

Graham wrote about **growth stocks** in *Security Analysis*, 2nd ed. (1940) and other writings.

First, Graham asserts that there is no such thing as a definite, proper value for a given bond, preferred, or common stock. Equally so, no magic calculation formula exists that will infallibly product a *specific* intrinsic value number with absolute accuracy.

Graham shows students how to think about and bracket, instead of attempting to define with precision, a security's **intrinsic value**. Based on earnings, cash flows, dividends, coupons, capitalization structure, and a realistic assessment of the future, Graham comes to the conclusion that it is best to work in **RANGES** of intrinsic values.

We want to study this great investor who could frame key questions, his emphasis on the potential for error and the need for internal cross-checking and consistency, and his steadfast awareness of the potential for the market short term verdict to stray from underlying reality.

Let's take away Graham's method of thinking so we can apply to the investing problems today.

From Security Analysis (1940)

Individual Growth as Basis of Selection.

Those who would reject the suggestion that common-stock investment may be founded securely on a general secular expansion may be attracted to a second approach. This stresses the element of selectivity and is based on the premise that certain favored companies may be relied on to grow steadily. Hence such companies, when located, can be bought with confidence as long-term investments. This philosophy of investment is set forth at some length in the 1938 report of National Investors Corporation, an investment trust, from which we quote as follows:

The studies by this organization, directed specifically toward improved procedure in selection, afford evidence that the common stocks of growth companies—that is, companies whose earnings move forward from cycle to cycle, and are only temporarily interrupted by periodic business depressions—offer the most effective medium of investment in the field of common stocks, either in terms of dividend return or longer term capital appreciation. We believe that this general conclusion can be demonstrated statistically and is supported by economic analysis and practical reasoning.

In considering this statement critically, we must start with the emphatic but rather obvious assertion that the investor who can successfully identify such “growth companies” when their shares are available at reasonable prices is certain to do superlatively well with his capital. Nor can it be denied that there have been investors capable of making such selections with a high degree of accuracy and that they have benefited hugely from their foresight and good judgment. **But the real question is whether or not all careful and intelligent investors can follow this policy with fair success.**

Three Aspects of the Problem. Actually the problem falls into three parts:

- First, what is meant by a “growth company”?
- Second, can the investor identify such concerns with reasonable accuracy?
- Third, to what extent does the price paid for such stocks affect the success of the program?

1. What Are Growth Companies?

The National Investors Corporation discussion defined growth companies as those “whose earnings move forward from cycle to cycle.” How many cycles are needed to meet this definition? The fact of the matter seems to be that prior to 1930 a large proportion of all publicly owned American businesses grew from cycle to cycle. The distinguishing characteristic of growth companies, as now understood, developed only in the period between 1929 and 1936–1937. In this one cycle we find that most companies failed to regain their full depression losses. The minority that did so stand out from the rest, and it is these which are now given the complimentary title of “growth companies.” But since this distinction is in reality based on performance during a single cycle, how sure can the investor be that it will be maintained over the longer future?

It is true, from what we have previously said, that many of the companies that expanded from 1929 to 1937 had participated in the general record of growth prior to 1929, so that they combine the advantages of a long period of upbuilding and an exceptional ability to expand in the last decade. The following are examples of large and well-known companies of this class:

Air Reduction	Monsanto Chemical
Allis Chalmers	Owens-Illinois Glass
Coca-Cola	J. C. Penney
Commercial Credit	Procter & Gamble
Dow Chemical	Sherwin-Williams Paint
Du Pont	Standard Oil of New Jersey
IBM	Scott Paper
International Nickel	Union Carbide and Carbon
Libbey-Owens	Ford

2. Can the Investor Identify Them (growth stocks)?

But our natural enthusiasm for such excellent records is tempered somewhat by a sobering consideration. This is the fact that, viewed historically, most successful companies of the past are found to have pursued a **well-defined life cycle**, consisting first of a series of struggles and setbacks; second, of a halcyon period of prosperity and persistent growth; which in turn passes over into a final phase of supermaturity—characterized by a slackening of expansion and perhaps an actual loss of leadership or even profitability.¹ It follows that a business that has enjoyed a very long period of increasing earnings may ipso facto be nearing its own “**saturation point.**” **Hence the seeker for growth stocks really faces a dilemma; for if he chooses newer companies with a short record of expansion, he runs the risk of being deceived by a temporary prosperity; and if he chooses enterprises that have advanced through several business cycles, he may find this apparent strength to be the harbinger of coming weakness.**

We see, therefore, that the identification of a growth company is not so simple a matter as it may at first appear. It cannot be accomplished solely by an examination of the statistics and records but **requires a considerable supplement of special investigation and of business judgment**.

