Advice *From the* Oracle:

50 Warren Buffett Quotes That Will Make You a Better Investor

Warren Buffett's success is inspiring. The fact that his ascent has not been successfully replicated is confounding.

His nearly 20% annualized returns may go uncontested in the investing hall of fame. Yet with a headquarters far removed from Wall Street's charging bronze bull he seems an odd champion for finance. He traded analysts and algorithms for pen and paper, preferring his own due diligence instead. While others prepared endless slide decks outlining an investment thesis, Buffett fired off a folksy one-liner to characterize his. His average holding period is longer than many investing careers, and his greatest hits replay dull industries like consumer goods, insurance, and banking.

What's more, his disarmingly simple philosophy has been freely shared for others to mimic. Buffett has regularly commented on his thinking publicly. Berkshire's annual shareholder letters are the best examples. Each year his wisdom is compressed down to a few pages of entertaining stories and commentary for the world to access. Reading the anthology of letters is a rite of passage for new investors and an ongoing rubric for veterans.

The Aesop-like maxims contained within them are easily understood. They are widely accepted and many are frequently promoted. Like the story of the tortoise and the hare they retain all relevance today. Yet Buffett's success remains singular. He has no challengers.

The pages that follow seek to explain that disconnect. After thoroughly reviewing all his letters and most famous quotations, it appears that disconnect between comprehension and adoption comes down to context. Just like the lessons from footrace-running turtles and tea-drinking rabbits, understanding them is easy, but applying them to your own life is a surprisingly difficult leap.

Context is usually best gained from experience. Consider one famously repeated Buffett axiom: "Be fearful when others are greedy, and be greedy when others are fearful." If you weren't investing through the 2001 tech bubble or 2009 collapse, it's hard to

know how far that greed or fear can stretch, not to mention where your own conviction would fall on the spectrum. Facing both adds perspective and extends the application of this wisdom.

Fortunately, you don't have to go skinny-dipping to know why Buffett warns about watching for the tide going out. The investors here have done that for you. They have read the anthology of Buffett's letters, extracting single elements as they went, and brought new life to each one with current examples and perspective. Buffett's best lessons have been modernized here to make them more salient and actionable than ever before. Even if you're an experienced investor with your own education to lean on, you'll find something new and valuable here.

You'll learn about failed buybacks in the context of Netflix, value traps via Washington Mutual, sketchy turnarounds at Sears and J.C. Penney, the difference between a good and bad acquisition from General Electric, what spending for the future looks like today at Nordstrom, why LeBron James highlights the importance of good management, what an eroding moat looks like at BlackBerry, and much more. The power of compounding, buy-and-hold, excellent management, wide moats, capital allocation, and concentration vs. diversification are all explored, too, as is the importance of your own investing temperament.

You'll also learn how to reconcile seemingly contradictory elements of Buffett's approach. He has poured his affection on investing in companies that can successfully raise prices over time, yet he has made a fortune on those that do the opposite, including Wal-Mart, Costco, Geico, and Nebraska Furniture Mart. He has derided excessive M&A activity, yet he runs the most successful conglomerate in history. He loves returns of capital to shareholders, yet he has never paid a dividend and has only sparingly repurchased shares. The answer to settling these incongruities also comes down

to context. Each situation is different and must be evaluated as such. Great investors must be flexible.

It appears even Buffett doesn't follow Buffett ideology too rigidly.

I hope you find these documents as valuable as I have – they already act as a guide for my own investing. A special thank you goes out to the investors who compiled these lessons and experiences.

Foolish Best,

Austin Smith

Table of Contents

Why Warren Buffett Loves When His Stocks Plummet

By Adam Levine-Weinberg

"We ordinarily make no attempt to buy equities for anticipated favorable stock price behavior in the short term. In fact, if their business experience continues to satisfy us, we welcome lower market prices of stocks we own as an opportunity to acquire even more of a good thing at a better price."

— Warren Buffett, 1977
Berkshire Hathaway Letter to Shareholders

For most investors, there's nothing more frustrating than seeing red numbers on your brokerage account homepage, showing that your stocks are down. But according to **Berkshire Hathaway** chairman Warren Buffett, this reaction is totally irrational.

Instead, Warren Buffett loves seeing red numbers when he looks at his stock portfolio. That's because he is a *long-term investor*. Only short-term investors or traders have to worry about sudden drops in the stock market. Once you approach investing with the mind-set of a long-term business owner, you'll never feel the same way about stock market fluctuations.

Buffett's strategy: buy and hold forever

Warren Buffett's point in the quote reproduced above is that he – and by extension, Berkshire Hathaway – is always looking for good deals on great businesses. Buffett will only buy stock in a company if he is very confident about its long-term prospects. As long as he remains convinced that a business is creating value, he will hold on to his shares.

This is why many people describe Buffett's investing style as "buy and hold forever". However, if Buffett is really planning to hold a stock forever – or even just 20-30 years – he doesn't need to worry if it suddenly plunges the day after he buys it. He still has decades to recoup his losses.

In fact, since Berkshire Hathaway generates money for investment every year, Buffett loves to see his stocks suddenly plunge for no reason. It creates an opportunity to buy even more shares at a better price than was previously available. Buffett has usually been pretty good about following his own advice – as his investment in **Wells Fargo** shows.

The making of a Buffett superstar stock

Buffett began buying stock in Wells Fargo in 1990 at a time when most investors were fleeing bank stocks due to the fallout of the savings-and-loan crisis. He didn't have very good timing. In fact, Wells Fargo shares dropped almost 50% within a few months after Berkshire Hathaway first invested in the company.

Many investors would have panicked in that situation. However, Buffett followed through on his long-term strategy. He thought the stock was cheap at its highs in mid-1990, making it absurdly cheap by the time it bottomed out in the fall.

Not surprisingly, Buffett's patience paid off in a big way. Berkshire Hathaway still holds Wells Fargo stock – in fact, it's Berkshire's biggest investment. Including dividends, Wells Fargo's total shareholder return is more than 3000% since its 1990 peak.

However, for the shares that Buffett bought after the sell-off, he is enjoying an even bigger 5,000% gain right now. No wonder why Buffett is happy when his stocks crash!

Are you buying or selling?

There are some things Warren Buffett can do that are hard to replicate as an ordinary investor. Staying calm in the face of big stock market drops isn't necessarily one of them. *The only people who need to worry when the stock market crashes are those who need to sell soon*.

Buffett returned to this point two decades later in another shareholder letter, writing: "... [S]mile when you read a headline that says 'Investors lose as market falls.' Edit it in your mind to 'Disinvestors lose as market falls— but investors gain.' Though writers often forget this truism, there is a buyer for every seller and what hurts one necessarily helps the other."

If you're saving for retirement, the best strategy is to save a little every year starting when you're young. If you're putting some money into the market each year, you're an investor, not a "disinvestor". Sometimes you'll be buying the peaks – but other times you will be buying the dips. The bigger the dip, the better off you'll be in the long run.

Even if you are 50 years old today, you still have 15-20 years before you'll need to start draining your retirement accounts in earnest. That gives you plenty of time to ride out short-term stock market gyrations. (Just consider that 15 years after he first invested in Wells Fargo, Buffett was sitting on a 15-bagger: despite the 40% drop he endured during the first few months of his investment.)

Foolish bottom line

Thus, once you commit to investing in high-performing companies and *not* selling them, stock market drops suddenly become opportunities rather than problems.

Following this piece of Warren Buffett's wisdom is simple enough; it just requires willpower and a change of perspective. Not only is it likely to produce better long-term investment returns; it will also give you peace of mind.

Warren Buffett's Most Famous Acquisition Was His Worst!

By Adam Levine-Weinberg

"The textile industry illustrates in textbook style how producers of relatively undifferentiated goods in capital intensive businesses must earn inadequate returns except under conditions of tight supply or real shortage."

— Warren Buffett, 1978

What is **Berkshire Hathaway**? Most people with an interest in investing know that Berkshire Hathaway is the big conglomerate run by Warren Buffett.

However, it wasn't always that way. 50 years ago, when Warren Buffett first became involved with Berkshire Hathaway, the company was a major textile firm. This incarnation of Berkshire Hathaway may have been the worst acquisition of Buffett's career.

The problem with Berkshire Hathaway was not bad management – it was just a tough business. There are many similarities between Berkshire then and the airlines today. Investors have bid up the stock prices of big airlines like **American Airlines** and **United Continental** based on rosy assumptions about their long-term profitability. They may soon learn the tough lesson Buffett learned at Berkshire Hathaway.

The hard thing about the textile business

Buffett's comment on the pitfalls of capital-intensive businesses reflected 15 years of experience trying to wring adequate profits out of Berkshire Hathaway. The root of the problem was that Berkshire

Hathaway's product was a commodity – it was no different than the products being produced by competitors.

As a result, Berkshire Hathaway had to match the prices of its competitors to sell its products. The capital-intensive nature of the textile industry compounded this problem. Once major capital investments have occurred (e.g. building or retooling a factory), the depreciation of those assets represents a fixed cost.

When the textile industry had too much capacity, Berkshire and its competitors were faced with a Hobson's choice: they could either keep their factories running or not. Either way, they were in a bad situation. If they kept the plants running, the oversupply would continue, forcing them to cut prices to clear excess inventory. If they idled the plants, they would lose money due to their high fixed costs.

Buffett's insight was that it is virtually impossible to avoid this issue in a capital-intensive commodity business. When times are good, companies will invest in fixed assets to meet the growing demand. However, that will leave them with overcapacity as soon as demand starts to drop off. Only during fleeting moments of "shortage" can such businesses earn high returns on invested capital.

Airlines are like textile mills

Despite identifying the problem with capital-intensive commodity businesses in the late 1970s, Warren Buffett made a big bet on USAir 10 years later. Shortly after Buffett invested in USAir, the airline industry ran into trouble due to overcapacity and irrational pricing by some carriers.

Buffett soon recognized that the airline industry displayed the same key characteristics as the textile industry: it was capital-intensive due to the high cost of airplanes, and it was a commodity-type business, as most travelers buy primarily based on price. He therefore described his investment in USAir as an "unforced error" – even though it eventually turned a profit.

Beware airline rocket stocks

Investors don't necessarily need to avoid all airline stocks, despite Buffett's warnings. (I personally own several airline stocks.) However, Buffett's insights about this type of business show that investors should be particularly cautious about airlines.

Recently, investors have abandoned this caution. For example, United Continental and American Airlines have both posted big stock price gains in the past year – even though in United's case, earnings estimates have been falling.

However, United and American are investing heavily in new capital – particularly new planes. As a result, free cash flow is essentially nil at both companies today. This means that investors are really betting on these airlines' ability to maintain or even improve earnings over the next 10-20 years.

In other words, airline investors appear to be ignoring Warren Buffett's wisdom. Buffett would argue that airlines are just benefiting from a temporary period of shortage right now. Capital is starting to pile into the industry, fueling growth among smaller U.S. airlines. There will be a lot more competition in the airline industry 5-10 years down the road than there is today – leading to lower industry profit margins.

Foolish conclusion

Warren Buffett learned the hard way that capital-intensive commodity businesses are poor long-term investments. Good management could produce good returns in Berkshire Hathaway's textile business occasionally, *but not consistently*. That's why Berkshire Hathaway was (arguably) the worst investment of Buffett's career.

Today, airline bulls think that "capacity discipline" has helped major airlines like American and United Continental become good long-term investments, despite being in a capital-intensive commodity business. In reality, capacity discipline has just created a temporary shortage of capacity. In the long run, new competitors will make up the difference, leading to lower margins for everybody.

Warren Buffett's 4 Rules for Stock Market Success

By Adam Levine-Weinberg

"We get excited enough to commit a big percentage of insurance company net worth to equities only when we find (1) businesses we can understand, (2) with favorable long-term prospects, (3) operated by honest and competent people, and (4) priced very attractively."

— Warren Buffett, 1978

Do you wish you could invest like Warren Buffett? Luckily for you, the Oracle of Omaha laid out his 4 big rules for investing success in a **Berkshire Hathaway** shareholder letter more than three decades ago.

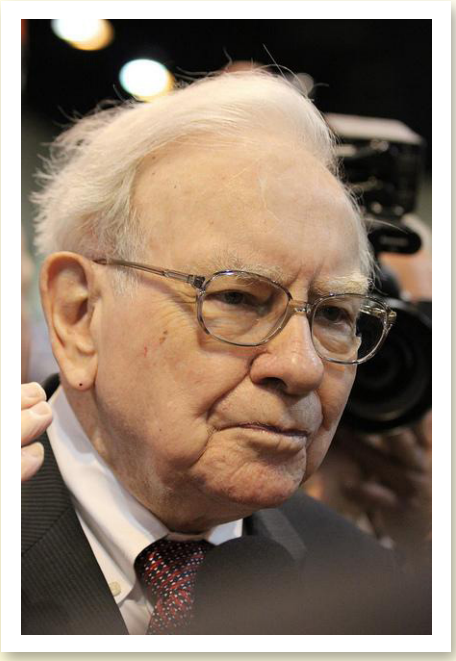
Buffett put his 4 rules into practice a decade later, when he invested in **Coca-Cola**. Not surprisingly, the investment was a smashing success. Within 10 years, Coca-Cola was a 10-bagger for Buffett. Despite a pair of recessions since 1999, Coca-Cola stock has maintained its value in Berkshire Hathaway's portfolio while generating billions of dollars in dividends.

Buffett's 4 rules

Buffett's first rule is simple enough. Buy stock in businesses that you can understand. There are surely tech start-ups you could invest in

today that will crush the market in the next 10 years. But if you're not a technology expert, how will you find them? (Remember, if you're buying a stock, someone else is selling because he/she sees better opportunities elsewhere.)

Buffett's point is: why bother? There are businesses out there with good prospects that you *can* understand – if you're willing to do some homework. Sticking with what you understand already gives you a leg up on a lot of investors.



Buffett's second rule is to stick to businesses with good long-term prospects. There are plenty of companies that have a good year from time-to-time – but many of them don't have sustainable businesses. If you have any doubts that a company's products will still be sought-after in 10 years, that's a big warning sign.

The third rule is to buy companies with honest, competent managers. In many businesses, good management is the difference between generating steady profit growth and lurching from crisis to crisis. A management team with a long track record of success is likely to continue posting strong results.

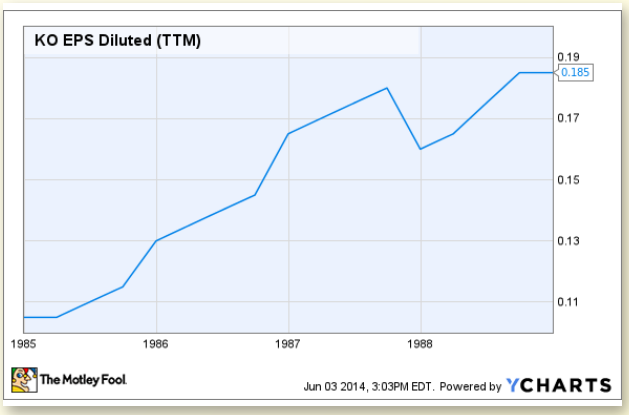
Buffett's final rule is to look for attractively priced stocks. You should be able to find plenty of companies with good long-term prospects and talented management in businesses you can understand. If you overpay, you can still wind up with a poor result despite following the first 3 rules. If a business fitting the first 3 rules is really pricey, wait until you find another one that's cheaper!

Buffett's love affair with Coke

In 1988, Coca-Cola fit all 4 of Buffett's criteria for a great investment. First, it's really easy to understand the business of selling sugary drinks backed by one of the strongest brands in the world. In his 1989 shareholder letter, Buffett remarked that he became a loyal Coca-Cola customer more than 50 years earlier.

Second, Coca-Cola's brand name (and secret recipe) had kept the company on an upward trajectory for a century before Buffett first invested in the company. With international markets representing a huge additional growth opportunity, Buffett could feel fairly confident in Coke's long-term prospects.

Third, Buffett had great admiration for Coca-Cola CEO Roberto Goizueta, who led the company from 1980 until his death in 1997. While Buffett wished that he had bought Coca-Cola shares long before 1988, Goizueta's strong leadership during the 1980s was a key factor motivating Buffett's investment. Coca-Cola had posted solid earnings growth in the few years prior to 1988.



Equally important, Coca-Cola shares were very reasonably priced when Buffett made his purchase. Despite the recent record of earnings growth, Coca-Cola shares traded for around 15 times earnings for most of 1988.

By the end of 1994, when Buffett stopped buying, he had put $1.3 billion to work in Coca-Cola stock, and that investment was already worth more than $5 billion. Once he had identified the opportunity, Buffett could relax and let Goizueta and his employees do the hard work. Two decades later, Berkshire Hathaway has not sold a single share. Its stake is now worth more than $16 billion, and produces nearly $500 million in dividends annually.

Foolish final thoughts

Buffett's first 3 rules of investing – buy what you know, and stick to companies with good long-term prospects and good management teams – are well-known by most Warren Buffett fans.

However, some Buffett admirers may be surprised by his focus on attractive prices. After all, Buffett also famously stated, "It's far better to buy a wonderful company at a fair price than a fair company at a wonderful price."

The two aren't really contradictory, though. Buffett always believed that the key to investing successfully was finding high-quality businesses. As long as you have a long-term mentality, it's possible to get a good return even if you pay a "fair" price – not a great price. That said, the real home runs are when you find a great business at a bargain price. That is exactly what Coca-Cola was for Warren Buffett and his fellow Berkshire Hathaway investors.

Warren Buffett Doesn't Always Care about Earnings Growth

By Adam Levine-Weinberg

"... [I]n industries with low capital requirements, or if management has a record of plowing capital into projects of low profitability; then earnings should be paid out or used to repurchase shares— often by far the most attractive option for capital utilization.

Warren Buffett, 1978

Most investors are obsessed with earnings growth, and for good reason. As a company's profit increases, its share price usually follows, as investors can typically expect higher dividends or share buybacks from a company with higher earnings.

However, legendary investor and **Berkshire Hathaway** chairman Warren Buffett has urged investors to abandon their single-minded focus on earnings growth. Sometimes, a company is better off *not* pursuing earnings growth, but instead returning cash to shareholders. In the last few years, department store operator **Dillard's** has proven the value of this approach.

Growth vs. capital return

At a basic level, Warren Buffett's point is that a company has two choices for what to do with its earnings. On the one hand, it can

reinvest the earnings in its business by pursuing organic growth projects or making acquisitions. On the other hand, it can return the money to shareholders through dividends or share repurchases.

Reinvesting capital can often allow a company to grow its net income. That *does not necessarily make it a good idea*. After all, if the company paid out all of its earnings in dividends, each investor could "reinvest" the money individually.

What really matters is how the internal rate of return (IRR) of any growth project compares to the company's cost of capital. If a project will provide a 5% annualized return but the cost of capital is 8%, then the project should be canceled – even though it might increase earnings from an accounting perspective.

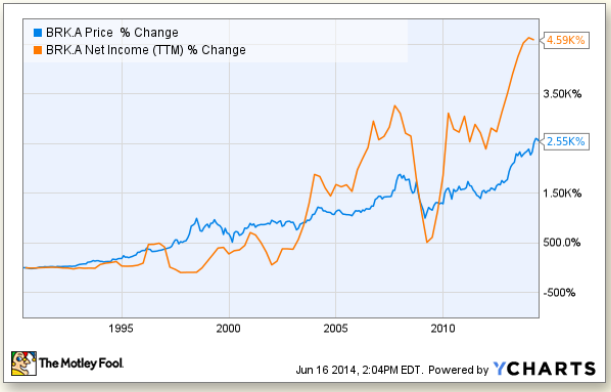
Suppose I own a company that generates $10/share in earnings. The company can either reinvest the $10/share in growth projects that will add $0.50 in annual EPS. Alternatively, it can return the $10/share to shareholders through repurchases or dividends. (Obviously, it could also do a combination of the two.)

If I have other investment opportunities that will earn $0.70 or $0.80 on a $10 investment, I would be better off getting the dividend and investing it in one of those other stocks. In other words, a big dividend and no earnings growth is often better than earnings growth with no dividend. If a company's stock is undervalued, share buybacks may be an even better way to return cash to shareholders than dividends.

Berkshire Hathaway: good growth opportunities

Despite Warren Buffett's insistence that dividends and buybacks are often the most attractive use of capital, Berkshire Hathaway has never paid a dividend since Buffett took over nearly 50 years ago. Berkshire Hathaway has bought back some stock, but not very much compared to its total earnings. Does this make Buffett a hypocrite?

The answer, of course, is no! Buffett hasn't returned very much capital to investors because he has consistently found investment projects that offered a higher return than investors could achieve elsewhere. (Just think: would you prefer to manage your investments yourself, or have them managed by Warren Buffett?) It's hard to argue with the results.

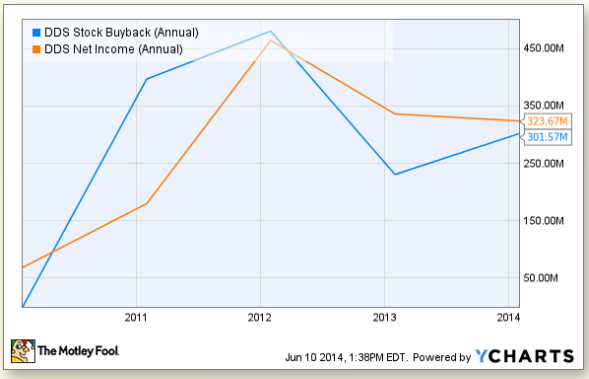


As the chart shows, Berkshire Hathaway's net income has grown nearly fifty-fold just since the late 1980s, and the stock has appreciated more than 2,500%. Very few investors can boast a better record than that. Whereas many companies reinvest capital to grow earnings without creating value, Warren Buffett has clearly created a ton of value for Berkshire Hathaway shareholders over the years.

Dillard's: disinvesting to return capital

Department store chain Dillard's is a polar opposite to Berkshire Hathaway. Whereas Warren Buffett has meticulously reinvested the vast majority of Berkshire's earnings, the management team at Dillard's has been "disinvesting" in its business in recent years, in favor of returning capital to shareholders through buybacks and (to a lesser extent) dividends.

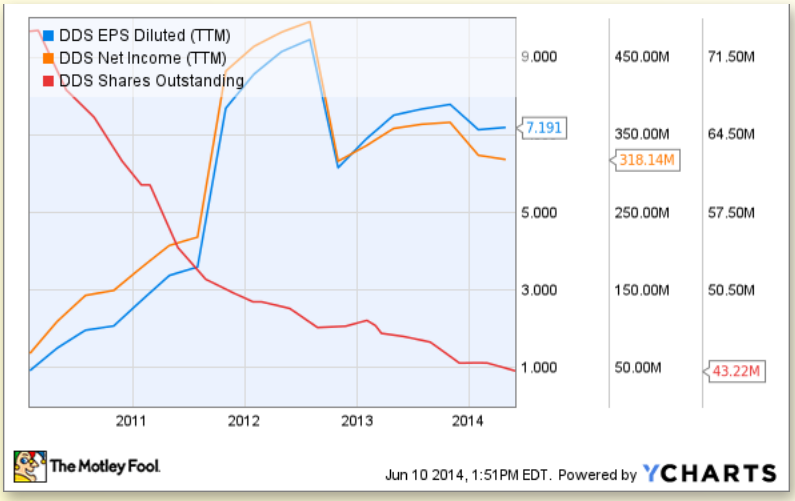
For the last several years, Dillard's has averaged more than $300 million in annual share repurchases. It has spent just as much money on buybacks as it has earned during that time period, while also paying nearly $300 million in dividends since 2010.



Dillard's has done this by closing numerous stores, minimizing investment in its remaining stores, and opening very few new locations. Dillard's depreciation and amortization expense – which reflects the annualized cost of past investments – is currently $255 million/year.

By contrast, it spent just $95 million on CapEx (i.e. new investments) last year, and plans to spend $150 million this year. In other words, Dillard's is investing less than the amount it would theoretically need to maintain its current business. Meanwhile, it has closed almost 10% of its full-line stores in the last 5 years.

However, considering the relatively uninspiring long-term potential of mall-based department stores and the cheap valuation of Dillard's stock, prioritizing share buybacks over organic growth was a smart decision. Dillard's has reduced its share count by about 40% since 2010, causing EPS growth to outpace net income growth.



It all depends on context

Berkshire Hathaway has historically reinvested almost all of its earnings, while Dillard's has recently been returning all of its earnings to shareholders. Despite taking diametrically opposed paths, Warren Buffett would argue that both companies made the right strategic decisions.

At Berkshire Hathaway, Buffett has found plenty of places to invest capital and earn better returns than could be found elsewhere in the market. Dillard's hasn't had many good investment opportunities, so it has instead returned all of its earnings (and more) to shareholders. In each case, the result has been market-busting stock gains.

