A Memorial Service for Ben Graham held at
the Columbia University Faculty Club on Oct 10,1976.
About 100 people were present

It was a lovely day to have a service for Ben. A great many of his friends and relatives were there. I met Buzzy for the first time. He's 31 and is studying to be a doctor. He's married with a young daughter. I met Winnie for the 1st time. His daughter Marjorie gave a moving little talk about her father. It seems he used to give them talks (lectures) on any number of subjects. I think she said he was a walking encyclopedia. On his 80th birthday they all went to La Jolla to celebrate. He gave a little speech in which he said that when he was young he was discouraged at all his mistakes but he was optimisitc about things in the future. When he was old, he was pleased at all he had accomplished but was pessimistic about the future. He also related himself a little to Ulysses altho he didn't travel in the same way. He felt the arts importar

Dave Dodd was there with his wife. He gave a little talk in which he said he had been greatly helped by Ben. It seems that in 1928 Columbia wanted him to give a course in finance and Ben said he would only do it if he had an assistant. Dave was a young instructor at the time and had told the administration he wanted to get some practical experience. He said he wasn't sure if he got to be Ben's assitant because of his request or because he had recently married the former Secretary of the Dea Roswell McCrea had induced Ben to take the assignment. Anyway Dave went on, Ben asked him to keep notes of the meeting. Dave took them not verbatim but then typed them all up. In 1932 after giving 4 years of lectures, Ben thought they could write a book on the lectures and that's how "Security Analysis was born. Dave said the book was really all Ben's thoughts but Ben had both their names on the book.

Throughout the service the constant repetition was of Ben's generosity. A group of Baptist Blacks from Bridgeport came down to pay tribute to Ben. It seems they had needed some money to build a meeting place or buy a building to worship i The minister gave a short little speech. 2 carloads of blacks had driven down for the service. Later I learned that Ben had given them $10,000 so they could buy a building after their church had burned down.

Jerry Newman officiated at the service by calling people to talk. McGill, the Pres. of Columbia was the 1st and talked about how he met Ben in La Jolla thru the student demonstrations at the University out there around 1965. He said he never found out about Ben's investment prowess thru Ben but only learned about it subsequently.

After the meeting I learned that Ben had translated Gilbert & Sullivan into Greek. He was a truly Renaissance Man.

Jack Traynor of the Analyst Journal spoke a few words and a telegram was read ~~byxxkm~~ sent by the ~~xxxxyx~~ Financial Analysts. Ben was really the founder of the Society but was ~~xxxxx~~ never really given credit for all his help. The Guild for the Blind sent a telegram.

After the meeting which lasted about 45 minutes We had coffee and Cake. Esty was there looking very pretty. I talked to her and Dave Dodd, Victor Graham, Dick and his sons and ex-wife. Also Larry & Marie Kessel, Bert Olden, Mr. Karp who had been active in the Wellesley Summer Program. Edwin talked to a man from the Guild for the Blind. Ed Laufer was there with Rose, Conrad Taff. Also some of Ben's former investors who I didn't know too well including Lottie and Howard Marcus and Louis Berall. Berall told me that Ben & Hazel had gone to his camp ~~whxxm~~ which was for young children. At that time I gather they were older and had several tents away from the camp but he let them used the grounds as he had a lot of acres. Bernie Werner also Florence Coh
Victor Graham really hadn't changed but some of the others had aged. Douglass Newman told me that he, Ben & Fred Greenman

over

Pals at Boys High and that when Ben went into business he had asked Douglass to go in with him before he asked Jerry. Douglass said he wasn't really interested in finance so he never took it up. Irving Kahn & his 2 sons were there. His first wife Hazel was there I was told.

I gathered from some of the conversation that Ben really didn't leave much money. He had given most of it away. He had left $10,000 each to his grandchildren and possibly some of his nieces and nephews but there wasn't enough to go around. I gathered that Ben's personal affairs were never very orderly.

Dave Dodd said that Ben had told him that he, Ben, wanted to do good every day. I think he achieved his objective.

Ben was the kind of man people loved but were not close to. I think he would have enjoyed the ceremony. It was simple but eloquent.

Walter 10/11/76

I forgot to mention that at the ceremony there was an excellent picture of Ben painted by Bernie Schwartz. While it wouldn't be my favorite because it was of Ben when he was old, it was beautifully done.

FOR THE ARCHIVES

Includes Rare and Previously Unpublished Articles, Lectures, and Interviews

THE REDISCOVERED BENJAMIN GRAHAM

SELECTED WRITINGS OF THE WALL STREET LEGEND

JANET LOWE

Author of *Benjamin Graham on Value Investing*

Benjamin Graham and *Security Analysis*: A Reminiscence

Walter J. Schloss

Ben Graham was an original thinker as well as a clear thinker. He had high ethical standards and was modest and unassuming. He was one of a kind. I worked for him for nearly 10 years as a security analyst.

In re-reading the preface to the first edition of *Security Analysis*, I am impressed all over again with Ben's views. I quote . . . "[W]e are concerned chiefly with concepts, methods, standards, principles, and above all with logical reasoning. We have stressed theory not for itself alone but for its value in practice. We have tried to avoid prescribing standards which are too stringent to follow or technical methods which are more trouble than they are worth."

Security Analysis says it all. It is up to analysts and investors to put Ben's ideas into practice.

Back in 1935 while working at Loeb Rhodes (then called Carl M. Loeb & Co.), one of the partners, Armand Erpf, gave a good piece of advice when I asked him how I could get into the "statistical department." In those days and perhaps today to some extent, the best way to advance was by bringing in business. If you had a wealthy family or friends, you brought in commissions. Security analysis was in its infancy and who you knew was much more important than what you knew. If you didn't have connections, it was difficult to get ahead. In any case Mr. Erpf told me that there was a new book called *Security Analysis* that had just been written by a man called Ben Graham.

Reproduced by permission from the private writings (1976) of Walter J. Schloss.

"Read the book and when you know everything in it, you won't have to read anything else."

I took Ben's course in Advanced Security Analysis at the New York Stock Exchange Institute (New York Institute of Finance).

Ben was a good speaker, enthusiastic and logical. Ben did something that I haven't seen done often. He would take an undervalued situation at that time, such as the bankrupt bonds of Baldwin Locomotive, and show how much the new securities would be worth based on their projected earning power and assets and relate this to the price of the bonds. Many bright Wall Streeters such as Gus Levy of Goldman Sachs, who later became the top arbitrageur in the country, used to take his course. I often wondered how much money people made on Ben's ideas by transforming them into investments.

Ben was very generous with his thoughts and his time, particularly with young people. By offering me a job as his security analyst as I was about to leave the Army at the end of 1945, he changed my life. I know he helped others in our field too.

At Ben's memorial service, Dave Dodd, Ben's co-author, told how he had got involved in the book.

It seems that Ben was asked to teach a course at Columbia University on investments and he agreed to do it with the stipulation that he would only do so if someone would take notes. Dave Dodd, a young instructor, volunteered and took copious notes at each of Ben's lectures. Ben, using the notes, then went ahead and wrote *Security Analysis*. As Dave said, Ben did the work but he insisted that Dave get credit by being co-author.

Professor Dodd went on to become a very successful investor and a director of Graham-Newman Corporation, an investment trust that Ben had founded in 1936 with his partner, Jerome Newman.

The ability to think clearly in the investment field without the emotions that are attached to it, is not an easy undertaking. Fear and greed tend to affect one's judgment. Because Ben was not really very aggressive about making money, he was less affected by these emotions than were many others.

