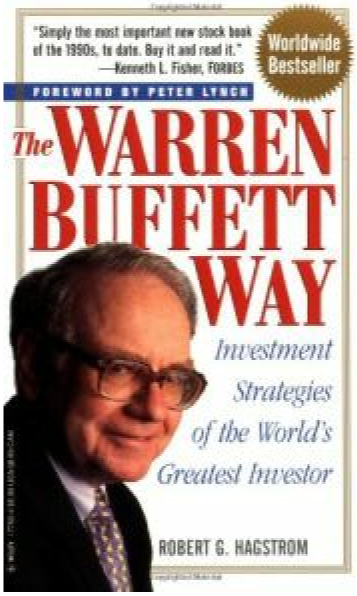

Book The Warren Buffett Way

Investment Strategies of the World

Robert G. Hagstrom
Wiley, 1995

Recommendation

Robert G. Hagstrom discusses Warren Buffett's secrets, covering how he became the most successful investor in the world and, as a result, one of the world's wealthiest men. Hagstrom begins by describing Buffett's early influences, from Benjamin Graham, the first professional financial analyst, to Philip Fisher, a professor and investment counselor. The key to Buffett's success is that he held onto his core principles for making investment decisions, based on four key steps: Turn off the stock market; don't worry about the economy; buy a business, not a stock; and manage a portfolio of businesses. The book is an excellent summary of the major principles and practices that led to Buffett's success. However, the extensive amount of financial analysis provides a lot of information about each of Buffett's investments. This can seem like too much detail if you just want an understanding of his basic investment principles. *BooksInShort* recommends this fundamental book to everyone involved in making investment decisions.

Take-Aways

- Warren Buffett started his investment partnership in 1956 with an investment of only $100.
- As of 1993, this investment had grown into $8.3 billion.
- Starting in 1965, Buffett used the Berkshire Hathaway Company as a holding company for his investments.
- Buffett carefully evaluates any company before investing. He studies the business, not the market.
- Be ready to say no and wait if the deal isn't right.
- It is better to buy a small selection of the very best businesses at reasonable prices than to have a widely diversified portfolio, just for the sake of having diversification.
- Forget what happens on the stock market; don't pay attention to it. Emotion heavily influences the market.
- It doesn't matter what happens to a stock's price on a day-to-day basis.
- Forget about what happens to the economy; don't worry about economic cycles.
- There is no difference between buying a complete business and buying shares in it.

Summary

America’s Richest Man

In 1993, Warren Buffett was America’s richest person, with a net worth of $8.3 billion. He is still the only person among the 61 Americans with a billion-dollar plus net worth who made his wealth from the stock market. Yet, he started his investment partnership in 1956 with an investment of only $100 and seven limited partners who contributed $105,000 to the investment pool. Thirteen years later, he had $25 million. In the following 22 years, he built it up to $8.3 billion.

Buffett’s Strategy for Success

Buffett’s success came from pursuing a strategy based on firm business principles. Starting in 1965, he used a textile firm, Berkshire Hathaway Company, as a vehicle - a holding company - for expanding into other investments. After buying stock in two insurance companies, he made a series of other very successful investments, including going into Blue Chip Stamps, the "Buffalo News," the Nebraska Furniture Mart, the H. H. Brown Shoe Company, and many others. In each case, he carefully evaluated the fundamentals of the business, including its management and its stock value relative to earnings, to decide if it was a good investment. Then, the earnings from these companies gave the Berkshire Hathaway Company the funds for further expansion.

Two Early Influences

Two men strongly influenced Buffett as he developed the investment approach that worked so well for him. Benjamin Graham was considered the dean of financial analysis, since he established the profession. His book, Security Analysis, provided Buffett with his initial orientation toward analyzing any stock investment as a business investment. This was predicated on the premise that a well-chosen, diversified portfolio of common stocks, based on reasonable prices, can be a sound investment. Graham emphasized the importance of gathering facts about the investment, analyzing the merits of the investment, and then determining the security’s attractiveness based on whether it has an underlying safety of principle and a satisfactory rate of return. He said investors would do best if they identified securities that were undervalued, regardless of the overall market price level.

