BUFFETTOLOGY

The Previously Unexplained Techniques That Have Made WARREN BUFFETT the World's Most Famous Investor

$

MARY BUFFETT & DAVID CLARK

A Fireside Book
Published by Simon and Schuster

FIRESIDE
1230 Avenue of the Americas
New York, NY 10020

First Fireside Edition 1999

FIRESIDE *and colophon are registered trademarks of*
Simon & Schuster Inc.

Designed by Jenny Dossin

Manufactured in the United States of America

31 33 35 37 39 40 38 36 34 32

Library of Congress Cataloging-in-Publication Data is available.

ISBN-13: 978-0-684-83713-0
ISBN-10: 0-684-83713-7
ISBN-13: 978-0-684-84821-1 (Pbk)
ISBN-10: 0-684-84821-X (Pbk)

To my children

ACKNOWLEDGMENTS

We wish to thank first and foremost our publisher, Eleanor Rawson. She is simply the most amazing person either of us has ever worked with. Every ship has a captain, and she was ours. We will be forever grateful to her.

We wish also to thank the staff at Scribner. They have a reputation for being the best. We can tell you that they far surpass their reputation.

We owe a very special thank you to Cindy Connolly, who suffered with us through our early drafts. She is a gifted journalist, who with just the simple stroke of her pen, solved many a literary conundrum that perplexed your authors.

We also wish to say thank you to Dan Mountain for being a dear friend and a rock of support in the most trying of moments. To Erica and Nicole for their wise and learned counsel. To Sam for being patient with both of us. To James Haygood, a beloved friend and wonderful father. To Valerie Schadt for running everything, including our lives. To Patti, who thirty-five years ago sat a small child down on the desk of a stockbroker and said, "You can either invest in the company where your father works or the company where Mickey Mouse works." (The child chose the mouse and the mouse paid for college.) To the late and great Benjamin Graham for being the most gifted of teachers. To the late Benjamin Franklin for teaching the Commodore about compounding sums of money. To Tim Zweiback for being a guiding light in a dark forest. To Brian Belefant for being infinitely the most creative and witty of our myriad manuscript readers. To Vincent Waldman and Alan Morelli at Manatt, Phelps & Phillips for always putting their clients' interests first. To Kitty O'Keefe for being a brilliant diamond in a world of junk jewelry. To our NYC research assistant, Andy Clark, who at times dug so deep into the stacks at NYU that we thought he'd end up in China. To our Omaha research assistant, Monte Lefholtz, who somehow managed to get government employees to find historical records they still maintain don't exist. To Richard Oshlo for taking the time to answer carefully all our questions about banking. To the brilliant British painter Helen Brough, whose stunning pastel drawings and paintings brought relief to tired eyes. To NYC artist Terry Rosenberg, who showed us how to get up every morning and attack an empty white canvas with gusto. To Beatrice Bonner, a dear friend from beginning to end. To John Johnson, our guardian angel. To Susie, who every day unselfishly and most graciously shares her heart with the rest of the world. And last but not least, to W.B. for his generosity and genius.

CONTENTS

Disclaimer 12

PART I: THE ART OF BASIC BUFFETTOLOGY

1. Before You Begin This Book 15
2. How to Use This Book 21
3. Roots 27
4. Investing from a Business Perspective 31
5. What Is Businesslike Investing? 33
6. Warren's View of Earnings 35
7. The Price You Pay Determines Your Rate of Return 39
8. The Corporation, Stocks, Bonds—a Few Useful Explanations 45
9. Valuing a Business 55
10. The Only Two Things You Need to Know About Business Perspective Investing: What to Buy—and at What Price 65
11. What We Can Learn from Warren's Secret Weapon: The Magic of Compounding 69
12. Determining What Kind of Business You Want to Own 77
13. The Theory of an Expanding Intrinsic Value 81
14. The Mediocre Business 87
15. How to Identify the Excellent Business—the Key to Warren's Good Fortune 93