Ben had been hurt by the Depression, so he wanted to invest in things that would protect him on the downside. The best way to do this was to lay out rules which, if followed, would reduce his chance of loss.

A good example of this was the day I happened to be in his office at Graham-Newman when he received a telephone call that they had bought 50 percent of Government Employees Insurance Co. (now GEICO). He turned to me and said, "Walter, if this purchase doesn't work out, we can always liquidate it and get our money back."

The fact that GEICO worked out better than his wildest dreams wasn't what he was looking for. As the saying goes, a stock well bought is half sold. I think Ben was an expert in that area.

Graham-Newman followed the precepts set down by Ben and the fund prospered. Compared to today's investment company, it was tiny. Its total net assets on January 31, 1946, were $3,300,000.

Ben's emphasis was on protecting his expectation of profit with minimum risk. If one wants to get hold of Moody's Investment Manuals for the 1947–1956 period, it is interesting to see Graham-Newman's holdings. Many of them were small, practically unknown companies but they were cheap on the numbers. It is instructive to read their annual report for the year ended January 1946. It states that their general investment policies were twofold.

1. To purchase securities at prices less than their intrinsic value as determined by careful analysis with particular emphasis on the purchase of securities at less than their liquidating value.
2. To engage in arbitrage and hedging operations.

I helped Ben with the third edition of *Security Analysis*, published in 1951. In the appendix is an article on special situations that first appeared in *The Analysts Journal* in 1946. In the article, he had worked out an algebraic formula for risk-reward results that could be applied today, 37 years later.

In 1949, *The Intelligent Investor* was published. This was a book for the layman but it focused on security analysis and gave prestige to the field. Its fourth revised edition is still in print.

One day, I came across a very cheap stock based on its price at the time, Lukens Steel. We bought some but expected to buy more.

At this point, Ben went out to lunch with a man who kept telling Ben about one blue chip after another. At the end of the meal he asked Ben if he liked anything and Ben said we were buying some Lukens Steel.

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I doubt if it took a day before the man went out and bought a great deal of Lukens and pushed the stock out of our buying range. I had the impression after Ben told me the story that he didn't want to be rude and hadn't realized how important his comments were.

He tried to keep things simple. He wrote that he didn't believe security analysts should use more than arithmetic and possibly a little algebra for any investment decision.

Because Ben was a cultured, many-faceted man, he didn't spend as much time on investments as did others in the field. He liked to try new ideas. In the late 1930s he became involved in promoting his ever-normal granary theory and wrote a book on it called *Storage and Stability* in which some commodities and metals would be used as a backing for our currency. His ideas made sense and with cotton at six cents a pound and other raw materials at low prices, it was an interesting proposal. He never had the clout to sell it to the Congress, although Bernard Baruch, a friend of his, supported the idea and it could have been a useful way to help the farmers and reduce the threat of inflation.

Of all the things that Ben accomplished in his lifetime, *Security Analysis* was, to me, his greatest achievement.

Ben Graham was the leader in giving status to security analysts. It was a privilege to know him.

"The sillier the market's behavior,
the greater the opportunity for the business-like investor.
Follow Graham and you will profit from folly
rather than participate in it."

—Warren E. Buffett

"[Graham] is the genius who literally created
the framework for investment analysis that leads
to successful investing. Like that other genius Edison,
Graham created light where there was none."

—Bill Ruane, Sequoia Fund

"It's never the wrong time to invoke the name
of Benjamin Graham, value investor par excellence."

—*Money*

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CRITERIA FOR LIQUIDATIONS WHERE MONEY IS HELD BY COMPANY.

1. Percent profit should be minimum 15-20% per annum based on estimate of time and payments to be made.

2. Should be a few <u>points</u> spread between market and estimated work-out despite percentage gain.

3. If in litigation - issue should be earning some money during period or at least not losing money. much

4. Prospect of loss on investment should appear remote. Use Graham's formula on special situations.

5. Issue should be first in line for payment - not junior security. (Preferably)

<u>COMMENT:</u> Preferable to buy liquidations before initial payout as most of money received back and low remaining cost then increases percent return.

WARNING: Liquidations not as profitable as formerly due primarily to competition of specialists in this field.

With the above criteria in mind I reviewed our present holdings and it appeared based on our figures and reports, that Wealdon Corporation still seems attractive.

We presently own $28,500 or 1500 shares in Graham-Newman and $68,000 or 3596 shares in Newman & Graham.

Our Average Cost	Present Market	Estimated Work-out	Time	Annual % Profit
19	18 7/8	23	1 yr.	21% (on 19 Price

It would appear likely that a large payment estimated $15-$20 a share will be paid within a year. To satisfy ourselves that the management is thinking along these lines, I would suggest that Lawrence Kessel go to Baltimore and talk with J. B. Wharton, Jr. the Treasurer, who is the active officer. If this appears inadvisable, then a telephone call to him is suggested.

If the additional information we secure is satisfactory, I believe we should increase our holdings in Graham-Newman Corporation to $50,000 and Newman & Graham to $100,000.

Walter J. Schloss

May 16, 1952.

GRAHAM FORMULA
80% CHANCE OF SUCCESS AT 23 WITHIN 1 YR

$$\frac{90 \times 4 \text{ PTS}}{19 \times 1 \text{ YR}} = 16.92$$

On common stocks March 10,1994

Walter & Edwin Schloss Associates, L.P.

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Factors needed to make money in the stock market

1. Price is the most important factor to use in relation to value.

2. Try to establish the value of the company. Remember that a share of stock represents a part of a business and is not just a piece of pape

3. Use book value as a starting point to try and establish the value of the enterprise. Be sure that debt does not equal 100% of the equity. (Capital and surplus for the common stock).

4. Have patience. Stocks don't go up immediately.

5. Don't buy on tips or for a quick move. Let the professionals do that, if they can. Don't sell on bad news.

6. Don't be afraid to be a loner but be sure that you are correct in your judgment. You can't be 100% certain but try to look for weaknesses in your thinking. Buy on a scale and sell on a scale up.

7. Have the courage of your convictions once you have made a decision.

8. Have a philosophy of investment and try to follow it. The above is a way that I've found successful.

9. Don't be in too much of a hurry to sell. If the stock reaches a price th you think is a fair one, then you can sell but often because a stock goes up say 50%, people say sell it and button up your profit. Before selling try to reevaluate the company again and see where the stock sells in relation to its book value. Be aware of the level of the stock market. Are yields low and P-E ratios high. If the stock market historically high. Are people very optimistic etc?

10 When buying a stock, I find it helpful to buy near the low of the past few years. A stock may go as igh as 125 and then decline to 60 and you think it attractive. 3 years before the stock sold at 20 which shows that there is some vulnerability in it.

11. Try to buy assets at a discount than to buy earnings. Earnings can change dramatically in a short time. Usually assets change slowly. One has to know much more about a company if one buys earnings.

12.Listen to suggestions from peole you respect. This doesn't mean you have to accept them. Remember it's your money and generally it is harder to keep money than to make it. Once you lose a lost of money it is hard to make it back.

13. Try not to let your emotions affect your judgment. Fear and greed are probably the worst emotions to have in connection with the purchase and sale of stocks.

14. Remember the work compounding. For example, if you can make 12% a year and reinvest the moneyback,you will double your money in 6 yrs, taxes excluded. Remember the rule of 72.Your rate of return into 72 will tell you the number of years to double your money.

