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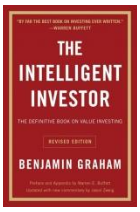

The Intelligent Investor

By Benjamin Graham

Introduction: What This Books Expects to Accomplish

- Book only deal with that portion of their funds which they are prepared to place in marketable (or redeemable) securities i.e. bonds and stock
- Laymen's guide on the Adoption and Execution of an Investment Policy
    a. Minimize odds of suffering irreversible losses
        i. Graham constantly emphasizes importance of avoiding losses
    b. Maximize changes of achieving sustainable gains
    c. Develop polices which investor will be comfortable (Psychology of investor)
        i. Main problem/Worst enemy: likely to be HIMSELF
        ii. Tendency to measure or quantify (whether the price cheap to buy or expensive to sell)
- Distinguished between Speculator and Investor
- NOT for those who trade in the market using "technical approaches"
- Underlying principles of sound investment should not alter from decade to decade but application of these principle must be adapted to significant changes in the financial mechanisms and climate
- 2 types of Investor: Defensive and Enterprising

Defensive/Passive	Enterprising/Active/Aggressive
• Avoid serious mistake or losses • Freedom from effort, annoyance and need for making frequent decisions	• Expect worthwhile reward for extra skill and effort • Willingness to devote time and care to the selection of securities that are both sound and more attractive than the average

- Definition of Intelligent investor (by Graham)
    - Nothing to do with IQ or SATS; is a trait more of character than the brain
        - Being patient, disciplined and eager to learn
        - Able to harness your emotions and think for yourself

Common view that art of successful investment	1. Choosing industries that are most likely to grow in future 2. Identifying the most promising companies in the chosen industries
Problem	It's not easy as it always look (based on past events); next "sure thing" most likely wrong in the end • Era of air-transport stocks in late 1940s and early 1950s • Internet stocks By the time, everyone decides the given industry the best to invest in: • Stock price might be too high (future return can only go down)
Lessons learn / Key notes	• Never succumb to the "certainty" that any industry will outperform all other in the future • Obvious prospect for physical growth in business ≠ obvious profits for investor • Experts do not have dependable ways of selecting and concentrating on the most

Art of investment has 1 characteristic (not generally appreciated)	Creditable (if unspectacular) result can be achieved by laymen with minimum effort and capability Reasons:- 1. To improve this standard require much application and more than a trace of wisdom 2. May have done worse if just try to bring just a little extra knowledge and cleverness to bear upon your investment program

- Main requirement – limit to investor on issues selling not far about their tangible-asset values

Growth Companies	• Pros: Worth several times of net-assets • Cons: Too dependent on the vagaries and fluctuations of the stock market
Sound and Expanding Business	• Investor can consider himself as an owner in such companies acquired at a rational price (regardless of perception of stock market) • Likely to work better

- Published stock-market predictions of the brokerage houses (strong evidence) that their calculated forecasts have been somewhat less reliable than the simple tossing of a coin.

Market	**Risk**
Bull (stock price Rise)	• More Risky (Stock become more costly to buy)
Bear (stock price Fall)	• Less Risky (Stock become cheaper to buy)
Note: Investor in advanced stage of retirement • may not outlast the bear market • not sell stock (merely when stock price gone down) – turn paper loss into real loss; deprive potential heir to inherit the stock at lower cost	

Chapter 1: Investment vs. Speculation (and the Defensive vs. Enterprising Investor)

Investment Operation – one which upon <u>thorough analysis</u> promises <u>safety of principal</u> and <u>adequate return</u>.	
Thorough Analysis	Study of facts in light of established standard of safety and value
Safety of Principal	Protection again loss under normal or reasonably likely conditions or variations
Adequate Return	• Rate/Amount of Return (no matter how low) that investor willing to accept; provided he acts with reasonable intelligence • Aspire to "adequate" not extraordinary performance
Speculative - as long as the operation did not meet the above requirements.	

Investor recognize existence of speculative factor in common-stock

- keep within minor limit
- prepared financially and psychologically for adverse result (regardless of duration)

Characteristic between Investor and Speculator	
Investor	**Speculator**
• calculate what stock is worth based on the value of its business • judge market price by established standards of value • "quotation" value matter much less • No interest in being temporarily right • Invest only if comfortable owning a stock without knowing the daily share price	• Based standard of value upon market price. • gambles that stock will go up in price because somebody else will pay even more for it • Value incessant stream of stock quotes

- People who invest make money for themselves; People who speculate make money for their brokers
- Distinction between investment and speculation is the **<u>disappearance on the cause for concern</u>**
- There are intelligent speculation as there is intelligent investing

Intelligent Speculation

Beneficial on 2 levels

1. Without speculation untested new companies would never be able to raise the necessary capital for expansion
2. Risk is exchange (never eliminated) whenever stock is bought or sold
    - Buyer (primary risk) – stock price goes down
    - Seller (residual risk) – stock price goes up

Foremost points on Unintelligent Speculation

- Speculating when you think you are investing
- Speculating serious (instead of pastime when lacking proper knowledge and skill)
- Speculating more money than you can afford to lose

Conservative view on speculating

- Non-professional who operate on margin; his broker's duty is to advise him
- Buy "hot" common-stock issue or purchase in similar way

How to handle (It's fascinating)

- Put aside a portion (smaller the better of the capital in a separated fund) – Never more than 10% of the asset in speculative account
    - Futile to suppress gambling instinct (most people) – Must confine and restrain
- Never add more money into this account (due to bull market or gained profit); Should consider taking out the money instead
- Never mix speculative and investment operation in the same account nor in any part of your thinking
    - Never fool yourself into confusing speculation with investment

<table>
<tr><th>Ways which investor and speculators tried to obtain better than average results</th><th>Explanation</th><th>Negative Points</th></tr>
<tr><td>1. Trading in the Market</td><td>Buy stocks (market advances)
Sell stocks (market decline)
Short-selling (To benefit from market decline where price sold is higher than price they will be backing back)</td><td>Not an operation which has thorough analysis that offer safety of principal and satisfactory return
Short-selling (popular therefore overvalue issue – test on one’s courage and stamina as well as one’s skill
Principle is sound and successful application is not impossible but not an easy art to master</td></tr>
<tr><td>2. Short-Term Selectivity (STS)</td><td>buy stocks which are report or expected to report increase earning or other favorable development is anticipated</td><td rowspan="2">Stemming from human error
Wrong estimate of the future plans
Nature of competition
Current market price might already full reflect on the anticipation:-
STS – To the extent, next year result might be predicted and already taken into careful consideration
Likely that other have done the same thing for the same reason
LTS – Possibility of outright error in prediction (e.g. Airline/Internet bubbles)</td></tr>
<tr><td>3. Long-Term Selectivity (LTS)</td><td>buy stocks of companies
excellent record of past growth which is considered likely to continue in future or
not yet shown impressive results but expected to establish a high earning power later</td></tr>
</table>

To able to enjoy reasonable chance for continued better than average result, must follow 2 policies:-

1. Inherently sound and promising
2. Not popular on Wall Street.

Reason on why such stock are available

- Speculative stock movement are carried too far in both direction
- Common stock maybe undervalue (lack of interest or unjustified popular prejudice)
- Large portion of the trading in common stock may not know the discrepancies between price and value
  - Intelligent person (Good head for figures) will be able to benefit other’s foolishness

