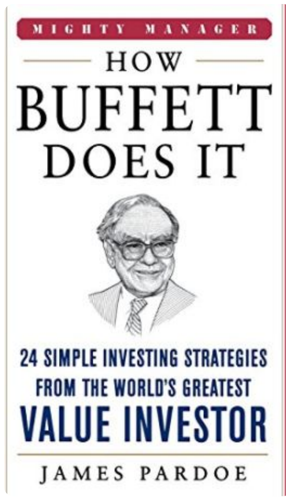

Rating ?
6

Qualities ?
Applicable
Well Structured
Concrete Examples

How Buffett Does It

24 Simple Investing Strategies From The World's Greatest Value Investor

James Pardoe • McGraw-Hill © 2005 • 120 pages

Leadership / Business Leaders
Life Advice / Personal Finances / Investing

Take-Aways

- Warren Buffett never inherited any money from his parents, yet he is worth more than $40 billion today.
- When Buffett was 11 years old, he bought three shares of Cities Service Preferred stock for $38 per share and sold it when it reached $40.
- The value of some stocks in Buffett's company, Berkshire Hathaway, has risen from $40 per share in 1974 to $97,000 per share in 2004.
- Buffett's mentor, Benjamin Graham, taught him value investing.
- Buffett's value-investment bible is Security Analysis, by Graham and David Dodd.
- Because value investing is simple, investment professionals have not endorsed it.
- Do your own research and make your own investment decisions.
- Be patient. Buffett says he is a "decades trader" as opposed to a "day trader."
- Invest in companies that you understand, that have successful business models and that don't experience competition and price controls.
- In 1999, during the Internet stock-buying frenzy, Berkshire Hathaway stock fell 50%, to $40,000 a share, but by 2004, it had risen to $97,000 per share.

Recommendation

This book is a great example of the architectural and design mantra, "form follows function." Its "form" is that of an easy-to-read handbook explaining the basics of value investing. Its "function" is to explain how Warren Buffett, a self-made investor who is now worth about $40 billion, used value investing to make his fortune. Buffett's premise is that people should base their investing strategies on common sense and search out assets that are selling for less than they are worth. For this, you don't need esoteric mathematical formulas; all you need are the guidelines that this book clearly enumerates. Although author James Pardoe often merely reiterates what Buffett has said in his own books, Pardoe deserves credit nevertheless for packing his handbook with illuminating examples and stories. *getAbstract.com* believes this book will be practical for anyone intimidated by investing, overwhelmed by data or vulnerable to pressure from brokers. In his description of value-investing, Pardoe raises a good question: Why does Wall Street dislike it so much? Buffett's answer: "It's too simple."

Summary

The Most Successful Investor in the World

Many consider Warren Buffett to be the world's most successful investor. He inherited no money, yet today he is worth more than $40 billion. Despite his success as an investor, most academics and business students do not study his philosophy - maybe because his ideas are so straightforward. He says:

- Choose a simple approach over a complex one.
- Develop emotional balance.
- Be patient.
- Think independently.
- Do not become distracted by major economic events.
- Invest in a few choice holdings.
- Don't be overactive.
- Buy and hold.
- Study companies' bottom line results. Don't choose stocks based on their price alone.
- Take advantage of unexpected opportunities.

> *"When investing, keep it simple."*

To apply Buffett's methods:

- Study accounting - Learn how financial markets operate. Read articles and books by famous investors, such as Benjamin Graham, Warren Buffett and Charles Munger.
- Cultivate a healthy skepticism - Brokers almost always have something to sell, so be sure you put your own financial well-being before theirs.
- Learn about Buffett's track record - It speaks for itself.

Buy, Hold and Use Your Laptop for Playing Bridge

Many people believe, wrongly, that investing is an arcane mathematical process and they need professional help to participate in it. Buffett disagrees. He believes that average people can learn to practice value investing. He stresses investing only in companies that you understand. If you can't figure out what a company does, don't buy its stock. Trying to apply complicated formulas rather than using your own instincts can actually hurt your earning potential.

