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Why 1925?

The Martin Capital Management Q2 2014 commentary ("Slaying Goliath") left readers in suspense. It closed with a cliffhanger question … and a promise that it would be answered in the Q3 2014 edition now in your hands or on your screen. The question: Why did the "Dean of Wall Street,"[1] Benjamin Graham, single out 1925 (not the more fortuitous years of 1926–29) in the following quotation from the first edition of *The Intelligent Investor* published in 1949?

> ***It is worth pointing out that assuredly no more than one out of 100 who stayed in the market after 1925 emerged from it with a net profit and that the speculative losses taken were appalling.***[2]

Before attempting to answer the question posed above, we suspect you'll want to know more about Ben Graham and why you should read what this man from an earlier era had to say. You will no doubt need to be satisfied that he was qualified to pen the words cited above 20 years after the great market crash. To close the link between then and now, let's reflect on the relevance today of what Graham wrote to investors in 1949.

In an attempt to provide a balanced view, consider at the outset Graham's presumptively most qualified and outspoken critic who recently held sway on the matter. Charlie Munger, 90, as most readers know, is Warren Buffett's alter ego and comic straight man at the Berkshire Hathaway annual meetings. However, when Charlie is center stage and unshackled, he morphs into the saucy, outspoken curmudgeon we've come to love and admire. During an interview with *The Wall Street Journal's* Jason Zweig at the annual meeting of Daily Journal Corp., the small publishing and software company that Munger chairs, Charlie gave his own candid assessment of the investment wisdom of Buffett's mentor, Ben Graham.

While first noting the uniqueness of the long and reverential relationship Buffett had with Graham, Munger nevertheless cuts to the quick: "Graham had a lot to learn as an investor. His ideas of how to value companies were all shaped by how the Great Crash and the Depression almost destroyed him, and he was always a little afraid of what the market can do. It left him with an aftermath of fear for the rest of his life, and all his methods were designed to keep that at bay." Concluding on a higher note, he conceded that Graham was a "good writer and a very good teacher and a brilliant man, one of the only intellectuals—probably the only intellectual—in the investment business at the time."[3]

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[1] Graham, Benjamin. *Benjamin Graham: The Memoirs of the Dean of Wall Street* (1996, McGraw-Hill). Graham's autobiography was edited by Seymour Chatman and published 20 years after Graham's death in 1976.
[2] Graham, Benjamin. *The Intelligent Investor: The Classic Text on Value Investing* (1949, HarperCollins), p. 34. Incidentally, Prem Watsa cited this same quotation in the 2013 Fairfax Holdings annual report, though paraphrasing it to read, "From the distant past comes the warning of our mentor, Ben Graham, whom I have quoted before: 'Only 1 in 100 survived the 1929–32 debacle if one was not bearish in 1925.'"
[3] Zweig, Jason. "A Fireside Chat With Charlie Munger," *The Wall Street Journal*, September 12, 2014.

My own once-removed view is a kinder and gentler variation on the Munger theme. I've studied the books for which Graham is most remembered:

- *Security Analysis,* from the relatively recent photographic reprint of the first edition published in 1934, my clear favorite, to the 1962 edition which was the text for a course by that name with which I was enthralled while a student at Northwestern.
- *The Intelligent Investor* (1949) and subsequent editions, including 1959, 1965, and 1973 (in which Graham had a hand) that went to print before his death in 1976.
- *Benjamin Graham—The Memoirs of the Dean of Wall Street,* published posthumously in 1996.

His books have arguably approached the status of modern classics. Such distinction speaks not only to the brilliance of his insights into the essential and transcendent nature of the difference between investment and speculation, but every bit as much to the predictably irrational and unpredictably cyclical behavior of the actors in the financial economy. From my early studies in the 1960s, I've always thought of Benjamin Graham as the archetypal financial philosopher, a thinker with few contemporary equals. An anomaly in our profession, it would be an insult to his memory to score his contributions merely in dollar terms.

There is little doubt that Graham's perspective, like all of ours, including that of Charlie Munger, was shaped by the times in which he lived. Born Benjamin Grossbaum in 1894, the precocious Graham graduated as salutatorian from Columbia University in 1915 after just 2½ years, with the further prestige of being invited to teach in three different departments: literature, philosophy, and mathematics. Instead, he left academia for Wall Street. With exquisite detail provided in his memoirs, Graham enjoyed notable success from 1915 to 1925, a time that included World War I and the depression of 1921.

