Summary of The Intelligent Investor (8 mins read)

Description

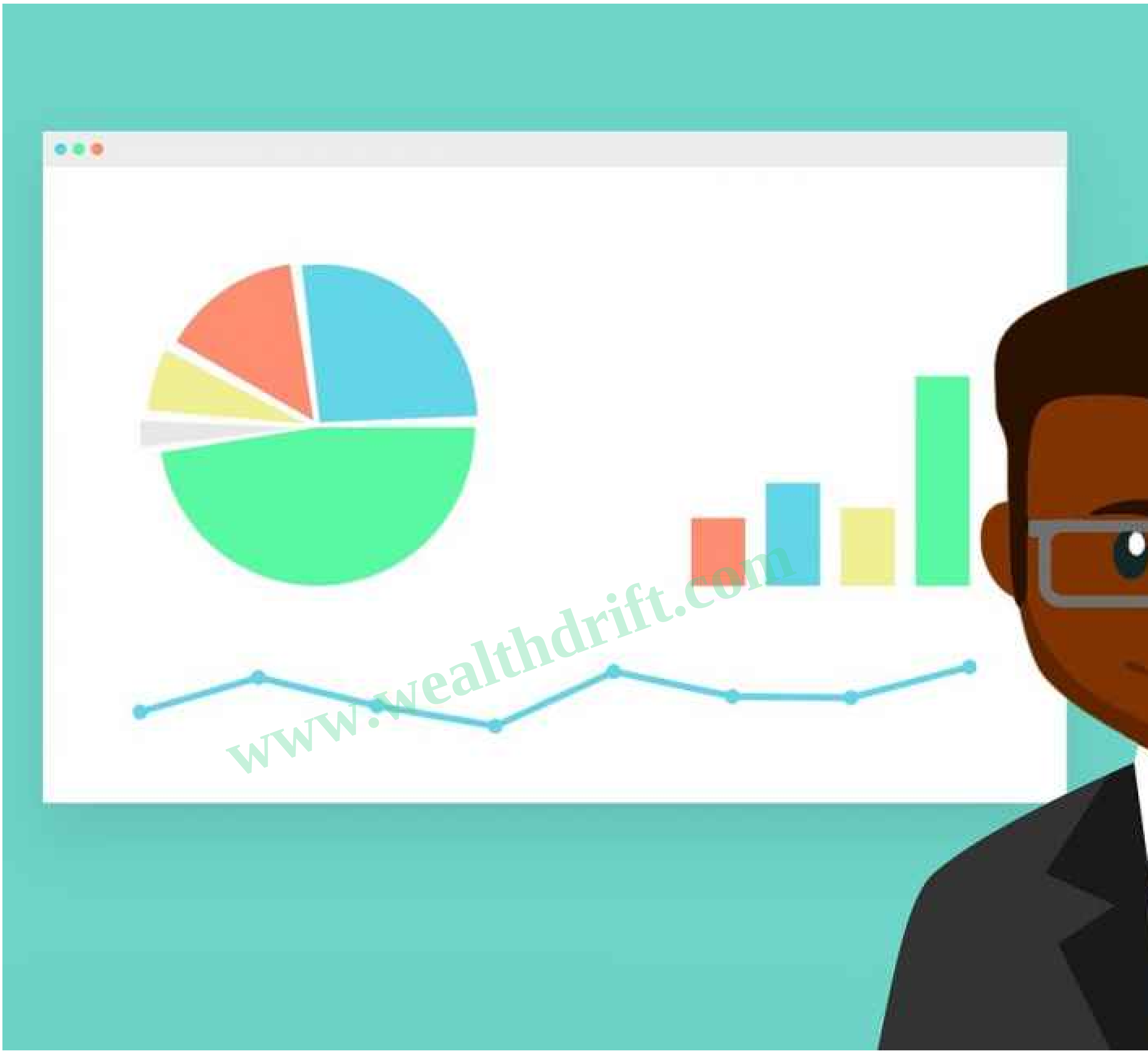
We, at WealthDrift, bring you a detailed article on a summary of the best lessons from one of the best-investing books of all time – “The Intelligent Investor” book written by Benjamin Graham who is also known as the father of “Value Investing”.