> “An investment operation is one which, upon thorough analysis, promises safety of principal and a satisfactory return. Operations not meeting these requirements are speculative.”

Buffett’s other major early influence was Philip Fisher, an investment counselor who began his career in the late 1920’s. Fisher taught Buffett the importance of investing in firms with an "above average potential" and a highly capable management team. Firms that could increase sales and profits over the years at rates greater than the industry average particularly impressed Fisher. He sought firms that grew by marketing products or services with enough potential to allow for further sales increase over several years. Such a firm has good profit margins, along with effective cost analysis and accounting controls.

> “Successful investing involves the purchase of stocks when the market price of those stocks is at a significant discount to the underlying business value.”

On the basis of these financial gurus’ ideas, his own early experiences and a few mistakes he made by investing in overpriced firms, Buffett learned to evaluate any companies carefully before he invested. He learned to study not only the financial report, but the firm’s management attributes. He developed a large number of contacts who told him how the firms he was evaluating were doing. Buffett also learned to disregard stock market fluctuations and to reach his own independent judgment of the potential of the business. He determined whether a business’ current price made it a good investment value. Then, as his approach was to invest for the long-term, he waited for the right time to invest.

Ignore the Market

Buffett has avoided being swayed by the stock market throughout his investment career. A key reason is that emotions, particularly fear and greed, heavily influence the market. Therefore, the value of a stock can be out of line with the fundamental value of a business. Speculators take advantage of these ups and downs by anticipating price changes. However, in the long run, stocks won’t indefinitely outperform the business fundamentals, so over time, the speculator won’t do as well as the serious business investor.

> “You are neither right nor wrong because the crowd disagrees with you: You are right because your data and reasoning are right.”

Most people investing in the stock market, and most fund managers, act like lemmings. They respond to the short-term shifts of the market, and can easily be led to disaster. However, the savvy investor is willing to go against the grain, including making substantial purchases at a time when others are panicking. This can be a time to take advantage of the low-valuation of a solid business. Ignore economic cycles, since the economy is like a horse on a racetrack, which runs well some days and poorly on others. The company’s long-term performance is important. Although economic cycles themselves are not important, it is critical to pay attention to inflation. Since inflation can dampen a company’s rate of return, investors should assess how well a company is dealing with it.

Economic Goodwill

A company’s economic goodwill is also important. This is not the same as its accounting goodwill, which appears on the balance sheet and determines the firm’s book value.

> “Because emotions are stronger than reason, fear and greed move stock prices above and below a company’s intrinsic value.”

Economic goodwill is the attitude people have about the company as a result of its good performance. As long as a company maintains a good, favorable reputation, it can charge premium prices and gain high returns for its products and services. Thus, economic goodwill helps to enhance the value of its stocks, as well.

Maintaining a Diversified Portfolio

You are better off purchasing a small selection of the very best businesses at reasonable prices than having a diversified portfolio, simply for the purpose of diversity. Rather than putting your eggs in a lot of baskets, be more selective of the particular baskets you choose. They should all be good businesses, bought at a good value. For the most part, Buffett’s own portfolio consisted of companies in the finance industry and in consumer manufacturing.

> “To be successful, one needs good business judgment and the ability to protect oneself from the emotional whirlwind that Mr. Market unleashes.”

In the past, he did not invest in any technology companies. He focused on certain types of industries because he wanted to invest in companies he could understand well in order to make an informed judgment. He also did not invest in utility companies, to avoid industries where the companies and their profits were regulated.

> “The first lesson of economic goodwill is that companies that generate above-average returns on capital are worth considerably more than the sum of their identifiable assets.”

Buffett has several effective stock purchasing strategies. For instance, he is always ready to say "no" if a deal isn’t right. While most investors frequently buy and sell stocks to make a short-term profit, Buffett often sits tight and holds onto stocks for the long term.

In his view, "tinkering with a portfolio each day is unwise." Rather, it’s better to buy and hold onto very good businesses than switch around from stock to stock in businesses that are "far from great."

