ROBERT G. HAGSTROM

THE ESSENTIAL BUFFETT

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TIMELESS PRINCIPLES FOR THE NEW ECONOMY

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FOREWORD

Investing is context dependent. The best investment advice is general and timeless, but not very helpful if you have to figure out what to do today. "Buy low, sell high" is advice that works in all investing environments. It doesn't matter if it's the twenty-first century and you're Warren Buffett buying junk bonds, or the nineteenth century and you're a Rothschild taking advantage of the panic surrounding Waterloo, or 500 B.C. and you're the pre-Socratic philosopher Thales of Miletus, making his fortune in commodity markets. The trouble with that advice, though, is that if you know what's low and what's high, you don't need it. If you don't know, you don't need it either, since you won't be able to use it.

The more specific the advice, the more its use depends on the current environment and how it evolves. The answer to almost every investment question is the same: It depends. Are technology stocks a good investment? They were from 1996 through 1999, but in 2000 they had their biggest yearly decline in history.

Are stocks a better long-term investment than bonds? It depends. Does your long term start in the late 1920s and end in the late 1940s? Then the answer is "no." Or does it start in the late l940s and end in the late 1960s? In that case, the answer is "of course." The amount of time is the same; the result is totally different. When the answer is "it depends," the question is context dependent.

Context dependence is why so much investment writing is useless after a few weeks. The more specific the advice, the quicker it becomes dated. No one reads last year's investment "strategy" pieces from the major Wall Street firms to get insight about what to do. The demand for investment books is context dependent, too. Books about monetary crises dominated the bestseller lists in the early to mid-1970s, inflation titles were the rage in the early 1980s, and books about the Internet just finished their brief flurry of fame.

The list of perennially useful investment books is short. *Reminiscences of a Stock Operator* is a book most professional investors and nearly every successful trader has read and found worthwhile. It is the thinly veiled story of legendary stock operator Jesse Livermore, told in his own words and transcribed by Edwin Lefèvre, who is listed as the author. Its value lies in its descriptions of situations that recur in every investment era, and the strategies Livermore used to deal with them. He became adept at recognizing recurring patterns and profiting from them. He was not so adept at recognizing that superficially similar patterns can turn out to be substantially different. He made and lost several fortunes; the last loss led him to shooting himself in the men's room of the Sherry Netherland hotel.

Another fine investment book is known more by its title than its contents. *Where Are the Customers' Yachts?* by Fred Shwed is interesting as a period piece—an amusing picture of a mostly vanished world.

The rarest investment books are those that can be profitably read by everyone interested in the craft of investing: books that inform, illuminate, and teach, that can be reread in different periods and contexts and that will deepen our understanding or provide new insights into the current situation.

For value investors, one classic is Ben Graham's *The Intelligent Investor*. First published in the late 1940s, it reflects *Security Analysis,* his pioneering text, without the heavy lifting. You can be a good investor and never have read *The Intelligent Investor,* but you'll be a better one if you have. Graham inspired and shaped the thinking of a generation of value investors, the best known, of course, being Warren Buffett.

I first became aware of Warren Buffett in the mid-1970s through Adam Smith's now out of print *Super Money,* the sequel to his best-selling tale of the late 1960s bull market, *The Money Game.* Written after the severe declines of 1969 and 1970 and the bankruptcy of the Penn Central Railroad, *Super Money* introduced Buffett in Chapter 5, titled "Somebody Must Have Done Something Right: The Lessons of the Master." The chapter was about Graham's principles of margin of safety and intrinsic value, illustrated through the activities of Warren Buffett, then in his early forties and comfortably rich. Unlike the famous fund managers of the 1960s such as Fred Carr, Fred Mates, and Gerry Tsai, Buffett avoided the collapse, disbanding his partnership when speculative excess removed the margin of safety he deemed necessary to continue investing in public markets.

I was then in my mid-twenties and what immediately got my attention was that Buffett's initial capital rounded to zero, but when he ended the partnership at 39 he had $25 million. The way "Adam Smith" told it, Buffett got some money from friends and family, and "sat in his bedroom office, reading through the manuals . . ." He bought "quiet simple stocks, easy to understand, with a lot of time left over for the kids, for handball, for listening to the tall corn grow." Having an almost infinite capacity for indolence, I thought this sounded pretty good. Start with nothing, read some stuff, buy a few stocks, wait, get rich, and then hang it up before 40.

