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Notes to book "Security Analysis" 6th edition
Written by: Benjamin Graham and David Dodd

I thought these quotes from Security Analysis Sixth Edition Hardcover might be food for thought.

Benjamin Graham and David Dodd first wrote security Analysis in 1934. The first edition was described by Graham as a "book that is intended for all those who have a serious interest in securities values." The book was not designed for the investment novice. One must have an intermediate to advanced understanding of financial statements, accounting and finance for the book to be understood. The book emphasizes logical reasoning. Graham wrote, "It is the conservative investor who will need most of all to be reminded constantly of the lessons of 1931 –1933 and of previous collapses."

On Page [xiv] Seth Klarman wrote:

"Losing money, as Graham noted, can also be psychologically unsettling. Anxiety from the financial damage caused by recently experienced loss or the fear of further loss can significantly impede our ability to take advantage of the next opportunity that comes along. If an undervalued stock falls by half while the fundamentals – after checking and rechecking – are confirmed to be unchanged, we should relish the opportunity to buy significantly more "on sale." But if our net worth has tumbled along with the share price, it may be psychologically difficult to add to the position."

On Page [xviii] Klarman wrote:

"Skepticism and judgment are always required."

"Because the value of a business depends on numerous variables, it can typically be assessed only within a range."

"In the end, the most successful value investors combine detailed business research and valuation work with endless discipline and patience, a well-considered sensitivity analysis, intellectual honesty, and years of analytical and investment experience."

On Page [xx] Klarman wrote:

"Even in the worst of markets, Graham and Dodd remained faithful to their principles, including their view that the economy and markets sometimes go through painful cycles, which must simply be endured. They expressed confidence, in those dark days, the economy and stock market would eventually rebound: "While we were writing, we had to combat a widespread conviction that financial debacle was to be the permanent order."

"It is always difficult to take a contrarian approach. Even highly capable investors can wither under the relentless message from the market that they are wrong."

On Page [xxii] Klarman wrote:

"Of course, for those value investors who are truly long term oriented, it is a wonderful thing that many potential competitors are thrown off course by constraints that render them unable or unwilling to effectively compete."

On Page [xxiv] Klarman wrote:

"When bargains are scarce, value investors must be patient; compromising standards is a slippery slope to disaster. New opportunities will emerge, even if we don't know when or where."

"Still value investors are bottom-up analysts, good at assessing securities one at a time based on the fundamentals. They don't need the entire market to be bargained priced, just 20 or 25 unrelated securities – a number sufficient for diversification of risk. Even in an expensive market, value investors must keep analyzing securities and assessing businesses, gaining knowledge and experience that will be useful in the future."

On Page [xxvi] Klarman wrote:

"In a bad real estate climate, tighter lending standards can cause even healthy properties to sell at distressed prices. Graham and Dodd's principles – such as the stability of cash flow, sufficiency of return, and analysis of downside risk – allow us to identify real estate investments with a margin of safety in any market environment."

On Page [xxxix] Klarman wrote:

"In a rising market, everyone makes money and a value philosophy is unnecessary. But because there is no certain way to predict what the market will do, one must follow a value philosophy at all times. By controlling risk and limiting loss through extensive fundamental analysis, strict discipline, and endless patience, value investors can expect good results with limited downside."

On Page [xl] Klarman wrote:

"The real secret to investing is that there is no secret to investing."
On Pages 22 and 23 there is an interesting table on Economic Data from 1911-1913, 1923-1925 and 1936-1938.

On Page 57 Roger Lownestein wrote:

"As a rule of thumb, investors should spend the bulk of their time on the disclosures of the security under study, and they should spend significant time on the reports of their competitors. The point is not just to memorize the numbers but to understand them; as we have seen, both the balance sheet and the statement of cash flow will throw significant light on the number that Wall Street pays the most attention to, the reported earnings."

