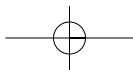
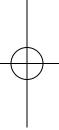
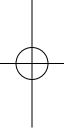
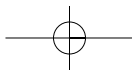
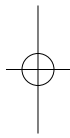
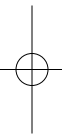
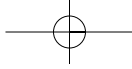


PART
one

Basic Concepts





CHAPTER 1**Introduction**

October 1929 marked a watershed of investing in the United States. Following a nearly decade-long bull market, the Dow reached a peak of 381.17. It then began a long and sharp decline, plunging to a sickening 41.22 in 1932, ruining many investors. Finally, the Dow recovered to the low 200s, which represented a “normal” level for the time. Serious investors wondered if these were random moves. Or could an intelligent investor determine “reasonable” levels for stock market prices and profit from this knowledge?

In 1934, a pair of investors, Benjamin Graham and David Dodd, began to make sense out of the wreckage. The problem during the late 1920s was that easy money, easy credit, and the resulting go-go era had turned the stock market from an investment vehicle into one of speculation. (This happened again in the mid-1960s and again in the late 1990s.) Stock prices had become divorced, in most cases, from the underlying value of the companies they represented. It took corrections of exceptional violence in the early 1930s, the early 1970s, and, by our reckoning, to come in the mid-2000s, to restore the link between stock prices and underlying values. In retrospect, one could, by careful analysis, find a reasonable basis for stock evaluations even in the Depression environment of the 1930s.

Graham and Dodd were among the first investors to make the transition from thinking like traders to thinking like owners. In the crucible of the Crash, they posed a set of questions that are still applicable today: What would a reasonable businessman, as opposed to a speculator, pay for a company and still consider that he was getting a bargain? What entry price would almost guarantee at least an eventual return of capital with good prospect for gains? Could a prudent investor reasonably allow for a margin of safety in his purchases?

If one believed the intrinsic value of a business was estimated to be worth \$100, and the stock was selling at \$95, it was no bargain. An estimate of the business value is just that—an estimate. The business might well be worth only \$90. However, if the stock were selling at \$50, it was clearly a bargain. A reasonable businessperson’s valuation of a company might easily be off by as much as 5 to 10 percent. It would not likely be off by

50 percent. The difference between a price of \$50 and an estimated value of \$100 allows for a large margin of safety.

There are two types of risk in the stock market: price risk and quality risk. Price risk signifies the tendency to overpay for the stock of a perfectly good company. Quality risk involves buying the stock of a company that will never prosper, or worse, go into bankruptcy, possibly costing the shareholders their entire investment. Although the latter type of risk is more dramatic, because of its higher stakes, the former is more common, and hence more costly in the long run. Only a handful of companies actually default, and many of the ones that do experience financial difficulties make out all right in reorganization. Price risk routinely affects nearly all companies from time to time, particularly good companies, for which investors have overly high hopes. If you buy at the top and there is a subsequent decline, you could lose 30 to 50 percent on your investment in short order. That is why price risk is considered the greater danger, even though default risk is a serious matter. If debt holders get less than 100 cents on the dollar, shareholders may end up getting nothing (although in practice, shareholders rarely lose everything in a bankruptcy, because a few crumbs are usually thrown their way to ensure cooperation in a restructuring).

However, Graham and Dodd felt that even default candidates were likely to produce profits if they were purchased at a sufficiently low price and enough of them were owned to allow the law of large numbers to work in their favor. Indeed, these investors managed a bankruptcy/liquidation fund that did somewhat less well than the regular fund on a nominal basis, and much less well than conventional investments, after adjusting for risk.

Classic Graham and Dodd investing involves buying the stocks of average- to above-average-quality companies at a low price. If a stock is trading at the low end of its historical valuation band, the downside risk is lower than it would otherwise be, and the upside potential is at its maximum. This book will discuss some of the diagnostic tools used by Graham and Dodd to determine value, and then present updated versions used by modern practitioners.