Why Warren Buffett Doesn't Diversify (Too Much)

By Adam Levine-Weinberg

"We try to avoid buying a little of this or that when we are only lukewarm about the business or its price. When we are convinced as to attractiveness, we believe in buying worthwhile amounts."

— Warren Buffett, 1978

Just about any book, article, or class purporting to be an introduction to investing will urge you to "diversify." According to the conventional wisdom, by owning stocks for a large number of companies in different sectors, you can reduce your risk in the event of problems affecting a single company or industry.

Berkshire Hathaway CEO and investing legend Warren Buffett would urge investors to take that conventional wisdom with a big grain of salt. Indeed, Buffett has consistently avoided diversification when investing at Berkshire Hathaway. Instead, he has made big bets on a few companies like **Coca-Cola** and **American Express**.

Stick to your best ideas

Buffett's main insight here is that it's very difficult for a single person – even Warren Buffett – to have unique insights about dozens of stocks across all industries. There are a few areas that Buffett knows well and is comfortable investing in: insurance, banking, media, and consumer goods are some of his favorites.

Buffett understands these areas well enough that when he becomes convinced a particular stock is undervalued, he is confident enough to make a big investment. Moreover, when he's been right,

Buffett has usually been willing to let his money "ride" rather than selling for quick profit.

Buffett takes on a lot of risk by owning such a concentrated portfolio at Berkshire Hathaway. However, it makes a lot of sense when you consider Buffett's alternative: investing in companies that he doesn't understand or that he doesn't like as much as his top holdings.

Two big Buffett buys

Berkshire Hathaway's investments in Coca-Cola and American Express show just how committed Warren Buffett is to holding an undiversified portfolio. At the end of 1999, Berkshire Hathaway had $11.65 billion of Coca-Cola stock and another $8.40 billion of American Express stock. Together, those two stocks made up more than $20 billion of Berkshire's $37 billion stock portfolio.

By that point, Buffett had been investing in both companies for about a decade. Berkshire Hathaway continues to have large ownership stakes in American Express and Coca-Cola today, as Buffett has remained satisfied with the long-term prospects of both companies.

By contrast, Buffett has generally avoided buying tech stocks at Berkshire Hathaway, with the notable exception of a recent investment in **International Business Machines**. It's not because Buffett is anti-technology or thinks tech companies are all bad investments. However, he realizes that he doesn't understand the tech industry well enough to have the same level of confidence he has about other investments.

The alternative: diversification

For individual investors, there are two main ways to build a diversified portfolio. One option is to buy stocks and bonds from lots of different companies or organizations. Alternatively, you can invest in one or a few broad index funds.

For many people, buying and holding a broad index fund – or a few such funds – is a smart move. Index funds tend to have low transaction costs and allow investors to achieve returns that mimic the performance of the market as a whole (or a particular sector). If you are patient, this strategy promises good long-term returns with relatively low risk.

By contrast, buying lots of stocks in an attempt to "diversify" is almost always a bad idea. If Warren Buffett can't find dozens of companies that he's excited to invest in, you aren't likely to do better in your spare time. Your best ideas may beat the market, but your 17th best idea will probably just drag down the rest of your portfolio.

Meanwhile, you will have to pay commissions for every time you buy or sell a stock in your big portfolio. You aren't likely to get rich from this kind of strategy – but your broker might!

Should you follow Buffett's example?

Warren Buffett's anti-diversification strategy isn't right for all investors. If you bet big on a few stocks and you don't find the next Coca-Cola or American Express, you could face significant losses.

If you are risk-tolerant, that may be OK. However, many individual investors can't afford to stake that much on a few investments.

If you fall into the second camp, but want to invest in individual stocks, your best bet is still to put most of your money in low-cost index funds to meet the goal of diversification. Then you can invest the rest in a few stocks without worrying about diversifying.

The key – if Warren Buffett's track record is any indication – is to stick with what you know when you invest in individual stocks. Find a few companies with business models that can thrive for decades and reasonable stock valuations. Do some research to get comfortable with their earnings power. Then bet big on your best ideas – with any luck, you will have found some real gems!

1 Money Mistake Warren Buffett Urges You to Avoid

By John Maxfield

"Our conclusion is that, with few exceptions, when a management with a reputation for brilliance tackles a business with a reputation for poor fundamental economics, it is the reputation of the business that remains intact."

—Warren Buffett, 1980

Of all the lessons Warren Buffett has imparted in his annual letters to shareholders of **Berkshire Hathaway**, few are as valuable as his excoriation of "turnaround" plays.

"Both our operating and investment experience cause us to conclude that turnarounds seldom turn," Buffett wrote in 1979, "and that the same energies and talent are much better employed in a good business purchased at a fair price than in a poor business purchased at a bargain price."

That Buffett said this more than three decades ago doesn't diminish its relevance today.

A brick-and-mortar retailer that can't profitably match prices with **Amazon.com** and **Costco** isn't a turnaround play; it's a suffocating enterprise. A casual-dining restaurant with a stale atmosphere and processed ingredients will never be able to compete against the likes of **Chipotle Mexican Grill** and **Panera Bread Company**.

The economics in both cases simply aren't present, regardless of how hard a company's management tries to persuade investors otherwise.

"We react with great caution to suggestions that our poor businesses can be restored to satisfactory profitability by major

capital expenditures," Buffett wrote in 1983. "The projections will be dazzling – the advocates will be sincere – but, in the end, major additional investment in a terrible industry is about as rewarding as struggling in quicksand."

Given this, it's ironic that much of Buffett's warnings about turnaround plays serve as the preamble to why he invested in them.

The quote at the top of this article was part of a conversation about GEICO, which Buffett doubled down on in 1976 just as the company seemed destined for failure thanks to loose underwriting standards in the previous decade.

The same can be said of **American Express**, which Buffett invested close to one-quarter of his assets in 1964, the year a massive fraud at one of its subsidiaries threatened an "enormous" loss that, by American Express' own admission, was "more than we had."

And ditto for Buffett's 1990 investment in **Wells Fargo** during a real estate disaster that was unmatched in severity until the financial crisis of 2008.

But unlike a traditional turnaround play, each of these companies had something unique and salvageable; they were phenomenal businesses with wide competitive moats and exceptional underlying economics.

Thanks to GEICO's cost structure – at the time, it spent $0.15 of each premium dollar on expenses whereas other insurers spent an average of $0.24 – it could charge less than competitors and be more selective about its customers. American Express had a near-monopoly in traveler's checks at the time. And Wells Fargo, while experiencing a temporary hiccup, was led by two of the finest bankers in American history: Carl Reichardt and Paul Hazen.

The takeaway here is as important as it is shrouded in nuance: Turnaround plays should be avoided unless there's compelling evidence the underlying business, while fighting through hard times, remains intact and is fundamentally sound.

Why Warren Buffett Wouldn't Touch J.C. Penney Stock

By Adam Levine-Weinberg

"Both our operating and investment experience cause us to conclude that 'turnarounds' seldom turn, and that the same energies and talent are much better employed in a good business purchased at a fair price than in a poor business purchased at a bargain price".

— Warren Buffett, 1980

There's a very good reason why **J.C. Penney** and other "turnaround" stocks have not found their way into **Berkshire Hathaway's** portfolio. After a few disappointing experiences with struggling businesses early in his career, Berkshire Hathaway CEO Warren Buffett realized that investing in turnarounds was just a waste of energy.

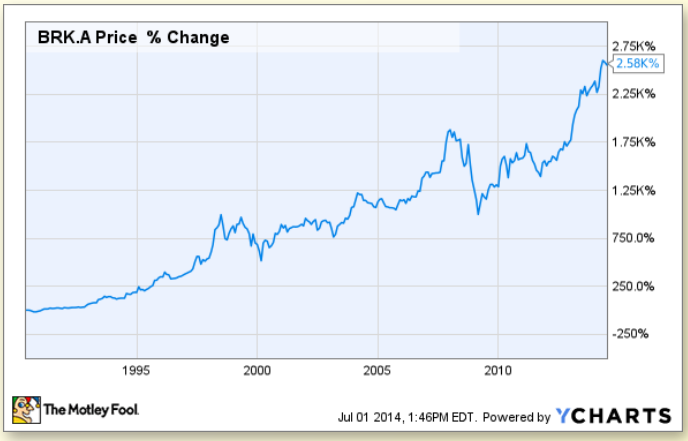
Investors in J.C. Penney would be wise to heed Buffett's wisdom. A large number of "value" investors have piled into J.C. Penney stock in recent months, driving the stock price up from a multi-decade low below $5 to more than $9. Yet J.C. Penney remains unprofitable – and if you believe Warren Buffett, it may never be fixed.

Buffett's turnaround allergy

Investors are usually attracted to turnarounds because shares of struggling companies tend to be cheap. Indeed, Warren Buffett's most famous acquisition – Berkshire Hathaway – was bought as a turnaround play at a big discount.

When turnarounds succeed, the gains can be extraordinary. It's not uncommon for investors who time a turnaround correctly to make 5-10 times their money or more in a few years. However, Buffett would caution that for every successful turnaround story, there are many more turnaround candidates that either limp along or quickly spiral into bankruptcy.

If there were no other way to make money in the stock market, perhaps it would still be worth it for investors to gamble on turnaround plays. However, Warren Buffett has shown that a skilled investor can find multi-baggers in the making without taking on the risk of failed turnarounds. Berkshire Hathaway shares have skyrocketed more than 2,500% in the last 25 years.



One of Buffett's secrets to success was realizing that he was better off putting effort into finding businesses with the strongest moats rather than trying to guess which corporate turnarounds were likely to work.

Speaking from experience

Buffett's impatience for turnarounds was already solidified by 1980. His inability to turn around Berkshire Hathaway's textile operations during the 1960s and 1970s played a big role in shaping this philosophy. Buffett bought Berkshire Hathaway for well below book value, and eventually bought another struggling textile business (Waumbec Mills) for pennies on the dollar.

Berkshire's textile operations notched several years of profitability during the 1970s. However, every "turnaround" was soon followed by another crisis. Both before and after the acquisitions, the Berkshire Hathaway textile business was in a cycle of "one step forward, two steps back," leading slowly but surely to persistent losses.

J.C. Penney – just another turnaround candidate

Many investors were enthusiastic about J.C. Penney's most recent earnings report. The company reported a 6.2% increase in same store sales, a higher gross margin, and lower operating expenses. J.C. Penney expects a continuation of these trends throughout 2014.

To some extent, investors' excitement makes sense in light of these improving trends. However, despite the sales and margin improvements, J.C. Penney still lost $344 million before taxes on sales of $2.8 billion. That's a double-digit *negative* profit margin!

If J.C. Penney maintains its current sales growth and margin improvement trajectories, it would take several years to return to profitability. Yet there is no guarantee that J.C. Penney can maintain this momentum. Warren Buffett learned this lesson the hard way: Berkshire Hathaway's textile business had a few promising years, but the improvements were never sustainable.

In fact, much of J.C. Penney's improvement last quarter can be attributed to its terrible performance the year before. It was simple for J.C. Penney to look good going up against such easy comparisons. However, there's little evidence that J.C. Penney is attracting new fans (as opposed to getting back some of the customers it lost), which bodes ill for its long-term prospects.

Foolish final thoughts

Warren Buffett learned the hard way that it's tough to predict whether a struggling business can be saved. (So did I.) You don't have to.

Rather than struggling to identify the turnaround candidate that's going to make you rich – and perhaps losing a boatload of money along the way – Warren Buffett would tell you to spend your time looking for truly great businesses. These companies can become big winners in your portfolio, without any of the risk of owning troubled businesses.

Warren Buffett's Money-Making Brilliance Was Founded on a Mistake

By John Maxfield

"Like virginity, a stable price level seems capable of maintenance, but not of restoration."

— Warren Buffett, 1981

For nearly a decade during the 1980s, Warren Buffett was convinced that the American economy would never be able to escape the scourge of high inflation.

He was wrong on this count, obviously.

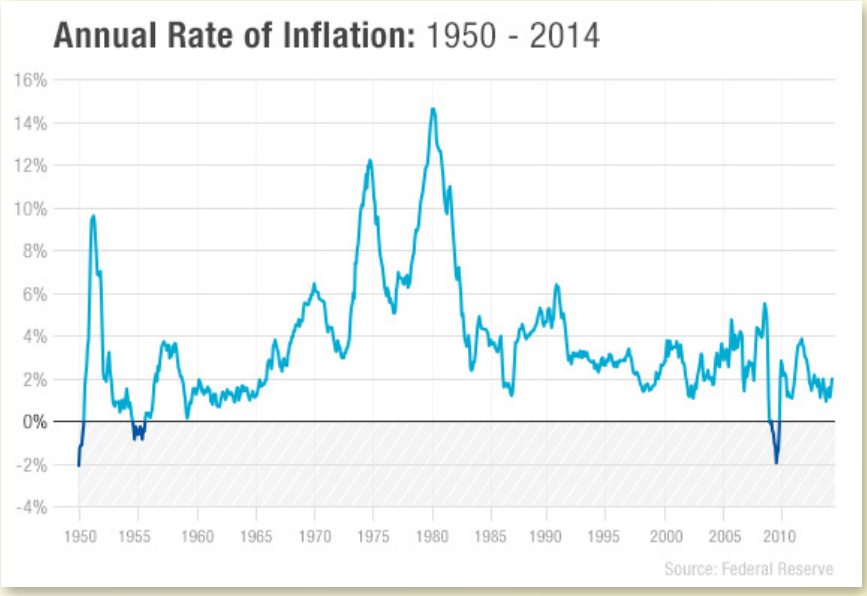
But what he got right was his response, as this error in judgment accelerated Buffett's embrace of the investment philosophy he's known for today and made shareholders in **Berkshire Hathaway** extremely rich.

Buffett and the scourge of inflation

If it's true that a person is the sum total of their experiences, then it seems impossible to deny that Buffett was deeply affected by the rapid price increases of the mid-1970s and early 1980s.

As you can see in the chart below, prices rocketed higher on two separate occasions. The first followed OPEC's 1973 oil embargo, which sent the price of oil from $3 per barrel to nearly $12 following the United States' decision to back Israel in the Yom Kippur War.

And the second, which topped out at nearly 15% in March of 1980, is generally attributed to an accumulation of imprudent monetary policy – though, by the time it peaked, the Federal Reserve had already begun to aggressively counter the trend under the chairmanship of Paul Volker.



While high inflation is rarely good for business, it was particularly bad for Buffett given Berkshire's concentration in the insurance industry.

Insurance companies make money by collecting more in premiums today than they pay out in claims tomorrow. Consequently, because inflation weighs on the latter more than the former, it threatens to reverse this fundamental relationship.

On top of this, rapid inflation also erodes the return an insurance company earns from its investment portfolio – which, oftentimes, is concentrated in fixed–income securities.

As Buffett observed in his 1979 letter to shareholders:

Just as the original 3% savings bond, a 5% passbook savings account or an 8% Treasury Note have been transformed by inflation into financial instruments that chew up, rather than enhance, purchasing power over their investment lives.

A mistake that didn't go to waste

It's with this as the backdrop that one begins to sense a transition in Buffett's investment philosophy from one focused almost exclusively on grossly undervalued securities to one that's equally cognizant of pricing power and competitive advantage.

Nowhere is this more apparent than in his 1981 letter to shareholders in which Buffett discussed the desire to buy businesses that "through design or accident . . . are particularly well adapted to an inflationary environment."

Such favored business must have two characteristics: (1) an ability to increase prices rather easily (even when product demand is flat and capacity is not fully utilized) without fear or significant loss of either market share or unit volume, and (2) an ability to accommodate large dollar volume increases in business (often produced more by inflation than by real growth) with only minor additional investment in capital.

The line between these characteristics and Buffett's later investments in companies like **Coca-Cola** and Gillette couldn't be clearer, as companies like this preside over enduring brands, scalable business models, and the ability to raise prices without igniting a fatal backlash from consumers.

Indeed, while alternative histories are speculative by nature, it isn't unreasonable to conclude that Berkshire Hathaway's portfolio of common stocks would look completely different today if it weren't for this epiphany coupled with Buffett's pessimism in the 1970s and 1980s that stable prices were forevermore a thing of the past.

"Like virginity, a stable price level seems capable of maintenance, but not of restoration," Buffett wrote in 1981.

In hindsight, he was mistaken on this point. But also in hindsight, it's clear that Berkshire Hathaway's shareholders have been greatly rewarded by his flawed forecast.

As Buffett went on to say nearly a decade later: "It's far better to buy a wonderful company at a fair price than a fair company at a wonderful price."

Why Warren Buffett Is Hiding $61 Billion in Plain Sight

By John Maxfield

"Managers and investors alike must understand that accounting numbers are the beginning, not the end, of business valuation."

— Warren Buffett, 1982

In most professional disciplines, going to the primary source is the best way to get an unblemished perspective on things. But thanks to a veritable tome of complicated accounting conventions that can obscure a company's substantive performance, the same can't be said of investing – for the record, by "primary source" I mean a company's quarterly and annual financial statements filed with the Securities and Exchange Commission.

This is a point that Warren Buffett, the chairman and CEO of **Berkshire Hathaway**, made in his 1982 letter to shareholders. "Managers and investors alike must understand that accounting numbers are the beginning, not the end, of business valuation," the 83-year-old billionaire wrote.

Accounting form vs. substance

While esoteric accounting rules are often used by executives to intentionally mask underperformance or to artificially inflate otherwise mediocre results, they can also convolute a company's success or failure even in the absence of wrongdoing. This was the position Berkshire found itself in at the beginning of the 1980s.

For much of the previous two decades, Berkshire had focused its (and its shareholders') attention on a very specific metric of success: operating earnings as a percent of beginning equity capital. "Management's objective is to achieve a return on capital over the long term which averages somewhat higher than that of the American industry generally," Buffett said in 1973.

While there's no doubt the Omaha-based conglomerate was successful at this, its large stakes in non-controlled companies like GEICO (at the time, Berkshire held only a minority stake in the insurance company) and The Washington Post, meant that its share of their earnings wouldn't be reflected in Berkshire's official results. And this wasn't just a nominal issue.

The magnitude of the distortion can be seen by looking at the performance of Berkshire's four largest holdings in 1982. That year, Berkshire reported operating earnings of $31.5 million, which amounted to 9.8% of its beginning equity capital. Meanwhile, its share of undistributed earnings from GEICO, General Foods, The Washington Post, and R.J. Reynolds Industries amounted to "well over $40 million."

As Buffett noted,

This number – not reflected at all in our earnings – is greater than our total reported earnings, which include only the $14 million in dividends received from these companies. And, of course, we have a number of smaller ownership interests that, in aggregate, had substantial additional undistributed earnings.

Fast forward three decades, Buffett's observation that accounting earnings can "seriously misrepresent economic reality" is abundantly clear. At the end of 2013, Berkshire's cost basis in its common stock portfolio was $56.6 billion. The market value, by contrast, was more than double that at $117.5 billion. That's a $61 billion gain not showing up in earnings. And, of course, this excludes the billions of dollars in dividends Berkshire has received from these companies throughout the years.

The Foolish takeaway

The point here is an important one. If you want to understand a business, it isn't enough to simply scan their regulatory filings on the SEC's website. One must also look beyond the veneer to the true sources of growth and profitability. Had you done this in 1982 with respect to Berkshire, perhaps you too would have enjoyed the subsequent 38,000% returns.

How Warren Buffett Views Mergers and Acquisitions

By Adam Levine-Weinberg

"[I]nvestors can always buy toads at the going price for toads. If investors instead bankroll princesses who wish to pay double for the right to kiss a toad, those kisses had better pack some real dynamite. We've observed many kisses but very few miracles. Nevertheless, many managerial princesses remain serenely confident about the future potency of their kisses – even after their corporate backyards are knee-deep in unresponsive toads."

— Warren Buffett, 1982

Wall Street loves mergers and acquisitions. This type of activity generates lots of banking fees and can provide a shot in the arm to trading revenue. However, it's much less common that M&A activity benefits long-term investors.

That's why **Berkshire Hathaway** CEO Warren Buffett is suspicious of most mergers and acquisitions activity – even though Berkshire Hathaway has bought up plenty of companies under Buffett's leadership!

Buffett is particularly wary of companies that acquire underperforming businesses and hope to fix them or improve their profitability through "synergies." The sad corporate history of **Sears Holdings** shows

exactly why Buffett has been wise to focus his own acquisition efforts on strong businesses.

The Frog Prince is just a fairy tale!

In his 1981 letter to Berkshire Hathaway shareholders, Warren Buffett hypothesizes that many corporate executives were captivated by the fairy tale *The Frog Prince* as children. In the most common modern version of the story, a prince is trapped in a frog's body, but the spell is released when a princess kisses the frog.

According to Buffett, many corporate CEOs seem to believe that they are the princess from the fairy tale. They buy up weak companies, thinking that their "kiss" can turn these apparent frogs (or toads) into princes. Unfortunately, they're just frogs – and they eventually turn into dead frogs!

Buffett points out that there are typically lots of struggling companies with low stock prices at any point in time. If people want to buy shares in these companies, they can buy shares on the cheap.

However, when these struggling companies are acquired outright, the purchaser almost invariably ends up paying a premium. Why would a CEO pay a premium to acquire a struggling business? This behavior only makes sense if corporate CEOs believe that they can wring profits out of companies that aren't making much money on their own.

Sears Holdings is a perfect example

In late 2004, hedge fund manager Eddie Lampert was featured on the cover of *Businessweek* in a story touting him as the next Warren Buffett. The story came out shortly after Kmart, which was controlled by Lampert's hedge fund ESL Investments, reached a deal to buy Sears (another big Lampert stock holding) to create Sears Holdings – which was supposedly destined to be the next Berkshire Hathaway.

Kmart, the smaller of the two, agreed to pay more than $11 billion in cash and stock for Sears. While both companies were struggling, Kmart seemed to be in the midst of a turnaround. Lampert believed he could create revenue and cost synergies by merging the two and selling each retailer's exclusive products at the other.

Unfortunately, Lampert hadn't heeded Warren Buffett's advice about paying top dollar for weak businesses. In the ensuing decade, Lampert cut billions of dollars in costs, but that hasn't made Sears a cash cow. In fact, Sears Holdings' market cap is now $4 billion – less than half of what Lampert paid for the Sears portion of the business, and down almost 80% from the peak in 2007.

Indeed, Lampert's giant bet on turning around two underperforming retailers through a merger has nullified a lot of his victories. Many of his wealthiest clients have pulled money out of ESL investments in recent years. Meanwhile, he has had to step in as CEO of Sears Holdings, which hasn't done anything to stop the bleeding.

All told, the Sears Holdings stock price today is lower than its predecessor's (Kmart Holdings) stock price 10 years ago – shortly before the Kmart-Sears merger and the *Businessweek* profile. Meanwhile, the market as a whole is up more than 75%.

Foolish bottom line

Deep value investors can occasionally find diamonds in the rough: businesses that appear to be struggling but have good long-term prospects. These stocks can be huge winners. However, some "deep value" investments turn out to be duds after all. As a result, Buffett has been willing to pay a premium at Berkshire Hathaway for high-quality stocks with defensible moats.

However, the worst of both worlds is paying a premium to buy a struggling business in the hope of turning it around or wringing out merger synergies to justify the price. Buffett likens such behavior to hoping you can turn a frog into a prince with a magical kiss. Eddie Lampert's failed strategy at Sears Holdings shows just how dangerous such a strategy can be.

Warren Buffett of Berkshire Hathaway Inc.: How to Avoid Ruining a Decade's Worth of Success

By John Maxfield

"The market, like the Lord, helps those who help themselves. But, unlike the Lord, the market does not forgive those who know not what they do. For the investor, a too-high purchase price for the stock of an excellent company can undo the effects of a subsequent decade of favorable business developments."

— Warren Buffett, 1982

There's a viable argument that Warren Buffett's success at the helm of **Berkshire Hathaway** was the result of luck and not, as others claim, his contrarian approach to investing, logic-based temperament, or prescience about the market's ebbs and flows.

"I am not saying that Warren Buffett is not skilled," Nassim Taleb wrote in the preface to *Fooled by Randomness: The Hidden Role of Chance in Life and in the Markets*, "only that a large population of random investors will *almost necessarily* produce someone with his track records *just by luck*."

The problem with this line of argument is that it relies on quantitative measures of performance – his "track record." By doing so, it excludes the more qualitative analysis of the Buffett's decades of superior performance that emerges from his annual letters to shareholders. To appreciate how the latter changes the equation, Buffett's observation about "too-high purchase price[s]" in 1982 are a revealing place to start.

1982: A watershed moment for the market

The year 1982 was a watershed moment for equities. The Federal Reserve had succeeded at breaking the back of double-digit inflation. Stocks set off on a rally that would culminate in the "most extraordinary bull run in U.S. history." And a corporate acquisition frenzy got under way thanks to "junk bonds" peddled by the since-disgraced financier Michael Milken.