Wide Group of “Special Situation”- bring annual return of 20% or better with minimum overall risk to people who knows the way around the field

- Intersecurity arbitrages, Liquidations (Pay-outs or Workouts), Protected hedges of certain kinds
- Typical Situations:-
  - Projected Merger or Acquisitions (offer higher value for certain shares compare to the price)

Things to Note for such Special Situation

- Merger announcement may have obstacles to merge and deal might not go through
- Such trading no longer feasible or appropriate to most people
  - Only million-dollar trades are large enough to generate worthwhile profit

Results Expected by Defensive Investor	

Recommend to divide his holdings between high-grade bonds and leading common stocks	• Proportion in bonds and common stocks
	(never less than 25% or more than 75%)
	• Simplest choice (maintain 50-50 proportion)
	  ○ Adjust to restore the equality when market development had disturbed it (changes of 5% or more)
	• Alternative Policy
	  ○ Reduce to 25% of stock (market dangerously high)
	  ○ Add to 75% of stock (decline in market; attractive stock price)

2 keys take-away based on examples in 1964, late 1971 and early 1972	1. Future of security prices is never predictable – must learn how to predict and control one's behaviour.
	2. Accelerating Inflation factor
	  ○ Make stock equities preferable to bonds payable in fixed amount of dollars
	  ○ Introduction of TIPS (Treasury Inflation-Protected Securities) in 1997 (Singapore does not have TIPS)
	    ▪ TIPS rise in value when Consumer Price Index goes up (effective immunizing the investor against losing money after inflation.)
	  ○ Stocks are relatively poor hedge against losing money after inflation.
	
	Overall results not likely to be decisively different from one diversified or representative list than from another (more accurately that neither he nor his advisers could predict with certainty whatever differences would ultimately develop)
	• Skeptical of the ability of defensive investors get better than average result

Selection of important companies	• Long record of profitable operations • Strong financial conditions
3 supplementary concepts or practices	1. Purchase of shares of well-established investment fund (Alternative to creating own common-stock portfolio) 2. Utilize 1 of the "common trust funds " or "commingled funds" operated by trust and banks (Got substantial fund – able to use professional administration service) 3. Dollar-cost averaging (This method is application of broader approach known as "formula investing")
• Investor cannot hope for better than average result by buying new offerings (IPO) or "hot" issues of any sort.	

Results Expected by Enterprising Investor	
Expectation	• Attain better overall result than defensive companion
Things to note	• Make sure the result will not be worse ○ Virtues (energy and knowledge) channel in wrong direction may become handicaps which might end up with losses instead.
Essential	• Start with clear conception to which course of action offer reasonable chance of success and which do not

Trendy Formulas that fall flat	Method	Outcome
1. Cash in on the calendar – "January effect"	• Many investors sell their lousiest stock late in the year to lock in losses that cut their tax bill • Profession money manager do the above as well (To preserve their outperformance; minimize their underperformance)	• Has not withered away but has weakened
2. Just do "what works	• buying a basket of 50 stocks with the highest one-year return, 5 straight year of rising earning and share prices less than 1.5x their corporate revenues"	• Stop working once O'Shaughnessy publicized it.
3. Follow "The Foolish Four"	• Choose 5 stocks in DJIA with lowest stock price and highest dividend yields. • Discard the one with the lowest price. • Put 40% of money into 2nd lowest price. • Spread 20% into 3 remaining stock. • Repeat the same method yearly.	• Same mistake as Just do "what works":- Look at large quantity of data long enough, a huge number of pattern will emerge (if only by chance) • Example: In 2000, 4 foolish stocks – Caterpillar, Eastman Kodak, SBC and General Motors lost 14% but Dow dropped by 4.7%
2 reasons why return fade away		
1. Formula based on random statistical flukes (over time will be expose that it made no sense) 2. Formula work in the past but after publicizing it, market pundit always erode or eliminate the ability to do so in future		

- In the end, stocks do well or poorly in future because the business behind do well or poorly (Nothing more, Nothing less)

Chapter 2: The Investor and Inflation

- Money illusion (investor overlook the importance of inflation), for example
    - 1st scenario: Receive a 2% raise in pay but inflation runs at 4%
    - 2nd scenario: Receive a 2% pay cut but zero inflation.

  Outcome for the both scenario are the same, majority feel better with 1st scenario.

Why Inflation is important
• Secretly taking away our wealth • Measure investment success by how much you keep after inflation • Mild inflation – allow companies to pass the increased costs of raw material to customers • High inflation – wreak havoc (customer will slashed their purchases) • Inflation is not dead (3 reasons) 1. US went through 1 of the most painful burst of inflation in history during 1973-1982 (Inflation at 1979 – 13.3%) 2. Since 1960, 69% of world's market-oriented countries suffered at least 1 year where inflation ran at annualized rate of 25% or more. 3. Rising prices allow US to pay off his debts with dollars cheapened by inflation.

- No close time connect between inflationary/deflationary conditions and the movement of common stocks earnings and prices.
- Only way inflation can add to common stock values – raising the Rate of Earnings on Capital Investment (This has not been the case based on history)
- One thing is guaranteed for the future:
    - Earning and average annual market value of a stock portfolio will not grow at uniform rate. (Market will fluctuate)
- Investor cannot afford to put all his fund into 1 basket i.e. neither bond basket (unprecedented high return bonds offer) nor stock basket (prospect of continuing inflation)
    - Stocks are NOT a GUARANTEE against inflation. Stocks have failed to keep up with inflation 20% of the time.
    - No certainty that stock will insure adequately against large-scale inflation but should carry more protection than all-bond holding.

Alternative to Common Stock as Inflation Hedges	Things to Take Note
1. Gold	• Near-complete failure of gold to protect against a lost in purchasing power of dollar in early 1972 Intelligent investor avoid investing in gold directly (high storage and insurance cost) • Seek out well-diversified mutual fund specializing in stock of precious metal companies • Limit 2% of total financial asset (maybe 5% - over age of 65)
2. Real Estate	• Subjected to wide fluctuations • Serious error made (location, price, etc.)
3. REITs (Real Estate Investment Trust)	• **Not a foolproof inflation-fighter in the long run but should give some defense against erosion of purchasing power without hampering overall returns**
4. TIPS (Treasury Inflation-Protected Securities)	• US government bonds – safe from risk of default (or non-payment of interest) as US stands behind them in full faith and credit • Value increase when inflation rises (IRS will consider the increase in value as taxable income even if it paper gain) • Can be volatile in short run; work best as permanent, lifelong assets (at least 10% of retirement assets) ***Not applicable to Singapore**

- More investor depends on the portfolio and its income
    - More necessary to guard against the unexpected and underestimated

Chapter 3: A Century of Stock Market History

General View on P/E Ratio		Results from Robert Shiller's Studies (based on historical records)
Below 10	Low	Typically produce handsome gains down the road
Between 10 -20	Moderate	-
Above 20	Expensive	Deliver poor return afterward

Heart of Graham's Argument: Never forecast the future exclusively by extrapolating the past.

- Only indisputable truth that past teach us – Future will always surprise us
- Staying humble about your forecasting power (Prevent from risking too much on a possibility that future view may be wrong)
- Lower your expectation but not to depress your spirit.

Graham's Warning: By the Rule of Opposite

- More enthusiastic investors become about the stock market in the long run
  - More certain they are proved wrong in the short run.

