Notes and Observations Based On:

 How To Think Like Benjamin Graham and Invest Like Warren Buffett

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Common Sense Investing as Opposed to Speculation

Common sense is at the heart of investing and business management. Yet the paradox of common sense is that it is so uncommon. For example, stocks are not over or under valued -- their value is based on the present value of the expected future cash flows. Yet people often refer to a stock as being over or undervalued. Share price can be over or under the intrinsic value of a stock, but value is like a yard stick that measures worth and isn’t subject to change. There must be a disciplined approach to estimating cash flows and determining the discount rate that provides the measure of intrinsic value.

Anyone who has bought an item on sale, or attended an auction knows that price can vary significantly from underlying value. Some people pay too much, others buy things for far less, than the value derived from the ownership of an item. Most buyers appreciate getting a well-made sweater that normally sells for $50 on sale for $25. Yet the growth and marketing of index funds, such as QQQ, have led to many trading the paper, rather than valuing the underlying securities on which the indexes or ETFs are based. This perspective has resulted in a day trading, casino culture, whereby the focus is on price rather than value. The day trader is seeking to make short term profits on small, immediate changes in price, rather than look towards long term increases in price, based on acquiring a business of great long term value.

An investor, rather than a speculator, has the view that ownership of a share of stock is the same as owning a business. Therefore, an investor will take the time to do a business analysis of a company prior to seeking to own shares in the firm. A business analysis approach runs counter to the current notion that growth and value investing are mutually exclusive activities. If one is buying a good quality business at an attractive price, then that enterprise should also have an outstanding record of growth in sales and earnings with good prospects for the future.

Examples of speculation under the guise of investing: Buying shares in an IPO, buying shares in a company without reading an annual report, buying mutual fund shares without checking out what stocks are actually in the fund and how it is managed are more likely to lead to long term loses rather than enduring value to those placing funds in these activities.

Once one develops the tools for knowing how to look for value, the next step is determining where to look. The main idea is to leverage off your core competencies for identifying good products and services that deliver value to customers. Your circle of competence represents an ability to understand a company’s products and operating context that may lead to outstanding value over a long range time horizon. If you don’t understand what the company does, it’s probably not a good idea to be buying shares.

Within the group of businesses that most are familiar with, there are what may be called C**lassic** **companies**  such as: GE, PG, KO,DIS, XOM,CVX, PEP, MRK, JNJ, UNP, MSFT, INTC, AAPL, EMR, MMM. These are firms that have overcome challenges over many years with a history of top managers who can navigate all phases of the business cycle.

Other, newer companies, that have been through some economic cycles, but have not yet established a long track record of continued sales and earnings with product/service innovation are considered: **Vintage firms operating in dynamic industries that are evolving at a rapid pace [tracking with the three major trends** – aging of the population [biotech, pharma: GLD, PFE, MDT], emergence of post baby boom generation [tech, telephone: GLW, AMAT, T], energy [COP, MRO, NOV] . These firms have less of a track record [maybe 15 to 20 years’ worth of data] and may be harder for a good share of the public to understand and evaluate. However, if an investor is willing to do their homework investing in these enterprises can be richly rewarding, because there can be great inefficiencies in the pricing of stock in this space relative to value. One long term investment strategy may be to invest about 20 to 40% of your portfolio in vintage firms when prices are attractive, hold them until you have generated significant price appreciation and then pare positions and re-deploy in either other vintage firms attractively priced or further build classic positions that are nicely priced with consistent, growing and higher dividends than with vintage stocks. More recently the distinction with respect to vintage modest dividend versus classic high dividend stocks has been blurring. There are some vintage firms, particularly in tech that are producing spectacular dividend yields, with no debt, and very good earnings that are equal to or better than some of the classics on the dividend front. You might call these vintage companies the emerging classics. In this instance you would seek to retain a larger portion of these hybrid vintage/classic firms in the portfolio – so instead of paring a position in half you might reduce it by a fourth.