> *The secret to your financial success is inside yourself. If you become a critical thinker who takes no Wall Street “fact” on faith, and you invest with patient confidence, you can take steady advantage of even the worst bear markets.*
>
> *Benjamin Graham*

Here, in this article on summary of “The Intelligent Investor” book, we will cover the followings –

1. **Who are Speculators and Investors?**
2. **Who are Defensive and Enterprising Investors and their investment portfolios?**
3. **How to select common stocks for the portfolio if you are a defensive investor?**
4. **How to select common stocks for the portfolio if you are an enterprising investor?**
5. **Security (Stocks, bonds, etc.) analysis for a lay investor (beginner)**
6. **Value Investing and criteria to select value stocks**
7. **Other important lessons learned (summary) from “The Intelligent Investor” book.**

Before reading this article, we, at WealthDrift, recommend you to read our article on ‘Terminologies in Stock Market that an Investor needs to know‘ and ‘The Accounting Game’ – Book summary and its key lessons.



A. Who are Speculators and Investors?

Speculators – A speculator who cherishes a quick profit from the short-term price movement. Speculators are interested in anticipating the market price and profiting from the short-term movement. E.g. Day trader who keeps buying & selling securities daily.

Investors – An investor who looks for profit while investing long-term. Investors are interested in searching for good companies to invest in at the right price. E.g. Investors who invest in quality stocks for the long term.

B. Who are Defensive & Enterprising Investors?

Defensive Investors (Passive)–Defensive investors are those who make a permanent investment portfolio and seek conservative investments that require little effort and energy in portfolio management. These investors generally are well disciplined and do not get affected by prevailing market sentiments.

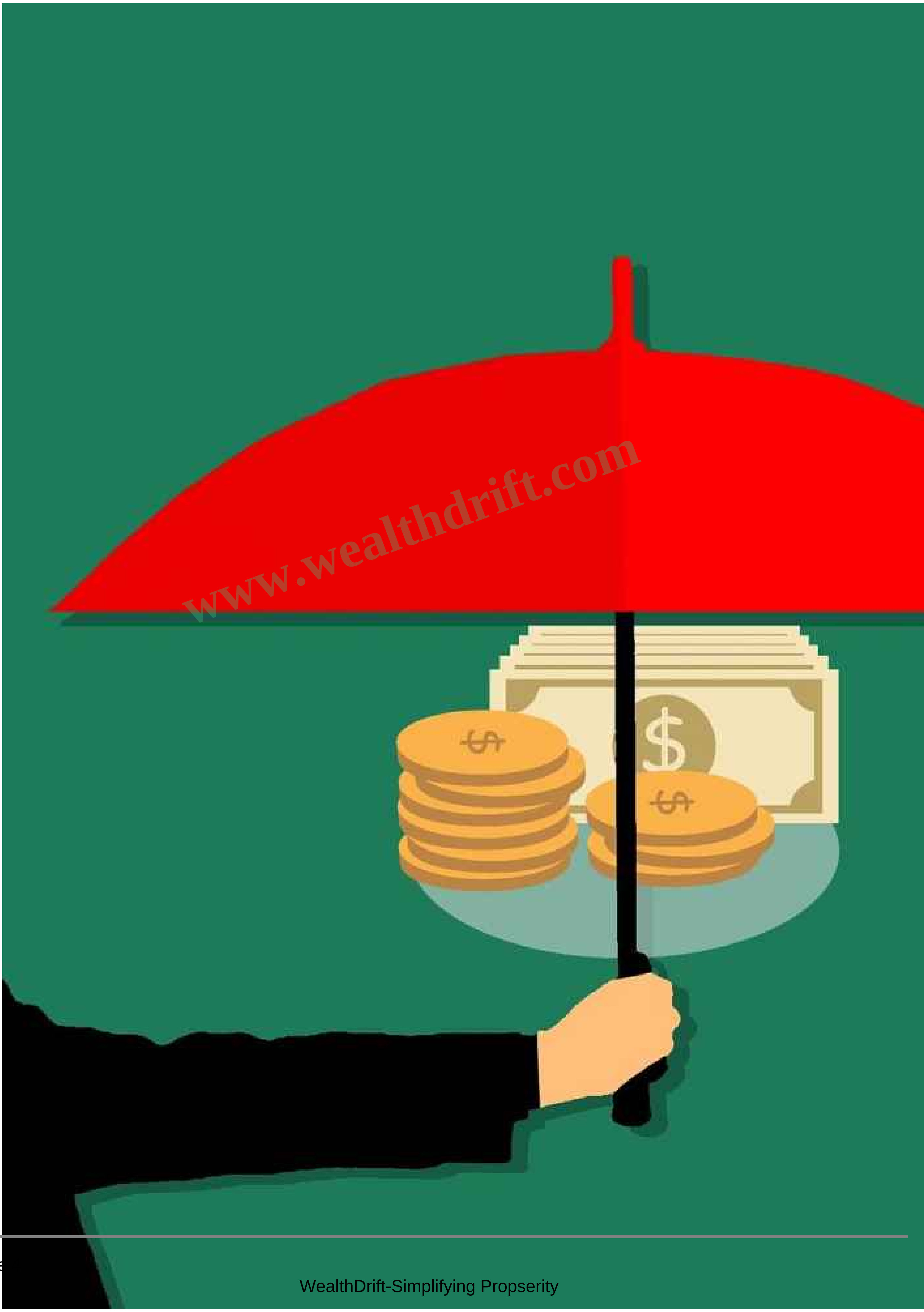
Defensive Investors' Portfolio – Stocks – 25% to 75%, Conversely for Bonds– 75% to 25% (Stick close to 50% stock and 50% bonds plan)