16. Nine Questions to Help You Determine If a Business Is Truly an Excellent One 99
17. Where to Look for Excellent Businesses 119
18. More Ways to Find a Company You Want to Invest In 127
19. What You Need to Know About the Management of the Company You May Invest In 135
20. When a Downturn in a Company Can Be an Investment Opportunity 139
21. How Market Mechanics Whipsaw Stock Prices to Create Buying Opportunities 147
22. Inflation 157
23. Inflation and the Consumer Monopoly 165
24. A Few Words on Taxation 169
25. The Effects of Inflation and Taxation on the Rate of Return, and the Necessity to Obtain a 15% Return on Your Investment 171
26. The Myth of Diversifications Versus the Concentrated Portfolio 173
27. When Should You Sell Your Investments? 175
28. Warren's Different Kinds of Investments 181

PART II: ADVANCED BUFFETTOLOGY

29. The Analyst's Role in Ascertaining Earning Power 191
30. The Mathematical Tools 193
31. Test #1, to Determine at a Glance the Predictability of Earnings 195
32. Test #2, to Determine Your Initial Rate of Return 199
33. Test #3, to Determine the Per Share Growth Rate 201

34.	Determining the Value of a Company Relative to Government Bonds	205
35.	Understanding Warren's Preference for Companies with High Rates of Return on Equity	207
36.	Determining the Projected Annual Compounding Rate of Return, Part I	215
37.	Determining the Projected Annual Compounding Rate of Return, Part II	221
38.	The Equity/Bond with an Expanding Coupon	229
39.	Using the Per Share Earnings Annual Growth Rate to Project a Stock's Future Value	233
40.	How a Company Can Increase Its Shareholders' Fortunes by Buying Back the Company's Stock	237
41.	How to Determine If Per Share Earnings Are Increasing Because of Share Repurchases	243
42.	How to Measure Management's Ability to Utilize Retained Earnings	247
43.	Short-Term Arbitrage Commitments	253
44.	Bringing It All Together: The Case Studies	259
	Gannett Corporation, 1994	259
	Federal Home Loan Mortgage Corporation, 1992	266
	McDonald's Corporation, 1996	273
45.	How Warren Got Started: The Investment Vehicle	279
46.	Fifty-four Companies to Look At	287
47.	Waiting for the Perfect Pitch	307
	Epilogue	311
	Index	313

DISCLAIMER

This publication contains the opinions and ideas of its authors. It is not a recommendation to purchase or sell the securities of any of the companies or investments herein discussed. It is sold with the understanding that the authors and publisher are not engaged in rendering legal, accounting, investment or other professional services. Laws vary from state to state and federal laws may apply to a particular transaction, and if the reader requires expert financial or other assistance or legal advice, a competent professional should be consulted. Neither the authors nor the publisher can guarantee the accuracy of the information contained herein.

The authors and publisher specifically disclaim any responsibility for any liability, loss or risk, personal or otherwise, which is incurred as a consequence, directly or indirectly, of the use and application of any of the contents of this book.

PART I

The Art of Basic Buffettology

1

Before You Begin This Book

This book is not another cut-and-paste of Warren Buffett's letters to Berkshire Hathaway shareholders, nor is it a biography filled with anecdotes about Buffett. It is, instead, the most comprehensive case study and detailed explanation ever written on Buffett's investment techniques.

The book is designed to teach you Buffett's extraordinarily successful system of business perspective investing, from the concepts and mathematical equations that assist him in making his investment decisions to the actual companies that have captured his interest.

Warren Buffett did not participate in the writing of this book, and I am sure he never envisioned that, of all people, his former daughter-in-law would write such a book. During the 1970s, I was a businesswoman working in the management of a music publishing company and the operation of a successful import-export business. But in 1981, after a very romantic courtship, I married Warren Buffett's son Peter and found myself a member of one of the world's wealthiest families.

F. Scott Fitzgerald wrote that the very rich are different from you and me. He was right. But they are different in the strangest of ways, the oddest being the code of silence that they demand of family and friends. While married to Peter, I was instructed more than once not to speak to anyone outside the family about Warren and his investment operations. Writing this book simply would have been out of the question.

