also an investment vehicle. Essentially, what's happened over the last year is that the ability to borrow money to undertake virtually any investment has become much reduced. Therefore, the demand for virtually any investment has become much reduced, and that's reflected in the price. It's hard to imagine that's a variable that's going to continue to operate for very long.

The actions that various nations have undertaken to address that problem are all inherently inflationary. They all involve greatly increasing liquidity, and they all involve increasing the money supply, and they all involve increasing national debt – in many cases enormous increases of national debt. It is the environment in which gold flourishes as an investment; it is not the environment in which gold collapses as an investment.

And, incidentally, it's worthy of note, the actions undertaken by the various governments in recent weeks are completely at variance to the actions or lack of action undertaken by the various governments in the Great Depression. In the Depression, the governments were greatly reluctant to expand public spending. As a matter of fact, where possible, the governments diminished public spending. They were interested in curtailing debt. It's the exact opposite now. Securities prices are acting much as they acted during the Great Depression; the governments are acting in the reverse. Gold is trading as if it were a repetition of the historical circumstance in the early 1930's; the governments are acting in the exact opposite fashion. So there's something incredibly irrational about the gold industry, and any of these companies would be an interesting investment, in my opinion.

Featured Companies

Just to show that irrational pricing is not confined to the gold industry, yet is widespread, here are some examples of companies that have valuations that I would've not long ago thought were impossible.

Charles River Laboratories International, Inc. (CRL)

Charles River is involved in a number of industries, one of which is that the company breeds and uses animals in pharmacological diagnostics. So it uses animals to support clinical trials of new drugs – it uses animals in genetic testing. It is a significant company. As a matter of fact, I don't think you can even have clinical or pre-clinical trials without companies such as Charles River.

One of the interesting things about Charles River, and it doesn't necessarily pertain only to this company, is Charles River recently established a 60,000 square foot pre-clinical trials laboratory in the City of Shanghai. That's something that is not necessarily important viewed from an earnings perspective; it's just important to illustrate another point. The axis of business activity worldwide is gradually shifting from the Atlantic to the Pacific. So if one reflects upon the number of doctoral awards from Chinese universities and the number of persons who are each year joining the ranks of pharmaceutical researchers, it's really astonishing and it makes one hopeful that within several years there are going to be amazing advances in science in this area.

Charles River itself has been expanding its global presence in all sorts of nations. Some of this has been done by acquisition, some by organic growth. The company in this sense is not at all different from the character of completely unrelated companies such as Coach or Tiffany's. They're gradually altering their geographical presence around the globe simply to reflect, as necessarily would be the case, a shift in the major axis of business activity from the Atlantic to the Pacific region. Organically, Charles River normally grows at 10% per annum simply because biological research around the globe is growing at 10% per annum and the company is obviously a direct beneficiary of that. Generally speaking, Charles River trades at a P/E ratio in the neighborhood of 20x. At the moment, it trades at a P/E ratio of 11.9x. So from the point of view of Charles River, it's virtually unheard of that one can buy a company of this quality for a valuation so low. The company, as should not surprise the reader, has been a buyer of its own shares. It's purchased $57 million of stock in the last six months. This is not small amount of money for a growing company.

Sotheby's (BID)

Sotheby's has lost 80% of its value in the past 12 months. At the moment, it trades at 4x estimated consensus 2009 earnings. To be fair, in the first six months of the year, the company experienced a very, very modest earnings diminution. But that earnings diminution did not result from a change in the organic fundamentals of the business – it simply resulted from a shift in the auction calendar from the second quarter to the third quarter. So, certain art auctions will take or have taken place in the third quarter that would ordinarily have taken place in the second quarter.

The real change in the Sotheby's business has very little to do with the economy. There has been, over the last four or five years, an enormous expansion of collectibles as a generalization. Anyone who studies Sotheby's will merely note the expansion of the Sotheby's catalogue to all sorts of objects that many years ago would not have been considered to be art or would not even have been considered to be of value. Sotheby's is a much bigger company than it was years ago in every respect other than its stock price. It was founded on March 11, 1744. So, clearly, the Sotheby's business franchise has endured wars, recessions, depressions, and inflations. I am not prepared to forecast what the economy might be several months hence, but it seems to me that whatever eventuality will ultimately arise, Sotheby's historically has experienced it and successfully weathered it.

