LESSON 1: THE SEVEN GOLDEN RULES OF INVESTING

DESCRIPTION

This lesson will teach you the basic formula for becoming a successful investor.

OBJECTIVES

At the conclusion of this lesson, you should:

- Become familiar with the Superinvestors, as well as Benjamin Graham
- Understand the Seven Golden Rules to investing
- Identify if you are a spender or an investor
- Better understand key terms such as "stock," stock market," "shareholder"

LENGTH

Approximately 60 minutes, can be covered in 1-2 blocks

RESOURCES

- Access to Computers and Internet is preferred, but not required
- YIS Website www.younginvestorssociety.org – curriculum, videos and lesson plans
- YIS Glossary of Terms (full database at younginvestorssociety.org/resources)
- Zacks.com – for company research including ratios and screens
- Morningstar.com -- for company research including ratios and screens
- Gurufocus.com -- for company analysis (Login name: yisinvestor, Password: password1)
- Wallstreetsurvivor.com -- for basic stock concepts (Login name: fletchbyu, Password: yisenter)
- Yahoo Finance and Yahoo Finance App -- for stock charts and basic company information
- Greenblatt, Joel. *The Little Book That Beat the Market.*
- Guest Speakers -- Write Contact@younginvestorssociety.org if you want help arranging a financial professional to come to your class

- Seeking Alpha – online portal of stock research reports (www.seekingalpha.com)
- Motley Fool – great daily content and stock picks (www.motleyfool.com)
- Investopedia.com – the "Wikipedia" of Investing, great online glossary of terms
- Stockcharts.com – for tracking stock market performance and comparison between stocks.

INTRODUCTION

Welcome Young Investors! Congratulations on joining the Young Investors Society. It is our goal to make you master investors. Many of the lessons you will learn have been used by successful investors over several generations. You will notice that a recipe for success is easy to follow but is actually followed by few. To start, let's read an article written by Warren Buffett. Mr. Buffett has been the single most successful investor since the late 1950s.

"I retire on Friday and I haven't saved a dime. Here's your chance to become a legend!"

The article began as a contest. In the 1980s, there had arisen a growing consensus that the stock market was fully efficient, called "Efficient Market Theory." Basically, this meant that it was impossible for someone to consistently pick stocks that would beat the overall market average, because everything was priced in already. Columbia Business School hosted a debate as a contest between Michael Jensen, a professor from the University of Rochester and strong advocate of the Efficient Market Theory versus Warren Buffett, famed stock-picker. Jensen went first. Then Buffett spoke and his speech was later published in this article called "The Superinvestors of Graham-and-Doddsville." Buffett was unequivocally declared the winner after his masterful speech. No one could doubt the numbers or the logic.

Buffett references Benjamin Graham and David L. Dodd. Together Graham and Dodd wrote *Security Analysis* in 1934. This book, still in print after several editions, has influenced many great investors since the very first publication. Additionally, Benjamin Graham wrote *The Intelligent Investor* in 1949. Mr. Buffett first read this book in 1950 and considers it, "by far the best book on investing ever written." Benjamin Graham is considered the father of value investing and so we start here. As you read the article make a note of the key concepts that are referenced, some are repeated several times.

(Article can be found at the end of the lesson or at the web address: http://www8.gsb.columbia.edu/rtfiles/cbs/hermes/Buffett1984.pdf)

ESSENTIAL QUESTIONS TO DISCUSS:

1. *What are the common traits of successful investors?*
2. *If there is a clear recipe for investment success, why do you think so few people follow it?*

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LESSON

THE SEVEN GOLDEN RULES

Being successful at anything requires following a set of rules. Good rules are the accumulation of decades of wisdom summed up into the few components that really matter. Successful football players win because they avoid penalties and because of the way they train. Successful students get A's because of the way they study.

Investing in the stock market is no different, except that when you succeed in investing you make money, a lot of money. Take Warren Buffett for example; he started out with $10,000 and turned it into a net worth of $60,000,000,000 (That's 60 BILLION!) . But he's not alone. Peter Lynch, Bill Ruane, Walter Schloss, Bill Miller, Charlie Munger, Joel Greenblatt, and many others generated similar extraordinary investment returns, consistently, over a long-term time horizon. Each successful fund manager's style was slightly different, but if you study them each carefully you'll start to see significant patterns. We summed these patterns into Seven Golden Rules.

So, without further ado, here are the **Seven Golden Rules of Successful Investing** that will guarantee that you crush it in the stock market.

RULE #1: THINK LONG-TERM

Trying to time the stock market or risking it all to "double your money in a year" is at best speculating, at worst gambling. You may as well just take your money to Vegas and lose it there. Those who are able to successfully navigate the stock market are not speculators or gamblers, they are investors. Investors know they can beat the market because they think differently, they think smarter, and they think longer-term.

"Time horizon arbitrage" means that if investors learn to think long-term and can see beyond the daily and quarterly noise, they can gain a real upper hand. In 1964, American Express was a great company but the stock was getting hammered due to an insurance scandal. The company had to pay millions of dollars in fines due to accidentally underwriting barrels of vegetable oil that turned out to be water. That is exactly the time when Warren Buffett began purchasing the stock. The best investors look beyond short term distress and keep their eyes on the long-term horizon.

"Only buy something that you'd be perfectly happy to hold if the market shut down for 10 years." Warren Buffett

RULE #2: GOOD COMPANIES MAKE GOOD INVESTMENTS (DITTO FOR BAD COMPANIES)

People need to understand that investing is not like placing a bet on whether the Cowboys will cover the spread against the Packers in the big game. Investing is not trying to get the quarterly press

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release a microsecond before the other person. It is not even about trying to predict which stock that you think will go up the most. Fundamental Investing is buying a tangible piece of a business, or a *share* of that business. And your investment portfolio (the collection of all the different shares you own) is only as good as sum of the companies in that portfolio.

If you buy shares of high quality companies at reasonable prices, you'll end up with a high quality portfolio with less risk. It's as simple as that. Good companies are ones that have a unique advantage that others can't copy. Good companies are ones that generate high returns on capital. Good companies don't need to borrow a lot because their business is self financing.

"It's far better to buy a wonderful company at a fair price than a fair company at a wonderful price" Warren Buffett

RULE #3: BUY WITH A MARGIN OF SAFETY

Nearly every professional investor began his career reading Benjamin Graham's, *The Intelligent Investor.* Warren Buffett called it, "by far, the best book on investing ever written." What makes it so special? One of the reasons is because it introduced the important concept "Margin of Safety."

In investing, a margin of safety is formed when one buys an investment at less than its value, while using conservative assumptions. The idea of a margin of safety is that you want to buy a business at a price that is low enough that your assessment could be completely wrong and you wouldn't lose much.

"Heads I win.Tails I don't lose much." Mohnish Pabrai, Dhandho Investor

RULE #4: DO YOU OWN HOMEWORK AND OWN WHAT YOU KNOW

There is no substitute for your own work. Buying a stock because CNBC recommended it, or because your uncle recommended it, or the stock chart looks good is a sure way to lose money.

Successful investors know what they own. They buy stocks of companies with products they believe in. Successful investors go the extra mile to analyze the financials of the company to make sure they're not missing anything. Remember, most of the extraordinary gains made in the stock market come after a stock is punished or after it has already risen a lot, but you're not going to have the conviction to stick with it unless you really know the company.

"You have to know what you own, and why you own it." Peter Lynch

RULE #5: DON'T FOLLOW THE HERD, STAY CALM AND RATIONAL

The typical buyer's decision is usually heavily influenced by those around him: buy when others are buying, sell when others are selling. Unfortunately, this is a recipe that is bound to backfire. The best investors are ones that can fight this urge remain calm through a storm, and remain on the sidelines through a bubble.

The world's greatest investor Warren Buffett said it best,"Be fearful when others are greedy, and be greedy when others are fearful!"

RULE #6: DON'T PUT ALL YOUR EGGS IN ONE BASKET, BUT DON'T HAVE TOO MANY BASKETS, EITHER

Diversification is one of the most critical strategies for your portfolio so that if one stock blows up, it won't sink the entire ship. As much as we think we won't make a mistake, we will. Even the masters do and that is why we can't put all our eggs in one basket. There's power in diversification.

However, research suggests that 90% of diversification benefits can be obtained in most markets with a portfolio of just over 20 stocks. The more you diversify beyond that, the less you know about each investment (See Rule #4). Your first and second best ideas are always better than your 100th best idea, so while diversifying is crucial, make your best ideas count!

"We try to avoid buying a little of this or that when we are only lukewarm about the business or its price. When we are convinced as to attractiveness, we believe in buying worthwhile amounts". Warren Buffett

RULE #7: NEVER STOP LEARNING

Perhaps the most important rule is learn, learn more, and then keep learning. The fun thing about investing is that the markets are always different and companies are constantly changing. Never stop learning about businesses, never stop learning from other great investors, and never stop learning from your own mistakes. Humility and an eagerness to learn are two traits found in all of the great investors. Even Warren Buffett credits his partner Charlie Munger with teaching him that it's better to buy a great company at a fair price than a fair company at a great price.