It's with the final development in mind that Buffett referred in his shareholder letter, written in March of the following year, to the "Acquisition Follies of 1982."

In retrospect, our major accomplishment of the year was that a very large purchase to which we had firmly committed was unable to be completed for reasons totally beyond our control. ... Had it come off, this transaction would have consumed extraordinary amounts of time and energy, all for a most uncertain payoff.

Buffett's opinion on this couldn't have been more contrarian. The impetus for the budding craze came when a small consortium of investors, spearheaded by former U.S. Treasury Secretary William E. Simon, purchased Gibson Greeting Cards for $80 million in January of 1982.

While the deal seemed simple enough at first glance, a deeper analysis revealed that the investors contributed a mere $1 million of their own money, financing the remainder by leveraging Gibson Greeting's assets. Fast forward 16 months, Simon's group took the company public in a $290 million initial public offering, reaping a 200-fold profit for the investors.

"Their phenomenal gain instantly became legend," wrote David Carey and John Morris in *King of Capital: The Remarkable Rise, Fall, and Rise Again of Steve Schwarzman and Blackstone*. And thus began a frenzied decade of leveraged buyouts that would send equity prices soaring, contribute to the largest single-day market crash of all time, culminate in the criminal conviction and subsequent bankruptcy of a leading Wall Street investment bank, and result in jail time for multiple leading financiers.

Buffett on over-paying for acquisitions

It's with this as a backdrop that Buffett discussed the dangers of paying too much for an acquisition. "For the investor, a too-high purchase price for the stock of an excellent company can undo the effects of a subsequent decade of favorable business developments," he wrote in his 1982 letter to shareholders of Berkshire Hathaway.

That Buffett recognized the budding trend in its infancy is a testament to both his disciplined approach to investing and his physical separation from New York, the then-epicenter of irrationality and global finance. And more than this, his observation about paying too much for even a good company rounded out his investment philosophy and transformed it into a two-part analysis that anyone can adopt.

The first step is to identify great companies with durable competitive advantages. "We continually search for large businesses with understandable, enduring and mouth-watering economics that are run by able and shareholder-oriented managements," Buffett wrote nearly a decade later. "Charlie [Munger] and I are simply not smart enough to get great results by adroitly buying and selling portions of far-from-great businesses."

The second step, to Buffett's point in 1982, is to ensure that one does not overpay for the right to own such companies, as doing so can "undo the effects of a subsequent decade of favorable business developments."

The Foolish takeaway

There is and will ever be only one Warren Buffett. But that doesn't mean savvy and disciplined investors shouldn't try to emulate his approach. By breaking it down into an analysis both of the company itself and the value of its stock, he's charted a path that even the most recreational of investors can follow.

Warren Buffett: 1 Thing You Need to Make Money in the Stock Market

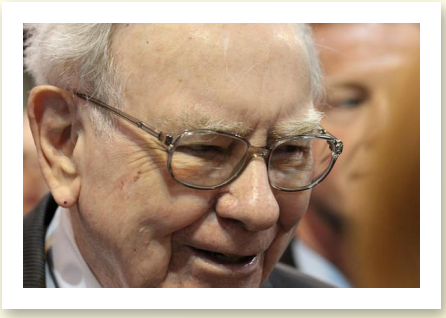
By Adam Levine-Weinberg

"We never take [one-year figures] very seriously. After all, why should the time required for a planet to circle the sun synchronize precisely with the time required for business actions to pay off?"

— Warren Buffett, 1984

Investors tend to be an impatient bunch. Indeed, this is the key reason that patient investors who play the long game can achieve outstanding investment returns. **Berkshire Hathaway** CEO Warren Buffett has become one of the richest people in the world by being one of the most patient investors ever.

One way that patient investors can achieve outsize gains is by identifying companies that are investing heavily to produce growth. If most investors are impatient, they will undervalue a company that sacrifices current earnings in order to produce more income in the future. Today, **Nordstrom** is just such a company, and it represents a big opportunity for long-term investors. (More on that later.)



Focus on the long run

In the above quotation, Buffett reveals one of the keys to his success at Berkshire Hathaway. In retrospect, it seems obvious that investments, profit improvement initiatives, etc. do not always pay

off immediately. In some cases, these actions even lead to lower short-term earnings.

However, in a world where so many others employ short-term thinking, Buffett's long-term mentality is very valuable – especially for Berkshire Hathaway shareholders! For example, Buffett grew Berkshire Hathaway's insurance business at an astounding rate for decades by being willing to accept "lumpy" results when other insurance company CEOs felt the need to keep earnings "smooth" by avoiding the risk of big one-time losses.

Instead of a one-year time horizon, Buffett argues that five years is the *minimum* time period that investors should consider when looking at a company's results. Buffett's time horizon tends to be even longer, as evidenced by the fact that he has held on to many of Berkshire Hathaway's main investments for decades.

Even with a five-year view, some prudent long-term investments may seem like losers. However, if you can't be quite as patient as Buffett, a five-year time horizon will still allow you to identify opportunities that other investors pass up.

One great company playing the long game

Warren Buffett hasn't invested in Nordstrom – perhaps because he has had some trouble in the retail sector in the past. However, Nordstrom is exactly the kind of company with a long-term focus that is undervalued due to the short-term mentality of many investors.

Nordstrom aims to maintain a long-term high-single-digit revenue growth rate. It also

wants to earn a mid-teens return on invested capital – this refers to how much money the company makes as a percentage of its capital base. (A higher ROIC means a company is more efficient at making money for any level of investment.) Very few large retailers can achieve both of these goals.

In order to drive future growth, Nordstrom is investing heavily in technology to boost online sales, growing its Nordstrom Rack store base (its off-price retail division), and expanding into Canada.

All of these initiatives result in short-term costs that are weighing on Nordstrom's earnings today. However, assuming the projected sales gains materialize, these investments will set the stage for higher long-term earnings power. (To put it a different way, earnings growth will accelerate in the next few years as Nordstrom's level of investment moderates.)

Nordstrom's expansion into Canada represents the most easily quantifiable example of this phenomenon. Nordstrom expects to lose $35 million in Canada this year. There are two main reasons for this.

First, new stores can take several years to ramp up to a normal sales rate, which means there is less revenue to cover fixed expenses. This is especially true in a brand-new market.

Second, Nordstrom is incurring significant pre-opening costs. For instance, it is hiring 30 managers for the Ottawa store that is opening next year and bringing them on an all-expenses-paid three-month trip to Seattle for orientation and training. It ran a similar program for the Calgary store that is opening in September. The Ottawa store, expected to open in March, will be the company's second in Canada and is expected to have 350 employees in sales and support roles.

The $35 million that Nordstrom expects to lose in Canada this year represents an investment in growth. Obviously, Nordstrom executives believe they can earn a high long-term return on the investment by building a profitable franchise in Canada. By contrast, the market is ignoring the value of that investment.

Foolish bottom line

Over the past five decades, Warren Buffett has used patience as a competitive advantage to deliver market-beating returns for Berkshire Hathaway investors. The key lesson for other investors is that you can use a long time horizon to your advantage, because many Investors undervalue companies that are sacrificing short-term earnings for long-term growth.

Nordstrom is a company that may not be getting credit for the costs it is incurring now to pave the way for future growth. Nordstrom's 2014 earnings will be depressed by start-up costs related to its rapid store expansion and heavy technology investments. However, the long-term result should be faster earnings growth – producing Buffett-like returns for patient investors.

What It Really Means to Invest Like Warren Buffett

By John Maxfield

"In selecting common stocks, we devote our attention to attractive purchases, not to the possibility of attractive sales."

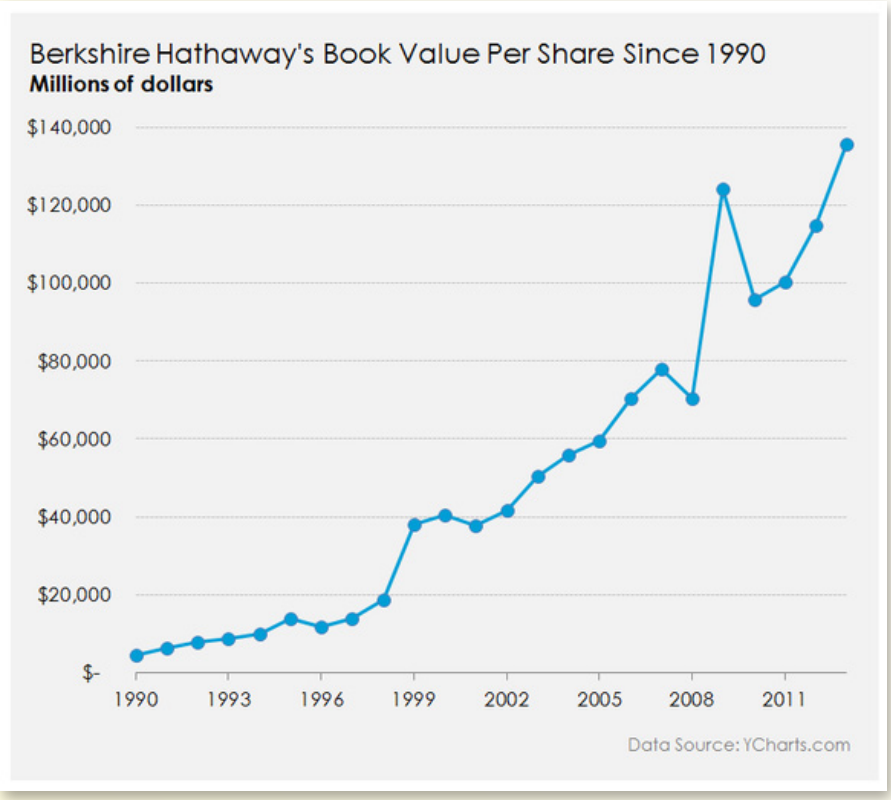
Warren Buffett, 1985

There is something supremely ironic about the market's embrace of Warren Buffett, the chairman and CEO of **Berkshire Hathaway**.

On the one hand, he's touted by traders and active investors as evidence that the average person can (or, at least, should try to) beat the market. On the other hand, it's probably safe to assume that he abhors anything which even closely resembles their approach.

Unlike the typical portrayal of an investor in an advertisement for an online brokerage (you know the one, with a guy sitting in an overly luxurious home office – in the middle of the day, no less – effortlessly trading in and out of stocks), Buffett does not actively sell stocks. He buys and then holds onto them for as long as possible.

"In selecting common stocks, we devote our attention to attractive purchases, not to the possibility of attractive sales," he wrote in his 1985 letter to shareholders. That this is subtle shouldn't be interpreted to mean it's unimportant.



The virtues of buying a select few stocks and then holding them for years if not decades is evident in Berkshire's portfolio of public securities.

Its three biggest holdings were initiated more than two decades ago – **Coca-Cola** in 1988, **Wells Fargo** in 1989, and **American Express** in 1991 (the initial stake was in American Express' preferred stock). Together, these three add an astounding $37.8 billion to Berkshire's balance sheet *above and beyond its cost basis*.

This is excluding the fact, moreover, that all of these companies distribute a considerable portion of their earnings each year in dividends, which Buffett then recycles into additional investment ideas. For its part, Coca-Cola pays out nearly two-thirds of its net income each year to shareholders like Berkshire.

Berkshire Hathaway's 10 Biggest Holdings

Rank	Company	Size of Position ($ millions)
1	Wells Fargo	23,632
2	The Coca-Cola Co.	15,760
3	American Express	13,180
4	International Business Machines	12,963
5	Wal-Mart Stores	4,269
6	Procter & Gamble	4,182
7	ExxonMobil	4,118
8	U.S. Bancorp	3,332
9	DIRECTV	2,954
10	DaVita HealthCare Partners	2,714

Data Source: CNBC's Berkshire Hathaway Portfolio Tracker

The point here is that Buffett *should be* used as an example for investors. But that example is *not* to actively trade in and out of stocks. It is rather to identify great companies, accumulate concentrated positions in them, and then allow the fruits of your work to mature in the years if not decades ahead.

"Lethargy bordering on sloth remains the cornerstone of our investment style," Buffett wrote in 1990. I encourage you to always remember that *this* is what the Oracle of Omaha stands for, and not what's often insinuated in the mainstream financial media.

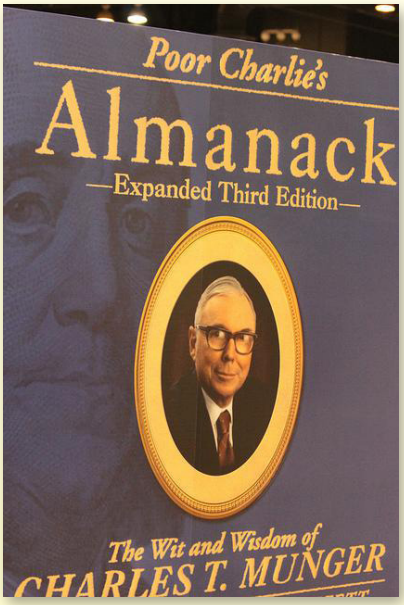
Warren Buffett Could Have Saved Me From My Worst Money Blunder Ever

By Adam Levine-Weinberg

"Our Vice Chairman, Charlie Munger, has always emphasized the study of mistakes rather than successes, both in business and other aspects of life. He does so in the spirit of the man who said: 'All I want to know is where I'm going to die so I'll never go there.'"

— Warren Buffett, 1986

As Bruce Springsteen remarks in his hit song "Glory Days", most people like to reminisce on their past successes. That certainly holds true in the investing world – it's not hard to get someone to tell you about their best stock pick ever.



However, if you're looking to improve, it's a lot more useful to study your mistakes: a point emphasized by **Berkshire Hathaway** Vice-Chairman Charlie Munger. Accordingly, today I'm going to take a look at my biggest investing mistake ever.

In 2007, in search of juicy dividends, I decided to invest in a bank. But I didn't pick **Wells Fargo**, a long-time Buffett favorite that is currently Berkshire Hathaway's largest investment. Instead, I bought 100 shares of

Washington Mutual. 16 months later, WaMu was seized by federal regulators and sold off for a pittance – taking a big chunk of my savings with it.

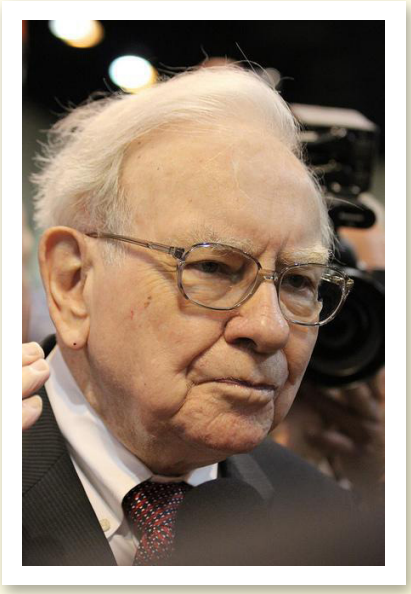
You can learn from your mistakes

Before getting into the gory details of my ill-fated investment, let's take a moment to consider why it's so important to study your mistakes. As Buffett explained in the above quotation, once you figure out where you *don't* want to go, you can make sure you don't go there.

This means that you need to know more than just that you invested in a certain company and its stock price went down. Sometimes, poor investment performance can be the result of bad luck – for example, a promising product turns out to be a bust. As a result, some mistakes may be unavoidable.

To truly learn from your investing mistakes, you need to understand both why you made the poor investment decision and whether you should have – or could have – known better at the time.

The reason why Munger and Buffett study mistakes is that once they understand the "whys" behind their mistakes, they are in a better position to change their behavior. This is a big reason why Berkshire Hathaway has been able to generate outsized returns for decades.



A look inside my biggest blunder

When I put some money into Washington Mutual stock in 2007, I was still an investing novice. I had been exposed to some basic lessons, such as the importance of being patient and the famous Warren Buffett aphorism:

"Be fearful when other are greedy and be greedy only when others are fearful."

However, I had not learned *all* of the important lessons for becoming a successful investor, and I certainly hadn't internalized them. For example, I focused too heavily on P/E ratios and Wall Street analysts' estimates when making investing decisions.

In early 2007, Washington Mutual was trading for 11.6 times earnings, whereas Wells Fargo was trading for 14.2 times earnings. WaMu also had a juicy 5% dividend yield, whereas Wells Fargo's dividend was closer to 3%.

If I had been a better Buffett disciple, I would have recognized that Wells Fargo was by far the better bet despite its premium price. Wells Fargo was extremely well-managed and maintained a conservative approach to risk-management. However, I was swayed by the (apparent) bargain price and high yield of WaMu shares.

WaMu stock began to decline soon after I made my initial investment, but I had an opportunity to escape that summer with a small loss. I did sell a portion of my shares then – but I repurchased them in October at a lower price as the bad news worsened! (I thought I was outsmarting the market by being greedy when others were being fearful.)

My confidence was buoyed by the fact that Washington Mutual CEO Kerry Killinger wasn't too worried about the company's deteriorating results. Killinger told investors on the company's October 2007 earnings call that WaMu was committed to maintaining its $0.56 quarterly dividend. (It lasted less than 2 months.) However, I assumed that the CEO must know what was going on more than second-guessers outside the company.

This was my big mistake

There was one key theme to my disastrous investment in Washington Mutual. I relied heavily on what other people were saying. When the

CEO and bullish analysts told me not to worry, I was happy to take the long view (which actually meant burying my head in the sand).

In fact, I didn't know much about the banking business. It never occurred to me that a company with a $60 billion+ market cap could go bust in just 1 year. The crux of the problem was that I ignored one of Buffett's most important lessons: buy what you know.

As an individual investor, it's OK to not understand how businesses in each sector of the market make money. However, that doesn't make it OK to invest in companies you don't understand! There are plenty of good index funds that can give you exposure to the broader market, giving you diversification without undue risk.

If you're going to risk your money on a single company's prospects, it's important to understand how its business works: just knowing its P/E ratio won't cut it. My key mistake was not picking the wrong horse in the banking sector – although Wells Fargo has provided a total return of 70% since May, 2007 – it was investing in a business I didn't understand whatsoever.

Foolish bottom line

I walked into the biggest investing mistake of my life by ignoring one of Buffett's most important lessons: buy companies whose business models you understand. I thought I was being clever by being greedy when others were being fearful. However, I didn't know enough about the banking business to have a clue about when to be greedy and when to be fearful.

There's absolutely nothing wrong with investing most or all of your money in index funds. If you're going to risk your hard earned money on a single stock instead, don't just do it on somebody else's say-so – make sure you understand what you're buying. Warren Buffett could have saved me a boatload of money. He could do the same for you.

1 Piece of Warren Buffett's Advice Most People Can't Follow

By John Maxfield

"Be fearful when others are greedy and greedy only when others are fearful."

— Warren Buffett, 1987

Among investors there are few quotes as well-known as Warren Buffett's advice to "be fearful when others are greedy and greedy when others are fearful."

Unfortunately, there are also few admonitions that are harder to follow.

Buffett eats his own cooking

Buffett first uttered this famous phrase (in writing, at least) in his 1986 letter to the shareholders of **Berkshire Hathaway**, which, it's worth noting, was written in March 1987.

To students of financial history, that year protrudes like a sore thumb.

The postwar bull market was roaring at full steam. Corporate dealmakers, fueled by the proliferation of junk bonds, were gobbling up competitors and unrelated businesses alike. And the Baby Boomer generation was getting its first taste of stock market riches thanks to the growth of mutual funds.

As Buffett recounted:

As this is written, little fear is visible in Wall Street. Instead, euphoria prevails – and why not? What could be more exhilarating than to participate in a bull market in which the rewards to owners

of businesses become gloriously uncoupled from the plodding performances of the businesses themselves? Unfortunately, however, stocks can't outperform businesses indefinitely.

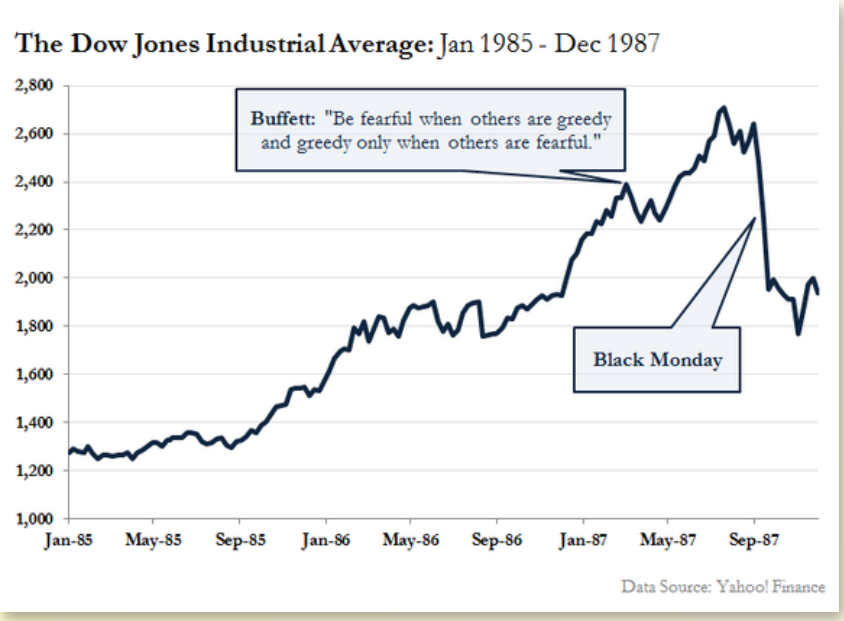
Seven months later, as if cued by Buffett, the market crashed.

On a single day in October 1987, the **Dow Jones Industrial Average** dropped by 508 points, or 22.61%. Known as "Black Monday," it was and remains the largest single-day percentage decline in the index's history, exceeding even the worst trading session of the Great Crash of 1929.

In this light, Buffett's prescience and foresight was astounding. And even more impressive is the fact that it was the third time in his career that Buffett had foretold such a calamity.

Nearly 20 years earlier, he shuttered his investment partnership at the height of the 1960s, aptly referred to as the "Go-Go Years."

"I am not attuned to this market environment," he wrote to his partners in May 1969, "and I don't want to spoil a decent record by trying to play a game I don't understand just so I can go out a hero."



The market plummeted soon thereafter. As Roger Lowenstein observed in *Buffett: The Making of an American Capitalist*, "By May 1970, a portfolio of every share on the stock exchange was down by *half* from the start of 1969."

And Buffett did the same thing in the mid-1970s, though this time he exploited the downside.

Following the cataclysmic decline of 1973 and 1974, Buffett increased Berkshire's stake in Blue Chip Stamps, the parent company of See's Candy Shops, among others, and in 1975 he acquired K&W Products, a manufacturer of specialty automotive chemicals for use in automobile maintenance.

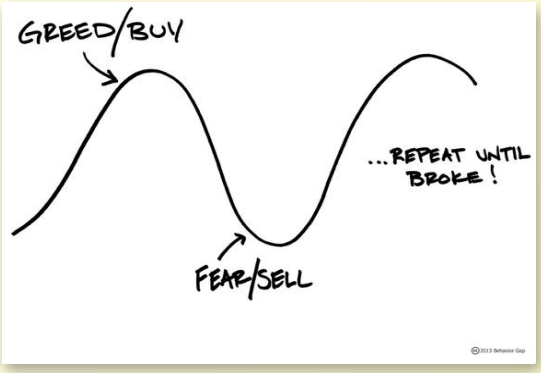
As he noted in his 1975 letter to shareholders, "stock fluctuations are of little importance to us – except as they may provide buying opportunities."

The road to underperformance is paved with good intentions

While this narrative makes market timing sound easy, nothing could be further from the truth.

As investors, we are our own worst enemies. Thanks to evolution, we're programmed to flee in the face of fear and fawn in the presence of greed.

The net result, as the author Carl Richards has aptly summed up in the diagram below, is that the vast majority of us, despite our best intentions, end up buying high and selling low.



"It's not that we're dumb," explains Richards in *The Behavior Gap*. "We're wired to avoid pain and pursue pleasure and security. It feels right

to sell when everyone around us is scared and buy when everyone feels great."

With this in mind, it should come as no surprise that most investors – professionals and individuals alike – dramatically underperform the broader market.

According to an annual study conducted by DALBAR, a Boston-based research and analytics firm, the average individual investor in an equity fund has underperformed the **S&P 500** by a factor of two since the early 1990s.

Between 1992 and 2012, the S&P 500 returned roughly 8% on an annual basis. Meanwhile, the individual investor notched annual gains of just over 4%.

The point here is Buffett's advice to be "fearful when others are greedy and greedy only when others are fearful" is easier said than done.

By the same token, however, it's also worth noting that the benefits to following it, if you have the temperamental fortitude to do so, can indeed be extraordinary.

Why Warren Buffett Is Probably Not Interested in Apple Inc. Stock

By John Maxfield

"Experience indicates that the best business returns are usually achieved by companies that are doing something quite similar today to what they were doing five or ten years ago."