Common Examples which people tried to forecast

1. Forecasters who argue that stocks have returned an annual average of 7% after inflation ever since 1802. Therefore, investors should expect the same in the future.
2. Stocks had beaten bonds over any period of at least 30 year (Stock must be less risky than bonds or cash in bank)
3. Eliminate all the risk of owning stock by hanging on to them long enough

Due to survivorship bias (early stock index ignore all the companies that went bust) e.g. between 1871 and 1920s (automobile, aviation and radio companies that went bust)

The truth

- Real-world, stocks did no better than cash and bonds (perhaps slightly worse)
- Anyone who claims that long-term record "proves" that stocks are guaranteed to outperform bonds or cash is an ignoramus.

Value of any investment is and always must be a function of the price you pay for it. (Profit that companies can earn are finite; Price that investor willing to pay for stock must be finite as well).

- Inflation was withering away (late 1990s), corporate profit appeared booming
  - Does not mean/ever mean that stock are worth buying at any prices

3 Factors affecting Stock Market's Performance

1. Real Growth (Rise of companies' earnings and dividends)
2. Inflationary Growth (General rise of price throughout the economy)
3. Speculative Growth/Decline (Any increase or decrease in the investing public's appetite for stocks)

Chapter 4: General Portfolio Policy: The Defensive Investor

Rate of Return – dependent/amount of intelligent effort that investor is willing and able to bring into performing this task.	
Minimum Return (Passive Investor)	**Maximum Return (Enterprising Investor)**
○ Wants both safety and freedom from concern ○ Create permanent portfolio (run on autopilot); requires no further effort (generate little excitement)	○ Exercises max intelligent and skill ○ Continuous researching, selecting and monitoring a dynamic mix of stocks, bonds or mutual funds
This approach is emotionally demanding	This approach is physically and intellectually taxing
Both approaches are equally intelligent and can be successful with either. • Need to know yourself well enough to pick the right one and stick with it • Allocations of assets between stocks and bonds (has nothing to do with age) based on Graham's discussion	

Defensive Investor's General Portfolio Policy

- Divide fund between High-grade bonds and High-grade common stocks
  - Fundamental Guide Rule (Min 25% bonds, Max 75% stocks… vice versa)
    - Graham insist on the minimum of 25% in bonds so that the cushion give you courage to keep the rest of the money in stock (when stock stink)
  - Once you set your proportion, change them only when life circumstances* [Refer to table on the next page] change. (To get a feel on how much risk to take)
    - Hard part: To adopt it and stick to it (Might be possible that this method is too conservative)
    - Graham's approach – To replace guesswork with disciple
  - 50-50 on bonds and stock might occur
    - Appearance of "bargain price" level created in a protracted bear market
    - Reduction of Stock below 50% when investor feel that market has become dangerously high
    - Extremely simple; aims unquestionably in the right direction (may not be the best in result achieved)
    - Give the follower the feeling that he's at least making some moves in response to market developments
    - Restrain him from being drawn more and more heavily into common stock (market rise to more dangerous heights)
- Suggest to re-balance the proportions every 6 months.

- Choice of Bond buying
  - Tax-able or Tax-free bond (Depends on the investor's tax bracket)
  - Shorter or Longer term Maturities
    - Interest rate rise, bond price fall (short term falls less than long term)
    - Interest rate fall, bond price rise (long term outperform short term)
  - Avoid Higher-yielding bond for ordinary investor
    - Too many individual risk (range from disquieting price decline to actual default)

▪ Require special study and skill to exploit successfully.

Question to ask about on your fundamental Life circumstance
• When will they kick in • When might they change • How are they affecting your need for cash • Single or Married • Children • Inherit or care for aging parent • Factors might hurt the career/business • Need for investment to supplement income • Salary and spending need?

Chapter 5: Defensive Investor and Common Stocks

2 main argument points for common stocks

1. Offered a considerable degree of protection against inflation (bond offer none).
2. Higher average return to investors over the years (due to average dividend income exceed the yield and underlying tendency for market value to increase)

Note:

- Above two benefits are lost if buyer pays too high a price.
- High stock price affect dividend yield, for example
    - Company pay $2 annual dividend when stock price is $100 – Yield is 2%
    - Company stock price double – Yield is 1%

Rules for Common Stock Investment

- Adequate not excessive diversification (Minimum of 10, Maximum of 30 different issues)
- Selected companies need the following characteristic
    - Large, prominent and conservatively financed
        - Large = At least 10 billion worth of stock value / market capitalization
        - Prominent = Company should be Top 25% or 33.3% of its industry by size.
        - Conservative = Book Value is at least half of the Total Capitalization include bank debt
    - Long record of continuous dividend payment (at least 10 years of continuous dividend payment)
- Limit on the price paid for an issue
    - 25x average earning for the past 7 year
    - 20x for the last 12 month period
- Decision of possibility to own common stock does not matter on the how much losses occurred in the past.
    - Stock are price reasonably enough to give future growth, you should own it.

Definition of Growth Stocks

- stock which has increased its per-share earnings in the past at a rate well over that for common stocks generally (expected to continue to do so in the future)
- some authorities say true growth stock – expected to double its earnings in 10 years.
    - Using Rule of 72 (estimate the length of time, an amount of money takes to double when divide the expected rate of return into 72). If compound annual growth rate is 7.1%, 72/7.1 = 10.1 years

Problems with Growth Stocks

- Generally, Price advanced many times faster than rate of growth in earnings
    - High price in relation to current earning; Higher multiple of their average profit over a past period
- Too uncertain and risky as a vehicle for Defensive Investor.
    - Therefore, a group of large companies that are relatively unpopular and obtainable at reasonable P/E ratio offers a sound if unspectacular area of choice by the general public.

Things to note

1. Portfolio changes (if list has been competently selected in the first instance, no need for frequent changes
2. Dollar-Cost Averaging (Monthly amount is small but result after 20 or more year can be impressive and important to save)
3. Personal Situation (Depends on the investor situation to determine the risk taken)
4. Not to waste effort and money in trying to beat the market
    a. Study security values and test out judgment on the price vs value with smallest possible sum
    b. Kind of security purchase and rate of return depends on financial equipment (knowledge, experience and temperament) not financial resource

Peter Lynch – "Buy What You Know"	
2 Steps Approach	**Result**
1. Find promising company you understand 2. Doing research (Financial Analysis – Study Financial Statement	• Can outperform the experts by investing in companies or industries you already understand
Problems	

• Without doing the 2nd step, this approach is dangerous.
• Corporate retirement plans (employee might have illusion of knowledge not the real thing e.g. Enron, WorldCom)
• Might cause overconfidence ("home bias" – breed complacency due to familiarity)
    ○ More familiar the stock is
    ○ More likely defensive investor might turn into lazy one (think that no homework is required)	

4 Ways to Assemble a Defensive Investor's Portfolio

1. Do It Yourself – Using online brokerage
2. Get Some Help – Using discount broker/financial planner/full-service stockbroker
    a. Never delegate the responsibility to investigate if adviser is trustworthy and charges reasonable fee
3. Farm it out – Getting Mutual Funds
4. Dollar-Cost Average – Getting Portfolio of Index Fund
    a. Refusal to be active and renunciation of any future prediction can be powerful
    b. Autopilot portfolio free you from market's power to upset you (No matter how bizarre it bounces)