15. Prefer stocks over bonds. Bonds will limit your gains and inflation will reduce your purchasing power.

WJS

16. Be careful of leverage. It can go against you.

FROM THE THOUGHTFUL BUSINESSMAN

From:
Walter J. Schloss, General Partner
Walter J. Schloss Associates

Re:
"Repurchase Stock to Revitalize Equity," by Charles D. Ellis, HBR July–August 1965

I have read Mr. Ellis' article carefully and am in agreement with his objectives. I would like to comment on one phase of this problem, however.

I can understand the reluctance of management to repurchase its stock at, say, $30 a share when the company's stock has a $10 book value. For example, assume a company has 2,000,000 shares of stock which have a book value of $10 and earn $3 a share. To repurchase 500,000 shares at $30 a share would cost the company $15,000,000, and assuming it could borrow some of the money to finance the purchase, the 1,500,000 shares remaining would have a book value of $3.33. Not a very prepossessing figure, despite the fact that earnings would now approach $4 a share. It also assumes good earnings for the future, which are never guaranteed.

Assume, however, a company's stock has a $100 book value, selling at $45 and earning $3 a share, with 2,000,000 shares outstanding. If the company repurchased 1,000,000 shares at $50 a share, the book value for the remaining shares would increase to $150 a share, and the earnings would increase to close to $6 a share.

My point is that a large book value would help the company repurchase its stock, since it would give it a bigger base from which to operate. It would also increase book value for the remaining shareholders, instead of decreasing it.

I cite the above example because it is typical of what Crane Company has done. I think Ellis should have discussed this phase in his study. In fact, those companies with large book values in relation to market prices offer the stockholder the greatest rewards, and this is the one area that I don't think Ellis covered. ●

From:
Charles D. Ellis, Financial Analyst
Rockefeller Brothers, Inc.

Re:
"Repurchase Stock to Revitalize Equity," by Charles D. Ellis, HBR July–August 1965, and the preceding letter from Walter J. Schloss

Given the examples provided in Mr. Schloss's letter, I would agree that a company whose shares are selling below book value might find share repurchasing highly appropriate, particularly when substantial nonoperating liquid assets are available. Many casualty insurance companies and some closed-end investment companies clearly fall within Schloss's observation. In general, however, I believe that an emphasis on book value is not appropriate for decision making in nonfinancial companies.

First, book value is often misleading because historic acquisition costs ignore rising values of long-lived assets and sizable expenditures to maintain the efficiency and the value of facilities. Moreover, accelerated depreciation is often deducted. Consequently, book value is typically substantially understated. On the other hand, trademarks, patents, management capability, and consumer franchises — all vital to corporate earning power and often worth far more than capital goods — are excluded from book value.

Second, the mere presence of substantial assets may be irrelevant to repurchasing if they are (a) illiquid or (b) necessary for continued operations. On the other hand, many companies whose shares sell far above book value have substantial liquid assets and/or unused debt capacity available for repurchasing.

Third, while asset values are surely of primary importance in privately held firms, in publicly held companies the investors exercise no direct control over assets (cannot sell them, etc.) and must, therefore, concentrate on the profits which are generated from them.

Finally, a corporation buying its own shares is not buying an asset. The company is making a single present payment in exchange for the termination of the stockholder's "right" to participate in future earnings of the enterprise. Consequently, the relevant analysis of repurchasing is not present assets, but future earnings. ●

Reprinted from
Harvard Business Review
November–December 1965

From:
Walter J. Schloss, General Partner
Walter J. Schloss Associates

Re:
"Repurchase Stock to Revitalize Equity," by Charles D. Ellis, HBR July–August 1965, and the preceding letters by Walter J. Schloss and Charles D. Ellis

I am not convinced by Mr. Ellis' arguments that book value is unimportant in the repurchase policy of corporations except in the case of the repurchase of insurance and closed-end investment companies at a discount. While I realize that he places his emphasis on earnings, it is also true that earnings are much more likely to fluctuate than are book values, and therefore estimating longer term earnings than, say, the next year or so can be subject to serious error. For example:

> If the management of Alpha Portland Cement had repurchased 800,000 shares of its stock at $30 a share in 1960 when it was earning $2.66 a share, it could subsequently be criticized for its policy when a few years later earnings took a tumble due to severe competition and the stock sold down to $11 a share in 1965. To say that the stock market erred in its estimate of the future is really not answering the question, because the cement industry has a brilliant future ahead of it. In 1956 Alpha sold as high as $47 with earnings of $3.45, and in 1958 sold over $42 a share, earning $3.06 the following year.

My point is that if the assets are large enough, the stockholders benefit by repurchases at discounts from book value and that the purchase of stocks above book value in times of prosperity can be later criticized if earnings decline through no fault of management but simply because of vicissitudes in the industry.

It is true that value should be determined by what a company can earn in the future, but the fact that this is an objective should not allow managements to ignore book value. The fact that book values tend to be understated in terms of today's prices is another reason to give some weight to large book values in industrial companies. ●

The Commercial and Financial Chronicle . . . Thursday, December 31, 1953

LETTER TO THE EDITOR:

In Defense of Stock Dividends

Walter Schloss, security analyst, commenting on recent communication from Dr. Neil Carothers, cites alleged advantages to stockholders of stock dividends over alternatives. Maintains stock dividend is instrument of expansion by progressive companies. States main purpose is to benefit shareholders while conserving cash, and build up future profits.

Editor, Commercial and Financial Chronicle:

It seems to me that Dr. Neil Carothers in his letter to the editor, published in the "Chronicle" of Dec. 10, regarding the evils of stock dividends over-simplifies a complicated situation. No one, I believe, has said that paying cash dividends is worse than paying stock dividends, although sometimes payment of large cash dividends may jeopardize a corporation's expansion program.

The payment of stock dividends is used when a corporation decides that earnings have to be retained for expansion purposes, but that the stockholder should get some tangible evidence that the directors are cognizant of his needs.

The articles, I believe, that Dr. Carothers is so incensed about appeared in the Aug. 3 and 10 issues of "Barron's" by Benjamin Graham. These articles pointed out the advantages of paying stock dividends rather than having the company pay large cash dividends which are taxable to the stockholder and then have the corporation turn around and issue rights to buy additional shares to these same stockholders (i. e. American Tel. and Tel.). A stock dividend program will also help those investors in companies which have been paying small cash dividends and re-investing the balance of the earnings without giving the stockholder a fair return on his investment (capital and surplus).

There is no question, in my opinion, that the company that pays a small stock dividend annually in addition to a cash dividend will sell at a higher price than the same company that just pays the cash dividend. In fact, it seems to me, the more wide-awake firms with a view to expand have paid stock dividends while the more old-fashioned firms have tended to ignore the advantages of paying them.

Where a company pays a cash dividend and a stock dividend as well, which total is more than the earnings of the company, there is no question that this could lead to an inflated market price for the shares. This explains the recent action by the New York Stock Exchange in regard to International Business Machines.

Preferable to Unincreased Cash Dividends

In Dr. Carothers letter he says "the misconceptions I have in mind boil down to three propositions." I will quote each alleged misconception and then try to answer them.

"*(A) Stock Dividends are a desirable substitute for cash dividends.*"

Stock dividends are not a desirable substitute for cash dividends, but they are better than no increase in dividends. When a corporation needs to expand and therefore feels that it is better to reduce its cash payout by reducing its dividend from say $3.00 to $2.00 a share (i.e. Caterpillar Tractor), it is better for the stockholders to get a stock dividend as well rather than a reduction of a cash dividend from $3.00 to $2.00 with no stock dividend. Marketwise the stockholder is better off than if the dividend was abruptly reduced with no stock dividend forthcoming.

