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The Education of a Millennial Value Investor: What I (Eventually) Learnt from Ben Graham

At the 2016 Aberdeen Road Lectures event, the CFA Society of the UK (CFA UK) and Brandes Investment Partners announced this year's winner of the investment essay competition honoring Benjamin Graham, the founding father of value investing and the CFA program. Liam Nunn, CFA, equity analyst at Old Mutual Global Investors, was awarded the £5,000 prize for his essay on how Graham's principles of investing reflect the way he practices today. The competition, which launched at the inaugural Aberdeen Road Lectures event in 2015, awards a prize provided by Brandes Investment Partners annually to one winner for a paper that draws on Graham's thinking and work, as well as promotes financial analysis as a profession. It is open to all members of CFA UK under the age of 35. Here is the text of Mr. Nunn's winning essay.

Synopsis

In this essay I'll explore three tenets of Graham's philosophy that have significantly influenced my development as a young investor. Firstly, the distinction he drew between precision and accuracy. Secondly, the priority he placed on history over forecasts; and finally, his revolutionary emphasis on long-term process over short-term outcomes.

The Education of a Millennial Value Investor: What I (Eventually) Learnt from Ben Graham

I wish I had a romantic tale to tell about falling in love with value investing from the moment I first stumbled across a copy of *Security Analysis*. However, the honest truth is, the first time I attempted to read it as a fresh-faced graduate, I didn't exactly fall head over heels. Having just plunged into an exciting world of flashing Bloomberg terminals, algorithmic trading and twenty-four hour news; I arrogantly dismissed Graham's works, with their archaic terminology and references to obscure, depression-era securities, as little more than quaint relics of a bygone era. Interesting in some historical sense perhaps, but about as far removed from the hectic 'reality' of modern equity markets as I could possibly imagine.

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As uncomfortable as that is for a value investor to admit, I doubt that I'm alone in the experience. As Graham himself quipped, his works have been "read by more people and disregarded by more people"[1] than any others on Wall Street. It was only when I revisited his writings after years of working in financial markets that I began to realise just how wrong I was. Indeed, I'd go as far as to argue it's impossible to fully appreciate the elegance of Graham's thought before you've experienced first-hand the stark contrast of conventional stock market behaviour. Far from being rendered irrelevant by technological change, Graham's patient approach has only increased in pertinence as the pace of stock market life has accelerated.

In this essay, I will explore three tenets of Graham's philosophy that seem particularly significant in the context of contemporary investment practice; and that have greatly influenced my development as an investor. Firstly, the distinction he drew between precision and accuracy in assessing the value of businesses. Secondly, the priority he placed on history over forecasts in security analysis; and finally, his revolutionary emphasis on long-term process over short-term outcomes in the stock market.

The Distinction between Precision and Accuracy

One of the biggest frustrations I encountered, when starting out as an equity analyst, was feeling pressured to have a high-conviction opinion and an explicit 'price target' on every company within my coverage. It frequently

[1] J. Quirt, 'Benjamin Graham: The Grandfather of Investment Value is Still Concerned' in J. Lowe (ed.), *The Rediscovered Ben Graham*, John Wiley & Sons, 1999, p. 254

didn't feel genuine to conclude that specific shares were either *definitely* overvalued or *definitely* undervalued; but as sitting on the fence was liable to be perceived as cowardice, it was tempting to trade nuance for conviction by delivering a binary conclusion regardless. Given how uncomfortable this made me, it was a huge relief to find that one of the greatest investors of all time was never afraid to say "I'm not sure". Graham argued that with the vast majority of businesses, "an analysis, however elaborate, is unlikely to yield a dependable conclusion as to its attractiveness or its real value";[2] and despite the centrality of 'intrinsic value' to his philosophy, he consistently stressed it was an "elusive concept"[3] and that it would be a mistake to view it "as definite and determinable".[4]

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To investors raised on a diet of Capital Asset Pricing Models (CAPM) and Discounted Cash Flow (DCF) models, Graham's inexact approach might seem strange, but personally I feel it's one of his most liberating insights. The fact that we cannot define the *exact* value of a given company doesn't prevent us from identifying when it is too cheap, just as not knowing a man's *exact* weight doesn't stop us from noticing when he is "heavier than he should be".[5] For Graham, the impossibility of pinpoint accuracy wasn't a paralyzing source of uncertainty; it was simply a powerful reminder that analysts must focus their efforts. Whilst it is foolish to believe we can pin a precise value on every company in the universe, we can certainly spend our time looking for shares that sell comfortably below an approximate range of conservatively estimated values. If we can identify such securities, the "indefinite and approximate"[6] nature of the value-calculation ceases to be a barrier to rational decision making.

