

What Is The Role of The Investment Advisor?

Benjamin Graham, Author

The Intelligent Investor, Security Analysis,

A great majority of investors cannot devote their full time to investing, and naturally many of these investors turn to "professionals" for advice.

Yet there is something naive, Mr. Graham cautioned, about asking others how to make money. Unless an investor has an intimate and favorable knowledge, Mr. Graham suggested investors limit their investments to "conservative and unimaginative forms."

The main benefit of a professional advisor, Mr. Graham argued, is to protect the investor from costly mistakes, not to help beat the market averages. Wall street historically has prospered from speculation, according to Mr. Graham, but he believed that speculators themselves on the whole lose money.

What is in the best interests of brokers - that is, maximizing fees - is not in the best interests of investors.

Sampling Ben Graham's Writing

Ben Graham was a great writer. The following quotes are suggestive of his writing and further reveal his investment philosophy.

Why bargains occur:

"The market is fond of making mountains of molehills and exaggerating ordinary vicissitudes into major setbacks. Even a mere lack of interest or enthusiasm may impel a price decline to absurdly low levels."

On stock market forecasts:

"It is absurd to think that the general public can ever make money out of market forecasts."

The powerful pull of the crowd:

"Even the intelligent investor is likely to need considerable willpower to keep from following the crowd."

The rationale for diversification:

"It appears to be almost impossible to distinguish in advance between those individual [stock] forecasts which can be relied upon and those which are subject to a large chance of error. ..reason for diversification.

Long-term forecasts are unreliable:

"No one really knows anything about what will happen in the distant future, but analysts and investors have strong feelings on the subject just the same."

Money managers promising miracles:

"Bright, energetic people - and usually quite young - have promised to perform miracles with 'other people's money' since time immemorial . . . they have inevitably brought losses to their public in the end."

Will Mr. Graham's Advice Make You Rich ?

Few investors will get rich overnight adhering strictly to Graham's investment philosophy. His conservative, diversified approach for most practitioners is likely to yield investment results only a little better than average. His aim is to assist investors to obtain good value for their money, not to make them rich quick. *Graham believed that this is the only legitimate function of an investment advisor.* Most investors would do well to achieve such results because professional investors on average do not fare so well.

Conclusion

Most stock pickers believe that they are among the tiny minority of investors who can beat the market after costs, and, for inspiration and encouragement, they point to legends such as Warren Buffett and Benjamin Graham.

What such investors often don't know is that even Mr. Graham and Mr. Buffett have said that the best strategy for most investors is to buy low-cost index funds and that the great Mr. Graham eventually changed his mind about the wisdom of traditional stock-picking.

Graham, you may remember, is considered one of the greatest stock pickers of all time, the man who wrote two classics on intelligent investing and whose security-analysis techniques are still taught in most serious investment classes. But in 1976, Graham told the *Journal of Finance* the following:

"I am no longer an advocate of elaborate techniques of security analysis in order to find superior value opportunities. This was a rewarding activity, say, 40 years ago, when [the bible of fundamental stock analysis, Graham and Dodd's Security Analysis] was first published; but the situation has changed. I doubt whether such extensive efforts will generate sufficiently superior selections to justify their cost."

Why did Mr. Graham conclude - more than three decades ago - that stock-picking practices that had defined his teachings is no longer a valid way to invest?

