SMART MONEY ON THE SIDELINES

Money managers of the Benjamin Graham school fear buying pricey stocks in the stampeding bull market. Big winners in the past, they are sitting on cash and their performance is off. The lack of bargains is enough to drive a Grahamite crackers. ■ *by Edward Boyer*

EVERY BULL MARKET has its bystanders who warn frenzied buyers that they are overpaying for stocks that soon may drop. The dissenters this time include a group of superstar money managers too important to ignore. Until recently their performance was so stunning that scores of Johnny-come-latelies copied their investing approach.

Known as Grahamites or value investors, this school searches diligently for companies whose values are not recognized by the market. These investors appraise companies according to principles laid down by the late Benjamin Graham, who taught finance at Columbia University. They are less impressed by a company's short-term earnings projections than by its returns on assets and shareholders' equity, its ability to generate cash, the strength of its balance sheet, and the degree to which it enjoys a franchise in its market. In their own minds the Grahamites are buying businesses rather than mere stocks.

RESEARCH ASSOCIATE *Brett Duval Fromson*

But as prices have streaked skyward, the Grahamites have unearthed fewer and fewer stocks that meet their exacting definitions of a bargain. "Today we cannot find significantly undervalued equities to purchase," laments Warren Buffett, chairman of Berkshire Hathaway, an insurance, retail, and publishing conglomerate in Omaha that he has used as an investment vehicle for multiplying money at awesome rates. A $10,000 stake in Berkshire Hathaway when Buffett acquired it in 1965 would have been worth $2.4 million at the end of last year.

Their inability to find attractive buys leaves the Grahamites in an awkward position. As share prices soared in recent months, they kept money out of the market, missing some of the rally. Buffett is staying busy in other ways; his company recently took a position in Capital Cities Communications, now merged with the ABC network (see Management), and bought Scott & Fetzer, a conglomerate whose products include vacuum cleaners and *World Book Encyclopedia*. But other Grahamites are sitting on growing mounds of short-term securities, such as U.S. Treasury bills, that portfolio managers lump under the term "cash." The money accumulates as they sell out of stocks they consider fully priced, or as companies buy back shares or are taken over.

Riskless T-bills offer none of the potential for capital gains that are possible with longer-term debt and stocks. That does not bother Michael Price, the Grahamite vice president of the $1.2-billion mutual fund called Mutual Shares, who sees plenty of risk these days. Some 25% of his fund was recently in cash, vs. 10% a year ago—still the average for all professional money managers. "When the music stops," says Price, "we want to have a chair."

He has plenty of company among money managers with impressive records. The stock portfolios managed by Tukman Capital

MARK HANAUER

Grahamites *Warren Buffett . . .*

JANET BELLER

Michael Price . . .

CHRISTOPHE VON HOHENBERG

Chuck Royce . . .

JONATHAN LEVINE

Mario Gabelli

Management were up 67% during the two years through December, according to CDA Investment Technologies Inc. of Silver Spring, Maryland, which measures institutional money managers' performance. In the same period Standard & Poor's 500-stock index climbed only 39.6%. But the proportion of cash in the firm's holdings has risen from 5% six months ago to 12%. "We'll bide our time," says President Melvin Tukman.

Cash at Windsor Fund, ranked No. 9 among mutual funds tracked by Lipper Analytical Services for its five-year showing through last year, has jumped from 1% a year ago to 21%. Sequoia Fund, No. 6 in the Lipper standings for its five-year performance, has one of the most cash-heavy portfolios in the land. Cash came to 40% of the portfolio on December 31 and was already 34% a year earlier. Because of a paucity of good ideas, Sequoia has taken no new money from investors since 1983.

"Over the near term," say Sequoia founders William Ruane and Richard Cunniff in their annual report for 1985, "we are following the dictum of the late great boxing trainer Cus D'Amato: 'The object of fighting is not to get hit.' " By ducking punches, it's clear, the Grahamites have failed to land some haymakers of their own. Seven value-oriented mutual funds returned investors 22.8% on average between last September 30 and March 13, trailing the 29.8% return on the S&P 500. The seven are Evergreen, Lindner, Mutual Shares, Pioneer II, Royce Value, Sequoia, and Windsor. Says manager John Neff of Windsor Fund, "We tend to get blitzed a little in markets like this."