There is a third group of companies that lie somewhere at the intersection between investment and speculation, called **Rookie firms that are brand new, perhaps operating in a brand new industry that have good balance sheets, growing earnings and may in fact blossom into vintage firms.** These firms carry much greater risk than the other two because of limited information with respect to management, finances, success of the product or service and/or how well the firm will do over an entire business cycle. In order to invest in these companies you would need to do a great deal of research about the product/service, management and finances and be willing to place a relatively small amount to start an initial position [which represents the cost of purchasing additional information] understanding that in some cases you may lose some or all of your principal. However, you will need to generate returns far greater than with classics and vintage positions in order to overcome loss of principal in some trades and still generate a return that is commensurate with the long term placement in the other two investment categories. So, with these somewhat speculative plays you should have a hard fast rule that no more than 20% of your entire portfolio will be invested in Rookie stocks at any given moment. Also, an additional guideline would be that once one of these stocks reached a point where significant returns had been generated [e.g. doubling your money in a short period of time (year or less)] then the position will be pared to at least take out all of the original investment.

The circle of competence concept must be tailored to the comparative advantages of each investor. If an investor has the knowledge, patience, and understanding to investigate a business or industry that others are incapable of doing, then they may be able to take this skill and use it to trade off informational inefficiencies. The irony of the internet age, is that there may be a great deal of financial/management information on a company, but most find it difficult to sort the wheat from the chaff in terms of what is significant. While numbers may offer some indication of value, it is the whole package relating to the skills of management, comparative advantages of the product or service, and regulatory environment that are equally important. So the presence of lots of information does not necessary lead to market efficiency. Bad information can in fact, lead to market inefficiency. Sometimes, as in the case of a good investment club, it may be possible to leverage off the expertise of others who work in a specialty field and can offer knowledge and perspectives not known or overlooked by most members of the public [e.g. a faculty member in the computer science department who works with neural networks may be able to offer an opinion on the merits of investing in Oracle vs. SAP]. However, as with stock tips, one should never invest on the basis of an opinion, but rather as a consequence of thorough fundamental and technical analysis. If you are talking with an expert, you should be able to understand just what are the merits versus of difficulties of the firm you are investigating. If you are unable to comprehend those characteristics, it would not be wise to invest in the company because at that point you really wouldn't know what you were investing in.

There is a hierarchy to the degree of certainty you acquire when investing in various types of companies characterized as classic, vintage or rookie, which may be helpful to portfolio management:

Degree of Certainty Type of Company

Required in Relation to in Relation to

Circle of Competence Portfolio Investment

 High Rookie

Intermediate Vintage

Low Classic

If you are going to invest in Rookies it is of paramount importance to have all relevant information to the extent of having a clear understanding of what you are purchasing. The purchase of a Rookie stock should come with some assurance that you are receiving something of significant value at a very inexpensive price.

 Whether you invest in a classic, vintage or rookie stock, there will always be an information deficit between what is available historically and what may occur in the future. An investment to some extent it is under the assumption that what has happened in the past will be replicated in the future. However, there are no guarantees even with the same management that there will be a high correlation between the past and the present. Therefore, **the edge used by both Benjamin Graham and Warren Buffett to overcome information discrepancies is margin of safety**. The difference between the price of a stock and its value represents an investment's margin of safety. The greater the margin of safety, the better an investor's chances of making money on a trade. Over the years, creative accounting [e.g. amortization of computer software fees], favorable accounting treatment of assets [e.g. goodwill accounting] and/or generous accounting treatment of liabilities [e.g. off-balance sheet pension liabilities] have demonstrated a vast need for margin of safety to overcome differences between reported results and actual reality. Unfortunately, when it comes to unethical behavior on the part of some company managers, history repeats itself all too often. The scandals in the 1960's, followed by those in the 70's, 80's, 90's and beyond tell the same story in terms of investor losses from the unethical actions of those motivated by greed[e.g. as chronicled in such books as FIASCO and Smartest Guys in the Room] . Even the best and most thorough investors may have lost money putting money in morally bankrupt firms. However, investors who used the margin of safety concept and had a good set of investment guidelines pared losses well before they became a major portfolio problem. Since a good share of fundamental analysis is based on using an honest set of financial records, based on the integrity of the accountants and auditors, it is entirely possible for an astute investor to be fooled into thinking they have invested in a great Rookie or Vintage company only to find out otherwise. One helpful investment guideline is the hard, fast rule that a position should be closed out as soon as possible once ethical issues arise concerning management's conduct in running the company you own. Despite some believing that the financial market in equities is efficient, it is surprising just how much time an investor appears to have after an announcement regarding the ethical failings of a company's manager [e.g.ADM in the 1990s, TYCO in 2005]. In most instances, an alert investor selling off their position shortly after news became public would have staved off considerable losses.