— Warren Buffett, 1987

Why is Warren Buffett, the chairman and CEO of **Berkshire Hathaway**, so successful when it comes to investing while the vast majority of people aren't? A big reason is that he doesn't get caught up in the prevailing investment fad of the day.

"Experience indicates that the best business returns are usually achieved by companies that are doing something quite similar today to what they were doing five or ten years ago," Buffett wrote in his 1987 letter to shareholders.

His point is well taken. If an investor's objective is to maximize their long-term returns, then the best way to do so is to invest in companies with durable competitive advantages and long track records of success.

If it ain't broke, don't fix it

Take a quick glance at Berkshire's portfolio of common stocks, and one thing immediately sticks out; it holds few if any companies that are on the forefront of an emerging trend or technology.

Wells Fargo, its biggest position, was founded over 160 years ago and is one of the least exciting banks in the country today. **Coca-**

Cola, Berkshire second largest holding, introduced its first product in 1886 and, aside from excluding cocaine since the early 1900s, has done little to change it since. And the same is true of **American Express**, **Wal-Mart**, **Procter & Gamble**, **ExxonMobil**, and so on.

Indeed, Berkshire's only major holding that appears to be inconsistent with this is **International Business Machines**, which Berkshire first began accumulating in 2011. Aside from the fact that IBM is now principally a service-based business, however, it wasn't technology that attracted Buffett. It was instead the company's management.

"I can think of no major company that has had better financial management, a skill that has materially increased the gains enjoyed by IBM shareholders," Buffett wrote that year.

The reason Buffett loves boring

If you watch or read the financial news, then Buffett's preference for boring companies may seem peculiar. Flip on CNBC, for instance, and

you're unlikely to see much talk about how Coca-Cola has yet again *not* changed its recipe for success.

But, and this is important to appreciate, Buffett doesn't invest for the purposes of entertainment. He does it to make money.

Businesses always have opportunities to improve service, product lines, manufacturing techniques, and the like, and obviously these opportunities should be seized. But a business that constantly encounters major change also encounters many chances for major error. Furthermore, economic terrain that is forever shifting violently is ground on which it is difficult to build a fortress-like business franchise. Such a franchise is usually the key to sustained high returns.

Remember, Buffett is a long-term investor. He's not interested in short-term stock market fluctuations. What he wants are businesses that have an above-average likelihood of compounding returns at market-beating rates for decades to come. And the only place he believes these can be found is among the biggest, oldest, and most boring companies in the market today.

Why Buffett would never buy Apple

To fully appreciate what this means, it's helpful to think about a company like **Apple**, the Cupertino-based technology firm behind the iPod, iPhone, and iPad.

No one in their right mind would claim that Apple isn't an exceptional company. Not only is it responsible for some of the most popular consumer products to be introduced over the last few decades, it's also exceptionally profitable.

In the latest fiscal year, it earned $37 billion in income from only $171 billion in revenue, equating to a profit margin of 22%. Meanwhile, ExxonMobil, the second largest company by market capitalization on the **S&P 500** (after only Apple), earned a comparatively paltry $32.6

billion from $438 billion in total revenue, yielding a profit margin of 7.5%.

But despite these accolades, there's a powerful argument, at least according to Buffett's philosophy, that Apple would make a horrible long-term investment. Here's my colleague Morgan Housel discussing this point in the middle of last year:

The key to [Apple's] success is that it has to keep innovating year after year after year, every single year, if not multiple times a year. The odds that sometime down the road, one of its cycles of creating new products won't live up to past successes it's had with the iPhone and iPad are pretty high and the market needs to discount that.

When you compare that to a company like Coca-Cola, or **Clorox**, or utilities like **Southern California Edison**, that's a totally different story because those companies don't need to innovate at all. Coke and Clorox sell the same products today that they did 50 years ago. They'll be selling the same products 50 years from now. There's much more predictability of earnings and the market will pay up for that with a higher multiple.

Boring is better

The point here is that boring is better.

Sure, buying and holding companies like Coca-Cola won't give you exciting conversation fodder for your next work party. And, yes, it eliminates the thrill of checking your brokerage account on a daily (or hourly) basis.

But as Buffett has demonstrated, what companies like this will do for you is to make you rich. If that's what you're interested in, then I'd encourage you to follow his lead.

How Billionaire Warren Buffett Avoids Failure

By John Maxfield

"In my opinion, investment success will not be produced by arcane formulae, computer programs or signals flashed by the price behavior of stocks and markets. Rather an investor will succeed by coupling good business judgment with an ability to insulate his thoughts and behavior from the super-contagious emotions that swirl about the marketplace."

— Warren Buffett, 1987

If you want to succeed at investing, you have to be able to control your emotions. In fact, if you want to succeed at investing, you must train yourself to act in a manner that's wholly inconsistent with the financial media's prevailing wisdom.

This is the essence of contrarianism. And no one is a bigger (and richer) contrarian than Warren Buffett, the chairman and CEO of **Berkshire Hathaway**.

Why it pays to be contrarian

There are few years in the history of the stock market that prove this point better than 1987. Less than a decade after *BusinessWeek* infamously proclaimed "The Death of Equities," the market had not only recovered, but had soared to previously unforeseen heights.

But by October this would all come to an end. On the 19th of that month, the **Dow Jones Industrial Average** plummeted by 22.6%. It was, and remains, the largest single-day loss in the history of the American stock market.

Capturing the sentiment, a *New York Times* headline asked, «Does 1987 Equal 1929?» And a headline over at *The Wall Street Journal* read, «The Market Debacle Rouses Worst Fears of Little Investors.»

In short, fear was in the air and everyone was headed for the exits. Everyone, that is, but Warren Buffett, who shared the following anecdote in his 1987 letter to shareholders:

Ben Graham, my friend and teacher, long ago described the mental attitude toward market fluctuations that I believe to be most conducive to investment success. He said that you should imagine market quotations as coming from a remarkably accommodating fellow named Mr. Market who is your partner in a private business. Without fail, Mr. Market appears daily and names a price at which he will either buy your interest or sell you his.

Even though the business that the two of you own may have economic characteristics that are stable, Mr. Market's quotations will be anything but. For, sad to say, the poor fellow has incurable emotional problems. At times he feels euphoric and can see only the favorable factors affecting the business. When in that mood, he names a very high buy-sell price because he fears that you will

snap up his interest and rob him of imminent gains. At other times he is depressed and can see nothing but trouble ahead for both the business and the world. On these occasions he will name a very low price, since he is terrified that you will unload your interest on him. Mr. Market has another endearing characteristic: He doesn't mind being ignored. If his quotation is uninteresting to you today, he will be back with a new one tomorrow. Transactions are strictly at your option. Under these conditions, the more manic-depressive his behavior, the better for you.

Buying high and selling low

The unfortunate truth when it comes to investing is that humans are programmed to fail.

When euphoria prevails, stock prices soar and greed induces us to buy into the hype, both literally and figuratively. Then, when fear takes hold, prices tank and we sell.

"We've been doing this for a long time," Carl Richards writes in *The Behavior Gap: Simple Ways to Stop Doing Dumb Things with Money*. "We do it because we make investment decisions based on *how we feel* rather than *what we know*."

And this is Buffett's point. In 1987, there was no reason to run for the exits. If anything, it presented a rare opportunity to buy stocks at a relative bargain.

If a tree falls in a forest...

It seems safe to assume that the level of hysteria that takes hold when the market swoons is directly related to the endless prodding of the financial media. In the latter's absence, it isn't difficult to imagine that market booms and busts would be both less frequent and less extreme.

The problem, at least according to noted financial blogger and columnist Josh Brown, is that people take the financial media too

seriously. Take this point he made in a recent interview with my colleague Morgan Housel:

Let me tell you something interesting about financial media. Of all the verticals across different types of news, financial media is the only one where there's supposed to be some sort of responsibility that comes along with it. When you think about fashion, art, sports, Hollywood gossip – huge categories of news that dwarf financial news – there is no responsibility. People don't watch ESPN and then think they're supposed to go out and play tackle football with 300-pound guys. But when they watch financial or business news, they take the next step and say, "Well I'm supposed to act on this now. I'm supposed to do something about this."

Part of that is the fault of the media. The word "actionable" gets thrown around a lot. Actionable for who? Oh I don't know, it's just actionable. But a lot of the responsibility is on the public. And I think what most people do incorrectly is they focus on the news of the day, the stocks that are moving on a given day, whatever is driving the markets now, but they've got no background whatsoever about how to invest.

Are you starting to see a theme?

The point here, to return to Buffett's quote at the top of this article, if you want to succeed as an investor, it's critical that you cultivate an "ability to insulate [your] thoughts and behavior from the super-contagious emotions that swirl about the marketplace."

Remember, the financial media exists to entertain you, not to inform you.

Warren Buffett's Secret Weapon You Never Hear About

By John Maxfield

"When we own portions of outstanding businesses with outstanding managements, our favorite holding period is forever."

Warren Buffett, 1988

If you want to invest like Warren Buffett, the chairman and CEO of **Berkshire Hathaway**, then there's at least one thing you better be willing to do: Wait. "Lethargy bordering on sloth remains the cornerstone of our investment style," the 83-year-old billionaire wrote in 1990.

Nikita Sobolkov/Hemera/Thinkstock

The key to Buffett's success is not simply the fact that he identifies outstanding companies. It's also not only because he chooses the most opportune time to invest in them. Indeed, these abilities would be worth little without the temperament to allow time and the law of compounding returns to fully monetize them.

Trading is hazardous to your wealth

"We are just the opposite of those who hurry to sell and book profits when companies perform well but who tenaciously hang on to businesses that disappoint," Buffett wrote in 1990. "Peter Lynch aptly likens such behavior to cutting the flowers and watering the weeds."

Buffett's affinity for long-term investing stems from two observations. The first is that frequent trading in and out of stocks increases transaction costs, both in terms of broker fees and taxes.

Long ago, Sir Isaac Newton gave us three laws of motion, which were the work of genius. But Sir Isaac's talents didn't extend to investing: He lost a bundle in the South Sea Bubble, explaining later, "I can calculate the movement of the stars, but not the madness of men." If he had not been traumatized by this loss, Sir Isaac might well have gone on to discover the Fourth Law of Motion: *For investors as a whole, returns decrease as motion increases.*

I trust you won't be surprised to hear that a chorus of academic and practitioner studies on the impacts of short-term investing agrees wholeheartedly.

A leading paper on the topic, titled "Trading Is Hazardous to Your Wealth," found that investors who traded the most between 1991 and 1996 earned an annual return of 11.4% compared to a gain in the broader market of 17.9%. And an annual survey of mutual fund investors suggests that active trading cuts an average investor's long-term returns in roughly half relative to the average market.

The power of compounding returns

The second observation is that the law of compounding returns, left to work its magic, will serve as a catalyst on one's initial ability to identify outstanding companies that are trading for reasonable prices. This is one of the reasons my colleague Morgan Housel believes that time is the individual investor's "last remaining edge on Wall Street."

And here too, the evidence is overwhelming. In the nearly century and a half between 1871 and 2012, an average holding period of one day generated positive returns 52% of the time – this is based on the inflation-adjusted performance of the **S&P 500**. Increase the holding period to one year, and the odds of realizing a gain improve to 68%. And by boosting it to 20 years, your chances of realizing a profit reach 100%.

Warren Buffett's Most Important Money-Making Revelation

By John Maxfield

"It's far better to buy a wonderful company at a fair price than a fair company at a wonderful price."

— Warren Buffett, 1989

Everyone wants to buy stocks that are cheap. Everyone wants a bargain.

But when it comes to investing, this desire puts the cart before the horse.

What matters first and foremost, at least according to Warren Buffett, arguably the greatest investor to ever live, is the quality of the company of you're investing in.

"It's far better to buy a wonderful company at a fair price than a fair company at a wonderful price," Buffett wrote in his 1989 letter to shareholders of **Berkshire Hathaway**.

If you're an investor, it'd behoove you to think long and hard about this simple admonition.

Simplicity is the ultimate sophistication

Like many of Buffett's best-known quotes, the substance and story behind his phrase about preferring wonderful companies at fair prices gets obscured by the simplicity of its delivery.

"Simplicity is the ultimate sophistication," wrote Leonardo da Vinci.

What's captured in Buffett's short and pithy maxim is the accumulation of knowledge that he acquired throughout his first 25 years at the helm of Berkshire Hathaway.

More specifically, it represents the lesson he learned about adhering too closely for too long to the value investing philosophy pioneered by his friend and mentor Benjamin Graham.

In a section of his 1989 letter to shareholders titled "Mistakes of the First Twenty-five Years (A Condensed Version), Buffett conceded that his "first mistake, of course, was in buying control of Berkshire."

Though I knew its business – textile manufacturing – to be unpromising, I was enticed to buy because the price looked cheap. Stock purchases of that kind had proved reasonably rewarding in my early years, though by the time Berkshire came along in 1965 I was becoming aware that the strategy was not ideal.

If you buy a stock at a sufficiently low price, there will usually be some hiccup in the fortunes of the business that gives you a chance to unload at a decent profit, even though the long-term performance of the business may be terrible. I call this the "cigar butt" approach to investing. A cigar butt found on the street that has only one puff left

in it may not offer much of a smoke, but the "bargain purchase" will make that puff all profit.

Unless you are a liquidator, that kind of approach to buying businesses is foolish. First, the original "bargain" price probably will not turn out to be such a steal after all. In a difficult business, no sooner is one problem solved than another surfaces— never is there just one cockroach in the kitchen. Second, any initial advantage you secure will be quickly eroded by the low return that the business earns. For example, if you buy a business for $8 million that can be sold or liquidated for $10 million and promptly take either course, you can realize a high return. But the investment will disappoint if the business is sold for $10 million in ten years and in the interim has annually earned and distributed only a few percent on cost. Time is the friend of the wonderful business, the enemy of the mediocre.

I quoted this passage in its entirety not because I'm unwilling to paraphrase, but rather because it contains critical insights for investors.

Indeed, not only does it represent a clear repudiation of Buffett's former philosophy, but it also reveals his willingness to both acknowledge and learn from former mistakes.

"There's no rule that says you have to learn by failing yourself," my colleague Morgan Housel recently wrote. "It is far better to learn vicariously from other people's mistakes than suffer through them on your own."

And there are few better people to learn from – mistakes and all – than the Oracle of Omaha.

Buying wonderful companies at fair prices

While volumes could be written about Buffett's evolved approach to investing, captured in his quote about buying wonderful companies at fair prices, the basic analysis is very simple.

What matters most is the quality of the company itself. I'd encourage you, for instance, to contemplate the adjective Buffett used: "wonderful."

In its purest form, that's a powerful word. Wonderful meals are rare. As are wonderful books and movies. And the same can be said of companies.

This is exemplified by Berkshire's portfolio of common stocks. Despite having untold billions of dollars to invest, Buffett has allocated the funds to a select few businesses, many of which are the absolute best in the world at what they do.

He accumulated a massive stake in **Wells Fargo** long before it conquered the financial crisis by devouring Wachovia and thereby more than doubling in size. He saw it early on in **American Express** when its business revolved principally around traveler's checks. And he recognized it, albeit belatedly by his own admission, in **Coca-Cola**, which oversees the most recognizable brand on earth.

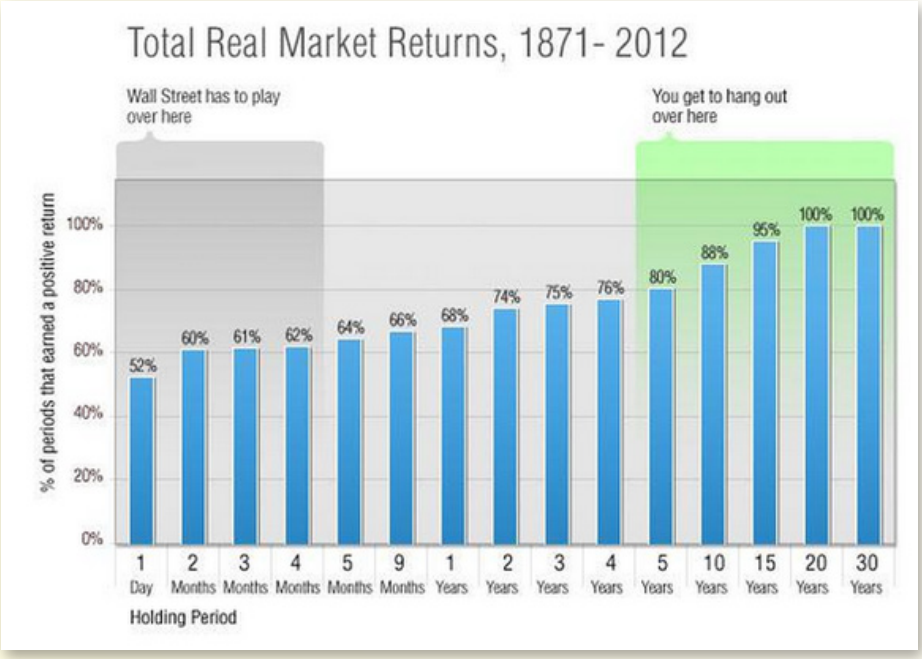
The point here is that great investors invest in great companies.

Now, just to be clear, this isn't to say that stock price and valuation don't matter. Indeed, nothing could be further from the truth.

"For the investor, a too-high purchase price for the stock of an excellent company can undo the effects of a subsequent decade of favorable business developments," Buffett wrote in 1982.

But the key to remember is that this is the second *and subsidiary* step in the analysis.

Consequently, the next time your neighbor, brother-in-law, or coworker talks about how such-and-such stock is a cheap right now, your response should be: "That may be so, but is it a *wonderful* company?"



Source: Morgan Housel

It should come as no surprise, in turn, that Berkshire's biggest holdings are also some of its oldest. Buffett first started buying **American Express** in 1964 following a scandal that caused its stock to drop more than 50% – though, to be clear, Berkshire's current stake more accurately dates to the early 1990s. His initial position in **Coca-Cola** was accumulated in 1988. And **Wells Fargo**, far and away Berkshire's largest position, was initiated the following year.

The point here is that it's not only important to identify great companies at great prices; it's also critical to allow them to reward your judgment with a long string of compounding returns.

How Warren Buffett Separates a Good Business From a Great One

By Isaac Pino, CPA

"Our extraordinary returns flow from outstanding operating managers, not fortuitous industry economics."

— Warren Buffett, 1990

They say there's more than one way to skin a cat, and the investing legend Warren Buffett would likely agree. For decades, Buffett produced one market-beating performance after another at **Berkshire Hathaway**, but he took a variety of paths to get where he is today. At times, he relied on the virtuous economic characteristics of what he calls a "wonderful" business; in other instances, however, it was his operating managers alone who were responsible for Berkshire's profits.

The year 1990 was a prime example of the latter scenario. In Buffett's letter to shareholders, he commended Berkshire's astute managers who delivered impressive results in spite of otherwise challenging industry economics:

[O]ur return was not earned from industries, such as cigarettes or network television stations, possessing spectacular economics for all participating in them. Instead it came from a group of businesses operating in such prosaic fields as furniture retailing, candy, vacuum cleaners, and even steel warehousing. The explanation is clear: Our extraordinary returns flow from outstanding operating managers, not fortuitous industry economics.

For investors, incidentally, there's more than one way to unpack this particular Buffett quote. A knee-jerk reaction would be to snatch up shares of tobacco and TV conglomerates like **Altria** or **Disney**, but that would probably just make you 25 years late to the party (timing is critical).

On second thought, you might dig deeper into Buffett's thoughts on identifying great managers. That would probably be a more fruitful activity, but it would nonetheless miss the core of this concept.

What Buffett meant to convey was an idea that had only recently crystallized in his mind: To evaluate a company, one of the most critical skills for an investor to master is the ability to differentiate between a "franchise" and a mere "business." In his eyes, the former is virtually "bulletproof," whereas the latter is considered simply "ordinary." This particular train of thought led to some of his greatest investments over time, including those in the standout franchises of **Coca-Cola** and Gillette.

But what exactly separates a bulletproof franchise from an ordinary business? In Berkshire's 1991 letter to shareholders, Buffett describes the three characteristics of a franchises that make them so durable:

An economic franchise arises from a product or service that:

(1) is needed or desired,

(2) is thought by its customers to have no close substitute,

(3) is not subject to price regulation.

The existence of all three conditions will be demonstrated by a company's ability to regularly price its product or service aggressively and thereby to earn high rates of return on capital. Moreover, franchises can tolerate mismanagement. Inept managers may diminish a franchise's profitability, but they cannot inflict mortal damage.

In short, a franchise sells a product or service that is highly differentiated. A prime example of a franchise would be a company

like Coca-Cola, which generates 18% profit margins on sales of well-branded flavored water. Coke has created a product that appeals to consumers' taste buds and carries emotional appeal; it's nearly the opposite of what we might call a "commodity."

Source: Coca-Cola

A commodity business, on the flipside, engages in the sale of generic products, ranging from raw materials like steel or lumber to retail goods like many groceries. In those respective industries, customers do not perceive the products as particularly unique, and therefore managers can only differentiate on price. Often, it becomes a race to rock-bottom prices in an extremely competitive environment. The result is less-than-fortuitous industry economics for everyone, managers and investors included.

As a result, a lowly commodity business faces persistent and severe headwinds. In this realm, think of grocers with razor thin margins like **Safeway** or **Kroger**. As Buffett points out, businesses

like these can ultimately prosper, but it requires an exceedingly smart and agile management team:

[A] 'business' earns exceptional profits only if it is the low-cost operator or if supply of its product or service is tight. Tightness in supply usually does not last long. With superior management, a company may maintain its status as a low-cost operator for a much longer time, but even then unceasingly faces the possibility of competitive attack. And a business, unlike a franchise, can be killed by poor management.

What Buffett realized over the years is that an appropriate symbol for a franchise is a castle, and its lucrative economic traits are the moat that protects the castle. In some cases, that moat provides such a formidable buffer that franchises can prosper in spite of poor decisions by the defenders of the castle, e.g. the management team. Companies with wide moats, however, are rare, as are those with no moat whatsoever. At the end of the day, most companies fall along a continuum with a true franchise on one end of the spectrum and a pure commodity business on the other.

For individual investors, this continuum is a tool developed by Buffett that can be applied to any business to better understand its economics. The determination will not always be cut and dry, but it can provide valuable context. In 1990, for instance, Berkshire's great managers overshadowed the great franchises, a feat the Oracle of Omaha was eager to point out to shareholders.

Buffett's lesson shows that buying stock in a company resembles buying a horse in an attempt to win the Triple Crown. In either case, an owner can employ one of two basic strategies: Identify the best all-around thoroughbred (a franchise) and ride it to victory; or, find

an average horse (a business) and hire the best trainer and jockey in the industry.

In the first scenario, as Buffett has said about businesses, you only have to be smart once, when selecting the absolute best horse for the race. In the second scenario, however, you and your team have to be smart forever.

How to Manage Your Portfolio Like Buffett

By Isaac Pino, CPA

A week ago, I wrote about a smart method of assessing portfolio performance employed by Warren Buffett. This idea – a "Buffettism," if you will – was first introduced in his annual letter to **Berkshire Hathaway** shareholders in 1990 as the "look-through" earnings approach. Buffett described it as follows:

We also believe that investors can benefit by focusing on their own look-through earnings. To calculate these, they should determine the underlying earnings attributable to the shares they hold in their portfolio and total these. The goal of each investor should be to create a portfolio (in effect, a "company") that will deliver him or her the highest possible look-through earnings a decade or so from now. An approach of this kind will force the investor to think about long-term business prospects rather than short-term stock market prospects, a perspective likely to improve results.

Buffett believes in the look-through method because it makes an investor focus on the underlying businesses, instead of using the stock price as an effective day-to-day arbiter of value. As the father of value investing, Benjamin Graham, once pointed out, the latter approach can often be misleading: "In the short run, the market is like a voting machine – tallying up which firms are popular and unpopular. But in the long run, the market is like a weighing machine – assessing the substance of a company."

Source: YouTube, CBSNewsOnline

Buffett apparently took this concept to heart. He developed the "look-though" method in an attempt to divert his and his investors' attention from the scoreboard (i.e., stock prices) and toward the playing field (i.e., the ebbs and flows of earnings), to employ his own baseball analogy.

In theory, Buffett's approach seems simple, but it can be a daunting task for investors to tune out the market's day-to-day noise. To determine for myself how easily this Buffettism could be applied to my stock investing strategy (or yours, for that matter), I subjected my portfolio to the look-through earnings test in a manner similar to Berkshire Hathaway.

First, I considered each of the five holdings in my concentrated portfolio as subsidiaries of a hypothetical mini-conglomerate (to act like an owner, it helps to think like one). Then, for the purposes of the following illustration, I limited my conglomerate's market capitalization to $1,000 in total, and in some cases, assumed ownership of only fractional shares to reflect allocation.