I read Ben Graham and began looking around for stuff on Buffett. I got some money from friends and began buying stocks, simple, easy-to-understand companies trading at low price-earnings multiples, preferably with lots of hard assets and a good current ratio. I looked for net/nets, just as Graham advised. It was a little more work than the method Nicholas Darvas advocated in *How I Made $2,000,000 in the Stock Market,* which involved drawing boxes around the pattern of price action of a stock, as I recall, but I figured if it was too easy then others might get the excess returns before I did.

I need not have worried. Twenty-five years later, it seems people are just as eager to avoid thinking about the businesses underlying the stocks they buy as they ever were. Markets behave pretty much as they have since the time of Thales. Most people prefer to buy what *is* going up rather than what *will* go up. Peter Lynch has often said people will do more research on a $1,000 purchase of a refrigerator than they will before they spend $10,000 on a stock.

Today's markets are larger, deeper, offer more investment choices, move more quickly, and are accompanied by much more noise than the markets of the past. Markets have become democratized; more people own stocks than ever before, and governments cannot ignore markets as they once thought they could.

Markets are all about value. Their function is to price assets and, despite their shortcomings, no better system has been devised. Value is rarely overlooked for long. That is true in the market for books, as well as in the market for stocks.

I have always been mystified by the desire to write books. If you are unknown to the public, writing must surely have among the lowest probabilities of achieving an adequate economic return of any activity. We are fortunate that Robert Hagstrom writes books the way I eat cottage fries at the Post House in New York: compulsively. His compulsion, unlike mine, is good for you.

The Essential Buffett revises, updates, and expands Robert's analysis of Warren Buffett's investment methodology. It covers both stock selection and Buffett's style of portfolio management, which Robert calls *focus investing*. It also contains much new material about how to think about and apply Buffett's approach to the "New Economy."

One of the challenges for investors who believe intrinsic value and margin of safety are the keys to investment success is how to use those concepts in a world that seems increasingly without firm valuation moorings. Many of the old rules no longer work. It used to be that stocks were unattractive relative to bonds when their yields exceeded those of bonds. That valuation rule always worked until it stopped working in the late 1950s, and it hasn't worked since. It used to be that the market was cheap at book value and a sale at twice book or more. That worked until it didn't. It used to be that if stock yields fell below 3 percent, stocks were overvalued. That always worked until it stopped working in the early 1990s.

As Robert Hagstrom ably demonstrates, Warren Buffett's investment thinking evolved, partly from his own experience and partly under the prodding of Charlie Munger. The evolution has been one of method, not one of temperament. The same timeless principles endure, the tenets are always applicable. It is only the environment, the context, which changes.

Bill Miller
Legg Mason Value Trust

PREFACE

With each passing year, the noise level in the stock market rises. Television commentators, financial writers, analysts, and market strategists are all overtalking each other to get investors' attention. At the same time, individual investors, immersed in chat rooms and message boards, are exchanging questionable and often misleading tips. Yet, despite all this available information, investors find it increasingly difficult to profit. Some are hard-pressed even to continue. Stock prices skyrocket with little reason, then plummet just as quickly, and people who have turned to investing for their children's education and their own retirement become frightened. There appears to be no rhyme or reason to the market, only folly.

Far above this market madness stand the wisdom and counsel of Warren Buffett. In an environment that seems to favor the speculator over the investor, Warren Buffett's investment advice has proven, time and again, to be a safe harbor for millions of lost investors.

Over the years, critics have argued that Warren Buffett's idiosyncratic approach to investing is impossible to duplicate. I wouldn't disagree that his approach is unique—in a market that emphasizes the frenetic buying and selling of securities, Buffett's buy-and-hold philosophy is an anomaly. But I do take issue with those who say that only Buffett can do what Buffett does.

The goal of this book is to showcase Buffett's entire methodology: to make it accessible and useful to all investors—individuals and professionals alike—and to demonstrate how

Buffett's thinking can be applied successfully in the New Economy.