"The game of life is the game of everlasting learning. At least it is if you want to win." Charlie Munger

8TH BONUS RULE WHEN YOU MAKE A LOT MONEY, FIND MEANINGFUL WAYS TO GIVE IT BACK.

Bill & Melinda Gates took their fortune and lifted millions of people out of poverty through their foundation. Warren Buffett has done the same with his billions. If you make millions or even billions of dollars through the concepts taught by YIS, we hope that you will take it and make the world a better place. At YIS, we believe it's possible to really make our investments count. That's why we're investing in you.

ARE YOU AN INVESTOR?

We have read the Superinvestors of Graham-and-Doddsville, followed by the list of Golden Rules. In the article, Warren Buffett found investors either embraced the idea of buying dollar bills for 40 cents and it took immediately or it didn't take at all. Let's find out if you embrace this idea or not…

Are you a spender or an investor? Pop Quiz. Ready. Go.

Question #1

I'll give you $100 today or a new Mercedes next year? Which one will you take?
A) The cash
B) The car
C) Why are you even looking at other options, you'd be crazy not to take the car!

Question #2

I'll give you $100 today or $100 next year. Which one will you take? Think about it...
A) The cash today
B) The same cash tomorrow
C) Of course you wouldn't wait! What's the point? You wouldn't get anything in return for waiting.

In one minute we've narrowed down whether you are an investor or a spender. You're a spender if you don't get a return. You're an investor if the future is worth somewhere between $100 and a new car. The question of whether you will invest is really just a question of how much you believe tomorrow can offer. How much could the future be worth for a bit of sacrifice today?

WHAT DOES IT REALLY MEAN TO INVEST IN THE STOCK MARKET?

Essential Question:

What is a "*stock*"?

What is the *stock market*?

The following link is a comprehensive video explaining a "stock" and the "stock market", please review Lesson 1 (What is the Stock Market) and Lesson 2 (What are Stocks).

https://younginvestorssociety.org/videos/stock-market-101/

You can see from this that investing in the stock market is "serious business," at the same time it can be a fun game. Never forget that when you buy shares in a company, you become one of its owners!

All companies have owners. A small company started by a single individual may have only him or her as the single owner. The large corporations that have "public" stock (shares that are traded by the

general public) have many owners.To simplify and organize the buying and selling of these shares by the general public, companies use the so-called equity or stock market. In fact, US government regulations require that a company, once it reaches a certain number of owners, *must* go public. This is to allow its now large number of owners to be able to buy and sell their shares of stock in the company more easily. This is what investors call stock market *liquidity*. The more actively a company's shares of stock trade in the public market, the more liquidity they are said to have. Liquidity is generally a very good thing. A house, for example is not a "liquid" investment in that it cannot be easily and quickly bought and sold. Companies, on the contrary, in the form of stock, can be traded very easily and quickly, and are thus said to have much higher liquidity than individual homes. Stocks are much more liquid investments than houses.

Just think about it this way. Let's pretend that your sibling or a close friend is starting a small company. He or she is doing really well, but needs more money (capital) to expand. He or she asks you to become a part owner in the business by investing in it some of your savings. You agree. Would you try to sell your ownership in the company just a few days later? Most likely not! It should be the same thing when you decide to buy a public company's stock. The only real difference is that your sibling's or friend's company is a private company with just two shareholders, whereas there are many more owners in a public company with shares in the "stock market."
:

"Without a saving faith in the future, no one would ever invest at all. To be an investor, you must be a believer in a better tomorrow" Benjamin Graham

CONCLUSION

Key takeaways:

1. Warren Buffet and many others made it clear that it is very possible to make exceptional returns from the stock market, following a few simple rules.
2. Investing is simple, but it is not easy. The Golden Rules of Investing are widely known but difficult to follow in practice.
3. By investing in a stock you are owning a portion of a business.

THE 7 GOLDEN RULES OF SUCCESSFUL STOCK MARKET INVESTING

1. THINK LONG-TERM.

2. GOOD COMPANIES MAKE GOOD INVESTMENTS. (DITTO FOR BAD COMPANIES).

3. BUY WITH A MARGIN OF SAFETY.

4. DO YOUR OWN HOMEWORK AND OWN WHAT YOU KNOW.

5. DON'T FOLLOW THE HERD. BE RATIONAL AND STAY CALM.

6. DON'T PUT ALL YOUR EGGS IN ONE BASKET

7. NEVER STOP LEARNING.

ACTIVITY

GOLDEN RULES QUIZ

Each question will present several investment options. Using the Golden Rules, select the best answer. Keep in mind the Golden Rules can apply to other investments (real estate, bonds) not just stocks. Answer the questions first alone, and then discuss them as a group. Debate if there are differing opinions. Discuss **which Golden Rule(s) are most applicable to each scenario**.

Scenario #1: Which one would you invest in?

A) Company BBB is a grocery store chain. BBB was slow to embrace the trend of organic food which has resulted in a drop in company sales and a drop in the company's stock price. The switch to organics at BBB is currently underway. BBB's management team forecasts customers who moved away due to the lack of organics will switch back quickly given their competitive pricing and preferred store locations. Also, after digging deeper you discover that the land that BBB owns for their stores is very valuable, worth $10/share at market value, compared to the company trading at $5/share.

B) Company MMQ is a sports clothing company. The company is growing quickly and is much more profitable than other clothing companies, most likely because customers are going nuts over their new jacket line. They have just signed your favorite baseball player to an endorsement deal and you are looking to buy the stock. It's currently trading at a very high valuation due to the high anticipated growth expected this year.

C) Company AAA is a discount retailer. The economy looks to be sluggish over the next several quarters which could benefit AAA. The stock has looks pretty expensive relative to historical valuations. The stock has doubled in the last 3 years.

Scenario #2: Which company would you invest in?

A) Map Snap, ticker SNAP, is a social media company that has very little revenue and a slower growth rate versus its peer group. You have a family member who works there so you think about buying some stock. A competitor launched a really cool app that is competing directly with Map Snap.

B) Kalifornia Cars, ticker KAR, is a car manufacturing company producing highly fuel efficient cars, only offering hybrids or electric. The company is in good financial health but trades at a substantial discount to the automotive industry. Recent technological improvements will improve margins and boost profits but not for at least two more years.

C) Newzzpaper Inc, ticker NUZ, is a struggling newspaper printing company. Newspaper print subscriptions are in a steady decline as customers opt for electronic delivery of their news. The company trades at a 20% discount to the value of its assets.

Scenario #3:

You are closely watching the quarterly earnings report of your largest holding Gizmo, almost 15% of your stock portfolio. The stock has not performed well as of late and is trading 10% lower than where you acquired your initial shares. There are no material changes in your analysis and you have a strong conviction the company's profits are going to be much higher than the market expects in the future. The quarterly earnings are announced and the company's profits were 10% less than analysts expects. The earnings miss was attributed to a 2 week delay in shipments of the newest product. The very next day the Wall Street Journal has an article discussing the recent earnings miss, and the stock declines by another 20%. What do you do with the stock?

A) Sell the stock and cut your losses

B) Do nothing

C) Sell another stock and buy more Gizmo

Scenario #4: Which company would you invest in?

A) Solid company with a slow and steady growth rate. The company is the dominant market leader with a strong brand that has been around for decades, but it's industry is mature and isn't growing very fast. Company pays a steady dividend.

B) Profitable company but using aggressive accounting practices which may or may not be distorting the reported numbers. The stock is trading at a small discount to where other comparable companies are.

C) Rapidly growing business that has increased revenue 200% over the last three years. To fund this growth the company has accumulated a lot of debt.

Scenario #5: Which investment would you make?

A) A friend has encouraged you to invest your money into an up and coming real estate development in Central America. The early investors look to make significant profits if the projected sales are accurate. You have never been to this country but the pictures look amazing. There is potential to double your money in a very short time. You know there are risks, but it looks like you buying much below market value, and this could be the investment of a lifetime.

B. You hear about a fantastic investment opportunity in North Dakota. Highly efficient oil wells have been discovered in the Bakken Shale. The towns in North Dakota are booming but there is a significant shortage of housing. Apartments are rented the second they are completed. You can invest in the very next apartment building being built and would recover your money in a very short period of about three to five years and then own the apartments outright. You don't live anywhere near North Dakota but seems like a conservative investment.

C. The condo building you live is in a great neighborhood. It is within walking distance of many great restaurants and shops. You have always wanted to buy another unit in the building and one was recently put on the market. The seller is a realtor and has agreed to reduce the commission which would allow you to purchase the condo well below market value. A fortune 500 company announced it would add several thousand jobs in your area, thus renting out the unit seems highly probable.