Advice to note – Keep high common stocks (equity) component in the portfolio in a down market and on the other hand, keep a high percentage of bonds (debt)component in the market which is dangerously high.

Enterprising Investors – This type of investor search for securities on a consistent basis and select the best available in the market. This investing style usually requires a high amount of energy and time, both physically and mentally at the investor's end.

Enterprising Investors' Portfolio – Buy growth stocks, stocks of larger unpopular companies, avoid lower-rated bonds and preferred stocks.

C. How to select common stocks for the portfolio if you are a defensive investor



Graham suggested below rules for stocks selection –

1. Adequate diversification but not in excess – minimum 10 to maximum 30 different issues.

2. Selected company should be large, well-known and conservatively financed

3. Selected company should hold a long record for continuous dividend payments (say, 20 years)

4. Limit the price you are willing to pay for an issue in relation to its average earnings –

- 25 times to average earnings for the past 7 years
- 20 times to average earnings for the past 12 month period

5. Adequate size of the enterprise should not be less than $100 million (now $2 billion).

6. Company should be sufficiently strong in financial condition –

- **Industrial Companies –**Current assets should be at least twice the current liabilities (2 to 1 current ratio); Long-Term debt should be less than the net current assets (or "working capital")
- **For public utilities –** The debt should be less than twice the stock equity (at book value).

7. Common stock should have earning stability i.e. positive earnings in the past 10 years.

8. Earnings Growth should be at least 1/3rd in per-share earnings over the past 10 years using 3-year averages at the beginning and end.

9. Stocks should have moderate Price/Earnings (P/E) ratio i.e. P/E < 15, here earnings are past 3 years average.

10. Stocks should have a moderate ratio of Price to Assets –

- The current price should be less than 1.5 times the book value last reported.
- Or, the Price/earnings ratio multiplied by 1.5 should be less than 22.5.

- ***Book Value –** Book value is the total worth of assets reflected in the balance sheet.*
- ***Note –** This criterion eliminates the category of growth stocks, nearly all the strongest and most popular companies from the portfolio* have been favorites of speculators and institutional investors.
- Growth Stocks – Some authorities define Growth Stocks as stocks that would double their per-share earnings in 10 years.
- The "Rule of 72" – Says that if you divide 72 by the rate of growth, you would get the time an amount of money takes to double. (For e.g. If the growth rate is 7.2% then 72 divided by 7.2 equal 10 i.e. an amount growing at a *7.2% growth rate yearly would take 10 years to double itself).*

