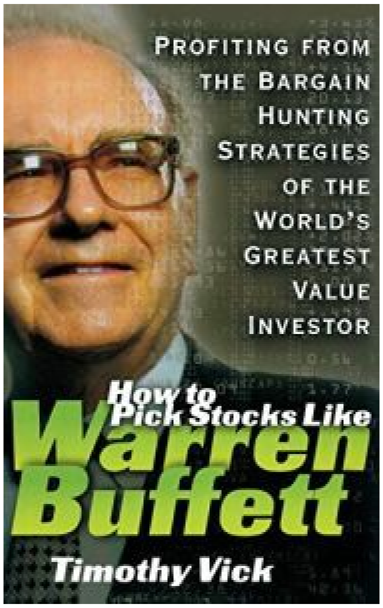

Book How to Pick Stocks Like Warren Buffett

Profiting from the Bargain Hunting Strategies of the World's Greatest Value Investor

Timothy P. Vick
McGraw-Hill, 2000

Recommendation

Timothy Vick is a fairly well known advocate for value investing, but in his latest book, he rolls out the mother-of-all value investors as a champion. In using Warren Buffett as the basis for his easily digestible lessons on value investing - the simple strategy of investing in companies that are currently undervalued by the market - Vick proves that the concept of an engaging investment book is not an oxymoron. By holding up the Buffett example, Vick illustrates the greatest axiom of value investing: Over time, the price of any asset will find its intrinsic value. Buffett clung to this mantra throughout the '90s, missing out on some of the biggest market returns in history. *BooksInShort* strongly recommends this book for its clear explanation of how Buffett analyzed the New Economy market and how you can mimic him going forward. Because in the end, he was right and they were wrong.

Take-Aways

- Warren Buffett amassed a $30 billion fortune through careful investing, using mathematics to guide his investment decisions.
- Buffett set up Berkshire Hathaway, which has been the world's largest investment pool for more than 30 years.
- One Buffett strategy is to buy an existing business and use its cash flow to buy other cash-rich companies.
- Buffett seeks profitable businesses with simple business models.
- Buffett demands the right combination of value and price to justify an investment.
- The power of compounding interest contributes to building wealth.
- In the long run, price and value can correlate perfectly.
- The biggest mistake investors make is copying others' actions in buying stock.
- To be a successful investor, pay attention to an asset's value, based on its earnings.
- Concentrate your purchases, since diversification undermines your ability to gain high returns.

Summary

Buffett's Billions: The Beginning

Warren Buffett accumulated a $30 billion fortune through careful investing using mathematics to guide his investment decisions. For 45 years, he has been essentially a capital allocator, or fundraiser, who seeks cheap money in the financial world. His usual approach is to buy a cash-generating company and then to compound that firm's money at annual rates reaching 20% to 30%, with the proceeds going into his investment firm, Berkshire Hathaway. His career has been based on exploiting the world's financial inefficiencies, again and again, compounding his income.

> "The real power of Berkshire derives from its use of financial leverage, that is, the ability to invest amounts well in excess of the company's capital base."

Buffett developed an early interest in the stock market working for the Omaha, Nebraska, brokerage managed by his father, Howard. By age 10, Warren was filing stock and bond certificates and posting stock quotes on a blackboard at Buffett, Sklenicka and Company. Even as a child, he charted price movements and read books about investing. After buying his first stock when he was 11 years old, Buffett began trading paper stock certificates.

> "The forces that link price to value are inevitable and immutable. Over long time periods, earnings for Standard & Poor's (S&P) 500 companies cannot grow much faster than these companies' sales."

In 1947, Buffett went to college at the Wharton School of Business at the University of Pennsylvania and finished his degree at the University of Nebraska. In his second year there, he was strongly influenced in the ways of value investing by money manager Benjamin Graham, a Columbia University instructor who wrote the book The Intelligent Investor. Buffett eventually went to graduate school at Columbia and received a master's degree in economics. Graham taught that stocks should reflect a company's inner worth and that superior returns could be gained by buying undervalued securities. That principle became Buffett's guide in managing money and investing in stocks.

> "It is wrong - and frequently risky - to link past returns to the future."