Secondly, I listed the five major holdings in my portfolio, their prices, and their market value as of May 30, 2014 in the following chart:

My Portfolio	Stock Price	Quantity	Market Value
Chipotle (NYSE: CMG)	$547.09	0.38	$208
General Electric (NYSE: GE)	$26.79	10.34	$277
LinkedIn (NYSE: LNKD)	$160.09	0.90	$144
SodaStream (NASDAQ: SODA)	$37.35	6.71	$251
Yahoo! (NASDAQ: YHOO)	$34.65	3.46	$120
Total			$1,000

The calculation above provided me with the market value of my hypothetical subsidiaries, and from there I could assess the earnings

stream I would derive from these operations, should they all be paid out. The portion of each company's last 12 months' earnings attributable to my portfolio is shown below:

My Portfolio	Quantity	TTM EPS	My Earnings (EPS x # of Shares)
Chipotle	0.38	$10.65	4.05
General Electric	10.34	$1.57	16.23
LinkedIn	0.90	$0.04	0.04
SodaStream	6.71	$1.47	9.87
Yahoo!	3.46	$1.27	4.40
Total			34.59

In the end, the two charts above took a mere 30 minutes to pull together, yet they produced a highly valuable x-ray of my holdings. Using this information, I was able to assess my portfolio's price-to-earnings (PE) ratio and earnings yields quite easily:

$$\text{My Portfolio PE} = \frac{\text{Market Value}}{\text{TTM Earnings}} = \frac{\$1{,}000}{\$34.59} = 28.91$$

$$\text{My Earnings Yield} = \frac{\text{TTM Earnings}}{\text{Market Value}} = \frac{\$34.59}{\$1{,}000} = 3.46\%$$

Next, I compared these metrics to stock market averages to get a sense of my risk-reward balance relative to an investment in something like the **S&P 500** index. What I found is that the S&P 500's P/E ratio of 18.26 is actually significantly lower than my portfolio's, which stands at 28.91, as shown above. This is likely because of the nature of my few high-growth businesses, which are more focused on expanding the top line than current earnings today. Thus, the S&P 500's earnings yield of 5.21% also beats out the 3.46% earnings yield generated by my mini-conglomerate.

Help yourself ask the right questions

Now, what does all of this tell me? Well, for one, that I might have an appetite for risk above and beyond that of a passive index fund investor. But more importantly, it sheds light on the nature of the high-growth but cash-intensive businesses in my portfolio, which includes nearly everything outside of General Electric.

To pry deeper, I might want to consider the free cash flow (FCF) of these businesses, perhaps generating a price-to-FCF metric in the same manner. Are certain companies sacrificing earnings and reinvesting cash flow heavily? Is this a wise move, and does it bode well for the earnings stream of my conglomerate over the next 5 to 10 years? After all, given my current earnings yield of only 3.46%, the expectation is that future earnings will expand rapidly enough to compensate for the current discount relative to the S&P 500.

At the end of the day, these are the types of questions I should be asking about my portfolio, but they're the ones I often forget. Instead, I might find myself fretting over stock price swings related to Chipotle's guacamole scare or the ongoing speculation over GE's blockbuster buyout.

There are definitely better uses of my valuable research time, and I imagine a regular look-through earnings test would help to focus my investing energy. Hopefully you'll take a moment to apply it to your mini conglomerate as well, and feel free to use my web-based spreadsheet as a starting point for your analysis.

While it's impossible to replicate Buffett's every move in the market, it's perfectly practical to manage your portfolio just like the Oracle.

Is Warren Buffett a Two-Faced Liar When It Comes to Bank Stocks?

By John Maxfield

"The banking business is no favorite of ours. When assets are twenty times equity – a common ratio in this industry – mistakes that involve only a small portion of assets can destroy a major portion of equity."

— Warren Buffett, 1991

Of all **Berkshire Hathaway**'s investments, its massive holdings of banks stocks are the most peculiar.

"The banking business is no favorite of ours," Warren Buffett wrote in 1991. Yet, fast forward to today and no less than four out of Berkshire's 10 biggest holdings are just that: banks.

What explains the about-face?

The answer is that while the vast majority of banks should indeed be avoided, a select few have proven themselves over time and multiple credit cycles to offer riches well beyond that of the average stock.

Buffett's banking aversion

If one were to visualize the banking industry, it's tempting to think of it as a lopsided barbell.

On one end are a large number of poorly managed lenders that seem to always fall prey to the ups and downs of the credit and interest rate cycles. On the other, meanwhile, are a select few with the discipline to restrain themselves during the best of times and the fortitude to expand when times are tough.

Of course, this isn't wholly unlike any other industry. Technology companies invest more when the economy is roaring, as do car companies, and retailers.

But the difference is that banks are uniquely susceptible to failure when the tide turns. You can see this in the chart below which illustrates bank closures since the Federal Deposit Insurance Corporation was founded during the Great Depression.

As you can see, a severe economic downturn doesn't just temporarily impact irresponsible lenders; it wipes them out.

Why banks are so susceptible to failure

The explanation for this is precisely what Buffett was referring to when he wrote, "When assets are twenty times equity – a common ratio in this industry – mistakes that involve only a small portion of assets can destroy a major portion of equity."

Take **Bank of America** as an example – which, it's worth pointing out, counts Berkshire as its largest shareholder.

The Charlotte, N.C.-based lender holds $2.2 trillion in assets on its balance sheet. Meanwhile its equity comes in at a mere $232 billion. Consequently, only 10% of its assets would have to default for the bank to be rendered completely insolvent.

And if you wanted to be more precise, the margin for error at most banks is even slimmer when you consider that many would

be deemed "undercapitalized" by regulators, and thus susceptible to seizure, after losing only a smaller sliver of capital.

The peculiar problem with banks – which Buffett most certainly recognizes given the similarities that banks share with insurance companies – is that it's easy for a lender to increase revenue. All one must do is to make more loans, as there are few people and businesses that would turn down a loan if the price (i.e., the interest rate) were right.

The challenge in other words is to underwrite only good loans and to run an efficient operation, as doing both maximizes the portion of a bank's revenue that makes its way to the bottom line.

Buffett's banking experience

Buffett has discussed all of these points throughout the years on multiple occasions.

Throughout the 1970s, when Berkshire Hathaway owned Illinois National Bank and Trust, he repeatedly lavished praise on its executives for outperforming more than 95% of its peers with respect to its charge-off ratio, which measure the percent of loans that go into default.

And upon Berkshire's investment in Wells Fargo, he commended its then-leaders for not having a bigger head count than was needed and "attacking costs vigorously when profits are at record levels as when they are under pressure."

The point here is that too many banks lose sight of the fact their objective is not to maximize short-term revenue, but rather to maximize profit over the long-run. And in order to do the latter, moreover, one must be careful to avoid placing undue emphasis on the former.

For investors, this is a valuable lesson. Bank stocks aren't like beer, where a cheap imitation can get the job done. They are instead like fine scotch in that there's no reason, outside of sheer desperation perhaps, to drink it unless it's the best.

Warren Buffett's Love-Hate Relationship With Index Funds

By Isaac Pino, CPA

If my universe of business possibilities was limited, say, to private companies in Omaha, I would ... try to buy into a few of the best operations at a sensible price. I certainly would not wish to own an equal part of every business in town.

— Warren Buffett, 1991

Does Warren Buffett love index funds – or hate them?

If the quote above provides any indication, he's not a fan of the concept. Buy shares in a broad range of unexamined businesses? That's not really this value investor's style.

Why, then, did Buffett do an about-face two decades later when he called index funds a "superior" alternative to managed funds? To find out, let's take a closer look at the Oracle of Omaha's thoughts on the matter.

Source : Flickr/
Fortune Live Media

Why Buffett finds indexing pointless (at times)

In his 1991 letter to shareholders of **Berkshire Hathaway**, Buffett wrote skeptically about the idea of buying a market index rather than actively managing a portfolio. Here's a full recap of what he had to say:

If my universe of business possibilities was limited, say, to private companies in Omaha, I would, first, try to assess the long-term economic characteristics of each business; second, assess the quality of the people in charge of running it; and, third, try to buy into a few of the best operations at a sensible price. I certainly would not wish to own an equal part of every business in town.

Buffett doesn't directly refer to indexing, to be sure, but he clearly reveals a lack of enthusiasm for the concept. Indexing implies ownership in a broad swath of businesses, many of which might not meet the investment criteria Buffett lays out above. If Buffett's made a fortune buying businesses that *do* meet those criteria, why would he adopt or advocate a different approach?

Buffett drives home his point by making an analogy to a universe limited to Omaha, Nebraska, his hometown. It's an attempt to connect the stock market – which can sometimes seem like an abstract concept – more directly to our day-to-day lives.

To extend Buffett's analogy, think for a moment of the neighborhood businesses that you love and patronize. Easy enough, right? Now think of the ones that you purposely avoid like the plague due to their poor service or inferior products. Holding an index fund containing the latter probably makes you cringe. Logically, then, it makes little sense for an investment manager either. And yet that's exactly what passive indexing requires.

By 1991, Buffett was actively disproving the efficient market theorists who believed that no individual investor could be smarter than the market itself. With Berkshire's compounded annual book value growing at 23%, Buffett and his investing partner Charlie Munger were defying all odds.

With that information in mind, his skepticism of index funds seems warranted. If Buffett bought into each and every stock in the S&P 500, there would be no reason to believe that Berkshire would ever beat the market. Passive indexing, by definition, cannot yield superior results.

Instead, Buffett reiterated to shareholders that he would continue to identify companies with superior "long-term economics" while paying particular attention to the "quality of the people in charge of running" those companies. Using that formula, he uncovered some incredible businesses, including companies like **Coca-Cola**, **Procter & Gamble**, and **Wells Fargo**, along the way. That was Buffett's job, plain and simple.

Get the picture? Now let's turn it on its head.

But also sings its praises

While Buffett put little faith in indexing in 1991, 23 years later his advice seems lost on investors. The amount of money put into index funds has ballooned since then. In the last decade alone, the percent of U.S. equity assets indexed jumped from 17% to 35%, reaching a sum of $2.3 trillion in total.

That's astounding. But what might seem more astounding is that Buffett wholeheartedly endorsed indexing in his 2013 shareholder letter. He outlined how his survivors should handle his estate, and here's what he had to say:

My advice to the trustee could not be more simple: Put 10% of the cash in short-term government bonds and 90% in a very low-cost S&P 500 index fund. (I suggest Vanguard's.) I believe the trust's long-term results from this policy will be superior to those attained by most investors – whether pension funds, institutions or individuals – who employ high-fee managers.

Really? A low-cost S&P 500 index fund? Juxtaposed with his earlier statement, this makes it seem as if Buffett had flip-flopped

and hopped on the indexing bandwagon. But here's where context plays an important role in interpreting these two Buffettisms.

What it boils down to is that Buffett has full faith in his investing ability, but he can't speak for the stock-picking ability and temperament of others. Investing is Buffett's full-time career, and he's honed his craft over the years. As studies have shown, he's a step ahead of the rest of us.

Most important, Buffett's seen too many professional money or fund managers nickel-and-dime their clients while generating inferior returns. These same "advisors" can often amplify their clients' tendencies to trade too often and at the wrong times. Faced with that alternative, Buffett's written glowingly about index funds in recent years. He pointed out these types of pitfalls in his 2013 letter:

Both individuals and institutions will constantly be urged to be active by those who profit from giving advice or effecting transactions. The resulting frictional costs can be huge and, for investors in aggregate, devoid of benefit. So ignore the chatter, keep your costs minimal, and invest in stocks as you would in a farm.

So, in a nutshell, average investors like us face some significant hurdles, including inferior stock-picking skills relative to Buffett, a tendency to take unnecessary actions, and a money manager who's probably tempting us to pull the trigger on costly trades. That's not a recipe for success. That's a laundry list of reasons to dive into a low-cost fund.

Do as Buffett says, not as he does

Buffett's comments over the years could be construed to reflect an ever-changing love-hate relationship with the index fund, but that would miss the point. His time-tested stock-picking approach beat the market, so he stuck with it. He recognized that for nonprofessional investors, however, passive investing would – on average – produce higher returns, primarily due to the elimination of fees.

Investors like you and I, quite frankly, are sitting in a different boat than Buffett. That doesn't mean we can't invest in stocks on our own account, it just means we should honestly reflect on our abilities. And stay away from costly advisors and fee-laden funds.

For some of us, it might be a perfectly good idea to do as Buffett says and not as he does: Avoid money managers, find a cheap index fund, and get on with our lives.

Warren Buffett: How to Avoid Going Broke

By John Maxfield

"It's only when the tide goes out that you learn who's been swimming naked."

- Warren Buffett, 1992

If Warren Buffett, the chairman and CEO of **Berkshire Hathaway**, repeats an idiom on numerous occasions throughout multiple decades, then it's probably not a bad idea to figure out what he means by it. His is, after all, the greatest investor of all time.

And so it is with his warning that "It's only when the tide goes out that you learn who's been swimming naked." By my count, he's written some variation of this in four separate shareholder letters spanning the years 1992 to 2007.

Buffett, a bathing suit, and Hurricane Andrew

I trust it's obvious that Buffett isn't speaking literally here. While the 83-year-old billionaire is fond of sexual metaphors – in 1974, for instance, he described feeling like an "oversexed man in a harem" thanks to an abundance of bargains in the stock market at the time – there's little evidence he either skinny-dips himself or hangs around others that do.

Instead, Buffett is referring to the more mundane tendency of financial companies to overextend when times are good only to regret their imprudence when the tide eventually (and inevitably) turns.

The year 1992 serves as an apt example. In August, large swaths of Florida and the Gulf Coast were ravaged by Hurricane Andrew. An estimated 63,000 homes were destroyed, causing the deaths of 65 people, and leaving roughly 175,000 other Americans homeless. It was the costliest hurricane in U.S. history, with a final tally of $26 billion worth of damage – adjusted for inflation, that's equivalent to $43.7 billion today.

The impact on the insurance industry was equally alarming. As Buffett recounted in his shareholder letter that year, a number of small insurers were destroyed, a major insurer "escaped insolvency solely because it had a wealthy parent that could promptly supply a massive transfusion of capital," and countless others were awakened to the fact that their own insurance against catastrophe, known as "reinsurance," was far from adequate.

In the absence of Hurricane Andrew, these companies would have continued to tout their underwriting discipline and profitability. Because of it, however, many were rendered in or on the cusp of insolvency. And herein lies Buffett's point that you only know who's been swimming naked when the tide goes out.

Insurance companies aren't the only businesses that swim naked

The validity of Buffett's observation extends beyond insurance companies. Most notably, the business of banking is just as susceptible to the same tendency to overindulge when times are good and then purge when the credit cycle inverts.

Perhaps nothing illustrates this better than the housing debacle that first reared its head in 2007. Mortgage lenders, including many of the biggest and best known banks in the country, had spent the previous five years underwriting trillions of dollars' worth of subprime loans to aspiring homeowners who had little to no hope of ever paying them back.

Yet, along the way, lenders were assuring their investors that everything was fine; that they were continuing to apply the same level of caution in the underwriting process as ever before. As late as July 2007, for instance, the CEO of Wachovia, the nation's fourth largest bank by assets at the time, was praising his bank's balance sheet growth and risk management.

> In risk management, I am particularly happy with their position in a very difficult environment.
>
> Net charge-offs continue to be a very low 14 basis points. [Nonperforming assets] increased for us slightly in this quarter; that was primarily in mortgage. But if you compare our mortgage company to almost any other in the industry, our NPAs are outstanding, and our NPAs at a company level would have to be considered outstanding in comparison to our peer group.
>
> Lastly, we are very comfortable with where we sit today in a conservative position in virtually all asset classes as markets reprice risks

Sadly, nothing could have been further from the truth. A little over a year later, Wachovia's losses thanks to imprudent underwriting rendered it insolvent, forcing the government to step in and broker its sale to **Wells Fargo**. To Buffett's point, in turn, it's only when the tide goes out that you know who's been swimming naked.

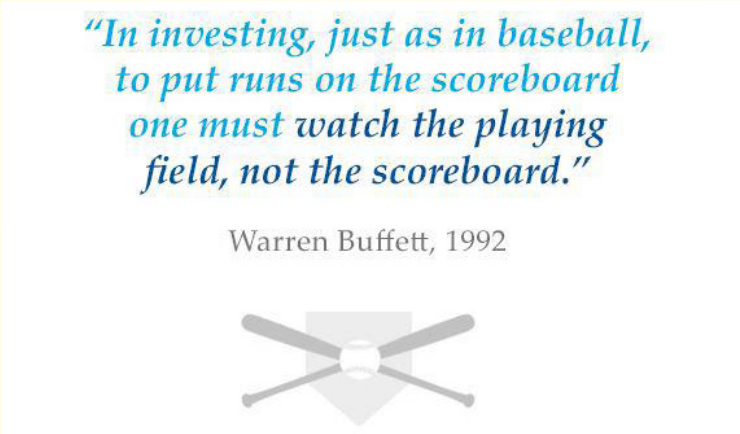
The Foolish takeaway

The takeaway here is simple. At least when it comes to insurance companies, banks, and other leveraged financial companies, investors would be wise to apply a healthy dose of skepticism to the pronouncements of executives. Take these for what they are: self-interested statements by people who are heavily compensated to make them.

How Warren Buffett Uses Baseball to Measure Success

By Isaac Pino, CPA

By 1991, Warren Buffett had accumulated 27 years of investing experience, and his track record placed him among the all-time greats. The book value of **Berkshire Hathaway** had increased an astounding 23.7% compounded annually since he took the helm.



But Buffett often eschewed traditional measures of investment performance, especially when evaluating year-to-year results. In the early 1990s, he developed a better performance barometer for Berkshire that he described as "look-through" earnings.

A different way to gauge growth

A "look-through" earnings approach, as the name implies, enabled Buffett to look beyond reported earnings – calculated according to standardized accounting principles – and specifically evaluate the income stream attributable to Berkshire by way of its investments and subsidiaries. This technique resulted in a true assessment

of operating earnings, not just a recording of dividends received. Further, it considered the implications of capital gains taxes, and most importantly, provided valuable insight about Berkshire's performance that could be otherwise misconstrued by fickle stock prices. In the quote above, Buffett told investors exactly why this is a better way to invest.

Put into practice, the "look-through" method sharpens the focus of shareholders on what really matters in evaluating a business – the ebbs and flows of an earnings stream. This approach reveals what's actually happening on the "playing field" while providing valuable context. The stock price, on the other hand, is merely the "scoreboard." It may ultimately determine winners, but in the short-run it can be close to useless as an evaluative tool.

From Buffett's perspective, any shareholder attempting to assess a company's results would do well to focus on the underlying operating earnings. For example, if a company's stock ballooned 45% by year-end, but earnings growth was 10%, rather than the expected 15%, then an otherwise rosy year looked less so in the eyes of an observant investor.

The benefits of this approach, he figured, are two-fold. In the short run, it requires investors to more diligently study earnings and cash flow, which are ultimately the only agents by which a company can increase its intrinsic value. In the long run, it places an investor in the right mind-set to assess the staying power of a business. With this frame of reference, it is likely that investors will become more capable of evaluating a management team's performance, less influenced by Mr. Market's mood swings, and thereby more rational about their buying and selling decisions over the long haul.

For Buffett, the logic of this approach made perfect sense, regardless of whether it always worked in his favor. In 1991, for example, the "look-through" earnings method actually delivered a far more sobering assessment. Using two commonly referenced yardsticks, book value (the accountants' yardstick) and market value

(the stock price), Berkshire's value soared by 39.6% and 18.4%, respectively. Buffett's method showed the opposite, however: "Look-through" earnings decreased by 14%.

By the market's standards, Berkshire had a phenomenal year. By Buffett's measure, it was subpar. Undeterred, he offered specific reasons for the decline – a process that forced him to think more deeply about how the changing nature of two industries, specifically media and newspapers, were affecting his portfolio. For Buffett, it's this rigorous approach that helps him separate the signal from the noise and has enabled him to outperform the market year after year.

Think about the "long-run," not the "long ball"

In this regard, Buffett resembled many of the greatest performers in other professions, baseball included. An admirer of standout sluggers like the Red Sox's Ted Williams, Buffett portrayed characteristics similar to those of his baseball idols at the top of their game. In picking stocks or buying companies, he was patient and refused to chase stray pitches. But when the right pitch came, he was quick to swing, and swing big. He once remarked on the swiftness with which he and his partner Charlie Munger evaluated opportunities: "Almost every business we have bought has taken five or 10 minutes in terms of analysis."

Beyond his brilliant execution, however, Buffett adhered to a finely tuned *process* that he believed would deliver long-term gains. As exhibited in other professions, it's a technique that's all-too-common for those performing at their peak.

Source: Flickr/Keith Allison

To compare Buffett's technique with his favorite sport, consider a remark made by one of the greatest sluggers of the current generation, Albert Pujols of the Los Angeles Angels of Anaheim. When asked how much he focused on blasting the ball out of the park, he said he didn't think about it at all. In his words, "I consider myself a line drive hitter with power. I just try to put my best swing on the ball every time."

Pujols, a nine-time all-star, tries to get the best crack at the fattest pitch, but he's not aiming for the upper deck. And, perhaps more importantly, just like Buffett, he's not even thinking about the scoreboard.

What Warren Buffett Might Say About GE's Megamerger

By Isaac Pino, CPA

"Growth benefits investors only when the business in point can invest at incremental returns that are enticing…In the case of a low-return business requiring incremental funds, growth hurts the investor."

— Warren Buffett, 1992

In the eyes of most investors, the concept of growth seems like an undeniably good thing. If the economy is growing, for example, that bodes well for company earnings. And if earnings are growing, that would likely lead to bigger, juicier dividends and, consequently, happier shareholders.

However, growth's not always a panacea, at least not from the perspective of the legendary investor Warren Buffett. For growth to benefit a business, Buffett believes it must be evaluated in a wider context. As he points out in the quote above, growth can be detrimental to companies – and thereby investors – if it fails to boost the bottom line as well.

To fully digest Buffett's thoughts on expanding a business, let's apply his framework to one of the largest acquisitions (a means to achieve growth) in recent history: **General Electric**'s $16.9 billion bid for France's industrial giant Alstom.

Here's a look at how "The Oracle" – a GE shareholder through **Berkshire Hathaway** – might feel about "The General's" latest megamerger.

GE's power grab

Source: Flickr/Jeffrey Turner

Since the financial crisis sidelined its banking business, GE had been searching for ways to reignite revenue growth. Meanwhile, across the pond, France's Alstom found itself in a similar predicament, but with even less momentum due to a stagnant European economy.

After management evaluated the situation at both companies, a light bulb went on at GE: With its war chest of $57 billion in cash, the American industrial giant could simply handpick the power assets from its French counterpart, providing liquidity for Alstom and bolstering its own growth prospects abroad.

In theory, it sounded like a win-win scenario for both parties. What really mattered, however, was whether it made sense for GE from a financial perspective – where the rubber meets the road. And that's where Buffett's insight into acquiring growth comes in handy.

Counting dollars and sense

For starters, let's take a look at the offer proposed for Alstom's power and grid business. Then we'll consider whether or not the deal can generate incrementally higher returns for GE, as Buffett would undoubtedly require.

As of June 23, GE's offer amounted to a sum of $13.5 billion, net of Alstom's cash. That's a hefty price tag, but what matters to GE is what it gets in return. To evaluate the exchange, we should examine whether the purchase of Alstom will be accretive to GE's earnings.

The term "accretive" might sound foreign at first, but it simply means that a dollar invested in combining these operations will generate more than a dollar for shareholders in the future. Buffett is known to paraphrase this concept using Aesop's famous fable quote, "A bird in the hand is worth two in the bush." The key, Bufett points out, is to "only look at the bushes you like and identify how long it will take to get [the birds] out."

With Alstom, GE predicted that the "birds" were squarely within its reach. The deal, in other words, would add value for investors immediately, not at some point in the distant future. GE estimated that its earnings per share (EPS) would be enhanced according to the following timeline:

- In 2015: 3 cents to 5 cents per share
- In 2016: 7 cents to 9 cents per share

By this measure, the purchase clears an important hurdle: In just over a year, Alston's assets would be producing an additional earnings "bump" of three to five pennies for the combined entity. That "bump" is what investors call an incremental return on investment. Without this excess return, the revenue added by Alstom would create zero value for shareholders, absent of synergies (more on that later).

Value, today and tomorrow

An easy way to think about this is to compare the price that GE is paying for Alstom's earnings to the price-to-earnings (PE) ratio for GE itself. If Alstom's PE is lower than GE's, the deal will boost EPS in the near-term with little to no dilution. The reverse is true if Alstom's P/E exceeded GE's.

