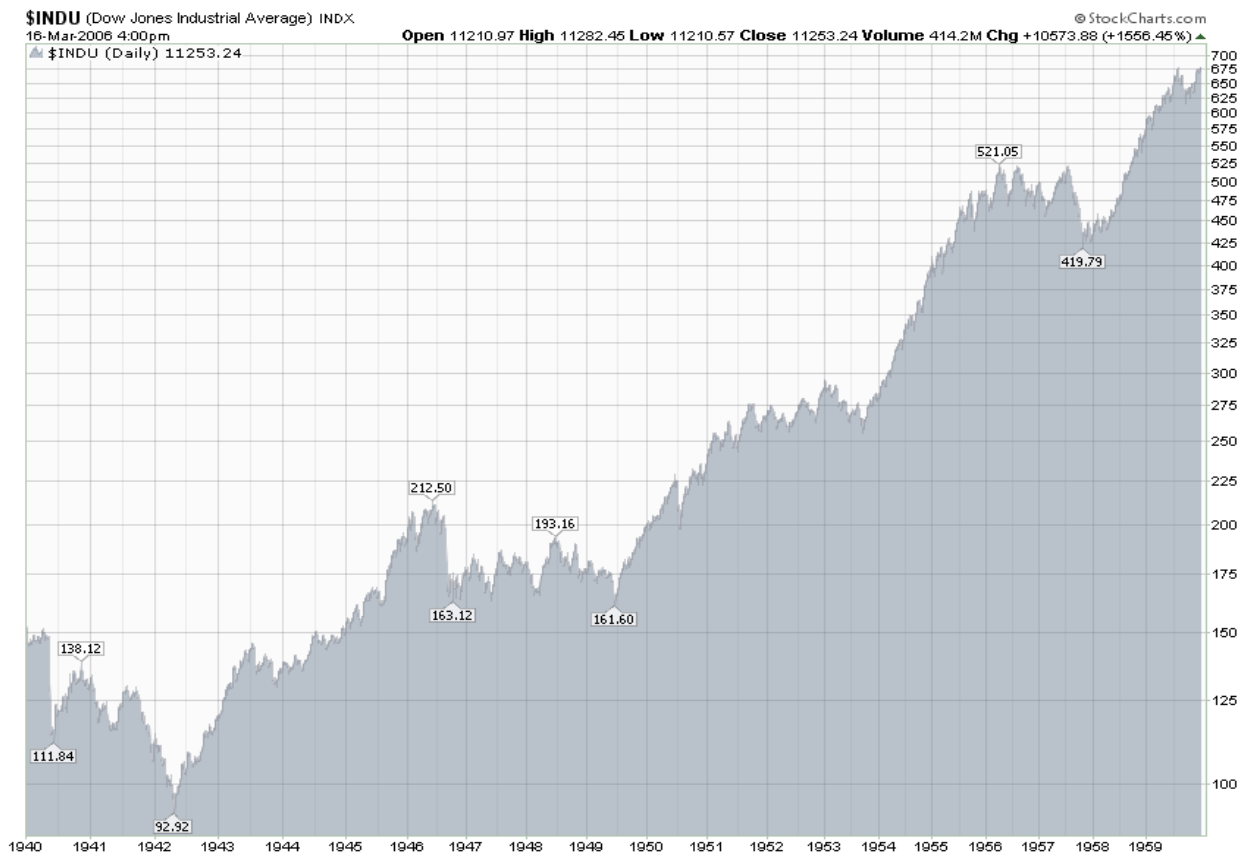
Benjamin Graham ("BG") found that **trends did not continue for any great length of time.** When sales go up there is a tendency for the profit margin to rise at least immediately--Kroger, the other way around.

Companies always seem to adjust themselves to a larger amount of business ultimately in such a way that **they don't make any more profit per dollar on the larger business** than they used to make on the smaller.

Next question is the *multiplier* we would apply to expected future earnings of $1.70 on this company (Barker). Suggestion that shares of smaller companies occupying a secondary position and with a record that is not satisfactory when you study them over a period of years. Those companies should be valued on a **fairly modest basis**, and I would be inclined to think that a **multiplier of 12 (8% Earnings Yield** would be as high as you would be likely to give and on that basis you would get a valuation of this company between 20 and 21 **without any allowance for the asset component or consideration**. Selling at moment above this value (1/17/47).

Valuation of this company is on conservative side—when we valued Dow Jones Average we tended to get a value higher than the market price. This shows that secondary companies do not show up as well in this method of analysis.



Then compared Barker Brothers to Mandel Brothers. Mandel $18.5 sales on an average before the war (profit margin very low)--$27 million during war, $30 million post war. (BG) feels profit margin should be better. Compares current earnings.

Word or two on **asset component** on **earning power valuation**. Don't want to stress it too much as it is not customarily used and we have no particular reason for believing we are right. For the record, BG indicates how he feels. If the earning power value *exceeds* the asset value, some reduction should be made for that fact. We suggest ¼ of the difference be taken off. An arbitrary figure. If difference is great, adjustment more important.

