A Modern Approach to Graham and Dodd Investing

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Dedication

To Clara Weber Lorenz, a caregiver born in 1896, a contemporary of Graham and Dodd

Ode to Investment

(Apologies to Ludwig van Beethoven and Henry Van Dyke)

Joyful, joyful, we all invest,
Not for pleasure but for greed.
Who wouldn't want to plant and harvest?
And take care of future need?
We will reap regret and sadness
If caution e'er is cast away.
But we will rejoice in gladness
Whene'er value rules the day.

—Tung Au (Author's Father)

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Preface

As a child growing up in the 1960s, I always wondered what the celebrated "Roaring" 1920s were like. This was said to be a wild and crazy time that most adults remembered fondly, like a favorite uncle, and yet the end of the decade had left a bad taste in everyone's mouth, as if that uncle had died a violent death before his time. How could such great times end so badly?

The "bad" 1930s immediately following were a distant time in the past to me, and yet well within the memory of many adults I knew (excluding my parents, who, as late 1940s immigrants, did not have the *American* experience of the 1930s). In contrast to the 1920s, the 1930s were a time of economic hardship, a step backward in the unfolding of the American dream. This was probably the least favorite decade for most people old enough to remember it. Could such times happen again despite the increasing sophistication of government economic policy? And were the wiser folks right when they whispered that the depressed 1930s were the natural result of the excesses of the 1920s, and not the fault of the government?

In the mid-1990s, I found some answers. An exciting new development called the Internet appeared to be playing the role that radio played in the 1920s—an apparent panacea for social and economic problems that was supposed to lead the world into a "New Era" or "New Paradigm." The giddy experience that resulted reminded me of what I had read of the earlier era. The stock market was already showing signs of overvaluation by the mid-1990s (see Chapter 18), but felt more likely to go up than down for some time to come. This, of course, would increase the probability that things would end badly, as they had in the 1920s. Was history repeating itself? And would this be a coincidence or not?

Browsing in a bookstore in Geneva, Switzerland (the world headquarters of my former employer) in 1995, I found a most convincing explanation of events in the most important book I would read in the whole decade of the 1990s, a paperback entitled *Generations* by William Strauss and Neil Howe. The book postulated a "Crisis of 2020" because recent elder generations worldwide had been unwilling or unable to grasp the nettle of the festering global economic and political problems. This task would be left to America's Baby Boomers, born during and just after World War II, who were the modern incarnation of Franklin Delano Roosevelt's "Rendezvous with Destiny" generation (or what Strauss and Howe call the "Missionaries"). The recently dubbed Generation X were the "New Lost," and the child Millennial generation would soon become a facsimile of the civic-minded "World War II" generation, ideal for executing the Boomers' directives, less well suited for directing their own children in their old age. If this were the case, all these people would substantially repeat the respective life cycles of their analog generations, probably with similar results.

There were already a number of disturbing parallels to the earlier period. The successful Persian Gulf War (and the collapse of the Soviet Union) in 1991 functioned much like 1917 (when America entered World War I victoriously and emerged triumphant, almost unscathed). Both sets of triumphs left the United States as the world's sole political and economic superpower in their respective times. The world would be our "oyster" for perhaps a decade; after that, we would stop getting our own way, politically and economically (as was the case in 2003, when much of the world pointedly refused to support our invasion of Iraq). Meanwhile, dark clouds soon appeared in the late 1990s with the near collapse of Long-Term Capital Management, which in turn was due to crises in Russia, Korea, Indonesia, and other developing countries, just as Germany's collapse in the mid-1920s infected other parts of Europe. And yet the U.S. stock market and economy in both the 1990s and the 1920s went on their merry ways, perhaps buttressed, rather than hurt, by the near meltdowns in other parts of the world.

Strauss and Howe's historical secular crises (World War II, the Civil War, and the American Revolution) all had economic causes beginning over a decade earlier. World War II in the early 1940s was caused by the Great (and global) Depression of the 1930s; the Civil War of the early 1860s by the economic lagging of the South starting in the late 1840s; and the American Revolution of 1776 by British taxation beginning in the mid-1760s. These ominous developments had, in turn, followed secular triumphs in each era's respective preceding decade; the "Brave New World" of the 1920s; the annexation of Texas, California, and Oregon in stages between 1836 and 1848; and the successful French and Indian wars of the 1750s.

It appeared, then, that the secular crisis of "2020" (or slightly earlier) could easily have its roots in economic developments such as those identified in this book, and which will likely take place in the current decade. These stresses, in turn, follow logically from the 1920s-like 1990s. "Signs of the times" included such social phenomena as "instant" young adult multimillionaires and fantasy "reality" programs on national TV. More substantively, these times were marked by a blind and naïve public faith in the financial markets, an orgy of industrial and economic speculation, greedy CEOs, and a Wall Street that until very recently, at least, abandoned its fiduciary responsibilities in favor of its commercial interests.

Two investors, Benjamin Graham and David Dodd, yanked the investment world back to reality with their 1934 book *Securities Analysis*. (This book attempts to do the same for the modern era.) Perhaps their most important contribution was drawing a line between investment and speculation. But their antidote to the depressed 1930s market set a standard for their time and represents a high hurdle, even today. Their investment methodology works better at some times than others, best in stress periods like the 1930s and 1970s, least well in boom periods like the 1960s and 1990s, and quite well in intermediate periods like the 1950s and 1980s. If history teaches us that we are on the brink of the modern 1930s, it makes sense to revive the methodology that was most successful during the earlier time. Naturally, such a methodology should be dusted off and updated, but the end result should be a recognizable facsimile of the original.

A large number of people contributed at least indirectly to my professional development, and thus, to this effort, over an investment career spanning 20 years. It is impossible to thank or even identify them all. Here are the more important contributors, in order from the oldest to the youngest, or in descending order of generations.

The inspiration for this book comes from a childhood nanny, Clara Weber Lorenz, whose birth year, 1896, lies squarely between Ben Graham's in 1894, and David Dodd's in 1897, and who was the one member of the "Lost" generation that I got to know well. "Lorie" transmitted her vivid memories of the Great Depression to my family, and harbored no doubts that there would be another one, if not in her lifetime, then certainly in mine. She taught the spirit, if not the letter, of Graham and Dodd investing by playing what I call "Depression Monopoly" with me when I was seven years old. In this version of the game, we were not allowed to mortgage property and didn't get anything for landing on Free Parking (which is true to the official, but not unofficial, rules of the game). In such a "tight money" environment, the Graham and Dodd investments were the railroads and the utilities, which would yield a strong income stream in the here and now, without any further improvement or growth. And Lorie's insistence that "expensive" Boardwalk was a better buy than "cheap" Baltic Avenue had a sound basis: Boardwalk sells for eight times unimproved rent, Baltic for fifteen times.

First acknowledgments to a living person go to my World War II generation father, Tung Au, who helped me polish this book, making the prose far stronger, and the equations and tables more meaningful. He also pushed hard for dividing the chapters into sections, drew most of the figures, and composed the investment song. He was the first author of a previous book that I wrote with him, *Engineering Economic Analysis for Capital Investment Decisions,* but declined to be listed as the second author of this book. He and my mother, a pediatrician, also had the good sense to hire Lorie.