But in 1993 Peter and I were divorced, which shattered my heart into a thousand tears. Shortly thereafter, I was set upon by a flock of hopeful literary agents, all beckoning me to write an exposé about Warren Buffett and his family. Very little had been written about Warren's personal life, and the deals I was offered, I admit, given my postdivorce state of mind, were very enticing. In the end I rejected them all.

I felt at the time, and still do, that people are really, truly interested only in learning how Warren, by investing in the stock market, turned an initial $105,000 into a $20 billion-plus fortune. I always found that aspect of Warren to be completely fascinating, which is why I wrote this book and not the other.

After deciding to undertake this project, I got in touch with David Clark, an investment analyst and longtime Buffett family friend in Omaha, whom I had met at Warren's home sixteen years ago. David once suggested to Peter that he write a book on his father's investment methods. (I know that many people assume Warren's children have little or no understanding of what their father does. This is not true. From the time the children were born, and throughout their teenage years, Warren ran part of his investment operations out of a small study in the family home. Though his oldest son, Howard, and his middle daughter, Susie, are probably better versed than Peter, all of them have an excellent grasp of how their father works his investment magic.)

I asked David if he would be interested in helping with a book on Warren's business perspective investment philosophy. David is considered by many in- and outside the Buffett camp to be one of the most gifted young Buffettologists practicing today. He is also something of a financial historian. Though I felt competent to present accurately the qualitative side of Warren's method of business perspective investing, I knew that I needed someone of David's caliber to fully explain the quantitative side. To my luck, David consented and soon became a major proponent in making this book the definitive work on Warren's investment methods.

Warren's interest in teaching his philosophy to his family ebbed and flowed. In the early years of my marriage, Warren celebrated Christmas morning by tossing out to each of his children and their spouses envelopes with a gift of $10,000. Like a jolly billionaire version of old Saint Nicholas, he would fling the envelopes across the living room, laughing "Merry Christmas" to each of the delighted recipients. Later he decided that we should be taking a stronger interest in the family business and replaced the $10,000 with $10,000 worth of stock in a business in which he had recently invested. The stock of Capital Cities, Americus Trust for Coca-Cola (a publicly traded trust, no longer in existence, that held Coca-Cola stock), Freddie Mac, and Service Master were some of the great companies I found in my Christmas stocking.

It didn't take long to figure out that as bountiful as Christmas was, it was even more profitable to add to our newly acquired stock positions. Without fail, these Christmas gifts would dramatically increase in value. They truly were the gifts that kept on giving. Eventually we began to refer to these gifts as the Christmas stock tip, with both stock and tip eagerly awaited as the holidays drew near.

But they were more than just Christmas gifts or stock tips. They were Warren's way of getting us to pay attention to the companies that these stocks represented. Walter Schloss, a great investor and longtime friend of Warren's, once said that you never really know a company until you own part of it. He was absolutely right. With each Christmas gift, annual reports and dividend checks would start appearing in the mail. The *Wall Street Journal* became a household fixture, and we all began carefully tracking our newly acquired interests in these wonderful businesses.

I realized Warren had little use for typical Wall Street banter. He didn't seem to care which way the Dow Jones Industrial Average went, and he certainly had no use for all the soothsayers and their predictions. In fact, he acted as if the entire stock market didn't exist. He never looked at a chart, and if anyone tried to give him a stock tip he would usually shut him or her off. He took particular delight in attacking the Efficient Market Theory, which he thought was absolute rubbish. He seemed to care only about the individual businesses he was interested in owning. He is an intensely focused individual.

As any good Buffettologist would, I began reading the old Berkshire Hathaway annual reports and Warren's original letters to his limited partners, all of which were fascinating. I was also fortunate to be on hand the few times that Warren lectured to graduate business students at Stanford University. Peter and I would sit in the back of the room with a video camera, recording Dad for posterity.