To do all of this, I have culled the best from two earlier books and highlighted their core principles: *The Warren Buffett Way,* which describes how Buffett analyzes companies and selects stocks, and *The Warren Buffett Portfolio,* which describes the guidelines by which he manages the Berkshire portfolio. Throughout, fundamental Buffett principles are called out, to detail and clarify Buffett's four-part investment strategy:

1. Analyze a stock as a business.
2. Demand a margin of safety for each purchase.
3. Manage a focus portfolio.
4. Protect yourself from the speculative and emotional forces of the market.

With that background as your framework, you will learn how the Buffett principles can be, and successfully have been, applied in three areas Buffett has traditionally not explored: technology, small-cap, and international stocks. Chapter 8, "New Opportunities, Timeless Principles," gives you an inside look at how three successful investors are applying Warren Buffett's investment principles in their special areas of expertise. Bill Miller, manager of the Legg Mason Value Trust, explains how he has extended Buffett's methodology into the technology arena. Wally Weitz, manager of the Weitz Value Funds, discusses how he uses Buffett's approach to invest in small- and mid-capitalization stocks. Mason Hawkins, manager of the Longleaf Funds, demonstrates how he uses Buffett's principles to invest in foreign companies.

Many people are aware of Buffett's long-standing decision to avoid technology stocks. However, it is important to realize that Buffett's unwillingness to invest in technology is not a statement that technology stocks are unanalyzable. As he confessed during Berkshire's 2000 annual meeting, "It is not that we don't understand a technology business or its product. The reason we don't invest is because we can't understand the predictability of the economics ten years hence." It is this lack of economic predictability that has prevented Buffett from venturing into the technology world. But it has not prevented others from applying Buffett's investment tenets to technology companies, with much success.

In fact, I would argue that what is missing in many analytical reports on technology companies is a businessperson's understanding of how the company operates, how it generates profits, and how a businessperson would then value the technology company. As you will discover in the chapters on portfolio management, one way to compensate for the lack of economic predictability in any company is to reduce its weighting in your portfolio, and another is to require a larger margin of safety with that purchase. The key point is: Warren Buffett's investment tenets are the only sensible way to invest in *any* company, technology or otherwise.

Is there a "New Economy"? While thoughtful people disagree on this question, I believe the answer is yes. We moved from an agriculture-based economy in the nineteenth century to a manufacturing-based economy in the twentieth. Now, in the twenty-first century, it is easy to observe our economy rapidly evolving into one dominated by technology. Broadly speaking, "technology" encompasses many different businesses and industries. Hardware machines fitted with software applications manipulate bytes of information that are then transported around the world to other hardware machines and software applications. In a nutshell, this instantaneous transmission of information is a technological revolution, and it is changing the entire business landscape.

The New Economy is also having a profound impact on the behavior of individual investors. Today, investors have a full menu of stocks to choose from. They can purchase small-capitalization stocks that only yesterday were venture capital investments. They can purchase shares of foreign companies in markets around the world, and obviously they can purchase technology stocks if they so choose. In the New Economy, individuals have easy access to information that only a short while ago was considered so highly valued and proprietary that it was available only to professional investors. Never before has so much information been so readily available to so many investors. In the New Economy, individuals no longer have to rely on investment professionals. They can now electronically trade stocks with a push of a button, or personally change their 401(k) retirement plan on a daily basis, if they wish.

In a world littered with information, the scarce resource is *understanding*. Information itself is not enough to ensure investment success. What is required is an understanding of how best to use the information to achieve the desired goals. We are indeed operating in a New Economy, but the rules of investing have not changed. Businesses still require profits to operate, and investors still calculate these profits to determine value. At first glance, Warren Buffett, who makes no bones about staying away from technology companies, may appear far removed from the New Economy, but a closer inspection will reveal that his investment principles are timeless.

The Chairman's Letters that Warren Buffett writes to shareholders in the Berkshire annual reports are famous; in the early days of my career, they were a profound influence. Taken together, these letters form the best investing textbook I could possibly imagine.

Here is one succinct and powerful lesson, from the 1996 report: "Your goal as an investor should be simply to purchase, at a rational price, a part interest in an easily understood business whose earnings are virtually certain to be materially higher, five, ten, and twenty years from now. Over time, you will find only a few companies that meet those standards—so when you see one that qualifies, you should buy a meaningful amount of stock."

