WALSKY INVESTMENT MANAGEMENT

What would Graham say?

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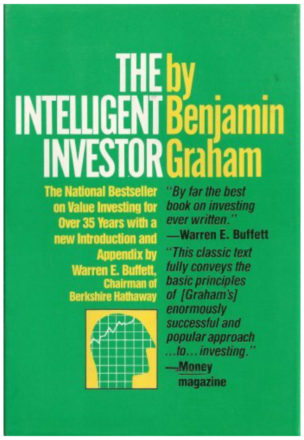
In 1949, Benjamin Graham wrote one of the most popular investing books ever published. With a mix of mathematical formulas, accounting concepts, and an investment philosophy that borders on stoicism, Graham introduced the world to the idea of value investing. He titled the book *The Intelligent Investor*. Graham is considered the father of value investing: the idea that every investment has an intrinsic value that can be determined by careful analysis. The book was written for average investors and challenged them to think about what a share of stock is *actually* worth, rather than what its current price may be. While the formulas are dated and many of the practices to which Graham refers (such as buying "odd lots") don't exist anymore, *The Intelligent Investor* prescribes a level of discipline that should be a prerequisite for any investor, regardless of the situation. Unfortunately, this is often not the case.



With over a million copies sold, Benjamin Graham's *The Intelligent Investor* remains a top-selling business book on Amazon. A first edition can be acquired for $20,000 from AbeBooks.

With the stock market reaching an all-time high, a government that has unofficially embraced Modern Monetary Theory, and a budget deficit that would have President Andrew Jackson (who paid off the national debt in 1835) turning in his grave, there are many reasons for investors to be concerned about the stock market and whether or not it is overvalued. However, Graham would caution readers not to act on emotions. Instead of acting on optimism or pessimism, one should act on careful analysis and the arithmetic it requires.

When people say they feel that the stock market is overvalued or undervalued, they are usually referring to the market's overall movement (as in, *The stock market is up x%, so how much farther can it go?*), or they are referring to the price/earnings (P/E) ratio of a particular stock or index. The P/E ratio is calculated by dividing the current price of a stock by its earnings per share. A higher P/E ratio would imply that the stock is more overvalued than if the P/E ratio was lower. Using the current P/E ratio, investors can compare one stock to another, or to historical P/E ratios.

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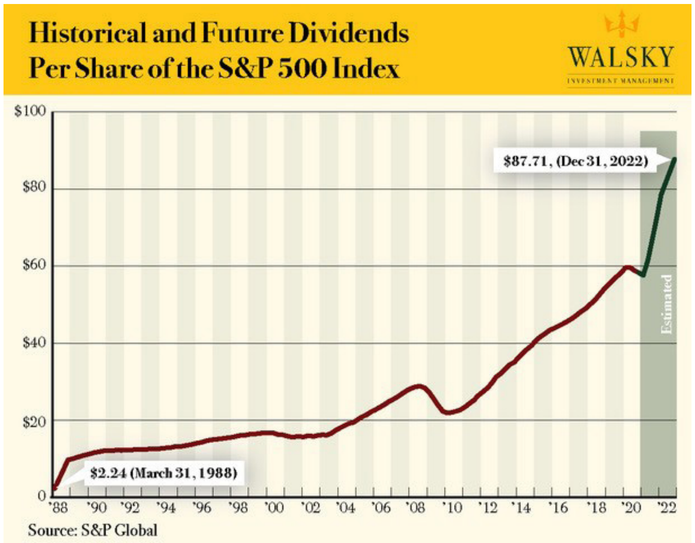
Today, the price/earnings ratio of the S&P 500 Index is around 35, which is well above its historical average. (From 2000 to 2020, the P/E ratio of the S&P 500 averaged 26.2). Looking at these two figures, one would assume that the market is currently overvalued. However, investors do not buy stocks based on *current* earnings, but instead on what they think *future* earnings will be. Earnings for publicly traded companies in the S&P 500 are expected to rise significantly over the next 18 months. For the period of June 2021 to December 2022, S&P Dow Jones is estimating that earnings for the S&P 500 will increase 29.4%. If we use today's market price (P) and the projected earnings (E), the P/E ratio would drop to 21.6, which is 18% below the 20-year average of 26.2. It is this prospect of significantly higher earnings that is causing stocks to reach all-time highs.

While the P/E ratio is helpful when comparing one stock to another, or a stock's current P/E to its historical norm, it has one significant drawback. It is very limited in how it can be used, and provides little information as to whether a stock's current P/E ratio is justified.

A more useful way of looking at the P/E ratio is to invert the formula. Instead of dividing the share price by the earnings, divide the earnings by the share price. A current P/E ratio of 35 would equate to an E/P ratio of .029, or 2.9%. In other words, the S&P 500 has an earnings yield of 2.9%. The usefulness of the E/P ratio is that it can be compared to interest rates of other investments such as bonds. Considering that cash is earning less than 1% and the 10-year U.S. Treasury is yielding 1.5%, the 3% earnings yield on stocks no longer looks so bad. The E/P ratio is also good for historical comparisons. In 1995, the P/E ratio of the S&P 500 was 15.5, while the E/P ratio was 6.5%. This lower P/E ratio, and thus higher E/P ratio, occurred when interest rates were significantly higher than they are today. In 1995, the yield on the 10-year Treasury was 6.57%.

The problem with using only earnings to determine the value of a stock or index is that earnings often do not meet expectations and are affected by a myriad of factors beyond a company's control. Compounding the problem is the constant pressure from Wall Street firms for companies to "make their earnings," leading some companies to find creative ways to manipulate their earnings figures, such as buying back shares of their own stock to reduce the number of shares outstanding, which in turn increases the earnings per share.

While earnings can be volatile and often miss analysts' estimates, dividends are more stable. In previous quarterly reports, we have explored this subject. If one wants to estimate the future performance of the stock market, it would appear that projected dividend increases are a much more reliable indicator than earnings estimates. From 2010 to 2021, dividends in the S&P 500 increased an average of 10.1% per year, while the market value of the S&P 500 increased 12.0% annually. Previous studies that we have conducted note that the increase in dividends is correlated to the growth of the S&P 500 Index. Current estimates from S&P Global indicate that dividends in the S&P 500 are expected to increase 52% by the end of 2022, an unprecedented increase if it comes to fruition.



Before he made his billions, Warren Buffett was a student of Graham's as well as an employee. On several occasions, Buffett has recalled that Graham would say that in the short term, the stock market is much like a "voting machine," tallying up which companies are popular or unpopular; however, in the long term, it is a "weighing machine," taking into consideration the substance of each company. In fact, the first chapter of *The Intelligent Investor* is about the difference between speculators and investors. Speculators chase stories and put a lot of value in the narrative of a company and how it will affect its stock price. Investors rely on fundamentals, mathematical models, and objective analysis to determine if the narrative has any substance.

With the current run-up in the market, Graham would encourage investors to avoid growth stocks and to instead search for value. Stocks with good fundamentals that pay a growing dividend can often create value in the long run. It is important to remember that in any market there are companies that have become unpopular, but still maintain sound fundamentals. As Graham would remind us, those who invest *intelligently* will be rewarded in the long run.