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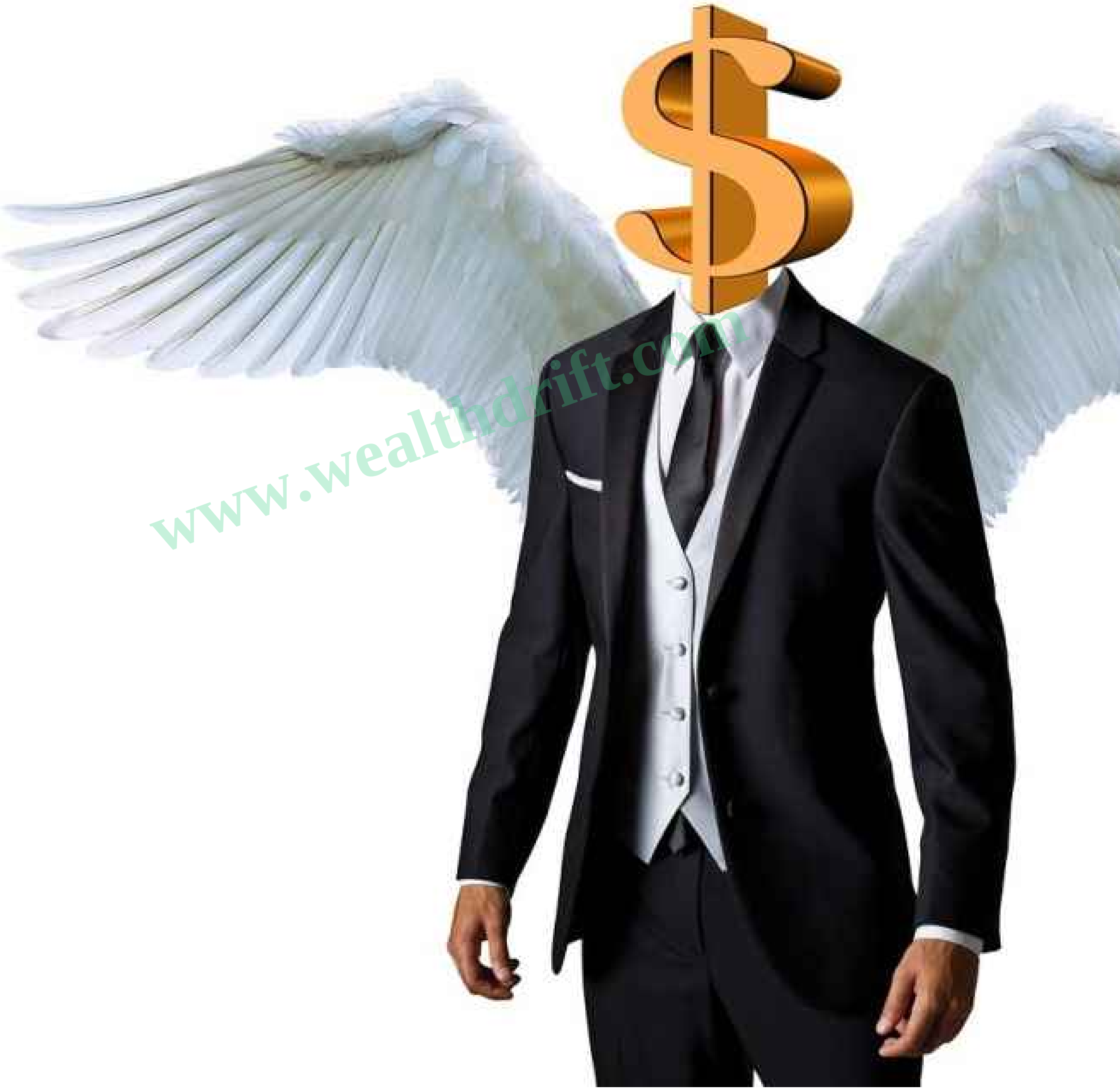
D. How to select common stocks for the portfolio if you are an enterprising investor?



The selected company should have strong financial conditions i.e. –

- Current assets should be at least 1.5 times the current liabilities
- Debt should not be more than 1.1 times the net current assets.