Eventually I perused copies of Benjamin Graham's two books, *The Intelligent Investor* and *Security Analysis.* As informative and insightful as Graham's books are, it seemed that his writings were very distant from where Warren now was. It was Graham who developed the concept of business perspective investing, which is the cornerstone of Warren's philosophy.

It was around this time that Warren began showing an interest in teaching the grandchildren. I'll always remember the day I discovered our eight-year-old twin girls curled up on the living room sofa with the *Wall Street Journal* spread out before them. They had just returned from visiting Grandpa's home in Omaha, and I couldn't help but be amused at what I found. Jokingly, I asked if they had any investment ideas. They looked up and replied, "Pillsbury," and then rattled off a list of consumer monopolies that Warren had taught them Pillsbury owned. The most fascinating to them were Burger King and Häagen-Dazs ice cream. As Warren says, invest in companies that make products you understand. (Pillsbury was bought out a few years later by Grand Metropolitan at about double the price it was trading at when the twins made their recommendation.)

I started to see Warren as a sort of collector. Instead of collecting expensive paintings, palatial mansions, million-dollar yachts, or the other clutter with which many superrich fill their lives, he collects excellent businesses. He has spent the majority of his life searching out a particular kind of business in which to invest. He calls it a consumer monopoly. It is a business entity that we'll discuss later on in great detail.

I noticed that Warren, like any sophisticated collector, was very careful about the price he was willing to pay for one of these trophy businesses. In fact, the price for the business absolutely determined whether he would buy it. I am not talking about whether he could afford it. That is a given. He was simply looking for the right deal. I discovered that Warren first identifies what he wants to buy and then lets the price of the security determine whether it should be bought.

These are two distinct thoughts: What to buy? At what price? That's what this book is about—how Warren determines what companies he wants to invest in and what price he is willing to pay. Sounds simple, doesn't it? It is and it isn't.

If you are at all interested in investing, I think that you are going to find this book immensely fascinating and very profitable. David and I wrote it in a manner that allows the reader to progress through the key concepts before diving into the more detailed stuff. The first half is the qualitative side of the equation. It covers the general theories for determining what sort of companies you should be interested in. The second half is the quantitative portion, and it is loaded with math. That's where you'll learn how to determine the right price to pay. Both parts are key to your understanding of Warren's investment philosophy. We think that you will find this book a complete revelation, for we cover an immense amount of never-before-seen material.

We have given you a list of fifty-four companies in which Warren has invested in the past and in which we believe he is still interested. Most of these companies are being identified as Buffett companies for the first time. But one word of caution. Don't fall into the trap of thinking that just because Warren might be interested in owning more of a certain company, you should buy it at any price. We will show you how to determine the right price. Please be patient.

We have incorporated into the book the use of a Texas Instruments BA-35 Solar financial calculator. Twenty-five years ago these little wonders didn't exist, but thanks to the brilliance of Texas Instruments, a world that once belonged only to Wall Street analysts is now accessible and understandable to anyone.

When planning the layout of the book we wanted it to be accessible to people who read on the run—in airports, on commuter trains, while waiting to pick up the children from school, or in that hour or so one has after the rest of the family has gone to bed. And so, the chapters have intentionally been kept short and focused. We also incorporate a teaching technique of reiterating key concepts throughout. So if you set the book down for a week or two, don't be afraid to pick it up and start reading where you left off.

I look to the future and see you truly understanding Warren Buffett's masterful manifestation of Benjamin Graham's brilliant insight: investment is most intelligent when it is most businesslike. In the process you will become, like Warren, an intelligent investor.

MARY BUFFETT
Los Angeles, 1997

2

How to Use This Book

Folly and discipline are the key elements of Warren Buffett's philosophy of investing—other people's follies and Warren's discipline. Warren commits capital to investment only when it makes sense from a business perspective. It is *business perspective investing* that gives him the discipline to exploit the stock market's folly. Business perspective investing is the theme of this book.

This discipline of investing from a business perspective has made Warren the second richest business person in the world. Currently Warren's net worth is in excess of $20 billion. *Warren is the only billionaire* who has made it to the Forbes list of the four hundred richest Americans *solely by investing in the stock market.* Over the last thirty-two years his investment portfolio has produced an average annual compounding rate of return of 23.8%.