On Page 138 Howard S. Marks wrote:

"Importantly, Graham and Dodd highlight the importance of cash flow stability in a company's ability to service its debts in an adverse environment. "Once it is admitted – as it always must be – that the industry can suffer some reduction in profits, then the investor is compelled to estimate the possible le extent of the shrinkage and compare it with eh surplus above the interest requirements. He thus finds himself…vitally concerned with the ability of the company to meet the vicissitudes of the future (p. 155 2nd ed.) This consideration contributed to the fact that, in its infancy in the mid – 1970's, the leveraged buyout industry restricted its purchases to noncyclical companies. Of course, like all important investment principles, this one is often ignored in bullish periods; enthusiasm and optimism gain sway and the stable –cash-flow rule can be easily forgotten."

On Page 140 Marks reminded us of a Graham quote from page 185 of 2nd ed.:

“During the great and disastrous development of the real estate mortgage-bond business between 1923 and 1929, the only datum customarily presented to support the usual bond offering—aside from an estimate of future earnings—was a statement of
The appraised value of the property, which almost invariably amounted to some 662/3% in excess of the mortgage issue. If these appraisals had corresponded to the market values which experienced buyers of or lenders on real estate would place upon the properties, they would have been of real utility in the selection of sound real estate bonds. But unfortunately they were purely artificial valuations, to which the appraisers were willing to attach their names for a fee, and whose only function was to deceive
the investor as to the protection which he was receiving.”

“This whole scheme of real estate financing was honeycombed with the most glaring weaknesses, and it is sad commentary on the lack of principle, penetration, and ordinary common sense on the part of all parties concerned that it was permitted to reach such gigantic proportions before the inevitable collapse.”

Here is a Graham quote from page 43 of 2nd ed.:

“Now let us consider a similar judgment based primarily upon the trend. In 1929 nearly all public-utility systems showed a continued growth of earnings, but the fixed charges of many were so heavy—by reason of pyramidal capital structures—that they consumed nearly all the net income. Investors bought bonds of these systems freely on the theory
that the small margin of safety was no drawback, since earnings were certain to continue to increase. They were thus making a clear-cut prediction as to the future, upon the correctness of which depended the justification of their investment. If their prediction were wrong—as proved to be the case—they were bound to suffer serious loss.”

Ezra Merkin (an alleged Madoff feeder) on page 288 wrote in an essay titled "Blood and Judgment."

"Still if Graham and Dodd's bible cannot be understood today without commentary, the attitude embodied in this work is timeless. As long as investors remain human, and thus subject to greed, fear, pressure, doubt and the entire range of human emotions, there will be money to be made by those who steel themselves to overcome emotion. As long as the human tendency to march in herds persists, there will be opportunity for contrarians who are unafraid to stand alone."

Glenn H. Greenberg wrote on page 399 and 400,

"Accounting has always presented management with opportunities to misrepresent results. In 1934, companies ran nonrecurring gains through the profit-and-loss statement and stretched out depreciation schedules to make earnings look better than they were.”

"The second challenge to rational investing is to maintain one's logical convictions in the face of excess gloom or euphoria as reflected in stock prices. I doubt many owners of private companies are preoccupied with the value of their business on a short-term basis - how different from the public markets, where a rising stock price makes us feel smart and a falling on makes us feel dumb."

"Obviously it requires strength of character in order to think and act in opposite fashion from the crowd and also patience to wait for opportunities that may be spaced years apart."

On Page 405 Greenberg discussed the 3 main challenges of Value Investing:

A. “Careful research takes time and seldom results in a clear case of taking a large position. It is tedious to always review and seldom uncover an opportunity.”

B. “It is difficult to maintain ones logical convictions in the face of excess gloom or euphoria as reflected in stock prices.” He discusses something we occasionally ponder. The concern that our analysis is incorrect as a company’s stock price gets pounded. Greenberg writes, “Our self-doubts and fears of failure cause us to glimpse catastrophe where we once envisioned opportunity. Graham and Dodd wrote, “Obviously it requires strength of character in order to think and to act in opposite fashion from the crowd and also patience to wait for opportunities that may be spaced years apart.”