Buffett sold stocks for his father's firm until 1954, when he joined Graham's investment management company for two years. Buffett amassed some $140,000 buying and selling cheap stocks. Using about $100,000 from family members and friends, he formed his first enterprise, an investment pool called the Buffett Partnership. His share was 25% of any earnings that exceeded six percent. As his investments proved successful, the word spread, and more investors contributed money. Buffett invested in arbitrage situations and selected common stocks, but - using a tactic far different from that of other money managers - he established a pattern of buying a significant position in an undervalued company. Having thus earned a board seat, he would take a leading role in correcting the company's financial position and assist management in selling the company for more than he paid. By 1969, when he closed the partnership, Buffett had earned between $20 million and $25 million.

Building Berkshire Hathaway

Buffett began buying shares in Berkshire Hathaway, a textile mill in New Bedford, Massachusetts, in 1962, took control of it in 1967 and became chairman in 1970. Through Berkshire Hathaway, he acquired more companies to expand his investments, eventually using the firm as the world's largest investment pool. Buffett reinvested profits for 30 years, and built a huge fortune by:

- Taking advantage of the cash flow of existing businesses held by his holding company (Berkshire Hathaway) and cutting their costs as necessary.
- Using this increasing cash flow to buy other companies.
- Buying only cash-rich companies at cheap enough prices to realize a high return on the original investment by increasing their net worth.
- Using the cash from acquired companies to invest in stocks and bonds.
- Adding a portfolio of insurance companies as conduits for buying stocks and bonds.
- Using these insurers to provide a low-cost float to increase available investment money.

> "Diversification is the bane of high returns. Great value-oriented investors such as Warren Buffett have no use for diversification. They are keenly aware that diversification poses no long-term benefit to a portfolio and drags down potential returns

Using this approach, Buffett benefited greatly from financial leverage. He obtained a large float and could invest much higher amounts than his company's capital base. Over the years, Buffett increased Berkshire's book value, which pushed up the value of its stock. By the end of 1999, Buffett had increased his own stake in Berkshire from 29% to 33.7%. Overall, he made a profit of more than 40% of Berkshire's book value.

Warren's Secrets of Stock Selection

Berkshire's book value and Buffett's net worth increased due to the success of his acquisitions and his stock investments. The characteristics Buffett seeks in choosing stocks or companies to acquire are:

- Being in a profitable business with a simple business model.
- Generating a high level of cash flow.
- Being in a relatively unique business with a good position in its market.
- Having stable management.
- Being available at prices that make mathematical and economic sense.

> "The trick is to obtain the float as cheaply as possible, and no insurer has done that better than Berkshire Hathaway."

For Buffett, the last factor is especially important. He has to be able to justify an investment in a company or stock mathematically. If it doesn't have the right combination of price and value, he doesn't buy it. Or, he waits until it fits his profile.

Maximization Through Mathematics

This fundamental of Buffett's approach - using mathematics to determine if a deal makes financial sense - works in tandem with his other key principle: maximizing the power of compounding money over time. Time is an especially critical factor, since it takes a bigger bite out of your wealth than taxes, inflation or poor stock choices because it magnifies the effects of each of these other factors. If you choose good companies at fair prices, you will generally see stock increases, since over a period of years, an increase in the value of the company and an increase in the price of the stock normally correlate. If you have chosen well, the power of compounding means that your net worth will grow by increasingly greater amounts because:

1. The longer your money can compound in value, the larger the amount will be.
2. Your rate of return acts as a lever to magnify or minimize your wealth. Adding just a few extra percentage points a year to your returns will increase your wealth over time.

> "Unless an investment (a company or a stock) can be justified by mathematics, it should be ignored until the right combination of price and value exists."

Buffett relies on the principle that, in the long run, perfect correlation between price and value will emerge. Over time, the price of any asset will find its intrinsic value, whether it's stocks, bonds, real estate, currencies, precious metals or even the U.S. economy as a whole. Accordingly, never pay stock prices that you can't justify in light of the company's long-term growth rate. Avoid any stocks that are rising much faster than the growth in the value of the company. When investors pay too much for a stock, they are behaving irrationally, since eventually prices will realign with value.

> "Buffett tells investors that it's possible to obtain returns far in excess of the market - whether the market rises 10% a year, 2% or 20%."