Whatever level of funds you have available for investing, whatever industry or company you are interested in, you cannot find a better touchstone than that.

Robert G. Hagstrom

Wayne, Pennsylvania
February 2001

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CHAPTER 1

THE UNREASONABLE MAN

Forty-five years ago, Warren Buffett began a career managing money. At the relatively young age of 25 and with a relatively small amount of capital (his own investment was only $100), Buffett started an investment partnership. With the support of family members and a few close friends, the Buffett Partnership began operations, on day one, with $105,000 and seven limited partners.

Buffett set himself a tough goal: to beat the Dow Jones Industrial Average by ten percentage points each year. He achieved that and more. From 1956 until 1969, the year the partnership disbanded, Buffett generated an average annual return that was 22 percentage points higher than the Dow. Along the way, the partnership took a controlling interest in a small textile company called Berkshire Hathaway. Over a 35-year period, Buffett grew its book value from $19 per share to $37,987 per share. That works out to a rate of 24 percent compounded annually. It is not surprising that Warren Buffett was recently voted the greatest investor of the twentieth century.

When we look back on the life of Warren Buffett, we can identify several important experiences that helped him become successful. He was raised in a loving home under the moral guidance of two parents who exemplified midwestern values. His father, a stockbroker and U.S. Congressman, stressed both honesty and integrity in all his dealings with clients and the public. Young Buffett had an entrepreneurial streak from the beginning; he quickly learned to appreciate the value of a dollar and, just as important, the value of growing a dollar. Taken together, Buffett's early personal experiences helped provide him with a lifelong moral compass.

In addition to this strong moral foundation, Buffett possessed a seemingly inexhaustible appetite for knowledge. While working at his father's brokerage firm, he devoured all the investment books he could find, which led him ultimately to one of the greatest investment books ever written: Ben Graham's *The Intelligent Investor*.

But it is not enough to say that Buffett's investment success is simply a result of good character and a good education. To this we must add the all-important characteristics of courage and self-confidence. Buffett deeply believed in the lessons taught by his father and by Ben Graham, so he was unafraid when he found himself at odds with the more popular Wall Street view. This quality, which we might call "intelligent contrarianism," has most helped Warren Buffett achieve remarkable success.

"The reasonable man adapts himself to the world," wrote George Bernard Shaw. "The unreasonable one persists in trying to adapt the world to himself. Therefore all progress depends on the unreasonable man."[1] Shall we conclude that Warren Buffett is "the unreasonable man"? To do so presumes that his investment approach represents progress in the financial world, an assumption I strongly make. For when we look at the recent achievements of "reasonable" men, we see, at best, mediocrity and at worst, disaster.

After the 1973–1974 bear market, the U.S. economy endured several difficult years. Not until 1981 were we able to finally throw off the shackles of high inflation and high interest rates, setting the stage for a new bull market. And did we ever have one! In the past 20 years, we have seen the Dow Jones Industrial Average rise from 1,000 to over 10,000.

Another interesting trend during this extraordinary period of price appreciation is the increased activity and interest level of individual investors. Using Individual Retirement Accounts, self-directed 401(k) plans, discount brokers, and electronic trading, individuals have taken a much more hands-on role in managing their own financial affairs. The net effect has been to shift a large portion of financial assets and decision making away from professional investors.

This in no way implies that professional investors have been left with little to do. On the contrary, they have kept themselves busy inventing program trading, leveraged buyouts, derivative securities, and index futures. And they have launched hundreds of hedge funds at a dizzying pace. These funds have shown the ability to roll financial markets, crush foreign currencies, and put to risk the economies of entire countries. This constant game of "I can design a more complex strategy than you can," played at a feverish pace in order to generate the highest return in the shortest period of time, has frightened many investors.

Today, the distinction between one money manager and another has faded. Fundamental research has been replaced by the whir of computers. Black boxes have replaced management interviews and company investigations. Automation has replaced intuition. As a consequence, professional money managers have put more distance between the financial securities we own and the businesses these securities represent. No wonder the average investor is becoming more of a do-it-yourselfer. No wonder passive index investing has increased in popularity. With most money managers unable to add value to their clients' accounts, active money management is increasingly viewed as a "satellite" strategy, a smaller adjunct to the much larger indexing strategy.