Scenario #6

After reading an independent research report you learn that you can invest in emerging markets stocks, which are more volatile but offer greater risk adjusted returns over the long run. This discovery prompts you to ask several financial professionals of the merits to the report, which is confirmed. You continue to research the Emerging Market opportunities and realize the reliability of company research reports can vary from country to country. Secondly, the research is often difficult to obtain and may not be available in English. Not to be discouraged you find a reputable investment management firm that advises a mutual fund specific to Emerging Markets. The well-respected mutual fund is open to new investors. What do you do?

A. Sell everything in your portfolio and put it all in the Emerging Market mutual fund

B. Re-balance your stock portfolio with a modest allocation to the Emerging Market mutual fund

C. Do nothing; the research report is probably inaccurate and seems risky.

PREPARING FOR THE YIS STOCK PITCH COMPETITION

Provide 10-20 minutes each meeting for the students to work on their individual Stock Pitch project for the YIS National Stock Pitch Competition or for Online Stock Idea Competitions.

In preparing for the YIS National Stock Pitch Competition (see Competition Guidelines) you should start thinking about finding a company that you believe would be a great investment idea.

To brainstorm for new ideas after this lesson, the following questions could be useful:

- What companies do I know well, and what products do I love? What product would I highly recommend to a friend?
- What brand or company do I know of that I am positive *will* havemore sales 10 years from now?

FOLLOW-UP IDEAS

Some ideas to further explore the concepts covered here are:

- Begin analyzing companies for your YIS Stock Pitch Competition and compile a "Best Business" list
- Contact a stock market professional
- Read professional stock investor articles in Barron's or Wall Street Journal
- Think of some companies that you would like to own , *and* as you learn more about the valuation process later on, see if they would rate as 'buys' for Benjamin Graham. Can you buy dollar bills for 40 cents?

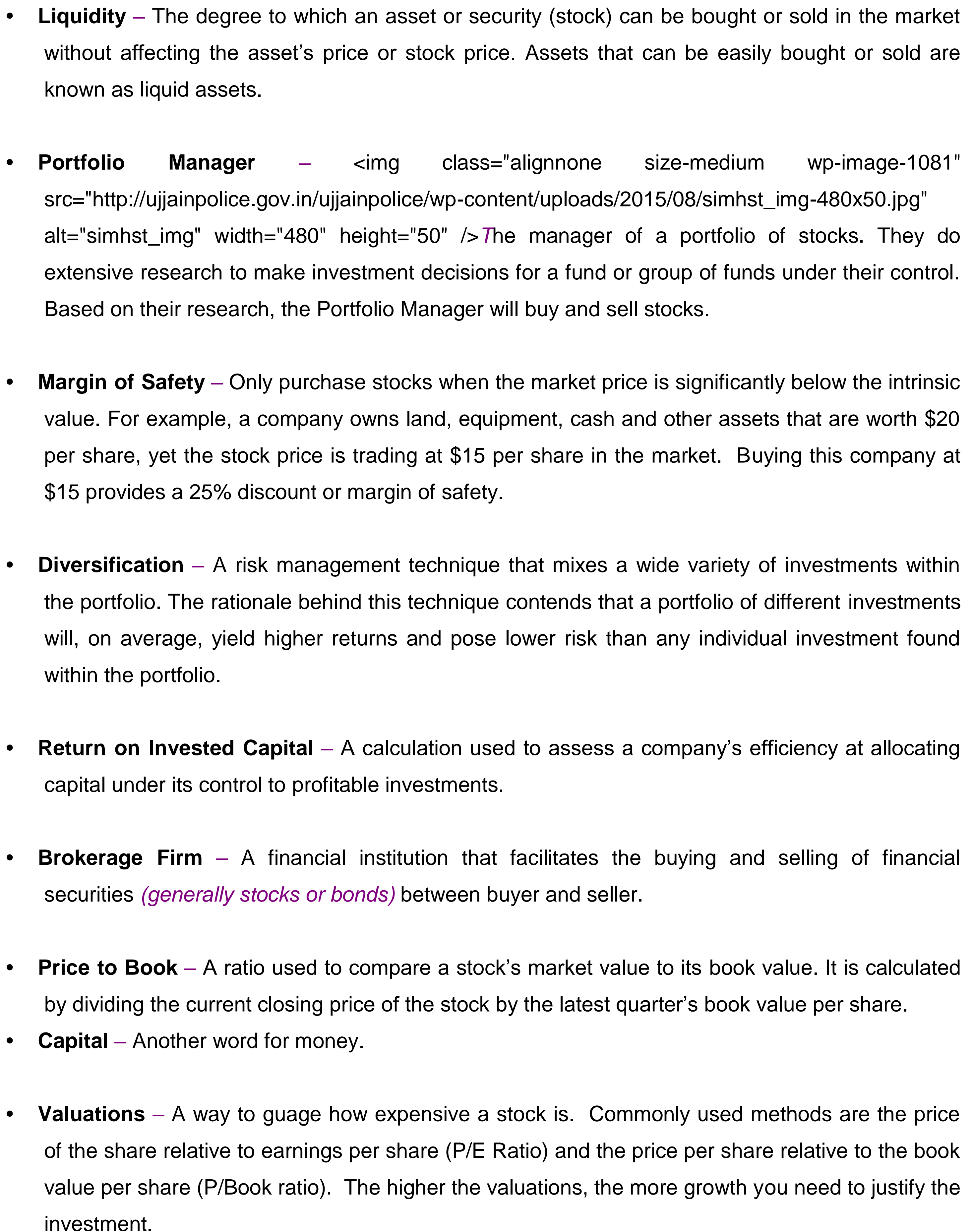
GLOSSARY OF TERMS

- S

- **Stock** – Stock is a unit of ownership in a company. When you buy a stock you become a shareholder, which means you own part of the company.

- **Stock Market** – The market in which shares of publicly-held companies are issued and traded, either through exchanges or over-the-counter markets. Also known as the equity market, it provides companies with access to capital (money) in exchange for giving investors a slice of ownership in a company.

- **Shareholder** – Any person, company, or other institution that owns at least one share of a company's stock. Shareholders are a company's owners.



- **Liquidity** – The degree to which an asset or security (stock) can be bought or sold in the market without affecting the asset's price or stock price. Assets that can be easily bought or sold are known as liquid assets.

- **Portfolio Manager** – *T*he manager of a portfolio of stocks. They do extensive research to make investment decisions for a fund or group of funds under their control. Based on their research, the Portfolio Manager will buy and sell stocks.

- **Margin of Safety** – Only purchase stocks when the market price is significantly below the intrinsic value. For example, a company owns land, equipment, cash and other assets that are worth $20 per share, yet the stock price is trading at $15 per share in the market. Buying this company at $15 provides a 25% discount or margin of safety.

- **Diversification** – A risk management technique that mixes a wide variety of investments within the portfolio. The rationale behind this technique contends that a portfolio of different investments will, on average, yield higher returns and pose lower risk than any individual investment found within the portfolio.

- **Return on Invested Capital** – A calculation used to assess a company's efficiency at allocating capital under its control to profitable investments.

- **Brokerage Firm** – A financial institution that facilitates the buying and selling of financial securities *(generally stocks or bonds)* between buyer and seller.

- **Price to Book** – A ratio used to compare a stock's market value to its book value. It is calculated by dividing the current closing price of the stock by the latest quarter's book value per share.
- **Capital** – Another word for money.

- **Valuations** – A way to guage how expensive a stock is. Commonly used methods are the price of the share relative to earnings per share (P/E Ratio) and the price per share relative to the book value per share (P/Book ratio). The higher the valuations, the more growth you need to justify the investment.

- **Ticker** – The abbreviation that a company is listed on the stock exchange. For example, Google has the ticker GOOG and Apple has the ticker AAPL.

- **Mutual Fund –** Professionally managed stock portfolio. Instead of investing in individual stocks yourself, you can invest money in a mutual fund, where professionals pick stocks for you. Fees are

TIPS FOR TEACHING

1. run YIS as much as possible. Chose a class leader as the portfolio manager of the day. Assign kids to present something ahead of time. The more the kids are teaching each other and engaging in lively discussion, the more successful the meetings will be.

2. Hands on, real life examples should be the focus. Feel free to bring in other company examples to supplement the lesson material. Go on to Zacks.com to research company fundamentals of the companies you are talking about.

3. For "Essential Discussions" consider breaking the group up into small groups or pairs to discuss and then have a couple present their thoughts to the class.

4. Invite guest speakers to come in, either from a local business or from the investment community. Have them present on what makes a great company.

5. When kids have a question, encourage them to find the answer themselves rather than spoon feeding the answer to them. Open it up to the group to answer. Don't worry if you don't know the answer. If you're stumped search online or contact your YIS representative.