As humans we are susceptible to the herd mentality, and so we often fall victim to the emotional vicissitudes that propel the stock market and feed enormous profits to those who are disciplined, like Warren. When the Dow Jones Industrial Average has just dropped 508 points and all the sheep are jumping ship, it is investing from a business perspective that gives Warren the confidence to step into that pit of fear and greed we call the stock market and start buying. When the stock market soars to the stratosphere, it is the discipline of investing from a business perspective that keeps Warren from foolishly allocating capital to business ventures that have neither hope nor prospects of giving him a decent return on his investment.

This book is about the discipline of *investing only from a business perspective.* Together we will explore the origin and evolution of this philosophy. We will delve into the early writings of Warren's mentor Benjamin Graham and the ideas of other financial luminaries of this century, and travel to the present to explore the substance of Warren's philosophy.

Warren made his fortune investing in the securities of many different types of businesses. His preference is to acquire *100% ownership* of an enterprise that has excellent business economics and management. When he is unable to do that, his next choice is to make *a long-term minority investment in the common stock* of a company that also has excellent business economics and management. What confuses people who are trying to decipher his philosophy is that he also makes investments in long-, medium-, and short-term income securities. And he is a big player in the field of arbitrage.

The characteristics of the businesses that he is investing in will vary according to the nature of his investment. A company that he is willing to invest in for arbitrage purposes may not be the kind of business in which he wants to make a long-term investment. But regardless of the type of business or the nature of the investment, Warren always uses the basics of business perspective investing as the foundation for his decision.

Most people have the intellectual capacity to understand Warren's philosophy of investing from a business perspective, but few have the dedication and willingness to work to learn the tools of his craft. The purpose of this book is to lay out, step by step, the foundation of Warren's philosophy *and the manner in which he applies it.* This book is a tool to facilitate the task of learning, and it is our intention to teach you Warren's philosophy so that you may acquire the skills to practice this discipline yourself.

Before we start, I would like to introduce a few concepts and terms that will be used throughout the book and give you an idea of where we will be heading as we voyage through the seas of high finance.

First of all, let's take the term "intrinsic value." Its definition has been debated for the last hundred years. It fits into our scheme because Warren will buy into a business only when it is selling at a price that makes business sense given the business's intrinsic value.

Determining a business's intrinsic value is a key to deciphering Warren's investment philosophy. To Warren the intrinsic value of an investment is the projected annual compounding rate of return the investment will produce.

It is this projected annual compounding rate of return that Warren uses to determine if the investment makes business sense. What Warren is doing is *projecting a future value* for the business, say, ten years out; then he compares the price he is going to pay for the business against the business's future, projected value, and the length of time required for the business to reach that projected value. By using an equation that we will show you later in the book, Warren is able to project the annual compounding rate of return that the investment will produce. The *annual compounding rate of return* the investment is projected to produce is *the value* he uses to determine if the investment makes *business sense* when compared to other investments.

In its simplest manifestation it works like this: If Warren can buy a share of stock in X Corporation for $10 and can project that in ten years the share will be worth $50, he can then calculate that his projected *annual* compounding rate of return will be approximately 17.46% for the ten-year period. It is this projected *annual* compounding return of 17.46% that he will then compare to other investments to determine whether the investment in X Corporation makes business sense.

You may be wondering: If Warren's intrinsic value model requires a projection of a business's future value, then how does he go about determining that future value?

That, my friends, is the crux of solving the enigma of Warren's investment philosophy. Just how does one determine the future earnings of a business in order to project its future value and, thus, its intrinsic value? This problem and Warren's method of solving it will be the focus of much of this book.

In short, Warren focuses on the predictability of future earnings; and he believes that without some predictability of future earnings, any calculation of a future value is mere speculation, and speculation is an invitation to folly.

Warren will make long-term investments only in businesses whose future earnings are predictable to a high degree of certainty. The certainty of future earnings removes the element of risk from the equation and allows for a sound determination of a business's future value.