Chapter 6: Portfolio Policy for the Enterprising Investor – Negative Approach

<table>
<tr><th colspan="2">Enterprising Investor start from the same base as Defensive Investor</th></tr>
<tr><td colspan="2">• Division of funds between high-grade common stocks (yield about 7.25%) and high-grade bonds (tax-free yield up to 5.30% on longer maturities)</td></tr>
<tr><th>What to Avoid</th><th>Why</th></tr>
<tr><td>1. High-Grade Preferred Stocks</td><td>• Leave it to corporate buyer
• 2nd grade bonds and preferred stock have 2 contradictory attributes
  o Nearly all suffer severe sinking spell in bad market
  o Large proportion recover their position in good market
<u>Difference between 1st and 2nd grade bond</u>
Usually found in no. of times the interest charges have been covered by earning.</td></tr>
<tr><td>2. Inferior type of bonds (2nd grade bond/Junk bond) and Preferred Stock</td><td>• High-coupon issue
  o Corporate bonds paying above average interest rate (8%) or preferred stocks paying large dividend yields (10% or more)
  o RISKY – Company who pay high rate of interest to borrow money
• Today's there might have funds that offer diversification that concern Graham at a much lower cost
  o There's still no cheap and widely available way to spread their risk
  o Most still charge high fees and perform poorly at preserving the original principal amount.
Unless they can be bought at bargain level (Price must be at least 30% under par for high-coupon issue and much less for lower coupons)</td></tr>
<tr><td>3. All kinds of new issues (including convertible bonds / preferred and common stock confined with recent past of excellent earning)</td><td>• Have special salesmanship; special degree of sales resistance (Normally sold with underwriting discount/built-in commission of 7%)
• Normally overpriced (most are sold under "favorable market conditions"). Favorable to Seller, Not Favorable to Buyer.
  o Violate 1 of Graham's most fundamental rules (Buy only if stock is a cheap way to own a desirable business)
• For every IPO like Microsoft, there are thousands of losers.
Must subjected to careful examination and unusually severe tests before purchase</td></tr>
<tr><td>4. Foreign Government Bond</td><td>• Graham consider them no better a bet than junk bonds</td></tr>
</table>

	• Poor Investment History Mitigated with the arrival of Exchange Traded Funds (ETFs) and mutual funds that specialize in lower-rated securities and foreign bonds Currently, only 1 variety of foreign bond may appeal to investors (who can withstand plenty of risk) 1. Mutual Funds specialize in bonds issued in emerging market nations o **Don't put** than 10% of total bond portfolio. o **Don't buy** any emerging market bond fund with annual operating expenses higher than 1.25% o **Take Note** some funds charge short-term redemption fee to discourage investor from holding them less than 3 months.

Chapter 7: Portfolio Policy for the Enterprising Investor: The Positive Side

Characteristic of Enterprising Investor

1. Devote fair amount of attention and effort to obtain a better investment result than run of the mill investment result
2. Not one who take more risk than average or who buy aggressive growth (Graham's reminder)
   - Simply the one who willing to put in extra time and effort in researching his or her portfolio.
3. Graham insist on calculating PE ratio based on multi-year average of past earnings
   - Lower the odd on overestimating the company's value based on a temporarily high burst of profitability.

To obtain better than average investment result over a long pull

(Requires a policy of selection or operation possessing a twofold merit)

1. Must meet objective or rational tests of underlying soundness
2. Must be different from the policy followed by most investors or speculators

Activities that Enterprising Investor used and Things to Note

(Highlighted in blue are recommended activities to look into)

Activities	Things to Note
1. Buying in Low Market and Selling in High Market (Formula Timing)	• No mathematical basis (Must exclude such activity) • Market timing is impossible (practically and emotionally) The best way for dealing with market fluctuation • Allocation of stock and bond investment proportions. **[Refer to section on Defensive Investor's General Portfolio Policy]**

2. Purchase carefully chosen "growth stocks"
Excellent Prospect (fully recognized in market) where current PE ratio > 20 or 25 (defensive investor) based on past 7 years
	• Statistical chore to identify companies that outperformed the average historically.
	• Stocks with good records and apparently good prospects in future (might be overprice = not good for investment)
	  ○ Stock price grow faster than companies value, investor always lose.
	• Judgement on future performance might be wrong
	  ○ Rapid growth can't continue forever and at some point it will flatten out and likely to turn downward.
	• Generally, no outstanding rewards came from diversified investment in growth companies as compared to that in common stocks.
	• No reason at all that average intelligent investor (with devoted effort) can derive better results over the year (purchase of growth stocks) than investment companies (more brains and better research facilities) specializing in this area.
	• Wide swing in market prices (remains true even for largest and longest established companies like GE and IBM)
	  ○ Even if company's investment calibre may not change over a

	long span of years but risk characteristic of its stocks depends on what happens to it in the stock market ○ More enthusiastic the public grow and faster its advances as compared with actual growth in its earnings ▪ Riskier proposition it becomes. • PE ratio is above 25 or even 30, the odds get ugly. Intelligent investor get interested in big growth companies when 1. Prices are reasonable 2. Something goes wrong (not when they are most popular)
3. Purchase of Bargain Issues	• Market fond of making mountains out of molehill (2 major sources of undervaluation) 1. Current disappointing results 2. Protracted Neglect or Unpopularity • Find stocks that hit new lows for past year (where well-establish company priced well below its average historical price and past average PE ratio) ○ Still can lose money. Rare occasion when Market generate true bargain.
4. Buying into "Special Situation" (Workouts)	• Securities markets tend to undervalue issues that are involved in any sort of complicated legal proceedings. • Not buying into a lawsuit may be sound advice for speculators but it creates bargain opportunities (Only small percentage of enterprising investors are likely to engage in it)
5. Relatively unpopular large company	• Market tends to over-value good companies and undervalue those out of favour (due to unsatisfactory development of a temporary nature) • Key is to focus on larger companies going through a temporary unpopularity • Large companies are better than smaller companies (2 reasons) 1. Have capital and brainpower to get through adversity and back to satisfactory earnings 2. Market is likely to respond with reasonable speed to any improvement • Companies with wide variation of earning tends to sell:- ○ at high prices and low multipliers (good years) ○ low price and high multiplier (bad years) Recommend to start with low multiplier idea but include other quantitative and qualitative requirements.
6. Foreign Stock (Mutual Fund that	• Not mandatory but advisable.

hold foreign Stocks)	• Never know what the future will happened (locally or foreign) • Limit up to 33.3% of stock money o Help to insure against the risk that local stocks performs poorly.

