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Get Rich Slowly

The Intelligent Investor (1949), by financial giant Benjamin Graham, is more relevant than ever, in a new edition updated with analysis by Jason Zweig

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Benjamin Graham was one of the most successful investors who ever lived and remains the most influential investment thinker of all time. Warren Buffett's teacher, first boss and intellectual hero, Graham worked on Wall Street for more than four decades, ran a market-stomping mutual fund, taught finance at Columbia Business School and wrote two classic books. Security Analysis (1934) is still the bible for professional money managers; The Intelligent Investor (1949) is, in Buffett's words, "by far the best book about investing ever written." Graham last revised The Intelligent Investor in 1972, four years before his death. At last, Graham has been updated for today's readers. MONEY magazine senior writer Jason Zweig has annotated the text and added extensive commentaries for each chapter. In the wake of Enron, WorldCom and the Internet bubble, Graham's counsel of logical analysis, patient ownership and vigilant monitoring of management is more relevant — and liberating — than ever. Here is an excerpt of the master's thoughts, plus Zweig's analysis, on three major choices that face investors.

How to Pick a Financial Adviser

Most security buyers obtain advice without paying for it specifically. It stands to reason, therefore, that in the majority of cases they are not entitled to and should not expect better than average results. They should be wary of all persons, whether customers' brokers or security salesmen, who promise spectacular income or profits. --Benjamin Graham

Many investors take comfort from the experience and second opinion that a good financial adviser can provide. The right advice can give just the psychological boost you need to keep investing steadily at a time when other investors' hearts may fail them. In screening an adviser, these should be your goals:

--To determine whether he or she cares about helping clients or just goes through the motions;

--To establish whether he or she understands the fundamental principles of investing and is sufficiently educated, trained and experienced to help you.

Here are some of the questions that prominent financial planners say any prospective client should ask:

Why are you in this business? What is the mission statement of your firm? What is your investing philosophy? Do you use stocks or mutual funds? Do you use technical analysis? Do you use market timing? (A "yes" response to either of the last two questions is a "no" signal to you.)

Do you focus solely on asset management, or do you also advise on taxes, estate and retirement planning, budgeting and debt management, and insurance? How do your education, experience and credentials qualify you to give advice in those areas?

How do you choose investments? What investing approach do you believe is most successful? What evidence can you offer that you have achieved success for your clients? What do you do when an investment performs poorly for an entire year? (Any adviser who answers "sell" is not worth hiring.)

Do you, when recommending investments, accept any compensation from any third party? Why or why not? Under which circumstances? How much do you estimate I would pay for your services the first year? What would make that number go up or down over time? (If fees will consume more than 1% of your assets annually, you should probably shop for another adviser.)

May I see a sample account statement? (If you don't understand it, ask the adviser to explain it. If you can't understand his explanation, he's not right for you.)

Do you consider yourself financially successful? Why? How do you define financial success? How high an average annual return do you think is feasible on my investments? (Anything more than 8% to 10% is unrealistic.)

Will you provide me with your resume, your Form ADV and at least three references? (If the adviser or his firm is required by the Securities and Exchange Commission [SEC] to file an ADV and he will not provide you with a copy, get up and leave — and keep a hand on your wallet as you go.)

Have you ever had a formal complaint filed against you? Why did the last client who fired you do so?

Finally, bear in mind that great financial advisers often have as many clients as they can handle — and may be willing to take you on only if you seem like a good match. So they will ask you some tough questions as well, which might include: Why do you feel you need a financial adviser? What are your long-term goals? What has been your greatest frustration in dealing with other advisers? Do you have a budget? Do you live within your means? What percentage of your income or assets do you spend each year? When we look back a year from now, what will I need to have accomplished in order for you to be happy with your progress? How do you handle conflicts or disagreements? How did you respond emotionally to the bear market that began in 2000? What are your financial fears? Your financial hopes? What rate of return on your investments do you consider reasonable? (An adviser who doesn't ask questions like these is not a good fit.)