GRAHAM AND DODD CRITERIA FOR SECURITIES SELECTION¹

Graham and Dodd proposed stringent criteria for their investments, and because of the generally depressed valuations, found many securities that met these criteria in the 1930s.

The first of these requirements was for the stock to sell below its stated per-share net asset value or book value. Provided that book value was a minimum estimate for asset value (as verified by other tests listed below), an investor who purchased a stock below book value would be getting assets worth more than the investment.

It would be much better if the company could also meet certain liquidity tests. Graham and Dodd found a number of companies whose market value (stock price multiplied by the number of outstanding shares) was less than the company's *liquid* assets, such as cash, accounts receivable, and inventory, minus accounts payable and short-term debt, or what we would now call *working capital*. In an even better situation, working capital would be greater than the market value of stock plus long-term debt, or what we would now call *enterprise value*. An investor who bought the stock of such a company would effectively be paying less than nothing for the business as a going concern. Given the Depression nature of the time, this was not an unreasonable requirement.

Moreover, the company had to be profitable. The growth rate of profits, on which most modern analysts base their decisions, was much less important because, during the Depression, profits often fell. But some profitability ensured that assets, at least, would grow. So the company was expected to be an all-weather earner, able to generate profits even in tough times, not just a fair weather operator.

Nearly as important was the question of dividends. Provided that they were covered by earnings, the periodic payouts would guarantee a return, while the assets underpinning the principal would increase. If there were earnings, but the dividends exceeded them, then the distributions would be more in the form of a payback of invested capital, rather than that of a return. But at least the investor could be confident of getting back the original investment, plus a little more.

Graham and Dodd asked for a dividend yield (dividend divided by the stock price) of at least two thirds of the AAA bond yield. This requirement ensured that the stock had to be competitive with bonds as an income-producing instrument—a sensible criterion. Since bonds are inherently safer than stocks, one would have to have a reasonable assurance that the total return, dividends plus capital gains, eventually would be greater than bond returns. If there were dividend growth, a dividend yield that started at two thirds of the bond yield would eventually exceed the fixed income stream, leading to capital gains as well.

Alternatively, the so-called earnings yield had to be twice the AAA bond rate. The earnings yield (ratio of earnings per share of the stock price) is an outdated term, but it is the inverse of the much more commonly used price-earnings (P/E) ratio. This requirement meant that a qualifying stock's P/E could be no more than $1/2r$, where r is the AAA corporate bond rate, measured in decimals. If the AAA bond rate were 5 percent, the P/E ratio could be no more than $1 / (2 * 0.05)$ or 10. If the AAA bond rate were 10 percent, the P/E ratio could be no more than $1 / (2 * 0.10)$ or 5. This relationship had to be true to compensate for the risk that earnings might fall.

The economic conditions that make this form of investing viable have seldom existed since the 1930s. There are few, if any, stocks that satisfy all of Graham and Dodd's conditions simultaneously. But it is interesting that some stocks satisfy some of the conditions taken individually. After all, it is easier to hope for A or B or C than to hope for A and B and C. This book offers an updated form of Graham and Dodd, tailored to more recent economic conditions.

If, for instance, we can buy stock of sound companies around book value (or some alternative measure of asset value), we would overlook the likelihood that the company paid little or no dividends. We would, instead, look for evidence of rapid asset accumulation, expressed as a percentage of existing assets, as well as assurance that such accumulation would lead to good earnings and dividends or, alternatively, make the company a potentially attractive takeover candidate. This does not mean that a takeover must occur. Just the fact that a takeover is a possibility is often enough to push up the price of the stock, especially during the recurring periods of takeover mania.

If a growing company were paying a large dividend, however, we might overlook a paucity of assets on the theory that they had been paid out in the past in the form of dividends. Instead, we would look for evidence that, first, the dividend was secure and, second, there were good prospects for at least moderate growth. Here again, the test is how does the stock compare to bonds as an income-producing vehicle, not only in the present, but also over time. If the stock (at current prices) is likely to be a superior income-producing vehicle, say, in five years, based on a rising dividend, the stock is more likely than the bond to rise in price, thereby producing capital gains as well as higher income.