6. Guide instruction and activities back to preparing their Stock Pitch Idea. Use the stock ideas they are working on as the main examples in the lesson.

7. Make it fun! Investing isn't easy, but it is definitely exciting *so* look for ways to make teaching exciting, unpredictable, and interactive.

8. Remember, you're awesome! You're building the next generation of great investors, teaching the skills and habits to build wealth and change lives for generations to come. We at YIS, just want to thank you for your time. Without you, none of this would be possible.

FREQUENTLY ASKED QUESTIONS

The Superinvestors of Graham-and-Doddsville

By Warren E. Buffett

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Is the Graham and Dodd "look for values with a significant margin of safety relative to prices" approach to security analysis out of date? Many of the professors who write textbooks today say "yes." They argue that the stock market is efficient; that is, that stock prices reflect everything that is known about a company's prospects and about the state of the economy. There are no undervalued stocks, these theorists argue, because there are smart security analysts who utilize all available information to insure unfailingly appropriate prices. Investors who seem to "beat the market" year after year are just lucky. "If prices fully reflect available information, this sort of investment adeptness is ruled out," writes one of today's textbook authors.

Well, maybe. But I want to present to you a group of investors who have, year in and year out, beaten the Standard & Poor's 500 stock index. The hypothesis that they do this by pure chance is at least worth examining. Crucial to this examination is the fact that these winners were all well known to me and pre-identified as superior investors, the most recent identification occurring over 15 years ago. Absent this condition—that is, if I had just recently searched

The Superinvestors of Graham-and-Doddsville

By Warren E. Buffett

"Superinvestor" Warren E. Buffett, who got an A+ from Ben Graham at Columbia in 1951, never stopped making the grade. He made his fortune using the principles of Graham & Dodd's Security Analysis. *Here, in celebration of the fiftieth anniversary of that classic text, he tracks the records of investors who stick to the "value approach" and have gotten rich going by the book.*

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among thousands of records to select a few names for you this morning—I would advise you to stop reading right here. I should add that all of these records have been audited. And I should further add that I have known many of those who have invested with these managers, and the checks received by those participants over the years have matched the stated records.

Before we begin this examination, I would like you to imagine a national coin-flipping contest. Let's assume we get 225 million Americans up tomorrow morning and we ask them all to wager a dollar. They go out in the morning at sunrise, and they all call the flip of a coin. If they call correctly, they win a dollar from those who called wrong. Each day the losers drop out, and on the subsequent day the stakes build as all previous winnings are put on the line. After ten flips on ten mornings, there will be approximately 220,000 people in the United States who have correctly called ten flips in a row. They each will have won a little over $1,000.

Now this group will probably start getting a little puffed up about this, human nature being what it is. They may try to be modest, but at cocktail parties they will occasionally admit to attractive members of the opposite sex what their technique is, and what marvelous insights they bring to the field of flipping.

Assuming that the winners are getting the appropriate rewards from the losers, in another ten days we will have 215 people who have successfully called their coin flips 20 times in a row and who, by this exercise, each have turned one dollar into a little over $1 million. $225 million would have been lost, $225 million would have been won.

By then, this group will really lose their heads. They will probably write books on "How I Turned a Dollar into a Million in Twenty Days Working Thirty Seconds a Morning." Worse yet, they'll probably start jetting around the country attending seminars on efficient coin-flipping and tackling skeptical professors with, "If it can't be done, why are there 215 of us?"

But then some business school professor will probably be rude enough to bring up the fact that if 225 million orangutans had engaged in a similar exercise, the results would be much the same—215 egotistical orangutans with 20 straight winning flips.

I would argue, however, that there *are* some important differences in the examples I am going to present. For one thing, if (a) you had taken 225 million

The New York Times

The late Benjamin Graham (left) and David L. Dodd wrote Security Analysis *in 1934. The book, still in print, went to four editions, and has become an invaluable investment management tool.*

Leslie Jean-Bart

David L. Dodd was awarded an honorary doctorate from Columbia University in May 1984, in recognition of the lasting intellectual achievement of the book. Dodd, professor emeritus at Columbia, lives in Maine.

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orangutans distributed roughly as the U.S. population is; if (b) 215 winners were left after 20 days; and if (c) you found that 40 came from a particular zoo in Omaha, you would be pretty sure you were on to something. So you would probably go out and ask the zookeeper about what he's feeding them, whether they had special exercises, what books they read, and who knows what else. That is, if you found any really extraordinary concentrations of success, you might want to see if you could identify concentrations of unusual characteristics that might be causal factors.

Scientific inquiry naturally follows such a pattern. If you were trying to analyze possible causes of a rare type of cancer—with, say, 1,500 cases a year in the United States—and you found that 400 of them occurred in some little mining town in Montana, you would get very interested in the water there, or the occupation of those afflicted, or other variables. You know that it's not random chance that 400 come from a small area. You would not necessarily know the causal factors, but you would know where to search.

I submit to you that there are ways of defining an origin other than geography. In addition to geographical origins, there can be what I call an *intellectual* origin. I think you will find that a disproportionate number of successful coin-flippers in the investment world came from a very small intellectual village that could be called Graham-and-Doddsville. A concentration of winners that simply cannot be explained by chance can be traced to this particular intellectual village.

Conditions could exist that would make even that concentration unimportant. Perhaps 100 people were simply imitating the coin-flipping call of some terribly persuasive personality. When he called heads, 100 followers automatically called that coin the same way. If the leader was part of the 215 left at the end, the fact that 100 came from the same intellectual origin would mean nothing. You would simply be identifying one case as a hundred cases. Similarly, let's assume that you lived in a strongly patriarchal society and every family in the United States conveniently consisted of ten members. Further assume that the patriarchal culture was so strong that, when the 225 million people went out the first day, every member of the family identified with the father's call. Now, at the end of the

Table 1 • Walter J. Schloss

Year	S&P Overall Gain, Including Dividends (%)	WJS Ltd Partners Overall Gain per year (%)	WJS Partnership Overall Gain per year (%)
1956	7.5	5.1	6.8
1957	−10.5	− 4.7	− 4.7
1958	42.1	42.1	54.6
1959	12.7	17.5	23.3
1960	− 1.6	7.0	9.3
1961	26.4	21.6	28.8
1962	−10.2	8.3	11.1
1963	23.3	15.1	20.1
1964	16.5	17.1	22.8
1965	13.1	26.8	35.7
1966	−10.4	0.5	0.7
1967	26.8	25.8	34.4
1968	10.6	26.6	35.5
1969	− 7.5	−9.0	−9.0
1970	2.4	− 8.2	− 8.2
1971	14.9	25.5	28.3
1972	19.8	11.6	15.5
1973	−14.8	− 8.0	− 8.0
1974	−26.6	− 6.2	− 6.2
1975	36.9	42.7	52.2
1976	22.4	29.4	39.2
1977	− 8.6	25.8	34.4
1978	7.0	36.6	48.8
1979	17.6	29.8	39.7
1980	32.1	23.3	31.1
1981	− 6.7	18.4	24.5
1982	20.2	24.1	32.1
1983	22.8	38.4	51.2
1984 1st Qtr.	− 2.3	0.8	1.1

Standard & Poor's 28 1/4 year compounded gain	887.2%
WJS Limited Partners 28 1/4 year compounded gain	6,678.8%
WJS Partnership 28 1/4 year compounded gain	23,104.7%
Standard & Poor's 28 1/4 year annual compounded rate	8.4%
WJS Limited Partners 28 1/4 year annual compounded rate	16.1%
WJS Partnership 28 1/4 year annual compounded rate	21.3%

During the history of the Partnership it has owned over 800 issues and, at most times, has had at least 100 positions. Present assets under management approximate $45 million.

6

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20-day period, you would have 215 winners, and you would find that they came from only 21.5 families. Some naive types might say that this indicates an enormous hereditary factor as an explanation of successful coin-flipping. But, of course, it would have no significance at all because it would simply mean that you didn't have 215 individual winners, but rather 21.5 randomly-distributed families who were winners.

In this group of successful investors that I want to consider, there has been a common intellectual patriarch, Ben Graham. But the children who left the house of this intellectual patriarch have called their "flips" in very different ways. They have gone to different places and bought and sold different stocks and companies, yet they have had a combined record that simply can't be explained by random chance. It certainly cannot be explained by the fact that they are all calling flips identically because a leader is signaling the calls to make. The patriarch has merely set forth the intellectual theory for making coin-calling decisions, but each student has decided on his own manner of applying the theory.

