

Benjamin Graham on Fixed Income

In his memoirs, Benjamin Graham describes the Wall Street environment he entered after he graduated from college in 1914. “When I started, investment was almost entirely limited to bonds. Common stocks, with relatively few exceptions, were viewed primarily as vehicles for speculation” (142). In subsequent years, Graham explains, stocks would gain respectability. Corporations, exchanges, and the financial services industry began to provide useful information on company operations and finances, while once-dominant insider influence on the prices of all securities gave way to more legitimate factors such as investment merit and intrinsic value.

This article explores Graham’s thoughts on fixed income securities. Our citations draw from the first edition of *Security Analysis*, published in 1934, and the final edition of *The Intelligent Investor*, published in 1973, three years before Graham’s death. In our opinion, the ideas espoused by Graham remain remarkably consistent across the nearly 40-year span between the publication of these two books, which represent his first and last major writings on investment. (Graham updated both of his investing books doggedly, revising them three times each in the decades following their initial release.)

BENJAMIN GRAHAM'S WRITINGS OVER TIME

		1930s	1940s	1950s	1960s	1970s
<i>Security Analysis</i>	year:	1934	1940	1951	1962	
	edition:	1 st	2 nd	3 rd	4 th	
<i>The Intelligent Investor</i>	year:		1949	1954	1959	1973
	edition:		1 st	2 nd	3 rd	4 th

HITTING THE BOOKS

Today, the legendary status afforded Graham’s investment acumen is paralleled by an appreciation of his commitment to sharing his insights. Beginning in the late 1920s, Graham taught a course on investing at Columbia University, his alma mater. David Dodd, an assistant professor of finance, was enlisted to take notes at Graham’s lectures, and these notes led to the publication of *Security Analysis*, a 700-page tome that captured Graham’s investment ideas. This book – often referred to as the value investor’s bible – currently stands as the longest running investment text ever published. *The Intelligent Investor*, a slimmer volume Graham wrote for the non-professional investor in 1949, also remains widely available.

Though Graham’s writings generally are cited in the context of investing in stocks, significant portions of his books address the fixed income asset class. For example, 21 of the 52 chapters in the first edition of *Security Analysis* deal directly with bonds, and several other chapters talk about fixed income investing at least tangentially.

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BEN GRAHAM ON FIXED INCOME

Early in *Security Analysis*, Graham explains the basic difference between stocks and bonds – and calls attention to a dangerous assumption that this difference tends to foster:

The bondholder has a fixed and prior claim for principal and interest; the stockholder assumes the major risks and shares in the profits of ownership.... Hence investors are led to believe that the very name “bond” must carry some especial [sic] assurance against loss. This attitude is basically unsound, and on frequent occasions is responsible for serious mistakes and loss. (57-58)

Indeed, Graham is careful to emphasize that the market prices of fixed income securities can be anything but stable, particularly for bonds with longer maturities. In *The Intelligent Investor*, he gives the example of very long-term Northern Pacific Railway bonds scheduled to mature in 2047. In 1920, these bonds were trading below the \$50 level on concerns about their safety. The concerns abated, and by the mid-1940s the bonds traded for more than \$90. In 1970, however, the bonds’ price had slipped into the \$30s, “chiefly because of the rise in general interest rates” (111).

Once an investor has absorbed this lesson, where should he or she turn to begin investing in fixed income securities? Graham believes that, before diving into issue-by-issue number crunching, would-be bond buyers need to look in the mirror and conduct some self-analysis. As he puts it in *The Intelligent Investor*, the right approach to bond investment “depends in the first place on a choice by the investor of either the defensive (passive) or aggressive (enterprising) role.”

The aggressive investor must have a considerable knowledge of security values – enough, in fact, to warrant viewing his security operations as equivalent to a business enterprise. There is no room in this philosophy for a middle ground, or a series of gradations, between the passive and aggressive status. Many, perhaps most, investors seek to place themselves in such an intermediate category; in our opinion that is a compromise that is more likely to produce disappointment than achievement. (90-91)

Graham notes that most people do not have the time, the determination, or the “mental equipment” the aggressive role requires, and therefore he believes most investors should place themselves in the defensive group. In *Security Analysis*, he recommends that these investors limit their fixed income investments to government securities and to the bonds of only the largest and most established companies. “A cautious investor...would apparently be justified in deciding to confine his purchases of fixed-value [corporate] bonds to perhaps the half dozen leading units in each industrial group” (98).

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For true security analysts, however, Graham believes that there is one group of both stocks and bonds that are particularly worthy of investigation. The preface to *Security Analysis* hints at the significance of this group, which the book goes on to discuss in detail: “In dividing our space between various topics...we have stressed the technique of discovering *bargain issues* beyond its relative importance in the entire field of investment, because in this activity the talents peculiar to the securities analyst find perhaps their most fruitful expression” (vii).

