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The Warren Buffett Approach to Choosing and Managing Your Organization's Investment Portfolio

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Introduction

Numerous articles have been written and research conducted on exactly how Warren Buffett chooses how and where to invest. His methods are not mysterious or convoluted. He looks at three fundamental things:

- The Economics
- The People In Charge
- The Price

Buffet sets a standard in these areas, and if a proposed investment meets the standard, he invests; if not, he doesn't. *That's it.* We all know the outcome of his method.

Is there any reason why companies can't allocate their capital dollars with the ease and confidence that Warren Buffett has when choosing where to invest? What would be the outcome if organizations that have struggled with failed capital investments applied a similar approach?

Given the current economic state that many organizations are facing today, there will be gains made by just picking an approach, any approach.

How confident are you with your organization's ability to exploit value-enhancing opportunities and effectively allocate capital? Aren't your potential capital investments really just a portfolio of opportunities that should collectively enhance the overall value of your organization?

If you want to achieve results like Warren Buffet, what are the questions that your organization must ask to make good investment decisions? What are the standards that determine whether you will make the investment? What do you expect in return?

Problem Statement

According to a survey conducted by VitalSmarts, 78% of 589 professionals and managers say they're now involved in at least one project they expect will fail to produce its proposed results. To add to the suffering, 61% said they knew an unsuccessful project was going to flop before its launch, or realized it shortly after it began.

Statistics from the Corporate Portfolio Management Association (www.corporateportfoliomanagement.org) state that:

- over 85% of corporate management believes their resource allocations are "not-in-good shape";
- 55% of corporate investments are "not-in-good shape" with respect to the accuracy of their benefits, costs and time of delivery estimates; and
- 86% of these corporation business decisions are driven by politics and relationships and not driven by data.

"There seems to be some perverse human characteristic that likes to make easy things difficult "

Warren Buffett

More than ever before, companies must make a concerted effort to optimize the benefits they get from capital expenditures (“CapEx”). Because these are often large, multi-year investments with major implications for future company growth, it makes sense to apply a sound method of scrutiny to these investments. Ironically, many corporations believe that their focus on CapEx takes attention away from operational expenditures (“OpEx”), when, in fact, many OpExitems are truly discretionary. Organizations have become so accustomed to managing the day-to-day costs of their operations that they fail to measure the value they get from their discretionary expenditures.

When making investment recommendations, managers often make statements such as “*Others are doing it*”, or “*This worked for us in the past*” to justify their decisions. In a sense, they are acting like gamblers in a casino, playing the odds, hoping that the investment or project pays off. This is a very expensive and risky proposition. Should any organization base its success primarily on luck? Warren Buffet would certainly not agree!

The Solution

The challenge is to move to a system where risk can be managed, and where dependence on luck is drastically reduced. As Warren Buffett knows, risk can never be eliminated, but there are definitely ways to manage it.

If your organization were to begin analyzing projects in the manner that Buffett analyzes companies, what might this approach look like?

It will be based on Warren Buffett’s three fundamental considerations:

– The Economic Prospect
– The People in Charge
– The Price

It will use Buffet’s ultimate measure of success: is the investment’s intrinsic value increasing at a satisfactory rate?

The Economic Prospect

Every major capital investment or discretionary spending project is expected to produce value to the organization. By clearly stating the measurable anticipated benefits, and the value these benefits generate, organizations can begin to see which projects have the biggest impact on company value, and which have the biggest risk.

Some people may argue that certain benefits and risks cannot be measured. Yet economists and actuaries have proven over and over that if you can systematically define what is important, *anything* can be measured.

Research from Applied Information Economics (www.hubbarddecisionresearch.com) has led to the following conclusions:

— Quantifying benefits and risk radically changes the decisions we make in allocating our resources;

— Current measurement priorities are “upside-down” when compared to priorities based on the economic value of information (i.e., we aren’t measuring what is most important, but are spending resources and measuring what may have the *least* impact);

"In evaluating people, you look for three qualities: integrity, intelligence, and energy. If you don't have the first, the other two will kill you."

Warren Buffett

— Quantitatively sound methods often cause major decisions to be very different – *and better!*

Just as organizations have now learned that traditional one-time, annualized budgeting processes are somewhat useless when compared against rolling budgeting and forecasting, companies need to begin implementing new methods for tracking benefits and risks in terms of the value to the organization. This approach of putting benefits and risks "face to face" with proposed investments keeps everyone focused on exactly what has to happen to realize value.