Now, GE can't justify its purchase on the short-term EPS bump alone. A host of other factors should be taken into consideration, one of which is whether Alstom's assets will continue to generate healthy returns. GE's CFO Jeff Bornstein ran some numbers, and he thinks they can:

The transaction is very attractive to us financially, with a high-teens IRR, well in excess of cost of capital. We expect to achieve our hurdle rate in year three. The valuation is built on modest revenue growth, conservative working capital assumptions, and cost synergies that we believe are highly achievable.

Once again, the returns *in excess* of capital are what would catch Buffett's eye. Revenue growth is only secondarily important, and so-called "synergies" would be merely icing on the cake. Of course, its true that complex deals imply that other factors are involved, including financing strategies, opportunity costs, and hypothetical synergies, but for our purposes we're focusing on what would matter most to Mr. Buffett.

Why Buffet might love it

As the Oracle of Omaha frequently laments, managers can be tempted to chase growth in a manner that ultimately shortchanges shareholders. Great managers of capital, however, recognize that

revenue growth needs to be balanced with healthy returns from an earnings – or cash flows – perspective.

In this particular example, the transaction was highly publicized, and nearly all of the moving parts have been presented to shareholders. Acquisitions like this happen infrequently, though, and it's the day-to-day internal investment opportunities that require most of management's attention. As you would expect, investors are rarely – if ever – privy to the decision-making process in those situations, yet it's just as critical that management evaluates their merit in the same way: Will they generate profits that exceed the company's cost of capital?

The old adage, "Revenue is vanity; profits are sanity; cash is reality" holds true here as always. At first glance, Buffett would probably look at the estimated $20 billion revenue impact from Alstom as pure vanity. But given the fact that there's upside to the bottom line, it's likely he'd approve of this manufacturing megamerger.

Why One of Warren Buffett's Greatest Strengths Is Knowing His Weaknesses

By Isaac Pino, CPA

"An investor needs to do very few things right as long as he or she avoids big mistakes."

— Warren Buffett, 1992

The world of business is complicated. For an investor like Warren Buffett, his job is to make it easier to comprehend.

In the following quote from his 1992 letter to **Berkshire Hathaway** shareholders, Buffett described how he does just that:

If a business is complex or subject to constant change, we're not smart enough to predict future cash flows. Incidentally, that shortcoming doesn't bother us. What counts for most people in investing is not how much they know, but rather how realistically they define what they don't know. An investor needs to do very few things right as long as he or she avoids big mistakes.

During his research, Buffett separates what he understands from the things he calls "too hard." The Oracle of Omaha, by his own admission, is not keen on working outside of his comfort zone. And it's this self-imposed restraint that's been central to Berkshire's market-crushing returns.

What makes Buffett wary of investing in tech

The tech industry serves as a prime example of a field that lies beyond Buffett's grasp. He's notoriously avoided cutting-edge technology like the plague, whether it's in his personal life or his investing activities.

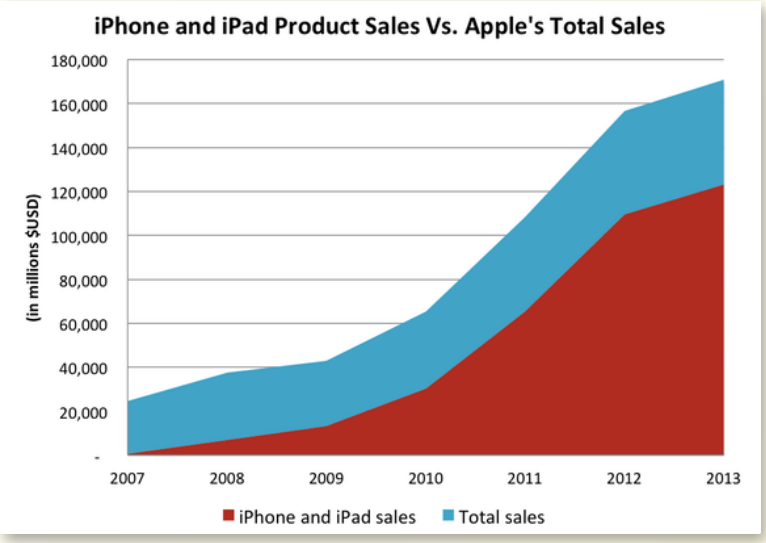
The born-and-bred Midwesterner lacks a computer in his Omaha office, struggles with the basic functions on his cell phone, and prefers a tried-and-true fax machine to email. By most definitions of the word, Buffett's a bit of a Luddite. He knows it, though, and it suits him just fine.

By the same token, Buffett steers clear of investing in high growth technology companies. For him and his partner Charlie Munger, buying shares in a company like **Apple** just wouldn't fit in their wheelhouse. And it's not that they don't appreciate the profound impact that Apple's products have on today's society.

In Buffett's eyes, it's undeniable that tech products can be a huge boon for businesses and consumers alike. But they're also highly subject to change, and it turns out that change is like kryptonite to Buffett's investing superpowers. He says as much in the following quote from a lecture to graduate students in 2005:

Technology is clearly a boost to business productivity and a driver of better consumer products and the like, so as an individual I have a high appreciation for the power of technology. I have avoided technology sectors as an investor because in general I don't have a solid grasp of what differentiates many technology companies. I don't know how to spot durable competitive advantage in technology. To get rich, you find businesses with durable competitive advantage and you don't overpay for them. Technology is based on change; and change is really the enemy of the investor. Change is more rapid and unpredictable in technology relative to the broader economy. To me, all technology sectors look like 7-foot hurdles.

Even the Oracle of Omaha admits that he doesn't have the stomach for making predictions about technology. So why would he even bother forecasting future cash flows of a constantly evolving company like Apple? For illustration, consider the following revenue chart, which reveals the products that generated the lion's share of Apple's sales over the past six years:



As of each year-ending in September. Apple's method of categorization changed slightly in some years, so iPhone sales reflect most recently reported figures. Source: Apple's SEC 10-K filings.

Back in 2007, the iPhone and iPad were basically off the radar for the tech giant, at least from a financial perspective. The iPhone had barely made its debut, and the iPad was still being conceived in the mind of Steve Jobs. Neither product would have merited much attention in a typical cash flow model at the time.

But fast-forward six years and the two combined gadgets accounted for 72% of Apple's revenue, which had grown at an astounding 40% annual clip. For Buffett, or virtually anyone for that matter, the astronomical growth that lied ahead for Apple was highly unpredictable, if not inconceivable. And that's why Buffett, by is own admission, is just "not smart enough" to play ball in that arena.

The other side of the coin

Now, you might be thinking that Apple's ability to blaze a new trail in smart devices proves that Buffett was wrong. From 2007 to today, he missed the boat on a mind-boggling return of 673% for patient

Apple investors. The latter looked like geniuses while Buffett got left in the dust!

But keep in mind an alternative scenario could have played out. What if Buffett *did* survey the tech landscape back in 2007? Another device-maker might have caught his eye, and compared to Apple, might have appeared virtually unbeatable. Consider the following characteristics of Apple›s rival device-maker back in 2007:

- Staggering 3-year revenue and net income growth of 72% and 179%, respectively;
- Mouth-watering returns on equity of 28% and profit margins of 21%;
- Minimal debt and a reputable, trusted brand name

Taking all of these virtuous traits into account, Buffett might have been tempted to pull the trigger on Apple's competitor. But guess what? These all-star stats belong to none other than **Blackberry**'s former parent company, Research in Motion. And we all know how the story unfolded for Blackberry once Apple put its foot in the ring back in 2007:

Buffett's mantra might not be best for you

What the Apple versus Blackberry showdown reveals is that Buffett has witnessed both sides of the coin flip over the years. As a result, he's opted out of the here-today-gone-tomorrow world of technology entirely.

He's not saying, however, that you should do the same. What Buffett expounds in his letters and teachings is to stay inside what he calls a "circle of competence." Consumer technology falls outside of his particular circle, but that doesn't mean others can't master it.

He suggests that all investors should stick to industries *they* know inside and out. If your decades of retail experience, for example, provides insight into **Costco** or **Target**'s competitive advantage, then that might be your bread-and-butter sector. If you're a computer programmer, on the other hand, you could have a leg up on identifying the next tech idol like **Google**.

Regardless of your chosen realm of expertise, however, Buffett and Munger emphasize the importance of recognizing the outer limits. Identifying that boundary at Berkshire Hathaway proved to be a challenging and oftentimes humbling experience. But in the end, as Munger describes in the quote below, avoiding the temptation to stray from one's comfort zone can separate the pros from the amateurs in investing: "We know the edge of our competency better than most. That's a very worthwhile thing. It's not a competency if you don't know the edge of it."

3 of Warren Buffett's Best Insights in 1 Great Quote

By Isaac Pino, CPA

"[W]e adopt 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."

— Warren Buffett, 1992

In our modern age of technology-driven lifestyles, speed is of the essence. We have speed dating, speed-reading, flash trading, and fast food. The idea "Fast is better than slow" is an inescapable principle of life – at least according to companies like **Google**.

But Warren Buffett, as you may know, isn't a man built for speed. So when the time comes for him to make big decisions, he turns to a methodical, tried-and-true approach. It's one that he enjoys and one that works. He laid it out in his annual letter to Berkshire shareholders in 1992:

Of all our activities at Berkshire, the most exhilarating for Charlie and me is the acquisition of a business with excellent economic characteristics and a management that we like, trust and admire. Such acquisitions are not easy to make but we look for them constantly. In the search, we adopt 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.

From Buffett's point of view, there are some decisions you just can't rush. Buying a business is one of them. Finding a life partner is another. Ironically, these "exhilarating" activities are often the ones that tempt us to act irrationally. While Buffett learned this lesson the

hard way, we can use the Oracle's wisdom to avoid falling into the same trap.

Source: Flickr/thetaxhaven

Buffett makes a rookie mistake

Believe it or not, Buffett wasn't born with an uncanny ability to identify great companies. On the path to investing success, he stumbled quite frequently, especially early on in his career.

His first major acquisition, in fact, was also his worst. That was the purchase of none other than the textile firm **Berkshire Hathaway**, which would ultimately become the namesake of his legendary holding company.

In the 1960s, Berkshire Hathaway was a Massachusetts manufacturer involved in the lowly business of making fabrics. Buffett identified Berkshire as "cheap" initially, but he also quickly recognized that it was operating in a rapidly declining industry. Still,

even as mills were being closed left and right, Buffett continued to acquire shares.

Why throw good money after bad? As Buffett would explain years later, he became infuriated when the CEO at the company offered to buy shares from him at a certain price, only to retreat and offer a lower value shortly thereafter. In an interview with CNBC, Buffett recounted the sequence of events as follows:

"[T]his made me mad. So I went out and started buying the stock. And I bought control of the company and fired [the CEO]."

End of story? Not quite.

Buffett went on to say, "I had now committed a major amount of money to a terrible business." In other words, the man whose career would be defined by his ability to keep his cool had just fallen prey to his own emotion-driven instincts.

Unfortunately, the textile operations went belly up and cost Buffett dearly. He estimated in 2010 that Berkshire would be worth *200 billion dollars* more had he avoided the textile industry altogether. Talk about an extraordinarily expensive way to learn a lesson!

On the bright side, Buffett learned these crucial lessons early on and they would serve him well for the rest of his career. There were three valuable takeaways from his experience with Berkshire Hathaway:

1. First, investors should buy only those businesses with superior economics. Textiles, at the time, were quite inferior.
2. Secondly, seek out businesses with great leadership, not managers that you want to fire.
3. And finally, investors need to keep their emotions out of the picture. Don't latch onto a flash-in-the-pan stock. Instead, take a moment and get a second opinion. But never, ever, act impulsively when your net worth is at stake.

Less than a decade into investing, Buffett had already begun to realize that he needed a system to use in evaluating businesses, and these three tenets would be at the core of that system. They might not always lead him to brilliantly executed investments, but they would surely limit his losses in an event similar to the textile industry's downturn. He shared these lessons in the early 1990s so others could learn from his hard-earned wisdom.

You can learn (and profit) from Buffett's blunders

In this instance, Buffett's experience provides a tangible example of what *not to do*, and his quote reveals what long-term investors should be doing. But how can we apply those lessons on economics, leadership, and temperament to a given investment opportunity? Let's take a look at an industry that everyone can relate to: retail.

In today's cutthroat retail environment, household names like **The Container Store** and **Williams & Sonoma** are prime examples of businesses Buffett would admire. The former is founder-led, entirely devoted to helping customers get organized, and capable of exerting incredible pricing power relative to big box stores. Williams-Sonoma, meanwhile, has effectively carved out a profitable niche in high-quality cooking accessories, a business that's made the leap to e-commerce quite nicely in recent years.

Source: Flickr/Dave Dugdale and Chris Potter

Both companies possess leaders with a vision of where retail is headed in the future. And, quite frankly, they're in a polar opposite position than the textile industry was in the 1960s. Investors looking for attractive retail operators should give these niche players a second look.

But, before you run out and purchase shares, just remember to do your research. A complex decision with profound implications on your personal wealth need not be rushed. Not now, not ever.

As Leonardo da Vinci once said, "He who wishes to be rich in a day will be hanged in a year."

Not your folksy Buffett-esque quote, but, hey, it gets the point across: Take your time. Develop a system. We're in this for the long haul.

How Warren Buffett Defied Popular Thinking on Risk

By Isaac Pino, CPA

"It is better to be approximately right than precisely wrong."

— Warren Buffett, 1993

Warren Buffett was not the first great thinker to the utter the words in the quote shown above. A variation of the quote was first attributed the British philosopher Carveth Read and then to the famous 20th-century economist John Maynard Keynes.

Nevertheless, the Oracle of Omaha eagerly borrowed the concept to communicate an invaluable lesson on risk to shareholders of **Berkshire Hathaway**. A decade prior, Buffett had drawn a line in the sand in his most famous speech ever, claiming that those who thought differently than he did about stock market risk were akin to those who wrongly believed the world was flat.

It was a bold proclamation from the humble man from Omaha. But it was another example of how he defied popular thinking time and again over the course of his career.

What we might call "dumb money" investors

To begin with, the stock market as we know it today is a very recent phenomenon. The actual trading floor of the New York Stock Exchange didn't exist until 1903, and with this new mechanism came a new way of thinking about valuing assets – whether we needed it or not.

Assets that were traditionally long-term investments, including businesses, could suddenly be traded like commodities. Forget a

twenty- or thirty-year time horizon. Shares in a blue chip company like **General Electric** could be bought around breakfast and flipped for a profit after lunch. And so they were, much to the chagrin of those who recognized the inherent contradiction.

The aforementioned economist Keynes pointed out the disconnect between the life of a long-term asset and the thought process of a short-term buyer in the following quote from 1930:

If farming were to be organized like the stock market, a farmer would sell his farm in the morning when it was raining, only to buy it back in the afternoon when the sun came out.

Put this way, flipping an asset like a farm based on hourly weather patterns sounds absurd. But the stock market allows so-called "investors" to engage in similar behavior on a daily basis, only in this case with businesses.

Nevertheless, this form of short-term speculation became more and more prevalent over time. Today, the average holding period of a stock is less than a week. In a sense, "trading" has triumphed over "investing," and this trend has given birth to an entirely new method of assessing the risk presented by a company's stock.

When ownership in a stock is measured in days or weeks rather than years, risk becomes a reflection of a stock's volatility – also known as its "beta." As the idea of beta grew increasingly popular in investing literature and academic circles, the long-term investor in Buffett became more incensed with the concept altogether.

In 1993, Buffett pounded the table on this issue in his letter to shareholders, excoriating the academics who preferred algorithms and regression analyses over the evaluation of business fundamentals.

How not to assess stock market risk

Summoning the message introduced in his 1984 speech, "The Superinvestors of Graham-and-Doddsville," Buffett contrasted his approach to assessing risk with the one so prevalent among those perched in their ivory towers:

[W]e define risk, using dictionary terms, as "the possibility of loss or injury."

Academics, however, like to define investment "risk" differently, averring that it is the relative volatility of a stock or portfolio of stocks— that is, their volatility as compared to that of a large universe of stocks. Employing data bases and statistical skills, these academics compute with precision the "beta" of a stock— its relative volatility in the past— and then build arcane investment and capital-allocation theories around this calculation. In their hunger for a single statistic to measure risk, however, they forget a fundamental principle: It is better to be approximately right than precisely wrong.

Buffett, at the time, had increased Berkshire's book value at a rate of 23.3% over the last 29 years. Along with the help of Charlie Munger, he had proven that buy-and-hold investing could produce tremendous wealth when put into practice.

Still, the very idea of long-term investing was being undermined by professors teaching at top-notch institutions across America. These were professors without a proven investing track record comparable to Buffett's who spent their time buried in data sets analyzing stock price movements instead of evaluating a business's fundamentals.

Their assignment of a value to beta could tell you whether the stock fluctuated wildly or remained relatively in-line with the broader market. That was it, however.

It told you nothing about whether you were paying less than a dollar for a business that was truly worth a dollar. And that's all that

mattered to Buffett. Their insight, in other words, was lost on him, and he made this known to his shareholders.

How to apply Buffett's approach

Back then, Buffett illustrated his point using a simple example with the stock of the Washington Post. To update his example, let's look back at the roller-coaster ride of the at-home coffee machine company **Keurig Green Mountain**. As you can see in the chart below, this stock has experienced its share of highs and lows since the beginning of 2011:

An investor interested in Keurig's stock in early 2012 would likely want to know the risk he or she would be taking on in buying shares. In terms of beta, the investor would conclude that this stock's risk fluctuated dramatically in the year prior to hitting its 52-week bottom: Shares in Keurig garnered a beta of anywhere from roughly .8 to roughly 1.15 during that timeframe. Was this acceptable for the investor? Did it tell you something about the company that would help you sleep at night as a shareholder?

Buffett would point out that this investor was missing the forest for the trees. In 2012, Keurig faced severe business risks unrelated to the movement of its stock price. First among those risks was whether the company could continue to prosper after the expiration of the company's patent on K-Cup technology. The patent, in the eyes of many analysts, seemed like a critical ingredient in its successful "razor-and-blade" business model. To think that the stock price

movement introduced a larger threat than a key aspect of Keurig's success to-date is simply ludicrous.

Those analysts who did their research and concluded that Keurig could succeed even after the patent expiration were the ones who likely profited from Keurig's rebound. And those investors fretting over the wild gyrations of the stock price around this time were probably hung out to dry.

Think like Buffett, and you too can profit

Over the years, Buffett's expressed his distaste for using beta to assess risk on numerous occasions. In his eyes, it's completely detached from the actual machinery that powers a successful business. Simply put, it's a distraction for investors that need to be focused on the *value* of a business relative to its trading *price*, and not the fluctuations of the latter.

Let the mathematicians and academics find false precision in their calculations, he might say, but long-term investors should keep their finger on the pulse of the actual business – not the whims of the market.

Warren Buffett's Staggering Success Rests on This 1 Must-Have Attitude

By Isaac Pino, CPA

"[W]hat makes sense in business also makes sense in stocks: An investor should ordinarily hold a small piece of an outstanding business with the same tenacity that an owner would exhibit if he owned all of that business."

— Warren Buffett, 1993

Warren Buffett once compared his stock-picking style to his shopping habits, noting, "I like buying quality merchandise when it's marked down."

Sounds simple enough, right? Like the frugal shopper in all of us, Buffett loves finding a good bargain.

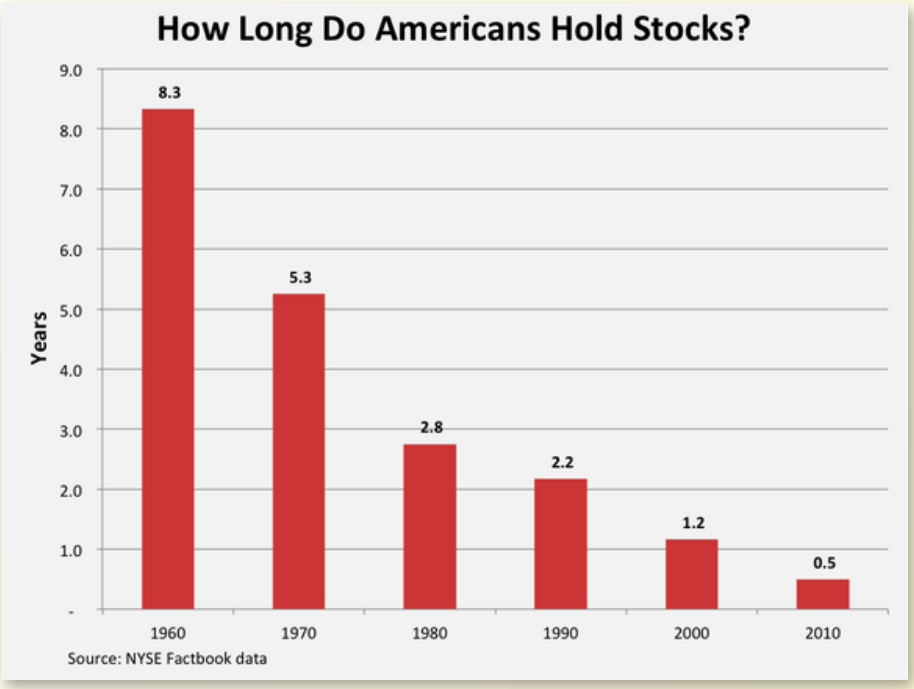
In investing, however, the Oracle of Omaha excels where the rest of us so often stumble: Once he commits his money to a stock, he cherishes that ownership interest like few other shareholders. This long-term perspective provides ample time for Buffett's businesses to flourish, thereby compounding the money that **Berkshire Hathaway** makes from his stock picks.

In 1993, Buffett described why this unique level of commitment makes sense in his letter to shareholders, as conveyed in the quote shown above. The charts that follow reveal why other investors should take a page out of Buffett's book.

Shareholders' shrinking attention span

It would be difficult to single out one trend as the most important change in the investing field during the past half-century, but the dwindling attention span of investors would definitely rank near the top.

From 1960 to 2010, the average holding period for owners of NYSE-listed stocks shrunk from 8.3 years to a mere six months. Here's what that looks like in a simple bar chart:



In other words, Americans once held on to their stocks like they held on to a reliable car – for the better part of a decade. Fast-forward 50 years, however, and our thinking as it relates to those two assets has diverged dramatically. We're ready to replace a long-term investment with a new security every six months, or around the time that new-car smell is just starting to fade.

To witness such a steep decline is nothing short of astounding. Since the 1960s, not a whole lot has changed in terms of what stock ownership offers to investors. We continue to purchase shares that entitle us to a fraction of a company's future profits. Those companies allocate resources to operations or long-term projects and pay out the remainder to shareholders. As profits grow, we realize a gain in our asset value or receive proceeds in the form of regular dividends, just as we always have.

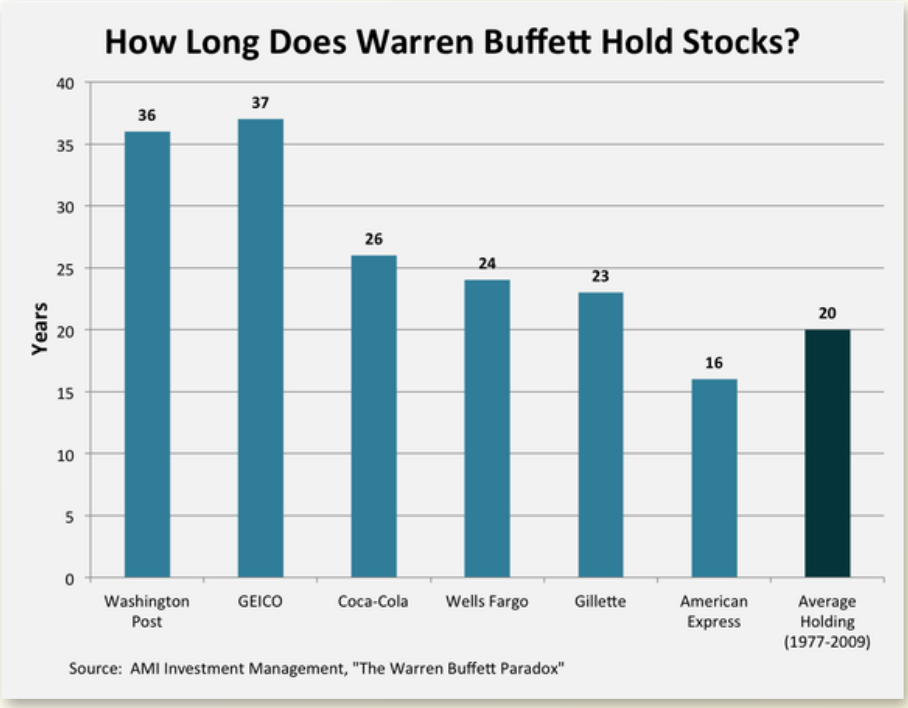
Meanwhile, business cycles have not shortened, but instead they follow the same typical four-to five-year pattern of contraction and expansion. That's a trend that's more or less remained constant for 160 years.

