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Foundational Elements: Focus on Fair Value

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What farmers can teach investors

Warren Buffett's annual shareholder letter is among the most widely read publications across the investment industry. His letters are renowned for being easy to read (but lengthy) and generally include an anecdote to help shareholders of Berkshire Hathaway remain focused on the fair value[1] of their investments. Buffett's 2013 shareholder letter discusses his ownership of a farm, which he purchased in 1986 from the Federal Deposit Insurance Corporation. When we come across well-written and insightful stories, we much prefer to use (with citation) the original author's language. The story begins, in his own words, as follows:

> From 1973 to 1981, the Midwest experienced an explosion in farm prices, caused by a widespread belief that runaway inflation was coming and fueled by the lending policies of small rural banks. Then the bubble burst, bringing price declines of 50% or more that devastated both leveraged farmers and their lenders. Five times as many Iowa and Nebraska banks failed in that bubble's aftermath as in our recent Great Recession.
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> In 1986, I purchased a 400-acre farm, located 50 miles north of Omaha, from the FDIC. It cost me $280,000, considerably less than what a failed bank had lent against the farm a few years earlier. I knew nothing about operating a farm. But I have a son who loves farming, and I learned from him both how many bushels of corn and soybeans the farm would produce and what the operating expenses would be. From these estimates, I calculated the normalized return from the farm to then be about 10%. I also thought it was likely that productivity would improve over time and that crop prices would move higher as well. Both expectations proved out.[2]

Avoid market noise

It is important to note that Buffett made the investment based on a concept similar to what we at Aspiriant refer to as the fair value of the farm: existing cash flow plus expected future growth. In fact, Buffett said he had not seen a market price quote on the farm from his original purchase date through 2013. He emphasized maintaining discipline and a focus on fair value:

> Focus on the future productivity of the asset you are considering. If you don't feel comfortable making a rough estimate of the asset's future earnings, just forget it and move on. No one has the ability to evaluate every investment possibility. But omniscience isn't necessary; you only need to understand the actions you undertake.

> Games are won by players who focus on the playing field — not by those whose eyes are glued to the scoreboard. If you can enjoy Saturdays and Sundays without looking at stock prices, give it a try on weekdays.
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> Forming macro opinions or listening to the macro or market predictions of others is a waste of time. Indeed, it is dangerous because it may blur your vision of the facts that are truly important.

Don't lose sight of valuation impacts

The challenge isn't calculating the fair value of an asset. Small business owners know that their return is the "money left in the till at the end of the day." The real challenge is understanding that what truly matters is the *return on investment* (10% for Buffett's farm). Return on investment is calculated as fair value divided by market value. At the time Buffett purchased his farm, he set the market value as the price he paid to purchase it. However, over time, market value changes when similar purchase transactions occur. At Aspiriant, we refer to the changes in the market value of an asset as the *Valuation Impact*, which can have a material effect on the overall return on investment of an asset.

His letter goes on to compare his ownership in the farm to ownership of publicly traded securities:

> Stocks provide you minute-to-minute valuations for your holdings. … It should be an enormous advantage for investors in stocks to have those wildly fluctuating valuations placed on their holdings — and for some investors, it is. After all, if a moody fellow with a farm bordering my property yelled out a price every day to me at which he would either buy my farm or sell me his — and those prices varied widely over short periods of time depending on his mental state — how in the world could I be other than benefited by his erratic behavior? If his daily shout-out was ridiculously low, and I had some spare cash, I would buy his farm. If the number he yelled was absurdly high, I could either sell to him or just go on farming.
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> Owners of stocks, however, too often let the capricious and often irrational behavior of their fellow owners cause them to behave irrationally as well. Because there is so much chatter about markets, the economy, interest rates, price behavior of stocks, etc., some investors believe it is important to listen to pundits — and, worse yet, important to consider acting upon their comments.
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> Tumbling markets can be helpful to the true investor if he has cash available when prices get far out of line with values. A climate of fear is your friend when investing; a euphoric world is your enemy.

We maintain perspective

Fair value (for stocks: dividends plus growth) primarily determines an investment's return over the long-term (20+ years). However, valuation impacts (for stocks: changes in margin and price-to-earnings ratios) play an extremely important role over any one market cycle (7-10 years).

Like Warren Buffett, our Capital Market Expectations (CME) framework is focused on fair value while maintaining sight of the risks and opportunities of Valuation Impacts, which are caused by our noisy neighbors in the investment community.

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[1] We consider the terms, "intrinsic value" and "fair value" to be synonyms and therefore interchangeable. Both terms refer to the underlying characteristics of the firm, not the value perceived by the market.
[2] Source: Fortune Magazine. Buffett's annual letter: "What you can learn from my real estate investments."