The People In Charge

Think about the people who are in charge of making the investments decisions and leading the major initiatives that are expected to provide significant benefit to the business. How closely are these individuals being evaluated? What tools are they given? How effectively are they being monitored? Are they being held accountable? How much impact does their effectiveness really have on these initiatives?

A weak or, even worse, nonexistent executive sponsor of a project almost guarantees failure. In the IT arena, where IT investments have a failure rate of more than 50%, weak business leadership causes projects to become "IT projects" rather than the true business initiatives that they need to be.

In order to hold one person accountable for results, there can only be one person in charge. It is the responsibility of the person leading the initiative to ensure that the expected benefits are realized. There should be a mutual agreement, a "contract" if you will, that this person will "sign up" for, committing to delivering these benefits. And, the agreement should identify and commit to providing the tools and resources that are needed for success. Everyone and everything should be measured by this agreement and its expected benefits.

Buffett specifically looks for managers who are candid, who are the first to speak up at the sign of trouble. He requires management to be honest and straightforward, as he believes it is required for a company's success. How often are the managers of your large projects the first ones to come forward at the sign of trouble? Are they really in it for the right reasons, and do they have the right qualities? These questions must be asked and answered *before* heading down the project "path."

The Price

By providing a portfolio approach and methodology to the organization, standards for creating a more comprehensive view of costs and benefits can be implemented. The upfront costs should be identified, as well as the projected "all-in" costs for reaping the expected benefits, along with the cost impact of potential changes to future operations.

Once costs have been identified, an organization must adopt a customized mechanism for comparing the benefits, value, and risks of proposed investments. Each investment must be able to make some type of positive contribution to the organization that can be tracked and monitored.

Once the organization has adopted a way to measure value and risk, it is much easier to know if the price is justified. Companies can use their internal rate of return expectations, along with cash flow projections, and other growth strategies to determine if they are willing to pay the established price.

Summary

By taking a portfolio view when looking at investments, organizations gain the ability to consistently evaluate discretionary projects. This helps people throughout the organization feel like every dollar of investment is on a level playing field, and is being evaluated for its merits, instead of being assessed and funded based on long-held organizational beliefs and the influence of certain groups or individuals.

Organizations tend to do what they know, and what they are comfortable with. That is typically referred to as “organizational bias.” Is your company investing and re-investing in the same types of projects year after year?

Warren Buffett prides himself on his unbiased approach. He believes that he doesn’t need to be an expert, or really know *anything* at all about the companies he buys. Furthermore, he completely ignores Wall Street and other “experts’” predictions of the future.

The facts speak for themselves: quantitative analysis can have the biggest impact on your investment decisions. The methods described here have been successfully adopted by many organizations.

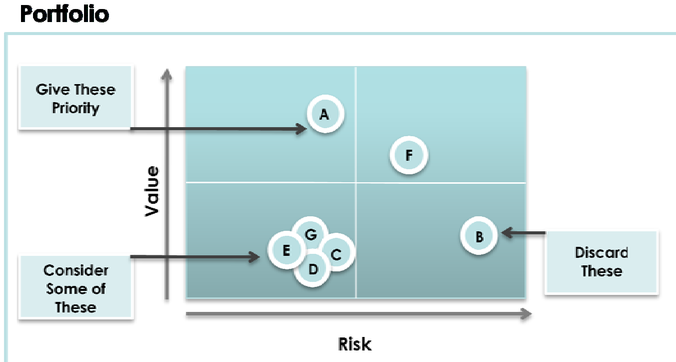
Try adopting a systematic approach to project investments, one that focuses on accountability and results, instead of serving the “project pushers” who propose the same investments over and over.

The implications of mismanaging a corporate portfolio can be significant. These problems become more acute when you have a competitor or potential new entrant into your arena that is not making the same portfolio management mistakes.

Does your organization decide on investments based on those who have the loudest voice? Do you have the “Screamer”, the “Deal Closer”, or the “Doomsayer” influencing these decisions?

Portfolio Management is about removing the “noise” from decision-making. It is about removing the non-objective, personality-driven reasons that projects happen. It is about choosing a system of measures, and measuring what is important. Find the measures that are meaningful to your organization. Keep it simple. Be consistent. Be diligent about picking winners. It doesn’t take a Warren Buffet to make good investment decisions, but following his lead should get you similar results.

Portfolio



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