To Graham, *precision* and *accuracy* were clearly distinct phenomena in investment analysis; and I can't help but feel that the subtlety of this distinction has been partially lost in today's markets, where DCF models are all too often deployed as "get-out-of-jail-free cards" by analysts looking to avoid uncomfortable questions around valuation. Although such models can occasionally be useful tools, the combination of 'precise formulae with highly imprecise assumptions'[7] leaves them very open to abuse. Describing them as a "new kind of philosopher's stone";[8] Graham warned that the illusion-of-precision inherent in such models threatened to undermine the concept of margin of safety and lend speculators a deceptive cloak of scientific legitimacy.[9]

Far from being symptomatic of cowardice, embracing the elusive nature of intrinsic value takes a fair amount of courage in a world where conviction and bogus precision is often held in higher esteem than balance and careful accuracy. Graham knew that accepting what we cannot know is a vital prerequisite to intelligent investment; and I aim to adopt a similarly humble attitude when approaching investment ideas today.

The Role of Forecasting in Security Analysis

Although, speculators can happily concern themselves with guessing future developments, investors should focus primarily on "values which are supported by the facts".

If aliens landed on earth and studied the research reports churned out by investment institutions, they might be forgiven for believing the past record of companies has very little to do with equity analysis. Most reports are overflowing with forecasts and predictions, but it's rare to find more than a couple of years of historical numbers; and finding a comprehensive analysis of how a business has behaved through a full economic cycle is about as probable as discovering aliens with a penchant for human financial affairs. Graham described research that focused purely on future developments as a "mere parody of true security analysis".[10] His view was that although speculators can happily concern themselves with guessing future developments, investors should focus primarily on "values which are supported by the facts".[11]

While this statement could be interpreted as some kind of dogmatic ban on thinking about the future, this would be a very unfair representation of Graham's thinking. He explicitly warned against blindly assuming historical

[2] B. Graham & D. Dodd, *Security Analysis* (1940), 6th edition., McGraw-Hill, 2009, p.348
[3] Ibid., p.64
[4] Ibid., p.64
[5] Ibid., p.66
[6] Ibid., p.66
[7] B. Graham, 'The New Speculation in Common Stocks' (1958), in J. Lowe (ed.) *The Rediscovered Ben Graham*, p. 36
[8] Ibid., p.42
[9] Ibid., p.43
[10] B. Graham, 'Current Problems in Security Analysis' (1946-47), in J. Lowe (ed.) *The Rediscovered Ben Graham*, p. 198
[11] Graham & Dodd, p.86
[12] B. Graham, *The Intelligent Investor* (1973), 4th edition (revised), Harper, 2006, p.517

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average profits were a more reliable basis for valuation than (conservatively) estimated normalised earnings; [12] and he urged investors to consider why the future may differ from the past.[13] In referencing Kierkegaard's observation that life must be lived forwards, but can only be understood backwards;[14] Graham clearly acknowledged the inevitable importance of the future to investment analysis, but nevertheless expressed discomfort that many investors barely glance in their rear-view mirror before slamming their foot on the accelerator.

Where Graham clearly did differ materially from many contemporary investors was in the distinctly defensive manner in which he thought about the future. For Graham, it wasn't that the future was irrelevant to security analysis; but rather that it was first and foremost "something to be guarded against rather than to be profited from".[15] While it is essential to consider future prospects as part of a thorough investigation; to pay a large upfront premium for projected future profits – that are entirely without precedent in the history of the company – is to cross the line between investment and speculation.

It seems important to note here that Graham's scepticism towards forecasting wasn't as two-dimensional as arguing that forecasting is dangerous because we might get it wrong. He was keen to urge that even if we had access to a crystal ball that could confirm the validity of our rosy projections; it still wouldn't make buying shares solely on the basis of those projections a sound enterprise.[16] There is a far more fundamental problem here: namely, the difficulty of determining the *right* price to pay for the foreseen favourable prospects. Graham was wary of the way in which projected growth, when combined with the "miraculous workings of compound interest",[17] could justify nearly *any* price for a particularly favoured business; echoing David Durand's comparison with the Petersburg Paradox in mathematics.[18]

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The brilliance of Graham's insight resides in his appreciation that the problem with over-reliance on forecasting doesn't rest solely on the inherent *difficulty* of predicting the future; but also on the impossibility of *valuing* future prospects in a sufficiently conservative manner. It's not just that we don't have access to a magical crystal ball; it's that such a crystal ball often wouldn't be that useful from an *investment* perspective, because the price Mr. Market quotes for such exciting issues is almost always too high to offer us margin of safety.[19]

In a world where ever greater emphasis is placed on forecasting, following Graham's advice is challenging. But as far as possible, I seek to ensure that a healthy respect for history remains at the forefront of my analytical process; and to firmly avoid the reliance on "potentiality and prophecy" of which Graham was so sceptical.[20]

The Importance of Process over Short Term Outcomes

When trying to persuade other investors of the merits of a value approach, one of the most common responses I've encountered is for them to list the occasions where they've made money in stocks that value investors wouldn't have touched with a bargepole. The fact that many people view this as a valid criticism of Graham's thinking just goes to show how commonly misunderstood his philosophy is (and perhaps how few people have actually read his works).