The common intellectual theme of the investors from Graham-and-Doddsville is this: they search for discrepancies between the *value* of a business and the *price* of small pieces of that business in the market. Essentially, they exploit those discrepancies without the efficient market theorist's concern as to whether the stocks are bought on Monday or Thursday, or whether it is January or July, etc. Incidentally, when businessmen buy businesses—which is just what our Graham & Dodd investors are doing through the medium of marketable stocks—I doubt that many are cranking into their purchase decision the day of the week or the month in which the transaction is going to occur. If it doesn't make any difference whether all of a business is being bought on a Monday or a Friday, I am baffled why academicians invest extensive time and effort to see whether it makes a difference when buying small pieces of those same businesses. Our Graham & Dodd investors, needless to say, do not discuss beta, the capital asset pricing model or covariance in returns among securities. These are not subjects of any interest to them. In fact, most of them would have difficulty defining those terms. The investors simply focus on two variables: price and value.

I always find it extraordinary that so many studies

Table 2 · Tweedy, Browne Inc.

Period Ended (September 30)	Dow Jones* (%)	S & P 500* (%)	TBK Overall (%)	TBK Limited Partners (%)
1968 (9 mos.)	6.0	8.8	27.6	22.0
1969	− 9.5	− 6.2	12.7	10.0
1970	− 2.5	− 6.1	− 1.3	− 1.9
1971	20.7	20.4	20.9	16.1
1972	11.0	15.5	14.6	11.8
1973	2.9	1.0	8.3	7.5
1974	−31.8	−38.1	1.5	1.5
1975	36.9	37.8	28.8	22.0
1976	29.6	30.1	40.2	32.8
1977	− 9.9	−4.0	23.4	18.7
1978	8.3	11.9	41.0	32.1
1979	7.9	12.7	25.5	20.5
1980	13.0	21.1	21.4	17.3
1981	− 3.3	− 2.7	14.4	11.6
1982	12.5	10.1	10.2	8.2
1983	44.5	44.3	35.0	28.2
Total Return 15 3/4 years	191.8%	238.5%	1,661.2%	936.4%
Standard & Poor's 15 3/4 year annual compounded rate				7.0%
TBK Limited Partners 15 3/4 year annual compounded rate				16.0%
TBK Overall 15 3/4 year annual compounded rate				20.0%

*Includes dividends paid for both Standard & Poor's 500 Composite Index and Dow Jones Industrial Average.

Table 3 · Buffett Partnership, Ltd.

Year	Overall Results From Dow (%)	Partnership Results (%)	Limited Partners' Results (%)
1957	− 8.4	10.4	9.3
1958	38.5	40.9	32.2
1959	20.0	25.9	20.9
1960	− 6.2	22.8	18.6
1961	22.4	45.9	35.9
1962	− 7.6	13.9	11.9
1963	20.6	38.7	30.5
1964	18.7	27.8	22.3
1965	14.2	47.2	36.9
1966	−15.6	20.4	16.8
1967	19.0	35.9	28.4
1968	7.7	58.8	45.6
1969	−11.6	6.8	6.6
On a cumulative or compounded basis, the results are:			
1957	− 8.4	10.4	9.3
1957–58	26.9	55.6	44.5
1957–59	52.3	95.9	74.7
1957–60	42.9	140.6	107.2
1957–61	74.9	251.0	181.6
1957–62	61.6	299.8	215.1
1957–63	94.9	454.5	311.2
1957–64	131.3	608.7	402.9
1957–65	164.1	943.2	588.5
1957–66	122.9	1156.0	704.2
1957–67	165.3	1606.9	932.6
1957–68	185.7	2610.6	1403.5
1957–69	152.6	2794.9	1502.7
Annual Compounded Rate	7.4	29.5	23.8

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are made of price and volume behavior, the stuff of chartists. Can you imagine buying an entire business simply because the price of the business had been marked *up* substantially last week and the week before? Of course, the reason a lot of studies are made of these price and volume variables is that now, in the age of computers, there are almost endless data available about them. It isn't necessarily because such studies have any utility; it's simply that the data are there and academicians have worked hard to learn the mathematical skills needed to manipulate them. Once these skills are acquired, it seems sinful not to use them, even if the usage has no utility or negative utility. As a friend said, to a man with a hammer, everything looks like a nail.

I think the group that we have identified by a common intellectual home is worthy of study. Incidentally, despite all the academic studies of the influence of such variables as price, volume, seasonality, capitalization size, etc., upon stock performance, no interest has been evidenced in studying the methods of this unusual concentration of value-oriented winners.

I begin this study of results by going back to a group of four of us who worked at Graham-Newman Corporation from 1954 through 1956. There were only four—I have not selected these names from among thousands. I offered to go to work at Graham-Newman for nothing after I took Ben Graham's class, but he turned me down as overvalued. He took this value stuff very seriously! After much pestering he finally hired me. There were three partners and four of us at the "peasant" level. All four left between 1955 and 1957 when the firm was wound up, and it's possible to trace the record of three.

The first example (Table 1) is that of Walter Schloss. Walter never went to college, but took a course from Ben Graham at night at the New York Institute of Finance. Walter left Graham-Newman in 1955 and achieved the record shown here over 28 years.

Here is what 'Adam Smith'—after I told him about Walter—wrote about him in *Supermoney* (1972):

He has no connections or access to useful information. Practically no one in Wall Street knows him and he is not fed any ideas. He looks up the numbers in the manuals and sends for the annual reports, and that's about it.

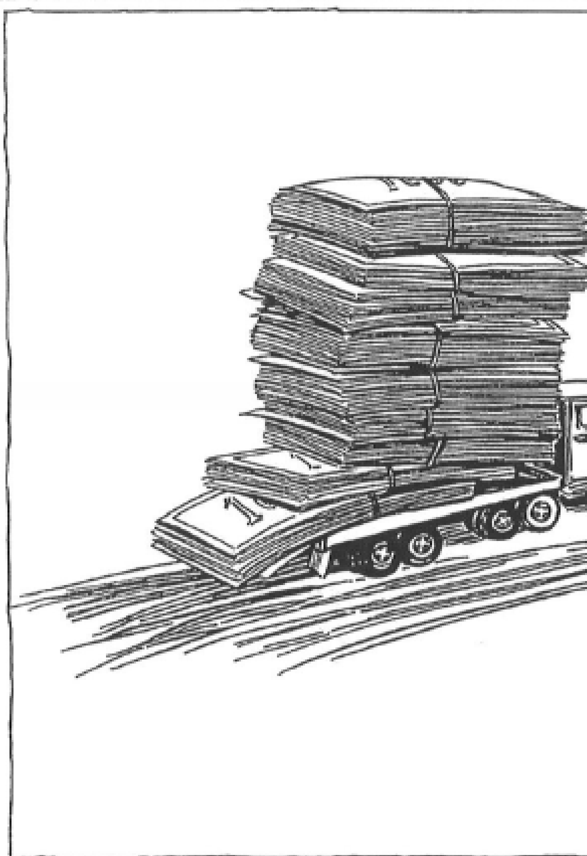
In introducing me to [Schloss] Warren had also, to

Table 4 • Sequoia Fund, Inc.

Year	Annual Percentage Change**	
	Sequoia Fund (%)	S&P 500 Index* (%)
1970 (from July 15)	12.1	20.6
1971	13.5	14.3
1972	3.7	18.9
1973	– 24.0	– 14.8
1974	– 15.7	– 26.4
1975	60.5	37.2
1976	72.3	23.6
1977	19.9	– 7.4
1978	23.9	6.4
1979	12.1	18.2
1980	12.6	32.3
1981	21.5	– 5.0
1982	31.2	21.4
1983	27.3	22.4
1984 (first quarter)	– 1.6	– 2.4
Entire Period	775.3%	270.0%
Compound Annual Return	17.2%	10.0%
Plus 1% Management Fee	1.0%	
Gross Investment Return	18.2%	10.0%

*Includes dividends (and capital gains distributions in the case of Sequoia Fund) treated as though reinvested.

**These figures differ slightly from the S&P figures in Table 1 because of a difference in calculation of reinvested dividends.



