THE WARREN BUFFETT WAY

Investment Strategies of the World's Greatest Investor

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MAIN IDEA

Warren Buffett is one of the most successful stock market investors of the past 30 years.

His entire approach is to focus on the value of the business and its market price. Once Buffett finds a business he understands and feels comfortable with, he acts like a business owner rather than a stock market speculator. He studies everything possible about the business, becomes an expert in that field and works with the management rather than against them. In fact, often his first act on buying shares in any company is to grant the managers his proxy vote for his shares to assure them that he has no intention to try and move the company away from its core values.

Buffett champions the value investment strategy, and puts no credence in day to day movements in share prices, the impact of the economic mood overall or any other external factors. He maintains a long-term perspective at all times, and never loses sight of the underlying value of a business.

THE BUFFETT APPROACH TO INVESTMENT

1. Never follow the day to day fluctuations of the stock market.

   The market only exists to make it easier to buy and sell, not to set values. Keep an eye on the market only for someone who is willing to sell a stock at a not-to-be-missed price.
2. Don't try and analyze or worry about the general economy.

   If you can't predict what the stock market will do from day to day, how can you reliably predict the fate of the economy?
3. Buy a business, not its stock.

   Treat a stock purchase as if you were buying the entire business, using the following tennets:

   Business Tennets
   1. Is the business simple and understandable from your perspective as an investor?
   2. Does the business have a consistent operating history?
   3. Does the business have favourable long-term prospects.

   Management Tennets
   1. Is management rational?
   2. Is management candid with its shareholders?

   Financial Tennets
   1. Focus on return on equity, not earnings per share.
   2. Calculate "Owner Earnings".
   3. Search for companies with high profit margins.
   4. For every dollar of retained earnings, has the company created at least one dollar's extra market value?

   Management Tennets
   1. What is the value of the business?
   2. Can the business currently be purchased at a significant discount to its value?
4. Manage a portfolio of businesses.

   Intelligent investing means having the priorities of a business owner (focused on long-term value) rather than a stock trader (focused on short-term gains and losses).

1. WARREN BUFFETT

In the 1993 *Forbes* list of America's richest people, Warren Buffett had an estimated net worth of $8.3 billion. Of all 69 people listed, Buffett is the only one who obtained his wealth from the stock market.

Buffett graduated from the University of Nebraska. While there, he read a book *The Intelligent Investor* by Benjamin Graham. This book so impressed Buffett that he went to New York to study with Ben Graham at the Columbia Graduate Business School.

At the age of 25 in 1956, Buffett started an investment partnership. He had seven limited partners who contributed $105,000 and Buffett as general partner put in $100. The limited partners received 6-percent interest per year and 75-percent of the profits generated above this level. Buffett was paid the other 25-percent. Over the next 13 years, this partnership compounded investments at an annual rate of 29.5-percent. In 1965, Buffett closed the partnership and cashed out with a personal stake of $25 million.

Warren Buffett used his capital to purchase a controlling interest in Berkshire Cotton Manufacturing, a well established but struggling textile company. This company merged with Hathaway Manufacturing, and also bought interests in two insurance companies in 1967. The combined company was renamed Berkshire Hathaway.

The insurance companies generated steady cash flow, which was invested in stocks and bonds to have the funds available for payment of claims. The company's stock portfolio in 1967 was $7.2 million, so Buffett assumed control of this. Within two years, the stock portfolio had grown to $42 million, and the insurance company profits far outweighed the return generated by the textile side of the company.

During the 1970s, Bershire bought three more insurance companies and started another five. Buffett also closed the textile side of the company and converted Berkshire Hathaway into a holding company. Berkshire owns a number of other varied companies which generate good returns on equity without using debt. By 1993, the noninsurance side of Berkshire-Hathaway group had a sales turnover of $2.0 billion and earned $176 million after tax - about 37-percent of the gorup's operating earnings.

Warren Buffett and his wife now own around 40-percent of the stock of Berkshire-Hathaway. He works as Chief Executive of the company for an annual salary of $100,000 per year. Many of his employees who manage different parts of the company earn much more.