It feels like the most natural thing in the world to judge the merits of investment decisions by their immediate outcomes. Our instinct tells us that if a stock appreciated in value after purchase, it was a good investment; while if it declined in price, it must have been a poor decision. In many aspects of our lives, this automatic reasoning is useful and I'm sure it was advantageous from an evolutionary perspective to see linear causality all around us (our ancestors that questioned the statistical rigour of every observation were probably less likely to run away when the same sabre toothed tiger that ate their mate last week reappeared on the horizon). The problem with such inductive reasoning in investment is that the stock market can be a terrible teacher in the short run; and it's

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[13] Graham & Dodd, p.65
[14] Graham, *The Intelligent Investor*, p.180
[15] Graham & Dodd, p.86
[16] Graham, 'Current Problems in Security Analysis', p.172
[17] Graham, 'The New Speculation in Common Stocks', p. 42
[18] Ibid., p.42
[19] Graham, *The Intelligent Investor*, p.517
[20] Graham & Dodd, p.349

all too easy to pick-up risky habits by focusing solely on our own statistically insignificant experiences.

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To my mind, one of the aspects of Graham's philosophy which marks him out as a truly revolutionary figure was his desire to look beyond the world of immediate *outcomes* in order to formulate a rigorous *process* that could be "demonstrated by figures, by persuasive reasoning, and by reference to a body of actual experience".[21] To Graham, it wasn't good enough for investors to judge their competence on the basis of their own anecdotal outcomes. For investment analysis to be elevated to the status of a true profession, he realised that it was necessary to lay-out a methodology that "*all* careful and intelligent investors can follow";[22] and to establish "a technique of a communicable sort – that a good instructor can pass on to his pupil".[23] Drawing upon the analogy of the game of bridge, Graham urged his students to appreciate the emphasis that expert players place on "playing a hand *right*, rather than playing it *successfully*. Because…if you play it right you will make money and if you play it wrong you lose money – in the long run".[24]

Unlike thousands of stock market operators before and since, Graham grasped the importance of playing the hand *right*; and set about the monumental task of formulating a replicable process that could be justified by both empirical observations and logical reasoning. Contrary to what ill-informed critics suggest, Graham never claimed that it was impossible for certain fortunate speculators to make money in the stock market (if it was *impossible*, the temptation to speculate wouldn't be there). He simply argued that "very *few* people are consistently wise or fortunate in their speculative operations";[25] and that such behaviour could therefore never be classified as investment in the true sense of the word.

For Graham, focusing on process over short-term outcomes wasn't only rational; it was an essential ingredient of professional integrity. It was in this spirit that he urged his students to appreciate that when they make mistakes, as all investors inevitably will, it's important that they can look back and say they were "intelligently wrong and not unintelligently *wrong*".[26] I'd like to think that all contemporary investors, regardless of their investing-style, can stand back and acknowledge the laudability of Graham's aim in this regard.

But with Graham as a guide, I'm hopeful I can find the inner-fortitude to stay the course.

Carrying the Torch

It's easy for me to pay lip service to Graham's thinking and to quote his wisdom in an effort to make myself feel smart. It's significantly harder to actually implement his ideas in reality. With the average professional investor ever more focused on short-term results, and with market volumes increasingly dominated by algorithms concerned with the "price of everything but the value of nothing",[27] the *opportunities* for contemporary value investors should be as great today as they've ever been. But, with the institutional pressure to deliver short-term performance increasing alongside the general pace of market life; *exploiting* those opportunities requires a 'firmness of character'[28] that few of us can claim to be naturally blessed with.

While I certainly hope to be among those investors that can carry forward Graham's torch, I also know there will inevitably be tough trials ahead and that the life of a millennial value investor is unlikely to be smooth sailing. There's a lot I've yet to learn about investing and there's perhaps even more I've yet to learn about my own psychology and mental strength. But with Graham as a guide, I'm hopeful I can find the inner-fortitude to stay the course. In any case, I would urge other young investors to avoid my initial mistake of dismissing his works as outmoded. Look beyond the surface level antiquities and absorb the timeless wisdom within: your investing life

[21] Graham, *The Intelligent Investor*, p.520
[22] Graham & Dodd, p. 368
[23] Graham, 'Current Problems in Security Analysis', p.197
[24] Ibid, p.228
[25] Graham & Dodd, p.499
[26] Graham, 'Current Problems in Security Analysis', p.191
[27] M. Johnson, 'How Human Traders Will Beat the Machines', *The Financial Times*, 25 January 2016, http://www.ft.com/cms/s/0/9c3a1b1a-c33f-11e5-b3b1-7b2481276e45.html#axzz46HbHk69y
[28] Graham, 'The New Speculation in Common Stocks', p.69

will be infinitely richer for the experience.

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Liam Nunn's views do not necessarily reflect the views of Brandes Investment Partners.

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