# The Essential Buffet
# Timeless Principles for the New Economy

**Robert G. Hagstrom**

***John Wiley & Sons, 283 pages***

**Rating: 7**

Robert Hagstrom is a fund manager, author and long time Buffett disciple. He has written other books on Buffett, and this work was published in early 2001 after the tech wreck had truly taken hold, and Buffett's strategy had proven, once again, to come out on top.

Hagstrom does not simply recite all Buffett wisdom in this book, although there is a comprehensive coverage of the overriding investment principles which have guided Buffett for the past 47 years. As well as lots of Buffett, we are treated to complementary wisdom and some alternative views emanating from such identities as Peter Bernstein, Phillip Fisher, Benjamin Graham and Keynes; together with the proponents of modern portfolio theory: Harry Markowitz and Eugine Fama. There is a healthy and robust analysis of the various theories within the investment universe, many of which Buffett ridicules – with convincing logic. Hence, although Buffett's views and prejudices pervade the text, you will not gain a distorted or totally one sided perspective of investment strategies and theories. This makes the book a quite handy reference tool, and a source of practical ideas and guiding posts.

The book opens with a discourse on Buffett's lessons for investing: how his strategy has never changed; why he does not rely upon conventional ratios and yardsticks (eg, P/Es); how he focuses upon business ownership; how his approach is totally different from fund managers (discussion of the many flaws in conventional managed/mutual funds eg, turnover); why he believes in concentrated portfolios (10 to 20 stocks); how he summons the fortitude to ignore short term stock price fluctuations and rather believes that price falls are buying opportunities; assessing "look through earnings" with a ten year performance horizon; screening stocks and being patient for the right opportunities to ripen; avoiding short term speculative tactics … and so on.

The second chapter takes us through Buffett's early days: his original investment partnership, which he cashed out in 1969, correctly believing that the market had become speculative to the point where he could not find value (a paradox on later market timing observations); and then the formation of Berkshire Hathaway (**BH**). You will start to gain an impression that Buffett is no ordinary mortal, and that his learning and experience places him in a tiny minority. After studying corporate and business behaviour for 50 years, and analysing financial data in the process, the average reader (me) will soon come to the realisation that any thought of replicating his strategy to the letter is totally unrealistic – there are not enough hours in the day nor years in a lifespan!

However, and as presented by Hagstrom, there are many lessons that can be applied and imported into the Australian context, which will only go to make the average investor and fund manager a more competent and balanced professional. Even if you only develop a streak of healthy scepticism and henceforth limit investment to those companies you can fundamentally understand, you will have made a great step forward and will avoid many a black hole. Having read this book, only an illiterate fool would have bought OneTel, or HIH; and you would have thought long and hard about rosy analyst reports of Austar and Computershare when these stocks were trading at their peaks – and of course there are numerous other examples.

Hagstrom researches the early influences on Buffett and how these developed with Charlie Munger, the Vice Chairman of BH. These lead to the "Twelve immutable Tenets" of investment, or buying businesses as Buffett describes it. There is a great deal on focus investing, and the advantages to be gained from running concentrated portfolios, as against those of mainstream fund mangers with 40 to 100 stocks. There are undoubtedly lessons here in the Australian context, and the critical comments on mutual funds ring very true to mainstream funds here – especially after the consolidation of recent years. However, modesty might make the perceptive reader somewhat cautious as to how far he can take Buffett's theories in practice. When dealing with the temperament of the true investor, the point is made that Buffett is blunt: "Unless you can watch your stock holdings decline by 50% without becoming panic-stricken, you should not be in the stock market. In fact, he adds, as long as you feel good about the businesses you own, you should welcome lower prices as a way to profitably increase your holdings." The key words here being "feel good". How many private investors, or even fund managers, really go to the extent of analysis and research that Buffett (or his team) does in order to gain such a level of comfort with a company? It is only from experience, the application of expertise and hard work on analysis, that proper (ie, well justified) confidence can be gained – and that, does not come easily!

Indeed, it is pointed out in the text that most investors stray outside their circle of competence and are frequently prone to misguided confidence.

Portfolio concentration has resulted in a fairly volatile, if spectacular, performance for BH, and this is tabulated going back to 1965. In 1999, the last peak year of the bull market, BH underperformed the S & P 500 by 20%, whereas in 1998 it outperformed by a similar amount. Buffett made no apology for this, and he joked about missing the wave in 1999 – in fact one of his most celebrated wins, as he completely avoided the "tech wreck" that immediately followed in 2000, 01 and 02.

Hagstrom ends with an interesting chapter on new/future opportunities within the discipline of Buffett's timeless principles. He examines small cap stocks (BH has latterly eschewed these because of its size and the low impact of any wins); how Buffett's DCF valuation methodology can be applied to technology companies; and then concludes with a rather skimpy note on international stocks – which BH has only recently taken any interest in, and this really by force due to overpriced US companies and the need to shoot for size.

There are 14 pages of footnote references, and this is undoubtedly a work founded upon solid foundations. Given Hagstrom' s fund manager experience, it would have been useful if he had added a chapter going through the basics of Buffett's valuation principles – ie, discounting free cashflows back to NPV after allowance for tax and maintenance CAPEX, so called "owner earnings" in Buffett-speak when he applies the bond/coupon analogy. He could have worked through a couple of examples, with use of a simple finance calculator (eg HP12C) doing the NPV discount cals. There is a need for a practical work in this area, but I suppose the problem is the complexities emanating from different accounting principles, especially between countries/jurisdictions.

And there is the rub: this book is useful, informative and easy to read, but to apply the proven principles in practice is no easy thing.

MKE
Jan 03