"*(B) Stock Dividends reduce income taxes for the stockholders.*"

Stock dividends tend to reduce income taxes by translating regular income to capital gains. Taxes are paid on dividends received. If the corporation is profitable and plans to build new plants on which additional earnings are created, the stockholder is better off to take stock rather than getting nothing while he waits. If a corporation is already paying something a stock dividend modestly increases the former dividend.

"*(C) Stock Dividends are a desirable instrument for converting earnings into permanent capital.*"

By converting earnings into permanent capital you are making the management earn money on this reconverted capital. Obviously the larger the invested capital is the more money the corporation should earn, and the more the stockholders should receive when the expansion program is completed. Note the recent Preferred Stock Dividend declared by Consolidated Cigar.

Misconception of Intent

Dr. Carothers implies in his article that those in favor of stock dividends claim that they are better than cash dividends. For example, Carothers states, "There is an attempt in the articles in question to present a stock dividend as a profitable exchange for a cut in dividends provided the stockholder sells his stock dividend."

This is not the intent of stock dividends. I believe that when a company needs its money for proper business purposes, it is better for the company to pay and for the stockholders to receive some stock dividends.

Corporations have many problems to meet. A large cash dividend does not necessarily solve these problems despite the fact that some stockholders need the immediate cash return.

The purpose it seems to me of a stock dividend policy is to help stockholders immediately when cash is not available for a larger distribution and at the same time give them and the corporation a more profitable business in the future.

WALTER J. SCHLOSS,
Security Analyst, Graham-Newman Corporation

441 East 20th St.,
New York 10, N. Y.
Dec. 28, 1953

year", "last year", "percentage change" and "percentage change after adjusting for inflation." The last column will save the stockholder the tedious job of making his own calculations should he want to find out what really happened.

— Ben Lansdale
Eugene, Oregon

Intrinsic Value Is Key Factor

I note in your Editor's Comment in your September/October issue, you quote Sidney Cottle as saying:

"Security analysis is 'the discipline of comparative selection.' Since stocks are only under- or over-priced with respect to each other, the process of comparison is going to identify over- and under-priced stocks with roughly the same frequency in good markets and bad."

I'm not sure what you have said above is what Mr. Cottle means but I must say as a security analyst, I take exception to this point of view.

I believe stocks should be evaluated based on their intrinsic worth, NOT on whether they are over- or under-priced in relationship with each other. For example, at the top of a bull market one can find stocks that may be cheaper than others but they both may be selling much above their intrinsic worth. If one were to recommend the purchase of Company A because it was COMPARATIVELY cheaper than Company B, he may find that he will sustain a tremendous loss.

On the other hand, if a stock sells at, say, one-third of its intrinsic value based on sound security analysis, one can buy it irrespective of whether other stocks are over- or under-priced.

Stocks are NOT over-priced or under-priced compared to other companies but compared to themselves. The key to the purchase of an undervalued stock is its *price COMPARED to its intrinsic worth.*

(Congratulations on printing Ben Graham's article on "The Future of Common Stocks." It was excellent!)

—Walter J. Schloss C.F.A.
Walter J. Schloss Associates
New York

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Analyst Journal   Nov-Dec 1974

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Analyst Journal Nov-Dec 1974

Walter & Edwin Schloss Associates, L. P.
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November 17, 1993

COLUMBIA BUSINESS SCHOOL UPPER LEVEL SEMINAR IN VALUE INVESTING

Before I begin to talk about the subject at hand, I'd like to tell you a little about myself so that you can see where I am comng from and perhaps from this you will understand why I am doing what I and my son, Edwin are doing. I have been around a long time and Wall Street has changed a lot so here goes.

Back around 1918, my mother's best friend married a very attractive man with no money. (What else is new?). Shortly thereafter, he got a tip from his uncle about Mexican Petroleum (what else is new?). In those days, you could buy stocks on very little margin, perhaps 5%. He bought as much stock as he could and as it went up he kept buying it. As luck would have it or inside information would have it, Mexican Petroleum was purchased by Harry Sinclair who merged it with his Consolidated Oil. Sinclair was later involved in the Teapot Dome scandal. In any case mother's friends husband took the money he made and bought a seat on the N.Y.Stock Exchange. He and a friend purchased a lovely 160 acre farm in Ossining NY and he and his wife went to live in the Sherry Netherlands Hotel. Because their son was close to me in age, I used to visit them quite often in the country. As a boy of around 10-12 I liked their life style (remember this was around 1928) and Neville, the father had a great jois de vivre. Wall Street sounded interest ng and exciting but i instinctively didn't like the gambling part. About this time arpund 1930, there was a lottery at the Exchange. Only 2 chances at $500. each, for a Chevrolet. Neville won it and I'm sure he got rid of it as he had a Cord car made by Auburn one of the high flyers of the day and a La Salle made by GM and didn't need another care.

I liked the results of the profits in the markets at that time but I didn't like the gambling and instinctively didn't like the way it

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was made. Then the Depression hit!

One of the things I've learned is to stay with what you like to do rather than do something you don't like but think you can make money out of it. Anyway, I got a job after graduating from high school in 1934 as a runner at Loeb Rhoades, now part of Lehman Bros. I don't know if they have any runners today but they were the men and boys who delivered securities by hand to the various brokers on the street. There was no Central Depository then and you worked half a day Saturday because the Exchange was open until 12 noon. About a month later I was promoted to the cashiers department, then called the cage because the stock were there during the day. About a year later, I went to Armand Erpf, a very bright man and the partner in charge of the statistical Department which is what it was called then and asked him if I could get into his department. Armand said no but he said there was a new book that recently had come out called "Security Analysis" by Graham & Dodd and if I studied the book and learned all that was in it, I wouldn't need to know anything else about securities. The N.Y.Stock Exchange ran a series of courses for the work on the stock exchange including accounting and finance and after taking them I was allowed to take a course in "Security Analysis" with Ben Graham. It was a great experience and I remember taking 2 different classes with him. The firm paid for the class which I think was $10 a semester but perhaps it was $20. In the class was a fellow named Bob Heilbrunn who is the man who created the Chair in value investing for Professor Greenwald some 50 odd years later. Ben was a very simple straightforward man with a brilliant quick mind. He would use current examples of undervalued stocks which made it profitable for some of the professionals on the street to take his class.

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Ben would like to take companies that appeared close in the alphabet and compare them statistically. I remember specifically Coca Cola and Colgate Palmolive where he showed statistically how much cheaper Colgate was than Coke and he compared Dow Chemical to Distillers Seagram (now Seagrams) in which Seagrams was much cheaper. There was no talk of franchises in those days. Ben didn't look for franchise value or managements. He felt that management showed up in the price of the stock. If management was good the stock sold at a higher P-E because its management was better. Basically Ben didn't want to lose money. He had had a rough time during the Depression and in 1938 to 1940 when I took his courses, he was looking for protection on the downside.

Since I liked the way Ben thought and I liked the statistical side, I guess I still look at stocks with the idea of not losing money. The only problem with this kind of thinking is that you don't emphasize the profit potential enough. When a stock goes up to what appears a reasonable price, we sell because the growth in our portfolio is limited.

In thinking about how one should invest, it is important to look at your strengths and weaknesses. If you don't like to lose money and it affects your judgment, don't buy things that can go down a great deal. I must say, I NEVER have put in a stop loss order because if you like a stock and buy it and it goes down, then you should buy more if you can afford to. I find it very difficult to buy a stock that has gone up after we start buying it.