Suppose a company were selling at a high multiple—two, three, or more times the book value or asset value—and suppose it paid little or no dividends, so that it was also expensive on a dividend basis. Perhaps it is cheap based on earnings. This can happen if the rate of return on assets is high enough. We would, of course, test the quality of these supposedly high earnings, taking careful account of the company's strategy, track record, and how it stands in its industry. If there were good and sufficient reasons, we would make some allowance for earnings growth. We would, however, be especially wary of the competition that is likely to be attracted to a good business, and would want evidence that the company had a franchise that it had defended successfully over some years.

A high P/E ratio usually means that there are expectations of high growth built into a stock, which a Graham and Dodd investor would tend to distrust. However, we might occasionally make allowance for this fact if the stock were cheap on other measures such as sales or cash flow, and if rapid earnings growth were structurally determined by one or the other of these two factors.

We would be particularly interested if the calculated “economic earnings” were significantly above the accounting earnings reported in financial statements. After all, leveraged buyout (LBO) artists use “private market value” calculated on the basis of the cash flow as their proxy for business value.

Intellectually, we should give the greatest weight to facts that we are most sure about and less weight to data that are based on estimates or even educated guesses. The only thing that we know for sure about a company, at least on a day-to-day basis, is the stock price. We also know the dividend rate based on the most recent declaration, and hope that it will at least be maintained, if not increased, in the future. Provided that the accounting is sound, we also know the assets and liabilities on the most recently reported balance sheet (usually as of the last quarter), as well as historical earnings for the past quarter, the most recent year, and past years. Of course, this information becomes somewhat obsolete as the current quarter proceeds, at least until the next report is issued.

To the extent possible, we would try to avoid overly relying on forecasts of the future. Of course, the future must be forecasted, but more on an ongoing, monitoring basis, rather than something on which to base a stock valuation. Estimates of earnings are just that—estimates. They should be considered in the context of the past performance of earnings or of related variables such as sales and cash flow. Greater weight can be given to an earnings trend that has been stable and consistent in the past than to one on which earnings have fluctuated erratically. But investors ought to be particularly suspicious of a proposition that earnings will soon increase dramatically after a long-term trend of bad results. This is reminiscent of the motto of the Brooklyn Dodgers: “Wait till next year.”

A certain cautious optimism is warranted, however. Over a five-year cycle, many companies can be expected to have perhaps two good years, two mediocre years, and one bad year, on the average. When things are going wrong for a short period of time (and stock prices are low as a result), there is a tendency for gloom-and-doomsters to extrapolate present conditions into the future. If there is a sound basis for believing that the present conditions are abnormal, one can reasonably believe that things will eventually revert to their long-term tendencies or trend lines. It is important to distinguish between the occasional pothole in an otherwise good road and the inherently bad road.

MODIFICATION OF GRAHAM AND DODD APPROACH TO MODERN PRACTICE

Having dispensed with the preliminaries, we can now concentrate on a discussion of the changes that have taken place in the financial world since the days of Graham and Dodd, and discuss the necessary modifications to

apply their principles to value investing. Many recent examples are introduced later in the book to illustrate the modern approach and the similarities in the treatment of these cases and those in times past.

Nowadays, greater importance is attached to the income statement and less to the balance sheets than in Graham and Dodd's time, partly due to the changing nature of financial disclosure. Early financial reports would typically present balance sheets but only a brief income summary, not a full income statement. The third major document of today's annual report, the statement of changes in financial position, was not present. So Graham and Dodd had to base their early investment decisions on information available to them, which was mainly balance sheet information. Today's investors are much more fortunate. Now there are footnotes to most income statement items, together with management's discussion of operations. And the statement of changes in financial position will tell an investor what management is doing with the money they have earned, whether they are paying dividends, making acquisitions or capital expenditures, or doing other things. It also tells whether the spending program is financed internally or whether the company has to go into debt in order to expand.