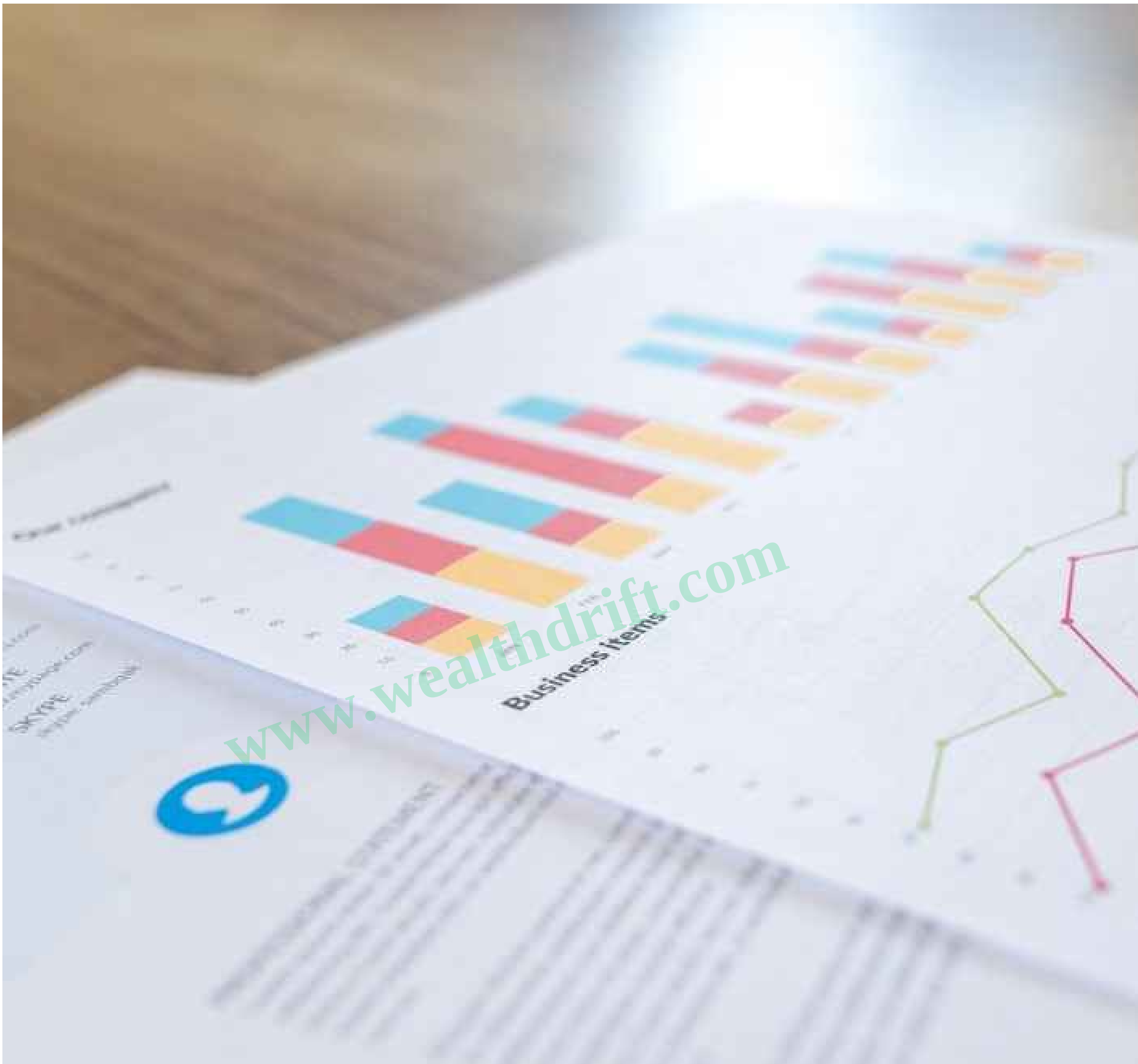
- Company stock should have positive earnings for at least 5 years.
- Company stock should be paying some dividends currently.
- Stock's current earnings should be greater than past years' earnings.
- The stock price should be less than 120% of net tangible assets.

Three investment approaches for the enterprising investor

a. **The Relatively Unpopular Large Company –**Enterprising investors should concentrate on the big companies that are going through a period of unpopularity. He/She should start with "low-multiplier'' investments i.e. low P/E ratios and in addition to low-multiplier, he/she looks for quantitative and qualitative requirements also in the investment.
b. Purchase of Bargain Issues– A bargain issue is when a security/issue, on analysis, indicates that is worth more than the market price. Graham suggests a true "Bargain" when an issue indicates a value at least 50% more than the market price i.e. 50% Margin of Safety.
c. **Special Situations, or "Workouts"**–"Special Situation" like the acquisition of smaller firms by larger ones, Arbitrage in the stock market, or buying bonds/stocks in bankruptcies that have good chances of return in the future, etc.

If you want to download the summary of The Intelligent Investor book by Benjamin Graham for free, then scroll to the end of the article for the pdf link.

E. Security (Stocks, Bonds) Analysis for a lay investor



Bond Analysis, factors & benchmarks

a. Earnings-Coverage Test (“Fixed-Charge Coverage Ratio”)–By this test, one would get to know that a bond is safer and secure if the issuing company issuing has significantly higher earnings that are required to pay the expenses associated with that bond.

Nowadays, referred to as Fixed-Charge Coverage Ratio and is calculated by dividing the sum of EBIT (Earnings before interest and charges) and Fixed charges before tax by the sum of fixed charges before tax and interest payments.

For e.g. Say, for a bond –

EBIT = $2 million,

Fixed Charges before tax = $0.4 million

Interest Payments = $0.15 million

Fixed-Charge Coverage Ratio – (2+0.4)/(0.4+0.15) = 2.4/0.55 = 4.36, which means a company can afford its fixed charges 4.36 times over. The higher the number, the more the debt interest handing capacity of the company, secure the bond.

Graham Recommendations for Coverage Ratio –i) Industrial Enterprise – 7 times when calculated on the average of past 7 years, 5 times when measured by “Poorest Year”

ii) Public-utility Enterprise – 4 times and 3 times.

b. Size of Enterprise –Size with minimum standards in terms of volume of business for a corporation and population for a municipality.

c. Stock/Equity Ratio – Ratio of market price to the total value of debt owed by a corporation.

d. Property Value – The assets value that is shown on the balance sheet or as appraised, considered as the chief security and protection for a bond issue.