Above all, you should trust your adviser enough to permit him or her to protect you from your worst enemy — yourself. "If the adviser is a line of defense between you and your worst impulsive tendencies," says financial-planning analyst Robert Veres, "then he or she should have systems in place that will help the two of you control them." Among those systems:

--A comprehensive financial plan that outlines how you will earn, save, spend, borrow and invest your money;

--A statement that spells out your approach to investing;

--An asset-allocation plan that details how much money you will keep in different investment categories.

These are the building blocks on which good financial decisions must be founded, and they should be created mutually rather than imposed unilaterally. You should not invest a dollar or make a decision until you are satisfied that these foundations are in place and in accordance with your wishes.

How to Pick a Mutual Fund

Large funds, soundly managed, can produce at best only slightly better than average results over the years. If they are unsoundly managed, they can produce spectacular, but largely illusory, profits for a while, followed inevitably by calamitous losses. --Benjamin Graham

Mutual funds offer investors a convenient way to diversify their stock and bond holdings. But it matters a great deal which funds an investor selects. Most funds underperform the markets, overcharge investors, create tax headaches and suffer erratic swings in performance. What should the intelligent investor do? First, recognize that an index fund — which owns all, or almost all, the stocks in the market, all the time — will beat most funds over the long run. Its rock-bottom overhead — operating expenses of about 0.2% annually and yearly trading costs of about 0.1%-- gives the index fund an insurmountable advantage. If stocks generate, say, a 7% annualized return over the next 20 years, a low-cost index fund like Vanguard Total Stock Market will return just under 6.7%. But the average stock fund with about 1.5% in operating expenses and 2% in trading costs will be lucky to gain 3.5% annually. Index funds have only one significant flaw: they are boring. You'll never be able to go to a barbecue and brag about how you own the top-performing fund in the country.

If you decide to put part of your money into actively managed funds, here's how to recognize the possible market beaters:

Their managers are the biggest owners. The conflict of interest between what's best for the fund's managers and what's best for its investors is mitigated when the managers are among the biggest holders of the fund's shares. At Longleaf Partners and other firms like Davis and FPA, the managers own so much of the funds that they are likely to manage your money as if it were their own — lowering the odds that they will jack up fees, let the funds swell to gargantuan size or whack you with a nasty tax bill. A fund's proxy statement and Statement of Additional Information, both available from the SEC through the EDGAR database at sec.gov, disclose whether the managers own at least 1% of the fund's shares.

They are cheap. Decades of research have proved that funds with higher fees earn lower returns over time. Why? High returns are temporary, while high fees are permanent.

They dare to be different. When Peter Lynch ran Fidelity Magellan, he bought whatever seemed cheap to him at any particular moment — Treasury bonds, foreign stocks, struggling Chrysler — regardless of what other fund managers owned. So before you buy a U.S. stock fund, compare its holdings against the roster of the S&P 500 index; if they look like Tweedledee and Tweedledum, shop for another fund.

They shut the door. The best funds often close to new investors — permitting only their existing shareholders to buy more. But the closing should occur before — not after — the fund explodes in size and becomes difficult to manage. Some firms with an exemplary record of shutting the gates are Longleaf, Numeric, Oakmark, T. Rowe Price, Vanguard and Wasatch.

They don't advertise. The best fund managers often behave as if they don't want your money. They don't appear constantly on financial TV shows or run ads boasting of their No. 1 returns. The Torray Fund, for example, has never run a retail advertisement since its launch in 1990.

What else should you watch for? Most fund buyers look at past performance first, then at the manager's reputation, then at the riskiness of the fund and finally (if ever) at the fund's expenses. The intelligent investor looks at the same things — but in the opposite order. Since a fund's expenses are far more predictable than its future risk or return, you should make them your first filter. There's never a good reason to pay more than these levels of annual operating expenses, by fund category:

--Taxable and municipal bonds: 0.75%
--Large and midsize U.S. stocks: 1.0%
--High-yield (junk) bonds: 1.0%
--Small U.S. stocks: 1.25%
--Foreign stocks: 1.50%

Next, evaluate risk. In its prospectus (or buyer's guide), every fund must show a bar graph displaying its worst loss over a calendar quarter. If you can't stand losing at least that much money in three months, go elsewhere. Finally, look at past performance, remembering that it is only a pale predictor of future returns.

