

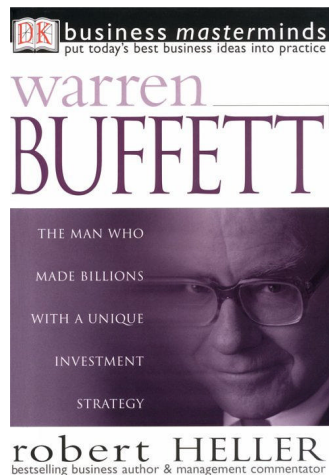
BusinessSummaries

WISDOM IN A NUTSHELL

PRESENTS  
**INSIDE THE GURU MIND SERIES**

# Warren Buffet

## The Man Who Made Billions With A Unique Investment Strategy



By  
**Robert Heller**

Published By Dorling Kindersley Ltd., London 2001  
ISBN: 0789451573; 1st edition (April 1, 2000)  
112 pages

Businesssummaries.com is a business book summaries service. Every week, it sends out to subscribers a 9- to 12-page summary of a best-selling business book chosen from among the hundreds of books printed out in the United States every week. For more information, please go to <http://www.bizsum.com>.

## The Buffet Fundamentals

**Warren Buffet** discusses his unique investment principles, the factors he considers when determining the real value of a business and his post-acquisition management style.

### **Assessing the Value of Companies**

#### **Finding the Diamond in the Rough**

How to Identify Outstanding Companies

Buffet selects investment targets through relatively simple criteria. First, he scrutinizes companies in non-financial terms:

1. *Is it simple and understandable?*
  - Buffet believes that if you do not understand the business, you cannot make a rational judgment regarding its real or intrinsic value.
  - This principle limits Buffet from participating in high-growth companies such as Microsoft. However, he is quick to point out that many other opportunities exist where growth rates are just as appealing.
2. *Has it consistently delivered above-average performance?*
  - Buffet believes that the probability of a bad company turning good is much lower than the probability of a good company remaining good.
3. *Does it have favorable long-term prospects?*
  - Buffet studies the quality of a company's leaders when determining its future.
    - Does management make rational decisions?
    - Are its leaders honest with its shareholders?
    - Does management resist the temptation to imitate other management practices and policies, whether they are applicable or not?

His stakes in Coke and Gillette are illustrative of his investment strategy and his definition of the intrinsic value of a company.

"Is it really so difficult to conclude that Coca-Cola and Gillette possess far less business risk over the long-term than, say, any computer company or retailer? Worldwide, Coke sells about 44 percent of all soft drinks, and Gillette has more than a 60 percent share (in value) of the blade market. Leaving aside chewing gum, in which Wrigley is dominant, I know of no other significant businesses in which the leading company has long enjoyed such global power."

#### **Calculating the Diamond's Real Worth**

Predicting Future Profits

Buffet looks at potential investments through the eyes of a business analyst – not a macroeconomic analyst, nor a security analyst because, as he states, "the market may judge a business to be more valuable than the underlying facts would indicate it is. In such a case, we will sell our holdings."

Buffet's definition of a rational price is based on four indicators of management excellence:

1. What percentage is the company earning on shareholders' equity?
2. How much are the earnings that belong to the shareholders?
3. What are the profit margins?
4. Does the company create at least one dollar of market value for every one dollar that it keeps in the business?

### Putting All Your Eggs in One Basket

How to Reap the Rewards of Calculated Risk – and Courage

Fund managers “spread the risks” by investing in a wide portfolio of stocks, and in so doing, make it difficult to do better than the market. Buffet recommends a sharp-shooter approach – choose five to ten stocks which are undervalued and hold on to them.

“If you aren't willing to own a stock for 10 years, don't even think about owning it for 10 minutes. Put together a portfolio of companies whose aggregate earnings march upward over the years, and so also will the portfolio's market value.”

### The Advantages of Holding Stocks Long-Term

- No dealing costs
- No taxation on your capital gains
- The magic of compound interest

#### Putting Ideas into Action

Internalizing the Contrarian Cause

- Only buy if you are prepared to put at least 10 per cent of your net worth into that stock.
- Expect to hold your investments forever.
- Only invest your cash when you can find something worth buying.
- Do your own research – and do it thoroughly.
- Ignore the market and its fashions.
- Do not watch the market intently.
- Have fixed investment principles.
- Do not switch holdings frequently.

### Masterclass 1: Investing in Shares

Investigating the Business	
<input type="checkbox"/>	Buy a few shares in any business that interests you and attend the annual general meeting to get a look at the management.
<input type="checkbox"/>	Read all you can about the business. Check out the Internet, annual reports and newspaper articles.
<input type="checkbox"/>	Sample its products and services. Does the company have a strong orientation towards customer satisfaction?