Principles for Identifying a Good Business Purchase

Buffett believes there is no difference between buying a complete business and buying shares in it.

> “Investors are better served if they concentrate on locating a few spectacular investments rather than jumping from one mediocre idea to another.”

He invests in businesses with these key characteristics:

1. He understands them.
2. They have favorable long-term potential.
3. They are managed by effective and honest managers.
4. They are available at attractive prices.

To use Buffett's approach in evaluating a business or stock, consider four factors: the business, the management, the financial profile and the market value.

1. **Business tenets** – The business is simple and understandable, with a consistent operating history and good long-term prospects.
2. **Management tenets** – Management is based on rational principles, including investing excess capital at above average rates of return to shareholders. Managers should be honest with the shareholders about the company.
3. **Financial tenets** – Look at the company's return on equity rather than the earnings per share. Select a company with a high profit margin. Seek a company that creates at least one dollar of market value for every dollar retained.
4. **Market tenets** – Value the business and then determine if it can be purchased at a significant discount compared to its value.

Buffett's Holdings

As he achieved his great success, Buffett acquired a mix of holdings. These include permanent holdings, fixed-income marketable securities, equity marketable securities, and some individual high-performance stocks.

> "Referring to money managers as investors is like calling a person who engages in one-night stands romantic."

His holdings include:

1. His permanent holdings, chosen because they represent great value, are four companies that Buffett has determined he will never sell. He chose the Washington Post Company, in part, because it is a dominant newspaper which has high economic goodwill value. Buffett values Geico Corporation, a property-and-casualty insurance provider, because of its long-lasting profitable franchise as a seller of low-cost insurance without an agent. Capital Cities/ABC is a third permanent holding. Capital Cities is an $11 billion media and communications business with TV, radio, cable, and other media networks. Buffett recently also invested in Coca-Cola, which has both high name-brand recognition and the best worldwide distribution system for its products.
2. Buffett's fixed-income marketable securities include investments that offer the highest after-tax returns. His long-term bonds include Washington Public Power Supply System and RJR Nabisco. His convertible preferred stocks include investments in Salmon, Inc., the USAir Group, Champion International and American Express.
3. Buffet has selected several equity marketable securities, including the Gillette Company, General Dynamics, the Federal Home Loan Mortgage Corporation, Guinness PLC and the Wells Fargo Company.
4. The individual stocks Buffett owns include the Gannett Company, PNC Bank Corporation, Salomon Incorporated, the American Express Company and the Walt Disney Company.

Buffett's Principles

Buffett's investment approach, based on his common sense philosophy, has proven consistently superior over time. While other investors see only a stock price and spend much of their time watching, predicting, and anticipating price changes, Buffett focuses on understanding the business.

> "Above-average results are often produced by doing ordinary things. The key is to do those ordinary things exceptionally well."

To understand the business, Buffett looks at a variety of factors, including, income statements, capital reinvestment requirements, and the cash-generating capabilities of his companies.

His view is that the investor and business person should look at a company in the same way, because they both want a profitable company. The only difference is that the business person wants to buy the whole company, while the investor just wants to buy part of it.

> “Energy can be more profitably expended by purchasing good businesses at reasonable prices than difficult businesses at cheaper prices.”

If these economic measurements keep improving, then the share price will eventually reflect that trend. It doesn’t matter what happens to the stock price on a day-to-day basis.

In its most simple form, Buffett’s Way boils down to four key steps:

1. Forget what happens on the stock market; don’t pay attention to it.
2. Forget what happens to the economy; don’t worry about economic cycles.
3. Remember that you are not buying a stock; you are buying a business.
4. Select the best businesses available when you manage your portfolio. You don’t have to widely diversify and you don’t need to include every major industry. Stick to businesses you know best, businesses that do well and provide good value.

About the Author

Robert G. Hagstrom is the Senior Vice President and Director of Legg Mason Focus Capital and Portfolio Manager of the Legg Mason Focus Trust. He previously wrote *The Warren Buffett Portfolio: Mastering the Power of the Focus Investment Strategy* and *The NASCAR Way: The Business That Drives the Sport*.