The greater richness of the income statement, with detailed analyses of sales, cash flow, operating earnings, and other categories of earnings, allows for a greater battery of tests and screens. No one methodology works well all the time. Even Ben Graham admitted the shortcomings of his approach during the late stage of a bull market, such as those that existed in the late 1960s to early 1970s and the more recent one in the late 1990s. Under those circumstances, and perhaps against his better judgment, he loosened his valuation criteria to accommodate the exigencies of that time just before his death in 1976. We don't like the idea of changing the rules as we go along. Instead, we would rather have a large number of yardsticks that have proven their robustness in less demanding markets.

The other factor is the changing nature of the economy and society. When Graham and Dodd first wrote their book, their world was still one of brick and mortar. Now, we are moving into an information society. The new developments are based on intangible assets such as knowledge held by people and computers. The assets are far more movable than they used to be. They are, however, no less real, if less dependable. But intangible assets are less likely to appear on the books as financial items.

On the macro level, the economy is better managed than before. This is not to say that there will not be business cycles and recessions, but that they will likely be shorter and shallower than they were during the days of Graham and Dodd. Logically, it should follow that acceptable price/book and P/E ratios would also be higher.

Moreover, with the development of modern accounting, and most importantly, of accounting analysis, investors are more inclined to look past

accounting definitions of earnings and asset value, and probe more deeply into the economic substance. Earnings that are hidden, let's say, for tax purposes, may well be as valuable to the company as more visible profits. The question, then, is whether, when, and how this extra value will be reflected in the marketplace.

In one respect, we are stricter than Graham and Dodd. We prefer a superb balance sheet, or at least a very good one. Except for inherently leveraged companies like banks and utilities, a debt ratio of more than 30 percent of total capital (debt plus equity) would be considered too high. In fact, a level of 20 percent would be more comfortable. If the investment case were based on asset value, then the ratios would be 30 percent and 20 percent, respectively, of asset values. A merely adequate balance sheet will protect investors against today's trouble, but not against unforeseen shocks that may occur in the future. We want the extra margin of safety that a very strong balance sheet will provide. A company that is all or nearly all equity financed will see fluctuations in its business fortunes, but offers a guarantee that it will retain at least part of its assets under even extraordinarily adverse conditions. However, it is a company that is overburdened with debt in which an investment may be lost.

It must be said that these rules and tests are a form of guidance. They are no substitute for good judgment. A master practitioner such as Warren Buffett realized his full potential only when he broke free of these rules and let his intuition supplement his logic. But these rules are designed for less talented investors as much to prevent harm as to produce winning investments. Or as Ben Graham put it, "Rule 1: Don't lose money. Rule 2: Never forget Rule 1."

REQUIREMENTS FOR VALUE INVESTING

Unlike Graham and Dodd, we do not advise conservative and aggressive investors to use different valuation parameters. Instead, the difference in our advice to each class of investors lies in the quality of the securities that can be admitted to the portfolio. For instance, we advise a conservative investor not to purchase the stock of a company that has a short earnings track record—one of less than 10 years—or a reported loss in the past five years. However, an aggressive investor can buy shares of a company that is currently losing money if the stock price has also been beaten down to an attractive level as a result, and he or she is convinced that the condition is temporary and most likely self-correcting.

In this regard, it is important to compare the company with others in the same industry. While different companies will have different sensitivities to a particular crisis, it is more comforting if the problem is industry-wide,

rather than specific to one company. Then, it may be a question of choosing the survivors that will prosper after the industry consolidates. This is a task for which the Graham and Dodd methodology is geared. In this case, investors are advised to buy the highest-quality company in the industry, on the theory that it will be the last to fail and the first to gain market share from the failures of others. But a fallen issue may not be a good investment if many other companies in the industry are prospering, because then the fault lies with the company, not with the industry. The exception may occur when there is a new chairman or other change of control.