For bonds, Graham explains that “bargain issues” mean “those senior securities which the purchaser may regard as safe investments, but which nevertheless sell at so low a price as to offer a chance of considerable enhancement in market value.” Graham acknowledges that many readers might protest that low prices for bonds indicate that their safety is questionable. “Admitting that in the great majority of instances this observation is correct, the fact remains that market prices are not an infallible measure of value, and hence that there will always be a small minority of cases in which the price may be speculative but the security measures up to strict investment standards” (237).

Of course, identifying bargains among bonds is no easy task. Graham recommends that the “untrained investor” think twice before joining the hunt, “because his search is likely to lead him astray into the acceptance of unsound securities.” For “the experienced and capable analyst” who possesses the necessary time and determination, however, Graham believes that this field offers opportunities greater than its restricted size would indicate:

If he has mastered the technique of the selection of sound fixed-value investments, he can apply his skill most effectively to the discovery of safe issues selling at low prices. This work requires the painstaking examination of literally hundreds of securities in order to find a mere handful of this desirable character, and they must then be subjected to especially critical study in order to detect concealed elements of weakness. (240)

WHENCE THE BARGAIN ISSUES?

So where do bargain bonds come from? Graham believes that, as with stocks, discrepancies between price and value arise because of the vagaries of the market, where sentiment can shift from sweeping, carefree optimism to overwhelming fear and uncertainty seemingly overnight. From *Security Analysis*: “Evidently the processes by which the securities market arrives at its appraisals are frequently illogical and erroneous. These processes...are not automatic or mechanical, but psychological, for they go on in the minds of people who buy or sell” (585).

In *The Intelligent Investor*, Graham elaborates on the market’s irrationality, pointing to two primary sources of bargain prices: temporary tough times and a longer-term lack of esteem. “The market is fond of making mountains out of molehills and exaggerating ordinary vicissitudes

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into major setbacks. Even a mere lack of interest or enthusiasm may impel a price decline to absurdly low levels. Thus we have what appear to be two major sources of undervaluation:

1. disappointing results
2. protracted neglect or unpopularity” (83).

TWO FAMILIAR KEYS: A MARGIN OF SAFETY AND DIVERSIFICATION

Like his philosophy regarding common stocks, Graham’s approach to fixed income is centered on the concept of the margin of safety. Simply put, the margin of safety is the difference between a security’s market price and its value. Graham believed that bonds offering this margin represented compelling opportunities, even if their issuers might not be very attractive in terms of earnings power or balance sheet strength. “It is our argument,” he writes in *The Intelligent Investor*, “that a sufficiently low price can turn a security of mediocre quality into a sound investment opportunity – provided that the buyer is informed and experienced and that he practices adequate diversification” (284).

On the topic of diversification, Graham makes an interesting connection between investing and insurance. First, he notes that any individual security purchase may not prove profitable, even if a margin of safety is present at the time of purchase. “For the margin guarantees only that he has a better chance for profit than for loss – not that loss is impossible. But as the number of such commitments is increased the more certain does it become that the aggregate of the profits will exceed the aggregate of the losses. That is the simple basis of the insurance-underwriting business” (282).

“IF YOU SPECULATE...”

In 1914, Ben Graham – freshly graduated from Columbia University – interviewed with Alfred H. Newburger, a senior member of the firm that would give Graham his first job in investing. As Graham describes in his memoirs, the tall and grey-haired Newburger “spoke with great earnestness and authority” of the opportunities available on Wall Street “for the right kind of man.” After finalizing the terms of Graham’s employment, Newburger raised a finger and closed the interview sternly: “One last warning, young man. If you speculate, you’ll lose your money. Always remember that” (127).

Graham never forgot this advice; he went on to eschew speculation in both his day-to-day investment operations and in the investing philosophy he taught at Columbia and recorded in *Security Analysis* and *The Intelligent Investor*. Graham’s preferred approach was true investment.

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Across his writings, he defined an investment operation as one which “upon thorough analysis promises safety of principal and an adequate return.”

For fixed income securities – much like common stocks – Graham believed that investment typically meant purchasing generally safe securities at prices below their true values. While he advised lay investors to resist the urge to search casually for these undervalued bonds, Graham thought professional security analysts could take advantage of bargain prices for select issues. He believed the following traits were keys to success: the time, determination, and experience necessary to do the job right – as well as familiarity with the concepts of diversification and a margin of safety. As Graham saw it, each of these elements helps pave the path to successful fixed income investment.

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