> *"Buffett has turned acorns into oak trees through sound investment practices."*

Buffett learned about this simple approach from his mentor Benjamin Graham, with whom Buffett studied at Columbia University. Graham insisted that it was not necessary to do "extraordinary things to get extraordinary results." He outlined this strategy in the book he wrote with David Dodd, Security Analysis. Graham and Dodd advise investors to seek stocks that are selling at a price cheaper than their valuation - for example, $1 stocks selling for 40 cents. Look for companies that have talented management and dedicated employees. If their share price is below what you predict it will be in the future, buy the stock - and hold it. Over time, the market will tell you whether you are right or wrong.

> *"Find a great business with great management...buy shares at a sensible price - and then hold on to them for dear life."*

Buffett used Graham's approach to turn his $10.6 million purchase of shares in the Washington Post into a $1 billion investment. Similarly, he nursed a $1 billion investment in Coca-Cola into $8 billion. His $45 million worth of GEICO insurance company stock grew to $1 billion. He turned his investment company, Berkshire Hathaway, into a $100 billion company by buying and holding discounted stock. He does not depend on technology. He says he uses his computer to play bridge, not to track his investments.

Mind Your Own Business

Make your own decisions. Buffett disagrees with the popular wisdom that says investment professionals know more than you do. Investment professionals must sell their advice, investment products and particular buying-and-selling strategy to collect fees or commissions from their clients. They don't earn commissions when their clients hold their stocks, so brokers are mainly interested in portfolio turnover.

> *"'Investing is where you find a few great companies and then sit on your ass'."*

Brokers are not dishonest. Many spend thousands of hours learning the formulas they use to analyze the market. But value investing is simple and inherently anti-establishment, which may explain why more investment professionals have not endorsed it. They'd lose their livelihoods if people simply invested on their own.

Cultivate Zen-like Detachment

Overly emotional people do not make great investors. Investing decisions must be rational, and you must be willing to hear bad news. Markets drop for no apparent reason. Wars start. Companies don't meet their sales goals. You lose money.

> *"When in doubt, be lethargic."*

Graham said, "The investor's chief problem, even his worst enemy, is likely to be himself." Buffett takes Graham's advice even farther. He calculates that if you become distraught when your investment loses half its original value, you don't have the temperament to be in the market. Furthermore, he says, if you invest in a company that looks good to you, but then suffers setbacks that are simply beyond its control, your evaluation of your original decision should not change.

> *"Don't succumb to the Chicken Little mentality."*

In 1999, at the height of the Internet stock-buying frenzy, Berkshire Hathaway had its worst year ever. By March 2000, its stock was selling at $40,000 per share, a decline of 50%. Distraught shareholders were selling in droves. Many concluded that value investing was dated or even dead - but they should have realized that the drop was a golden opportunity for value investing. By 2004, Berkshire Hathaway stock was selling for $97,000 per share.

> *"Keep an eye on business performance rather than on price performance."*

Buffett has had to learn from his own mistakes. When he was 22 years old, he owned 350 shares of GEICO Insurance, which he sold for $15,000. If he had held onto them for 20 years, they would have been worth $1.3 million. Of course, in 1996, he bought the entire company.

Seize the Decade, Not the Day

Buffett considers himself a "decades trader" as opposed to a "day trader." With so many short-term traders in today's stock market, he says, it has become a "relocation center" for moving money between short-term traders and long-term investors. He proposes the following thought-experiment: imagine that the day after you buy a stock, the market closes for five years. Would that change your decision to buy? It shouldn't.

> *"Earnings and cash flow are two of the pillars of a successful company."*

Cultivating patience is essential to value-investing. For inspiration, look to the group of investors in Buffett's hometown of Omaha, Nebraska. More than 25 families there have held their Berkshire Hathaway stock for more than 35 years. Their original investments of about $50,000 each are now worth more than $100 million each. The value of an "A" share of Berkshire Hathaway has appreciated over 30 years as follows:

- 1974 - $40.
- 1984 - $1,275.
- 1994 - $15,400.

- 2004 - $97,000.

> *"Search for certainty in uncertain markets - businesses that are...likely to outperform their peers over the long run."*

Buffett advises his shareholders to think of buying Berkshire Hathaway stock as they would of buying a farm or apartment building - as an investment that will stay in the family for a long time. In 40 years, Buffett himself has never sold one share of his stock in his company.