C. He discusses the presence of greed and how that is now exaggerated in 2008 by the proliferation of hedge funds.

On Page 406 Greenberg wrote:

“A recurring theme of Security Analysis is the importance of gathering as much information as possible, but then making judgments, which are subject to being wildly of the mark.”

On Page 482 Graham wrote:

”*In the absence of indications to the contrary we accept the past record as a basis for judging the future. But the analyst must be on the lookout for any such indications to the contrary. Here we must distinguish between vision or intuition on the one hand, and ordinary sound reasoning on the other. The ability to see what is coming is of inestimable value, but it cannot be expected to be part of the analyst's stock in trade.*

On Page 642 Graham wrote:

“The relaxation of investment bankers’ standards in the late 1920’s, and their use of ingenious means to enlarge their compensation, had unwholesome repercussions
in the field of corporate management. Operating officials felt themselves entitled not only to handsome salaries but also to a substantial participation in the profits of the enterprise. In this respect the investment- trust arrangements, devised by the banking houses for their own benefit, set a stimulating example to the world of “big business.”

On Page 653 Graham wrote:

“The industrial field never offered the same romantic possibilities for high finance as were found among the rails and utilities, but it may well be that the ingenious talents of promoters and financial wizards will be directed towards the industrials in the future. The investor and the analyst should be on their guard against such new dazzlements.”

On Page 654 Graham wrote about analyzing companies using some fundamental methods. This makes an excellent source to revisit and study.

On page 687 Graham discussed the apparent nationalization of, and then future privatization of the railroads. This is eerily similar to me in relation to Banks as I write this in February 2009.

“In the years following 1932 a large part of the country’s railroad mileage went into the hands of trustees. At the close of 1938 a total of 111 railway companies operating 78,016 miles (31% of the total railway mileage in the United States) were in the hands of receivers or trustees. This is the greatest mileage ever in the hands of the courts at any one time. Reorganization in every case has been long delayed, owing on the one hand to the complicated capital structures to be dealt with and on the other to the uncertainty as to future normal earnings. As a result the price of a great many issues fell to extremely low levels—which would undoubtedly have presented excellent opportunities for the shrewd investor, had it not been that the earnings of the railroads as a whole continued for some years to make disappointing showings as compared with general business."

On Page 708 Graham wrote:

"Purchase of securities selling well below intrinsic value. Intrinsic Value takes into account not only past earnings and liquid asset values but also future earning power, conservatively estimated – in other words, qualitative as well as quantitative elements. We think that since a large percentage of all issues nowadays are relatively unpopular, there must be many cases in which the market goes clearly and crassly astray, thus creating real opportunities for the discriminating student."

The following are notes and quotes from the hardcover 3rd edition, commonly known as "The Classic 1951 Edition."

Page 1.

"The objectives of security analysis are twofold. First, it seeks to present the important facts regarding a stock or bond issue, in a manner most informing and useful to an actual or potential owner. Second it seeks to reach dependable conclusions, based upon the facts and applicable standards, as to the safety and attractiveness of a given security at the current or assumed price."

Graham goes on to explain that the analyst must understand security forms, accounting, basic elements that account for success or failure of businesses, the general workings of the economy and securities markets.

"He must be able to dig for facts, to evaluate them critically, and to apply his conclusions with good judgment and a fair amount of imagination. He must be able to resist human nature itself sufficiently to mistrust his own feelings when they are part of mass psychology. He must have courage commensurate with his competence."

Graham presents 4 charts on pages 4 – 7.

A. Stocks Versus Bonds for Maintaining Real Income.
B. Financial Data (including Income, Debt and Corporate Tax)
C. Physical Data
D. Price and Wage Data, Common Stock Prices and Bond Yields.