To provide context, during the bull market of the 1920s, the Dow Jones Industrial Average had risen 144% from 1921 to 1925, but it was still only halfway up the mountain. The Dow continued its advance from 156 in 1925 to its peak at 381 in October 1929, another 144%, before its ignominious collapse of almost 90%, sinking to 41 by June 1932. Quoting from *A Decade of Delusions*:

> At the quarter-century mark of 1925, the great bull market was under way, and Graham, then 31, developed what he later described as a "bad case of hubris." During an early-1929 conversation with business associate Bernard Baruch (about whom he disparagingly observed, "He had the vanity that attenuates the greatness of some men"), both agreed that the market had advanced to "inordinate heights, that the speculators had gone crazy, that respected investment bankers were indulging in inexcusable high jinks, and that the whole thing would have to end up one day in a major crash." Several years later he lamented, "What seems really strange now is that I could make a prediction of that kind in all seriousness, yet not have the sense to realize the dangers to which I continued to subject the Account's[4] capital." In mid-1929, the equity in the "Account" was a proud $2,500,000; by the end of 1932, it had shrunk to a mere $375,000. The dismay and apprehension Graham experienced during those three long years he summarized by saying:

[4] The Benjamin Graham joint account established on January 1, 1926.

> The chief burden on my mind was not so much the actual shrinkage of my fortune as the lengthy attrition, the repeated disappointments after the tide had seemed to turn, the ultimate uncertainty about whether the Depression and the losses would ever come to an end. … Add to this the realization that I was responsible for the fortunes of many relatives and friends, that they were as apprehensive and distraught as I myself, and one may understand better the feeling of defeat and near-despair that almost overmastered me towards the end.[5]

As for Graham's investment acumen about which Charlie Munger spoke with faint praise at best, I would not be quite so harsh. Graham, it should be noted, did not ply his trade in the best of investment times. The Dow, excluding dividends,[6] advanced roughly fivefold during his 40-year career ending with his retirement in 1956. By stunning contrast, the Dow increased 35-fold after Charlie Munger joined Buffett in 1959. Moreover, to the outside observer it doesn't appear that Munger was ever traumatized by anything comparable to the disorienting "new era" whipsaw of 1927–33.

As best I can determine, Graham exhibited extraordinary brilliance, skill, and equanimity of temperament during unquestionably the most unsettling investment period in the 20th century. Writing the scholarly *Security Analysis* from 1932 to 1934 dispassionately and with remarkable lucidity, to say nothing of being almost "overmastered" in the midst of his own travails from 1930 to 1933, Graham's detachment appears superhuman. The trials imposed by the compressed carnage from September 2008 through March 2009 seem insignificant by comparison.

Make no mistake, though: A single investment is credited with cementing Graham's record. The Graham-Newman Corporation was launched in 1936. Twelve years later it committed 20% of its capital to buy 50% of GEICO for $712,000 and Graham became chairman. By 1972 the value of the investment had grown to $400 million. In Graham's own words: "In 1948, we made our GEICO investment and from then on, we seemed to be very brilliant people." For the record, Jason Zweig, one of the foremost authorities on Benjamin Graham, has noted that Graham broke several of his own rules with GEICO. Two of note include: Never put more than 5% of your money on one horse, and sell it once it no longer qualifies as a value investment.[7]

In a self-effacing postscript, Graham acknowledged—sort of—the role of serendipity:

> Ironically enough, the aggregate of profits accruing from this single investment decision far exceeded the sum of all the others realized through 20 years of wide-ranging operations in the partners' specialized fields, involving much investigation, endless pondering, and countless individual decisions. Are there morals to this story of value to the intelligent investor? [One] is that one lucky break, or one supremely

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[5] Martin, Frank K., *A Decade of Delusions: From Speculative Contagion to the Great Recession* (2011, Wiley & Sons), pp. 13–14.
[6] Unlike today, dividends represented the bulk of long-term market returns in Graham's time. They averaged 5.6% during his career (1916–56) compared with an average of less than 2% since 1995.
[7] Graham closed the Graham-Newman Corporation in 1956 when he retired. It is assumed that the corporation's investment in GEICO was distributed in kind.

