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What Benjamin Graham Would Tell You to Do Now: Look in the Mirror

The great investment analyst and Buffett mentor often counseled that investors must first know their own risk tolerance

By

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Forget about what the stock market is going to do. Instead, focus on what you, as an investor, ought to do.

That advice from Benjamin Graham, the great investment analyst and Warren Buffett's mentor, can help you navigate the market's latest storm. Should you jettison some stock or stay the course? How should you act now to reduce the odds that you will kick yourself later for taking too much risk or too little? A few of Graham's guidelines can help you know yourself and act accordingly.

In his writings, including the classic book after which this column is named, Graham laid out basic distinctions that should guide your behavior.

First, determine whether you are an investor or a speculator. "The investor's primary interest lies in acquiring and holding suitable securities at suitable prices," Graham wrote. The speculator, on the other hand, cares mainly about "anticipating and profiting from market fluctuations."

If you're an investor, "price fluctuations have only one significant meaning," according to Graham: "an opportunity to buy wisely when prices fall sharply and to sell wisely when they advance a great deal."

Speculators are in thrall to the mythical, moody figure Graham called "Mr. Market," who offers either to buy your stock or sell you more. As Graham imagined him—based on reality, of course—Mr. Market always wants to trade. Much of the time, the prices he sets are sensible. Often, however, they are "ridiculously" high or low.

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Paradoxically, many people become more eager to trade with Mr. Market as his prices become more chaotic. A speculator is happy to buy more shares when prices rise, betting that Mr. Market will buy them back later at even crazier prices. When Mr. Market's enthusiasm turns to fear and prices fall, the speculator sells into that panic.

"The investor who permits himself to be stampeded or unduly worried by unjustified market declines in his holdings is perversely transforming his basic advantage into a basic disadvantage," warned Graham. He "would be better off if his stocks had no market quotation at all, for he would then be spared the mental anguish caused him by *other persons'* mistakes of judgment." (The italics are Graham's.)

The primary reason many individuals fail as long-term investors, Graham said in 1972, is that "they pay too much attention to what the stock market is doing currently."

Intelligent investors, he insisted, don't need superior intellect, training or expertise. Instead, intelligence consists of patience, independence and self-control. You don't have to let Mr. Market do the thinking for you. "The true investor scarcely ever is forced to sell his shares, and at all other times he is free to disregard the current price quotation," Graham wrote.

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If you are an investor rather than a speculator, figure out whether you are what Graham called "defensive" or "enterprising." If you are defensive, you seek to avoid severe mistakes and losses, but also don't want to spend extensive time, effort and emotion on investing. If you are enterprising, you are willing to "devote time and care" in an attempt to outperform.

Either way, Graham wrote, you should reconcile yourself "to the probability rather than the mere possibility" that stocks will fall by 33% or more at least once every five years.

If the S&P 500's 19% decline since Feb. 19 fills you with fear, you aren't enterprising. You are defensive—perhaps much more than you ever imagined. Weathering another steep drop, which no one can rule out, could take more of a toll in effort and emotion than you can withstand. You should consider shaving back your stock position to the point where your fears subside.

Even if you are defensive in Graham's other sense of not wanting to obsess over investing, you might need to take some action. It, too, shouldn't be drastic.

Because of "the very insecurity of the world," investors should always keep some money in stocks and bonds, he said in 1963. Graham advised keeping a minimum of 25% and a maximum of 75% in stocks, with the rest in bonds. As stocks become cheaper, inch your exposure to them upward; as they get more expensive, you should edge your position downward.

That way, you respect the difference between what he called "timing" and "pricing." Timing is the attempt to guess what the market is going to do next, a form of forecasting that Graham believed inevitably ends in speculation. Pricing is simply the observation that when the market goes down, stocks get cheaper.

Getting the timing right, Graham said, is close to impossible. No one knows how much longer or farther stocks might fall from here. The change in pricing is clearer.

At the market's intraday low on Monday, the S&P 500 was trading at less than 26 times its average earnings over the past decade, adjusted for inflation, according to data from Yale University economist Robert Shiller.

True, stocks are still no bargain. The historical average for that measure, since 1881, is 16-17 times long-term adjusted earnings. But stocks have seldom fallen so fast; only a month ago, the S&P 500 was trading at 31.5 times the Shiller figure.

That decline, as Graham taught, should make you incrementally more enthusiastic about buying stocks—not less. If you are "the right kind of investor," he wrote, you should "take added satisfaction" from knowing that your actions are "exactly opposite from those of the crowd."

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