Ben Graham the Growth Investor?

We're all for debunking myths, and given the performance of growth stocks recently, we're making a pre-emptive strike in defense of the father of value investing.

Every once-in-a-while, a rumor will re-surface that Benjamin Graham "made all of his money from growth investing." The implication is that his value principles didn't work as well as everyone thinks; and if you are a growth monkey, there is nothing more satisfying than reading that Benjamin Graham was also a growth monkey. The "growth stock" that supposedly renders useless Graham's value-investing success is Geico. There are many articles discuss the subject[1], and this is a summary.

The History

In 1934, Ben Graham was just 40 years old, and published – with David Dodd – the seminal value investing book Security Analysis. Fifteen years later, at the age of 55, he published the first edition of The Intelligent Investor. At that time Graham was teaching at Columbia, and co-managing an investment partnership with Jerome "Jerry" Newman, aptly called the Graham-Newman Partnership. Shortly before publication of the first edition of The Intelligent Investor, the Graham-Newman partnership purchased a controlling 50% interest in The Government Employees Insurance Company (or GEICO) for $712,500. This represented about 20% of the partnership's $3.5 million in AUM. At the time, according to Graham "the price was moderate in relation to current earnings and asset value." No one else was interested, and in Graham's own words "for some reason the industry did not have Wall Street appeal at the time and the deal had been turned down by quite a few important houses." The insurance industry was reeling from post-WWII inflation losses, and he took advantage of the panic (or lack of interest) by making the purchase at a 10% discount to book value.

By the time he wrote his final (fourth) edition of The Intelligent Investor in 1973 at the age of 79, the stock had performed so well that Graham felt it necessary to add a postscript to the edition. **What gets the anti-value guys so excited is the comment that Graham made in his final edition**, where he claimed that the aggregate profits from their partnership's investment in Geico alone exceeded the sum of the gains in all other positions that partnership held over the previous 20 years.

Geico was indeed a 200-bagger up to that point. Graham goes on to say that instead of treating it like a public company, they treated it like a "family business" and didn't sell it. Another point he made was that it was difficult to differentiate between a "lucky break" and a "shrewd investment decision" and concluded that "the intelligent and enterprising investor should be able to find both enjoyment and profit in this three ring circus."

After revisiting this postscript (which becomes a very popular pursuit whenever valuation multiples reach historical highs) the natural conclusion of the growth crowd is that value doesn't work, and that growth does. We'll grant that in regard to a few individual names (FAMANGs?) some of this may be a fair assessment, although identifying the winner in hindsight is much, much easier than it is prospectively, and sticking to it through thick and thin is even harder.

And in this case, Geico was surely a winner, but we need some perspective here and need to see how things ultimately played out.

Long before publishing The Intelligent Investor, and long before GEICO started its march of outperformance, Benjamin Graham was already a tremendously successful investor based on tenants of value investing, and an influential teacher and communicator of its virtues.[2]

Yay, Ben Graham is just like me!

[1] *Was Benjamin Graham Skillful or Lucky?* https://blogs.wsj.com/totalreturn/2012/12/13/was-benjamin-graham-skillful-or-lucky/
The Luck of A Gecko: The Impact of GEICO on Benjamin Graham and Warren Buffett's Success
https://www.ifa.com/articles/impact_geico_benjamin_graham_warren_buffett_luck_gecko/

[2] *The Superinvestors of Graham-and-Doddsville:* https://www8.gsb.columbia.edu/rtfiles/cbs/hermes/Buffett1984.pdf

He wrote Security Analysis in 1934 and had started training some of the sharpest investing minds to do the same. The fact that, nearly 40 years later, at the age of 79, he mentioned that he did incredibly well over his last two decades with an initial bargain that became a 200-bagger doesn't damage, or even dent, his value legacy.[3]

And What About Buffett?

For what it is worth, the growth crowd also likes to tarnish Warren Buffett with the same brush. Buffett started getting to know Geico in the 1950s while studying under Graham at Columbia and even wrote an article about it, describing it as a tremendous growth company.

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The Security I Like Best

WARREN E. BUFFETT

Buffett-Falk & Co., Omaha, Nebr.

Government Employees Insurance Co.

Full employment, boomtime profits and record dividend payments do not set the stage for depressed security prices. Most industries have been riding this wave of prosperity during the past five years with few ripples to disturb the tide.

