Investment Principles

Confronted with a challenge to distil the secret of sound investment into three words, we venture the motto, Margin of Safety.

Benjamin Graham
The Intelligent Investor (1949)

Benjamin Graham (1894-1976), author of *Security Analysis* (1934) and *The Intelligent Investor* (1949), was a principal of Graham-Newman Corp. (1926-1955). He is also regarded as a (and perhaps the primary) founder of modern financial analysis. Leithner & Company Limited ("Leithner & Co") is a Graham-style value investor.

Graham's key insight is that "investment is most successful when it is most businesslike. An investment operation is one which, upon thorough analysis, promises safety of principal and a satisfactory return." Operations that don't meet these requirements are speculative. Value investors recognise that price is what's paid and that value is what's received; they observe that over time price and value gravitate towards one another but that at any given point in time may diverge (sometimes by a wide margin); and they regret that most market participants apparently seldom recognise – and some wilfully ignore – the fundamental distinction between value and price. Value investors emphatically reject the prevailing view that the price and value of a security (i.e., stock, bond, title to real estate) coincide at all times.

In order to appreciate the distinction between price and value, Graham urged market participants to ignore "the market," and individual bonds and stocks, and instead to focus upon the business which issues a security. *The investor regards a stock as a share in the ownership of a business, and its value over time will correspond to that of the entire enterprise.* From this insight follow two others:

1. occasionally an investor can purchase a security at a price less than its value, and the greater this disparity the greater its "margin of safety."

2. to obscure the relationship of value to price – for example, to buy a security on the basis of its current popularity and in the hope that its price, reflecting this popularity, will shortly rise – is to forsake investment and embrace speculation.[1]

These insights imply the ten principles that underpin Leithner & Co's operations.

Principle 1: Ignore "The Market" and "Market Experts"

> *Graham-style value investors ignore "market experts" and their predictions about the level of or movements in overall financial markets, prices of individual securities, etc. They conduct their own analyses and draw their own conclusions.*

Market experts, strategists commentators and the like are human beings; *homo sapiens*, since time immemorial, has attempted to prophesy the future; and from the start, the confidence of the general public about the ability of certain people to predict the future has vastly exceeded the actual ability of these certain people to do so.

A comprehensive study published in the *Hulbert Financial Digest* in January 1994 corroborates this conclusion – which scores of studies since then have corroborated. Of the 108 market timing and economic forecasting newsletters analysed during the preceding five years, the predictions of only two corresponded even crudely to subsequent events. This number is much smaller than would be expected by pure chance, and thereby suggests that although experts cannot get things systematically right they can and do get things comprehensively wrong. Market strategists, commentators and gurus, it seems, are seldom in doubt but virtually always in error! It's noteworthy that Warren Buffett and Peter Lynch, two of the most successful investors of the last seven decades, expressly disclaim any ability to predict markets' level. In Lynch's words, market timers "can't predict markets with any useful consistency, any more than gizzard squeezers could tell the Roman Emperors when the Huns would attack."[2]

Principle 2: Don't Try to Predict "The Economy" – and Ignore Those Who Do

> *Value investors pay little attention to forecasts about "the economy," the level and direction of interest rates, the Consumer Price Index, the exchange rate of the Australian dollar vis-à-vis other currencies, unemployment, the balance of payments and who-knows-what else.*

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1 For details, see Chap. 1 of Chris Leithner, *The Intelligent Australian Investor: Timeless Principles and Fresh Applications*, John Wiley & Sons, 2005).

2 For a demonstration from first principles of the folly of market timing, see Chap. 2 of *The Intelligent Australian Investor*.

In *The Fortune Sellers: The Big Business of Buying and Selling Predictions* (John Wiley & Sons, 1999), William Sherden reviewed research about the accuracy of economic forecasts that has been conducted since the 1970s. He found that

- economists can't predict turning points (i.e., when a growing economy falls into recession, when a recession ends, etc.);
- their ability to forecast accurately is, on average, neither better nor worse than flipping a coin or simply guessing;
- more powerful computers, far more complicated econometric models and far greater amounts of data haven't improved the accuracy of their forecasts;
- practice doesn't make perfect: over time, forecasters' skill hasn't increased – if anything, it's deteriorated;
- "consensus" forecasts (i.e., the combination of individual forecasts) are no more accurate than individual forecasts;
- the further into the future that economists attempt to forecast, the less accurate their forecasts become;
- no individual forecasters is consistently more accurate than the group.