### Measuring the Financials

Determining the intrinsic worth of a business means comparing its future streams of income against the returns of risk-free government bonds. If the projected future returns of the company in question exceed the risk-free alternative, it is worth buying.

1. Earnings to Equity Ratio (ROE)
  - The proportion of after-tax income divided by equity should be higher than the return on long-term bonds.
  - Equity is defined as the company's capital less its long-term liabilities.
  - Expect the company's value to increase by the same proportion as ROE.
2. Shareholder Earnings
  - Owner's earnings are after-tax profits plus depreciation and profits from other interests.
  - This indicator gives us a more accurate picture of the company's real earning power.
3. Profit Margins
  - This indicator measures the relationship between price and costs and the strength of the company's customer base.
  - A low margin (5%) is a no-go while a too-high margin (20%) may be unsustainable.
4. Market Value
  - Add back retained earnings not paid out in dividends and taxes over two or three years. If this figure is lower than the incremental increase in market value for the same period, it demonstrates the capability of management to use the shareholders' money wisely.
  - What is the company's cash flow trend? Be wary of companies with increasing profits and declining cash flows.
  - Consider the company a "buy" when market value as a percentage of sales is low.

## **Making Acquisitions Pay**

### **Kissing Princes, Not Toads**

#### Hunting for Acquisitions

While mergers and acquisitions are motivated by the exploitation of savings and other synergies—the desire to increase the size of the corporation and the belief that acquirer's management "kiss" will make the acquired company more profitable, often leads to acquisition binges. When the expected profits do not materialize, toad-kissing management divests itself of the acquired toads, often at great expense to shareholders.

It is characteristic of Buffet to invest in companies whose growth is dependent on internal expansion rather than on acquisitions. He is willing to pay fair prices for good businesses rather than pay bargain prices for mediocre businesses. In addition, he dismisses earnings projections prepared by the selling company's management because these figures are often biased.

Buffet believes in taking "the same attitude one might find appropriate in looking for a spouse. It pays to be active, interested, and open-minded, but it does not pay to be in a hurry."

### **Buying with Cash or Stocks?**

#### How to Pay for the Acquisition

Cash is Buffet's usual mode of payment when buying a business, with the exception of the purchase of General Re, America's largest re-insurance company, which was paid for entirely in shares.

The difficulty with the use of shares is that its worth is dictated by the prevailing market price whereas the business that is up for sale usually goes for its full business value. Buffet is clear on

this point, “we will not issue shares unless we receive as much intrinsic value as we give...Why...would anyone issue dollar bills in exchange for fifty-cent pieces?”

## Running with the Pack

Rationalizing a Bad Deal

1. *The company we are buying will be worth more in the future.*
  - The imbalance in price will not be corrected because the value of the buying company also increases over time.
2. *We need to grow.*
  - From the perspective of the shareholders’ this is untrue. All existing businesses shrink when shares are issued. This means that the shareholder’s interest in the “old” business shrinks as well.
3. *The selling shareholders want a tax shelter, so we need to give them 51 percent in stock and 49 percent in cash.*
  - The toad-kisser should think about his shareholders first.

Aside from the dilution of the acquirer’s equity, the relative decline in the acquirer’s share price further erodes the position of its shareholders. Buffet sums up the situation: “most major acquisitions...are a bonanza for the shareholders of the acquiree...But, alas, they usually reduce the wealth of the acquirer’s shareholders.”

## A Matter of Trust

Managing the Acquisition

1. Buffet offers the acquired company autonomy and a pleasant corporate environment that underscores the fact that he is buying for keeps.
  - “When we buy a business, the sellers go on running it just as they did before the sale, we adapt to their methods rather than vice versa.”
2. When buying a family business, Buffet leaves 20 percent of the business with the operating members of the family.
  - Buffet understands that the reason behind the success of the company is the dedication and capability of the owner-managers.
3. Buffet’s goal is to provide a corporate home that will enable the acquired company to live up to its earnings projections. This means leaving the operations in the hands of the experts.
  - Berkshire Hathaway does not have the operating people to manage the acquired companies. It limits itself to choosing the head of the company and to capital allocation.

### Decision Rules for Acquisitions

- Look for organic growth first before you consider acquisitions.
- Be prepared to wait until a satisfactory deal comes along.
- Buy good businesses at fair prices, not fair businesses at good prices.
- Seek only a true exchange of business value for business value.
- Never look at earnings projections that have been prepared by sellers.
- Don’t spend time on discussion unless a price is already known.

