DR. JOSEPH BELMONTE

BUFFETT and Beyond

SECOND EDITION

Uncovering the Secret Ratio for Superior Stock Selection

+website

WILEY

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and Beyond

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Uncovering the Secret Ratio for Superior Stock Selection

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This book is dedicated posthumously to Tom Barnes, chief engineer of the S.S. Yellowstone in 1978. Without him, I would not be here to write this book.

To those of you who insisted that I write this book. To my wife,
Debby, who “forced” me to write the first edition and for Tula at
Wiley who insisted I write this second edition.

To my wonderful family who always stood behind me. Always. I
miss you, Dad.

And, of course, to both Jimmy and Warren Buffett. If you want to
live life on the beach like Jimmy, you have to learn to invest like
Warren.

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Preface: From Then Until Now

The first edition of this book was written between 2003 and 2004. We had just gone through the great market advance of the late 1990s, with 1999 being the absolute best year for our stock selection method in my market history. The rest of the stock market also roared and soared. Everyone seemed to be an expert or at least had tips on the next stock that would gain 100 percent over the next six months. The Internet gave everyone free research on company data, and people quit their jobs to become day traders.

Then there was Warren Buffett. Many of the new brokers and new investment advisers of that time had never heard of him. To all the younger folks, he was a relic of the past. In the late 1990s, fundamental analysis was not important because everything went up in price. Then the bubble blew. The tech bubble began to break in 2000, and the culmination of the market decline took place in 2002. By then, billions of dollars had been lost, especially in those companies that had no earnings. Enron happened and stock analysts were exposed because of their conflicts of interest. Wealth managers began scratching their heads. What happened?

The market came back to life in 2003 with our model portfolio gaining a bit over 52 percent, doubling the S&P returns. During the next four years we saw a housing boom turn into a housing bubble followed by the eventual bubble burst in 2008. We are still feeling the effects of that disaster, and some folks will never recover as the market and housing prices declined 50 percent and more by the end of February 2009.

Even before the dust began to clear, Warren Buffett came to the forefront to help try and put a calm on the markets. There he was, buying various securities while blood was running in the streets. Helping to save good companies while their stock prices seemed to be going to zero was a Buffett specialty. We all prayed that Buffett would come through and help us as he had in the past and, yes, our prayers were answered.

As the dust settled, Buffett began to be sought after for investment advice once again. Of course, by this time, Buffett had already purchased what he needed for the next decade. Yes, buying growth stocks at a good value was coming back into style. The problem was that very few people really understood how Warren Buffett selected his stocks and even fewer had any clue whatsoever how he selected his all-important purchase price.

Even by 2015 many investors continued to stay away from the market and no longer had money to purchase real estate (at good or fair prices) due to losses in the stock market during the 2008 debacle. Those who stayed in the stock market to weather the 2008 storm (Buffett, myself, and those of you who read the first edition) are very happy we did. We already had the very best companies gracing our portfolios, and we relied on good, sound management to keep adding value to these companies even though their stock prices were falling. Always remember that during panic sell-offs, value and price diverge tremendously.

Portfolio Insurance

A very important addition to this second edition shows you how we generate cash when the market goes through one of its very nasty declines. It is called—yes, you guessed it—portfolio insurance. Portfolio insurance allows you to keep your portfolio value mostly intact during those adverse economic market cycles. When the insurance pays off, it pays off in cash. And it pays off in cash when you need it most in order to buy stocks at or near market bottoms.

A Dividend Income and Growth Portfolio

Another new addition to this second edition is developing a dividend income and growth portfolio using the Buffett and Beyond stock selection method. There are several chapters covering this topic, and it just may be the answer to your investment future. You *must* read these chapters.

Now that the investing world has regained some semblance of sanity after a rather nasty 10 years since our last edition, you'll find out why the timeliness of this book will be so very important to your financial future. This book will show you the little-known stock selection methods of Warren Buffett. In addition, this book will show you my latest research, which, in turn, will take you one very important step *beyond*.

Introduction: A Sea Story
Luck: When Opportunity Meets Preparation

A sea story is a tale or a yarn. Something like one of those "fish that got away" stories. However, our tale actually does begin with a story about the sea.