> shrewd decision—can we tell them apart?—may count for more than a lifetime of journeyman efforts.[8]

Yet the GEICO saga would be irresponsibly incomplete if we were to stop there. In the mid-1970s, the company ran into serious financial problems, the result of extremely rapid growth combined with new and onerous government regulations, such as no-fault insurance requirements. From the summit of success to the dregs of disgrace, the stock plunged from a high of $61 per share in 1972 to a paltry $2 per share in 1976, unceremoniously the year Graham died. I don't know when Graham or his heirs sold their GEICO shares. That matter notwithstanding, the rest of the story, at least to date, can be found at the conclusion of this commentary.

With that hopefully credible historical profile of Graham as preamble, we return to the original question: Why, in the first edition of *The Intelligent Investor* (1949), did Graham determine 1925 as the point in the 1921–29 bull market when the intelligent investor had to step away from the fray in order to avoid being sucked into the black hole of the 1929 market collapse? To begin, Graham identifies the largely emotion-driven dilemma investors faced then (and quite likely today):

> Many conservative investors actually sold out their stocks in 1925 or 1926, believing the market was too high. Probably the majority of them were later so carried away by the market's insistent advance as to blame themselves for a foolish blunder in selling, and therefore returned to the buying site at much higher levels. Similarly, many of those who bought in the declining market after 1929 were demoralized by its subsequent fall to completely unexpected depths. These fluctuations, of course, were unique in their amplitude, but even in more normal markets the typical investor feels uncomfortable when he buys too soon and unhappy when he sells too soon. Yet to be a true practitioner of the buy-low-sell-high rule he must be entirely ready to do both.[9]

Perhaps Graham concluded that 1925 was the inflection year when investment conspicuously morphed into speculation, when prudence succumbed to the fascination of markets' self-reinforcing positive feedback loops, where advancing prices begat ever-higher prices (even as they departed further from the flagging growth in intrinsic value). For the reader's edification, the 10-year real moving average of S&P earnings, which peaked around $30 during World War I, fell to less than $5 in the depths of the short-lived depression in 1921.[10] Recovering with the economy to $16 by 1925, earnings flatlined at that level until decimated by the Great Depression.

Additionally, in the archives[11] one finds that, for the first time in the 1920s, broker's loans (funds borrowed to purchase stocks on "margin") spiked in 1925, eclipsed only by 1928 (calendar 1929 would've been included were it not for balances collapsing concurrent with the market in the fourth quarter). Equally telling, until late 1924 the New York City banks made the majority of broker's loans. As other financial institutions across the country were discovering the font of easy money,

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[8] Graham, Benjamin, *The Intelligent Investor,* 4th revised edition (2006, Collins Business Essentials), Postscript, p. 533.
[9] Graham, Benjamin, *The Intelligent Investor* (1949, HarperCollins) pp. 33–34.
[10] For those interested in learning more about this topic, please see the text box at the end of this commentary regarding Jim Grant's forthcoming book, *The Forgotten Depression—1921: The Crash That Cured Itself.*
[11] http://www.thebhc.org/publications/BEHprint/v017/p0129-p0142.pdf

the New York City banks' market share began to drop precipitously beginning in 1925, reaching a low of 13% in the quarter preceding the collapse.

Graham, the philosopher and the teacher, was more circumspect as he wrote in 1949:

> A more basic kind of psychological problem, however, is inherent in the simple maxim of buying in low and selling in high markets. The practice might be easy if the market were something impersonal. Actually it is people generally who make high and low markets, because they are optimistic (and greedy) in high markets and pessimistic (and disgusted) in low markets. How can you—the general reader representing the public at large—be expected to act otherwise than the public acts? Does not this mean that you are doomed, by some laws of logic, to buy when you should be selling and to sell when you should be buying?
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> This point is vital. The investor cannot enter the arena of the stock market with any real hope of success unless he is armed with mental weapons that distinguish him in *kind*—not in a fancied superior *degree*—from the trading public ... But, if the investor intends to buy and sell recurrently, his weapons must be a frame of mind and a principle of action which are basically different from those of the trader and the speculator. He must deal in values, not in price movements. He must be relatively immune to optimism or pessimism and impervious to business or stock market forecasts. In a word, he must be psychologically prepared to be a true investor and not a speculator masquerading as an investor. If he can meet this test, he will be a member not of the public at large but of a specialized and self-disciplined group.[12]

Graham did not overlook another conundrum investors faced at the time:

> Duration or frequency of the [market] swings has changed considerably since 1921. This is an added obstacle to the pleasing prospect of investing regularly in low markets and selling out in high ones … Between 1899 and 1921 the market made five definable highs and lows, averaging about four years. Since then there have been only two clear-cut swings and the intervals between the low points have been 11 years and 10 years, respectively. An investor nowadays is likely to grow uneasy and impatient while waiting for his cyclical buying opportunity to reappear. In the meantime, also, his funds will bring him no interest in the bank or only a negligible rate if placed in short-term securities. Thus he can lose more money in dividends forgone than he can ever gain from buying at eventual low levels.[13]

Since the average dividend yield from common stocks was 6% during those 50 years—and constituted much of the total return from common stocks—being out of the market was indeed costly. With dividend yields averaging less than 2% since 1995, the opportunity cost expressed in dividends forgone is noticeably less and thus the cost of patience today is far less onerous than it was for investors of that earlier era.

As to the second question posed at the outset, of what relevance is 1925 for us today? As evidenced by MCM portfolio management decisions implemented in April 2010—after the market

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12 Graham, Benjamin, *The Intelligent Investor* (1949, HarperCollins) pp. 33–34.
13 Graham, ibid., p. 35

had risen 61% from early 2009[14]—I believe there is a possibility, however remote, that *2010 may be remembered as our generation's 1925*. The probability and timing of rare and anomalous events are not calculable; the consequences are somewhat more knowable. Accordingly, in order to make decisions that do not result in destruction of wealth, one must focus on outcomes and not the unknowable probabilities. This is the central idea behind coping with uncertainty, and much of our firm's decision making is based on it. In a lifetime filled with yet unrevealed opportunities, one might end up missing them all because of one colossal, wealth-destroying failure. That certainly is the legacy of 1925.

When the Federal Reserve launched QE2 late in 2010—an action I did not anticipate, having assumed the Fed was neither that desperate nor that irresponsible[15]—the uncoupling of the prices of risk assets from underlying values accelerated, similar to the post-1925 market environment about which Benjamin Graham wrote. While the markets in risk assets ascended on cue (or one might say, "on QE2"), other vital parts of the economy have not responded as expected by central planners, including GDP, net employment (i.e., labor force participation rate), and financial stability – all presumed to be primary beneficiaries of experimental macro policies.

Unlike the "Roaring Twenties," and all that era symbolizes, the 67% rise to recent highs in the S&P 500 since the spring of 2010 has been, at least at the lay-investor level, *need*-based rather than *greed*-based, as the Fed effectively closed the door on any and all safe-harbor alternatives. The need was exacerbated because what was already an acute problem before the crisis of 2007–09—that the share of national income earned by the bottom 90% fell to 25%, an extreme of income inequality reached only once before, in 1928—has subsequently become a crisis.[16] In an economy where 70% of spending comes from consumers, is it logical to expect the top 10% to spend us back to prosperity?

No one can forecast the timing or circumstances that may sooner or later result, amidst the ashes, in the greatest investment opportunity of our lifetime. As much an admonition to those of us who present ourselves as investment managers as to those who aspire to be prudent stewards of their own capital, the following quotation from *A Decade of Delusions* is offered to those readers who, as Graham would sympathize, are understandably both weary … and wary. I note with a sense of foreboding that *no more than one in 100 will give credence today to what Graham wrote below in 1934*. Were such forward-thinking wisdom widely embraced, little purpose would be served by including it here:

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[14] From the end of February 2009 through April 2010, MCM equities were up 154%. The S&P 500 Index during the same time period rose 61%.

[15] It appears others were equally shocked. In an open letter to Ben Bernanke (http://www.hoover.org/research/open-letter-ben-bernanke) on November 15, 2010—less than two weeks after QE2 was announced—a group of prominent, nonconformist, forward-thinking economists, investors, and political strategists did not equivocate. Stating that QE2 was neither necessary nor advisable, they concluded that it should be reconsidered and discontinued. They argued that it could lead to currency debasement and inflation and that it would not achieve the Fed's goal of promoting employment. They disagreed that inflation needed to be pushed higher and worried that another round of asset purchases, with interest rates still near zero over a year into the recovery, would distort financial markets and greatly complicate future Fed efforts to normalize monetary policy. The Fed responded, stating it was "confident that it has the tools to unwind these policies at the appropriate time." As regards all of the above, see MCM 2013 Annual Report, p. 10: "The Folly of Forecasting." All signatories recently surveyed—now four years later—say they still feel the same way: (http://www.bloomberg.com/news/2014-10-02/fed-critics-say-10-letter-warning-inflation-still-right.html).