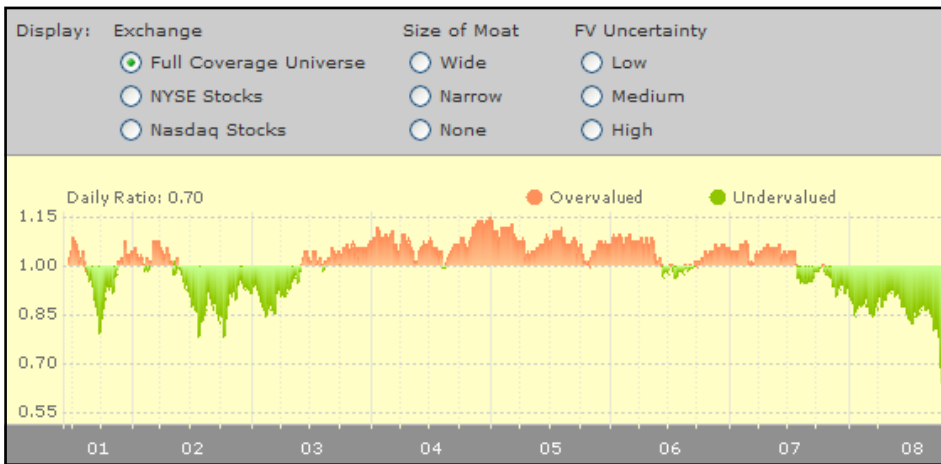
- First, in the seven decades since Graham wrote *Security Analysis*, the stock market has gone from being a playground for amateurs to a battlefield dominated by full-time professionals.
- Pricing errors that once might have gone unnoticed for months in Graham's day are now discovered and exploited instantly.
- The moment the information is released, it is dissected, discussed, and debated by thousands of analysts.
- When Graham wrote *Security Analysis* in 1934, the lack of an Internet was the least of an analyst's worries.
- There were no spreadsheets, computers, or information databases. There weren't even any *calculators*.
- There were no company conference calls or quarterly earnings releases. There were few filing requirements, lax accounting rules, and little legal enforcement.

- There were only a handful of mutual funds, no hedge funds, no computerized trading.
- There was no CNBC, no market radio, no Bloomberg, no Yahoo! Finance, no 24 hour trading abilities and no real-time quotes.
- There were *paper tickers*, for God's sake.

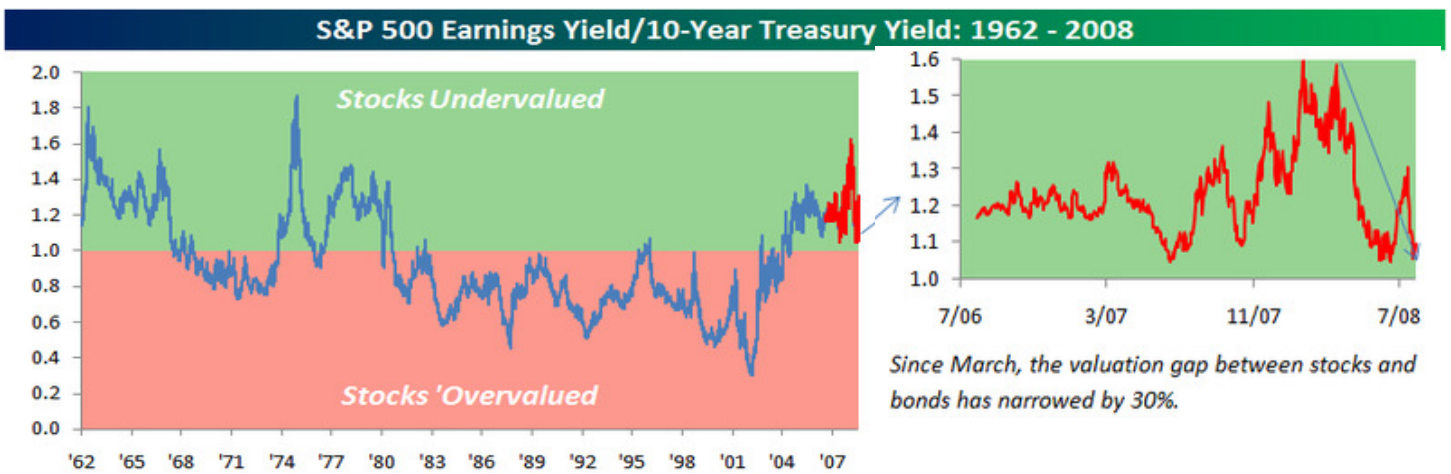
Summary

The facts are clear, however. For the vast majority of investors - including professionals - stock-picking efforts waste both money and time. The stock-picking mystique is so deeply entrenched in our financial culture that it feels like heresy to suggest that it is, on balance, dumb to time the market.

- Today's technology allows even part-time investors to screen tens of thousands of stocks in dozens of markets in the time it would have taken a Graham-era analyst to compute the "net current assets" of a single company.
- Look at the chart below that is produced by Morningstar - with one click of the mouse we can create charts and review if stocks are overpriced or under-priced.



