Charles Brandes on Investing Lessons from Benjamin Graham

By Dan Richards
October 5, 2010

To view a video of this interview, go here.

Charles Brandes is Chairman of the Brandes Investment Management's five-member Executive Committee where he shares responsibility for driving strategic decisions and monitoring implementation of the firm's vision and objectives. Prior to founding Brandes in 1974, he was an acquaintance of Benjamin Graham, widely considered the father of the value investing approach.

Dan Richards interviewed Charles Brandes on September 17, 2010

Brandes is associated very closely with the work of Benjamin Graham, the Columbia professor who is considered the founder of value investing; among his students was Warren Buffett. I want to ask about some of the things that you learned from Graham. How did you first meet Professor Graham?

It was happenstance. He walked into the office that I was working in and wanted to buy a particular stock, which I bought for him. This was at the very beginning of my career, in the early 1970s, when I had a chance to meet the guru of not only value investing, but of security analysis.

After that initial meeting did you have further contact with Ben Graham?

I did. I asked him if I could come and talk about investing with him, and he said sure. So I had a few meetings with him at his apartment.

If someone were to ask you, having met with Ben Graham a few times, if there were two or three key things that you took away from those conversations, what would be first on the list?

First, I asked what the definition of investing is and what is really true about investing. He explained that most people, when they are thinking short-term, are thinking about stock markets. They are thinking about forecasting quarterly earnings. He said everybody calls that investing, but when you really think about it, it is speculation on short-term price movements which has nothing to do with investing.

So, he pointed out to me what real investing was, which is taking a long term view on the true worth of companies.

What was second on the list in terms of the key takeaways from Ben Graham?

Stock prices and bond prices fluctuate in value a lot more than the actual underlying value of the security that you own. The reason for that is fear and greed, human behavior.

So the notion is that stock prices in the short term don't necessarily really reflect the true underlying value of companies.

That's correct.

Was there a final lesson that you could point to from Ben Graham?

This does not change: If you think fundamentally, and you are conservative, and you understand how wealth is actually produced – not by the stock market – but by businesses, you are doing a fundamentally right thing that not everybody is doing. You don't have the competition so you can be successful that way.

A common view today is that the traditional ways of valuing stocks and companies and of investing may have worked at one time, but they have less relevance going forward. What is your view on this? Do the core principles that Ben Graham talked of still apply today?

I don't understand this at all. How can you imagine that how wealth is produced in economies, and how businesses do well or fail, is changing? That doesn't make any sense.

The question comes down to whether you are talking about short-term speculation on stock price movements again. So you are saying everybody should speculate now, rather than be fundamental investors. Of course, that makes no sense at all. You get the results of speculation, and you get the results of speculators. Over history they are not nearly as good as basic investing.

I want to ask about the mood today, and your outlook for the future. Let me start by saying the US especially seems to be in a bit of a "funk." People look at the headlines, and see negative news after negative news. What is your view on this?

I've been doing this type of investing for over 40 years, and I haven't seen anything different from what is happening today. The "funk" is a normal thing after we have been through a recession and a bear market.

You have been managing money since 1974. I want to talk a little bit about some of those past periods of pessimism, and put those in perspective compared to today. Let's start with the early 1974-1975 period. Can you talk about what the mood was and what was happening then?

In a lot of cases, it wasn't very much different than what we have today. We had a severe bear market in 1974. The market was down 45% top to bottom, very similar to what we went through. We had somewhat different problems. We had inflationary problems. We had the price of oil going up considerably.

That was the OPEC issue. It is always somewhat different, but it is always the same. And 1982 was the bottom of the "funk." Since that time, between 1982 and 2003, the market compounded about 17% a year.

In 1982, at the bottom, what was the mood among investors? What was going on in 1982 that depressed investor sentiment at the time?

There were still very major inflationary problems then, and very, very high interest rates. The economies in North America were not growing very fast at all. There was high unemployment.