Tied to the question of certainty in evaluating the long term prospects of a business is the certainty and commitment the management has to channel rewards to shareholders. A business that has significant advantages in terms of economics of scale and margins can overcome mediocre management. However, poor economics rarely, if ever, can be cured by exceptional management. Inferior management can harm a good business and sometimes poor management can hide behind relatively good results due to pleasant economic conditions [Good to Great --- out of the 10 so called "exceptional" companies showcased in the book, 2 went bankrupt or were reorganized shortly after the book's publication!]

The main criteria for evaluating management is trustworthiness. Can the corporate managers be trusted to maintain ethical standards, lead the firm to benefit shareholder interests, and make quality long term decisions? Sources of information in this area include, business records, the quality and frequency of information to investors, and the reputation of board members. The wild card lending to market inefficiency is the potential for management change due to death or retirement.

Common sense investing requires that one grasp the basics of finance, accounting and corporate governance to recognize the following factors:

 (1) Market efficiency is at most about 80%s and investors can take advantage of the remaining 20% due to economic externalities imposed by regulation, taxes, management change [due to death or retirement], and macro-economic conditions [causing there to be out of favor industries/companies that have strong business models, and very capable managers].

 (2) Traditional financial analysis can be an investor's best tool for evaluating companies, but earnings management and accounting manipulation can be their worst enemy. An investor needs to be fully focused on management integrity. It is important to regularly determine whether the financial accounting accurately reports the firm's current condition and if not, take action to avoid future loss.

 (3) Intelligent investors pay special attention to who the managers are and whether they are trustworthy.

 You need to develop independent and objective judgment in investing, which further emphasizes the need for a sound set of investment guidelines.

Volatility -- A Crucial Concept When evaluating Stocks and Options

Price volatility can move stock and option prices towards their true values (approaching market efficiency) or away from those values (resulting in market inefficiency) over time. The greater the volatility associated with a security, the higher the probability that its price will move significantly over a given period of time in one direction or another. Consequently, in general, volatility may be considered one of the surrogates for price risk in holding a security. However there is a certain subtlety in using this concept to reflect risk. Because most options contracts [with the exception of LEAPS] are short term, time/price arrangements, inefficiencies are arbitraged out of any price/value discrepancy very quickly. While one may be able to trade high volatility options prior to an exogeneous event [such as an earnings report or rumored spin-off], this activity is more speculation than investing, because it's based on what one projects may happen, rather than what is likely to occur based on long term company trends. However, with the long term nature of common stock ownership, higher volatility can, on occasion, introduce the possibility of rewards in excess of risk for those who can incorporate fundamental and technical analysis into stock selection. One exception to this dichotomy between stock versus option risk/reward relationships is the long, ITM call option. Appropriately priced, relative to long term value of owning underlying shares, a long, deep in the money call used to purchase stock, may offer the benefits of leverage and capital appreciation in owning common stock. There are three different varieties of volatility that impact stocks and options.

Informational Volatility - relates to information changes that has both a positive [efficient] dimension and a negative [inefficient] dimension.

Bipolar Aspects of the Financial Markets

Many investors in the financial markets exhibit classic characteristics of manic depression -- combining episodes of euphoria leading to buying sprees, but then with new information, a sudden shift to depression resulting in heavy selling of what was bought earlier. Despite going through these manic cycles over many years, investors either ignore the pattern to their behavior or convince themselves that this time is different [e.g. what goes up, must continue to go up even when valuations in the form of P/Es are at astronomical levels].

Rational investors when viewing this market behavior believe that this manic condition is incurable, with the market being prone to fat gains followed by fat losses without an semblance to economic reality. Ironically, rational people acting independently can produce irrational market results. Some people will defer to financial experts or majority opinion that is influenced by market conditions rather than independent assessment of the companies owned or purchased. Prices on particular stocks rise sharply and fall furiously within days and weeks without any link to underlying business values. Market volatility has increased roughly in proportion to the dramatic increase in information -- both real and imagined - that is readily available.