Basically, we try to buy value as expressed in the differential between its price and what we think its worth. What we think a company is worth may not be the correct one and this means we have to look at the risk on the downside.

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Ben Graham didn't visit managements because he thought the figures told the story. Peter Lynch visited literally thousands of companies and did a superb job in his picking. I never felt that we could do this kind of work and would either have to quit after a few years or I'd be dead. I didn't like the alternatives and therefore, went with a more passive approach to investing which may not be as profitable but if practiced long enough would allow the compounding to offset the fellow who was running around visiting managements. I also liked the idea of owning a number of stocks. Warren Buffett is happy with owning a few stocks and he is right if he's Warren but when you aren't, you have to do it the way that's comfortable for you and I like to sleep nights.

When you are managing the other fellow's money, it is important not to get sick over it.

When Ben was operating in the 1930s and 1940s, there were a lot of companies selling below their net working capital (NET NET). Ben liked these stocks because they were obviously selling for less than they were worth but in most cases, one couldn't get control of them and so, since they weren't very profitable, no one wanted them. Most of these companies were controlled b the founders or their relatives and since the 30s was a poor period for business, the stocks remained depressed. What would bring about a change?

1. If the largest controlling stockholder died, the Estate may want to sell control.
2. If business got better, then the company would make money. WW 2 was a good example of this. The large asset base let many secondary companies earn good money in the war years, the excess profits tax didn't apply to them and the stocks did well. I have given you a list of Graham-Newman's holdings in 194 . It was an Open-End investment co that did well in those years because the business in which those companies were in prospered.

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Graham-Newman didn't do too well after the war in that type of security but their stockholders got rich when G-N distributed GEICO stock to the stockholders in 1949 and GEICO became a growth stock.

I remember going to Chicago when I worked for Ben in the late 40's and talked to Mr. Bush the President of Diamond T Motors (no relation to George) a manufacturers of heavy duty trucks alongside Mack, White and Autocar. A Mr. Tilt owned 50.1% of the stock and wouldn't sell. The stock sold for 10 and had a working capital of $20. a share. I asked Mr. Bush why anyone would buy their trucks as they were quite expensive and he said there were people who liked to buy trucks that weren't made by the big companies. I guess that may also be true in our business. Anyway, when Mr. Tilt finally died at age 90, a few years later, the stock was sold at a premium over $20 to Mack or White. Easy Washing Machine and Thriftimart both on the Amer. Stock Exchange had an "A" voting and a "B" non voting stock. The companies were eventually sold but it took a long time for these things to occur with a law suit in the latter case. Unfortunately, these kinds of situations are hard to find which is why we don't publish our portfolio. If the stock goes down we may want to buy more. We certainly don't want to show the world our mistakes.

In running an open end fund, there are problems that a closed-end fund doesn't have. Each year starts January 2nd and ends on December 31st. This means that if you were fortunate enough to buy a stock at $10 and find it at $20. at the year end, you had a great year with a big unrealized profit but beginning on a new year, you are starting at $20. If at the end of the second year, the stock is at $15. you have lost 25% of the stockholders money THAT YEAR if that were your only holding. For the investor who bought in at the beginning of the second year, he will be very unhappy and may liquidate his holdings. If enough people do this, you

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won't have a company. This is and will be a big problemfor open-end funds. They want more investors but have to recognize the risk. This is why we like to own stocks that we think have downside protection. The trouble is that many might not have too much upside potential. It's a more passive way to invest but it's comfortable for us.

If you are investing for yourself, this can be most rewarding but assume you are investing for others as a portfolio manager. Your clients have to understand your approach to investments. If they don't agree with this approach, then they probably shouldn't invest with you

When Warren Buffett gave his Hermes talk about value in 1984, he talked about the innoculation to value investment. For some people it takes but others don't care for it. Let them go elsewhere for investment management. By setting up Berkshire Hathaway, Warren has done everything very rationally.

1. By having insurance companies, he is able to use stocks as well as bonds as reserves. By having large reserves he doesn't have to pay dividend If Berkshire was only a very profitable manufacturing company with no insurance companies it would have to pay out some dividends.

2. By keeping all the earnings, Berkshire can keep reinvesting their profits and compound their results. By owning growth stocks he is able to increase the value of the company. There has never been an investor in other companies who has been as brilliant or as successful as Warren. Since, it is in effect a closed-end investment company, Warren doesn't have to worry about investors redeeming their shares. For example, the market collapes and Berkshire goes down 30% which it has done several times before, no one can redeem their shares. Some investors have 90% of their net worth in Berkshire. I know a man, an outstanding bridge player, who told me he cashed in his Berkshire stock when it was liquidated in 1969-70 because he thought he could do better in the stock market.

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If you are a portfolio manager with a lot of clients and you own growth stocks such as GEICO or Coca Cola and you are up say 40% for the year, you worry that if the market goes down say 30% your clients are going to be very unhappy even if you write them what great cpmpanies they are. I remember having a woman client who was raving about A.W.Jones an early hedge fund. They had done brilliantly for a number of year and each year she put back more and more money until 1 year, I guess it was around 1962, A.W.Jones was down 50%. She panicked and liquidated her holdings at that time. That is one danger in an open-end fund or a private limited partnership. You can never rest on your success, While closed-end funds can keep on going even if they sell at large discounts from Net Asset Value which they used to do. My point is that one has to invest in ways that are comfortable for you. I like Ben's analogy that one should buy stocks the way you buy groceries not the way you buy perfume. Some kinds of stocks are easier to analyze than others. I agree with Warren to keep it simple and not use higher mathematics in your analysis. I'm always amused when I see a stock go from say 25 to 20 in 1 day when the quarterly earnings come out because the company earned 31¢ instead of 35¢. I saw a recent headline in the Wall St Journal (8/23)"MORE INVESTORS TRY PLAYING COMMODITIES"

I've been down in Wall Street including midtown for some 56 years excluding the 4 years in World War 2. Actually the 4 years in the service were good training years in building confidence. In any case I find that we don't own stocks that we'd never sell. I guess we are kind of a store that buys goods for inventory (stocks) and we'd like to sell them at a profit within 4 years if possible. We receive some income while we wait which is more than a store does but,unfortunately, we have to wait for someone to come along and make our merchandise go up in price. We can't do this ourselves by running sales.

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We invest the way that makes us sleep nights.
Not everyone likes to invest this way and we'd say to them, "Fine do it the way that you prefer".

It is hard to change the way you have been doing things and even though there may be better ways, I'm happy with our approach.
Phil Carret is about 96 and has been investing for over 70 years . He has done very well but he is very patient. I'm not as patient as he is but I'd like to last as long.
INSERT ABOVE CARRET:
To summarize: Know what you want to do, know your strengths and weaknesses, don't kid yourself, enjoy your work and have high ethical standards. Despite all the insider stock market trading scandals of the 1980s, not one chartered financial analyst was involved.

I thought you might like to see what securities Graham-Newman held some 43 years ago, so I dug up an old report I kept had it Xeroxed and have enclosed it for your perusal,As of January 31,195

As you can see the numbers are tiny compared to today's markets. I find it interesting that of the 62 industrial common stocks in the list .. valued at $3,288,000, only 2 stocks,Crowley Milner and Lukens Steel remain. Douglas Aircraft is part of McDonnell-Aircraft, Todd Shipyerds recently emerged from Chapter 11. Over 50% of the total market value is made up by Atlantic Gulf & West Indies which was a controlled company and was liquidated by Graham-Newman.

You might find it interesting after perusing the list to look up what happened to some of the items Graham-Newman owned.