Twenty years later, these results remain sound. Hence value investors ignore forecasters. But this *doesn't* mean that they ignore the future. Quite the contrary: they plan for tomorrow not by making particular predictions about what will happen but by considering general scenarios – and particularly pessimistic ones – of what might conceivably happen. They then adapt their actions and investments in order to reduce the risk of permanent loss of capital in the event that undesirable events and developments actually occur.

Principle 3: Analyse Businesses – Not "the Market" or "the Economy"

> *Because value investors don't spend fruitless hours obsessing about "the market" or worrying about "the economy", they can devote considerable time to a far more productive purpose: the search for businesses whose securities are available at reasonable or bargain prices.*

It bears repeating: to followers of Graham, investing is most successful when it is rational; and it's most rational when it's most businesslike. Accordingly, with respect to any security under consideration they ask, investigate and answer questions such as:

- is the underlying business understandable and sensible?
- does it have a consistently favourable operating history? Are there any obvious and major factors which might affect adversely its prospects?
- is management candid with shareholders? Does it recognise and correct its errors? Do managers treat shareholders' funds as their own?

In answering these questions, followers of Graham ground their analysis in simple maths, clear logic and hard evidence. Value investors therefore ignore others' optimism and wishful thinking (or despondency); insofar as possible, they exclude emotional considerations from their analyses. Accordingly, they accept at face value little of what they encounter in mainstream and social media – and accept without careful consideration even less of what they hear on non-mainstream media. In particular, they run as fast as their legs can carry them from "tips" and never visit investment chat sites on the internet.

Principle 4: Buy Only When the Price Is Right

> *When research can derive a justifiable estimate of a business's value (it often can't); when hard evidence indicates that it possesses solid long-term investment value (often it doesn't or is inconclusive); and when there's a "margin of safety" (i.e., the business is selling at a price which is significantly less than a conservative estimate of its value, which it usually doesn't), value investors ask themselves a hypothetical question. "If financial markets were to close for the next five years, would I still be happy to own this business's securities?" Only if the answer is "yes" and there exists no other opportunity that is more compelling do they act. When they act, they act decisively.*

If this sounds extraordinary, remember that estate agents don't quote on a daily basis the market price of your house. Further, reflect that despite the absence of daily price quotations you probably don't lose sleep over its worth.

Principle 5: Ignore Institutional and Bureaucratic Imperatives

> *Leithner & Co resists what Mr Buffett has called the "institutional imperative." This is the lemming-like tendency, which is particularly marked within large organisations, to imitate others' behaviour – no matter how silly or self- destructive that behaviour might be.*

John Maynard Keynes, the British economist and keeper of the investments of King's College, Cambridge, described the institutional imperative in *The General Theory of Employment, Interest and Money* (1936): "[most] investors may be quite willing to take the risk of being wrong in the company of others, while being much more reluctant to take the risk of being right alone." Peer pressure, in other words, prompts us to do things as members of a group that we'd never countenance as individuals. "Groupthink," as Irving Janis showed in *Victims of Groupthink: A Psychological Study of Foreign Policy Decisions and Fiascos* (Houghton-Mifflin, 1972),[3] spawns a range of unintended negative consequences.

Unlike most market participants, who run in herds and follow the crowd, followers of Graham are individualists – and, at opportune times, contrarians. They work alone or with one or a handful of colleagues but virtually never within large organisations; they analyse primary data and sources of information but discount secondary sources (such as media reports, the assertions of economists, politicians, et al., and gossip and scuttlebutt); and they draw a sharp distinction between the veracity and the popularity of their actions. They endeavour to use justifiable premises, valid logic and reliable evidence to reach sound conclusions. They're not

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[3] See also Gary Belsky and Thomas Gilovich, *Why Smart People Make Big Money Mistakes* (Simon & Schuster, 1999), and *The Intelligent Australian Investor*, Chap. 9).

dissuaded from a course of action simply because alleged experts or "the market" disagree. Nor do they undertake an action simply because others are doing so. As Graham put it in *The Intelligent Investor*, "you are neither right nor wrong because the crowd disagrees with you." Rather, "you are right because your data and reasoning are right." Indeed, and as he also emphasised, "the right kind of investor [takes] added satisfaction from the thought that his operations are exactly opposite to those of the crowd."