Recent Dow Busts

Date Close Point Change % Change

October 27, 1997 7,161 -554 -7.18

August 4, 1998 8,487 -299 -3.41

August 27, 1998 8,165 -357 -4.19

August 31, 1998 7,539 -512 -6.37

January 4, 2000 10,997 -359 -3.17

March 7, 2000 9,796 -374 -3.68

Recent Dow Booms

Date Close Point Change % Change

September 2, 1997 7,879 257 3.38

October 28, 1997 7,498 337 4.71

September 1, 1998 7,827 288 3.82

September 8, 1998 8,020 380 4.98

September 23, 1998 8,154 257 3.26

October 15, 1998 8,299 330 4.15

March 15, 2000 10,131 320 3.26

March 16, 2000 10,630 499 4.91

Three busts in August of 1998 were promptly followed by three bursts of September 1998, much the way the bust of March 7, 2000 was followed by the bursts on March 15 and 16 of that year. It is hard to believe that these successive bursts and busts are based on changes in fundamental information investors were rationally and efficiently acting on.

One of the better examples of investor irrationality might be the crash of 1987. The Dow vaporized 22.6% of value in a single day. This crash was not limited to just Dow stocks but impacted all shares that were traded in the market. If stock market prices really obeyed the ever-popular efficient market theory (EMT) and accurately reflected information about business values, some major changes in the body of financial information would be required to justify a crash of that magnitude.

To their credit, the market prognosticators did seek to provide [ex post] some incredible explanations of why the market crashed on October 19th, 1987.

Reason #1: On September 4th, 1987 the Federal Reserve raised the discount rate.

Reason #2: On October 13, 1987, the House Ways and Means Committee in the US Congress voted to approve income tax legislation that would disallow interest deductions on debt used to finance business acquisitions [forget that such a proposal would need to be passed by both houses of Congress which is as likely as Hell freezing over].

Reason #3: On October 18th, 1987 Treasury Secretary James Baker publicly announced an intention to reduce the value of the dollar [forget the fact that we had been on free floating exchange rates for about a decade].

Reason #4: Market prices were already high by historical standards [based on what measures and whose standards?]

More likely explanations, based on the lack of common sense market regulation are: (1) program trading and portfolio insurance which caused large investors to automatically sell off positions when prices started to fall on held securities (2) derivative securities that were tied to market indexes being coupled to a set of stocks in those indexes held by the investment banking houses which allowed them to trade the index against their holdings.

If the EMT hypothesis were true, the US stock markets would be unique among all markets throughout human history and across the contemporary globe ---the Dutch tulip boom and bust cycle in the 1600's, the South Sea bubble of the 1700's, the Railway Mania of the 1800's in Great Britain, the Florida everglade land rush of the early 1900's, as well as, the Australian Poseidon mine bubble in the 1960's.

Market Anomalies that Call into Question EMT

Abundant evidence refuting EMT includes an extraordinary number of unexplained market phenomena, such as:

(1) The January effect (prices tend to rise in January).

(2) The insider effect (a stock's price tends to rise after insiders disclose purchases to the SEC and fall after insider sales are disclosed).

(3) The value line effect (stocks rated highly by Value Line tend to outperform the market in terms of price).

(4) The analyst effect (stocks of companies followed by fewer analysts tend to become pricier compared to those followed by more analysts).

(5) The month effect (stock prices tend to rise at the end and the beginning of months).

(6) The weekend effect (stock prices tend to be lower on Mondays and higher on Fridays).