I want to ask about one final period, over the last 30 years when there was a very negative sentiment among investors. That would've been in the 1990-1991 period. What was going on then?

During that period, especially in the US, we had some big banking problems and real estate problems – the Savings and Loan crisis for example. During that period of time was when Saddam Hussein had invaded Kuwait and we had that problem. It was not known what was going to happen there or what would happen to the price of oil.

We had a lot of the same types of concerns that we have today. Today it is Iran. There is always something going on to worry about.

What was the experience for investors at those times – what John Templeton would have called "periods of maximum pessimism" – who hung on? How have investors done who had the courage to invest at those periods of time?

When you buy equities during those periods of time, and you can look back as far to want to, through all sorts of crises: 1970, 1974, 1982, 1990, and 1991, you've always done very well.

I want to shift gears and talk about today and the future. Today you have concerns around housing markets in the US, unemployment, and the economy coming back. In your view, are those real issues?

They are certainly real issues, and those issues have to get themselves worked out. If you look at history, they always eventually get worked out, because we are now doing the right things. We are better at productivity now, technology is so much better, and management is better. Yes, I think we will continue to do okay in the future.

Let's talk about the investment landscape going forward and whether some of the principles that worked in the past are relevant today. What are your views on the "new normal?" that Bill Gross from PIMCO talks about , that going forward investors are going to have to get used to lower returns on bonds and stocks as well.

I see no reason why real returns on stocks are not going to be the same or even better than historically. The reason that they might even be better than historically is that our economy is getting better. As we talked about earlier, technology is getting better. Information is getting better. Management is getting better. So I see no reason for real returns after inflation to be worse.

Another opinion that you read about is that the US has entered a sideways market, and for a period of maybe 5 or 10 years the market is going to be flat, going sideways. As a result, the only way for managers to make money is to be opportunistic and nimble, and jump in and out. What is your view on that?

First of all, being opportunistic and jumping in and out is speculation, and it is never good to be a speculator; you should be an investor.

But look back to the period after the 1974 era when the market and the benchmark didn't do all that well. Investors, and value investors especially, during that period of time after 1974 and 1975 actually had very satisfactory rates-of-return, not very large rates-of-return, but they were quite satisfactory.

So if that is going to be the case for the next five or six years, based on the prices that we have in some of these companies, I'd say your return could be quite satisfactory.

Another concern that is heard sometimes is that income statements and balance sheets from companies have become incredibly opaque and complex, and the level of transparency has gone down. As a result, the traditional approaches to evaluating companies and their financial statements are going to have to change. Do you have a point of view on this?

I would have to disagree with that totally. Balance sheets and income statements have always been necessarily interpreted, and that hasn't really changed. But the information that you get, if you dig into it, is much greater than what we got in the past. How you use that information, of course, is what's important.

When you say there is much greater information, why is that?

It's because the standards have been made tougher for what you have to report and how you to report it.

When you look at the stock market, what are going to be the factors that drive superior performance by managers going forward?

I don't really look at the stock market for that sort of thing. I look at businesses and forget the stock market, and look to see how businesses are doing.

,We talked earlier about some positive trends in terms of technology and we are better at making decisions, things are speeding up economically. It's not the stock market; forget the stock market. Economically, businesses and their ability to create wealth or not create wealth is speeding up.

Some businesses that are not able to do that are going out of business faster than they have in the past. Businesses that are adding a lot of value are able to do that faster than in the past too.

I'd like to talk about some research that the Brandes Institute did recently on the role of expectations when it comes to stock market returns. First, what have been the long-term returns for stocks going back to 1920 or so?

The long-term after-inflation returns for stocks going all the way back has averaged about 6 1/2% or 7%. The return on stocks was about two- or three-times the return on bonds, after inflation.

Academics look at those results and they say the reason that stocks outperform bonds is because of something called a "risk premium." Because stocks are more volatile and riskier, they demand a higher return. What is your view on the role of the "risk premium" in explaining why stocks outperform?

