

JANUARY 8, 2009



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A good time to follow Graham's principles

Insist on strong balance sheets, low multiples

Recent market activity reminds me of a Family Circus cartoon from 2002 where one of the children asks, "Could we all go to Wall Street someday and ride the roller coaster?" Bil Keane should re-run it because I'm sure it would resonate with investors today. From the peak on October 9th, 2007 to the trough on November 20th, 2008, US equities declined 52.0% and, along the way, there were many triple digit movements both upward and downward.

The market roller coaster has generated panic and pandemonium, causing investors to doubt their approach. They've been examining their monthly statements, questioning whether they've done the right thing and wondering if they should be sticking to their financial plans. One reader recently asked, "Is buy-and-hold over? Should I sell out or take a more active approach?" To answer those questions, I think it's wise to review history.

We don't need to go further back than the teachings of Benjamin Graham, the famous economist regarded as the father of value investing. His 1934 book "Security Analysis" is still used as a teaching text in business schools. I believe that Mr. Graham would view today's markets as an opportunity to apply his principles, beginning with the Margin of Safety - a concept about minimizing risk.

In essence, this principle says that you should only buy a stock when its market value is significantly below its intrinsic value. The difference is the Margin of Safety. For example, if you determine that a stock's intrinsic value is \$40 but the market value is \$25, you have a \$15 buffer against errors in your calculation. If your

evaluation is slightly off and the intrinsic value turns out to be \$37, you're still ahead of the game. It's important to have the margin because there will always be something potentially variable and difficult to predict, such as a company's future earnings.

However, this does not mean that you simply run out and buy anything that *looks like a bargain*. Mr. Graham's philosophy included strict adherence to the principles of fundamentals analysis with a strong and objective focus on balance sheet items such as net assets, revenues, profit margins, debt, dividends and cash flow - with an expectation of solid numbers in each.

As with any investing philosophy, after you have made your purchase decisions your investments must be monitored. You have to know when to stick to your guns or, conversely, if the company's fundamentals have changed negatively, you need to know when to exit your positions. This is consistent with Benjamin Graham's statement that an investor must have "... sufficiently stringent standards of selection and reasonably frequent scrutiny thereafter..."

It is believed that Benjamin Graham's book had its roots in the lessons he learned from being personally wiped out in the crash of 1929. He wrote: "The old idea of 'permanent investments', exempt from change and free from care, is no doubt permanently gone". I agree - it is naïve to think that the markets are not going to have dramatic excursions, and therefore we should invest with that in mind.

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How did Benjamin Graham's approach work for him? In a partnership with Jerome Newman from 1926 to 1956 he had an average annual return of 17%. It is quite amazing when you consider that this time span included the crash of 1929, the entire Great Depression, WW II, the Korean War and sundry other major events.

How has his approach worked for others? Eminent investors who've applied Mr. Graham's principles include Jean-Marie Eveillard, William J. Ruane, Warren Buffett, Irving Kahn and Walter J. Schloss – each a major success story.

If you are considering a more active approach, I advise caution. Although current markets are providing some good short-term trading opportunities, most investors are not equipped to capitalize on them. Using an active approach is risky because short-term trading opportunities are often *very* short-term - sometimes within a single trading day.

This technique can be very difficult for the average investor because it requires constant monitoring for good entry and exit points. If you miss them, you can

miss the boat altogether which can lead to hefty losses. You also incur significantly more fees, inevitably putting a damper on profits. Given the tricky nature of active investing, the average investor is not destined to do very well.

In times of volatility you want to be sticking with tried-and-true techniques, not trying to re-invent the wheel. Inevitably you'll get into trouble if you delve into tactics you either misunderstand or for which you simply do not have enough experience to truly benefit. You have to ask yourself if you are an investor or a speculator.

In these markets, it's really important to keep your head. If you invest in good companies, whose purchase decisions are based on thorough analysis and made within the context of your timeline and risk tolerance, you shouldn't have a problem sleeping.

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