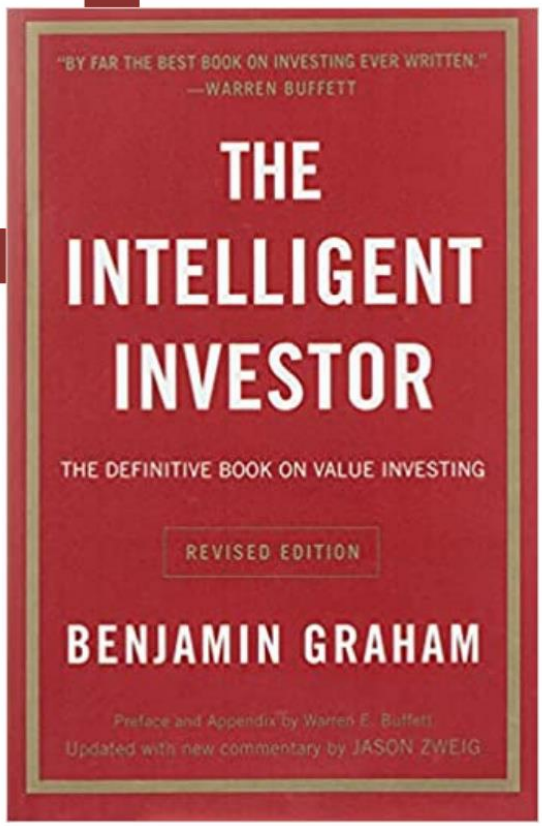

CLIFFS NOTES

THE INTELLIGENT INVESTOR

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THE INTELLIGENT INVESTOR – CLIFFS NOTES

The Intelligent Investor by Benjamin Graham was first published in 1949. It is a widely acclaimed book on value investing. For many new investors however, it can be a 'tough' read. Here, we'll explore the key concepts from the book that you can take home with.

Still, we're only scratching the surface. If you don't already have the book, you can order it from your nearest bookstore.

Inflation

Cash becomes less valuable over time. A dollar ten years ago is worth more than a dollar today. Therefore, instead of holding onto cash, we must invest our cash to beat inflation. Despite this, the majority of investors do not take inflation into account.

You should measure your investing success by how much you make *after* inflation rather than just how much you are making from your investments.

Intelligent Investing

There is lots of money to be made through investing. Then again, there are countless stories of investors losing money in the stock market. You can avoid the latter as long as you approach your investment intelligently.

Intelligent investors use detailed analysis to make safe and consistent returns. They **avoid speculative stocks or stocks that are focused on the short term.** Speculation is risky as nobody can predict the future.

For example, a speculative investor might invest in a company because the FDA is set to approve its new drug. Should the new drug be approved and become successful, he may stand to profit from it. Then again, the opposite could happen. If the drug fails FDA approval, he may stand to lose a lot.

As an intelligent investor however, you need to take time to rationally examine a company's long-term value. After which, you **buy when the stock is trading below its 'intrinsic' value**. The idea is to have a margin of safety between what you pay and what you earn as the company grows.

There are three principles that apply to intelligent investors:

1) Intelligent investors **look at the long-term development and fundamentals of a company before buying its stock**. This can be evaluated by looking at how well the company has performed over time.

Don't just focus on short-term earnings but **dig deep into the company's history to get a better picture about how and *why* this company has performed over the years**. You can also look at the quality of its management and whether they are shareholder friendly.

2) Intelligent investors diversify their investments. They **avoid putting all their eggs in one basket** in case anything goes wrong with the investment.

3) Intelligent investors **look for steady and consistent returns instead of 'moonshot' bets**. Aiming for fast money and chasing the dollar signs can make us greedy and careless, resulting in bad and biased investment decisions.

The Stock Market

The stock market is always fluctuating. It goes up and it comes down. This is completely normal. Likewise, economic crises will happen from time to time. Again, this is completely normal.

As an investor, you must be prepared financially and psychologically for these crashes. The thing about these crashes is that, **the market will always recover**. So don't be too eager to sell your stocks at the first sign of danger.

Instead, **always look at the business**. Before you buy a stock, you should look at it as if you are the sole owner of the business.

To understand the stock market, sometimes it is easier to picture him as a person: Mr Market.