Is the market cheap or expensive? Here's a new way to look at market valuations based on Morningstar's fair value estimates for individual stocks. The graph shows the ratio of price to fair value for the median stock in each coverage universe over time. A ratio above 1.00 indicates that the stock's price is higher than Morningstar's estimate of its fair value; a ratio below 1.00 indicates that the stock's price is lower than our estimate of its fair value. The further the price/fair value ratio rises above 1.00, the more the median stock is overvalued. The further it moves below 1.00, the more the median stock is undervalued



The above chart compares the S&P 500 (US market) earnings yield to the 10-year US Treasury interest yield. The higher the treasury interest yield (as in the 1980s when interest rates hit over 10%) stocks could be overvalued because the stock market yields are too low (on a comparison basis). Or, having low stock market earnings yield (like in the tech bubble of the 1990-2001 period) could also cause stock markets to be overvalued.

In 2008, with treasury yields at historical lows and even with the current lower stock market yields, the stock is undervalued (on a comparison basis).

The last time the stocks were this undervalued on a yield comparison basis was in the 1971 - 1977 period.

ROI Capital Market Commentary Letter

"There is Room for Optimism!" Oct 21, 2008

I could list a very, very long list of pessimistic facts that will act as 'head winds' to positive stock market performance; however, this long list (especially as it relates to the economy) will be triumphed with time by two large positive factors.

1. Stocks have dropped significantly from their respective highs and they are frequently trading at a price to earnings ratio of 10 or less (the inverse being the earning yield of 10%) which means if nothing changes the book value (sometimes referred to as replacement value) of the business is growing at 10% per year – in short, stocks are cheap and they don't have to do much in order to generate some positive returns (in fact, Caterpillar announced earnings this morning, missed expectations by 2 cents per share and discussed various negative factors affecting the business and yet the stock is up 6% in Europe – in the past these results would have resulted in big losses in the stock but investors have significantly reduced their current expectations).
2. The Central Banks have demonstrated a willingness to do almost anything to unlock 'thawed' or frozen credit markets and get banks lending again (money in motion is a prerequisite to a health economy). On October 9th I became very 'concerned' that Central Banks were 'silent' on the solution but since the G-7 finance ministers met on Thanksgiving weekend (October 11th) we have seen a material change in their conduct and how quickly they are willing to deploy capital in a coordinated and consistent manner (and these actions are paying off as we see LIBOR rates dropping to pre Lehman Bankruptcy levels (the Lehman bankruptcy was the key catalyst that caused credit markets to freeze up). LIBOR or London Intra Bank Offerory Rate is the key global measure of the cost of companies to borrow money from the bank (and the cost of banks lending money to other banks). LIBOR has dropped more than 1% in the last 2 days (that is a big deal and equity markets are reacting to that news big time)! In addition, we might see another stimulus package from the U.S. Congress later this year (more on that in a minute).

I also highlighted earlier that Warren Buffet has written an article in the New York Times publicly stating that he is bullish on stocks (especially U.S.) stocks.

What is interesting to note is that he has only publicly stated twice in his career that he is bullish on stocks

(followers of Warren Buffett will know that he is not a market timer nor does he comment on the market – a true stock picker).

- The 1st time came in 1974 when he said, "I feel like an oversexed man in a harem. This is the time to start investing." The Dow Jones Industrial Average gained almost 100% in the next two years (it is also interesting to note that the last time the Dow dropped by more than 40% was in 1972).
- The 2nd time came in 1979, when he told Forbes Magazine that "stocks now sell at levels that should produce long-term returns far superior to bonds." That prediction also proved to be correct and last 'call' came last Friday.
- Only time will tell if he is correct for the 3rd time in his career although, one could argue that he rarely makes a call but I would argue that Warren only makes a call when stocks are uncharacteristically 'cheap' and things have rarely been this 'cheap.' In addition, Warren also admits that he (nor anyone) else knows the short-term direction of stocks but over the long-term fundamentals will prevail.