- High-grade Bonds (short maturity – 7 years or less) – Minimal impact by changes in market prices

2 possible ways which investor may try (when they allow their emotions to affect buy and sell decisions)	**Things to Note**
1. Timing (Market Forecasting on the action of the stock market)	• Investor might become Speculator by placing the emphasis on timing. • Absurd to think general public can ever make money out of market forecast • No basis in logic or experience
2. Pricing (Buy Low Sell High Approach)	• Maybe suffice for defensive investor but it means an essential minimum attention to market level. • Anyone waiting to "buy low" will feel completely left behind (Without bear market to bring stock prices down). Often, will end up abandoning any former caution and jumping in with both feet. That's why is important to have emotion discipline.
Best way to deal with market changes • Use proportions of common stocks to bonds **[Refer to section on Defensive Investor's General Portfolio Policy]**	

Characteristic of Bull Market
• Historically High Price Level • High PE ratios • Low dividend yields against bond yields • Much Speculation on Margin • Many offering of new poor quality common-stock issues

- Most formula don't work consistently or don't work once more people start using it as well.
- Look at Price to Book (PB) ratio
  - Greater the premium above book value (less certain the basis of determining its intrinsic value)
  - Therefore, the more this value will depend on the changing mood and measurement of the stock market

More successful the company, greater the likelihood on fluctuations in the share price
• Better quality common stock, the more speculative it likely to be (i.e. Most successful and impressive enterprise have most erratic price behaviour) Investor need to concentrate on issue selling at reasonably close approximation to their tangible asset values (No more than 33.3% above that figure)
Therefore, beside low book value (close to its asset value), investor need the additional factors • Low PE ratio • Strong Financial position • Prospect on its earning will at least be maintain over the years

- Investor who willing to forego brilliant prospect (better than average expected growth)
    - Will be able to find wide selection of issues

Differences in attitude toward Stock-Market movement between Investor and Speculator	
Investor	**Speculator**
• Primary interest lies in acquiring and holding suitable securities at suitable prices • Movement create low price level (he would be wise to buy) • Movement create high price level (he would refrain from buying and perhaps sell instead) • With portfolio of sound stock will expect prices to fluctuate but not concerned by huge decline or excited by huge gains. • Refuse to judge your financial success by how bunch of total strangers are doing o Whole point of investing – not to earn more money than average but earn enough to meet your own needs Motto: "Never buy a stock immediately after substantial rise or sell one immediately after substantial drop"	• Primary interest lies in anticipating and profiting from market fluctuations.

- Best way to measure your investment success
    - Check if you have place a financial plan and behavioral discipline that likely get to one's aim. (Not beating the market)
- Mr. Market will provide you with prices
    - True investor will take advantage of the daily price (dictated by own judgment and inclination)
- In a short run, the returns will always be hostage to Mr. Market and his whims but Investor can control the following:-
    - Brokerage cost (Trading rarely, patiently and cheaply)
    - Ownership cost (Refusing to buy mutual funds with excessive annual expenses)
    - Expectations (Using realism not fantasy to forecast return)
    - Risk (Deciding how much total asset into stock; Diversifying and Rebalancing)
    - Tax bill (Holding stock for at least 1 year or 5 years to lower capital gains liability)
    - Own Behavior

- Focus on long term financial goals and tune out Mr. Market’s mood swings.

Chapter 9: Investing in Investment Fund

- Generally, funds do not do better as compare to common stocks as a whole
    - Cost of funds hit the fund performance for the investor
- Based on 1961-1970, the overall results for 10 funds were similar as S&P 500 and slightly better than DJIA
- Performance funds significantly underperformed the market.

Problems with Most Fund	
• Underperform the market • Overcharge the investor • Create tax problems • Erratic swings in performance • Check for any significant outperformance ○ Outperformance in rising market may indicate speculative behavior of the portfolio manager. Usually, end up in large losses	
Conclusions based on at least 50 years of studies	
• Average fund don't pick stock well enough to overcome the cost of research and trading • Higher the fund's expenses, Lower its returns • More frequently the fund trade its stock, Lesser its turns • Highly volatile funds are likely to remain volatile • Funds with High past returns are unlikely to remain winner over a period of time.	
Why winning funds can't stay winners	**Reasons**
1. Migrating manager	• When stock picker seems to be profiting, everybody want him
2. Asset elephantiasis	• If fund manager pump in the money – Stocks might be dangerously high (Losses might occur) • If fund manager buy new stocks – Research from scratch and have to monitor them including those that he has. • When fund earn high return and more investors pour in more money • If fund manager keep the money safe and stocks goes up – Low return on cash
3. No more fancy footwork (Fund test driving privately before selling to public)	• Returns of incubated and fee-waived fund have faded into mediocrity after public invested millions of dollars
4. Rising Expenses	• Costly to trade stocks in very large blocks than small ones. (Especially if high return makes fund increase greatly. Trade might easily eat up at least 2% of those asset) • Cost of running funds rarely fall, might even rises when assets grow.
5. Sheepish Behavior	• As fund grows, its fees become lucrative – manager reluctant to rock the boat • By protecting their own fee income, fund manager compromise their ability to produce superior returns for outside investor Individual investor must either avoid shopping from the same list of favorite stocks that have been picked by giant institutions or own them far more patiently.

What should intelligent investor do?
1. Buy index fund which owns all the stock in the market, all the time (without any pretense of being able to select the best and avoid the worst) will beat most funds over the long turn. E.g. 401(k)   • Index fund are boring. Job of index fund is to match the market's return not to exceed it.

2. Find one with rock bottom costs
  • Operating cost – 0.2% or less yearly
  • Trading cost – 0.1% or less yearly

• Warren Buffett and Benjamin Graham think that low-cost index fund is best choice for individual investor

Qualities to pick the best fund	**Reason(s)**

1. Managers are biggest shareholders
(e.g. Longleaf, Davis and FPA)
	• Conflict of interest between what's best for fund's managers and its investors is mitigated
	• Own so much funds that they are likely to manage your money like their own
	• Lowering the chance
	  ○ Jack up fees
	  ○ Funds increase to gargantuan size
	  ○ wack you with nasty tax bill

2. Fund are cheap	• Myth – high returns are best justification for higher fees. 2 problems
	  1. Higher fee earn lower returns over time.
	  2. High returns are temporary while high fees are permanent.

3. Fund and manager dare to be different	• If the fund looks the same as other funds, shop for another fund.

4. Fund shut the door
(e.g. Longleaf, Numeric, Oakmark)
	• Best fund often close to new investors
	  ○ Stop feeding frenzy of new buyers who want to pile in
	  ○ Protect fund from asset elephantiasis
	• Closing should occur before not after the fund explodes in size.

5. Fund don't advertise	• Best fund managers often behave as if they don't want your money

Other points to look out for Intelligent Investor (in order)	**Reason(s)**
1. Fund's Expenses	• More predictable than its future risk or return
2. Riskiness of Fund	• Prospectus (buyer's guide), every fund must show a bar graph displaying its worst loss over a calendar quarter • If can't stand losing at least that much money in 3 months, skip the fund. • Worth checking the fund's Morningstar rating
3. Manager's Reputation	• Manager who are major shareholders; don't hype returns; willingness to shut down before fund get too big
4. Past performance	• Pale predictor of future returns • Today's winner often become the biggest losers for tomorrow • Today's losers rarely do better (Avoid fund with poor performance record)

Do not pay more than these level of annual operating expenses by fund category

- Taxable and Municipal bonds – 0.75%
- US equities (large and mid-sized stocks) – 1.0%
- High-yield Junk bonds – 1.0%
- US equities (small stocks) – 1.25%
- Foreign stocks – 1.5%

When to Sell a Fund

- Sharp and Unexpected change in strategy
- Increase in expenses
- Large and frequent tax bill generated by excessive trading
- Sudden erratic returns

Chapter 10: The Investor and His Advisers

- Graham mentioned "Much bad advice is given free"
    - Expect to pay a fee (Annual limit: 1% of investment asset as advisory fee)
- If you have less than $100,000 to invest, may not be able to find a financial adviser who will take your account
    - Buy diversified basket of low-cost index fund instead.