After we have learned what Warren believes are the characteristics of a business with predictable earnings, we will learn how to apply the mathematical calculations he uses for determining the business's intrinsic value and what the return on his investment will be. The nature of the business enterprise and whether it can be bought at a price that will yield a sufficient return will determine the investment's worth and whether or not we are investing from a business perspective.

If I were to sum up Warren's great secrets for successful investing from a business perspective, I would offer up the following:

1

Warren will invest long-term only in companies whose future earnings he can reasonably predict. (You know that one already.)

2

Warren has found that the kind of company whose earnings he can reasonably predict generally has excellent business economics working in its favor. This allows the business to make lots of money that it is free to spend either by buying new businesses or by improving the profitability of the great business that generated all the cash to begin with.

3

These excellent business economics are usually made evident by consistently high returns on shareholders' equity, strong earnings, the presence of what Warren calls a *consumer monopoly,* and management that functions with the shareholders' economic interests in mind.

4

The price you pay for a security will determine the return you can expect on your investment. The lower the price, the greater your return. The greater the price, the lower your return. (We will explore this point in great detail in Chapter 7.)

5

Warren, unlike other investment professionals, chooses the kind of business he would like to be in and then lets the price of the security, and thus his expected rate of return, determine the buy decision. (This is like Warren in high school identifying a girl he wants to date and then waiting for her to break up with her boyfriend before beginning his pursuit.)

6

Warren has figured out that investing at the right prices in certain businesses with exceptional economics working in their favor will produce over the long term an annual compounding rate of return of 15% or better. How Warren determines what is the right business and the right price to pay for it is what this entire book is about.

7

Last but not least, Warren found a way to acquire other people's money to manage so that he could profit from his investing expertise. He did this by starting an investment partnership and later by acquiring insurance companies.

I'm going to teach what I have gleaned about how he does all the above, and if I have done my job, at the end of this book you will understand Warren and the craft of investing from a business perspective. But most important, you will see the secret to achieving an annual 15% or better compounding rate of return on your money.

Now, I know a lot of you think that in order to get rich you have to make tons of money overnight. That is not the case. You just have to earn consistently above-average annual rates of return over a long period of time. Just like Warren.

I'll also show you how to start an investment partnership, which is one of the keys to getting really wealthy, and a method Warren used with great skill. In short, it is my intention to take you from Step A all the way to Step $. So let us begin your education. Let's explore and learn the world of Buffettology.

3

Roots

The late Benjamin Graham, Wall Street's high priest of investment philosophy, stately author of four editions of the masterful treatise on investing *Security Analysis* (McGraw Hill, 1934, 1940, 1951, 1962), was Warren Buffett's professor at Columbia University, his employer at the New York investment firm of Graham-Newman, and his mentor and friend for nearly thirty years. It was Graham who taught Warren that "investment is most intelligent when it is most businesslike." If there is a single credo that Warren holds sacred and to which he attributes his success, it is this concept. It is upon the framework of this single idea that Warren has built his entire financial empire.

Warren's path to riches began in 1957, when friends and family invested $105,000 in his investment limited partnership. Warren's wealth today is valued in excess of $20 billion. Without Graham's tenet of "investing from a business perspective" guiding the way, Warren's performance as an investor might have been no better than the average. With it, he has created one of the great fortunes in contemporary history.

Although Warren readily espouses this philosophy—be it as the chief executive officer of Berkshire Hathaway, his publicly traded holding company, or in an occasional college lecture—its subtleties seem to have eluded the investment profession and public up until now. One would think that anyone whose profession is investing would make Warren a serious case study and analyze and dissect his philosophy. But the investment profession and its academic brethren seem to prefer to label him a four-star enigma, and pay essentially only lip service to his real gifts as an investment genius.

What few people realize is that Warren is first and foremost a thinker, a philosopher whose subject matter and realm of expertise are the world of business. He is a man who has taken the investment and business philosophies of some of the greatest minds that have addressed the subjects of commerce and capital and synthesized an absolutely new approach based on these old lessons. His approach is in many ways contrary to conventional Wall Street wisdom.