Proponents of the growth-company principle of investment are wont currently to lay great emphasis on the element of industrial research. In the absence of general business expansion, exceptional gains are likely to be made by companies supplying new products or processes. These in turn are likely to emerge from research laboratories. The profits realized from cellophane, ethyl gas and various plastics, and from advances in the arts of radio, photography, refrigeration, aeronautics, etc., have created a natural enthusiasm for research as a business asset and a natural tendency to consider the possession of research facilities as the *sine qua non* of industrial progress.

Still here, too, caution is needed. If the mere ownership of a research laboratory could guarantee a successful future, every company in the land would have one. Hence, the investor must pay heed to the kind of facilities owned, the abilities of the researchers and the potentialities of the field under investigation. It is not impossible to study these points successfully, **but the task is not easy**, and the chance of error is great.

3. Does the Price Discount Potential Growth?

The third source of difficulty is perhaps the greatest. Assuming a fair degree of confidence on the part of the investor that the company will expand in the future, **what price is he justified in paying for this attractive element? Obviously, if he can get a good future for nothing, i.e., if the price reflects only the past record, he is making a sound investment.** But this is not the case, of course, if the market itself is counting on future growth. Characteristically, stocks thought to have good prospects sell at relatively high prices. How can the investor tell whether or not the price is too high? **We think that there is no good answer to this question—in fact we are inclined to think that even if one knew for a certainty just what a company is fated to earn over a long period of years, it would still be impossible to tell what is a fair price to pay for it today.** It follows that once the investor pays a substantial amount for the growth factor, he is inevitably assuming certain kinds of risk; viz., that the growth will be less than he anticipates, that over the long pull he will have paid too much for what he gets, that for a considerable period the market will value the stock less optimistically than he does.

On the other hand, assume that the investor strives to avoid paying a high premium for future prospects by choosing companies about which he is personally optimistic, although they are not favorites of the stock market. No doubt this is the type of judgment that, if sound, will prove most remunerative. But, by the very nature of the case, **it must represent the activity of strong-minded and daring individuals** rather than investment in accordance with accepted rules and standards¹.

¹ The “expanding-industry” criterion of common-stock investment is vigorously championed in an arresting book *The Ebb and Flow of Investment Values*, New York, 1939, by Edward S. Mead and J. Grodinsky. For a consideration of their views in some detail see Appendix Note 71, p. 845.

May Such Purchases Be Described as Investment Commitments?

This has been a longish discussion because the subject is important and not too well comprehended in Wall Street. Our emphasis has been laid more on the pitfalls of investing for future growth than on its advantages. But we repeat that this method may be followed successfully if it is pursued with skill, intelligence and diligent study. **If so, is it appropriate to call such purchases by the name of “investment”? Our answer is “yes,” provided that two factors are present: the first, already mentioned, that the elements affecting the future are examined with real care and a wholesome skepticism, rather than accepted quickly via some easy generalization; the second, that the price paid be not substantially different from what a prudent business man would be willing to pay for a similar opportunity presented to him to invest in a private undertaking over which he could exercise control.**

We believe that the second criterion will supply a useful touchstone to determine whether the buyer is making a well-considered and legitimate commitment in an enterprise with an attractive future, or instead, under the guise of “investment,” he is really taking a flier in a popular stock or else letting his private enthusiasm run away with his judgment.