Most important objective for an adviser
• Save investor from his worst enemy, HIMSELF • Keep investor's emotion in control
Key Points on screening an adviser
• Care about helping client • Understand fundamental of value investing • Satisfactory amount of education, training and experience in investing
Adviser should have some systems in place
• Comprehensive financial plan – Outlines how you will earn, save, spend, borrow and invest your money • Investment policy statement – Spell out your fundamental approach to investing • Asset-allocation plan – Details how much money to keep in different investment categories

- Refer to the book for more details on the questions to ask the advisor and questions that advisor might ask.

Chapter 11: Security Analysis for the Lay Investor

1. Greater the amount of assumptions made about the future, the greater the possibility of misjudgement or error.
   - Greater the margin of safety will be required
2. Mitigate the risk of only looking at past result (2-Part Appraisal)
   i. Work out "past-performance value" based solely on past record
   ii. Consider how much adjustment is needed because of new conditions expected in future.

Conditions taken during Bond Analysis	Things to Note
1. Most reliable benchmark for safety is Earnings-coverage test (Ratio of Earning to Total Fixed Charges – Before and After Tax)	• How often and How much, company earnings covered interest charges over a considerable period of time (Past 7 years) • Alternative is to measure by the poorest year
2. Size of Enterprise	• Minimum standard in terms of volume of business for a corporation • Varying between industries • Population for a municipality
3. Stock / Equity Ratio	• Rough measure of the protection afforded by presence of junior investment (include market's appraisal of future prospect) • Ratio of Market Price of common stock to Total Face amount of Debt (or Debts + Preferred stock)
4. Property Value	• Asset value retains importance as separate test of ample security for bonds and preferred stock (in 3 enterprising groups: Public Utilities, Real-Estate concerns and Investment Companies)

Conditions taken during Common Stock Analysis	Things to Note
1. Company's valuation	• Compared to current price to determine if it is an attractive purchase. • Estimated average future earning multiply by appropriate "capitalization factor" • Capitalization rate depends on the quality of investment.

- Minimal practical value of most industry studies that are available to investors.

<table>
<tr><th>5 factors to determine the price of an investment (Affects Capitalization Rate)</th><th>Things to Note</th></tr>
<tr><td>1. General Long Term Prospect</td><td>
Look at minimum of 5 year financial statement
Look to avoid
Serial acquirer – average of more than 2 or 3 acquisitions/year; why it rather buy stock of other business than invest in its own.
Corporate bulimic – firm that wolf down big acquisitions but end up vomiting them back out e.g. Lucent, Mattel, Quaker Oats
Chronic write-off or account charges prove overpaid past acquisitions.
OPM addict – borrowing debt or selling stock to raise boatloads of Other People's Money. Make sick company appear growing when underlying businesses are not generating enough cash e.g. WorldCom, Global Crossing
(look for cash from financing activities)
Revenue and Earning that have grown smoothly and steadily over the past 10 years
wide moat or competitive advantage, created by things like
strong brand identity - Harley Davidson
monopoly or near monopoly - Gillette
unique intangible asset – Coke
resistance to substitution – utility companies
revenues and earnings that have grown smoothly and steadily over the past 10 years
the fastest growing companies tend to overheat and flame out
pre-tax growth rate of 10% may be sustainable over a long time (6% to 7% after tax) but 15% is may not. Anything over 15% is certain to fade.
effective research and development
P&G spends about 4% on R&D
JNJ spends 10% on R&D
look for consistency in R&D expenditures
Company who spending nothing on R&D is as vulnerable as one that spends too much.
</td></tr>
<tr><td>2. Quality of Management</td><td>
what forecasts made and how do they accomplish or fail them
Forthrightly admit their failures and take responsibility for them rather blaming all-purpose scapegoat e.g. economy, uncertainty or weak demand.
excuses of the economy and other matters
consistency on the tone and substance on the chairman's message in good times and bad
Look to void
big CEO salaries (suggest that the firm is run by managers for the mangers)
reprices/reissues/exchanges options for insider
big option overhang (need to factor in the potential flood of new shares from stock options during the estimation of a company's future value)
promoters (executives should spend most of their time managing their company in private not promoting it to investing public)
use of accounting gimmicks, restatements, non-recurring charges and extraordinary items (might be used to cloak actual losses)
</td></tr>
<tr><td>3. Financial Strength and Capital Structure</td><td>
Generate more cash than it consumes
Good manager keep finding ways of putting that cash to productive use.
</td></tr>
</table>

	• Steady growth in Cash from Operations over the past 10 years
	• Look at amount and growth of Owner Earnings
	  ○ Owner earnings per share that have grown at a steady average annual growth of at least 6% or 7% over the past 10 years
	• Look at capital structure
	  ○ Long term debt should be less than 50% of total capital
	  ○ Look at ratio of earnings to fixed charges

4. Dividend Record
5. Current dividend rate
	• Company need to proof that investor is better off without getting a dividend payout
	  ○ Company outperform competition in good and bad market; managers are clearly putting the cash to optimal use
	  ○ Company faltering or stock is underperforming, managers and directors are misusing the cash by refusing to pay a dividend
	• For US, Dividend Payout Ratio has dropped considerably as tax law discouraged investor from seeking and companies from paying, dividend

Additional point to take note	

1. Stock Policy	• Avoid company who repeatedly spilt their shares and hype the split.
	  ○ condescending manipulator (aiding and abetting the worst instinct of the investing public)
	• Avoid company who buy-back their shares when it's expensive (at or near record highs).
	  ○ Buyback of shares should happen only when it's cheap.

Chapter 12: Things to Consider About Per-Share Earnings (EPS)

2 Advice that cannot avoid being contradictory in their implications
1. Don't take single year's earning seriously

2. Look out for booby traps in per share earnings figures (i.e. extraordinary items)
*If you pay attention to short-term earning
• special charges
• dilution
• special income tax situations (loss carry forwards, credits, etc.)
• depreciation (accelerated depreciation which distorts income?)
• How R&D is handled (expensed or capitalized)
• "pro forma" assumptions (shows how well company might have done if they hadn't done as badly)
  ▪ Intelligent investor will ignore it.
• Change in accounting principle
• Transforming normal operating expense into capital assets
  ▪ Intelligent investor need to understand what and why company capitalize
• "Nonrecurring cost" that keep recurring (e.g. Inventory adjustments every 6 months)
• Net pension benefit (anything above 6.5% of the company's net income is implausible)
If 1st warning is followed, 2nd advice will be unnecessary.

- Use average earning over long period of time (e.g. 7 to 10 years)
  - Better idea of the company's earnings power than the results of a single year
  - Normally, resolve issues on special charges and distortions.

Things to Note about Past Growth Rate

• Prime importance that growth factor to be taken adequately into account
• Comparing last 3 years to the corresponding figures 10 years earlier
• Recent history and huge chunks of financial data has shown
  ○ Market is unkindest to rapidly growing companies that suddenly report a fall in earning.
  ○ More moderate or stable growers tend to suffer somewhat milder stock decline if they report a fall.
Great Expectations lead to Great Disappointment (if they are not met); Moderate Expectation lead to much milder Reactions (if they are not met)

• 1 of the biggest risk in owning growth stock
  ○ Not that their growth will stop (it will merely slow down)
  ○ Especially in the long run where it not merely a risk, it's a virtual certainty.