To give an example of the change in the nature of the Sotheby's business, one can observe the following. On October 8, 2008, in Paris, there was an auction – not for a work of art, but for the manuscript of a song. This particular song might not mean very much to the Anglophone world, but the name of the song is "Amsterdam" and the artist was Jacque Brel, who in France is more or less an icon. The manuscript of that song sold for 108,750 Euros. It's not something you would've seen at Sotheby's historically. Similarly, on September 20, 2008, at a rare wine auction, Sotheby's raised $2,867,397 for selling some unique wines. That's not the sort of thing one ordinarily associates with Sotheby's.

So what is really the virtue of Sotheby's business franchise? It basically brings buyers and sellers together in an environment where there actually is price discovery. Of course, one could buy old manuscripts, paintings, vases, or collectibles from dealers but it's not the auction format. And if you buy outside of the auction format, you really have no notion of market depth. If you buy in auction, you at least have the comfort, such as it is, of knowing that someone else was willing to pay slightly less than you were willing to pay. In the world of collectibles, where each collectible is unique, how does one achieve price discovery and knowledge of value without the auction process? I suppose ultimately someone owned the manuscript for Jacque Brel's "Amsterdam" – in principle, one could've encountered that person and made an offer, but how is one to assess value if one doesn't have a sense of what the market is willing to pay?

So Sotheby's is a unique company – it has a genuine mission to fill in the marketplace and its main competitor is Christie's. Those two companies for well over two centuries have

dominated this market. And there's no reason to believe that's going to change. In the first six months of 2008, the actual Sotheby's auction sales was a record $3 billion. So it was never greater. Sotheby's in July sold $175 million worth of convertible notes due 2013. At that time, the conversion price was set at $34 a share. Sotheby's is now trading at less than $11. So it gives one a sense of how in a little over three months the price of the shares collapsed irrespective of what might be happening in the company. So, to repeat, Sotheby's is trading at 4x the consensus 2009 earnings forecast.

Forest City Enterprises (FCE)

Forest City Enterprises is unique among real estate companies because it is an owner and developer of all sorts of properties and it is not a real estate investment trust. It actually functions in the C-corp status, which makes it unique. Unlike a REIT, which is required to pay out 90% of its earnings, a C-corp can reinvest al of its earnings. The cash flow of a typical real estate company, because of depreciation charges is, generally speaking, rather large. Forest City essentially has had the following investment methodology for, roughly, seven decades. It buys property in deteriorating metropolitan neighborhoods. It buys up sufficient quantities of property so that it can undertake a vast redevelopment of an entire area and thereby change the character of the neighborhood, that the value in part is actually created by the projects themselves. In that sense, the company actually creates its own appreciation potential.

Forest City represents a cross section of all the different types of real estate. This is very different than a typical REIT, which is generally confined to a certain type of real estate, such as malls or office buildings. The distribution of types of real estate for Forest City is as follows: it owns 19 regional malls, 32 specialty retail centers, 50 office buildings with 13.5 million square feet, 5 hotels with 1,823 rooms, 120 apartment buildings comprised of 35,000 units, 10,497 acres of land that might be developable, and 8 military housing complexes with 11,950 units within them. Forest City trades at a price of, roughly, $15. Its 2007 cash flow per share, defined as earnings before depreciation and taxes, was $2.47. By that measure Forest City is trading at 6x its cash flow. The 2008 EBDT should be over $3, so its cash flow multiple is 5x.

The occupancy rates, at least insofar as we know them, are as follows: the retail occupancy rate is 92.5%, the office occupancy rate is 92.7%, and the residential apartment occupancy rate is 92.5%, which actually has modestly diminished versus last year when it was 93.9%. The leases are generally structured to have escalation privileges within them, unless the occupancy rates drop enormously, the cash flow is likely to rise.

The company has a variety of projects in various phases of construction. It opened five projects in the first half of 2008. As those projects reach higher occupancy levels, it's rather likely that the cash flow is going to be higher in 2009 than 2008.

The company has, at the moment, 13 projects under construction valued at $2.3 billion. There are also 15 projects under development, as opposed to under construction, and the development really involves development costs. These 15 projects have so far entailed the expenditure of $900 million. So there's a lot in the pipeline, so to speak. The market is very concerned because Forest City has a leveraged balance sheet. For every dollar of equity there is at least $5 of debt. Most of the debt, though, is non-recourse mortgage debt; its recourse only to a given property. However, there are some debt maturities. In 2009, there are approximately $901 million worth of debt maturities. Of that $901 million, approximately 50 percent have already been restructured and are in the course of being refinanced. So the actual 2009 maturity structure is manageable.