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Common-Stock analysis, factors & benchmarks

The common-stock analysis is doing a valuation of the issue whether you should buy that stock issue or not. Valuation is estimated by the average earnings over a period of years in the future and then multiplying that estimate by an appropriate “capitalization factor.”

Factors affecting the Capitalization Rate –

1. General Long-Term Prospects –Analysts and investors have strong views on the distant future of a company and those views are reflected in the substantial differentials between the price/earnings ratios of individual companies and of industry groups.

2. Management –It is usually fair to assume that an outstandingly successful company has good management.

3. Financial Strength and Capital Structure – The stock of a company with a lot of surplus cash and nothing in debt is clearly a better purchase (at the same price) than another one with the same per-share earnings but with large bank loans.

4. Dividend Record – A record of consistent dividend payments for the last 20 years or more is an important factor in the company's quality rating.

5. Current Dividend Rate –Distribution or Dividend of about 2/3rdof their average earnings except that in inflationary demands for more capital.

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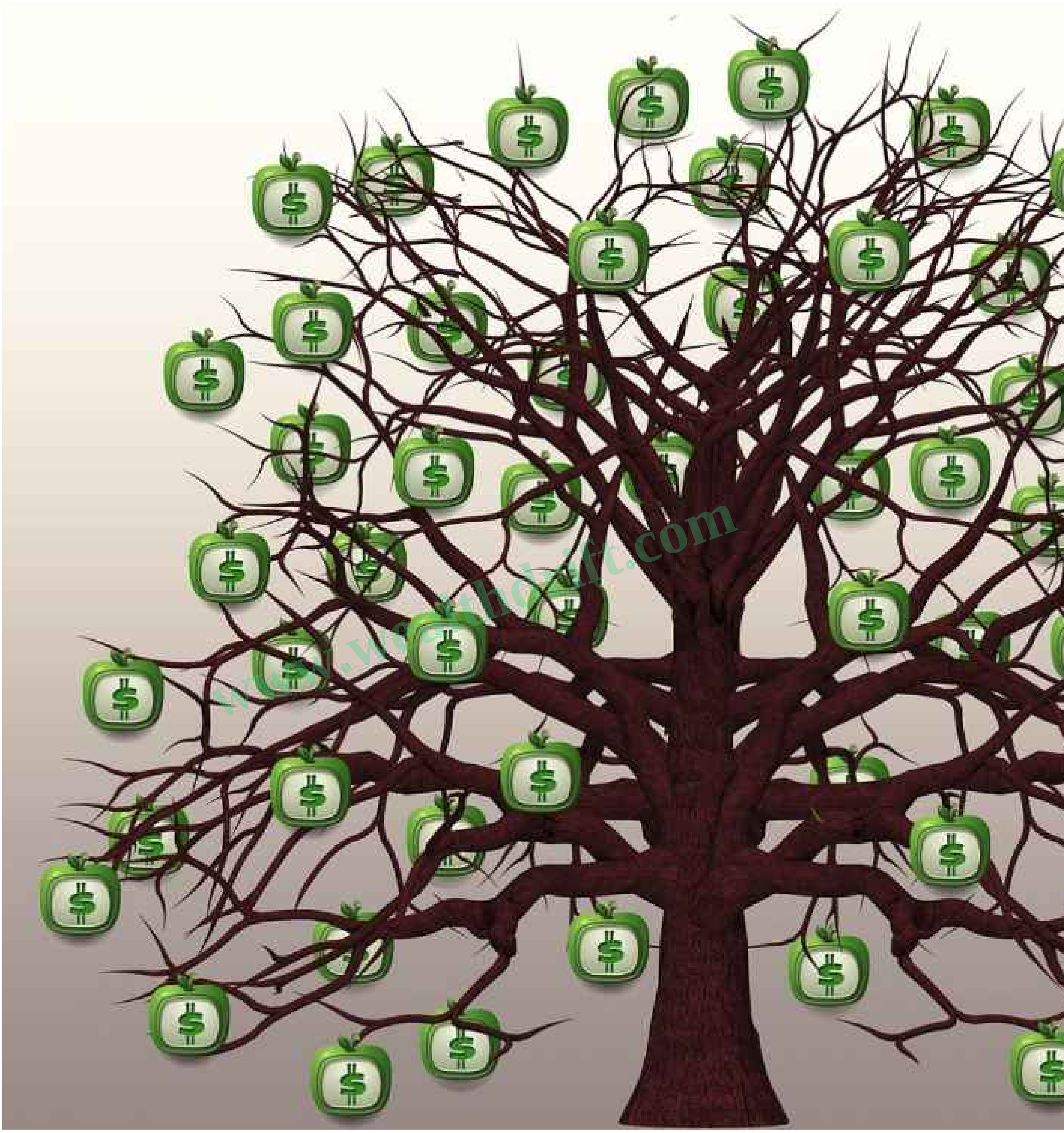
F. 'Value Investing' according to 'The Intelligent Investor'