Likewise, a conservative investor is advised to stick to the securities that are not only currently paying dividends, but also have paid them for at least the past 10 years. The investor is getting at least some current return if the payout is covered by earnings, and a bird in hand is worth the proverbial two in the bush. The dividend also underpins the stock price in a similar way as a high coupon does for a bond. An aggressive investor can buy the stocks of companies that have only recently started paying a dividend, however, and may even consider the purchase of a security that has no yield if the stock meets other Graham and Dodd parameters. This is partly because some of the best securities are those of relatively new companies and partly because a fast-growing company may wish to retain cash for expansion, if the likely returns on investment are greater than the investors can hope for in most other securities. Certainly, it is better to see a company pay no dividend than to see it borrow to make a distribution to shareholders.

Conservative investors will pay more attention to asset values in trying to buy stocks “net” of working capital or, better yet, “net-net” of working capital and long-term debt. These issues derive their protection from asset values, which are known, rather than earnings prospects, which are less well known. However, aggressive investors need not worry so much about coverage of their investment by working capital or “quick” assets or even book value. Instead, they should focus on high returns on assets, which are usually generated by investing in higher-return fixed or tangible assets. Sometimes a company in this position may even be somewhat short of working capital.

Another set of requirements has to do with the nature of companies and securities. For instance, a company should be a certain size to be able to withstand economic vicissitudes and uncertainties. Here, one has the right to be quite demanding. In this day and age, hundreds of companies have sales, assets, and/or market capitalization of \$1 billion or more. This one-time magic number carries far less prestige than it used to, much as \$1 million for net worth of an individual is a far smaller number, relative to the overall economy, than it might have been some decades ago. Indeed, there is no shortage even of companies with profits of \$1 billion or more. Given this fact, a qualifying investment for a

conservative investor should have sales and/or assets of some significant fraction of \$1 billion, say at least \$500 million or more. An aggressive investor might shade these figures down to \$100 to \$200 million, but no lower than that.

Perhaps a more useful measure is net profits. For a conservative investor, a net income of \$25 million in the most recent year, or an average of this figure in the most recent five years, gives a company at least some—though far from perfect—staying power against economic uncertainty. Again, an aggressive investor might shade this requirement down to \$5 to \$10 million. But a company with normal earning power below this level cannot be said to be an investment and must be regarded as a speculation.

A company also should have a sufficient corporate history in order for one to be able to form a judgment of its prospects. At the very least, the company should have been around during the last major recession (i.e., in 2001) and demonstrated its ability to manage tough times. A conservative investor should feel better with the stock of a company that has been in business for at least 20 to 25 years. An enterprise that has been in business that long has been through at least two or three recessions, several stock market cycles, and normally part of both halves of the 30- to 40-year-long cycle described in Chapter 20 of this book. Moreover, it takes a period of time for most companies to build up an asset base and establish a track record for inventory and other working capital components that will be satisfactory to a Graham and Dodd investor.

This minimum provenance is an important requirement for the conservative investor. A brilliant child of 12 or 15 may well have the mental capacity of an intelligent adult. In rare cases, he or she may be enrolled in college courses or participate in other activities far beyond the normal scope of his or her years. But this child will not legally be allowed to drink or drive or vote, even though a more pedestrian individual some years older will be permitted to do all of these things. These legal limits are imposed with good reasons because the child will not have enough of a life history to be relied on in such matters. Nor will this same child have the capacity to do certain things that are normally the province of adults until he or she goes through certain physical changes, typically during or just before the early teens. Likewise, a company with only a few years of history, however stellar, will not be “mature” enough for the conservative investor.