## Avoiding the Accountancy Trap

### Look-Through Earnings

The True Earning Capacity of a Firm

If ownership in a company is less than 20 percent, only dividends are reflected in the profit statement of the owner-company. But true earning power lies in the profitability of the acquired company. Thus, the value of the owner-company is understated when studied from a business perspective.

#### Investigating below the Iceberg

"I believe the best way to think about our earnings is in terms of 'look-through' results, calculated as follows: Take \$250 million, which is roughly our share of the 1990 operating earnings retained by our investees; subtract \$30 million, for the incremental taxes we would have owed had that \$250 million been paid to us in dividends; and add the remainder, \$220 million, to our reported operating earnings of \$371 million. Thus, our 1990 'look-through' earnings were about \$590 million."

### Accounting for Goodwill

Paying More than What a Firm is Worth

When a business is purchased for an amount that is higher than book value, the difference appears in the balance sheet as goodwill and is amortized over 40 years. Although Berkshire reflects goodwill in its books, Buffet disagrees with its accounting treatment. He points out that goodwill is a real cost that cannot be recovered if the intrinsic value of the acquired business is lower than its selling price. "Because it can't go anywhere else, the silliness ends up in the goodwill account. Considering the lack of managerial discipline that created the account, under such circumstances it might better be labeled 'No-Will'."

Berkshire Hathaway also accounts for economic goodwill – the difference between the tangible and the intrinsic value of the business. This type of goodwill is what matters to Buffet. When he acquired See's Candy Stores in 1972, he paid \$17 million more than its net tangible assets, but the economic goodwill from the deal is much more than the accounting goodwill.

### Accounting for Stock Options

Reflecting the Opportunity Cost

In accounting practice, stock options are not treated as an expense like cash incentives, even though there is a real cost to the company. The hidden cost to the company is the difference between the market price at the date of exercise and the grant price.

"If options aren't a form of compensation, what are they? If compensation isn't an expense, what is it? And if expenses shouldn't go into the calculation of earnings, where in the world should they go?"

The motivation for top management to conceal a reward system that benefits them is often at the expense of the shareholders. Buffet warns, "Clearly, investors must always keep their guard up and use accounting numbers as a beginning, not an end, in their attempts to calculate true 'economic earnings' accruing to them."

### The Value of Intangible Assets

Escaping from Old Ideas

Buffet's predisposition to buy businesses that have a large base of tangible assets is a legacy left by his mentor, Benjamin Graham. Buffet's investment strategy was hinged on the rationale that tangible assets protected the investor against inflation.

Through the years, Buffet changed his views and began acquiring businesses that possessed large amounts of economic goodwill and a minimum of tangible assets. He noted that businesses with a large amount of tangible assets were often saddled with low rates of return during times of inflation and only had enough to maintain operations. On the other hand, owners of intangible assets with high intrinsic value and few tangible assets enjoyed increasing profits during inflationary periods. Telecommunications is one good example.

### **Putting Ideas into Action**

How to Determine the Real Value of a Firm

- Study the economic performance of the firm during the past 5 years.
- Work out the present value of the future pay-offs of the business.
- Ask whether the business can meet its future obligations.
- Make each dollar of retained earnings create at least a dollar of market value.
- Focus on long-term business prospects, not on short-term share gains.
- Invest in intangible assets that promise to have lasting tangible value.
- Insist on getting as near as you possibly can to financial reality.

## **Masterclass 2: Buying Companies and Assessing Management**

The principles of purchasing businesses are also a good guide if you are thinking of buying shares or are evaluating a prospective employer. As an employee, you are investing your time and energy, so it makes sense to be able to determine early on whether the company you work for can give you a good return on your investment.

### **Measuring Motives**

Being a Rational Buyer

As a manager considering an investment or acquisition:

- Do you find making this deal more fun than running the business, and is that why you are interested?
- Are you pursuing the deal because you have a strategic purpose in mind?
- If so, how exactly will achieving that purpose enhance the intrinsic value of the business?
- If not, why are you considering the deal at all?

### **The Quality Issue**

Sources of Company Growth

- Were the results achieved through mostly debt? Less debt means less risk. Avoid investing in companies with high debt-to-asset ratios.
- Are the high profit margins due to good management or to a monopoly?
- Only take an interest in companies where quality is high. A high price and high quality is profitable but will invite competition that will narrow its margins. Whereas, a company with low prices and high quality is a good long-term investment.

