

The year ahead

Investing in shares

An average of 10 years should include the peaks and troughs of the business cycle and provide a more accurate estimate.

To establish whether a company's shares were cheap or expensive he divided the current price by the average earnings to give the price/earnings (P/E) ratio. Do it the other way, divide the earnings by the price and express it as a percentage, and you get the earnings yield, which can, in theory, be compared to an interest rate as a rough and ready indicator of the return an investor can expect.

As Graham refused to overpay for shares, a price earnings share of sixteen, equating to an earnings yield of just over 6 per cent, was his maximum and he preferred to buy shares with a price earnings ratio of less than 10, a yield of 10 per cent. He didn't think it was worth investing in shares for less than 6 per cent, and 10 per cent gave him his margin of safety.

CURRENT NET-NETS		
Epic code	Company	Sub sector
FCCN	French Connection	Apparel Retailers
RNVO	Renovo	Biotechnology
AGA	AGA Rangemaster	Durable Household Products
CRND	Central Rand Gold	Gold Exploration
GLE	M.J. Gleeson	Heavy Construction
BDEV	Barratt Developments	Home Construction
BWY	Bellway	Home Construction
BVS	Bovis Homes	Home Construction
PSN	Persimmon	Home Construction
TW	Taylor Wimpey	Home Construction
ORE	Aricom	Non Ferrous Metals
BVC	BATM Advanced Comm's	Telecommunications Equip.
FTC	Filtronic	Telecommunications Equip.

Source: SG, 25 November 2008

Value investing

Graham's ideas informed the 'value' style of investing, and investors and funds that use methods derived from Graham often apply the value tag to themselves, if only to distinguish their style from 'growth' investing which Graham described as 'fantasia' and 'pre-scientific'.

Growth investors, he said, are fixated on performance and the elaborate methods analysts concocted to forecast future profits were nothing more than speculation with a veneer of doubtful mathematics.

I had established a way of doing business to a point where it no longer presented any basic problems

Benjamin Graham

Since we can't see the future, Graham thought it best to make his results independent of it, absolving the investor of performing any calculation beyond basic arithmetic.

Graham's critics, and even some disciples such as Warren Buffett, the world's most famous living investor, counter that Graham's bargains are often cigar-butt companies, old companies often in declining industries from which it's possible to draw one or two last puffs. Graham might argue that doesn't matter so long as you make a good return, but he also recognised that when prices are low even great companies become affordable.

Critics also complain the price of shares is so high most of the time, often very few com-

panies meet his strictest criteria. That's true of his favourite situation, companies selling at less than two thirds the value of their net working capital, or net-nets.

Bargain issues: net-nets

By net working capital Graham meant the current assets of a company, the value of its stocks, cash in the bank and debtors (for example customers that owe it money), minus all its liabilities.

Having disregarded the fixed assets of the company, property, equipment and intangibles that might be worth very little if it went bust and they had to be sold quickly, Graham found that companies with shares priced below the value of their net working capital (per share) were often cheaper than estimates of their liquidation value.

Graham found so many bargains on the stock market that much of the time he invested in little else. Companies at such low prices, he reasoned, would turn themselves around, succumb to bids, or liquidate at a profit to the shareholder.

The problem for modern value investors is that Graham was investing during the Great Depression and its aftermath. In prosperous times, net-nets are difficult to find. Ying Xiao and Glen Arnold of the University of Salford counted only seven net-nets listed in London in 2000, but during the recession of 1981 there were 74.

If you had invested in net-nets between 1981 and 2005 though, you would have done very well. Xiao and Arnold found that £1 million invested in a series of net-net portfolios, each held for five years, would have increased to £432 million whereas £1 million invested in the stock market would have increased to £34 million.

James Montier, an analyst at Société Générale, counts 13 net-nets listed on the FTSE All-Share in November. Half are housebuilders and property companies.

The number is rising as share prices fall, but there are still not enough to make a diversified portfolio of 20 or 30 shares, as Graham recommended. Although net-nets tend to recover strongly, individually they are more likely to go bust, perhaps even catastrophically, leaving investors with nothing. Buying a handful of net-nets, therefore, is risky.

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