3 bedrock principles for investors

When Benjamin Graham arrived on Wall Street, he had no idea he would one day be heralded as the father of value investing.

Here are three essential principles that formed the bedrock of his investing style. If Warren Buffett is to be believed (“no one ever became poor by reading Graham”), it would do you good to base your investing strategy on these principles.

Investing is most intelligent when it is most businesslike.

Stocks are not merely pieces of paper or electronic quotations on a computer screen, but partial ownership interests in real businesses. Investors must have an obligation to themselves to thoroughly analyse the underlying business and its prospects before purchasing a stock. The facts must be studied in light of established standards of safety and value.

Graham often bemoaned the apathy of shareholders. He noted that the typical American stockholder was the most docile animal in captivity who never thinks of asserting his individual rights as owner of the business. They vote in a sheep-like fashion for whatever the management recommends, not matter how poor the management’s record of accomplishment may be.

He urged shareholders never to forget that they are owners of a business and not merely owners of a quotation on the stock ticket. It is obvious from his writings that Graham considered managements the stewards of stockholder money and cited four important ways in which management may fail to act in the best interests of shareholders:

- Failure to pay dividends commensurate both with earnings and the value of the stockholders’ equity
- Use of stockholders’ money in a relatively unprofitable manner
- Use of stockholders’ money to buy back their stock at an inadequate price
- Maintenance of a holding company set-up in the face of the fact that the shareholders would be much better off if they owned the underlying assets directly

You are your biggest enemy.

What is risk?

You will get different answers depending on whom, and when, you ask.

In 1999, risk meant making less money than someone else. What many people feared was bumping into someone who was getting richer than them by trading dot-com stocks.

In 2003, risk meant that the stock market might keep dropping until it wiped out whatever traces of wealth you still had left.

Risk is losing money. Losing some money is an inevitable part of investing, and there's nothing you can do to prevent it. But you must take responsibility for ensuring that you never lose most or all of your money. Risk exists in another dimension: inside you.

At the peak of every boom and in the trough of every bust, Graham's immortal warning is validated constantly: "The investor's chief problem — and even his worst enemy — is likely to be himself."

Give thought as to what kind of investors they are. Being able to understand yourself would go a long way in making the right decisions. Enterprising or defensive? Investor or speculator? In case you think you are both, he has some words of advice: Never mingle your speculative and investment operations in the same account, nor in any part of your thinking.

Investing isn't about beating others at their game. It's about controlling yourself at your own game. By developing your discipline and courage, you can refuse to let other people's mood swings govern your financial destiny. In the end, how your investments behave is much less important than how you behave.

Investing is not an emotional undertaking. It's analytical and unemotional, which is why it should be approached like any other business. You look for value where others don't see it and take advantage of that. Fear and greed will cause investors to bid up the prices of stocks to nosebleed levels or push them to unreasonably low levels. Don't react. Stay focused on your research and investment thesis. Get swayed by cold, hard facts, not emotion.

Expect volatility and profit from it.

When investing in stocks, volatility comes with the territory. In his book The Intelligent Investor, Graham makes note of the market fluctuation in the price of General Motors. It rose from $13 in 1925 to $92 in 1929; collapsed to $7½ in 1932; climbed back to $77 in 1936; relapsed to $25½ in 1938; then mounted to $80½ in 1946 and fell back to $48 the very same year.

The behaviour of stock prices departs radically from the stock's intrinsic worth. Prices respond vigorously to any significant change in either current earnings or short-term earning prospects. Both favourable and unfavourable situations are part of any normal long-term picture and both should be accepted without undue excitement.

Price fluctuations have only one significant meaning; they provide an opportunity to buy wisely when prices fall sharply and sell wisely when they advance a great deal. Consequently, view downturns as great buying opportunities since that is the time when the market insists upon offering a stock at considerably less than its indicated true value.

Investing with a margin of safety is what he refers to as the "central concept" of investing. It is the difference between the fundamental, or intrinsic, value of the stock and the price at which the stock is trading. The aim is to pay less than the real value. In other words, purchase assets at a rate below the valuation of the business because it offers a safety net in case your evaluation of the business was wrong or if the business falters.

By refusing to pay too much for an investment, you minimize the chances that your wealth will ever disappear or suddenly be destroyed.

Imagine that you find a stock that you think can grow at 10% a year even if the market only grows 5% annually. Unfortunately, you are so enthusiastic that you pay too high a price, and the stock loses 50% of its value the first year. Even if the stock then generates double the market's return, it will take you more than 16 years to overtake the market-simply because you paid too much, and lost too much, at the outset.

The greater the margin, the more leeway the investor has for negative conditions or unforeseen events before he loses money. The greater the margin of safety, the less risky the investment. Conversely, a stock that trades close to or above its intrinsic value offers almost no margin of safety. And buying without a margin of safety, in Graham's book, is no better than mere speculation.

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