The Price / Quality Matrix		
High price/ high quality	Medium price/ high quality	Low price / high quality
High price/ medium quality	Medium price/ medium quality	Low price/ medium quality
High price/ low quality	Medium price/ low quality	Low price/ low quality

## Sources of Organic Growth

Increase sales from existing and new customers by:

- increasing demand for existing products and services.
- improving existing products and services.
- introducing new products and services.

## How to Handle Managers

Leaving Well Alone

Trusting managers to do a good job is the key to good performance. Ask yourself:

- Is this person competent to do the job?
- If “no”, why did I keep them?
- If “yes”, why am I refusing to let them show their competence?

## Linking Rewards to Responsibility

Options and bonuses are based on the performance of the company as a whole rather than the performance of the individual. Buffet believes that organic growth is achieved by linking the reward system to activities within the individual’s control.

## Managing the Managers

Buffet measures managers on their ability to deliver above-average returns on capital. If management cannot deliver, they face three theoretical options:

- *Invest the profits at inferior rates of return.* This scenario is, of course, unacceptable because it misuses the funds of shareholders.
- *Acquire other businesses to enhance performance.* But why should investors expect managers to run another business well when they deliver below-average earnings on their current business?
- *Give back the money to shareholders and allow them to seek a better place to leave their funds.* On this point, Buffet agrees with management guru, Peter Drucker: that businesses have no right to keep funds that are not put to good use.

## The Owner’s Manual

Imbibing Owner-Related Principles



Better returns on shareholder investment naturally follow from able and properly motivated managers. Buffet believes that managers perform better when they have a personal stake in the business, and he outlines the principles that his managers live by:

- Think of shareholders as owner-partners, and of yourselves as managing partners.
- Have a major portion of your net worth invested in the company.
- Aim to maximize the average annual rate of gain in intrinsic business value on a per share basis.
- For preference, reach your goal by directly owning a diversified group of businesses that generate cash and consistently earn above-average returns on capital.
- Ignore conventional accounting, with its insistence on consolidating the earnings of individual companies, and concentrate on their individual earnings.
- Do not let accounting consequences influence your decisions on operations or allocating capital.
- Use debt sparingly and, when you do have to borrow, try to structure your loans over a long term at a fixed rate of return.
- Never ignore long-term economic consequences for the shareholders when buying businesses.
- Check noble intentions periodically against results – does every dollar of retained earnings over time deliver at least a dollar of market value?
- Only issue shares when you receive as much in business value as you give.
- Regardless of the price you may be offered, never sell any good business.
- Be candid in reporting to shareholders, emphasizing the pluses and minuses that are important in appraising business value.

## **Providing Information**

### The Role of the Board of Directors

Transparency and accurate reporting to shareholders is key. However, the ability of the board of directors to influence decisions varies, depending on the distribution of power:

1. A corporation where there is no controlling shareholder is the most common type of organization. The CEO must secure the majority vote to implement a decision.
2. A corporation where the controlling owner is also a manager can relegate the role of the directors to commentators.
3. A corporation where the controlling owner is not involved with management is the ideal set-up to Buffet. The owner can appoint directors, who in turn, know that their advice will reach the right ears.

“If they lack integrity or the ability to think independently, directors can do great violence to shareholders while still claiming to be acting in their long-term interest. But assume the board is functioning well and must deal with a management that is mediocre or worse. Directors then

have the responsibility for changing that management, just as an intelligent owner would do if he were present.”

## **Criticizing the CEO**

### Setting Standards

It is much more difficult to get rid off an incompetent CEO than it is to get rid of an inadequate subordinate for two reasons:

- The standards for the CEO are “often fuzzy or they may be waived ore explained away, even when the performance shortfalls are major and repeated.”
- The CEO has no boss whose performance is likewise measured. The role is filled by the directors who are often not held accountable for poor company performance.

The differences between the CEOs in Buffet's team and other CEOs are evident. The former think and act like owners because they have been owners and were also directly responsible for the stellar success that caught Buffet's interest in the first place. They share Buffet's investment and management's principles. And most importantly, they are candid. When there is bad news, Buffet expects to be told early on.

## **Criticizing Stock Options**

### Deciding on an Appropriate Incentive Scheme

Buffet does not believe that stock options are a fair reward system:

“When the result is equitable, it is accidental. Once granted, the option is blind to individual performance, and because it is irrevocable and unconditional (so long as a manager stays in the company, the sluggard receives rewards from his options precisely as does the star. A managerial Rip Van Winkle, ready to doze for 10 years, could not wish for a better ‘incentive’ system.”

In Buffet's opinion:

- Options are based to overall company performance, so they should be awarded to top management.
- Compensation should be based on performance that is under the manager's control.
- Options should be priced at real business value, not market value.