Principle 6: Buy With the Intention to Hold Indefinitely

> *A strategy of buy-and-hold (i.e., buying parts of good businesses with the intention of holding these investments as long as these businesses remain good, thus achieving returns commensurate with their underlying economics) lies at the core of Leithner & Co's operations.*

Few market participants can resist the temptation constantly to buy and sell securities. They feel the need to "churn" (i.e., to buy and sell within short periods of time) rather than wait for attractive opportunities to buy and then hold. Churning is costly. On each side of the transaction brokers (or "croupiers" as Charles Munger, Berkshire Hathaway's Vice-Chairman, has called them) extract a commission. Warren Buffett has estimated that the sum of all commissions, fees, etc., generated by churning is vast. As he told *Fortune* (22 November 1999),

> my estimate is that investors in American stocks pay out well over $100 billion a year – say, $130 billion – to move around on those chairs or to buy advice as to whether they should! Perhaps $100 billion of that relates to the FORTUNE 500. In other words, investors are dissipating almost a third of everything that the FORTUNE 500 is earning for them by handing it over to various types of chair-changing and chair-advisory "helpers" … In my view, that's slim pickings.

It's fundamentally important to understand: the more frequently one trades the poorer one's results tend to become (see in particular Chris Leithner, *The Intelligent Australian Investor*, Chap. 2). This point applies at least as much to major institutions as to retail investors and day traders. The greater the frequency of trading the greater the amount paid in brokerage and commissions. And as Charles Ellis[4] has demonstrated, the more frequently one trades the more profitable one's trades must be in order to counteract the "drag" imposed by commissions and other charges.

Leithner & Co doesn't churn securities in anticipation of favourable short-term movements of their prices – or for any other reason. Given the benefits of the buy-and-hold approach, it makes sense to devote considerable amounts of time and energy to the identification of securities with a significant "margin of safety." And given the costs of churning, it makes sense to regard market prices not as signals to trade but rather as opportunities to acquire part-ownership of sound businesses at reasonable prices.

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[4] See The Loser's Game and *Winning the Loser's Game: Timeless Strategies for Successful Investing* (McGraw-Hill, 2002).

We attempt only to locate and purchase a manageable number of securities whose values (at the time of purchase) exceed their prices. Once purchased, the intention is to retain these securities indefinitely. If their values do indeed exceed their prices, then over time such a portfolio will tend to generate reasonable returns for its owner.

Principle 7: Diversify, but Don't Over-Diversify

> *The securities of well-managed and cautiously-financed businesses are not often available at attractive prices. It thus makes sense to research diligently and wait patiently until such opportunities present themselves; and when they do, to place significant sums in those businesses.*

Since its inception in 1999, Leithner & Co's investment portfolio has comprised a limited (10-20) number of securities. To diversify beyond this number is necessarily to lower one's buying standards and to buy less discriminately; to do this, in turn, increases risk and reduces returns.

What's wrong with diversification? Up to a point, nothing. When a portfolio contains 10-20 securities, diversification is indeed very beneficial. Beyond this point, however, it greatly increases the chances that the buyer buys securities about which he knows (too) little. John Maynard Keynes outlined the rationale for focusing the portfolio in a limited number of investments. In a letter to a business associate dated 15 August 1934, he wrote:

> As time goes on, I get more and more convinced that the right method in investments is to put fairly large sums into enterprises which one thinks one knows something about and in management of which one thoroughly believes. It is a mistake to think that one limits one's risk by spreading too much between enterprises about which one knows little and has no reason for special confidence … one's knowledge and experience is definitely limited and there are seldom more than a handful of enterprises at any given time in which I personally feel myself entitled to put full confidence.

Similarly, Warren Buffett says "diversification serves as a protection against ignorance. [It] makes very little sense for those who know what they're doing." If it raises both the intensity with which an investor thinks about a business and the comfort he must derive from its operations before becoming an owner or part-owner, then a strategy of mental and financial concentration may *lessen* the risk that accompanies any investment operation.