In terms of the basic balance sheet apart from these mortgages there is a $20.4 million development bond issue due in 2010, a $287 million puttable equity note due to the company on October 15, 2011, and as far as other notes or bonds that have recourse to the company, there's $300 million due in 2015, $150 million due in 2017, and $100 million due in 2034. The balance of the debt is non-recourse mortgage debt, and it is actually very considerable, since it represents 75% of all debt. 75% of all the mortgage debt is at a fixed rate and the refinancings have been taking place, giving the company declining debt costs. So at the moment, Forest City is well on its way to refinancing most of its mortgages with an average coupon of 5.5%. $1.76 billion have been refinanced thus far.

If one enters a world of inflation, which is a not unlikely consequence of various government policies around the world, this will be an extraordinary investment. The company is locking in a multi-decade cost of capital at 5.5%, which is more or less equal to the inflation rate as it exists today, and there are many who would assert that that inflation rate is understated. Cash flow is highly likely to grow and the company will undoubtedly embark upon new projects. The company has also been, in the last six months, a re-purchaser of its own shares for reasons that should be self-evident.

Texas Pacific Land Trust (TPL)

Last but not least, Texas Pacific Land Trust is literally a trust that owns slightly fewer than one million acres of land in Texas, most of which is used for grazing purposes. So the land generates a modest cash flow from grazing fees. The company also owns a variety of mineral rights and, at different prices of oil, the company is able to exploit those. Occasionally the company sells small amounts of acreage. The implied value of the acreage is, roughly, $300 an acre. This is land located in West Texas – one cannot buy grazing land in West Texas at a price anything remotely close to $300 an acre. So on the basis of land values as they exist today, the stock is enormously undervalued.

But the interesting feature of Texas Pacific is actually a mathematical feature. Texas Pacific typically takes a certain portion of its cash flow each year and uses it to buy in shares. In recent years it has been repurchasing approximately 1.7% of its shares annually.

So 13 years ago, when Horizon originally published a ***Contrarian Research Report*** on the company, the situation was much the same except the asset values were much lower. 13 years ago, we constructed a table that was designed to model what might happen to the stock price given a certain more or less predictable share repurchase rate and a certain more or less predictable reasonable inflation rate. As a consequence, the asset value per share, by definition, is consistently rising; and if the stock price doesn't change, the asset value is continuing to rise, by definition, at an increasing rate. Just like a problem from calculus.

Ironically, in a weak equity market as the price of all shares, inclusive of Texas Pacific Land Trust, fall, the purchasing power of the cash flow such as it is at Texas Pacific becomes necessarily greater. So in a weak equity market the asset value will rise at a greater rate than it ordinarily would. A weak equity market is actually an ally of a company that seeks to repurchase its own shares. So I think Texas Pacific Land Trust, illiquid though it is and likely to become less liquid as the company pursues its share repurchase program, is at an interesting entry point for an investor.

APPENDIX A

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:

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[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

$2.5M	long convertible preferred
2.5M	short common stock
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

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

price at a given moment. It makes no claim to see the diminutions of value that are caused by economic crises.

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.