Beyond 50 years, the benefits of additional corporate age are small indeed. There are probably some advantages to a company that was around during or before the Great Depression of the 1930s, as opposed to having been started immediately after World War II. But a company established in the nineteenth century (in rare cases the eighteenth) offers no advantage over one founded in early twentieth century. In fact, too long a history may well be self-defeating. Things are changing at a faster rate than they ever have

throughout human history, and a company confronting the twenty-first century with its roots in the nineteenth century may well find itself at a disadvantage. It is probably no accident that relatively recently banks such as Irving Bank and FleetBoston, which were founded over 200 years ago, about the time of the American Revolution, were taken over by others.

In addition to corporate age, the company's stock should have a trading history. Even allowing for the fact that stock market cycles are typically shorter than economic cycles, the trading history should not be less than two or three years. This would give investors some feel for how the stock will trade during periods of optimism and pessimism, and allow the establishment of upper and lower value bands.

We advise our investors not to participate in new issues, otherwise known as initial public offerings (IPOs). These issues are managed by large investment houses for the benefit of their favorite clients, usually institutions, but occasionally a wealthy individual customer such as a corporate chief executive officer (CEO). They are priced to sell or "move," which is to say that they are priced below the level where the favored customers can sell or "flip" them to less favored retail investors. Small investors may try to capture the initial momentum when a new issue hits the market, but by the time they place an order, the stock price may have already adjusted to a "normal" or even unsustainable level.

A final set of requirements has to do with liquidity or tradability. Preferably, a stock will be listed on a major exchange, either the New York or American Stock Exchange. Of course, some of the largest, most liquid names like Microsoft and Intel are traded at the national over-the-counter exchange, otherwise known as the National Association of Securities Dealers Automated Quotations (or NASDAQ for short), which has become a significant player in recent years. Other over-the-counter stocks (listed in financial pages simply as other OTC stocks) trade infrequently. The investor cannot be sure of getting the best prices on either the purchase or sale of such issues because the gap between the market maker's "bid" (or buy) price and his "asking" (or sell) price is large, typically a quarter of a point, sometimes more. Investors are also advised to stay clear of regional exchanges, especially those such as Spokane or Vancouver, which seem to have a disproportionate number of fly-by-night or "mousetrap" stocks sold by manipulative and unscrupulous promoters.

SUCCESS OF WARREN BUFFETT²

Perhaps the greatest living practitioner of the Graham and Dodd philosophy, although not exactly their methodology, is Warren Buffett. He was a former student of Ben Graham, but his investment method eventually

evolved into a growth-at-a-reasonable-price style, rather than an asset-based approach.

Buffett's early achievements were in the Graham and Dodd style. He bought the controlling interest in a textile producer, Berkshire Hathaway, at a discount to book. Although textiles was a bad business, the working capital of the company was used to buy the stock of other companies, rather than reinvested in textiles. So Berkshire Hathaway became the vehicle for a very different type of entity—an investment concern.

In the early 1970s, Buffett bought stock of the *Washington Post*. The company, with double-digit margins, was selling at only two times sales. The P/E ratio was also low, in the mid to high single digits. Finally, the company had radio stations, newspapers, and other components, which had a total asset value of \$400 million. Yet, the company was sold at a market value of only \$80 to \$100 million. This represented a discount of not 50 percent but 75 to 80 percent to takeover value. The market was low at the time and represented the most recent ideal Graham and Dodd environment.

Although the *Washington Post* paid only a small dividend, it did a related thing—it bought back stock. Given the gross undervaluation of assets, this was a smart thing to do. (If the money had been paid out as dividends, a shareholder would have to reinvest to get the same benefit.) Thus, although the newspaper business was inherently attractive, the *Washington Post* outperformed the *New York Times* and other newspaper stocks. At the same time, Buffett got a seat on the board and became a confidant of chairperson Katherine Graham. This enabled him to prevent the *Washington Post* from making the great mistake of its time—overpaying for high-priced media properties through the use of leverage. Instead, the company, despite its share buybacks, maintained a strong balance sheet.