As we dissect Warren's investment philosophy you will see that he is really

- part Benjamin Graham, from whom he took the concepts of investing from a business perspective and emphasizing price as a major motivating factor in selecting investments
- part Philip Fisher, the legendary California money manager and author, from whom Warren took the idea that the only business worth investing in is one with excellent business economics and the theory that the time to sell an excellent business is never
- part Lawrence N. Bloomberg, 1930s thinker and author, who introduced to both Graham and Warren the idea of the superior investment value of the consumer monopoly (Graham cites Bloomberg in his 1951 edition of *Security Analysis*)
- part John Burr Williams, 1930s mathematician, financial philosopher, and author of *The Theory of Investment Value* (Harvard University Press, 1938), from whom Graham acquired the idea that a business's worth is related to what it will earn in the future
- part Lord John Maynard Keynes, famed British economist and author, from whom Warren derived the concept of the concentrated portfolio and the emphasis of learning one area really well and not straying from it
- part Edgar Smith, who in 1924 wrote the then much-heralded, but now long-forgotten *Common Stocks As Long-Term Investments* (Macmillan, 1924), which introduced to Graham the concept of *retained earnings adding value to the business* over a period of time
- and most important, part Charlie Munger, legal pundit and financial impresario, who as Warren's friend and partner persuaded him to focus on the more sophisticated philosophy of purchasing excellent businesses at prices that made business sense, instead of seeking only Graham-type bargains.

This is an eclectic group, whose writings span nearly a hundred years of thought on the subject of investing in securities.

Graham was aware of all these philosophies, but it took Warren's extraordinary and unique turn of mind to synthesize them into a strategy that would *excel each of their individual efforts.* Warren is not afraid of anyone discovering his secret for success, for like any great chef he leaves out a thing or two when discussing the recipes for his best dishes.

Warren is an extremely intelligent and competitive individual. He is not about to give away the store. He has always maintained that great ideas in the realm of investing are few and far between and should be considered proprietary and guarded. He will discuss the details of his philosophy only with members of his family and inner circle. To the rest of the world he feeds tidbits, and then only enough to pique interest. He freely asserts that Graham's *Security Analysis* is the best book ever written on investing, but he may fail to tell you that Graham's philosophies are not the only ones he embraces today. Graham may have provided the foundation, but he is not the house.

Graham gave Warren the basics, and from there Warren went forward, borrowing and creating as all great geniuses do. But to say that Warren is Graham is to say that Oppenheimer is Einstein, or Balanchine is Diaghilev. One may have been influenced by the other, but in reality they are entirely different beasts.

Warren did not happen into investment genius overnight. His voyage began with Graham's 1934 edition of *Security Analysis* and has continued through a maze of financial thought to the present. Any strategy used in a highly competitive field requires the ability to adapt and change as the environment evolves. What worked for Graham in the 1930s and 1940s ceased to work for Warren in the 1970s and 1980s.

If one were to compare the relatively pure Grahamian investment style of, say, the legendary portfolio manager/investor Walter Schloss (who studied under and worked for Graham and now runs a very successful investment partnership with his son, in New York City) with Warren's current style, it would be apparent that they are as different as night and day.

Schloss runs an expansive and diversified portfolio, often holding more than a hundred different stocks. He lets price be the dominant force in the reasoning that goes into his buy decision. He searches for stocks selling at a price below their intrinsic value. Schloss, practicing a traditional Grahamian philosophy, then sells any investment that has reached its intrinsic value, thus ending the romance of the economic benefits of a great business and at the same time inviting the tax man to the party.

Warren, on the other hand, runs a far more concentrated portfolio, with the economic nature of the business weighing in just as heavily as price in his determination of what to buy. Warren is also willing to hold a stock forever as long as the economics of the business remain at least the same as when he bought it. This *ensures that he will benefit from the compounding effect of retained earnings*. It ensures also that he will avoid the profit-eroding taxes that would be imposed if he sold his investment.