Value Investing is determining the intrinsic (true) value of the common stock by analyzing the company's assets, dividend payouts, earnings, cash flow, revenue, company's history, management, etc.

That means buying stocks at their intrinsic value which is more than market value and holding it till the market value of stock reaches equal or greater than the intrinsic value of the stock rather than reacting to market swings.

Seven Criteria for selecting value stocks –

i) Quality Ranking – Look for quality rating stocks that ranked average or better (B+ or higher) by Standard & Poor (S&P) (In India, SENSEX/NIFTY).

ii) Financial Coverage – Select stocks of companies whose debt to current asset ratio is less than 1.1 (for industrial companies).

iii) Company's Liquidity – Select stocks of companies whose ratio of current assets to current liabilities is greater than 1.5.

iv) Earnings Growth – Select stocks of companies with positive earnings per share growth at least by 1/3rd in the past 10 years.

v) Price to earnings ratio – Invest in companies with low to moderate price to earnings ratio (less than 15)

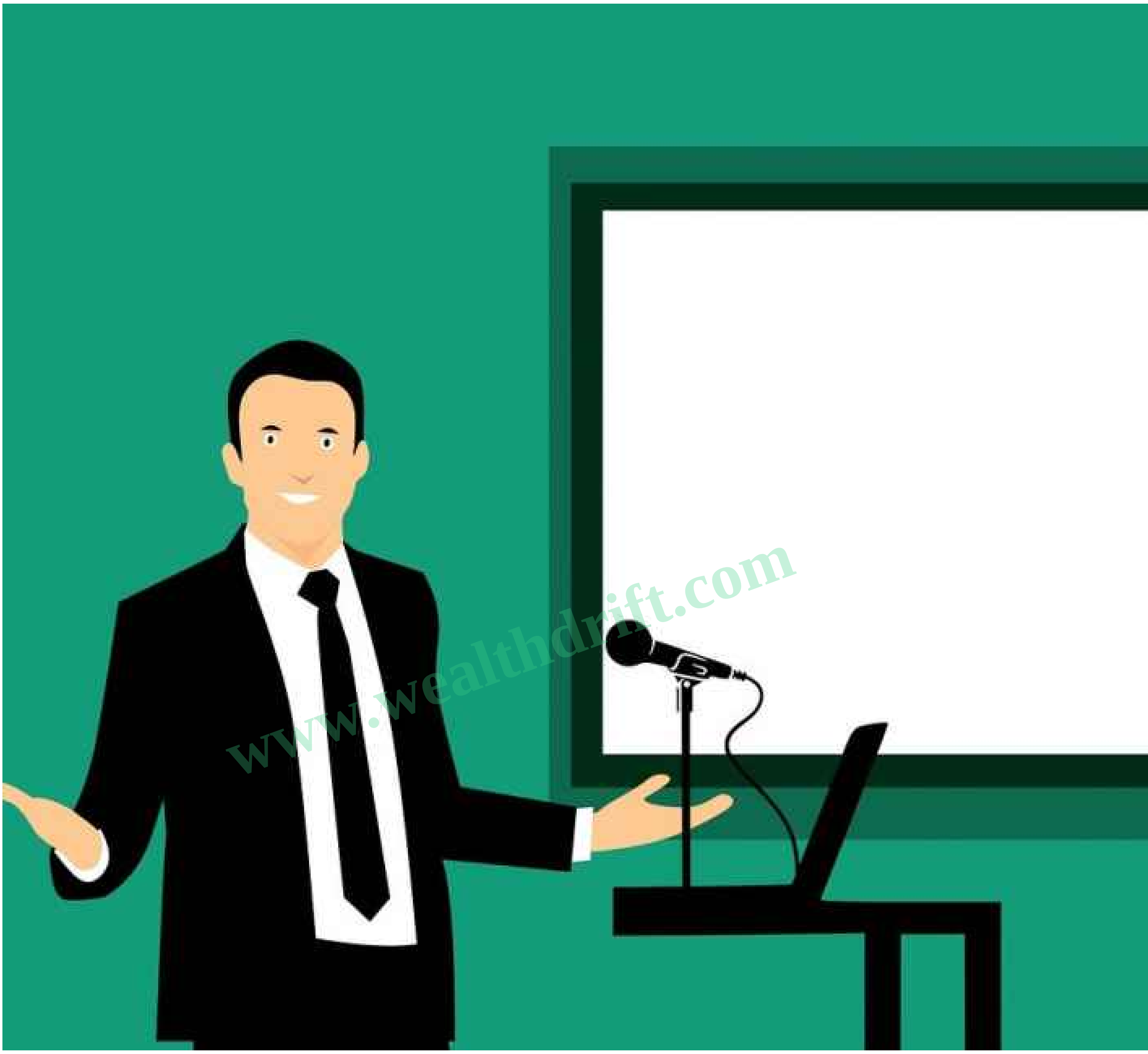
vi) Price to book ratio – Price to Book Value (P/BV) ratio of stock should be less than 1.5.