EMT buffs call these market effects anomalies. When some of these, such as the January effect disappear, they then claim the market is efficient. The only problem is that some of these phenomena, like the January effect were present for many years prior to their disappearance [7 decades to be exact]. In some cases, EMT adherents claim that the results of Buffett, Munger, Keynes, Baruch, or Lynch are merely anomalies. The leading proponent of this explanation for the spectacular results of these investors is Burton Malkiel who wrote the book, A Random Walk Down Wall Street. His argument is premised on a statistical observation from an experiment where 1,000 people each flip a coin with heads representing a winner from each trial. After the 1,000 flip their coins it is expected that 500 will be considered successful. If these remaining 500 flip their coin 250 will turn out to be successes. In the next stage, 125 will remain and then following that trial around 62 will be successful. Eventually you would get down to only a handful who would be deemed super winners or in the case of Malkiel super investors. However, (1) investing is not an activity completely determined by chance, because the businesses on which investments are based, have managements that hopefully make decisions where the results are not subject to chance, (2) great investors and on occasion good financial advisors base their decisions on studying fundamental characteristics, management quality, and the strength of a company's business model rather than leaving their recommendations to the chance flip of a coin (3) the super investors described by Malkiel would have had to be trading the market every day [ie., operate as day traders] in order to eventually become ultimate winners, however, investors like Buffett, Sir John Templeton, Ben Graham, or Peter Lynch aren't making trades every day, but are focused on holding an investment for many years. Buffett generated most of the billions in Berkshire Hathaway by concentrating funds in 10 companies over a period of more than 40 years. His strategy based on the teachings of Ben Graham were to buy positions at very low prices where the business had great value [i.e., creating a margin of safety] and then waiting for the market to catch up with true value of the company [future cash flows]. The market does not always perfectly price the business value of a stock. Buffett takes this perspective dead seriously by limiting his purchases to only those stocks that are way underpriced by the market. Conversely, he also emphasizes not buying stocks that are overpriced by the market based on what is certainly known about what the company can produce.

Even though the coin flipping experiment fails to fully represent the way investors make long term financial decisions, there may be some perspectives one can derive from using coin tossing within the context of stochastic processes.

With a random process, where you have a large number of trials, it is likely that there can be a series of long run favorable results sometime during the process. As an example, consider a process where you flip a fair coin 100 times. What is the likelihood that you will obtain 7 heads in a row sometime during these 100 trials?

Solution: First, what is the probability of getting 7 heads in a row when flipping a fair coin?

Answer: 1/(2)^7 or 1/128. So each time you flip a coin you start a sequence that has a 1/128 chance of producing 7 heads in a row. Conversely, each time you flip a coin you have a:

1-1/128 or 127/128 probability of NOT getting 7 heads in a row.

Second, if you flip a coin 100 times, you start a sequence 93 times that may result in 7 heads in a row [i.e., the last seven flips before reaching 100 does not start a sequence that could be successful]. Therefore, the probability of not being successful in getting 7 heads when flipping a coin is: (127/128)^93 or 48% and so, the chance that you really do get 7 heads when flipping a coin 100 times is: 1 - 48% or 52%. So, you are more likely in getting a run of 7 heads in 100 flips than not having that occur.

This result reinforces the notion that stock prices over a long period of time, may very well have times when there is a run within a short period of time. In her book, Beyond the Basics, Mary Farrell, provides empirical evidence of how share prices move in fits and spurts over short time frames. Her thesis is that there is only a short window when stocks move from one level to another, and it is important for an investor to stay in a position long enough to benefit from such price movements. A short term, day trading strategy increases the odds that an investor will miss out on a majority of the move in a stock's price over time.

The two competing views, EMT vs. Fundamental/Value analysis, boils down to whether one believes that stock prices represent random events, or by evaluating a firm's financial ratios, business model, brand power, pricing strength, and management capabilities an investor may be able to take advantage of unrecognized long term value of a stock relative to its price. The fact that economic externalities exist within the markets due to regulation, age of management, or technological change implies inefficiencies producing non-random pricing, long term. One particularly vexing question is why investment texts and courses that adhere to EMT still encourage students to seek work within the investment consulting business. If EMT exists, investors can do no better than buying an index and scrupulously avoiding investment advice which costs money and is supposedly counterproductive. The existence of a robust investment consulting industry with CFAs who develop skills in offering investment advice appears to support a position that investors benefit beyond simply buying an index by seeking investment advice. Equally puzzling is the widespread use of investment game contests at universities and within the investment community that encourage students to evaluate and create investment portfolios in an effort to outperform the market. One irony to this debate is that investment courses, texts and a good deal of finance literature are predicated on the notion that EMT rules the markets, but enrollment in the courses and the material espoused concerning career opportunities in finance depends on market inefficiency.