He is very unpredictable, moody, and not very clever.

He is very easily influenced by the crowd. When something exciting happens, Mr Market gets very excited, and prices goes up. When people become overly optimistic, they are willing to overpay, thus, the market becomes very expensive.

On the other hand, when the market is pessimistic, few are willing to buy anything, sending the market into discount territory. It is at this point that you, as an investor, can **take advantage of these low price levels**.

As an investor, you should always ignore the mood swings of Mr Market and avoid following the crowd. Just because a stock is the 'flavor of the month' does not necessarily mean it's a good investment for the long term.

The Defensive Investor

Before you start your investment journey, you need to decide which investor are you: the defensive investor or the enterprising investor.

If you hate risk, the defensive approach might be for you.

As a defensive investor, you can **invest in high-grade bonds, such as AAA-rated government debt securities as well as common stocks**. Ideally, you should split your portfolio on a 50-50 split among bonds and stocks. If you are extremely risk averse, a 75-25 split is also acceptable.

Bonds are more predictable but produce lower returns. Stocks, on the other hand, are more volatile but give the potential for higher returns.

Besides just splitting between stocks and bonds, your *stock* portfolio should be diversified as well. You should invest in large, well-known companies with strong track records of success. They have low to zero debt and have a consistent dividend-paying history.

Here are the general stock selection criteria for the defensive investor:

1) Assets should be at least 2 times liabilities, and long-term debt should be less than net current assets
2) It must have positive earnings for the past 10 years
3) Consistent dividend payout for the past 20 years
4) Earnings per share should have grown by at least 33% over the past 10 years
5) Price-to-earnings ratio should be no more than 15 times the average earnings of the past three years

6) The ratio of price to book value should not be more than 1.5 times the book value

You should also diversify across at least 10 and up to 30 stocks to reduce and diversify your risk.

One way to look for investment ideas for these 10-30 companies would be to look at the portfolios of well-established investment funds and align your portfolio with theirs.

You can also employ services of an expert since they know the game better than you. They may guide you to making better investment decisions.

Once you've decided what stocks to buy, the next step would be to follow a strict set of capital deployment by dollar-cost averaging.

Dollar-Cost Averaging

Dollar-cost averaging is an approach whereby you invest in a stock every month, quarter, or year by the same amount every single time.

For example, you buy $50 worth of ABC stock in January, $50 worth of ABC stock in February, $50 worth of ABC stock in March, and so on.

This way, you'll **never have to worry about the noise in the market. It doesn't matter if the market goes up or down**. Because you average out your buying prices at the end.

Even though you employ the dollar-cost averaging approach, **it is still prudent to check on your holdings once every six months** to ensure that your companies are still doing fundamentally well.

The Enterprising Investor

The enterprising investor uses the same strategy as a defensive investor. The main difference is that **the enterprising investor will allocate more of his portfolio to stocks**.

Besides that, enterprising investors should also experiment with other kinds of stocks that have higher reward (but higher risk).

For example, as an enterprising investor, you may discover a young company that you believe to be 'the next Google'. You could take a small position in the company if you truly believe it's a great company to own.

It is important, however, to limit the percentage of these kinds of stocks to a maximum of only 10% of your overall portfolio. This is to protect against downside in case the investment goes wrong.

Trading the market and following fast-rising stocks can be risky. This is because when a stock price rises too fast, chances are it is already more expensive than its actual value, thus increasing its risk.

Now if the prices of the stocks you own start falling, do you start selling or should you hold onto them?

Before we can answer that question, it is important to revisit the *fundamentals* of the company.

Is the management doing a good job growing the company?

How is the financial strength of the company?

Here are the general stock selection criteria for an enterprising investor:

1) The company should be in a strong financial position. It should have current assets of at least 1.5 times its current liabilities. Its debt should be not more than 10% of its net current asset (industrial companies only).
2) The company must have positive earnings in the last five years
3) It should be paying some dividends currently
4) The earnings must be growing
5) Its current stock price is less than 120% of its net tangible assets

Margin of Safety

The margin of safety is one of the most important parts of your investment strategy. According to Graham, you should aim to buy a company's stock at least 50% below its intrinsic value. This will minimize your downside as much as possible and maximize your opportunity for making money.