This introduction is a short story in itself. It is the story of how I came into contact with a little-known type of accounting, which was developed for the sole purpose of determining the predictability (or not) of the future performance of a company.

Predictability of future performance is the Holy Grail of investing. After all, if we could predict future earnings reasonably well, we would be able to determine which stocks should grace our portfolio in order to outperform the market averages on a consistent basis over any multiple-year time period.

One try at predictability was developed by the accounting community, and it was called Clean Surplus Accounting. My doctoral dissertation (2002) was the very first attempt by anyone to statistically test this method as to predictability. To everyone's surprise in the academic community, the tests came out exceptionally well: well enough, in fact, to be put into practical use in which actual results mimicked the very positive test results.

With much coercion by several folks close to me, the first edition of this book was written shortly after the publication of the doctoral dissertation. During the ensuing 10 years, the track record for the method I was testing showed a doubling of the returns of the S&P. With much coercion by more folks, this second edition came along.

Clean Surplus Accounting had pretty much been lost since its possible beginnings in 1895, except for a few rare instances between then and now. The field of accounting just did not evolve in the direction of being able to provide much-needed predictability. It very well could have, but it didn't. Clean Surplus Accounting was designed to try and provide that predictability. Very few people are presently aware of how to apply a reliable method of predictability to the fundamental elements of a stock. Those very few people are a very small group of academics, a handful of practitioners, and our friend, Warren E. Buffett.

Luck

I would like to discuss the events that guided me to my discovery of Clean Surplus in the first place.

It was luck, of course. But the definition of "luck" is when opportunity meets preparation. Had I not been involved in researching Clean Surplus Accounting and also at the exact same time reading everything about Warren Buffett that I could find, I never would have figured out that Clean Surplus was used by the greatest investor ever. On with our sea story and the events that guided my discovery.

I began my postgraduate education late in life. I began a master's program in business and finance at the ripe old age of 48 or so. In my prior life, I had been a marine engineer, and over the course of 13 years I worked on ships sailing to far away places with strange-sounding names. During that time, I rose to the position of chief engineer. I was working on a ship carrying grain from the United States to the then Soviet Union, and our ship had just entered the Mediterranean Sea through the Strait of

Gibraltar. My position on the ship at that time was first engineer, which is the position directly under the chief engineer.

I brought most of the engine crew up on deck to see the great Rock of Gibraltar, but it was not to be, as we were sailing directly into a huge fog bank. With much disappointment, we went back down into the engine room to continue with the day's work. Unknown to us at that moment, our ship was soon to be involved in a horrible collision with a Liberian freight ship headed in our direction.

Ah, the egos of the men in positions of power are all too great. Which ship would give way to the other? Which ship would lose 20 minutes to avoid a collision at sea? Of course, neither one. That's why we were involved in a collision.

The approaching ship smashed into us in our rear port (left) side. Our ship was constructed with the engine room aft (in the rear of the ship). Since we were loaded with cargo and sat deep in the water, and the other freighter was light in the water, the other ship shattered the hull of our ship like paper and smashed into the engine room just above our heads, where I was working with most of the engine gang.

The engine room lights went out as an immense wall of water, as well as the bow of the other ship, entered our workspace. I found myself trapped in the engine room of a sinking ship quickly filling with water. The lights were extinguished immediately due to the entering seawater short-circuiting the electric panels. This left the entire engine room totally in the dark as we were being thrown about like paper dolls on a gigantic ocean wave.

If it hadn't been for the quick thinking of the chief engineer, Tom Barnes, this book never would have been written. He was able to start the emergency generator, which is located in a separate space away from the engine room, in order to provide us with very limited lighting for an extra 60 seconds or so. This light, seemingly sent from heaven, would lead the way for some of the men fighting for their lives in the turbulent water, helping them to find their way out of what would become a watery grave for several of our friends.

Some men made it to safety and some didn't. Five men died prematurely due to the total negligence of the captains of both ships. Some men were saved due to the quick thinking of the chief engineer who was, of course, not in the engine room at the time, but was on deck and in a position to help save some of us who were otherwise sure to die. Now you know why this book is dedicated to the memory of Chief Engineer Tom Barnes.