Throughout the past few decades, money managers have flirted with many different investment approaches: small capitalization, large capitalization, growth, value, momentum, thematic, and sector rotation. At some point, each has proved financially rewarding, and each has stranded its followers in periods of mediocrity.

Buffett is the exception. He has rarely suffered periods of underperformance. His investment performance, documented over the past 45 years, has been consistently superior. What makes his record all the more remarkable is that, despite the market's ever-changing landscape, his investment strategy has changed very little. While other investors and speculators, over time, have been distracted by fads and have toyed with many esoteric approaches to investing, Buffett's consistent commonsense approach has helped him amass a multibillion-dollar fortune.

How did he do it?

When we study Buffett's success and compare his approach with the practices of a majority of other investors, we can easily distill critical differences in three areas. The differences have to do with the way Buffett:

1. Analyzes stocks.
2. Manages a portfolio.
3. Thinks about the stock market.

LESSON 1

Analyze Stocks as Businesses

When Buffett invests, he sees a business. When he looks at a stock, he quickly moves past the share price and begins to analyze the attributes of the business. One by one, he weighs them against the business tenets, the management tenets, and the financial tenets that represent the core of his investment analysis (see page 79). Next, he calculates what the business is worth. Only then does he take a look at the stock price.

Most other investors look *only* at the stock price. They spend far too much time and effort watching, predicting, and anticipating price changes, and far too little time understanding the business. And even when investors do try to gauge the value of a stock, they use single-factor models like price-to-earnings ratios, book values, and dividend yields. But these simple metrics, as we shall see, tell us nothing about the value of the company.

I am convinced this is a critical variable that helps to explain Buffett's investment success. Most people look only at stock factors; Buffett analyzes only business factors.

Buffett's unique combination of business experiences gives him an advantage that separates him from all other investors. He gained hands-on experience by owning and managing a wide variety of businesses while simultaneously investing in common stocks. He has experienced both success and failure in his business ventures, and he has applied to the stock market the lessons he learned.

Other professional investors have not had the same kind of education. While they were busy studying capital asset pricing models, beta, and modern portfolio theory, Buffett studied the income statements, balance sheets, capital reinvestment requirements, and cash-generating abilities of his companies.

That kind of direct experience offers insights that can be learned only from doing. As Buffett himself puts it, "Can you really explain to a fish what it's like to walk on land? One day on land is worth a thousand years of talking about it, and one day running a business has exactly the same kind of value."[2]

Owning and operating businesses has given Buffett a distinct advantage. But I do not mean to suggest that to be successful using the Warren Buffett tenets you first have to manage a business. What is most important for all investors, whether they have ever managed a business or not, is to think about the stock as if they actually had to manage the business.

Look at the Stock as a Business

Look at the company's economics, and look as intently as if you were taking over as CEO tomorrow. Then *check the price.*

Buffett believes the investor and the businessperson should look at the company in the same way because they both want essentially the same thing. The businessperson wants to buy the entire company, and the investor wants to buy portions of the company. If you ask businesspeople what they think about when purchasing a company, the most frequent answer is: "How much cash can be generated from the business?" Finance theory dictates that, over time, there is direct correlation between the value of the company and its cash-generating ability. Theoretically, then, the businessperson and the investor should be looking at the same variables.

"In our view," says Buffett, "investment students need only two well-taught courses: How to Value a Business, and How to Think About Market Prices."[3]

The necessary first step for anyone who wants to emulate Warren Buffett's approach is to think about stocks first and foremost as businesses. "Whenever Charlie [Munger] and I buy common stocks for Berkshire," Buffett has said, "we approach the transaction as if we were buying into a private business. We look at the economic prospects of the business, the people in charge of running it, and the price we must pay."[4]

LESSON 2

Manage a Focused, Low-Turnover Portfolio

In 1996, Stephen Jay Gould, the noted biologist, prolific writer, and lifelong Yankees fan, published *Full House: The Spread of Excellence from Plato to Darwin*. Gould is fascinated by the complex nature of life, and he studies intensely the variations of different systems. In this illuminating book, he talks about, among other things, the death of .400 hitting in major league baseball.