POOR short-term showings, as a rule, do not faze this bunch. "I think value investors will continue to do well over the next ten years," says Mario Gabelli, chairman of Gamco Investors, a money management firm whose equity portfolios scored best among those tracked by CDA Technologies for the three years through 1985. "But their relative performance over the next three years is going to look awful."

Much of the Grahamites' time these days is devoted to selling stocks. One stock in disfavor is H.J. Heinz, which has soared sixfold since the late Seventies and recently sold at 19 times earnings, vs. the average price-earnings multiple of 15 for the S&P 500. Value-oriented investors are still clinging to stocks whose prices are below their estimates of a company's worth. Remaining in many portfolios are IBM and Schlumberger, with solid franchises in the computer and oil service industries, respectively. Stocks in the broadcasting business, long a pet of the Grahamites, are still major holdings.

To boost returns, many Grahamites are parking some of their cash in companies due to be taken over in announced deals. The gains from arbitraging the stocks—holding them as they move up to the stated price—can be handsome when converted to annualized rates. "We sometimes enter the arbitrage field when we have more money than ideas," says Buffett.

A few new stocks pass the Grahamites' rigorous valuation tests. Convinced that the Gramm-Rudman budget cuts will not seriously affect military expenditures and that rumors of cuts have unduly depressed the stocks, some portfolio managers are buying

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1984 SEQUOIA FUND HOLDINGS	MARKET VALUE in millions on 12/31/84
Stocks FMC Corp.	$34.1
Exxon Corp.	$31.5
Dart & Kraft	$25.1
Consolidated Papers	$21.7
H.J. Heinz Co.	$21.5
Supermarkets General	$20.5
Consolidated Foods	$19.0
P.H. Glatfelter	$19.0
Meredith	$14.7
Western Pacific	$14.7
Others	$66.8
Total	**$288.6**
Treasury bills and notes	**$151.6**
TOTAL PORTFOLIO	**$440.2**

■ Stocks sold in 1985

1985 SEQUOIA FUND HOLDINGS	MARKET VALUE in millions on 12/31/85
Stocks Capital Cities Communications	$42.9
Consolidated Papers	$40.0
Dart & Kraft	$38.6
P.H. Glatfelter	$37.5
ABC	$33.3
FMC	$31.3
Sara Lee	$30.5
Western Pacific	$20.3
Meredith	$13.5
Pitney Bowes	$13.2
Others	$54.2
Total	**$355.3**
Treasury bills and notes	**$234.0**
TOTAL PORTFOLIO	**$589.3**

■ Stocks bought in 1985

A Growing Ballast of Cash

Finding ever fewer stocks it deemed buys, Sequoia Fund wound up 1985 with 40% of its portfolio—$234 million—in cash-equivalent T-bills and notes. Sequoia sold completely out of some stocks (red) while adding others (blue). It also lightened holdings of certain companies, such as FMC.

Grumman, McDonnell Douglas, Northrop, and United Technologies. Gabelli likes Libbey-Owens-Ford. He figures that after a restructuring under way the stock, which now sells for $75 a share, could be worth $110.

Grahamites are finding some undervalued smaller companies as well. A favorite of Chuck Royce, who runs Royce Value Fund, is Penn Virginia Corp., a Philadelphia outfit that owns substantial coal and gas reserves; Royce reckons the stock is worth twice its current price of $41 a share. Royce also likes CRS Sirrine, a Houston company with an excellent worldwide reputation for its design and engineering services.

Getting most Grahamites to predict where the market is headed is like throwing a rose petal down a well and waiting for the splash. The few willing to reflect for the record are unsurprisingly downbeat. Royce thinks falling inflation and interest rates, which have powered the market's advance, are a passing thing. "In the next year," he says, "we'll be back to higher interest rates and a difficult equity market." Says Neff of Windsor Fund: "Lord knows, the market could go further. But it is overdriven, aggressive, extended, pushy, and exposed. I think it's going to get a kick in the teeth." ■