On Page 13 Graham reminds us that the serious obstacle is that analysis is not an exact science. He also mentioned, "An exception may be seen in the new-era markets of 1927-1933. Both the advance and the decline in stock prices were so extreme during this period that the conclusions suggested by informed and conservative security analysis were found to have little practical utility. This was truer because the business depression of the early 1930's was so unexpectedly severe as to vitiate many conclusions regarding safety and value that had been reasonable in the light of past experience.

On page 17 he writes, "A valuation may be very skillfully done in the light of all the pertinent data and the soundest judgment of future probabilities; yet the market price may delay adjusting itself to the indicated value for so long a period that new conditions may supervene and bring with them a new value."

On page 21 he writes, "It is a matter of great moment to the analyst that the facts be fairly presented, and this means that he must be highly critical of accounting methods."

On page 23 he writes, "We do not believe that short-run price movements – the day-to-day or month-to-month variations – are a valid or profitable concern of the security analyst.

On page 27 he writes, "Practically all common stocks are subject to recurrent wide changes in market price. It was formerly an accepted tenet that investment grade common stocks could be purchased at all times without regard to the market level." The crash of 1929 – 1932 showed us that even the highest-grade stocks could be dangerously overpriced in the upper reaches of a bull market. The analyst must stay unemotional and "resist the persuasive optimism and pessimism of alternating market swings."

On page 28 he writes one of his more famous quotes, "In other words, the market is not a weighing machine, on which the value of each issue is recorded by an exact and impersonal mechanism, in accordance with its specific qualities. Rather should we say that the market is a voting machine, whereon countless individuals register choices which are the product partly of reason and partly of emotion."

"Beware of "bargains" when most stocks seem very high."

On page 59 he writes, "However, for most investors, we think, the real implication of dollar averaging is that they should be wary of putting more money in stocks at higher prices than they did at lower prices – which is a common failing – and that they should never let a lower price level scare them away from buying."

On page 65 he writes, " The security analyst uses a vast amount of economic statistics. " He cites the importance of Government statistics and use of trade journals.

On pages 70 and 71 he writes, "There is a strong tendency in the stock market to value the management factor twice in its calculations. Stock prices reflect the large earnings
which the good management has produced, plus a substantial increment for "good management" considered separately. This amounts to "counting the same trick twice," and it proves a frequent cause of overvaluation."

"Now let us consider a similar judgment based primarily upon the trend. In 1929 nearly all public-utility systems showed a continued growth of earnings, but the fixed charges of many were so heavy—by reason of pyramidal capital structures—that they consumed nearly all the net income. Investors bought bonds of these systems freely on the theory
that the small margin of safety was no drawback, since earnings were certain to continue to increase. They were thus making a clear-cut prediction as to the future, upon the correctness of which depended the justification of their investment. If their prediction were wrong—as proved to be the case—they were bound to suffer serious loss."

Page 307 has an interesting sentence. "It would appear to be sound theory to require regularly some protective provisions on the score of working capital in the case of industrial bonds. We suggest that a ratio of 100% in net current assets to funded debt be considered as one of the specific criteria in the selection of fixed-income industrial bonds."

On page 322, Graham tells us to use "The Poorest-Year test" in determining the minimum interest coverage needed for a company to survive an economic downturn. It is acceptable for the company to come reasonably close, since the poorest year will be less than average for a longer period.

On page 334, in regards to Industrial Bonds, "The best criterion that we are able to offer for this purpose is the ratio of the market value of the capital stock to the total funded debt." This can be performed with a look at stockholders equity compared to debt as well. Graham would use both, and felt that market value was a proper tool for determining safety of bonds. He used an example of requiring enterprise value to be at least twice the amount of the debt. He discusses how market prices are always fluctuating, and that one should allow considerable leeway for the vagaries of Wall Street.

He goes onto discuss that operating rentals should be capitalized at an appropriate rate. From that rate one can estimate a fair value for debt. This has always been a confusing task for me, yet I write it here, as one day I may start using it.