The act of trading, of course, has changed significantly. Even the nonprofessional investor can conduct cheap, real-time trades today, and he can do so from almost anywhere in the world with the use of a smartphone. But reduced friction in trading can hardly be blamed for such a profound shift in our investment approach.

The main culprit here is a radically different perception of what stocks and the market as a whole represent. A dense cloud of short-term thinking appears to have blurred the vision of many investors, while disciples of the buy-and-hold approach – including Warren Buffett – have been able to remain above the fray. As our time frame contracts from years to months, Buffett's found success in a holding period that can often be measured in decades.

The simple genius behind Buffett's approach

Take a look at the chart below. What it shows is how starkly different Buffett's approach is from the average investor's. Not only has he clung to some of his most famous stock picks, including **Coca-Cola** and GEICO (which Berkshire now owns outright), but the average holding period across *all* of Berkshire's common stock investments is an eye-popping 20 years. In today's market, that's 40 times as long as the typical investor's holding period!



As always, what's particularly impressive about Buffett is his simple approach and consistency, even when he sees the rest of the herd moving in a different direction. The data reflected in the chart above includes every common stock investment made by Berkshire from 1977 to 2009, a period of time when the behavior of most investors was changing considerably. Throughout that time frame Buffett stuck to his guns, and he had a simple rationale for doing so.

Instead of thinking like a trader, Buffett adapted a true owner's mentality. Even when Berkshire owned only a tiny slice of a company's common stock, Buffett pretended as though he owned it all. By putting himself in the shoes of an owner, Buffett acted like one. Here's how he described this tactic in his 1993 letter to shareholders:

A parent company that owns a subsidiary with superb long-term economics is not likely to sell that entity regardless of price. "Why," the CEO would ask, "should I part with my crown jewel?" Yet

that same CEO, when it comes to running his personal investment portfolio, will offhandedly – and even impetuously – move from business to business when presented with no more than superficial arguments by his broker for doing so.

The path less traveled can lead to riches

When times are bad, most investors are tempted to sell in fear of losing more money. When times are good and a stock price is high, they're tempted to take the money and run.

In acting like an owner, Buffett hardly ever follows those temptations, and this strategy has served him quite well. Recent data show that the average investor's 30-year annualized return was a meager 1.9%. Meanwhile, Berkshire's compounded annual gain since 1965 is a staggering 19.7% annualized.

Buffett's owner-centric strategy might be as rare as a black swan riding a unicorn these days, but the results speak for themselves. If you want to rid yourself of the temptation to hop in and out of the market, think like Buffett does. Think like a real owner.

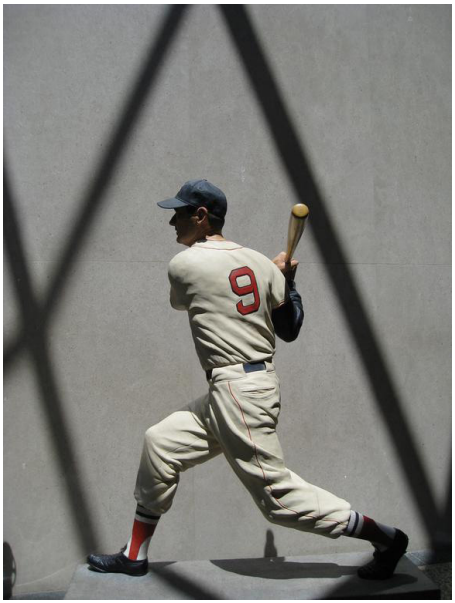
How You Can Hit Home Runs in the Stock Market Like Warren Buffett

By Isaac Pino, CPA

Ted Williams, in The Story of My Life, explains ... "My argument is, to be a good hitter, you've got to get a good ball to hit. It's the first rule in the book. If I have to bite at stuff that is out of my happy zone, I'm not a .344 hitter. I might only be a .250 hitter." Charlie and I agree and will try to wait for opportunities that are well within our own "happy zone."

— Warren Buffett, 1994

Warren Buffett exhibits a childlike sense of excitement when talking about his all-time favorite baseball player, the Boston Red Sox's Ted Williams. He grew up admiring the left fielder's swing, and later on he channeled the wisdom of the legendary slugger to enhance his stock-picking strategy.



In 1994, Buffett borrowed the quote shown above to convey to **Berkshire Hathaway**'s shareholders the importance

of being selective when hunting for great companies. What worked at the plate for Ted Williams worked just as well for Buffett and his investing partner Charlie Munger. And there's no doubt that a similar approach can boost your portfolio, too.

Here are three key strategies you can use to hit home runs in the stock market *a la* Buffett:

1. Swing within your "happy zone"

The most obvious takeaway from this particular quote is Buffett's suggestion that investors should stick with the industries and companies they know best.

Instead of chasing curveballs all over the plate, Buffett and Munger exhibit a patient approach in their search for great stocks. They admitted they weren't smart enough, for example, to predict the future landscape of the tech industry, so they opted to avoid it almost entirely over the years.

Ironically, one of the best quotes Buffett frequently repeats to convey this idea is from Tom Watson, the founder of tech giant **IBM** (one of Buffett's extremely rare tech investments): "I'm no genius. I'm smart in spots and I stay around those spots."

That's exactly what Buffett and Munger opted to do over the years, refusing to veer off course even when Berkshire grew from a $22 million company to a multibillion-dollar conglomerate. Over time, this approach served them well, increasing Berkshire's book value at a 23% annual clip from inception until the 1994 letter to shareholders quoted at the start of this article.

Still, it's important to keep in mind that your "happy zone" as an investor might not mirror Buffett's and Munger's. Legendary fund manager Peter Lynch, for example, swung at all types of pitches during his day, accumulating up to 1,400 stocks at a single point in time. He, too, managed to absolutely destroy the market's average during his career.

Lynch became known as the Will Rogers of investing since he "Never saw a stock he didn't like." Obviously, his "happy zone" was quite a bit wider than Buffett's, but he too was very familiar with his limitations. And that's what matters the most.

2. Be wary of overhyped industries

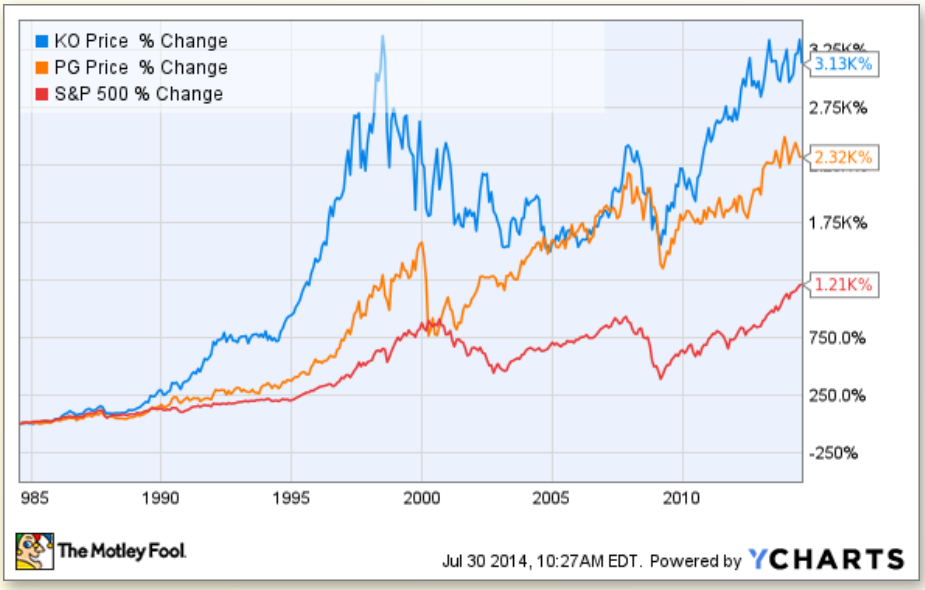
If there's one consistent theme that can be found among successful investors, it's that they're usually searching for opportunities in places where the masses are not.

It's very difficult, for example, to say that an investor could find an edge over the market in evaluating a company like **Google** or **Apple** in this day and age. Both tech giants have been completely picked to the bone by the media and analysts. It could be done, perhaps, but it's unlikely that an investor could gain an information advantage over the rest of the market when it comes to blue chips like those.

What's more is that the hype around these companies can lead to wildly fluctuating stock prices and lofty valuations due to a follow-the-herd mentality. Not to mention the fact that they operate in a rapidly changing industry that requires constant innovation.

Buffett loathes those types of companies, where leadership must always have its finger on the ever-changing preferences of consumers. As he once said, "We see change as the enemy of investments... so we look for the absence of change. We don't like to lose money. Capitalism is pretty brutal. We look for mundane products that everybody needs."

For Buffett, those products include household staples like Gillette razors (now part of **Procter & Gamble**) or soft drinks from **Coca-Cola**. Over the past three decades, the value of Procter & Gamble's shares has increased by 2,320% for investors. Coca-Cola, meanwhile, boasted gains of 3,130% during that timeframe. There's nothing "mundane" about that when you consider the **S&P 500**'s less impressive return of 1,210%.



Fortunately for Buffett, he realized early on that a boring business often beats a "whiz-bang" tech outfit over the long haul.

What's fascinating is that those types of brands have absolutely crushed the returns generated from tech companies. The consumer staples sector racked up 13.3% annual returns versus the tech industry's paltry 9.8% over the last 50 years, according to information gathered by fellow Fool Morgan Housel.

3. Avoid making big mistakes

If the above lessons are about resisting temptation – by staying within your comfort zone and ignoring the market hype – the last bit of wisdom is about limiting your downside if you do swing at an outside pitch. As Buffett has pointed out in previous letters to shareholders, "An investor needs to do very few things right as long as he or she avoids big mistakes."

To a clutch hitter in baseball, that translates to taking calculated risks. If a batter steps up to the plate during the late innings of a tight game, it's probably not the right time to aim for the upper deck

if a runner's in scoring position. Why swing with reckless abandon when a base hit could put your team over the top?

This logic holds true in investing as well. If you avoid taking too much risk when the stakes are high, you'll effectively limit your potential losses. But using leverage while attempting to time the market's bottom is a recipe for disaster. Even selling a winning stock for superficial reasons is an example of allowing greed-driven emotion to overtake a more rational decision-making process.

With practice, you can be an investing slugger

These three rules might sound surprisingly simple, but remember that Buffett once said, "You don't need to be a rocket scientist. Investing is not a game where the guy with the 160 IQ beats the guy with 130 IQ."

Being the most skilled player on the playing field is one thing. Knowing how to translate that talent into home runs is another. Follow Buffett's straightforward advice, and you'll have a better chance at clearing the outfield fence.

Warren Buffett's Worst Enemy Is Also Yours

By Isaac Pino, CPA

"We will continue to ignore political and economic forecasts, which are an expensive distraction for many investors and businessmen...A different set of major shocks is sure to occur in the next 30 years. We will neither try to predict these nor to profit from them."

— Warren Buffett, 1994

Throughout his annual letters to shareholders, Warren Buffett discusses all types of subject matters beyond business, from sports to psychology to – yes, even sex. But there's one rabbit hole even Buffett won't venture into, and that's the dark and desolate world of forecasting.

As described in the quote above, Buffett has no interest in predicting the future when it comes to large, complex events. In his eyes, it's a sucker's game. Beyond that, the long-term investor's tendency to worry about the wrong risks at the wrong time just might be our own worst enemy.

Fortunately, an effective remedy does exist, and Buffett laid out the prescription in his writings and lectures over the years.

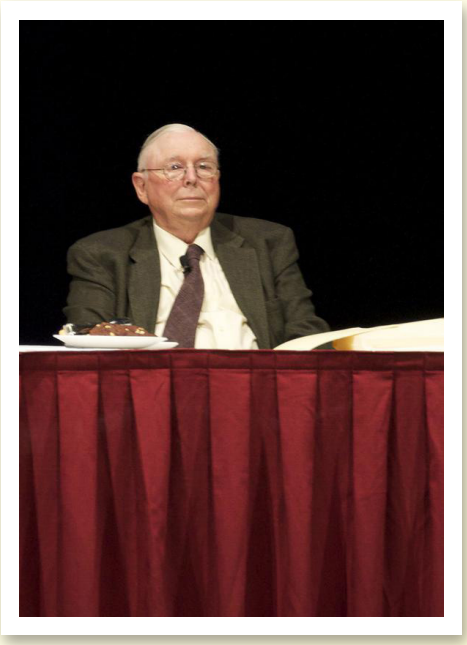
Why we worry about tomorrow

The two years preceding Buffett's 1994 letter to shareholders were nothing short of phenomenal for investors. In 1993 and 1994, **Berkshire Hathaway**'s book value had increased 14.3% and 13.9%, respectively, and its share price had ballooned by 68.6% during that timeframe. This trounced the **S&P 500**'s gain of 5.5%.

But in spite of the recent success, investors remained anxious. At the time, the U.S. was merely three years removed from a deep recession, oil price shocks, and the end of the Gulf War. And only seven years removed from the stock market crash of 1987.

What's more is that anxiety, whether rational or not, seems to be a built-in part of an investor's life. In fact, we all worry about the future, because of the numerous uncertainties it presents. Buffett's partner Charlie Munger commented on this undeniable yearning for future clarity a decade later:

People have always had this craving to have someone tell them the future. Long ago, kings would hire people to read sheep guts. There's always been a market for people who pretend to know the future. Listening to today's forecasters is just as crazy as when the king hired the guy to look at the sheep guts. It happens over and over and over.



Source: Flickr/Nick Webb

So, in the old days, it was sheep guts. Maybe tea leaves. But in the modern world, who's better than the "Oracle of Omaha" to provide us with some sort of supernatural intuition?

It's no surprise, for example, that thousands of investors flock to Berkshire's annual meeting in the hopes of gaining some unique insight into the state of affairs affecting their portfolio. Surely, the thinking goes, Buffett is preparing his portfolio to buffer against these same economic, political, or other potentially systemic risks, right?

Well, not exactly.

Why Buffett needs no crystal ball

As it turns out, Buffett spends very little of his time trying to predict the highly complex events that could dampen or even enhance his returns in the short-term. These types of events might affect the stock market at-large – at least for a time – but in the long run the well-run businesses on which he places his bets are likely to endure in spite of a few hiccups along the way.

Buffett described his rationale, which was inspired by none other than the father of value investing Benjamin Graham, in his 1994 letter:

Thirty years ago, no one could have foreseen the huge expansion of the Vietnam War, wage and price controls, two oil shocks, the resignation of a president...

But, surprise - none of these blockbuster events made the slightest dent in Ben Graham's investment principles. Nor did they render unsound the negotiated purchases of fine businesses at sensible prices. Imagine the cost to us, then, if we had let a fear of unknowns cause us to defer or alter the deployment of capital. Indeed, we have usually made our best purchases when apprehensions about some macro event were at a peak. Fear is the foe of the faddist, but the friend of the fundamentalist.

Always comfortable as a contrarian, Buffett sees value in frequently ignoring whatever it is that others are fretting about, be it the pundits, journalists, or oft-quoted analysts. Opportunities can present themselves in the form of a great business at the right price even when the rest of the world least expects it. With the right mindset, the long-term investor can capitalize on these opportunities when others are running for cover.

Why you need to embrace market chaos

At first blush, it may sound odd for Buffett to warn investors about their worst enemy: The temptation to make predictions or follow

the prognostications of others. After all, investing hinges on one's ability to successfully *make predictions* about the future.

But Buffett advises investors to specifically steer clear of broad, short-term forecasts and focus on the ones that are *directly relatable* to the long-term viability of a particular business or industry. This will serve them well, even when the investing waters get choppy.

In a similar vein, investors need to embrace the market's ebbs and flows without losing sight of long-term goals. As interconnected economies amplify volatility, this has emerged as a critical lesson for all participants, CEOs included. Back in 2011, **General Electric**'s CEO Jeffrey Immelt described this realization in a letter to shareholders: "Volatility has become a way of life... Classic economic cycles will be shorter and more segmented. Long-term growth will be interrupted by short-term volatility."

To some, volatility might seem like an investing deterrent. It's unsettling when it comes to managing one's finances. But given its 100-plus years of operation, GE has a long-term perspective, as does Buffett. They believe the economy will continue to grow even after hitting a few minor speed bumps.

It may not be the easiest pill to swallow, but it's better to worry about those things in your control than those that aren't. If you're optimistic about the long-term health of the capital markets – as Buffett is – then you can put those volatility demons to rest.

Warren Buffett Loves a Good Moat

By Adam Levine-Weinberg

"In contrast to this have-to-be-smart-every-day business, there is what I call the have-to-be-smart-once business. For example, if you were smart enough to buy a network TV station very early in the game, you could put in a shiftless and backward nephew to run things, and the business would still do well for decades."

— Warren Buffett, 1996

When scouring the market for long-term investment opportunities, **Berkshire Hathaway** CEO Warren Buffett always looks for a solid "moat." A moat is a long-lasting competitive advantage. A business with a solid moat is likely to generate strong, consistent profits.

Companies in the media industry tend to offer strong moats, and none more so than network TV stations. As a result, Buffett has made several significant media investments at Berkshire Hathaway. The best-performing of all these investments was the Washington Post Company (now known as **Graham Holdings**) – which Buffett recently sold as a 100-bagger.

The beauty of network TV stations

Buffett's key insight about the broadcast TV business was that you didn't need to be a very smart entrepreneur to make a lot of money owning a TV station – you just needed to be smart enough to buy it for a decent price.The reason is that a relatively small number of broadcast TV licenses/frequencies were available in any given

market. There were an even smaller number of TV networks. In the pre-cable era, this meant that each local TV market in the U.S. was dominated by a few TV stations that could command top dollar for commercials.

Even today, with the proliferation of cable channels and the rise of Internet TV, broadcast TV channels still tend to draw the biggest audiences. (For example, new episodes of popular network TV drama NCIS have regularly drawn 15-20 million viewers in recent years.) As a result, despite significant technological changes, broadcast TV stations remain quite profitable.

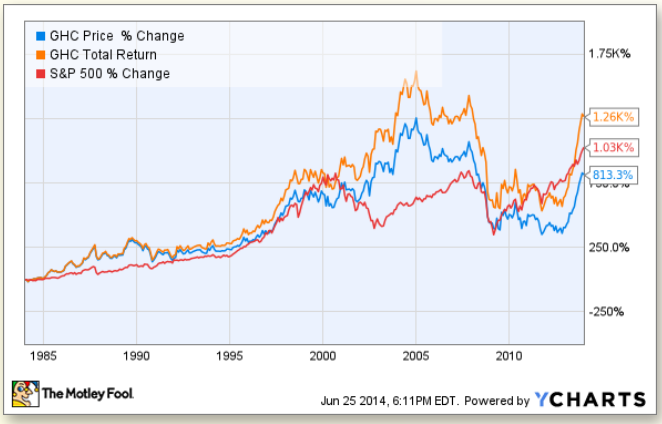
One of Buffett's best investments

In 1973, Berkshire Hathaway began acquiring stock in the Washington Post Company. Within a short time, Buffett had acquired more than 10% of the company's stock for just $10.6 million. That stake increased to more than 20% over time due to significant share repurchases by the Washington Post Company.

In addition to its flagship newspaper and some other businesses, the Washington Post Company already owned several TV stations in 1973. These were located in the Washington D.C., Jacksonville, and Miami markets. It added to its TV holdings in subsequent years.

It didn't take long for Buffett's bet to pay off for Berkshire Hathaway shareholders. By the end of 1983 – just 10 years after Buffett started buying shares of the Washington Post Company – his investment's value had risen from $10.6 million to $137 million!

Despite that relatively quick gain, Buffett was not interested in selling, because he recognized the favorable economics of the broadcast TV business and expected it to generate a steady profit stream. Indeed, he held on to all of his Washington Post Company stock for another 3 decades – and the stock continued to rise.



Graham Holdings Price/Total Return Price (1984-2013)

As Buffett expected, the Washington Post Company's days of market-busting performance were mostly over by the mid-1980s. However, since the beginning of 1984, the Washington Post Company stock has kept pace with the rest of the market, especially including the impact of dividends.

Buffett still loves TV

Warren Buffett's recognition that the Washington Post Company could practically print money thanks to its ownership of several TV stations helped him make more than $1 billion for Berkshire Hathaway investors on a $10.6 million investment.

Buffett is always looking for businesses that have strong moats, and apparently he still thinks broadcast TV stations fit the bill. When he finally decided to exit Berkshire Hathaway's investment in the Washington Post Company (now known as Graham Holdings), he didn't just sell his shares for cash.

Instead, he got one of Graham Holdings' top TV stations – Miami-based WPLG-TV – in exchange for Berkshire's Graham Holdings shares. (The deal also included cash and the return of some Berkshire Hathaway shares owned by Graham Holdings.) Buffett's love affair with TV stations isn't over yet: nor is his affection for businesses protected by solid moats.

Why Warren Buffett Doesn't Chase Rocket Stocks

By Adam Levine-Weinberg

"You can, of course, pay too much for even the best of businesses."

— Warren Buffett, 1997

Berkshire Hathaway CEO and investing legend Warren Buffett is well known for his focus on buying high-quality companies. Indeed, more than 3 decades ago, Buffett stated that he preferred investing in a "*good business purchased at a fair price than in a poor business purchased at a bargain price.*"

However, Warren Buffett's willingness to pay up for high-quality companies only goes so far. Some businesses sell at "unfair" prices in the stock market. Today, **Amazon.com** may be just such a company.

Amazon.com is certainly a great business. Indeed, Amazon recently became the first 100-bagger for The Motley Fool co-founder David Gardner. However, its price has reached stratospheric levels in recent years. As a result, Amazon shares may underperform the market for the foreseeable future.

A fine line between growth and value

One reason for Warren Buffett's extraordinary success at Berkshire Hathaway has been his ability to walk the fine line between "value

investing" and "growth investing." Both investing strategies have advantages and pitfalls.

Value investors look for stocks that are cheap, and this part of the investing process is easy. But stocks are often cheap for a reason. Perhaps the company is in a terrible business, or is about to face the entry of a disruptive competitor. Warren Buffett learned in his early years at Berkshire Hathaway that earnings can evaporate rapidly for a bad business.

That's why it's usually better to pay a premium for a strong company's stock than to buy shares of weak businesses just because they seem cheap. However, every company has a finite value. If you massively overpay, even a great business will generate lousy stock returns. This has proven true for numerous tech stocks in the last 15 years.

Buffett has navigated this dilemma by being picky. There are plenty of great businesses that you can invest in. There's no reason to invest in one that's incredibly expensive relative to its likely future earnings prospects.

Amazon is priced for perfection – and beyond

Amazon.com stock has struggled recently, as investors have finally started to pay attention to its price. Amazon has certainly posted strong revenue growth, but it has not been reliably profitable recently. Investing in Amazon.com requires a leap of faith – you must believe that Amazon will eventually become a highly profitable business, even though it has had low margins for many years.

Amazon's most recent earnings report reinforced the recent pattern. Revenue grew by 23% to $19.34 billion. However, the company's loss widened year-over-year. Amazon lost money in the first half of 2014, and it expects to lose hundreds of millions of dollars in Q3 2014 – perhaps due to launch costs for its new "Fire Phone."

Even as Amazon's earnings have deteriorated in the last few years, its stock price has soared. Today, Amazon has a market cap of about $150 billion – and its market cap peaked at more than $180 billion in early 2014. This makes it one of the most valuable companies in the U.S., even though it is on pace to lose money this year.

To some extent, Amazon's astronomical valuation can be explained by its high revenue growth rate. Sales are growing by about 20% annually, whereas **Costco** –arguably Amazon's closest competitor – is posting high single-digit annual sales growth. Still, this cannot quite explain why Amazon trades at a price-to-sales ratio that is 4 times that of Costco.

Indeed, just 5 years ago, Amazon was growing faster and had a dramatically higher profit margin than it does today. In the last few years, Amazon's operating margin has dropped from around 5% to less than 1%.

Meanwhile, annual revenue growth has fallen from a 30%-40% range to just more than 20%.

Even as Amazon's revenue growth and operating margin have dropped, its price-to-sales multiple has stayed roughly constant. This suggests that Amazon investors have not incorporated Amazon's slowing growth or lower margins into their expectations.

Amazon may be able to maintain a double digit revenue growth rate for the next decade while gradually rebuilding its profit margin to a respectable level. That would be an impressive business achievement – but would still produce disappointing results for investors. Investors are simply paying too much for Amazon shares today.

Foolish bottom line

In the current slow growth economy, it's not too surprising that investors are willing to pay top dollar for companies that are generating rapid revenue growth. However, Warren Buffett would caution investors that you can pay too much even for a great business.

The investors bidding up shares of Amazon.com in recent years have probably been paying too much. Amazon is likely to experience strong revenue and margin growth in the next 10 years. However, barring an *extraordinary* revenue growth rate or a return to 2004-era margins, Amazon stock is likely to underperform the market during that time frame.