vii) Dividend record – Graham recommends investing in companies that are paying dividends currently.

This is one of the best and most recommended lessons from "The Intelligent Investor" book by Benjamin Graham.

Read our article on "Great investors of all time & their tips to invest in share market". Click here to read

G. Other important lessons learned (summary) from "The Intelligent Investor" book



1. Buy Stocks with Margin of Safety – It means when an investor buys stocks that undervalued in the market. Therefore, one should buy investments below the true or intrinsic value of the particular investment. Graham points out that the margin of safety decreases with rising stock prices and investment becomes riskier. Some of the biggest losses occur from buying bad stocks in the bull market.

Methods to buy stocks with Margin of Safety – a) Use Market Psychology (Fear and Greed), b) Invest in various undervalued assets, c) Buy stocks of companies with high dividend yields and low debt-to-equity ratios.

Benjamin Graham has stressed more on buying stocks with a margin of safety in his book “The

Intelligent Investor".

2. Make use of Mr. Market – Graham says that you should never trust the market as it is majorly driven by greed and fear sentiments. Instead, he asks us to take advantage of the market's volatility and liquidity to earn profits. He also says Mr. Market provides an opportunity to buy the best investments and to get rid of bad ones. The more irrational the behavior of Mr. Market, the greater the opportunity for investors.

3. Diversification and Formula Investing/Dollar-Cost Averaging – It is a concept of formula investing that says an investor shall set up a plan for how and when to invest and continuously stick with it i.e. making investing every month a variety of prices in a diversified manner to balance out market ups-downs. That is balancing the investments between equity and debt.

4. While buying securities (stocks, bonds, etc.) of a company, analyze company business not securities which can be done by asking yourself, would I buy the whole company at the present valuation of this company in the market.

5. Track the performance of your investments as an intelligent investor an intelligent owner.

6. Don't go for investment by seeing the obvious growth of an Industry. For e.g. Airline Industry, High Growth but has been terrible for investors.

7. The higher the price you pay, the lower your returns would be.

8. Two Principle reasons for undervaluation –

- Stock performing bad i.e. currently showing disappointing results.
- Stock unpopularity

9. Play for safe and steady returns instead of big gambles. Diversification is the key, therefore buy a mix of both stocks and bonds (i.e. equity and debt)

10. Always learn from your investing mistake and never give up.

11. Be cautious with new companies.

12. Neither underinvest nor overinvest in equities.

13. Be conservative in bond investing, because the bond is often less safe than one would expect.

14. Make the investment and investment strategies backed by data and figure out the best, worst, and most likely outcome for an investment based on the data.

15. Know market history as knowing history could better inform future investment decisions. Look past changes in the relationship between price, earnings, dividends, bond yields, etc.

16. Buy stocks that are trading at 2/3rd of their net-net value.

17. Stock Market's performance depends upon 3 factors –

- **Real Growth –** Increase in companies' earnings and dividends.
- **Inflationary Growth –** Rise of prices throughout the economy due to inflation.
- **Speculative Growth –** Increase or decrease in investing public's appetite for securities based on sentiments, emotions, etc.

18. Look for the valuation of the company and do not pay whatever the price the market is currently asking for the perceived future growth.

19. Do not exceed the maximum permissible limit for speculation investing which is 10% of your overall wealth.

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This was the summary of "The Intelligent Investor" book by Benjamin Graham. If you liked and got some knowledge out of it, then please share this article with your family, friends, and peers. Do put your thoughts in the comment section below.

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Category

1. Book Summary

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