UNIT-3

FUNDAMENTAL ANALYSIS

3.9 GRAHAM AND DODD'S INVESTOR RATIO

Graham and Dodd's Investor Ratio, also known as the Graham Number, is a financial metric named after Benjamin Graham and David Dodd, who are considered the pioneers of value investing. The ratio was introduced in their classic book "Security Analysis." The Graham Number is a valuation measure designed to identify potential undervalued stocks by combining elements of both book value and earnings.

The Graham Number is calculated using the following formula:

Graham Number = √22.5 × Earnings per Share × Book Value per Share

Here's a breakdown of the components:

Earnings per Share (EPS):

The trailing 12-month earnings per share, which represents a company's net income divided by its number of outstanding shares. It reflects the company's profitability on a per-share basis.

Book Value per Share:

The book value per share is calculated by dividing the company's total equity by the number of outstanding shares. It represents the net asset value attributable to each share of the company.

22.5 Multiplier:

This multiplier is derived from Graham and Dodd's belief that a stock with a price-to-earnings (P/E) ratio of 15 and a price-to-book (P/B) ratio of 1 is fairly valued. The multiplier 22.5 (15 times 1.5) allows for a margin of safety.

The Graham Number is used as a conservative estimate of a stock's intrinsic value. If the current market price of a stock is significantly below its Graham Number, it may indicate that the stock is undervalued and potentially a good investment opportunity.

Interpretation:

If the market price is less than the Graham Number, the stock might be undervalued according to Benjamin Graham's value investing principles.

If the market price is close to or above the Graham Number, the stock may be considered fully valued or overvalued.

Limitations:

- The Graham Number has its limitations and should not be used as the sole criterion for investment decisions. It is a simplified metric and does not consider factors like future growth prospects, industry trends, or qualitative aspects.
- The formula assumes a constant multiplier (22.5) across different industries. In reality, different industries may have different average P/E and P/B ratios.
- The Graham Number is more suitable for stable and mature companies with consistent earnings and book values. It may not be as effective for growth-oriented or highly volatile companies.

Investors should use the Graham Number as one of several tools in their toolkit and conduct thorough fundamental analysis before making investment decisions. It is important to consider a range of financial metrics and qualitative factors to build a comprehensive view of a company's value and potential for long-term success.