Page 388, "The boom of the 1920's operated in the field of corporation finance largely by two distinctive manifestations: the public utility holding company and the investment trust. Nearly all of the holding company structures had at their base a group of sound and growing operating utilities. But above them were reared fantastic pyramids, comprising as many as six successive layers of holding companies – each with its own complicated capitalization. These never ending corporate developments added continuous fuel to the speculation of Wall Street. They also created huge amounts of inadequately secured bond and preferred stock issues, together with a sad record of financial exploitation and malpractice."

Page 407, "Thus the best industries for valuation are those which do not show large losses in severe depression. Such industries would include, in addition to public utilities, the insurance companies, chain stores, chemical and pharmaceutical companies, cigarette makers, can manufacturers and perhaps others."

Page 408, "Diversification is almost a necessary adjunct of the margin-of-safety idea. A single issue bought for less than it is fairly worth may still "go sour" for some special reason and produce a loss. A group of twenty or more issues will average out the individual favorable and unfavorable developments. Thus if a margin of safety is soundly calculated it should have full opportunity to create a profit in the aggregate result."

Page 459, "A frequent procedure of the security analyst is to form a favorable opinion of the long-term prospects of a certain industry, because of his general knowledge and judgment, and then make an intensive study of the available materials to find confirmation of his views. The figures will generally prove quite encouraging – since he was attracted to the industry in the first place by some optimistic indications."

"So, too, on industry prospects the analyst must beware of worshipping what may prove to be, in Lord Bacon's phrase, the "idols of the market place." The payment of an exceedingly liberal price for expected future improvement – in the form of a very high multiplier of past earnings – is hardly a businesslike procedure." Graham goes onto discuss how this type of investment has "served at times to turn some of our best and strongest common stocks into speculative and risky vehicles."

Page 476, "In the large sector of financial companies the asset value remains a prominent element in the valuation of a common-stock issue. In fact the appraisal process is likely to start with the asset value as a point of departure and to add a premium or subtract a discount there from to reflect the many other elements of the valuation. This statement applies fairly generally to banks, insurance companies, and investment funds, but only slightly, if at all, to finance or credit companies."

Chapter 39, page 492 is titled, "The Valuation of Public-Utility Common Stocks."

I have indicated this as a reference tool for the future.

Page 493, Graham emphasizes that projections of earnings are "subject to a considerable margin of possible error and that the best the analyst can do is to try to make his assumptions as reasonable as possible in the light of all the facts at hand." He informs us that we should arrive at a level of earnings, within a margin of error on the low and

high side and base some valuations on that. He indicates that as time goes on, circumstances change and that we must adjust our analysis.
On page 502 he writes, "This suggests that a favorable time to buy electric-utility common stocks is when the earned return is low in relation to the property-value base apt to be used by the regulatory commission in setting rates."

Page 504, "Except during periods of temporary stress, therefore, the earnings figure for the analyst to keep in mind is what we would describe as the estimated earnings potential. This expression is one we use to indicate the maximum per-share earnings reasonably expectable under the regulatory policies of the state in which the company operates. It represents the earnings resulting from a "full," or over-all return, after deducting the annual service requirements on all senior securities outstanding."

Chapter 40 discusses an appropriate capitalization rate for expectable earnings. This is called the "Earnings-Capitalization Rate."

He indicates that this rate fluctuates widely over time. Also mentions that electric utility companies have a tendency to have somewhat predictable historical averages. You can see a table that Graham devised here.

Factors Affecting the Capitalization Rate

1. Prospective Growth of the enterprise.
2. Known or expected stability of the business.
3. Dividend pay-out ratio.

The following are notes I found in a note book. I believe they refer to 3rd edition, but need to verify:

Page 327 – Charles Tatham Jr. had 2 useful ratios for use in Public Utility Bond Analysis.

Jay Sawell had a “Charges to Property Ratio.”

‘Debt Service Requirements or Fixed Charges’ / Minimum Value of Property for Rate Making.’ If debt service ratio is 1% or 2%, all is cool. If 45 or 5%, bond holder is weakened.