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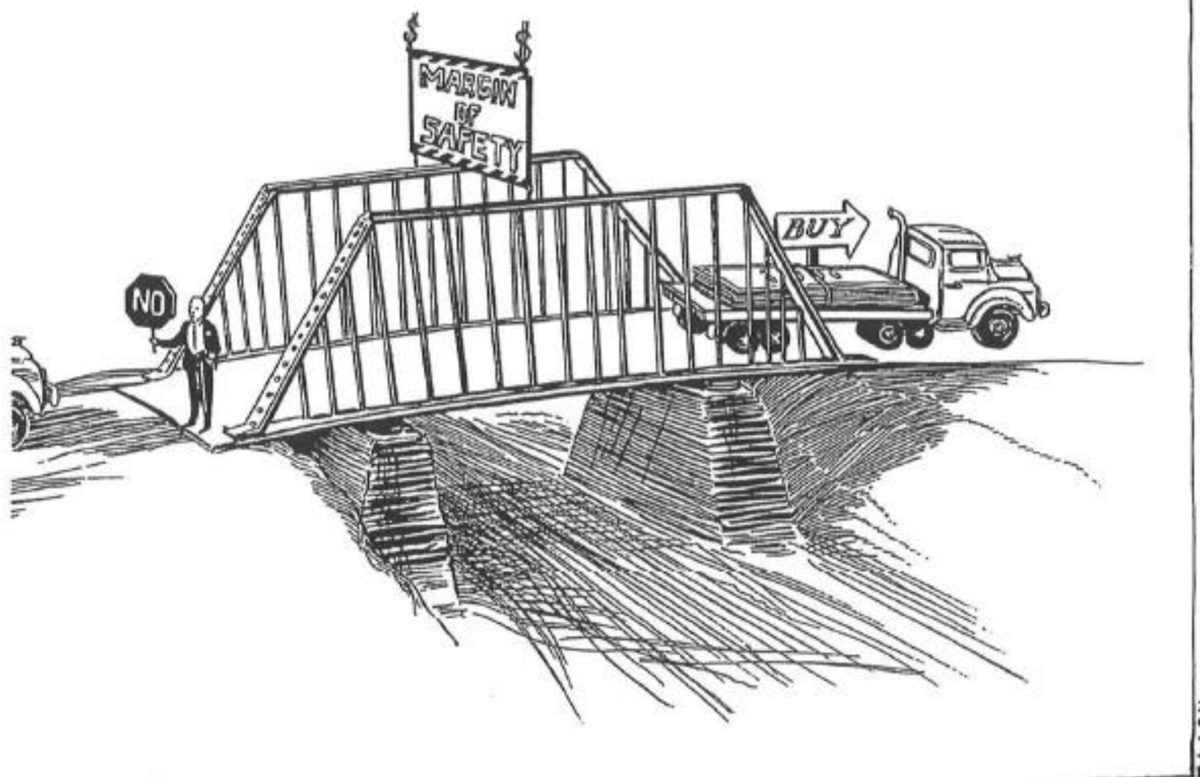
my mind, described himself. 'He never forgets that he is handling other people's money and this reinforces his normal strong aversion to loss. He has total integrity and a realistic picture of himself. Money is real to him and stocks are real—and from this flows an attraction to the 'margin of safety' principle.

Walter has diversified enormously, owning well over 100 stocks currently. He knows how to identify securities that sell at considerably less than their value to a private owner. *And that's all he does.* He doesn't worry about whether it's January, he doesn't worry about whether it's Monday, he doesn't worry about whether it's an election year. He simply says, if a business is worth a dollar and I can buy it for 40 cents, something good may happen to me. And he does it over and over and over again. He owns many more stocks than I do—and is far less interested in the underlying nature of the business; I don't seem to have very much influence on Walter. That's one of his strengths; no one has much influence on him.

The second case is Tom Knapp who also worked at Graham-Newman with me. Tom was a chemistry major at Princeton before the war; when he came back from the war, he was a beach bum. And then one day he read that Dave Dodd was giving a night course in investments at Columbia. Tom took it on a non-credit basis, and he got so interested in the subject from taking that course that he came up and enrolled at Columbia Business School where he got the MBA degree. He took Dodd's course again, and took Ben Graham's course. Incidentally, 35 years later I called Tom to ascertain some of the facts involved here and I found him on the beach again. The only difference is that now he owns the beach!

In 1968 Tom Knapp and Ed Anderson, also a Graham disciple, along with one or two other fellows of similar persuasion, formed Tweedy,Browne Partners, and their investment results appear in Table 2. Tweedy,Browne built that record with very wide diversification. They occasionally bought control of businesses, but the record of the passive investments is equal to the record of the control investments.

Table 3 describes the third member of the group who formed Buffett Partnership in 1957. The best thing he did was to quit in 1969. Since then, in a sense, Berkshire Hathaway has been a continuation of the partnership in some respects. There is no single index I can give you that I would feel would



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be a fair test of investment management at Berkshire. But I think that any way you figure it, it has been satisfactory.

Table 4 shows the record of the Sequoia Fund, which is managed by a man whom I met in 1951 in Ben Graham's class, Bill Ruane. After getting out of Harvard Business School, he went to Wall Street. Then he realized that he needed to get a real business education so he came up to take Ben's course at Columbia, where we met in early 1951. Bill's record from 1951 to 1970, working with relatively small sums, was far better than average. When I wound up Buffett Partnership I asked Bill if he would set up a fund to handle all of our partners so he set up the Sequoia Fund. He set it up at a terrible time, just when I was quitting. He went right into the two-tier market and all the difficulties that made for comparative performance for value-oriented investors. I am happy to say that my partners, to an amazing degree, not only stayed with him but added money, with the happy result shown.

There's no hindsight involved here. Bill was the only person I recommended to my partners, and I said at the time that if he achieved a four point per annum advantage over the Standard & Poor's, that would be solid performance. Bill has achieved well over that, working with progressively larger sums of money. That makes things much more difficult. Size is the anchor of performance. There is no question about it. It doesn't mean you can't do better than average when you get larger, but the margin shrinks. And if you ever get so you're managing two trillion dollars, and that happens to be the amount of the total equity evaluation in the economy, don't think that you'll do better than average!

I should add that, in the records we've looked at so far, throughout this whole period there was practically no duplication in these portfolios. These are men who select securities based on discrepancies between price and value, but they make their selections very differently. Walter's largest holdings have been such stalwarts as Hudson Pulp & Paper and Jeddo Highland Coal and New York Trap Rock Company and all those other names that come instantly to mind to even a casual reader of the business pages. Tweedy Browne's selections have sunk even well below that level in terms of name recognition. On the other hand, Bill has worked with big companies. The overlap among these portfolios has been very, very low.

Table 5 · Charles Munger

Year	Mass. Inv. Trust (%)	Investors Stock (%)	Lehman (%)	Tri-Cont. (%)	Dow (%)	Over-all Partnership (%)	Limited Partners (%)
Yearly Results (1)							
1962	−9.8	−13.4	−14.4	−12.2	−7.6	30.1	20.1
1963	20.0	16.5	23.8	20.3	20.6	71.7	47.8
1964	15.9	14.3	13.6	13.3	18.7	49.7	33.1
1965	10.2	9.8	19.0	10.7	14.2	8.4	6.0
1966	−7.7	−9.9	−2.6	−6.9	−15.7	12.4	8.3
1967	20.0	22.8	28.0	25.4	19.0	56.2	37.5
1968	10.3	8.1	6.7	6.8	7.7	40.4	27.0
1969	−4.8	−7.9	−1.9	0.1	−11.6	28.3	21.3
1970	0.6	−4.1	−7.2	−1.0	8.7	−0.1	−0.1
1971	9.0	16.8	26.6	22.4	9.8	25.4	20.6
1972	11.0	15.2	23.7	21.4	18.2	8.3	7.3
1973	−12.5	−17.6	−14.3	−21.3	−13.1	−31.9	−31.9
1974	−25.5	−25.6	−30.3	−27.6	−23.1	−31.5	−31.5
1975	32.9	33.3	30.8	35.4	44.4	73.2	73.2
Compound Results (2)							
1962	−9.8	−13.4	−14.4	−12.2	−7.6	30.1	20.1
1962–3	8.2	0.9	6.0	5.6	11.5	123.4	77.5
1962–4	25.4	15.3	20.4	19.6	32.4	234.4	136.3
1962–5	38.2	26.6	43.3	32.4	51.2	262.5	150.5
1962–6	27.5	14.1	39.5	23.2	27.5	307.5	171.3
1962–7	53.0	40.1	78.5	54.5	51.8	536.5	273.0
1962–8	68.8	51.4	90.5	65.0	63.5	793.6	373.7
1962–9	60.7	39.4	86.9	65.2	44.5	1046.5	474.6
1962–70	61.7	33.7	73.4	63.5	57.1	1045.4	474.0
1962–71	76.3	56.2	119.5	100.1	72.5	1336.3	592.2
1962–72	95.7	79.9	171.5	142.9	103.9	1455.5	642.7
1962–73	71.2	48.2	132.7	91.2	77.2	959.3	405.8
1962–74	27.5	10.3	62.2	38.4	36.3	625.6	246.5
1962–75	69.4	47.0	112.2	87.4	96.8	1156.7	500.1
Average Annual Compounded Rate	3.8	2.8	5.5	4.6	5.0	19.8	13.7

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These records do not reflect one guy calling the flip and fifty people yelling out the same thing after him.

Table 5 is the record of a friend of mine who is a Harvard Law graduate, who set up a major law firm. I ran into him in about 1960 and told him that law was fine as a hobby but he could do better. He set up a partnership quite the opposite of Walter's. His portfolio was concentrated in very few securities and therefore, his record was much more volatile but it was based on the same discount-from-value approach. He was willing to accept greater peaks and valleys of performance, and he happens to be a fellow whose whole psyche goes toward concentration, with the results shown. Incidentally, this record belongs to Charlie Munger, my partner for a long time in the operation of Berkshire Hathaway. When he ran his partnership, however, his portfolio holdings were almost completely different from mine and the other fellows mentioned earlier.