Appendix B

Money Manager Index

From Jan 1983 to October 2008

Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Yr. End	Index	Yearly return	Annualized retu (since inceptio
1983								1.00	0.81	0.76	0.87	0.75	1983	0.75	(60.5)%	(50.2
1984	0.75	0.71	0.70	0.66	0.67	0.67	0.61	0.83	0.79	0.76	0.67	0.65	1984	0.65	(13.5)%	(26.5
1985	0.92	0.93	0.99	0.95	1.20	1.30	1.32	1.38	1.28	1.50	1.86	2.02	1985	2.02	211.8%	33.
1986	2.46	2.78	2.47	2.31	2.36	2.33	2.03	2.23	1.98	2.37	2.34	2.34	1986	2.34	15.9%	28.
1987	3.21	3.27	3.16	2.55	2.37	2.30	2.39	2.47	2.22	1.56	1.44	1.52	1987	1.52	(35.0)%	9.
1988	1.80	1.87	1.78	1.79	1.69	1.94	1.92	1.96	2.01	1.97	1.95	2.07	1988	2.07	36.0%	14.
1989	2.42	2.37	2.54	2.63	2.64	2.64	2.93	3.12	3.07	3.05	3.23	3.26	1989	3.26	57.8%	20.
1990	3.12	3.15	3.53	3.06	3.47	3.45	3.30	2.70	2.68	2.40	2.52	3.02	1990	3.02	(7.3)%	16.
1991	3.08	3.49	3.70	3.68	3.71	3.61	3.86	4.05	4.07	4.69	4.47	5.72	1991	5.72	89.4%	23.
1992	5.76	5.61	5.30	5.12	4.98	4.99	5.93	6.06	6.19	6.56	7.25	7.36	1992	7.36	28.6%	23.
1993	8.06	8.04	8.20	7.94	8.15	8.57	9.05	10.00	9.99	9.31	8.97	8.90	1993	8.90	21.0%	23.
1994	9.52	8.73	8.05	7.85	7.81	7.53	7.66	8.31	8.15	8.52	7.88	7.95	1994	7.95	(10.6)%	19.
1995	7.74	8.38	8.72	8.77	9.20	9.35	9.93	10.78	11.22	10.53	10.89	10.40	1995	10.40	30.8%	20.
1996	11.12	11.50	11.33	11.62	11.86	12.53	11.91	12.36	13.32	14.03	14.42	15.02	1996	15.02	44.4%	22.
1997	16.04	16.81	15.32	17.27	18.42	20.29	22.28	21.39	25.31	24.95	24.95	25.50	1997	25.50	69.8%	25.
1998	25.67	29.00	29.89	30.60	28.90	30.44	27.67	21.33	21.74	25.16	27.27	25.41	1998	25.41	(0.4)%	23.
1999	26.00	23.71	23.92	26.77	28.94	29.74	28.78	26.74	25.89	27.73	28.54	30.55	1999	30.55	20.2%	23.
2000	31.07	31.19	36.01	35.60	35.20	40.32	43.58	45.75	45.62	48.69	44.05	49.84	2000	49.84	63.1%	25.
2001	50.23	46.41	44.27	46.96	48.90	49.98	50.67	49.70	46.47	44.81	48.04	51.91	2001	51.91	4.2%	23.
2002	53.62	53.74	55.11	52.52	52.83	50.48	42.58	44.92	41.54	42.66	45.78	43.17	2002	43.17	(16.8)%	21.
2003	42.72	41.18	42.36	45.98	49.02	50.71	53.47	53.97	53.46	56.12	55.83	58.49	2003	58.49	35.5%	22.
2004	64.38	65.08	64.63	61.68	60.86	62.30	58.71	64.08	65.73	68.86	73.53	78.16	2004	78.16	33.6%	22.
2005	76.46	77.94	74.06	72.83	77.02	80.25	83.59	83.07	86.03	89.19	96.58	97.35	2005	97.35	24.6%	22.
2006	107.62	111.44	110.75	111.88	101.89	100.61	100.62	104.98	114.61	116.64	113.78	118.05	2006	118.05	21.3%	22.
2007	125.73	123.77	122.62	127.58	133.57	134.68	126.61	124.07	133.57	148.09	135.13	135.56	2007	135.56	14.8%	22.
2008	127.53	115.76	115.94	121.58	130.51	115.68	119.94	120.55	109.69	72.70			2008	72.70	(46.4)%	18.

Name	Amount Invested
Affiliated Manager	$ 22,947
Alliance	$ 7,633
BlackRock	$ 23,205
Waddell & Reed	$ 27,513
Eaton Vance	$ 2,641
T. Rowe Price	$ 2,423
Franklin resources	$ 908
Legg Mason	$ 1,000
Federated Inv	$ 26,381