Since numbers are much larger today and the working capital stocks (net net) have all but disappeared, I can understand why investors are looking elsewhere. You may find my discussion of a company I find undervalued not to your taste but it may offer some protection on the downside which I find interesting.
An awful lot of effort was put into finding these stocks and after finding them, you can see how little money was invested in them.

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November 17, 1993

COLUMBIA BUSINESS SCHOOL UPPER LEVEL SEMINAR IN VALUE INVESTING

WHat kind of stocks do we look at for investments?

We look for stocks that are depressed.
Why are they depressed?
Are they selling below book value?
Is good will in book value?
What has been the high low over the past 10 years?
Have they any cash flow?
Have they any net income?
How have they done over the past 10 years?
What is their debt level?
What kind of an industry are they in?
What are their profit margins?
How are their competitors doing?
Is this company doing poorly compared to its competitors?

We get their annual report,proxies and valueline and quarterlies.
What appears to be the risk on the downside vs. the upside potential?
How much stock do the insiders own?

Based on the above factors and perhaps a few other items, if the figures look satisfactory, we will take an initial position. We will watch the action of the stock and decide how much more we may want. It will depend a good deal on price. Generally, we are happy with a 5% holding but we can go up to 10-12% if we really like it a lot. Since we own some 60-75 stocks, we have small holdings in a number of securities. One reason for this is that while selling a stock, it goes down so that we end of holdings some of its shares. Sometimes when buying a stock it goes up and we don't want to follow it up so we stop buying it. On the whole we are allergic to bonds.

Today, what has happened? Everyone is now looking for franchises. The key, in my opinion, to successful investing is to relate value to price today. Instead of present value many investment managers are relating future value to present price. Since I can't do that, I will let others do it and stick to what has worked for us.

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November 17,1993

Since you undoubtedly like to hear about a current situation, we will use ASARCO as an example of a stock we have an interest in. The shares are currently selling at

ASARCO is the old American Smelting and Refining Company founded by the Guggenheims. Bernard Baruch was one of the early owners. Interestingly enough, during the 1940s, Ben Graham advised Baruch on several situations, notably Northern Pacific which Ben wrote up in the Intelligent Investor.

In any case, American Smelting was one of the Dow-Jones 30 stocks until it ran into a lot of financial trouble. Dow-Jones dropped it just like it dropped International Harvester and Loews before Larry Tisch made it such a success. At least these changes show the fluidity of the capitalist system.

Anyway ASARCO decided that they had to own some copper mines because the smelting business was no longer profitable. They bought the RAY mine from Kennecott after Kennecott was taken over and they also purchased the Mission Mine both in Arizona. To modernize these mines and other operations ASARCO between 1989 and 1992 spent some $20. a share and had a cash flow of $20. a share. They have reduced their dividend from $1.60 a share to .40¢ on about 42 million shares, to reduce their debt but so far haven't been too successful. They have some $873 million debt compared to a net worth of $1.3 billion Will copper prices recover? They have some silver but copper is their main natural resource. 25% of their stock is held by the M.I.M.Holding company of Australia but they own some 17% of MIM. ASARCO owns 52% of Southern Peru Copper which has a lot of copper but they are reinvesti their Peruvian earnings back into new mines there. Asarco has been trying to sell their Mexican Copper mine but haven't got a good offer.

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Since ASARCO'S copper costs are higher than Phelps Dodge's, AR is adversely affected by the decline in the price of copper but since ASARCO sells below $20 with a $32. book and a .40¢ dividend compared to Phelps Dodge selling at with a book of $29., we prefer the discount from book. Cyprus Mines is involved in a takeover of AMAX and is also selling above book value.

Time will tell which of these companies will do the best over the years but we thought ASARCO offered us the most bang for the buck or as others might say the most promise at the price. It certainly is no growth stock but we aren't paying for growth.

The Dow Jones Industrial Average Amended

Walter J. Schloss

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The Dow Jones Industrial Average Amended

WALTER J. SCHLOSS

BECAUSE THE DOW JONES IS the most widely used average, it carries more weight and prestige than it should be entitled to on the basis of accuracy. As Harry Comer has indicated the Standard & Poor's index is a much more accurate one than the Dow Jones because the price of each stock is multiplied by the number of shares outstanding and a constant divisor is used. This takes care of stock splits and stock dividends. Since the Dow Jones Industrial Average is simply the addition of the prices of 30 different stocks, the divisor has to be changed every time shares are split. Thus the divisor of 30 which was used in 1928 has now been reduced to 6.16. This technique tends to distort the average, because a stock selling at 150 has 10 times the weight of a stock selling at 15, regardless of the size of the enterprise.

Although the Standard & Poor's average is used by a great many security analysts and others as a truer method of measuring market conditions, it is not so acceptable to many in the financial community and others outside of it. My suggestion (which is the reason for this article) is simply to have the Dow Jones adopt the principle of multiplying each stock by the number of shares outstanding and of dividing through by a fixed divisor.

To adopt this new method of computation, a certain time would have to be fixed for the change-over, and henceforth this new method would be used. If necessary, for, say, 6 months the new and old averages could both be published to show that over a short period of time there is relatively little difference between the two. Many chartists and others could see that this new method would

Table 1. Dow Jones Industrial Average with Suggested Change December 31, 1951

30 Dow Jones Stocks	A Market Price	B Shares Outstanding, Thousands	C Total Market Value, Millions
Allied Chemical & Dye	75½	8,856	668.6
American Can	113¾	2,474	281.4
American Smelting	47⅝	5,260	250.5
Am. Tel. & Tel.	156¼	32,832	5,130.0
Am. Tobacco	62¼	5,378	334.8
Bethlehem Steel	51½	9,583	493.5
Chrysler Corp.	70	8,702	609.1
Corn Products	70½	2,652	187.0
Du Pont	92	45,141	4,153.0
Eastman Kodak	46	16,537	760.7
Genl. Electric	59½	28,846	1,716.3
Genl. Foods	44⅞	5,575	250.2
Genl. Motors	52	87,453	4,547.6
Goodyear	44	4,131	181.8
Intl. Harvester	35	13,131	459.6
Intl. Nickel	42¼	14,578	615.9
Johns-Manville	68	3,162	215.0
Loews	17¼	5,143	88.7
Natl. Distillers	34⅛	8,489	289.6
Natl. Steel	53⅛	7,362	391.1
Proctor & Gamble	66½	9,615	639.4
Sears Roebuck	56	23,647	1,324.2
Std. Oil of Calif.	50⅞	28,673	1,458.7
Std. Oil of N. J.	75¾	60,571	4,588.3
Texas Co.	56⅛	27,521	1,544.6
Union Carbide	63⅝	28,806	1,832.8
United Aircraft	31⅝	3,186	100.8
U. S. Steel	39⅞	26,110	1,041.1
Westinghouse Electric	39⅞	15,458	616.4
Woolworth	42⅜	9,704	411.2
Total	1,758.12		35,181.9
Divisor	6.53		130.7
Dow Jones industrial average	269.2		269.2