Risk, as the academics define it, is wrong. For a long-term investor, risk has to do with how well companies do. The academics define it as just price changes, or their volatility. That is true for speculators. Price changes and volatility in the short term is risk for speculators, but not for investors. So academics' explanation of why stocks outperform bonds is not the right explanation.

The real simple explanation is that stocks represent businesses that create goods and wealth. They create the wealth that can pay bond interest, so they have to create more wealth than bonds create.

Within stocks there are a couple of different categories – value stocks and growth stocks, the latter I think you call "glamour stocks." What is the difference between value stocks and glamour stocks?

It's just a definition of the price that they're trading for in relation to the earnings of the company. A glamour stock would be one whose price is quite high compared to the earnings of the company, because the market is anticipating the earnings are going to grow. Glamour stocks are growth stocks.

Value stocks are where there is usually very little anticipation of growth, and their earnings are high compared to the actual price of the stock.

What does the long-term performance look like for those two kinds of stocks?

If you take those categories and you look at the most expensive glamour stocks versus the cheapest value stocks, the value stocks over a long period of time will outperform by as much as 5% or 6% a year, and in some periods you can see them outperform by as much as 10% a year.

An academic might look at that and say well, if you've got a category of stocks like value stocks that outperform to that extent, the reason must be that they are more volatile and riskier than those other categories of stocks. What is your observation on that?

There are a couple of problems with their conclusion. First of all, they are not more volatile, as academics define risk as volatility, so that is not right.

From the other definition of risk, which I mentioned earlier, value companies over a long period of time are also less risky. They are actually safer, because what you are paying for the stock has a lot less factored in pricewise for future development.

If value stocks aren't more volatile, and they aren't riskier, why do they deliver superior long-term performance?

That's primarily behavioral. It's the fear and greed in the stock market. That has not changed for many, many years. We can see that obviously with the way stock prices fluctuate so much more than the actual value of the company.

Do you see that fear and greed with some of those glamour stocks when they hit the headlines and investors get all excited and enthused?

Everybody wants those.

They want Apple or Google?

And it doesn't matter what the price is.

The other thing that we look at with stock valuations is that stocks are really priced as a function of the future earnings and cash flows, discounted to today. Those are often driven by expectations. When you are buying a stock, you are really buying the expectations that the market has for those future earnings. Would that be a fair characterization?

Very correct.

So an interesting question is, what happens when a company announces its earnings and they are different than what the market expected, either higher or lower? Let's start with those glamour stocks, Apple or a Google let's say. What would happen if earnings came in and they were less than the market expected?

We have done a study of this in the Brandes Institute. We found, for the top glamour stocks, those at the top of the valuation levels, if a surprise earnings comes in, and it is a surprise negative versus the expectations, then the stock goes down very, very considerably.

Even if it's a surprise positive -- because the market in the most expensive glamour stocks is always looking for much, much more positive news, it also can go down even if it outperforms what everybody expects it to do, because everybody is so enthusiastic about these companies.

Value stocks are relatively cheap by your standards. What happens with them when there are positive earnings surprises for the cheapest value stocks compared to expectations?

The positive earnings surprise really is a surprise for value stocks, because nobody expects it at all. If you're looking at the very cheapest stocks, there is no expectation there of them doing anything good. The stock prices will rise considerably in those instances. We found in a study by the Brandes Institute that it is so considerable that that is one of the reasons why value stocks outperform.

How about a negative earnings surprise, if it comes in below what the market expects?

This is the part that is really surprising. For the cheapest value, non-glamour stock, even if the earnings surprise is negative, the expectations for these companies are so negative that the stock price still goes up over time, because even if they report anything – it's amazing. We found this in our study over many years about these earnings surprises.

When you look at the research that you have done, what would be your overall conclusion regarding the long-term impact of results reporting compared to expectations?

Since expectations are so negative for the value stocks, if you buy them at these prices and anything positive changes, which it does quite often, that is why value outperforms glamour stocks.