The record books say that between 1901 and 1930, a span of 30 years, there were nine seasons in which at least one player achieved a batting average better than .400. But in the 68 years that followed, only one player reached that milestone: Ted Williams hit .406 in 1941.

From those statistics, we might conclude that batting skills, over time, have deteriorated. But Gould wants us to consider the ease with which statistics can be misread. He believes another force is at work. Hitting is not getting worse, but, overall, defensive play is getting better. The pitching is more sophisticated, the fielding skills are better, and the team's ability to develop a full defense against strong hitting is much advanced. Gould the scientist explains, "As play improves and the bell curve marches toward the right wall, variation must shrink at the right tail. [And] .400 hitting disappears as a consequence of increasing excellence in play."[5]

Peter L. Bernstein, founding editor of the *Journal of Portfolio Management* and author of two outstanding works on finance—*Capital Ideas: The Improbable Origins of Modern Wall Street* and *Against the Gods: The Remarkable Story of Risk*—takes Gould's thesis on .400 hitting and applies it to the business of portfolio management. "The performance data for equity portfolio managers," he says, "reveals patterns that are astonishingly similar to what has happened in baseball."[6] Bernstein reasons that a lack of above-average performance by professional money managers is a result of the ever-increasing level of investment management education and knowledge. As more and more people become more and more skilled at investing, the odds of a breakout performance by a few superstars diminish.

It is an intriguing analogy. Following this argument to the end, one could conclude that heavy hitters like Warren Buffett will gradually be displaced completely by an efficient market of well-informed, intelligent investors. Indeed, Bernstein points out that Berkshire Hathaway's record, when compared against the S&P 500, was better in the 1960s and 1970s than in the 1980s and 1990s. However, I would argue: considering that the stock market is more competitive today and that Berkshire's enlarged capital base becomes a relative handicap in this kind of comparison, Warren Buffett still qualifies as a .400 hitter.

In his article (titled "Where, Oh Where Are the .400 Hitters of Yesteryear?"), Bernstein willingly left the back door unlocked in his performance analysis. He wrote that, to become a .400 hitter, the portfolio manager must be *"willing to make the kinds of concentrated bets that are essential if the aim is to provide high excess returns"* (emphasis added).[7] To my mind, "concentrated bets" equate to a focused portfolio of no more than 20 stocks. Never mind that Bernstein believes the risk of tracking error and high standard deviation would dissuade any portfolio manager from taking on a focus portfolio. The fact still remains: A focus portfolio stands the best chance of beating a market rate of return, and providing the "high excess returns" that only the .400 hitters can deliver.

Not surprisingly, if we open Bernstein's back door and look out, whom do we see? Brilliant financial thinkers: John Maynard Keynes, Phil Fisher, Warren Buffett, Charlie Munger, Lou Simpson, and Bill Ruane, all of whom we shall meet later. Just as a young rookie might have intently watched Ted Williams, we can learn a great deal by studying the batting stance and swing of these .400 hitters. As Buffett once said, "The key to life is to figure out who to be the batboy for."[8]

Best way to hit a home run: Don't swing at everything; wait for a fat pitch.

* * *

Best way to outperform the market: Don't load up on hundreds of stocks; wait for the few outstanding opportunities.

How many stocks should an investor own? Buffett would tell you it depends on your investment approach. If you have the ability to analyze and value businesses, then you are not likely to need many stocks. As a buyer of businesses, there is no law that requires you to own a stock from every major industry. And you are not required to include 40, 50, or 100 stocks in your portfolio to achieve adequate diversification. Even the high priests of modern finance have discovered that, on average, "85 percent of the available diversification is achieved with a fifteen-stock portfolio and increases to 95 percent with a thirty-stock portfolio."[9]

Buffett believes that the only investors who need wide diversification are those who do not understand what they are doing. If "know-nothing" investors want to own common stocks, they should own a large number of equities and space out their purchases over time. In other words, they should use an index fund and dollar-cost average their purchases. There is nothing shameful about this simple technique. In fact, Buffett points out, the index investor will actually outperform the majority of investment professionals. "Paradoxically," he notes,