Although pure Grahamian philosophy continues to have an exploitable niche in the investment world, its greatest value is as a foundation upon which to learn the investment process. Graham's *Security Analysis* is more than just a treatise on investing. It is a running historical commentary on the techniques used to evaluate securities for investment purposes. Between 1934 and 1962, Graham wrote four editions of *Security Analysis,* each deciphering and analyzing old and new methods of security analysis as applied to the present.

One learns through experience, and if not from experience, from those with experience. That is what Graham provides us with. While working for Graham, Warren made a vow that he would not make another investment until he had read Graham's book twelve times. To this day he keeps all four editions next to his desk, and he still finds subtleties that escaped his eye in past readings. As with the Bible, worldly experience enhances each reading of *Security Analysis,* sparking revelation upon revelation.

Truly, Graham was a man who planted trees so that others could sit underneath them and feast upon their fruit. Thus, it seems only appropriate that we begin your education in Buffettology with the basic tenet of Graham's philosophy and the one that Warren holds as the foundation of his own thinking.

4

Investing from a Business Perspective

Investing from a business perspective is the most challenging concept you will address in this book. This is not because it requires a fair amount of financial and accounting knowledge, which it does, but rather because it is so different from the prevailing wisdom peddled by the great investment houses of Wall Street.

As you read through this book you will come to see that having a business perspective on investing is more about discipline than philosophy, and once the concept is understood, it demands absolute devotion. Stray from it, and you will wander the financial lunar landscape, forever dancing to the folly called forth by fear and greed.

Adhere to its wisdom, and the foolishness of others becomes the field in which you reap your harvest. In short, other people's follies, brought on by fear and greed, will offer you, the investor, the opportunity to take advantage of their mistakes and benefit from the discipline of committing capital to investment only when it makes sense from a business perspective.

But be warned: it is not an all-encompassing discipline, on which the practitioner can rely in any situation in order to produce a profit. It is, rather, as Graham said in reference to bond selection, "a negative art." It is a discipline that tends to tell the investor as much if not more what *not* to buy as what *to* buy.

You will find that almost everything that relates to business perspective investing is alien to Wall Street folklore.

- You will find yourself waiting for the market to go down instead of up, so that you can buy partial interests in publicly traded companies that you have been wanting to own.

9780684848211TEXT_POD.indd 31 3/15/23 1:40 PM

- You will adopt the wisdom of businesslike thinking and come to realize that the stupidest reason in the world for owning a common stock is that you think the per share price is going up next week.
- You will change your perspective from one that leads you to buy a stock in hopes of a 25% move in the next six months to one that leads you to buy a partial interest in an ongoing business venture—a business venture that you anticipate will in five to ten years produce for you an annual compounding rate of return of 15% or better.
- You will learn that diversification is something people do to protect themselves from their own stupidity, not because of investment savvy.
- You will find yourself getting great investment ideas from shopping in the supermarket.
- You will discover that Pollyanna and your stockbroker both may be wildly optimistic but neither is very intelligent in matters of finance.
- You will learn that a $1,500 per share stock may be cheap and a $2 stock may be grossly expensive.
- You will start thinking of stocks as bonds with variable interest rates.

And you will realize that though Warren adheres to the philosophical underpinnings of Graham, he has long since left the fold. Warren is seeking value, but not in the same mode or framework in which Graham did.

So let's begin by looking at the history of the thought process that Warren used to reach his revolutionary approach to investing. We will travel back in time to an earlier part of this century and look at the roots of Warren's strategy. We will discuss the financial philosophies of that time and how they influenced Graham and how Graham, in turn, influenced Warren. We will see the evolution of Warren's thinking as he digests not only his successes and losses but also wisdom bestowed upon him by two of the greatest thinkers of modern finance, Philip Fisher and Charles Munger.

We shall see where Warren breaks with Graham and has, as in the words of the poet Rainer Maria Rilke, a "conflagration of clarity," which gives birth to Warren's new synthesis of Graham's original idea that investment is most intelligent when it is most businesslike.