How to Pick a Stock

The moral for the intelligent investor is to avoid second-quality issues in making up a portfolio, unless — for the enterprising investor — they are demonstrable bargains. --Benjamin Graham

For most investors, selecting individual stocks is unnecessary — if not inadvisable. The vast majority of people who try to pick stocks learn that they are not as good at it as they thought; the luckiest ones discover this early on, while the less fortunate take years to learn it. A small percentage of investors can excel at picking their own stocks. Everyone else would be better off getting help, ideally through an index fund.

If, nonetheless, you decide to invest part of your money in individual stocks, how should you go about looking for the best ones? You can use websites like finance.yahoo.com and morningstar.com to screen stocks. And you should take a patient, craftsman-like approach. Many of the best professional investors first get interested in a company when its share price goes down, not up. Christopher Browne of Tweedy Browne Global Value Fund, William Nygren of the Oakmark Fund, Robert Rodriguez of FPA Capital Fund and Robert Torray of the Torray Fund all suggest looking at the daily list of new 52-week lows in the Wall Street Journal. That will point you toward stocks and industries that are unfashionable or unloved and thus offer the potential for high returns once perceptions change.

By checking "comparables," or the prices at which similar businesses have been acquired over the years, managers like Oakmark's Nygren and Longleaf's O. Mason Hawkins get a better handle on what a company's parts are worth. For an individual investor, it's painstaking and difficult work. Start by looking at the "Business Segments" footnote in the company's annual report, which typically lists the industrial sector, revenues and earnings of each subsidiary. (The "Management Discussion and Analysis" may also be helpful.) Then search a news database like Factiva, LexisNexis or ProQuest for examples of other firms in the same industries that have recently been acquired. Using the EDGAR database at sec.gov to locate their past annual reports, you may be able to determine the ratio of purchase price to the earnings of those acquired companies. You can then apply that ratio to estimate how much a corporate acquirer might pay for a similar division of the company you are investigating. By separately analyzing each of the company's divisions, you may be able to see whether they are worth more than the current stock price. Longleaf's Hawkins likes companies whose stock is trading at 60% or less of the value at which he appraises the businesses. That helps provide the margin of safety that Graham insists on.

Most leading professional investors want to see that a company is run by people who, in the words of Oakmark's Nygren, "think like owners, not just managers." Two simple tests: Are the company's financial statements easily understandable, or are they full of obfuscation? Are "nonrecurring" or "extraordinary" charges just that, or do they have a nasty habit of recurring? Hawkins looks for corporate managers who are "good partners"--who communicate candidly about problems, have clear plans for allocating current and future cash flow, and own sizable stakes in the company's stock (preferably through cash purchases rather than grants of options).

At Vanguard Primecap Fund, Howard Schow tracks "what the company said one year and what happened the next. We want to see not only whether managements are honest with shareholders but also whether they're honest with themselves." (If a company boss insists that all is hunky-dory when business is sputtering, watch out!) You can listen in on a company's regularly scheduled conference calls even if you own only a few shares. To find out the schedule, call the investor-relations department or visit the company's website.

Robert Rodriguez of FPA Capital Fund turns to the back page of the company's annual report, where the heads of its operating divisions are listed. If there's a lot of turnover in those names in the first one or two years of a new CEO's regime, that's probably a good sign; he's cleaning out the deadwood. But if high turnover continues, the turnaround has probably devolved into turmoil.

Graham wants you to realize that when you buy a stock, you become an owner of the company. Its managers, up to the CEO, work for you. Its board of directors must answer to you. If you don't like how your company is being managed, you have the right to demand that the managers be fired, the directors be changed or the property be sold. So how should you, as an intelligent investor, go about being an intelligent owner? In its proxy statement, a company discloses details about the compensation and stock ownership of managers and directors, along with transactions between insiders and the company. The intelligent owner will vote against any executive-compensation plan that uses option grants to turn more than 3% of the company's shares outstanding over to the managers. And you should veto any plan that does not make option grants contingent on a fair and enduring measure of superior results — say, outperforming the average stock in the same industry for a period of at least five years. No CEO ever deserves to make himself rich if he has produced poor results for you.