3 pointers that will help to avoid buying stock that turns out to be account time bomb (Caveat investor)	**Reasons**
1. Read financial statement notes backward	• damaging stuff are usually buried in the back

2. Read the notes to the financials	• NEVER buy a stock without reading the footnotes to the financial statements in the annual report
	• Usually labeled "summary of significant accounting policies"
	  ○ Describes how company accounts its item and other major aspects of its business.
	• Other footnotes, watch for disclosures on "risk factors "that take a big chunk out of earning
	• Compare the footnotes with at least 1 close competitor firm
	  ○ Gauge how aggressive company accountants are

3. Read more	• Learn more about financial report (Enterprising Investor)
	  ○ Minimize the odds of being misled by shifty earnings statements
	• 3 Recommended books:
	  ○ Martin Fridson and Frenando Alvarez's Financial Statement Analysis
	  ○ Charles Mulford and Eugene Comiskey's The Financial Numbers Games
	  ○ Howard Schilit's Financial Shenanigans

Chapter 13: A Comparison of Four Listed Companies

- **Using 4 examples to explain on the Leading Factors for Performance and Price:-**
  - Profitability
  - Stability
  - Growth
  - Financial Position
  - Dividends
  - Price history
- No reason to expect low-multiplier would outperform high-multiplier (in short period of term)
  - However, frequently lower multiplier with slower growth might be outperform high-multiplier (in long period of time)

Chapter 14: Stock Selection for the Defensive Investor

2 Approaches to choose	Reason
1. DJIA type of portfolio / Low-cost index fund ideally that track the return of total US stock market	• Acquires sample of leading issues (some growth companies) and less popular and expensive enterprises • Expected approximately the same future results • Any effort to improve low-cost index fund is not justifiable to defensive investor; may incur more risk and higher cost.

2. Quantitatively-tested portfolio	• Require to apply a set of standards for
	  • minimum quality (in the past performance and current financial position of the company)
	  • minimum quantity in terms of earnings and assets per dollar price

• Researching and selecting your own stock is not necessary for most people • Defensive investor who enjoy diversion and intellectual challenge of picking individual stock ○ Can consider making the foundation of portfolio (90% of stock money in index fund and 10% in stock picking)	

Set of standards on the selection of common stocks (Graham's criteria)	Things to Note
1. Adequate size of the company	• estimate $2 billion in current dollars • $10 billion is equivalent to Graham's "big companies"
2. Strong Financial Condition	• Ratio of Current Asset: Current Liabilities (2:1) • Long term debt should be less than working capital
3. Earnings stability	• Past 10 years of positive earning
4. Dividend record	• Past 20 years of uninterrupted dividend pay-out
5. Earnings growth	• Past 10 years with minimum increase of 33% per-share earnings in using 3 year averages at the beginning and end
6. Moderate PE ratio	• Past 3 years - no more than 15x
7. Moderate ratio of Price to Assets (PB ratio)	• PB value should be less than 1.5 times (This might be an issue based on today's context) • Alternatively, (PE Ratio x 1.5) or (PE ratio x PB ratio) should not exceed 22.5

- **2 ways which investor might approach the future**
  - By Prediction (projection) – fool's errand; even forecasts by so-called experts are less reliable than the flip of a coins
  - By Protection – Best solution since it protect from overpaying a stock and overconfidence in the quality in judgment on the quality of stock.

- **2 steps which even Defensive Investor cannot afford to skip**
  - Do your homework – Read at least 5 year worth of company's annual and quarterly reports (along with proxy statement)
  - Check out the neighborhood – Anything over 60% of company's shares owned by institutions suggest that stock is scarcely undiscovered and probably over-owned.
    If money-management firms are largest owners of the stock that invest in a style similar to your own, that's a good sign.

Chapter 15: Stock Selection for the Enterprising Investor

Summary of Graham-Newman Methods	**Definition**
1. Arbitrage	Purchase security and simultaneous sale of one or more other securities into which it was to be exchanged under a plan of reorganization, merger or the like.
2. Liquidations	Purchase of shares which were to receive 1 or more cash payments in liquidation of the company's assets
3. Related Hedges	Purchase of convertible bonds or convertible preferred shares and simultaneous sale of the common stock into which they are exchangeable
4. Net-Current Asset (Bargain) Issues	Acquire as many issues as possible at a cost for each of less than their book value in terms of net current asset alone
5. Secondary Companies	Companies that are making a good showing, have satisfactory past record but appear to hold no charm for the public.
6. Winnowing of Stock guide (Stock Criteria suggested for Enterprising Investor)	**Things to Note**
1. No minimum limit on the size of the company.	• Small companies may afford enough safety if bought carefully and on a group basis
2. Strong Financial Condition	• Ratio of Current Asset: Current Liabilities (at least 1.5 : 1) • Debts not more than 110% of Net Current Assets
3. Earnings stability	• Positive earnings for at least 5 years
4. Dividend record	• Some current dividend
5. Earnings growth	• Current earning greater than those of 1966
6. Stock price	• Less than 120% of net tangible assets

- 2 simpler methods to choose stocks with quite consistently good results in the longer past
    1. Purchase of low-multiplier stock of important companies (e.g. DJIA list)
    2. Purchase the choice of a diversified group of stocks selling under their net current asset value (or working capital value)

- Bargain issues
    - Able to make money without taking a serious risk provided
        - find enough of them to make a diversified group
        - don't lose patience if they fail to advance soon after you buy them.
    - Most bargain issue don't take that long to show good profit nor have they shown high rate.
    - Avoid lower tier bargain issues unless they are validated as bargain

- To see how company is truly earning on the capital it deploys in its business
    - Look beyond EPS to Return On Investment Capital (ROIC)
    - Return On Investment Capital (ROIC) = Owner Earning / Invested Capital
        - Virtue of showing what the company earns from its operating businesses (after all legitimate expense) and how efficiently it has used the shareholders' money to generate that return.
        - At least 10% is attractive. Even 6-7% is tempting if the company has good brand names, focused management or is under a temporary cloud.

Check if the company's managers people who think like owners:

• Are the financials easy to understand or full of obfuscation
• Are the nonrecurring or extraordinary or unusual charges just that or do they keep recurring?
• Does management act like a good partner with good communication?
    ○ what do they say? what do they do?
    ○ do they focus on the business or are they focused on stock price?

Chapter 16: Convertible Issues and Warrants

- Wall Street has attempt to market convertibles as "best of both worlds"
  - Superior protection over stock
  - Opportunity of capital gains if underlying stock increases
  - Issuing company has advantage of lower cost of capital and ability to get rid of debt obligations through bond conversion.
- Graham points out the fallacy of above argument
  - Buyer is usually giving up yield
  - Accepting greater risk in exchange for the conversion right
  - Possibility that company is giving up common shareholders' benefits of future growth.
- Truth
  - Higher yield and Lower risk do not always go hand in hand.
  - Convertible issue must be evaluated individual (as of any other form of security); type of security by itself, does not make it worth investing.

- Investor should be cautious about new convertible issues
  - Advantageous for the company
  - Near the end of bull market

- Most bargain convertible issues can be found among older issues

- Based on historical records, convertible bond provide less total return but more income and less risk than stock; compared to bond, their total return is greater but provide less income with greater risk.
  - In truth, they act more like stock than bond.