Principle 8: Remember That Risk Accompanies Any Investment

> *Mammoth and esoteric tomes have been written, and much popular ink has been spilt, about the concept of risk. Yet despite academics' strenuous – and mostly successful – attempts to complicate it unnecessarily, the concept is very simple: it is the probability that a bad thing might happen. Applied to investments, "risk" has nothing whatever to do with the volatility of the price of a security. Rather, it has everything to do with the likelihood that (i) one pays more for a security than a*

reasoned assessment of its worth justifies; and (ii) that a sound company ceases at some point in the future to exhibit this characteristic.

Most market participants, including institutions, brokers, advisors and private investors, define investment risk in terms of the short-term ups-and-downs of a security's market price (relative either to comparable securities or that of 'the market' as a whole). As a result, the practice of investment risk management is conventionally understood as an attempt to reduce within acceptable bounds the short-term variability – particularly in a downward direction – of an investment portfolio's current market worth.

Value investors reject both the conventional definition of risk and practice of risk management. Absent any change in a company's operations or prospects, any sudden or unanticipated fluctuation of its shares' market price doesn't make an investment in the company "risky." Once he has acquired part-ownership of a company at a sensible price, the value investor monitors its operations and prospects; and as long as these remain constant or improve he retains confidence in his judgement. If the shares' price decreases after purchase – again, assuming no change in the business's operations or prospects – he won't be alarmed. On the contrary, in the absence of more favourable opportunities he will consider the purchase of more shares.

As Graham wrote in *The Intelligent Investor*:

> the bona fide investor does not lose money merely because the market price of his holdings declines, and the fact that a decline may occur does not mean that he is running a true risk of loss … we apply the concept of risk solely to a loss which is either realised through actual sale, or is caused by a significant deterioration in the company's position – or, more frequently perhaps, is the result of the payment of an excessive price in relation to the worth of the security.

Principle 9: Adopt a Sensible Criterion of Success

Value investing builds upon the foundation that investment is most successful when it is most businesslike. Similarly, the measurement of the results of one's investment operations is most sensible when it, too, is businesslike. One's results, in other words, have everything to do with the earnings which one's businesses generate and nothing to do with the extent to which the prices of their shares fluctuate. As a business, Leithner & Co. thus gauges its own results in the same way that it would gauge the progress of any other business, e.g., by its earnings, margins and return on equity.

Academic conceptions of risk, the standard practice of investment risk management and the institutional imperative conspire to bastardise the criteria by which most market participants measure their results. The vast majority obsess about "the market" and its short-term (i.e., yearly, semi-annual, quarterly and even weekly or daily) "performance." And they compare their "performance" to others' and some other index. Accordingly, if Index A (say, Jack's portfolio) increases relative to Index B (Jill's portfolio or some market index), then A has "outperformed" B.

Most market participants' obsession about markets leaves them little time to analyse individual businesses and securities. In *The Warren Buffett Portfolio*, Robert Hagstrom asks "if you owned a business and there was no daily quote to measure its performance, how would you determine your progress? Likely you would measure the growth in earnings, or perhaps the improvement in operating margins, or a reduction in capital expenditures. You would simply let the economics of the business dictate whether you are increasing or decreasing the value of your business." *In order to buy or sell a security, one requires a price. In order to evaluate its worth, one doesn't: rather, one requires valid and reliable information about the business, its operations and prospects.*

Principle 10: Explain Yourself Plainly and Remember the People Involved

> *Graham asked his students "have you ever seen a human being mentioned in a corporate business plan?" and beseeched them to "always remember that you are dealing with people and their hard-earned savings."*

To a Grahamite with plenty of cash, a bracing bear market is an opportunity. Younger investors benefit most from dramatically lower prices. Hence they should rejoice when stocks and bonds go on sale – for they will enjoy the benefits in the years to come. For older ones, the point is psychologically more difficult to accept; cognitively, however, it's no less compelling. *This is because many of Leithner & Co's shareholders are investing not for themselves, but for their children and grandchildren.* Regardless of their age, their time horizons are long. Surplus liquid assets will buy considerably more stocks and bonds towards the bottom than they did during the boom. Hence the family members (namely children and grandchildren) of older investors will enjoy the benefits.