REAL MONEY

Rob Rikoon

Back to Basics

Given the sideways direction of the stock market lately, it is worthwhile to look at the example of an investor who has excelled during both up and down markets. Last week, my colleague, Chris Schreur, helped me teach a class at the University of New Mexico's Anderson School of Management about Warren Buffet, considered by many to be the most successful investor in history. He started with a stake of $100 and the most recent estimate of his personal wealth was over $30 billion.

Along with his acumen in terms of investing, Mr. Buffet seems to have more than a normal quota of common sense. One of my favorite expressions concerning wealth is from him regarding how much money to leave to one's children. His view is that children should be left enough money so that they don't have to work at something they don't want to but not so much that they don't have to work at all!

The reason behind Mr. Buffet's success and that of his holding company, Berkshire Hathaway, draws on some fairly simple premises. These are easy to describe but difficult to put into practice. Buffet was inspired by Benjamin Graham, whose book *The Intelligent Investor,* is the classic treatise on how to stay outside of, and perhaps above, the emotional fray inherent in the stock market. Mr. Graham's philosophy can be summed up by this quote: "A true investment is that which thorough analysis shows will offer both safety of principal and a satisfactory return. Anything less is speculation."

Taking this advice to heart, Buffet returned to Omaha in 1956, when Graham retired. For the next thirteen years, Buffet managed a limited partnership that returned 29.5% per year while during the same time period the Dow Jones Industrial Average grew at 8% per year. The limited partnership never had a down year while the Dow had five negative years during this time.

Like a well-managed hedge fund, Buffet knew when enough was enough. In 1969, he did not see any further reason to stay in the market as there were few decent buys. So he voluntarily ended his successful venture and sent the proceeds of his complete liquidation of all the stocks back to the investors. He used his own portion to buy an ailing textile company, Berkshire Hathaway, which struggled over the next fifteen years until it was finally closed as a manufacturing business in 1985.

Interestingly enough, while Buffet struggled in the world of textiles, which was pummeled by foreign competition and high labor costs through the inflation-ridden decade of the 1970s and 1980s, Buffet changed course and during that same time period bought stakes in two insurance companies. By the mid-1990s, Buffet owned GEICO, as well as General RE, establishing himself as a major player in the insurance business.

The approach used by Berkshire Hathaway holds some lessons for all individual investors, no matter what the size of their portfolio. They can be summarized under the following five tenets:

1. Buy simple businesses that you understand.
2. Buy companies that have consistent profitability.
3. Buy companies whose management is concerned with having a good return for stockholders in terms of the intrinsic value of the business.
4. Look for companies with low debt levels.
5. Look for companies with good management in place and who have a long-term stake in the business.

Buffet passed over the technology sector because he did not understand the tech products and was uncomfortable with potential competition from new and unforeseen inventions. Companies with wildly fluctuating earnings, such as those that take advantage of popular infatuation with new technologies, are at the opposite end of the investing spectrum from established businesses that earn slow and steadily growing profits. Buffet likes the tortoise versus the hare in corporate earnings terms!

Berkshire Hathaway is not interested in turnaround situations where businesses are on the ropes and investors think that sooner or later they must come around. Likewise, hostile takeovers or situations where management is not totally behind a change in ownership hold no interest for Buffet.

How can you know if a company is simple and understandable? If you look at the basic business, there has to be an intrinsic value in that there is an established place the company holds in satisfying some fairly constant demand in society. Dairy Queen is a good example of a solid, if unexciting, operation. It qualifies under the intrinsic criteria, though health food buffs might disagree. Berkshire Hathaway owns Dairy Queen in its entirety. It may be hard to believe, but Buffet has lunch every day at the local Dairy Queen!

A company's management must be focused on its shareholders to attract an "intrinsic value" oriented investor. The business's long-term prospects should not depend on constant innovation but on continued basic demographic trends and consumption patterns.

There is a basic need, more apparent in the post-Enron environment, for management to be candid with its shareholders. Everyone makes mistakes, but how often do you see a CEO step up to a microphone and display the humility to air the company's dirty laundry with candor and forthrightness?

The stock market places tremendous pressure on management of every public company in this country to produce ever-increasing profits. One common game on Wall Street is to beat the earnings expectations of professional analysts. To do this, companies are forced to focus on "earnings per share", which is the reported profitability measure.

Earnings per share has nothing to do with the intrinsic value of a business or increasing shareholders' stakes. Warren Buffet prefers to look at ROE.

One difference between an intrinsic value investor and other types of investors is that the expected time period for holding an investment is very long. Buffet feels that when you buy a company, if you have done your homework, you should ignore monthly, quarterly, and even the yearly valuations of the company made by the stock market. You are in business with the company and should have a firm conviction that business success will eventually be recognized by the stock market. Companies that meet these criteria constantly reinvest in their employees, in their products, and are not trying to acquire new business lines that may be exciting and immediately profitable. Great companies are willing to stay with what they know and do well.

Like all investors, Buffet looks to pay the right price for any company that he is buying. This is commonly known as a "discount". We all like to go shopping and feel that we are getting a good deal. Buying at a discount and focusing on what you know helps create a low-turnover portfolio. Unlike conventional wisdom, Buffet feels that in a period of a sideways moving stock market, picking a few great companies is more profitable than trying to cover all the bases with a portfolio of neutral funds. The "focused" investor's golden rules are:

1) Concentrate investments in outstanding companies run by strong management.

2) Limit yourself to the number of companies that you can truly understand and follow. Ten is a good number; more than that may be asking for trouble.

3) Pick out the best ideas in industries in which you have experience and put the bulk of your investments there.

4) Think long-term: five to ten years should be your minimum holding period if you are buying into a business and you consider yourself to be a "partner" in that business, as opposed to being a short-term investor.

5) Expect volatility. Ignore the ups and downs in the price of your companies. Carry on and you will be enriched if your initial analysis was thorough.

Here is a quote of Mr. Buffet's that sums up his color and flavor:

"When the price of a stock can be influenced by a herd on Wall Street, with prices set at the margin by the most emotional person, or the greediest person, or the most depressed person, it is hard to argue that the market always prices rationally. In fact, market prices are frequently nonsensical. "

So, take heed of your own counsel regarding what basic trends you can rely on. Do your homework, establish your positions, and then go for a nice hike free of worry about what the market is doing today.

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