## **Masterclass 3: Learning from Mistakes**

### **Analyzing your Successes**

You can learn from both your successes and failures. Some serious questions to ask yourself:

- Did you succeed because of luck or because of your ability to comprehend the situation?
- Did success flow from repeating previous experience, or breaking into new ground?
- Did you go about doing the right thing in the wrong way, but succeeded because the outcome was so successful that the mistakes did not matter.

## Sticking to Your Principles

Avoid mistakes by being true to yourself. Mistakes occur when following conventional wisdom rather than your own convictions. Here are five rational principles explained by Buffet:

- Focus on a few things, not many things.
- Ignore short-term fluctuations, unless they invalidate your long-term expectations.
- Do not believe that booms will continue forever, or that slumps will never end.
- If you have done your homework thoroughly, have the courage of your convictions.
- Be as ruthless when analyzing your success as you are when analyzing failure.

## Applying the Power of Reason

Buffet explains that irrational behavior interferes with a person's output and gets ingrained into the person's habits and temperament over time. To minimize irrational behavior he advises young people to develop good habits early on.

## Developing Good Habits

A Rational Approach

"Pick out the person you admire the most, and then write down why you admire them. Then put down the person that, frankly, you can stand the least, and write down the qualities that turn you off in that person. The qualities of the one you admire are traits that you, with a little practice, can make your own, and that, if practiced, will become habit-forming. Look at...what you find really reprehensible in others and decide that those are things you are not going to do. If you do that, you'll find you convert all of your own horsepower into output."

Buffet also points out the rationality of working with people you like. With the numerous choices at your disposal, why work with someone you dislike?

"We intend...working only with people we like and admire...working with people who cause your stomach to churn seems much like marrying for money – probably a bad idea under any circumstances, but absolute madness if you are already rich."

## Making the Wrong Decisions

The Cost of Lost Opportunities

We make mistakes by either omission or commission, and both types have an accompanying cost. The purchase of Berkshire Hathaway, which was originally a textile firm was a mistake of commission. Buffet bought the company because it was selling below the value of its working capital. Over nine years, Berkshire lost \$10 million on sales of \$530 million. "We went into a terrible business because it was cheap."

Most of Buffet's mistakes he concedes are those of omission. Not executing a decision to buy. Not optimizing his profits. The opportunity costs attached to these mistakes are real, but are not recorded under conventional accounting procedures.

## **Following the Rational Course**

### Seizing a Few Good Opportunities

Buffet's best business decision was to take advantage of the post-war boom, an opportunity open to anyone, by becoming a professional investor. He followed a rational approach to investing: "you do not need a great many deals to succeed in the investment business."

"In fact, if...you got a punch card with 20 punches on it, and every time you made an investment decision you used up one punch, and that's all you were going to get, you would make 20 very good investment decisions. And you could get very rich, incidentally. You don't need 50 good ideas at all."

Buffet's decision not to split Berkshire stocks has kept the price at \$70,000 per share. His rationale is that Berkshire would then attract "a slightly more long-term oriented group of investors" and would save on resources by not having to report quarterly earnings or maintaining an investor relations department.

## **Focusing on the Predictable**

### Minimizing the Probability of Change

Buffet focuses on businesses that he predicts will remain fundamentally the same in the next 20 years. His investment in Gillette is an example. The Internet is not going to change the way people will shave in the future.

## **Measuring True Success**

### The Rational Tests

When analyzing earnings on a year-to-year basis:

1. Make sure that the figures in the base year are not depressed. Compare the proportion of earnings against capital to determine whether profits are significant.
2. Check growth in profits against the additional capital employed to create those profits. If the growth in profits exceeds the capital infusion, then the business is considered truly profitable.

## **No Dividends Policy**

### Ensuring Sustainable Growth

Berkshire has consistently delivered more than \$1 of market value for every dollar reinvested. The payment of dividends would diminish the amount of capital that could be reinvested and would, in turn, diminish the amount of future returns. This is why Buffet is not in favor of distributing dividends.

In the early years of Berkshire's existence, a pay-out would have been disastrous. Buffet committed the profits instead to more lucrative businesses and closed down the textile operations. "It's been like overcoming a misspent youth."

### **Putting Ideas into Action**

- Start as early as possible in your career to develop only good habits.
- Look at what you find really reprehensible, and avoid it.
- Try to do work that you like and only with people you like.
- Focus on a few good things, rather than making many investments.
- Look for businesses whose long-term futures are predictable.
- Confess our serious errors fully to yourself as well as to others.
- Invest money to earn more for shareholders than they can for themselves.