[16] Piketty, Thomas. *Capital in the Twenty-First Century* (Bellknap Press, 2014), p. 297.

The Rise and Fall of Security Analysis

> In the introduction to the scope and limitations of security analysis, Graham described the preceding three decades as a period during which its prestige experienced both a "brilliant rise and an ignominious fall":
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> > *But the "new era" commencing in 1927 involved at bottom the abandonment of the analytical approach; and while emphasis was still seemingly placed on facts and figures, these were manipulated by a sort of pseudo-analysis to support the delusions of the period. The market collapse in October 1929 was no surprise to such analysts as had kept their heads, but the extent of the business collapse which later developed, with its devastating effects on established earning power, again threw their calculations out of gear.* [Italics added.] Hence the ultimate result was that serious analysis suffered a double discrediting: the first—prior to the crash—due to the persistence of imaginary values, and the second—after the crash—due to the disappearance of real values.[17]

Since Graham's voice can no longer be heard, it is incumbent upon those of us who fancy ourselves at least somewhat philosophical to write as he might have written were he alive today—and to practice our trade as if he were looking over our shoulders.

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[17] Martin, ibid., pp. 14–15.

GEICO: The Rest of the Story …

Warren Buffett was introduced to GEICO in 1950 while he was Benjamin Graham's student at the Columbia Business School. The prodigious intellectual capacity of Buffett's instructor and mentor at Columbia allowed Graham to be both practitioner and professor, having returned in 1928 to teach at his alma mater. It was in that setting that he and David Dodd wrote *Security Analysis* in the depths of the Great Depression.

Due to his relationship with Ben Graham, Buffett was already on GEICO's board of directors in the early 1970s, though he was not then an investor. Presented with a distressed company that he thought he could help turn around, Buffett and his company, Berkshire Hathaway, began buying shares at a little over $2/share. In just one year, GEICO returned to profitability.

Through the years, Buffett steadily increased Berkshire's stake in GEICO, until he bought the remaining 49% of it in 1995 for $2.3 billion. Since GEICO is no longer a publicly traded company, it is not possible to determine Buffett's exact gain, though it can be approximated. One investment manager whom I respect estimates the market value of GEICO at $14 billion versus Buffett's all-in cost basis of $2.4 billion for a gain of $11.6 billion, an annual compounded rate of return from 1995 of 9.2%.

With change being the only constant in life, there are no doubt more fascinating, and possibly surprising, chapters yet to come in the GEICO book.

The Forgotten Depression
1921: The Crash That Cured Itself
by James Grant

Jim Grant's latest book, *The Forgotten Depression—1921: The Crash That Cured Itself*, will be available November 11, 2014. Grant, whose work I have long admired, gives an account of the deep economic slump of 1920–21 and proposes, with respect to federal intervention, "Less is more." The book is a free-market rejoinder to the Keynesian stimulus applied by Presidents Bush and Obama to the 2007–09 recession, in whose aftereffects, Grant asserts, the nation still toils.

Grant tells the story of America's last governmentally untreated depression. Relatively brief and self-correcting, it gave way to the Roaring Twenties. His book appears in the fifth year of a lackluster recovery from the overmedicated downturn of 2007–09.

In 1920–21, Woodrow Wilson and Warren G. Harding met a deep economic slump by seeming to ignore it, implementing policies that most 21st-century economists would call backward. Confronted with plunging prices, wages, and employment, the government balanced the budget and, through the Federal Reserve, raised interest rates. No "stimulus" was administered, and a robust, job-filled recovery was under way by late in 1921.

In 1929 the economy once again slumped—and kept right on slumping as the Hoover administration adopted the very policies that Wilson and Harding had declined to put in place. Grant argues that well-intended federal intervention, notably the White House-led campaign to prop up industrial wages, helped to turn a bad recession into America's worst depression. He offers the experience of the earlier depression as lessons for today and the future. This is a powerful response to the prevailing notion of how to fight recession. Grant demonstrates that the free-enterprise system is more resilient than even its friends often acknowledge. (*This description provided by Amazon.com:* http://www.amazon.com/Forgotten-Depression-Crash-Cured-Itself-ebook/dp/B00IWTWSS8/ref=sr_1_1?ie=UTF8&qid=1413385641&sr=8-1&keywords=james+grant+1921)