Chapter 17: Four Extremely Instructive Case Histories

4 extremes	Things to Note
1. Overpriced tottering giant	• Unjustifiable giant valuation (e.g. Lucent)
2. Empire-building conglomerate	• Acquiring a lot of companies at a very fast pace (e.g. Tyco International Ltd) • Huge amount in acquisition-related charges that are recurring
3. Merger in which a tiny firm took over a big one	• Overvaluation of stock on the tiny firm (e.g. AOL and Time Warner) • Huge company did not have the lion share of the stock.
4. IPO of shares in a basically worthless company	• Company does not have earning. (e.g. eToys)
Key-takeaway: • Basic analysis of these companies might give investor the information need to recognize any fraudulent behavior of a few companies and the gross overvaluation of some stock	

Chapter 18: Comparison of Eight Pairs of companies

- There’s no such thing as a good stock (there’s good company and bad company)
    - Good stock prices which come and go (Cheap stock may later become overprice and Expensive stock may turn cheap)
- Buying stock purely on its rising prices instead of checking if the underlying company value is increasing
    - It’s a certainty that you will be sorry (Market scoffs at Graham’s principles in the short run but they always revalidated in the end)

Chapter 19: Shareholders and Managements – Dividend Policy

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<tr><td colspan="2">

- More intelligent and energetic attitude by shareholders toward their management
  - Generous attitude toward those who demonstrated good job done
  - Demand clear and satisfying explanations when result appear worse than they should; support movement to improve or remove unproductive management. 3 point of bad results:-
    1. Unsatisfactory in themselves
    2. Poorer than those obtained by other similar companies
    3. Unsatisfactory market price of long duration

</td></tr>
<tr><th>2 basic questions that Intelligent Owner need to have attention on (When you buy a stock, you become an owner of the company)</th><th>Things to Note</th></tr>
<tr><td>

1. Is the management reasonably efficient

</td><td>

- Judge the efficiency of management by comparing firms in its industry
  - Profitability
  - Size
  - Competitiveness
- If managers are no good
  - Few of the more substantial stockholder should be convince that change is needed
  - Open-minded to read proxy material and weigh the arguments on both sided
    - Able to know when their company has been unsuccessful and be ready to demand more than artful platitudes as a vindications of the incumbent management
  - When results are well below average if it became the custom to call in outside business engineers to pass upon the policies and competence of the management

</td></tr>
<tr><td>

2. Are the interest of the average outside shareholder receiving proper recognition

</td><td>-</td></tr>
</table>

<table>
<tr><th>What is proxy martial</th></tr>
<tr><td>

- Proxy statement which sends to every shareholder; containing:-
  - Agenda for the annual meeting
  - Discloses details about compensation and stock ownership of manager and directors
  - Transactions between insider and the company

</td></tr>
<tr><th>Why is it important</th></tr>
<tr><td>

- By using common sense while reading the proxy can flag out early warning that something is wrong (e.g. Enron)
  Always read proxy material before and after buying a stock

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</table>

- Dividend
  - Most manager are wrong when they say they can put cash to better use
  - Paying out dividend does not guarantee great result but improve the return of typical stock
    - Before manager squander or squirrel it away

- Corporate Stock Buyback (using the excess cash on hand)
  - Only good if the shares are cheap
  - Tax-free to investor since it might increase the stock value without raising the tax bill as compared to dividend.

Chapter 20: Margin of Safety as the Central Concept of Investment

- Sound investment's motto - MARGIN OF SAFETY.
  - Experienced investor recognize margin of safety concept is essential to the choice of sound bonds and preferred stocks
  - Applicable to common stock as well (require some necessary modifications)
  - Protect investor against loss or unease in the event of some future decline in net income

Application of Margin of Safety to Growth Stocks

• Philosophy in the growth stock investment seems to go parallels in part and in part contravenes the margin of safety principle
• Growth stock buyer
  ○ relies on expected earning power (greater than average shown in the past)
  ○ substitute expected earnings for the past record by calculating the margin of safety expected earnings in excess of those projected
Could work if
  ○ calculation of the future is conservatively done
  ○ shows a satisfactory margin in relation to the price paid
Danger in Growth Stock program
  ○ tendency to set prices that will not be adequately protected by a conservative projection of future earnings
  ○ margin of safety is always dependent on the price paid
  ○ require special degree of foresight and judgment on individual selection to overcome the hazards inherent in the customary market level for such stock

Application of Margin of Safety to Undervalued or Bargain securities
• Margin of safety is much more evident when applied to such securities. • To absorb the effect of miscalculation or worse than average luck / withstand adverse developments. • **If prospect are definitely bad, investor will prefer to avoid the security no matter how low the price.** • Margin of safety served its proper purpose when the undervalued issues (where future uncertain of promising or unpromising) are purchase at bargain basis. Such that even with moderate decline in earning power need not prevent the investment from showing satisfactory results.
Diversification is related to Margin of Safety but different.
• Even with margin of safety is in the investor's favor, investment may still go badly. • Margin of safety only provide a better chance for profit than from loss (Not that loss is impossible) • As the number of investment increase, more likely that in the aggregate there will be profit (basis of insurance underwriting business)

Criterion of Investment vs. Speculation	
• Many see no benefit or usefulness in distinguishing the investment from the speculation. • Graham suggest that margin of safety may be "the touchstone" to distinguish an investment operation from speculative one. • To have true investment, it must present a true margin of safety.	
Investor	**Speculator**
• Believe the concept of margin of safety rest upon a simple and definite arithmetical reasoning from statistical data • No guarantee that the fundamental quantitative approach will successful in the future but no valid reason for such pessimism.	• Believe the odds are in their favor when they take their chance and may claim margin of safety (by propitious time, skill in analysis, adviser or system) Such claims are unconvincing. • Rest on subject judgment, unsupported by favorable evidence or conclusive line of reasoning
Note: It is our argument that a sufficiently low price can turn a security of mediocre quality into a sound investment opportunity - provided that the buyer is informed and experienced and that he practices adequate diversification. For if the price is low enough to create a substantial margin of safety, the security thereby meets our criterion of investment.	

Summary	
• Investment is most intelligent when it is most business-like • Every corporate security may best be viewed as an ownership interest in / a claim against specific business enterprise ○ Investor seeking to make profits from his security purchases and sales is embarking on a business venture which must be run in accordance with accepted business principles.	
4 Principle of Business	

1. Know your business	• Investor don't try to make "business profits" out of securities
	  ○ returns in excess of normal interest and dividend income
	  ○ Unless you know much about security value as the value of merchandise that you proposed to manufacture or deal it.

2. Do not let anyone else run your business	• Unless there's adequately supervision (care and comprehension) and • Strong reason to have confidence in the integrity and ability of the person
3. Do not enter upon an operation (e.g. manufacturing or trading in an item)	• Unless reliable calculation shows it has a fair chance to profit ○ Not based on optimism but on arithmetic
4. Have courage of your knowledge and experience	• Only after above 3 points are done, act on it. ○ Even if others may hesitate or differ

• Typical investor (by no means necessary for his success) need to bring these qualities into his program. Provided:
  ○ Limits his ambitions to his capacity
  ○ Confines his activities within the safe an narrow path of standard, defensive investment
• Achieve satisfactory investment result is easier than most people realize
• Achieve superior result is hard than it looks	