Where the assets exceed the earning power we do not value the company upward because we are not very much impressed by assets that do not have earning power.

There is one rather important difference there and that relates to working capital. **When the working capital exceeds the earning power value,** we are impressed by experience to believe that there is some significance in that fact and in summary fashion we are inclined to add ½ of the difference to the earning power value to allow for the excess working capital which in some way or other tends to make itself felt over the years. Sometimes you get it in a distribution; sometimes you get it in sale of the property; sometimes you get it because the company changes its policy and is able to use its working capital more effectively than otherwise. He is not inclined to stress that technique of analysis too much. (Now BG takes stock in what we are trying to do in these lectures.)

We discussed first. The market behavior in general in the years 1941-45 in relation to economic changes that affected security values. We considered new factors that were involved in the correct statement of the results that an individual company may have achieved during the war and post-war periods. An then we have just recently finished our discussion of the technique of valuing companies, based upon the capitalization of earning power and with a minor adjustment for the asset picture.

Scope of the analysts activities in the securities markets and his approach to his function of analyzing securities and drawing conclusions from his analysis.

Two fundamentally different approaches that the analysts may take to securities as a whole.

1. The conventional one—that is based primarily on quality and on prospects.
2. The penetrating one and that is based on value.

The conventional one is divided into three separate ways of dealing with securities.

A. Identification of good stocks i.e.; strong stocks, strong companies. Well-entrenched companies or high quality companies and those companies presumably can safely be bought at *reasonable* prices. This seems like a simple enough activity.
B. The selection of companies which have better than average long-term prospects of growth and earnings. They are generally called **growth stocks**.

C. An intermediate activity which involves the selection of companies which are expected to do better business in the *near-term* than the average company. All three of these activities I call conventional.

The second approach should be divided into two sub-classifications of action.

A. The purchases of securities generally when the market is at a low level as the market is considered by analysts.
B. The purchase of special or individual securities at almost any time when the price appears to be well below the appraised or analyzed value.

II. AN APPRAISAL OF THE APPRAISERS THEMSELVES (BG)

A. Is the most useful of the conventional approaches as long as a conscientious effort is made to see **that a good stock is not selling above the range of conservative value.** Investors do not make mistakes or bad mistakes in buying good stocks at fair prices. To see that good companies and their prices are on the whole reasonable is their job and also of established investment counsel and it **accounts for their ability to survive in spite of the fact that they are not in a very easy kind of business.**

Getting into type B is more interesting and difficult ground. For a long while selection of **growth stocks** was the best regarded type of activity of analysts.

It is questionable whether you can establish a technique and transmit it to someone else. **BG thinks at bottom success of identification of growth stocks comes from being smart or shrewd and doesn't consider it a standard quality of a good security analysts to be smart or shrewd--**doesn't seem to him to fit into the general pattern or canon of security analysis to require these rare qualities.

Security Analysts should be require to be wise in the sense that this he (she) is technically competent, that he is experienced, and that he is prudent. **Doesn't think this type of wisdom is adapted for selection of growth stocks.**

Third activity of conventional sort. This is done most day by day in Wall St. operations. The trade investigation which leads one to believe that this industry or company is going to have an unusually good year in the *next 12 months* and therefore should be bought. **He is most critical of this Wall St. activity** probably because it is the most popular form of passing the time of the Security Analyst. (BG) regards it as naïve in the extreme.

To carry conventional lines of activity and analysis it is necessary that you impose some fairly obvious but nonetheless *rigorous conditions* on your own writing and recommending. If you select good stocks, determine and specify that the price is within a range of fair value. **If you select growth stocks, determine and specify the round amount which the buyer at the current price is already paying for the**

growth factor as compared with its reasonable price if the growth prospects were only average. Then determine and state whether in the analyst's judgment, the growth prospects are such as to *warrant* the payment of the current price by a prudent investor.

See statements of that kind made in the security analysis and in circulars. In recommending a stock for its near-term prospects, determine and state whether in the analyst's judgment the market price and it's fairly recent market action has reflected the expectations of the analysts. *(What has the market discounted?)*

Near term valuation, one or two years.

Unconventional or penetrating type of analysis which emphasizes value. First division represents buying into the market as a whole at low levels—that is copy book procedure.

Low market in relation to the past pattern of the market and by simple valuation methods such as the type we have been discussing. **A good analyst doesn't change his concept of what the earnings of the next five years are going to be because the market changes.** His views of average future earnings would change only because he is convinced that there has been some change in underlying factors of a very significant sort.

An example is the Yale University method.

Good to buy undervalued securities. One proviso don't buy them when the general market seems very high.

A cheap stock tends to decrease along with the popularity of others when the stock market falls. Lower prices stocks lose more percentage wise than the high priced ones. Field of undervalues securities is popular at all times.

END