It will be argued, perhaps, that common-stock investments such as we have been discussing may properly be made at a considerably higher price than would be justified in the case of a private business, first, because of the great advantage of marketability that attaches to listed stocks and, second, because the large size and financial power of publicly owned companies make them inherently more attractive than any private enterprise could be. As to the second point, the price to be paid should suitably reflect any advantages accruing by reason of size and financial strength, but this criterion does not really depend on whether the company is publicly or privately owned. On the first point, there is room for some difference of opinion whether or not the ability to control a private business affords a full counterweight (in value analysis) to the advantage of marketability enjoyed by a listed stock. To those who believe marketability is more valuable than control, we might suggest that in any event the premium to be paid for this advantage cannot well be placed above, say, 20% of the value otherwise justified without danger of introducing a definitely speculative element into the picture.

c. Purchase of “growth stocks” at generous prices. In calling this “speculation,” we contravene most authoritative views. For reasons previously expressed, we consider this popular approach to be inherently dangerous and increasingly so as it becomes more popular. But the chances of individual success are much brighter here than in the other forms of speculation, and there is a better field for the exercise of foresight, judgment and moderation.

1. Investments in growing industries and switches out of declining industries are to be made regardless of current prices. If a large percentage of stock owners followed this principle, the price of “good” stocks would advance sensationally, whereas unpromising stocks would fall to almost nothing—regardless of their earnings and assets. Neglect of the price factor in this theory must reflect the belief either that the price makes no difference or that, on the average, investors do not in fact have to pay too high a differential for good stocks. The first alternative is clearly untenable; the second is more than doubtful. The behavior of the market in the past decade already betrays the influence of this philosophy in the heavy premiums being paid for growth stocks. Its further extension might work havoc.

Graham says the analyst’s job falls into four different categories, as follows:

1. The selection of safe securities, of the bond type.
2. The selection of undervalued securities
3. **The selection of growth securities**, that is, common stocks that are expected to increase their earning power at considerably better than the average rate.
4. The selection of “near-term opportunities,” that is, common stocks that have better-than-average prospects of price advance, within, say, the next twelve months.

Selection of Growth Stocks

The third objective of security analysis is the selection of growth stocks. How scientific a procedure is this now, and how scientific can it be made to be? Here I enter difficult waters. Most growth companies are themselves tied in closely with technological progress; by choosing their shares the security analyst latches on, as it were, to the coattails of science. In the forty or more plant inspections that are on your scheduled field trips for this convention week, no doubt your chief emphasis will be placed on new product and new process developments; and these in turn will strongly influence your conclusions about the long-pull prospects of the various companies. But in most instances this is primarily a qualitative approach. Can your work in this field be truly scientific unless it is solidly based on dependable³ measurements, that is, specific or minimum projections of future earnings, and a capitalization of such projected profits at a rate or multiplier that can be called reasonably conservative in the light of past experience? Can a definite price be put on future growth—below which the stock is a sound purchase, above which it is dear, or in any event speculative? What is the risk that the expected growth will fail to materialize? What is the risk of an important downward change in the market’s evaluation of favorable prospects? A great deal of systematic study in this field is necessary before dependable answers so such questions will be forthcoming.

.....I cannot help (in 1952) but feel that growth stock is still in the pre-scientific stage. It is at the same time more fascinating and less precise than the selection of safe bonds or undervalued securities. In the growth stock field, the concept of margin of safety loses the clarity and the primacy it enjoys in those other two classes of security analysis. True, there is safety in growth, and some of us will go so far as to declare that there can be **no real safety EXCEPT IN GROWTH**, and some of us will go so far as to declare that there can be no real safety except in growth. But this sounds to me more like slogans than scientifically formulated and verifies propositions. Again, in the growth field the element of SELECTIVITY is so prominent as to place diversification in a secondary and perhaps dubious position. A case can be made for putting all your growth eggs in the one best or a relatively few best baskets. Thus in this branch of security analysis the actuarial element may be missing, and that circumstance³ undoubtedly militates against truly scientific procedures and results.

---There is undoubtedly an organic but inverted relationship between the growth stock concept and the theory of undervalued securities. The attraction of growth is like a tidal pull which causes high tides in one area, the assumed growth companies, and low tides in other areas, the assumed non-growth companies, We can measure, in a sense, scientifically the distorting effect

of this influence by using as our standard the minimum business value of enterprises in the non-favored group.