Yesterday (Oct 20, 2008) we experienced a broad rally in stocks markets led by North American stocks markets with energy, materials and financials leading the way (stocks were up between 4.5 to 6+% but energy was up more than 10%). OPEC is rumored to be cutting oil production by more than 2 million barrels per day at an emergency meeting later this week which is pushing oil prices up but I would expect some profit taking in the near term as oil prices start inching back up to \$80 per barrel from the current \$74 per barrel. In the short-term there will be no shortage of 'things to worry about' not all companies will achieve their respective earnings targets and there will be signs of investor anxiety and concerns over corporate earnings (Texas Instruments also reported earnings this morning and they failed to impress and TI has long been considered a leading indicator to the overall health of the technology sector and some negative reports on RIM yesterday pushed their shares lower).

Things will continue to be volatile since the Chicago Board of Options Exchange (CBOE) VIX index (measure of fear or volatility) is still trading above 50 but off its historic high of more than 81 set last week (that is a very material change) but 50 is still very, very high and thus, investors are still expecting big price swings in either direction in the short-term.

Wilfred Vos Bcs, CFP, FMA, FCSI, CIM, CFA, MBA, DMS

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October 17, 2008

OP-ED CONTRIBUTOR

Buy American. I Am.

By WARREN E. BUFFETT

Omaha

The financial world is a mess, both in the United States and abroad. Its problems, moreover, have been leaking into the general economy, and the leaks are now turning into a gusher. In the near term, unemployment will rise, business activity will falter and headlines will continue to be scary.

So ... I've been buying American stocks. This is my personal account I'm talking about, in which I previously owned nothing but United States government bonds. (This description leaves aside my Berkshire Hathaway holdings, which are all committed to philanthropy.) If prices keep looking attractive, my non-Berkshire net worth will soon be 100 percent in United States equities.

Why?

A simple rule dictates my buying: Be fearful when others are greedy, and be greedy when others are fearful. And most certainly, fear is now widespread, gripping even seasoned investors. To be sure, investors are right to be wary of highly leveraged entities or businesses in weak competitive positions. But fears regarding the long-term prosperity of the nation's many sound companies make no sense. These businesses will indeed suffer earnings hiccups, as they always have. But most major companies will be setting new profit records 5, 10 and 20 years from now.

Let me be clear on one point: I can't predict the short-term movements of the stock market. I haven't the faintest idea as to whether stocks will be higher or lower a month — or a year — from now. What is likely, however, is that the market will move higher, perhaps substantially so, well before either sentiment or the economy turns up.

So if you wait for the robins, spring will be over. A little history here: During the Depression, the Dow hit its low, 41, on July 8, 1932. Economic conditions, though, kept deteriorating until Franklin D. Roosevelt took office in March 1933. By that time, the market had already advanced 30 percent. Or think back to the early days of World War II, when things were going badly for the United States in Europe and the Pacific. The market hit bottom in April 1942, well before Allied fortunes turned.

Again, in the early 1980s, the time to buy stocks was when inflation raged and the economy was in the tank. In short, bad news is an investor's best friend. It lets you buy a slice of America's future at a marked-down price.

Over the long term, the stock market news will be good. In the 20th century, the United States endured two world wars and other traumatic and expensive military conflicts; the Depression; a dozen or so recessions and financial panics; oil shocks; a flu epidemic; and the resignation of a disgraced president.

Yet the Dow rose from 66 to 11,497. You might think it would have been impossible for an investor to lose money during a century marked by such an extraordinary gain. But some investors did. The hapless ones bought stocks only when they felt comfort in doing so and then proceeded to sell when the headlines made them queasy.

Today people who hold cash equivalents feel comfortable.

They shouldn't. They have opted for a terrible long-term asset, one that pays virtually nothing and is certain to depreciate in value. Indeed, the policies that government will follow in its efforts to alleviate the current crisis will probably prove inflationary and therefore accelerate declines in the real value of cash accounts.

Equities will almost certainly outperform cash over the next decade, probably by a substantial degree. Those investors who cling now to cash are betting they can efficiently time their move away from it later. In waiting for the comfort of good news, they are ignoring Wayne Gretzky's advice: *"I skate to where the puck is going to be, not to where it has been."*

I don't like to opine on the stock market, and again I emphasize that I have no idea what the market will do in the short term. Nevertheless, I'll follow the lead of a restaurant that opened in an empty bank building and then advertised: "Put your mouth where your money was."

Today my money and my mouth both say equities.

Warren E. Buffett,
Chief Executive of Berkshire Hathaway,
a diversified holding company.

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