An investor's classic shows its value again

By John Authers

Published: June 17 2008 03:00 | Last updated: June 17 2008 03:00

The biggest event in the world of investment publishing this year looks certain to be the re-publication of a book that came out almost three-quarters of a century ago.

Security Analysis , by the late Benjamin Graham and David Dodd, was the tome that launched value investing. It was first published in 1934. McGraw Hill is publishing a sixth edition of their magnum opus later this year, and it is hard to imagine better publicity.

Warren Buffett, no less, announces in a foreword that the book "laid out a road map for investing that I have now been following for 57 years. There's been no reason to look for another."

A more effective endorsement for an investment book would be harder to come by. But it also raises important questions. If Mr Buffett has no reason to look for another investment road map, what is the need for another edition? And Mr Buffett, and many others, have built more on the foundations laid by Graham and Dodd in the intervening 74 years. Why do we need to re-read a book that was written in the exceptional circumstances of the 1930s, during the worst economic recession the US has suffered?

The basics of the Graham creed are well known - buy companies that are cheap and have a margin of safety, or a strong reason to believe they are worth more than they are currently priced. In the midst of the Great Depression, when sentiment had understandably become very pessimistic, it was relatively easy to find companies that were plainly undervalued. So why do we need a new edition?

McGraw-Hill has gone to great lengths to make it relevant, bringing in modern practitioners to write introductions to each chapter. The impressive list includes Howard Marks of Oaktree Capital, Bruce Berkowitz of the Fairholme Fund, and Bruce Greenwald, the Columbia Business School professor, who teaches the school's flagship class in value investing, which Graham himself initiated.

This list is led by the edition's editor Seth Klarman - who heads the Baupost Group and is an important figure in the value tradition, while James Grant, who edits Grant's Interest Rate Observer, contributed a chapter putting the book in historical context.

"Graham knew the Great Depression was a thousand-year flood," says Mr Grant. "He dismissed it as having any heuristic value."

But he points out that an application of Graham's principles would have helped investors, and indeed banks, avoid the subprime disaster of the past year or any of a series of bubbles that preceded it.

More to the point, in spite of the detail in *Security Analysis* and the painstaking study of company accounts it requires of investors before they invest, its greatest strength is in its broader principles. "What strikes me forcefully," says Mr Grant, "is that Graham insists on opportunism rather than prophecy or forecasting. What he leads us to do is to consider the opportunity in front of us and not to guess about the outcome of future events, which are unknowable."

The *Security Analysis* framework is a way to judge those opportunities using facts and without needing to resort to conjecture. As such, it remains powerful.

Mr Klarman agrees. "One of the ways I like to think about Graham and Dodd is that *Security Analysis* is not a book about investing, it's a book about thinking about investing. It's definitely not a get-rich-quick book."

He also points out that Graham, who would often talk about how "Mr Market" could make systematic mistakes, in many ways prefigured the currently fashionable discipline of behavioural finance. "It's about reversion to the mean or, to put it differently, markets overshoot while reality tends to be more stable. It is the perception of reality that tends to overshoot in both directions. Certainly sentiment in the depths of the depression was so bad that if investors could have seen past the valley they would have done incredibly well. Five years earlier, in 1929, such contrary insights would have been incredibly useful as well."

He opted to make a few small cuts to the original text, although the book will come with a CD-Rom including the entire original. "The only chapter we added, which was an obvious addition, was the international investing chapter. Graham wrote in a world where he was restricted to the US. Potentially, this approach could be applied not only to global markets but to other asset classes such as real estate or private equity."

None of this means Security Analysis ended the discussion. "There are still challenges for value investors," says Mr Klarman, "and there are questions that remain unanswered, such as when to sell or how to value growth.

"The interesting thing about the sixth edition is that while it is the next edition of a classic, I think people will find what the modern-day investors have to say is very beneficial."

The biggest contribution to value investing since Graham and Dodd, he says, came unsurprisingly from Mr Buffett, although even here there is controversy.

"Certainly it was Buffett and [Charles] Munger's [Buffett's business partner] contribution that if you buy bad businesses, you often see value stay flat or erode. Even if you buy these businesses at a discount, you may lose money.

"There is currently a debate over how much more investors should be interested in paying for better businesses. But this involves predicting the future. It is easier said than done sometimes, even for Warren Buffett."

Second, the investment world has seen the rise of hedge funds. Graham, in the 1920s, ran what was in effect a hedge fund. "Graham and Dodd were thinking about the merits of being long and short, but hedge funds weren't an established part of the profession in those days," Mr Klarman says.

There has also been the advent of absolute return investing. Areas such as arbitrage and bankruptcy investing are not "plain vanilla" and may interest value investors. They might also develop a view on private equity and venture capital as well, although Mr Klarman warns that the conclusion "might not be all that enthusiastic".

"The rise of the institutional investor is another massive change since Security Analysis was written. The whole world Graham and Dodd wrote about was dominated by individuals. An individual can need to sell stock for a different reason than Fidelity. In today's world, the institutions act differently from individuals for the most part; they make different kinds of mistakes. But when Graham and Dodd were thinking about the markets and investor behaviour, they were thinking about individuals."

All of these changes amply show why a new edition could be useful. Another important development since Security Analysis has been the "efficient markets" hypothesis, which holds that markets follow a "random walk" and always incorporate all available information. One of its most important corollaries is that there is no point in trying to beat the market, and it is better simply to invest through index funds.

However, efficient markets theorists, looking through huge amounts of historical data, have identified a "value effect" - over time, stocks that are cheap by popular measures such as the price/earnings ratio can be predicted to outperform.

Mr Klarman is dismissive of the entire enterprise. "The interesting thing to think about is: 'Why would one think the stock market is efficient? Do we think the market for bus drivers is efficient or are some better than others? Do we think any market has completely efficient pricing?' There is no reason to think that.

"I read a book about Wilbur and Orville Wright several years ago. It basically says when they were learning how to fly, Wilbur posited there were two ways to learn. You could either sit for a long time and imagine in theory what it would be like or you could get on a glider and learn how to deal with it in the air.

"It is the same thing with investment. You can observe or you can go to the dunes and you can build a glider and begin to fly. The academics can sit there and think. But every time one of them leaves to work for Goldman Sachs they make a fortune, and they aren't making a fortune because markets are efficient."

He adds that there are many reasons why people do not behave rationally and why mispricings will persist, saying they are "deeply rooted in human nature".

Intriguingly, the first person to identify this was Mr Buffett in 1984 when he wrote *The Superinvestors of Graham and Doddsville.* Mr Klarman says: "It's an extraordinary article in which he talks about how there are many value investors who have almost no overlap in their portfolios, and yet many academics were failing to investigate the value philosophy and why it was so successful - they dismissed his record as an aberration.

"Value investors couldn't understand why you would call it an aberration rather than study it carefully and understand whether it was replicable. Buffett resented being dismissed, and he was right."

For all the tenacity of the value tradition, there are still comparatively few investors who follow it. That might be, Mr Grant suggests, because it is simply less entertaining. "Value may not be as entertaining as some other kinds of investing. In many trading rooms, you can tell by the buzz of the room whether the market is up or down that day. In a value investing office, you can't even tell if the market is open."

But they still deliver their returns. While Graham would have disapproved, it seems safe to forecast that publication of the new edition will be a big event.