Warren E. Buffett

The auto insurance business has not shared in the boom. After the staggering losses of the immediate postwar period, the situation began to right itself in 1949. In 1950, stock casualty companies again took it on the chin with underwriting experience the second worst in 15 years. The recent earnings reports of cas-

The company has no agents or branch offices. As a result, policyholders receive standard auto insurance policies at premium discounts running as high as 30% off manual rates. Claims are handled promptly through approximately 500 representatives throughout the country.

The term "growth company" has been applied with abandon during the past few years to companies whose sales increases represented little more than inflation of prices and general easing of business competition. GEICO qualifies as a legitimate growth company based upon the following record:

Year—	Premiums Written	Policy-holders
1936	$103,696.31	3,754
1940	768,057.86	25,514
1945	1,638,562.09	51,697
1950	8,016,975.79	143,944

Of course the investor of today

3.0% and GEICO's dropped to 18.0%. GEICO does not write all casualty lines; however, bodily injury and property damage, both important lines for GEICO, were among the least profitable lines. GEICO also does a large amount of collision writing, which was a profitable line in 1950.

During the first half of 1951, practically all insurers operated in the red on casualty lines with bodily injury and property damage among the most unprofitable. Whereas GEICO's profit margin was cut to slightly above 9%, Massachusett's Bonding & Insurance showed a 16% loss, New Amsterdam Casualty an 8% loss, Standard Accident Insurance a 9% loss, etc.

Because of the rapid growth of GEICO, cash dividends have had to remain low. Stock dividends and a 25-for-1 split increased the outstanding shares from 3,000 on June 1, 1948, to 250,000 on Nov.

Fast forward 200 bags later to 1972 (with Geico at $62), and – as mentioned above – Graham was naturally extolling the luck-or-skill driven virtues of owning Geico shares during such a run.

Yet, **within four years, the stock was off 95%.** After a government-led introduction of no-fault insurance, regulator-mandated premium reductions, poor risk underwriting, and a dozen class action lawsuits, the stock was trading at $2 per share.

The growth guys don't like to talk about the risk, only the reward. Some growth story, eh?

But after that collapse, someone saw value when no one else did. Guess who?[4]

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[3] *There is another, nuanced point related to the math of "one winner generating more than all the gains of the rest of the portfolio. Imagine that you have foresight about a tremendously successful investment that will initially represent 50% of your fund, and you have one other similarly tremendous successful investment capturing the balance of your assets. You aren't sure which one is going to be the winner. In this case, the odds that the first investment generates more gains than the second investment are about 50/50.*

Then imagine that instead of having one other single 50% investment, you have four other 12.5% investments making up the balance of your portfolio. Furthermore, let's suppose that you are going to be "right" on 75% of these (a pretty good batting average), and that the magnitude of the gains in percentage terms will be the same as the magnitude of gains in the 50% position. In this scenario, there is a 100% certainty that the tremendously successful investment representing 50% of your fund will generate more gains than the other four investments combined. This is true whether your batting average turns out to be 75%, 85%, or even 95%.

So, with this framework, let's turn it into a Grahmian analysis. If we then bring the first investment down to a 20% starting position, the odds of it generating more profit than the rest of the portfolio indeed drop, but not by as much as you might think. With one 20% starting position and 25 additional 3.2% positions, each moving similarly in magnitude, and with a 60% stock-picking accuracy on these 25 names, ***there is still a 100% chance that the 20% position will generate more gains than the sum of the balance of the portfolio****!*

If you increase the batting average to 64%, then the scales tip back in favour of the 25-stock portfolio which is capturing the other 80% of your AUM. However, this math only works if you are absolutely certain that your ex-post batting average is going to by 64%. Heck, even with a 64% batting average across two investments, there is still a ~1-in-8 that you will lose money on both of them.

And all of this is before you consider that the original 20% position, which ultimately was a 200-bagger according to Graham, probably became a lot larger than 20% of fund AUM in the process! So ***if Graham is stating that a tremendously successful value-turned-growth position that was initially 20% of fund AUM ultimately generated more gains than the rest of his portfolio, that shouldn't surprise anyone. It is just math.***

[4] *Some great history of the entire saga in this link: https://www.gurufocus.com/news/218282/geico--the-growth-company-that-made-the-value-investing-careers-of-both-benjamin-graham-and-warren-buffett-wedgewood-vic-presentation---*