

## Markets

# Heed the harsh lessons of history to find value



**John Authers**  
THE LONG VIEW

*"A day like today is not a day for, sort of, soundbites, really - we can leave those at home - but I feel the hand of history upon our shoulders, I really do."*  
Former UK prime minister  
Tony Blair

It is easy to see how Tony Blair felt as he responded to the agreement that led to peace in Northern Ireland.

It is now plain that we are living through what history will almost certainly call the second great crash in stock markets. The hand of history is so heavy on our shoulders that it is hard to respond with more than soundbites, or to see any opportunities that this appalling loss of wealth may have given us.

My life with Benjamin Graham over the past month illustrates this.

Graham was an academic at Columbia University in New York. In the worst days of the 1930s, he worked out a way to invest profitably in the stock market, now known as "value investing". Rather than attempt to time the market, he said investors should look at exactly what a company was worth, and how much it would be worth if the worst came to the worst.

This meant you should look at a company's assets on the balance sheet, and also look at its ability to produce cash. If the company is so cheap that its value would scarcely be less if it

were to go out of business, then you have what Graham called a "margin of safety". And if the company looks cheap compared with a conservative forecast of the cash it will generate, then the chances are that "Mr Market", as Graham would say, has mispriced it, and that you will make a lot of money once that mispricing is corrected.

Thus you have an asymmetric bet; heads you win a lot, tails you do not lose much.

This was a great way to profit in the Depression. Confidence had collapsed, but in the process it had brought down the prices of many companies that were still healthy.

Value investing still has many adherents, but also detractors. The most common line against the strategies Graham, and his colleague David Dodd, laid out in a classic tome called *Security Analysis*, is that the measures he uses worked in the extreme conditions of the 1930s, but were no longer relevant.

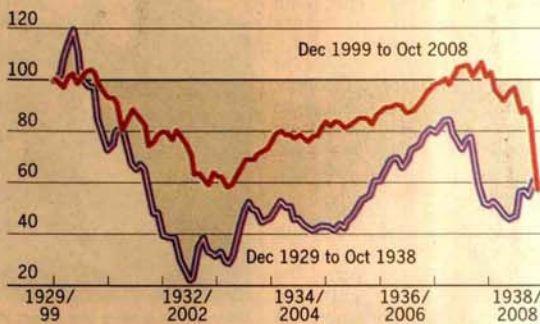
To address this, a sixth edition of *Security Analysis* came out last week. Each chapter had a preface by a current-day investment manager on how to apply Graham's insights today.

It was a big publishing event, but I could not get along to the launch. The book remains unread on my desk. The "hand of history" - watching the historic collapse in share prices - kept me at my desk.

This is ironic. The very extremity of last week's crash made it hard to keep an eye out for bargains in the methodical way Graham laid out 75 years ago.

A deeper irony is that there may not have been any need to update the book. Stock market

**The thirties and noughties**  
S&P 500 index (rebased)



Source: Thomson Reuters

conditions look ever more like the 1930s.

The noughties are much more similar to the 1930s than commonly thought. In morning trading yesterday, the S&P 500's fall for the decade was almost identical to its fall for the decade on the same date in 1938. The pattern of the two decades is freakishly similar, with a big sell-off followed by a prolonged rally and then a fresh bear market. The key difference is that the sell-off in this decade before the "fools' rally" began was far less severe than in the 1930s.

This, we can now see, was because cheap credit had inflated a new bubble.

This is what followers of Graham had argued. They said the market during the twin lows of the WorldCom crisis in 2002 and the invasion of Iraq in 2003 was still not cheap. Dividend yields, for example, were still barely half their level of the mid-1990s, before the tech bubble took hold.

But the similarities between the market tops in 1929 and 2000 are compelling. Both saw wildly overvalued stock markets and economies that were still in decent shape.

Measures based on cash, such as dividend yield or cash flow multiples, show that the market is now much cheaper than it was during the false bottom of 2002-03, even if overall indices are still higher.

We are not, therefore, in a new 1929. Our position is more similar to that of the late 1930s. That is not so encouraging: in the decade after October 10 1938, the S&P gained 5 per cent.

But at least we have a clear historical comparison, and a clear guide for how to proceed. Providing you are not using borrowed money, and you can afford to wait a matter of years for Mr Market to thrash out his problems, then *Security Analysis* is all you need.

Do not try to work out how long the market will take to recover or when it will hit bottom - that task is impossible. Use basic balance sheet methods to work out how much a stock is worth and how much it would be worth if the worst came to the worst. If that calculation leaves you with a margin of safety, then buy it. Don't let the hand of history gripping your shoulder stop you.