Table 2. New Average 11 Months Later Month End November 28, 1952

30 Dow Jones Stocks	D Market Price	E Shares Outstanding, Latest Date, Thousands	F Total Market Value, Millions
Allied Chemical & Dye	76¾	8,856	679.7
American Can	34½	10,886	375.6
American Smelting	41	5,260	215.7
Am. Tel. & Tel.	160¼	34,406	5,513.6
Am. Tobacco	64¾	6,454	417.9
Bethlehem Steel	53	9,583	507.9
Chrysler Corp.	83¾	8,702	728.8
Corn Products	71	2,652	188.3
Du Pont	95⅜	45,290	4,319.8
Eastman Kodak	44⅝	16,532	737.7
Genl. Electric	70¼	28,846	2,026.4
Genl. Foods	52⅜	5,569	291.7
Genl. Motors	64¼	87,291	5,608.4
Goodyear	49	4,145	203.1
Intl. Harvester	33	13,132	433.4
Intl. Nickel	43¼	14,578	630.5
Johns-Manville	73¼	3,166	231.9
Loews	12⅝	5,143	64.9
Natl. Distillers	22¼	8,500	189.1
Natl. Steel	48½	7,348	356.4
Proctor & Gamble	68½	9,615	658.6
Sears Roebuck	59⅝	23,647	1,410.0
Std. Oil of Calif.	56⅜	28,673	1,616.4
Std. Oil of N. J.	75¾	60.571	4,588.3
Texas Co.	56⅛	27,492	1,543.0
Union Carbide	68⅞	28,806	1,984.0
United Aircraft	36½	3,192	116.5
U. S. Steel	41¼	26,110	1,077.0
Westinghouse Electric	46¼	15,664	724.5
Woolworth	44⅜	9,704	430.6
Total	1,747.38		37,869.7
Divisor	6.16		130.7
Dow Jones industrial average	283.7	New average	289.7
		Difference	*2.1%

result in little relative change except over a much longer period of time.

In Table 1, I have assumed that the Dow Jones people decided to change over as of December 31, 1951. As of that date each stock is multiplied by the number of shares outstanding according to the latest published reports. Since the Dow Jones closed on December 31, 1951, at 269.2, it is obvious that the new average would have to start at the same place. This can be easily done by dividing the total market value of all the stocks by 269.2. The quotient would be the new divisor which would remain constant unless a stock in the average were removed.

In this way over the years the Dow Jones average would reflect stock splits. Therefore, not the highest-priced stocks but rather the total market value of each of the common stocks involved would determine their weights. Although the tremendous differences that have resulted since 1929 between the Standard & Poor's and Dow Jones averages would not be eliminated, the important fact to bear in mind is that the Dow average would be much more accurate in the future than in the past. One further fact should be kept in mind. The Dow Jones average includes most of the largest industrial corporations in the United States. If at some future time these large corporations do not act market-wise in the same way as many lesser corporations, then the Dow Jones may be misleading. For now, however, its general popularity can be accepted and used as a guide, provided it is changed along the lines suggested.

If the Dow Jones method of computation is not changed to reflect the outstanding shares, then it is probable that the Standard & Poor's index will gradually be accepted by more and more of the financial fraternity as well as by others. When the divisor gets down to 3 or 4, a flood of articles pointing this out will appear, if not sooner, and after these criticisms it is to be expected that there will be a gradual shift to a more accurate barometer.

On the assumption that the Dow Jones people decided that December 31, 1951, was a good time to change their average, Table 1 shows the old method and alongside of it the new method which simply multiplies the number of shares of stock by the market price. As we know that the Dow Jones closed at 269.2 on December 31, we simply total up column C and divide by 269.2 to get the new divisor which is 130.7.

In Table 1, we selected November 28, 1952, as the date to use. This was purely arbitrary; it happened to be the last month end before the writing of the article, and it provided a convenient period of time to illustrate the difference between the old average and the new one.

In column F of Table 2, one sees the total market value of the 30 stocks divided by 130.7. The net result is 289.7. As the old Dow Jones average was 283.7, the difference in the 11-month figures is 2.1%.

Though it is undoubtedly true that the new average would take slightly longer to compute, with a good calculating machine it should be only a matter of minutes to compute the hourly results.

If the financial community were to demand action now along the lines suggested, an average that dates back over half a century would become a more useful instrument of measurement, meeting today's needs.

Walter J. Schloss

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THE HIPPOCRATIC METHOD IN SECURITY ANALYSIS
by Cogitator (Analysts Journal 2nd quarter 1946)

That excellent compendium of reflective thinking known as The Practical Cogitator-from which our own pseudonym may have been filched - contains an interesting account by L.J.Henderson of the method of Hippocrates, "the most famous of physicians." This procedure is described as follows:

"The first element of that method is hard, persistent, intelligent, responsible, unremitting labor in the sick-room, not in the library; the complete adaptation of the doctor to his task, an adaptation that is far from being merely intellectual. The second element of that method is accurate observation of things and events; selection, guided by judgment born of familiarity and experience, of the salient and the recurrent phenomena, and their classification and methodical exploitation, The third element of that method is the judicious construction of a theory - not a philosophical theory, nor a grand effort of the imagination, nor a quasi-religious dogma, but a modest pedestrian affair, or perhaps I had better say, a useful walking-stick to help on the way - and the use thereof."

Henderson goes on to suggest that this procedure, so successful in the study of sickness, may well be employed in studying " the other experiences of everyday life." That phrase would scarcely suggest our special line of endeavor; yet the temptation to draw parallels between security analysis and medicine is almost irresistible.[1] Both medicine and security analysis partake of the mixed nature of an art and a science; in both the outcome is strongly influenced by unknown and unpredictable factors; in both we may find - in Henderson's phrase - "the concealment of ignorance, probably more or less unconsciously, with a show of knowledge."

If we give our imagination a little rein we can develop systematic analogies between the work of the physician and that of the analyst We can set off the client, with his cash resources and his security holdings, good and bad, against the patient with his constitution and his physical vigors or ailments. This suggests that the typical doctor who ministers only to the sick is fulfilling but a part of his function, as would a security analyst who was consulted only when investments went wrong. The full duty of the physician as of the analyst, should be to assist the patient-client to make the most effective use of all his resources - in one case physical, in the other financial.

Another analogy, more forced yet perhaps more useful, may be drawn between the individual patient and the individual security. Suppose doctors were asked by insurance companies to tell at what rate they should insure given applicants against sickness and death. This would involve an appraisal of each applicant's health factors in quantitative terms, perhaps as a per cent of "par." Is not this at bottom what the security analyst does, or should do, with respect to the stock or bond issues he examines? He must judge whether they are good risks at going prices; or conversely, name the price at which they would be good risks. Both the physician and the analyst must consider a host of factors in arriving at these judgments; they must expect unforeseeable events to play hob with some of them; they must rely on sound methods, experience and the law of averages to vindicate their work.

We have pursued our analogies farther than is prudent, in order to gain a better hearing from security analysts for the Hippocratic method. The first element listed at the outset - "unremitting labor in the sick-rrom" - we shall concede is followed by our responsible analysts. We do work hard and persistently; we do gain our knowledge of securities at first hand - in the board room, if not in the sick room.

It is the second and third steps that invite our self-critical attention. To what extent do we address ourselves to the "classification and methodical exploitation... of the salient and recurrent phenomena"? Of this we have as yet only the rudiments. Very little effort has been made to construct systematic inductive studies of our experience with various types of securities, or security situations. The experience we draw upon in forming our judgments in largely a matter of rule-of-thumb, of vague impressions or even prejudices, rather than the resultant of many recorded and carefully studied case histories.

What warrant have we for our views on questions such as the following: Do higher yielding bonds or stocks show better over-all results than low yielders? Are (statistically shown) upward earnings trends reliable enough to warrant the payment of substantial price premiums? Are the mathematical odds in favor of low priced stocks (in normal markets) sufficient to warrant giving preference to this group? Can the near term earnings outlook be used soundly as a primary basis for common stock selection? and countless others.