Another Graham and Dodd-type investment of the time included GEICO, a turnaround situation. GEICO was technically insolvent until Buffett, working through Salomon Brothers, bailed it out by infusing \$25 million of new capital at a bargain price. This was a rescue rather than a classic arbitrage situation, Graham and Dodd style. The idea was to hold on, rather than liquidate at a profit. (Berkshire Hathaway finally acquired all of GEICO in 1996.) Although the infusion of capital solved the problem that had depressed the stock price, the bargain remained.

In the mid-1980s, when GEICO stock moved from undervalued to basically fairly valued, there was a crossroads. At this point, Buffett decided that he would rather have a great company at a good price than a good company at a great price. He liquidated most of Berkshire's existing holdings except for the previously mentioned companies in order to help Capital Cities, headed by his good friend Tom Murphy, to finance the acquisition of ABC. Capital Cities was bought at a fair value, rather than at an undervaluation. So the investment case depended on Murphy's ability to

generate growth by cutting ABC's costs. The combined company, Capital Cities/ABC, had a high level of leverage for several years because of the high purchase price, but Murphy took it down by selling assets, cutting costs, and using cash flow to repay debt.

Later in the decade, Buffett took a large position with Coca-Cola at a substantial premium to book. Because he was the most brilliant graduate of the Graham and Dodd school, he could afford to take these liberties, generating a total return of over 20 percent. More traditional Graham and Dodd practitioners earned somewhat lower percentages, in the high teens.

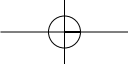
UNCERTAIN NATURE OF THE MARKET

A word of warning: While this book is about investment, all investments involve an element of speculation. The object is not to avoid speculation, but only to enter the market when the odds are favorable. The difference between a casino and the market is the odds. In the casino, the advantage lies with the house, and the game is rigged against the player. In the stock market, the odds are in favor of the investor, who will win on average, although not every time. In this regard, the stock market is more like farming or any other business than it is like a casino.

An example may illustrate the point. Suppose there were an even-money bet in which you and the croupier in a gambling house agreed on a number from one to six. Then you roll a fair die, winning if the number on the die is greater than the agreed-upon number, losing if it is less, and tying if it is the same. If the number were as low as three, you should take the bet. In this case, there are three chances out of six of winning, two of losing, and one of tying, so you are a three-to-two favorite on the bet. You would be ill advised to take the bet with a number of four or higher, because you would be an underdog.

Suppose, instead, that the croupier randomly called out numbers—mainly threes and fours, with occasional twos and fives, and rare ones and sixes—and the investor were allowed to choose which rounds to play. Rejecting the high-numbered rounds, you would willingly choose rounds in which the called-out number was three, and eagerly play rounds in which the called-out number was two, not to mention the ones. Even with favorable odds, you won't win all your bets. But a rational calculation of the chances indicates that these bets should be taken.

This is exactly the situation in the stock market. Ben Graham called upon the investor to imagine himself in business with a partner, Mr. Market, who would call out daily prices for a wide range of securities and allow the investor either to buy or sell (or do nothing). Being very temperamental, Mr. Market would call out vastly different prices on different days. Even



allowing for the fact that the underlying values of the companies would move somewhat over time, the price–value relationships for a given company would be better on some days than others. It is up to the investor to pick the advantageous prices at which to “bet” on a purchase or sale.

Another analogy comes from poker. There is a saying in poker: “If you look around the table and can’t identify the sucker, you are the sucker.” Too many amateur investors get in at the top of the market, just when the “smart money” is selling. This process is called *distribution*, because the stock is being distributed by large investors to small investors, who are the buyers of last resort. So these small investors take the brunt of the losses that are likely to result. We prefer to be the grizzled veteran who perhaps drops a few hands by declining to call. But we will avoid being tricked into making large contributions to pots that we have little hope of winning.

Although Graham and Dodd investors are seldom the biggest winners, they tend to walk away with good gains at the end of the day because they have avoided large losses. The wins take care of themselves.