Name	Amount Invested
Pzena Investment Mgt	$ 122,426

Appendix C

International Money Manager Index

From Jan 1983 to Oct 2008

Year	31-Jan	28-Feb	31-Mar	30-Apr	31-May	30-Jun	31-Jul	31-Aug	30-Sep	31-Oct	30-Nov	31-Dec	Yr. End	Index	Yearly return	Annualize (since in
1986											1.00	1.02	1986	1.02	10.0%	
1987	1.25	1.37	1.48	1.48	1.37	1.33	1.39	1.40	1.33	0.81	0.76	0.73	1987	0.73	(27.7)%	
1988	0.75	0.92	1.02	0.95	0.80	0.89	0.88	0.82	0.86	0.88	0.89	0.93	1988	0.93	26.4%	
1989	1.03	1.02	1.06	1.17	1.19	1.18	1.25	1.16	1.17	1.20	1.21	1.28	1989	1.28	37.8%	
1990	1.24	1.24	1.18	1.19	1.22	1.24	1.26	1.26	1.23	1.24	1.25	1.33	1990	1.33	3.7%	
1991	1.34	1.52	1.56	1.58	1.57	1.47	1.52	1.64	1.81	1.89	1.94	1.92	1991	1.92	44.8%	
1992	2.01	1.93	1.88	2.14	2.19	2.13	2.08	1.99	1.95	1.77	1.76	1.96	1992	1.96	1.9%	
1993	1.98	2.03	2.20	2.39	2.42	2.45	2.54	3.05	3.01	3.07	3.01	3.30	1993	3.30	68.7%	
1994	3.72	3.39	3.17	3.04	2.99	2.89	3.01	3.14	3.13	3.19	3.15	3.15	1994	3.15	(4.7)%	
1995	3.07	3.12	3.28	3.41	3.56	3.59	3.87	3.76	3.76	3.77	3.70	3.73	1995	3.73	18.6%	
1996	3.76	3.85	3.70	3.79	3.96	3.90	3.75	3.96	4.16	4.47	4.90	4.86	1996	4.86	30.3%	
1997	5.11	5.37	4.99	4.96	5.43	5.94	6.57	6.32	7.45	7.24	6.80	7.19	1997	7.19	47.9%	
1998	7.12	8.05	8.78	9.25	8.95	8.74	8.91	6.67	6.08	7.01	7.51	7.71	1998	7.71	7.3%	
1999	7.99	8.21	8.68	9.07	8.71	8.61	8.63	8.43	8.47	8.79	9.80	10.79	1999	10.79	39.9%	
2000	11.23	12.27	13.95	13.50	13.73	15.39	15.85	16.82	17.07	16.31	14.43	16.76	2000	14.43	33.8%	
2001	17.42	15.88	13.46	15.14	15.84	15.15	14.21	13.61	10.77	11.43	13.90	14.12	2001	14.12	(2.2)%	
2002	14.74	13.78	15.09	15.11	16.38	14.14	12.92	12.10	11.23	11.06	11.33	10.50	2002	10.50	(25.6)%	
2003	10.18	9.52	9.69	10.62	12.17	13.04	13.98	15.38	16.67	17.88	18.16	18.07	2003	18.07	72.1%	
2004	20.00	22.41	29.98	35.46	26.68	30.80	25.37	25.20	23.67	23.34	27.56	31.48	2004	31.48	74.2%	
2005	32.19	32.57	31.88	27.79	27.36	29.05	30.38	31.49	33.39	32.24	32.95	37.18	2005	37.18	18.1%	
2006	41.01	40.97	43.69	46.45	42.39	41.58	40.60	43.32	43.55	43.70	44.58	49.38	2006	49.38	32.8%	
2007	50.95	51.18	53.59	56.09	58.16	56.37	53.90	48.65	50.96	57.03	48.21	45.75	2007	45.75	(7.3)%	
2008	38.71	39.71	38.59	40.18	39.25	35.10	34.59	33.33	26.09	18.72			2008	18.72	(59.1)%	

Name	Amount Invested	Name	Amount Invested	Name	Amount Invested
IGM FINANCIAL INC	$1,000	HENDERSON GROUP PLC	$14,447	BLUEBAY ASSET MANAGEMENT/UNI	$37,469
F&C ASSET MANAGEMENT PLC	$1,203	RAB CAPITAL PLC	$24,603		
INVESCO PLC (PREVIOUSLY AMVESC	$1,357	AZIMUT HOLDING SPA	$21,908		
SCHRODERS PLC	$1,208	AUSTRALIAN WEALTH MANAGEMENT	$27,789		
RATHBONE BROTHERS PLC	$1,208	EVEREST BABCOCK & BROWN LTD	$23,437		
ABERDEEN ASSET MGMT PLC	$1,208	NEW STAR ASSET MANAGEMENT	$27,700		
CI FINANCIAL INCOME FUND	$2,585	CHARLEMAGNE CAPITAL LTD	$36,848		
MAN GROUP PLC	$2,862	PARTNERS GROUP-REG	$36,848		
AGF MANAGEMENT LTD-CL B	$3,343	INVISTA REAL ESTATE INV MNGT	$36,589		
SPARX GROUP CO LTD	$11,762	ASHMORE GROUP PLC.	$36,688		