As the engine room completely filled with water, even the emergency lights were soon extinguished. After what seemed an eternity of struggling and swimming, I could no longer hold my breath and began to suck in seawater. It was at that exact moment that my head popped through the surface to breathe in the sweet salt air. It was also then that I decided to change careers and leave the salty sea, where pirates don't plunder and cannons don't thunder anymore (thank you, Jimmy Buffett) and head back to my cabin by the lake in the mountains of the Hudson River Valley. But what was I to do with the rest of my life? I had the feeling this was the beginning of a real midlife crisis.

While sitting on my outside deck and looking at the peaceful lake and the *Wall Street Journal* (now there's an oxymoron), I figured I should be able to take all those little numbers and make “cents” out of them. After all, I was an engineer.

Engineering is probably where my quantitative ability was honed to a fine edge. Ok, I'm being a bit silly here, but engineers are supposed to walk, talk, and dream in numbers. And to a certain extent this is true. I would rather look at the bottom-line results of a company's performance than think about the qualitative reasons the company obtained those results.

By “qualitative,” I mean the good things a company does for its workers, which really can't be measured or valued in dollars and cents. If you can't put a dollar value on certain aspects of a company's operations, then those aspects won't show up as value on an income statement or a balance sheet. It could be the quality of life in the workplace. It could be those special folks in positions of power that smile at you and pat you on the back when you do well and encourage you when you are mediocre. It could be the daycare center run by the company or the special perks such as free lunch or flextime schedules.

Qualitative aspects could be the brainpower and/or work ethic of the employees and employers. You certainly can't put that on the balance sheet. How about those few people who light up the room when they walk in and make everyone around them happy to be there? Go ahead, accountants and finance people; put a dollar value on that!

However, if you think about it, all those good things about a company will eventually flow to the bottom line. I guess when mom said, “It all comes out in the wash,” when I was a kid, she meant for me to take note of the bottom-line numbers once I eventually learned to read. I always knew mom was a finance person at heart.

During the next 10 years, I made my living investing in both real estate and stocks. I found the key to performing well in the stock market was being able to consistently outperform the market averages. However, I found consistently beating the market to be very difficult indeed.

I learned about stocks by sitting in a broker's office for an entire year while trading my own account and learning all I could. I learned technical analysis, and I also learned to use covered option writing, which I use to this day.

My stock strategy was simple back then. Buy stocks in the Dow Jones Industrial average (all 30 of them) and sell covered calls on those securities. Yes, I had more than enough taxable, short-term gains. However, back then, before most of my college students were four years old, you could invest in real estate and have the paper losses such as depreciation from real estate or other business assets offset other gains such as income from stocks or even salary income from your job. It was a great world back then. Combining a stock portfolio with real estate was the perfect strategy. I did it, I loved it, and life was good. However, some good things eventually come to an end.

The Tax Reform Act of 1986 changed my world. It changed the way certain items were allowed to be written off against other income. For you young folks, before the Act, in addition to the real estate write-offs, you could also write off the interest from your car loan, credit card loans, and school loans to help offset the taxable income from your job. Uncle Sam said it was good to be in debt because you could use the write-offs against salary, which in turn would reduce your total tax liability. And if your real job was investing in stocks, which sometimes gave you short-term gains, then the write-offs from real estate as well as other write-offs mentioned earlier could offset the income from stocks.

But as I said, the Tax Act of 1986 changed all of that. Full-time investing just wasn't as much fun as before. I figured it was time to change careers once again, and thus began yet another midlife crisis.

After much thought, I felt it was time to begin preparation for the fulfillment of an obligation I imposed upon myself earlier in life. My commitment was to pass on the knowledge I learned in this world before I left this world.

A hippie friend of mine once warned me against dying an ego death. An ego death is the act of learning all your life and not passing that knowledge on to others. My obligation was definitely not to die an ego death. So, I felt I could fulfill my obligation by going back to school to teach for a while, and at the same time I would be able to show the academic world just how they should be teaching about the real world.

I thought I would begin my teaching career by drawing up an outline for the finest investment course that could possibly be devised. I then submitted it to the university geographically closest to me at the time. Not to embarrass me, they did mention it would be a wonderful course coming from a “practitioner,” but I really needed to obtain a few more academic degrees in order to qualify as a university instructor. After all, I “only” possessed a bachelor of science in engineering and really, what did an engineer know about investing? They told me that if I were going to teach a course on investing, I really should possess a Ph.D. in finance or something of the sort. Well, I had nothing to do for the next 10 years, so I went back to school with all the kids.