Table 6 is the record of a fellow who was a pal of Charlie Munger's—another non-business school type—who was a math major at USC. He went to work for IBM after graduation and was an IBM salesman for a while. After I got to Charlie, Charlie got to him. This happens to be the record of Rick Guerin. Rick, from 1965 to 1983, against a compounded gain of 316 percent for the S&P, came off with 22,200 percent which, probably because he lacks a business school education, he regards as statistically significant.

One sidelight here: it is extraordinary to me that the idea of buying dollar bills for 40 cents takes immediately with people or it doesn't take at all. It's like an inoculation. If it doesn't grab a person right away, I find that you can talk to him for years and show him records, and it doesn't make any difference. They just don't seem able to grasp the concept, simple as it is. A fellow like Rick Guerin, who had no formal education in business, understands immediately the value approach to investing and he's applying it five minutes later. I've never seen anyone who became a gradual convert over a ten-year period to this approach. It doesn't seem to be a matter of I.Q. or academic training. It's instant recognition, or it is nothing.

Table 7 is the record of Stan Perlmeter. Stan was a liberal arts major at the University of Michigan who was a partner in the advertising agency of Bozell & Jacobs. We happened to be in the same building in

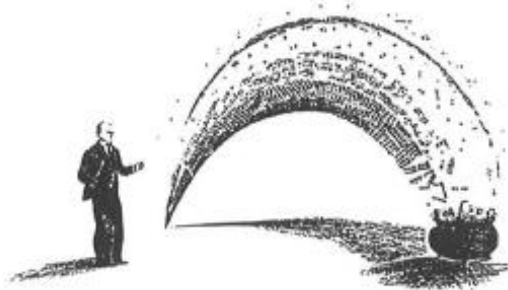

Table 6 · Pacific Partners, Ltd.

Year	S & P 500 Index (%)	Limited Partnership Results (%)	Overall Partnership Results (%)
1965	12.4	21.2	32.0
1966	−10.1	24.5	36.7
1967	23.9	120.1	180.1
1968	11.0	114.6	171.9
1969	− 8.4	64.7	97.1
1970	3.9	− 7.2	− 7.2
1971	14.6	10.9	16.4
1972	18.9	12.8	17.1
1973	−14.8	− 42.1	− 42.1
1974	−26.4	− 34.4	− 34.4
1975	37.2	23.4	31.2
1976	23.6	127.8	127.8
1977	− 7.4	20.3	27.1
1978	6.4	28.4	37.9
1979	18.2	36.1	48.2
1980	32.3	18.1	24.1
1981	− 5.0	6.0	8.0
1982	21.4	24.0	32.0
1983	22.4	18.6	24.8
Standard & Poor's 19 year compounded gain			316.4%
Ltd. Partnership 19 year compounded gain			5,530.2%
Overall Partnership 19 year compounded gain			22,200.0%
Standard & Poor's 19 year annual compounded rate			7.8%
Ltd. Partnership 19 year annual compounded rate			23.6%
Overall Partnership 19 year annual compounded rate			32.9%

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Omaha. In 1965 he figured out I had a better business than he did, so he left advertising. Again, it took five minutes for Stan to embrace the value approach.

Perlmeter does not own what Walter Schloss owns. He does not own what Bill Ruane owns. These are records made *independently*. But every time Perlmeter buys a stock it's because he's getting more for his money than he's paying. That's the only thing he's thinking about. He's not looking at quarterly earnings projections, he's not looking at next year's earnings, he's not thinking about what day of the week it is, he doesn't care what investment research from any place says, he's not interested in price momentum, volume or anything. He's simply asking: What is the business worth?

Table 8 and Table 9 are the records of two pension funds I've been involved in. They are not selected from dozens of pension funds with which I have had involvement; they are the only two I have influenced. In both cases I have steered them toward value-oriented managers. Very, very few pension funds are managed from a value standpoint. Table 8 is the Washington Post Company's Pension Fund. It was with a large bank some years ago, and I suggested that they would do well to select managers who had a value orientation.

As you can see, overall they have been in the top percentile ever since they made the change. The Post told the managers to keep at least 25 percent of these funds in bonds, which would not have been necessarily the choice of these managers. So, I've included the bond performance simply to illustrate that this group has no particular expertise about bonds. They wouldn't have said they did. Even with this drag of 25 percent of their fund in an area that was not their game, they were in the top percentile of fund management. The Washington Post experience does not cover a terribly long period but it does represent many investment decisions by three managers who were not identified retroactively.

Table 9 is the record of the FMC Corporation fund. I don't manage a dime of it myself but I did, in 1974, influence their decision to select value-oriented managers. Prior to that time they had selected managers much the same way as most larger companies. They now rank number one in the Becker survey of pension funds for their size over the period of time subsequent to this "conversion" to the value approach. Last year they had eight equity managers of any duration

Table 7 • Perlmeter Investments

Year	PIL Overall (%)	Limited Partner (%)
8/1–12/31/65	40.6	32.5
1966	6.4	5.1
1967	73.5	58.8
1968	65.0	52.0
1969	−13.8	−13.8
1970	− 6.0	− 6.0
1971	55.7	49.3
1972	23.6	18.9
1973	−28.1	−28.1
1974	−12.0	−12.0
1975	38.5	38.5
1/1–10/31/76	38.2	34.5
11/1/76–10/31/77	30.3	25.5
11/1/77–10/31/78	31.8	26.6
11/1/78–10/31/79	34.7	28.9
11/1/79–10/31/80	41.8	34.7
11/1/80–10/31/81	4.0	3.3
11/1/81–10/31/82	29.8	25.4
11/1/82–10/31/83	22.2	18.4

Total Partnership Percentage Gain 8/1/65 through 10/31/83	4277.2%
Limited Partners Percentage Gain 8/1/65 through 10/31/83	2309.5%
Annual Compound Rate of Gain Overall Partnership	23.0%
Annual Compound Rate of Gain Limited Partners	19.0%
Dow Jones Industrial Averages 7/31/65 (Approximate)	882
Dow Jones Industrial Averages 10/31/83 (Approximate)	1225
Approximate Compound Rate of Gain of DJI including dividends	7%

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beyond a year. Seven of them had a cumulative record better than the S&P. All eight had a better record last year than the S&P. The net difference now between a median performance and the actual performance of the FMC fund over this period is $243 million. FMC attributes this to the mindset given to them about the selection of managers. Those managers are not the managers I would necessarily select but they all have the common denominator of selecting securities based on value.

So these are nine records of "coin-flippers" from Graham-and-Doddsville. I haven't selected them with hindsight from among thousands. It's not like I am reciting to you the names of a bunch of lottery winners—people I had never heard of before they won the lottery. I selected these men years ago based upon their framework for investment decision-making. I knew what they had been taught and additionally, I had some personal knowledge of their intellect, character and temperament. It's very important to understand that this group has assumed far less risk than average; note their record in years when the general market was weak. While they differ greatly in style, these investors are, mentally, always *buying the business, not buying the stock*. A few of them sometimes buy whole businesses, far more often they simply buy small pieces of businesses. Their attitude, whether buying all or a tiny piece of a business, is the same. Some of them hold portfolios with dozens of stocks; others concentrate on a handful. But all exploit the difference between the market price of a business and its intrinsic value.

I'm convinced that there is much inefficiency in the market. These Graham-and-Doddsville investors have successfully exploited gaps between price and value. When the price of a stock can be influenced by a "herd" on Wall Street with prices set at the margin by the most emotional person, or the greediest person, or the most depressed person, it is hard to argue that the market always prices rationally. In fact, market prices are frequently nonsensical.