Berkshire-Hathway had a corporate net worth of $22 million when Warren Buffett assumed control. Today, it is worth more than $10.2 billion. Buffett's goal is to increase the company's worth by a 15-percent compound rate each year.

Berkshire pays no dividends but reinvests all money earnt. Therefore, shareholders look to a capital gain in the value of their stock. Since 1964, Berkshire shares have grown from $19 each to more than $22,000 per share today. Over the past 25-years, Berkshire has grown at an compound rate of 23.2-percent per year - well above Buffett's target of 15-percent per year.

2. TWO MENTORS

Main Idea

Warren Buffet's investment methodology is a hybrid mix of the strategies put forward by two 1930s style investment advisers, Ben Graham and Philip Fisher.

From Graham, Buffett learned the margin of safety approach - that is, use strict quantative guidelines to buy shares in companies that are selling for less than their net working capital. Graham also emphasized that following the short-term fluctuations of the stock market is pointless, and that stock positions should be long term.

From Fisher, Buffett added an appreciation for the effect that management can have on the value of any business, and that diversification increases rather than reduces risk as it becomes impossible to closely watch all the eggs in too many different baskets.

Supporting Ideas

1. Benjamin Graham

   Author of *Security Analysis* and *The Intelligent Investor*, Graham is widely considered as the first professional financial analyst.

   Ben Graham grew up in New York and had a science degree from Columbia University. By the age of 25, he was a partner in a brokerage firm earning $600,000 per year. He was financially ruined by the 1929 crash and had to rebuild his fortune.

   Graham's investment philosophy was that a well-chosen, diversified portfolio of common stocks, based on reasonable prices, were the soundest possible long-term investment anyone could make.

   To Graham, the distinction between an investment and a speculation was: *"An investment operation is one which, upon thorough analysis, promises safety of principal and a satisfactory return. Operations not meeting those requirements are speculative."*

   An investment requires safety of principal and a satisfactory return. Safety is a relative term, and can never be determined in an absolute sense. Similarly, the concept of a satisfactory return (whether dividend income or stock price appreciation) is also subjective.

   Graham described three approaches to investing in common stocks:

   1. The Cross-Section Approach.
   The investor buys some shares in companies in every sector of the market. Then, whatever happens in the economy, at least one stock will be performing well.

   2. The Anticipation Approach.
   a. Short-Term Selectivity.
   This is the investment in companies which have the most favourable outlook in the next 6-months to a year. Although this is volatile and superficial, this is the dominant approach used by most sharebrokers.
   b. Growth Stocks
   These are companies whose sales and earnings are expected to grow at a rate above those of the average business. The trick is to buy stock in any company whose products were at an early stage of their life cycle, when profits and revenues were just about to take off. The difficulty here is in accurately forecasting rates of growth.

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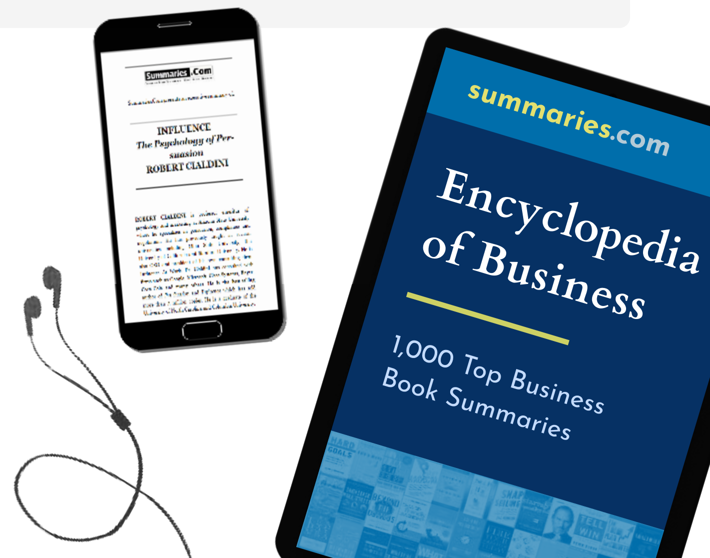

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