Several years later, while I was at the end of the one-and-one-half-year master's program (which took me four years), I went to yet another ho-hum lecture on stock selection. Within the first two minutes of this seminar I really thought

I'd found the Holy Grail. I felt I had discovered (come across, not discovered) a method that was so unique and so simple that I wondered why I never heard about it before. Even more bewildering was why I had never thought of this uncomplicated, straightforward method myself.

The problem was there was no name for this system, but who cared? I didn't need a name for a stock selection system that was much simpler and seemingly better than anything I had seen up to that time (and since).

I sat in front of my computer for the next four-and-a-half months formulating spreadsheets on the Dow 30 stocks. I tested this simple but common sense strategy in every way possible. I took into consideration those academic measures of risk, with strange sounding names such as “beta” and “standard deviation.” I also tested the strategy on certain Dow stocks at market bottoms, at market tops and, yes, even market middles.

The Academic World

Allow me to explain something here, folks. The academic world is filled with egos. It is filled with a lot of very bright people, many of whom do not use common sense. After all, it takes a long time to earn a Ph.D. or doctoral degree. It takes so much time to get a Ph.D. or doctoral degree that there is little time left to gain real-world experience. But those who do have those academic designations and want to combine real-world experience with their teachings are left at the mercy of the academic system. They must obey the number one rule of the academic world: *Thou shalt not teach anything in the university system that students might find useful in real life.*

An economics professor once told me that things you can actually use in the real world should only be taught in technical schools and not at the university level. Hmm.

I read somewhere that Sam Walton, founder of Wal-Mart Stores, Inc., would not be allowed to teach at the university level because he didn't have the proper credentials (degree). Hey, Warren Buffett wouldn't be allowed a full-time job as a university instructor either because he doesn't have a Ph.D. Now tell me, are the rules of the academic world arcane and bewildering, or what?

Risk

There are two definitions of risk taught by the academics: Beta, which is a measure of how a stock moves relative to the market; and standard deviation, which is a measure of how a stock moves relative to its own past returns. These are very simple definitions. If you want the full definitions, just take a 16-week finance course.

Now let me explain my very own, real-life definition of risk. The market goes up, my stocks go up. The market goes down, my stocks go down. The market goes back up, and somehow my stocks forget to go back up. That, my dear friends, is risk.

It is really this type of risk that the method used in this book will help you avoid. It is this risk that Warren Buffett tries to avoid. It is this risk that can almost always be eliminated by using Clean Surplus Accounting and investing for the longer term. And talking about Clean Surplus Accounting, let's finish up with our sea story so we can begin both this book and your education of selecting a superior performing portfolio.

The Doctoral Degree

After finishing the master's program, I finally entered a university in order to obtain my doctoral degree. During the doctoral program, one must find a suitable theme for his or her dissertation. The dissertation is like the final burst of glory at the end of a fireworks display. All coursework should be finished, and finally, this very huge research paper must be completed, accepted, and defended in front of a committee of Ph.D. and/or doctoral type of people who are there just to make sure you jump through all the hoops and whistle all the whistles. If it doesn't take a person two or three years to complete the dissertation, well, it probably isn't up to the expectations of the academic community. One of my professors told me his dissertation took him seven years to complete after all his coursework was finished.

Before we do go on, let me loosely define a few terms just for your own worldly knowledge. There is a difference between a Ph.D. degree and a doctoral degree. Of course, the academic world likes to confuse us common folk as they bestow the title of “Doctor” upon both of these academic degrees. In short, the Ph.D. develops the theoretical work, and the owners of the doctoral degree take that theory and attempt to put it into practical use. You can remember it this way: Next time you enter the hospital for a procedure, you want a doctor operating on you and not a Ph.D.

Are there Ph.D.-type people in the real world who transgress the boundary and go into business and the real world? Are there doctoral-type people who are just theoretical and not very practical? Of course.

In order to complete either a Ph.D. or doctoral program, the dissertation (which I just spoke about) must be undertaken and completed. The dissertation is based upon past research. In other words, there must be a foundation of research in your particular area of choice. It is upon this