It is amazing to reflect how little systematic knowledge Wall Street has to draw upon as regards the historical behavior of securities with defined characteristics. We do, of course, have charts showing the long term price movements of stock groups and of individual stocks. But there is no ready classification here except by type of business. (An exception is Barron's index of low priced stocks). Where is the continuous, evergrowing body of knowledge and technique handed down by the analysts of the past to those of the present and the future? When we contrast the annals of medicine with those of finance, the paucity of our recorded and digested experience become a reproach.

There are explanations and answers in rebuttal. Security analysis is a fledging science; give it (and the Analysts Journal) time to spread its wings. Contrariwise, many of us believe, perhaps unconsciously rather than consciously, that there is not enough permanence in the behavior of security patterns to justify a laborious accumulation of case histories. If physicians and research men keep on investigating cancer, they will prabably end by understanding and controlling it - because the nature of cancer does not change during the years it is being studied. But the factors underlying security values and the price behavior of given typs of securities do suffer alteration through the years. By the time we have completed the cumbersome processes of inductive study, by the time our tentative conclusions have been checked and counterchecked through a succession of market cycles, the chances are that new economic factors will have supervened - and thus our hard won technique becomes obsolete before it is ever used.

That is what we may think; but how do we know whether, or to what extent, it is so? We lack the codified experience which will tell us whether codified experience is valuable or valueless. In the years to come we analysts must go to school to the older established disciplines. We must study their ways of amassing and scrutinizing facts and from this study develop methods of research suited to the peculiarities of our own field of work.

The final element of the Hippocratic method is "the judicious construction of a theory." In our initial quotation, Henderson emphasizes the modest nature of any such theory based on medical observation. It is to be "only a useful walking-stick to help on the way."

So, too, in security analysis, we need theories which stem from experience and close observation, but which are appropriately limited in their scope and modest in their pretensions. We must steer a middle course between starry eyed doctrinairism on the one hand and vacillating opportunism on the other. It is precisely this judicious admixture of the theoretical and the practical approach which characterizes the truly successful security analyst- and the outstanding physician.

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"Why We Invest the Way We Do"

(Lecture delivered by Walter J. Schloss on May 16th, 1996 at the Behavioral Economics Forum at the Harvard Faculty Club in Cambridge, Mass.)

A friend of mine who is a therapist at a mental facility in the New York area, asked me as a favor if I would give a lecture at his facility. He said that there were many intelligent patients there who had emotional problems, but he thought my speech would be helpful to them. I agreed to go, and after being introduced to the audience, I started to talk about investments. After a time, a big fellow in the front row got up and shouted "Shut up, you idiot and sit down". I turned to the therapist and asked him what I should do. My friend said, "The therapy is working, that's the first intelligent thing that fellow has said in months!".

I was reminded of this, because back in 1973, Forbes Magazine wrote an article about me modestly entitled, "Making Money Out of Junk". I hope that this lecture will moderately improve my standing in the investment community. In any case, I'm approaching this meeting on behavioral economics with some trepidation. I don't think investing is a science. I rather look at it as part art and part science with some boundaries. My son, Edwin, and I don't consider our approach a behavioral science, it's just bargain hunting and since a number of value investors have gotten into the field, it has become harder to find bargains.

We want to buy value. We buy a lot of securities. We know a lot of people who don't like our kind of diversification, but we

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can't help that. If you were running a department store, you would like the buyers you employ to purchase suits or dresses, etc. that are good value for the customer. My daughter thought it would be nice to go to Saks Fifth Avenue in New York and buy my wife a dress for $640. plus tax that wasn't on sale. My wife, being a Depression baby like me was horrified at the price and brought it back.

We are bargain hunters in the stock market instead of the retail trade or similar areas. As Ben Graham said, we buy stocks like groceries not like perfume, or as they say, "a stock well bought is half sold". One reason why we don't disclose our holdings is that we don't want competition. If the stock goes lower, which is quite possible, we'll want to buy more.

We don't want to lose money, although, we do from time to time. We have found that if we are somewhat contrarian, we seem to do better than if we purchased companies that are doing well today. When we buy depressed stocks, we seem to reduce our stress. Some people seem to thrive on stress, but we feel in the long run it is bad for them. I note that Peter Lynch of Fidelity Magellan Fund did brilliantly, but after 10 years or so, he retired because it became too difficult to keep up the pace. I've been managing our fund for 40 years and Edwin has been with me for 23 years, and we aren't stressed out yet and we hope we never will be.

We do it our way for several reasons: it fits our personality; it avoids stress, and for me, I remember the Depression of the 1930s very clearly and how it affected our family. People who have been laid off in recent years won't forget what has happened to them and

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their families, and it will affect how they or their children will act in the future. As they say, if the other fellow is laid off it's a Recession, but if you are laid off it's a Depression. I never want this to happen to my family, and so Edwin and I look for ways to protect us on the downside and, if we are lucky, something good may happen. We are basically passive investors. We expect corporations to treat us fairly, which, unfortunately, doesn't always happen. Since Edwin and I work together, we, obviously, have similar points of view, but Edwin is more aggressive in searching out for new investment opportunities, although, he tries to stay within our parameters.

When we buy into a company that has problems, we find it difficult talking to management as they tend to be optimistic. Very rarely will an officer say, "We are doing badly, the outlook is poor and we are very pessimistic about our future". We aren't too good, generally, in interpreting what managements say, assuming we get to top management rather than stockholder relations people.

There is a saying that the less risk you take the better you sleep. Someone may say, "Why not buy short term treasuries?". There is no risk, but little gain. If we are managing other people's money, we have to take some risk. We have another problem managing other people's money, although, we have a good chunk of our own included in our fund. Every year we pay out our realized gains, most of it in long term capital gains, as our average holding period is 4 years not forever, the way some funds operate. Since many of our limited partners want to reinvest, it doesn't seem right that they buy

into a fund with large unrealized gains. In addition, some of the partners can use the income but are reluctant to sell part of their holdings if we have no distributions. This way we just give them a good return.

We want to buy cheap stocks based on a small premium over book value, usually a depressed market price, a record that goes back at least 20 years, even though, the company may be somewhat different then than now, and one that doesn't have much debt. We don't like a lot of debt and we don't think most value investors care for it either. Price is the key factor in the purchase of a stock compared to what we think the company is worth.

A few months ago, I was down in Jamaica and I started talking to a lady from Atlanta. I mentioned Coca Cola and she said that her grandmother had a little coffee shop there during the Depression. She sold the shop and took the money and invested it in Coke. She said that her father owned the stock today, never sold any and that it was worth millions. The punch line is that she told me that they are hanging onto Coke because it's going to be worth $600. a share adjusted for future splits. She made this statement before the recent 2 for 1 stock split this year. It's kind of hard for me to imagine that Coke will be selling for $800 billion dollars, but then many years ago I didn't think the Dow-Jones Industrials would sell for over 5600 in my lifetime.

We are not handling large sums of money and, therefore, we don't have the pressure that the big money managers have. We try to do what is comfortable for us so that we don't develop ulcers. It is important to know what you like and what you are good at and

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not worry that someone else can do better. If you are honest, hardworking, reasonably intelligent and have good common sense, you can do well in the investment field as long as you are not too greedy and don't get too emotional when things go against you.

We want to continue to do what we have been doing over the years. When Howard Browne, Chris Browne's father at Tweedy, Browne let me have a desk in his office, he never thought I'd still be there 40 years later. Chris, I'd like to hang around for a while longer as its brought me luck and good fortune. Maybe that's part of behavioral economics.