Buy Businesses, Not Stocks

In 1973, Buffett bought $10 million worth of stock in the Washington Post. It immediately fell by 50%. However, Buffett never sold. Today, he receives an annual return on his Washington Post stock equal to his original investment of $10 million, plus an additional $10 million in dividends. Buffett had reasoned that although newspaper and publishing stocks might fluctuate, the business overall was relatively stable. He distinguished between a volatile stock and a volatile business.

> *"A glamorous business may have a spectacular short-term success, but ultimately, it is likely to flop."*

Like Buffett, become a business analyst, not a stock analyst. Focus on industries as a whole, not simply on stock prices. Examine the operations of the businesses in which you are thinking of investing, and compare them to their peers. Consider their size and potential for growth - their long-term "business performance."

> *"If management stresses the appearance over the substance of performance, says Buffett, keep your wallet in your pocket."*

During the Internet boom, stock prices rose astronomically. However, Buffett observed that these prices had no connection with the purpose, value or growth potential of the companies involved. So, he continued to invest in businesses that he understood, such as See's Candies, the Nebraska Furniture Mart, Benjamin Moore paint and Coca-Cola. All were stable companies, with solid earnings, healthy cash flows, loyal customers and well-known brands. Dairy Queen ice cream, another company Buffett owns, makes a product that will be popular well into the future, in contrast to software, which soon becomes outdated.

> *"It's less about solving difficult problems, says Buffett, and more about avoiding them."*

Buffett buys companies that lead their fields and have few competitors. They sell things people need, do not require cash infusions and aren't subject to pricing regulations. Buffett used these criteria in 2003, when he bought a large share in PetroChina, the largest oil company in China and the fourth most profitable company in the world.

Buffett's other key ideas include:

- Avoid "gee-whiz" companies - Buffett invests in low-tech companies that make products such as candy, underwear, bricks, paint, carpets and furniture. He looks carefully at their cash flow and avoids high-tech, "new economy" companies that do not pass along value to investors and whose stock price can easily become inflated. He stays away from businesses in volatile industries and likes established, predictable companies with successful business models. Thus, he declined to invest in Webvan.com, a company that proposed using the Internet to organize grocery deliveries and enjoyed a market capitalization of $7.5 billion. Buffett couldn't figure out who would make money on the venture. Webvan.com eventually collapsed.

- Consolidate, don't diversify - Most investment professionals tout the benefits of diversification, but Buffett says the opposite. He believes that if you discover a good company, you should take a large position in it; he once invested $1 billion to buy 200 million shares of Coca-Cola and 151 million shares of American Express. Individual investors' portfolios, he says, should consist of no more than 10 stocks. Berkshire Hathaway's portfolio often comprises only 10, and it has held as few as five.
- Hibernate - Investing is not an action game; overactive traders may become their own worst enemies. Buffett buys stock and waits. He estimates that during 20% of the time he has been investing, he's found nothing worth buying. He goes years without changing his holdings. His position in Moody's has not changed since 2000, in American Express since 1998 and in Coca-Cola since 1994. This kind of low turnover reduces taxes and bolsters returns. John Bogle, founder of Vanguard mutual funds, agrees with Buffett. He warns his clients about the "hidden costs" of investing, which include mutual fund commissions and related trading costs.
- Ignore the stock ticker - Buffett does not follow daily, weekly or even monthly stock movements. He claims he has not seen a price quote on See's Candies since he bought it in 1972. Instead, he analyzes business activities, since that is what drives stock prices. If you had spent $1,650 to buy 100 shares of Wal-Mart stock in 1970, you would have owned 51,200 shares worth $3 million by 1990. The lesson is to focus on value, not price.
- Hunt for bargains - The best time to buy stocks is when prices are falling. During bear markets, Buffett bought large positions in the Washington Post, GEICO and Wells Fargo.

Be like Ted - Buffett likes baseball great Ted Williams's idea that you have to wait for the right pitch. Buffett waits for the right stock. Buffett and Williams both recognize that you need only a few great hits to enhance your overall batting average. Buffett's partner, Charlie Munger, says that Berkshire Hathaway is successful because of exceptional returns on about 15 investments. Without these, its portfolio would be merely average.

About the Author

James Pardoe is the principal attorney with Pardoe & Associates.

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