I would like to say one important thing about risk and reward. Sometimes risk and reward are correlated in a positive fashion. If someone were to say to me, "I have here a six-shooter and I have slipped one cartridge into it. Why don't you just spin it and pull it once? If you survive, I will give you $1 million." I would decline—perhaps stating that $1 million is not enough. Then he might offer me $5 million to

Table 8 • The Washington Post Company, Master Trust, December 31, 1983

	Current Quarter		Year Ended		2 Years Ended*		3 Years Ended*		5 Years Ended*	
	% Ret.	Rank	% Ret.	Rank	% Ret.	Rank	% Ret.	Rank	% Ret.	Rank
All Investments										
	4.1	2	22.5	10	20.6	40	18.0	10	20.2	3
	3.2	4	34.1	1	33.0	1	28.2	1	22.6	1
	5.4	1	22.2	11	28.4	3	24.5	1	—	—
Master Trust	3.9	1	28.1	1	28.2	1	24.3	1	21.8	1
Common Stock										
	5.2	1	32.1	9	26.1	27	21.2	11	26.5	7
	3.6	5	52.9	1	46.2	1	37.8	1	29.3	3
	6.2	1	29.3	14	30.8	10	29.3	3	—	—
Master Trust	4.7	1	41.2	1	37.0	1	30.4	1	27.6	1
Bonds										
	2.7	8	17.0	1	26.6	1	19.0	1	12.2	2
	1.6	46	7.6	48	18.3	53	12.7	84	7.4	86
	3.2	4	10.4	9	24.0	3	18.9	1	—	—
Master Trust	2.2	11	9.7	14	21.1	14	15.2	24	9.3	30
Bonds & Cash Equivalents										
	2.5	15	12.0	5	16.1	64	15.5	21	12.9	9
	2.1	28	9.2	29	17.1	47	14.7	41	10.8	44
	3.1	6	10.2	17	22.0	2	21.6	1	—	—
Master Trust	2.4	14	10.2	17	17.8	20	16.2	2	12.5	9

*Annualized
Rank indicates the fund's performance against the A.C. Becker universe.
Rank is stated as a percentile: 1 = best performance, 100 = worst.

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pull the trigger twice—now that would be a positive correlation between risk and reward!

The exact opposite is true with value investing. If you buy a dollar bill for 60 cents, it's riskier than if you buy a dollar bill for 40 cents, but the expectation of reward is greater in the latter case. The greater the potential for reward in the value portfolio, the less risk there is.

One quick example: The Washington Post Company in 1973 was selling for $80 million in the market. At the time, that day, you could have sold the assets to any one of ten buyers for not less than $400 million, probably appreciably more. The company owned the *Post*, *Newsweek*, plus several television stations in major markets. Those same properties are worth $2 billion now so the person who would have paid $400 million would not have been crazy.

Now, if the stock had declined even further to a price that made the valuation $40 million instead of $80 million, its beta would have been greater. And to people who think beta measures risk, the cheaper price would have made it look riskier. This is truly Alice in Wonderland. I have never been able to figure out why it's riskier to buy $400 million worth of properties for $40 million than $80 million. And, as a matter of fact, if you buy a group of such securities and you know anything at all about business valuation, there is essentially no risk in buying $400 million for $80 million, particularly if you do it by buying ten $40 million piles for $8 million each. Since you don't have your hands on the $400 million, you want to be sure you are in with honest and reasonably competent people, but that's not a difficult job.

You also have to have the knowledge to enable you to make a very general estimate about the value of the underlying businesses. But you do not cut it close. That is what Ben Graham meant by having a margin of safety. You don't try and buy businesses worth $83 million for $80 million. You leave yourself an enormous margin. When you build a bridge, you insist it can carry 30,000 pounds, but you only drive 10,000-pound trucks across it. And that same principle works in investing.

In conclusion, some of the more commercially minded among you may wonder why I am writing this article. Adding many converts to the value approach will perforce narrow the spreads between price and value. I can only tell you that the secret has been out

Table 9 · FMC Corporation Pension Fund, Annual Rate of Return (Percent)

Period ending	1 Year	2 Years	3 Years	4 Years	5 Years	6 Years	7 Years	8 Years	9 Years
FMC									
1983	23.0								*17.1
1982	22.8	13.6	16.0	16.6	15.5	12.3	13.9	16.3	
1981	5.4	13.0	15.3	13.8	10.5	12.6	15.4		
1980	21.0	19.7	16.8	11.7	14.0	17.3			
1979	18.4	14.7	8.7	12.3	16.5				
1978	11.2	4.2	10.4	16.1					
1977	− 2.3	9.8	17.8						
1976	23.8	29.3							
1975	35.0							*18.5 from equities only	
Becker large plan median									
1983	15.6								12.6
1982	21.4	11.2	13.9	13.9	12.5	9.7	10.9	12.3	
1981	1.2	10.8	11.9	10.3	7.7	8.9	10.9		
1980	20.9	NA	NA	NA	10.8	NA			
1979	13.7	NA	NA	NA	11.1				
1978	6.5	NA	NA	NA					
1977	− 3.3	NA	NA						
1976	17.0	NA							
1975	24.1								
S&P 500									
1983	22.8								15.6
1982	21.5	7.3	15.1	16.0	14.0	10.2	12.0	14.9	
1981	− 5.0	12.0	14.2	12.2	8.1	10.5	14.0		
1980	32.5	25.3	18.7	11.7	14.0	17.5			
1979	18.6	12.4	5.5	9.8	14.8				
1978	6.6	− 0.8	6.8	13.7					
1977	− 7.7	6.9	16.1						
1976	23.7	30.3							
1975	37.2								

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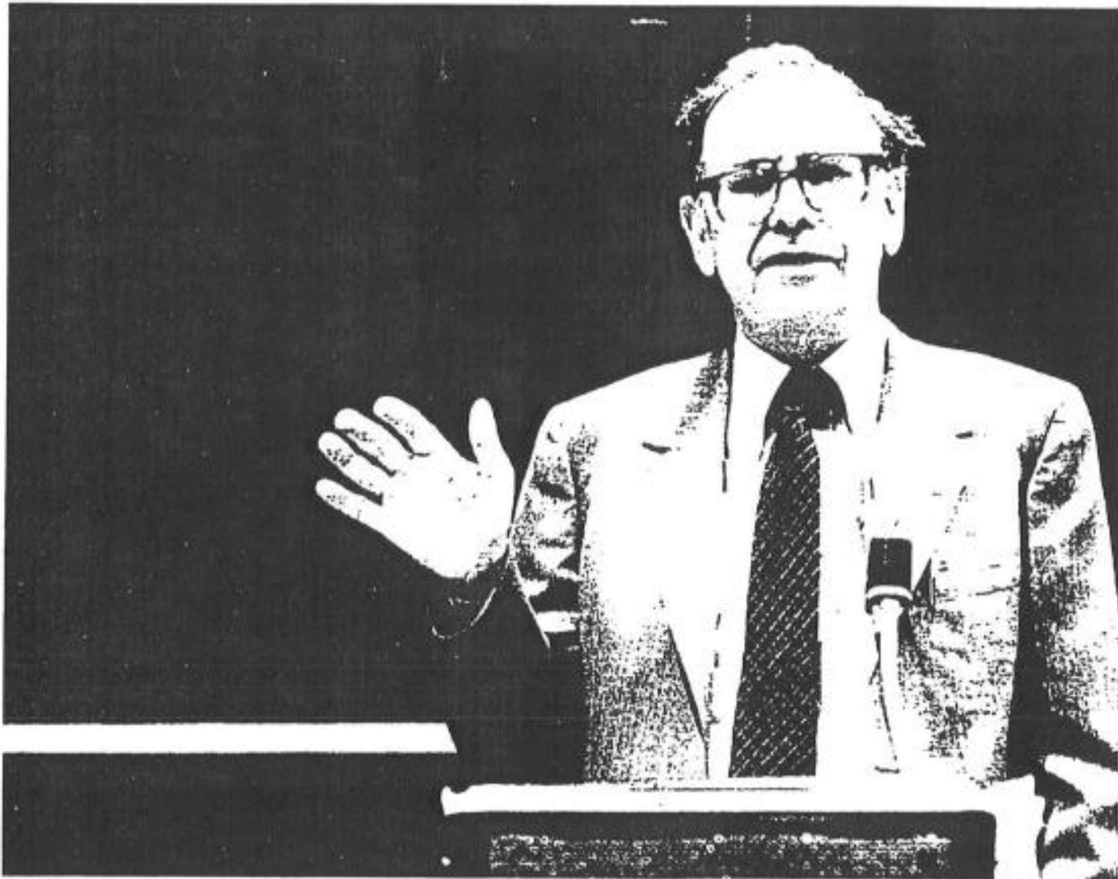
for 50 years, ever since Ben Graham and Dave Dodd wrote *Security Analysis*, yet I have seen no trend toward value investing in the 35 years I've practiced it. There seems to be some perverse human characteristic that likes to make easy things difficult. The academic world, if anything, has actually backed away from the teaching of value investing over the last 30 years. It's likely to continue that way. Ships will sail around the world but the Flat Earth Society will flourish. There will continue to be wide discrepancies between price and value in the marketplace, and those who read their Graham & Dodd will continue to prosper.

Warren E. Buffett, is chairman and chief executive officer of Berkshire Hathaway, Inc., an Omaha-based insurer with major holdings in several other industries, including General Foods, Xerox and Washington Post Company.
After getting an A+ in Benjamin Graham's class and graduating from Columbia Business School in 1951, Buffett went to work on Wall Street at Graham-Newman & Company. In 1957 founded his own partnership, which he ran for ten years. This article is based on a speech he gave at Columbia Business School, May 17, 1984 at a seminar marking the 50th anniversary of the publication of Benjamin Graham and David Dodd's Security Analysis.



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