The biggest mistake investors make is basing stock trading decisions on the actions of others. For example, you are better off if you ignore Wall Street performance predictions, such as the belief through most of the 1990s that investors should expect 11% annual returns on the stock market. Extrapolating stock-price trends is dangerous, since the stock market often doesn't behave as predicted. Moreover, buying too many stocks puts a statistical ceiling on your earnings. To be a successful investor, ignore the marketing scripts, such as automatically linking past returns to the future. Instead, pay attention to the value of an asset, which is based on its earnings. Over the long term, no asset can grow faster than its earnings.

How Does Buffett Boost Returns?

Look for value, let your money compound and use these strategies to increase your returns:

- Buy low and sell high - This long established principle still applies. Before you buy, examine a stock's return potential. Over the past 70 years, numerous studies have shown that buying undervalued stocks results in more gains than buying high-priced stocks.
- Keep your purchases concentrated - Diversification undermines your ability to gain high returns. The more stocks you own, the more difficult it is to keep track of the winners and losers in your portfolio or to reap yearly returns above expectations.
- Pay attention to expenses - Watch such costs as the commissions you pay your broker. Use deep-discount brokers to reduce your commissions.
- Reinvesting all of your dividends can increase your returns.
- Evaluate everything you buy or don't buy now, including whether to spend money on unnecessary personal expenses or luxury items. Whatever money you spend needlessly now can be turned into numerous dollars later.
- Maximize your gains with a buy-and-hold strategy - Those who hold stocks for the long term maximize their earnings. Frequent traders earn less, particularly if they pay commissions with each trade. The longer you hold your stocks, the more chances you have to make money, regardless of your ability to pick stocks.
- Avoid relying on complicated systems, such as market forecasts and involved stock-picking systems, to make choices - If you try to over-predict, you will end up in a chain link of errors, in which one faulty forecast leads to another and another.
- Don't buy stocks just because you have cash or they are undervalued - Buffett identifies the stocks he wants to own and buys them only when they fall to an attractive price.

Picking Stocks the Warren Way

When you analyze companies as Buffett does, your goal is to determine how much a business is really worth. To do so, focus on what yearly net income the business can return to you, not only on the share value. View the market price just as a point of reference to determine if a company is undervalued, correctly valued or overvalued at its present price.

> "If you can obtain even minor improvements over the market's return, you will generate staggering long-term results due to compounding."

Buffett examines the traditional standards of valuation, rather than the new economy claims that technology businesses should be treated differently because they are new and unique. Ultimately, judge a business by how well it can convert sales to earnings and the annual rate at which earnings increase. A company is worth the present value of its expected earnings. To estimate these future earnings, look initially to the past, since a company's growth record is generally the most reliable predictor of its future course. Averaging past earnings will help you more realistically assess how well a company is likely to do.

> "Mathematics lies at the heart of virtually every endeavor in which Warren Buffett engages."

Also, consider the level of business risk. The more risky or unpredictable a company's earnings are, the less you should pay for it, depending on other criteria. Additionally, once you determine a company's proper growth rate, apply a discounting factor to compensate for the time value of your money, which is what you give up in other returns to buy this stock.

> "Buffett detests rapid trading. To him, it is a money-wasting activity that usually leads to inferior returns for investors."

Use book value as a good yardstick of growth, since as a company's book value increases so does its intrinsic value and share price. Over time, book value and share-price growth correlate closely. A good measure of performance, according to Buffett, is the company's growth in per-share book value. Most companies increase their book value by expanding profits, producing high returns on assets and acquiring companies that add economic value.

Buffett also uses a 15% rule, and looks for stocks that are able to return at least 15% a year over the long-term. Finally, avoid losses by avoiding risk. Don't expose yourself to a high probability of loss. While no one can avoid periodic losses, you can minimize your mistakes by staying abreast of market conditions and buying for the long-term.

About the Author

Timothy Vick is a senior analyst with Arbor Capital Management, which has offices in Anchorage, Alaska; Jacksonville, Florida and Chicago. He is the founder and former editor-in-chief of the nationally distributed market newsletter *Today's Value Investor* , the author of *Wall Street on Sale* , and a consultant to small businesses on valuation and strategic planning. He has appeared on CNBC and CNN.