Warren Buffett: Investors Win When the Market Falls

By Adam Levine-Weinberg

So smile when you read a headline that says "Investors lose as market falls." Edit it in your mind to "Disinvestors lose as market falls – but investors gain." Though writers often forget this truism, there is a buyer for every seller and what hurts one necessarily helps the other.

— Warren Buffett, 1998

When the stock market is in a tailspin, it's natural for investors to feel a sense of panic. If you check your investment account balance daily – or even more frequently – it can seem like your hard-earned money is inexorably disappearing.

According to Warren Buffett, if you're feeling stressed about falling stock prices, it's because you are thinking about investing the wrong way. In fact, true "investors" should prefer to see stock prices falling.

Investors vs. disinvestors

The key to Warren Buffett's insight is that by definition, long-term investors are not looking to sell for a long time. If you really do have a long-term horizon, all that matters is what the value of your investment will be far in the future: when you plan to sell.

As an individual investor, it's not unusual to have a long time horizon. If – like most people – you are primarily investing for retirement and you're not planning to retire for 10 years or more, today's stock market gyrations will have little effect on your final selling price. Just consider how the market is up 75% in the last 10 years, despite losing more than half of its value during the Great Recession!

Indeed, if you are continuing to add money to your investment fund – i.e., you are saving for retirement – you are better off with lower stock prices in the short term. This will allow you to buy at better prices, knowing that over long periods of time, the stock market provides fairly consistent returns.

Thus, it is only "disinvestors" – people who are planning to sell stocks soon – who lose when the market falls. People who are putting more money into the market than they are taking out should be happy when the market tumbles, because it means stocks are going on sale.

Changing your perspective

Warren Buffett's insight that only "disinvestors" lose when the market falls means that if you tend to worry about your investments two simple changes could do wonders for your stress level.

First, you want to *be an investor* – not a disinvestor – for as long as possible. In other words, you shouldn't invest money that you think you'll need within the next few years. As long as you're not planning to sell soon, the day-to-day ups and downs of the market will have no impact on your ultimate investment performance.

Second, you need to *think like an investor*. This can be surprisingly hard, because financial news outlets often cater to Wall Street professionals who are not investors in Buffett's sense of the word – they are constantly buying and selling stocks.

However, by remaining focused on your own goals and strategy, you should be able to adopt a Buffett-like perspective. If you resolve to continue adding to your retirement fund no matter what the market is doing, stock market plunges will seem more like opportunities and less like calamities.

Foolish bottom line

Changing your perspective from that of a "disinvestor" to that of a long-term investor can be very hard. The constant blare of headlines about the stock market's every move encourages a short-term mentality.

However, as Warren Buffett wisely pointed out more than 15 years ago, true investors ought to be happy when the market is falling. Unless you're close to retirement, you should be putting money into the market in the near-term, not selling. As long as you are a buyer and not a seller, lower prices are better.

If you commit to a long-term investing strategy and maintain a long-term investor's perspective, you literally have nothing to worry about when it comes to investing. If you tend to worry about your investments, changing your mind-set in this way could help you sleep a whole lot better at night.

Warren Buffett: The Only Time Share Buybacks Make Sense

By Adam Levine-Weinberg

There is only one combination of facts that makes it advisable for a company to repurchase its shares: First, the company has available funds – cash plus sensible borrowing capacity – beyond the near-term needs of the business and, second, finds its stock selling in the market below its intrinsic value, conservatively calculated.

— Warren Buffett, 2000

Investors love share buybacks. When a company buys shares of its own stock and retires them, it leaves fewer shares outstanding. This boosts earnings per share, because the company's net income is spread over fewer shares. Additionally, the buyback program tilts the supply demand balance for the stock in favor of sellers, which can push the share price higher.

However, buybacks don't always make sense. Investing legend and **Berkshire Hathaway** CEO Warren Buffett has said that two conditions must be fulfilled for share buybacks to be a good use of capital. The company must have excess cash and borrowing ability to fund the buyback, and the stock needs to be clearly undervalued.

Unfortunately, not all management teams are as savvy as Warren Buffett when it comes to share repurchases. For example, **Netflix** executed a poorly conceived buyback a few years ago, which has cost present-day shareholders more than $1 billion.

When do share repurchases make sense?

In the quotation above, Warren Buffett explains when share buybacks make sense – and when they do not. The first key ingredient is adequate liquidity. Some businesses have minimal capital requirements, but others require high capital investments. Making necessary investments is critical to a business's long-term health – skimping in order to buy back shares could erode competitiveness.

Additionally, while it sometimes makes sense to borrow money in order to repurchase shares, that's only true up to a certain point. Buffett points out that it is important not to take on an unwieldy debt load to fund buybacks.

The second requirement is that the stock must be selling for less than its "conservatively calculated" intrinsic value. In other words, a company's management should take a sober look at its future business prospects and stock price compared to those of competitors. Unless the stock is clearly undervalued, a buyback is the wrong way to go.

These two requirements are significant hurdles, but they are certainly not insurmountable. In late 2011, Berkshire Hathaway announced a share buyback program that was expressly guided by Buffett's two key principles.

Netflix's buyback gaffe

Netflix's behavior in 2011 demonstrated the cost of ignoring Buffett's buyback criteria. In early 2011, Netflix management openly admitted that the company was not "price sensitive" when it came to buybacks. Whenever executives felt Netflix had excess cash, they used it to repurchase stock, regardless of the price.

That clearly violates Warren Buffett's second rule for stock buybacks. According to Buffett, Netflix executives should have made some effort to ensure that they weren't overpaying. Alternatively, Netflix could have returned cash to shareholders through dividends.

As it turned out, Netflix's management team also did a poor job of calculating its excess cash. In the first three quarters of 2011, Netflix spent approximately $200 million to repurchase 900,000 shares of stock. However, Netflix's subscription price increase that summer caused a customer backlash, while the company's international expansion turned out to be very costly.

With more obligations looming and an uncertain path to profit recovery, Netflix decided to raise money that fall. It sold 2.86 million shares at $70/share, for a total of $200 million. Between the buyback in the first three quarters of 2011 and the share sale in Q4, Netflix essentially gave away 2 million shares (worth over $800 million at today's market price).

Netflix also issued $200 million of convertible debt in late 2011. This eventually converted to another 2.3 million shares (worth about $1 billion today: a gain of nearly $800 million for the holder). By spending freely on share buybacks when it should have been bolstering its balance sheet, Netflix was forced to raise capital on extremely bad terms, costing shareholders more than $1 billion.

Foolish final thoughts

Properly executed buybacks can create plenty of value for shareholders. A company that repurchases its stock for less than its intrinsic value makes all of the remaining shares more valuable. However, a poorly executed buyback can just as easily destroy

shareholder value: a lesson that Netflix's management learned the hard way.

For other management teams trying to decide whether to buy back shares, Buffett has some simple rules to follow. First, don't spend beyond your means – make sure you have more than enough cash and borrowing ability to run the business properly. Second, don't buy back shares unless they are clearly undervalued.

Investors should thus be cautious when a company announces big buyback plans. If it seems like the company has thoughtfully evaluated its cash needs and the stock's intrinsic value, it may be good news. If not, then the chances of a good outcome are much lower.

Warren Buffett Reveals Boring Can Be Beautiful

By Patrick Morris

"I will tell you now that we have embraced the 21st century by entering such cutting-edge industries as brick, carpet, insulation and paint. Try to control your excitement."

— Warren Buffett, 2001

Those witty words were written by Warren Buffett in his 2001 letter to **Berkshire Hathaway** shareholders.

Source: Flickr / twoblueday.

But these words are more than just witty, they also under score an important investing lesson: the dullest of businesses can make for the best investments.

The turn of the century

In the year 2000, Berkshire Hathaway purchased eight companies for $8 billion. Combined, the firms employed more than 58,000 individuals and had more than $13 billion in sales.

The simple businesses

Which eight companies did Buffett buy in the middle of the roaring tech bubble? Nothing that would've made investors hearts race in the slightest:

Date	Company	Description
10/25/1999	MidAmerican Energy	Iowa-based Energy firm with 2.2 million electric and 1.2 million natural gas customers
1/14/2000	CORT Business Services	Provider of rental furniture, accessories and related services in the "rent-to-rent"
5/18/2000	Ben Bridge Jeweler	A 63 store jewelry retailer
6/20/2000	Justin Industries	Holding company of Acme Brick, a brick manufacturer and Justin Brands, boot and shoe companies
8/8/2000	United States Liability Insurance Group	Provider of excess and surplus lines of insurance
9/6/2000	Shaw Industries	World's largest manufacturer of broadloom carpet
11/8/2000	Benjamin Moore	Manufacturer and retailer of premium paints, stains and industrial coatings
12/20/2000	Johns Manville	Manufacturer and marketer of building products

Source: Company Investor Relations

Nothing on this list is terribly "exciting," but there's more than meets the eye.

Boring but beautiful

All too often in investing, we are led to believe only exciting businesses will deliver great returns. The thought of investing in the next high-growth phenom in the technology industry brings dreams of great riches.

Yet we can so easily forget that for every **Amazon** – which has seen its stock price skyrocket by more than 175 times since it went public – there's a Pets.com . The latter raised $82.5 million from its IPO in February 2000 and collapsed just nine months later. *CNET* called the collapse of Pets.com the "latest high-profile dot-com disaster."

But take a step back and reconsider those businesses Buffett bought. "Brick, carpet, insulation and paint."

What is required of nearly every home that is built? Brick, carpet, insulation and paint. What industry saw one of the most remarkable rises during the first decade of the 21st century? Housing.

While we know what happened to housing in 2008, it turns out more homes were built in the 2000's than both the 80's and 90's.

It's also important to remember all those manufacturing businesses Buffett bought were paid as the homes were built and they didn't have to deal with the mortgage fiasco which characterized both the boom and the bust.

Buffett was able to see beyond the pundits who proclaimed the Internet was the next big industry, and instead invested in boring businesses that serve our everyday needs. Although these companies lack the flash of the "next big thing," their products and services are staples of our economy. Their leadership positions in their respective markets don't hurt either.

This isn't to say technology investments should be avoided altogether – Berkshire Hathaway has a $13 billion position in **IBM** – or that manufacturing, service, and retailing businesses should be blindly bought. Instead, it's critical to understand the business you're investing in, rather than to follow the "market expectations" for a specific sector or company. It's only then that we'll be able to have a real sense for the value of a company.

And it's this kind of honest humility in sticking to what he knows – even if it's boring – that has netted Buffett some of the greatest investment success the world has known.

This 104 Year-Old Woman Taught Billionaire Warren Buffett a Lesson He'll Never Forget

By Patrick Morris

One piece of wisdom she imparted to the generations following her was, "If you have the lowest price, customers will find you at the bottom of a river."

It turns out one of the best pieces of wisdom Warren Buffett received didn't come from Wall Street, but a woman who sold the business she started with $500 to **Berkshire Hathaway** for $60 million.

The little business that could

Much has been made of the various businesses Buffett has acquired to build his empire, and one that has been instrumental is **Nebraska Furniture Mart**. Founded by Rose Blumkin – affectionately known as Mrs. B, and the woman Buffett cited in the quote you see above – in 1937, it has become one of the most successful furniture retailers in the country.

Buffett and Blumkin.
Nebraska Furniture Mart.

When Buffett bought the store in 1983, he remarked:

Today Nebraska Furniture Mart generates over $100 million of sales annually out of one 200,000 square-foot store. No other home furnishings store in the country comes close to that volume. That single store also sells more furniture, carpets, and appliances than do all Omaha competitors combined.

In 1984, sales spiked another 15% and in its first full year it contributed $14.5 million to the $90 million of operating earnings at Berkshire Hathaway. And that growth hasn't stopped, as its stores in Omaha and Kansas City netted about $450 million *each* in sales last year.

And with the store in Dallas being built now, Buffett said he predicts "the Texas store will blow these records away."

So how has NFM been so successful? It turns out the answer reveals why Berkshire Hathaway has major positions in both **Wal-Mart**.

The bottom of the river

With the opening of the Kansas City Nebraska Furniture Mart in 2003, Buffett penned the above quote. It's evidence he believes providing cost advantage to customers can be one of the strongest competitive advantages.

In his 2007 letter to Berkshire Hathaway shareholders, Buffett said businesses need a "moat," to protect them, and "formidable barrier such as a company's being the low-cost producer (GEICO, Costco) or possessing a powerful worldwide brand (**Coca-Cola**, **Gillette**, **American Express**) is essential for sustained success."

After all, it's this low cost lead that has allowed GEICO to watch its policies grow from just 2.5% of the U.S. insurance market when Berkshire fully acquired it in 1995 to more than 10% in 2014. In total, it's increased its policies by nearly $16 billion, from $2.8 billion to $18.6 billion. And one of the biggest reasons behind this growth is its ability to offer the lowest price to customers.

Buffett said this year while "no one likes to buy auto insurance," it's a necessity, and as a result, "savings matter to [families] – and only a low-cost operation can deliver these." In his words:

GEICO's cost advantage is the factor that has enabled the company to gobble up market share year after year. Its low costs create a moat – an enduring one – that competitors are unable to cross.

Remember it was just a few weeks ago when we learned Buffett grew its holdings of Wal-Mart by 17% through the first three months of the year. And what does Wal-Mart offer its customers? Products they need at low costs.

Or in its words, the opportunity to: "Save money. Live Better."

While the Costco holding of Berkshire Hathaway is much smaller than its Wal-Mart position – $500 million versus nearly $4.5 billion – it too is best known for the savings it offers customers.

The key takeaway

Buffett concluded his discussion on the Manufacturing, Service and Retailing Operations of Berkshire Hathaway this year by telling us:

Aspiring business managers should look hard at the plain, but rare, attributes that produced Mrs. B's incredible success. Students from 40 universities visit me every year, and I have them start the day with a visit to NFM. If they absorb Mrs. B's lessons, they need none from me.

Whether running a business, or looking for one to invest in, we too must recognize how powerful low prices can be.

Warren Buffett Reminds Us of the Critical Importance of Treating Customers Well

By Patrick Morris

"If we are delighting customers, eliminating unnecessary costs and improving our products and services, we gain strength. But if we treat customers with indifference or tolerate bloat, our businesses will wither. On daily basis, the effects of our actions are imperceptible; cumulatively, though, their consequences are enormous."

— Warren Buffett, 2005

We don't often think of the customers of the various companies **Berkshire Hathaway** owns. But Warren Buffett knows that their satisfaction is more important than just about everything else.

In the 2005 letter to Berkshire Hathaway shareholders, Buffett penned the above quote, further explaining how he thinks about and invests in great businesses.

Beyond the financial statements

Often in investing we can be drawn into thinking about only what the balance sheet or income statement tell us. Yet Buffett continually reminds us about the overriding importance of having a "moat" that protects a business from competition.

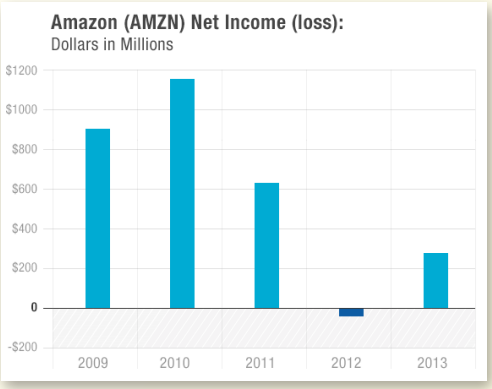
One of the ways to do that is through low costs. Another is through a powerful brand. Yet in each of those approaches, Buffett understands that the satisfaction of customers who pay for goods and services is critical.

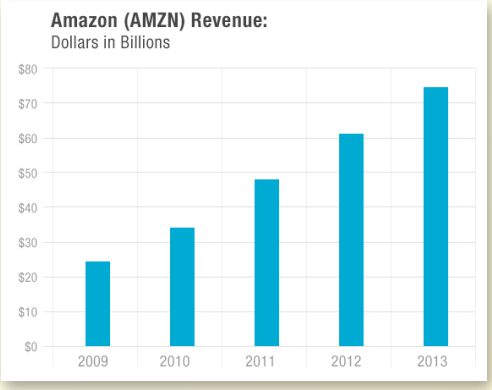
The powerful thought

Buffett built on the above quote by adding:

When our long-term competitive position improves as a result of these almost unnoticeable actions, we describe the phenomenon as "widening the moat." And doing that is essential if we are to have the kind of business we want a decade or two from now. We always, of course, hope to earn more money in the short term. But when short term and long term conflict, widening the moat *must* take precedence.

Though it isn't a Berkshire investment, this quote fits well with **Amazon.com**'s approach. Amazon made less in the three years from 2011 to 2013 *combined* – $866 million – than it did in either 2009 or 2010:





Source: Company Investor Relations

Yet over those five years, Amazon watched its stock sky rocket by almost 650%, from $54 a share to nearly $400. Why? It obviously wasn't the bottom line.

Instead, it had everything to do with revenue growth. By the end of 2013, revenue was triple what it was in 2009:

So how did it grow its top line so remarkably? Its low prices played a role. But there is also the fact that Amazon is one of the best companies at satisfying its customers.

Amazon CEO Jeff Bezos once said: "We're not competitor obsessed; we're customer obsessed. We start with what the customer needs and we work backwards."

In 2013, Amazon topped the American Customer Satisfaction Index for Internet retail with a score of 88, an improvement over its own leading mark of 85 in 2012. Meanwhile, the rating for the Internet retail industry as a whole fell by 5% to 78 last year.

The 2014 Temkin Customer Service rating for Amazon was even more impressive – its score of 79% placed Amazon second among the 232 companies in the United States. In addition, Amazon was head and shoulders above the 59% posted by the broader retail industry, and its showing was a remarkable improvement over the 67% it posted in 2013.

It should come as no surprise that Buffett had this to say about Amazon's chief last fall: "It's a tremendous accomplishment what Jeff Bezos has done – I tip my hat to him. He's a great businessman and a good guy, too."

All too often investors think short-term quarterly improvements in income are the only thing that matters. However, Buffett emphasizes that "when short-term and long-term conflict, widening the moat *must* take precedence." Bezos and so many others who have been successful have clung to this reality, and they've widened their moats by offering great service to customers.

Warren Buffett wants us to see that while satisfying customers and widening a moat may not impress anyone on Wall Street in the short term, over the long run, it makes all the difference in the world.

Warren Buffett: LeBron James Can Teach Us a Valuable Money Lesson

By Patrick Morris

It's hard to overemphasize the importance of who is CEO of a company.

We know a lot about what Warren Buffett looks at when he makes an investment or buys company outright. But it turns out one thing that isn't discussed is of huge importance to Buffett himself.

In the 2005 letter to **Berkshire Hathaway** shareholders, Warren Buffett penned the quote above when discussing the merger of **Procter & Gamble** and **Gillette** which was finalized as the year drew to a close.

When it was all said and done, Berkshire Hathaway recognized a $5 billion pre-tax gain as a result of the merger. Considering the original cost of the Berkshire Hathaway investment in Gillette was $600 million, it is one more example to jot on the long list of successes by Buffett.

But it turns out one of the driving factors behind Buffett's investment success with Gillette wasn't simply its cost, or the "moat" around its business model, but – taking the moat language a little further – the man atop the castle itself.

The power of leadership

Jim Kilts took the helm of Gillette in 2001, and Buffett notes before he arrived, "the company was struggling," as the acquisition of**Duracell** in September of 1996 for $7 billion "cost Gillette shareholders billions of dollars."

Buffett suggests the acquisition was a prime example of the company's "blunders," as it could neither efficiently nor effectively use its earnings to generate returns for shareholders. But Kilts swiftly changed that. Buffett went on to say:

Upon taking office at Gillette, Jim quickly instilled fiscal discipline, tightened operations and energized marketing, moves that dramatically increased the intrinsic value of the company. Gillette's merger with P&G then expanded the potential of both companies.

And while Buffett notes as a result of his work, "Jim was paid very well – but he earned every penny."

The key to remember

The compensation of CEOs draws endless attention, and much has been made of Buffett's absence in voting on the compensation of **Coca-Cola** executives this year. It was just a few lines after discussing Kilts in the 2005 letter when Buffett openly admits "too often, executive compensation in the U.S. is ridiculously out of line with performance."

Yet the thing with executive compensation is that in select instances, Buffett also suggests:

Indeed, it's difficult to overpay the *truly* extraordinary CEO of a giant enterprise.

So is Buffett full of contradictions when it comes to this? The answer: Of course not.

In 2008, Buffett said, "Price is what you pay; value is what you get." And the same reality applies not just to the investments in stock, but those leading the company. And taking a step into another industry, consider LeBron James for a moment.

Source: Flickr / zennie62.

With the Heat now in their fourth-straight NBA Finals – only the fourth time a team has done that – questions about LeBron's

ability to lead a team have (rightfully) vanished. But what isn't discussed is that despite his $19 million salary, LeBron may in fact be *underpaid*.

In 2010, the Wall Street Journal suggested if the NBA didn't have such restrictive salary cap rules – it limits how much a maximum contract can be – LeBron should be earning $43 million a year. Last year, an economist at the University of Oklahoma, Kevin Grier, told NPR LeBron is "getting hosed," by his current salary.

What we can learn

In the examples of both LeBron James and Jim Kilts, the key here isn't the pay the men receive, but the*value* they provide.

Jim was able to improve Gillette on multiple fronts, from accounting, manufacturing, and even marketing. In the same way, LeBron is known for his ability and contributions offensively and defensively. His skill allows him to not only play, but excel on any area of the basketball court.

Discussion surrounding the value of individual leaders occurs often in sports, but not nearly enough when we make investments.

When we make investments, we can be trapped into thinking the only critical considerations are those quantitative ones based on what value can be found on balance sheets and income statements. But from Buffett, we can learn we must explore not only the value offered by the company and its business, but those at the top of it as well.

Leaked: Warren Buffett's Recipe for Financial Success

By Patrick Morris

"ISCAR makes money because it enables its customers to make more money. There is no better recipe for continued success."

— Warren Buffett, 2006

All too often, we only think about the businesses **Berkshire Hathaway** runs that we know by name. Fruit of the Loom. Geico. Heinz. But one of its businesses you've likely never heard of has a simple but remarkable history of success.

The big business that could

In May of 2006, for $4 billion, Berkshire Hathaway agreed to acquire 80% of Israel-based **International Metalworking Companies**, which provides metal cutting tools through ISCAR and other brands for business across the globe. The remaining 20% would be owned by the family. And it was in the 2006 letter to shareholders detailing why Berkshire made the purchase when Buffett wrote the quote found above.

Eitan Wertheimer, the chairman of IMC and member of the family who started it, wrote Buffett a 1.25 page letter asking if he'd like to buy it in 2005. In Buffett's own words, it has a "simple and profitable business model"; he and Charlie Munger couldn't turn it down when the opportunity to acquire it arose.

ISCAR makes a variety of small tools that are used by customers – largely in the automotive, aerospace, and mold industries – that operate massive machines for metal working. And while it's

"groove-turn," "turning & threading," "hole making," "milling," and "tool holding," businesses won't grab headlines, its recipe for success should.

The recipe for success

In 2009, as the economy spun downwards, Buffett noted even though Iscar's results were "down significantly from 2008," he continued, "when manufacturing rebounds, Iscar will set new records." That didn't take long: Its profits rose by a staggering 159% in 2010.So, how did it do that? Let's take another look at Buffett's words:

ISCAR makes money because it enables its customers to make *more* money. There is no better recipe for continued success.

Buffett has long touted the benefit of GEICO providing the least expensive insurance policy – an unwanted requirement for Americans – which has allowed it to take over the auto insurance industry little by little. In this year's letter, he said:

GEICO's cost advantage is the factor that has enabled the company to gobble up market share year after year. Its low costs create a moat – an enduring one – that competitors are unable to cross.

And while it's a touch different, it's this business model that has allowed ISCAR to be successful. It provides value to its customers by ensuring there is a true benefit to their bottom lines when they use its products. It may not offer the cheapest tools, but it offers those with the most value.

Taking a step toward another Berkshire Hathaway investment consider, **USG**, or United States Gypsum Corporation. This non-exciting business manufactures drywall and other construction materials for residential and commercial properties. Like ISCAR, it isn't anything exciting, but it provides, "low-cost capacity and market-leading brands," which allows it to provide value to its customers. And as a result, it's "a leader in each of its three core businesses."

So why bring up USG? While it too may be a small company that doesn't grab headlines, it's clearly one Buffett believes in. The $1.1 billion common stock position held by Berkshire Hathaway represents an ownership stake of more than 30%.

The key takeaway

Last year, Warren Buffett shelled out $2.1 billion to buy the remaining 20% of IMC, meaning its value had more than doubled since 2006. Buffett said it "has enjoyed very significant growth over the last seven years," and he was "delighted to acquire," the remaining 20%.

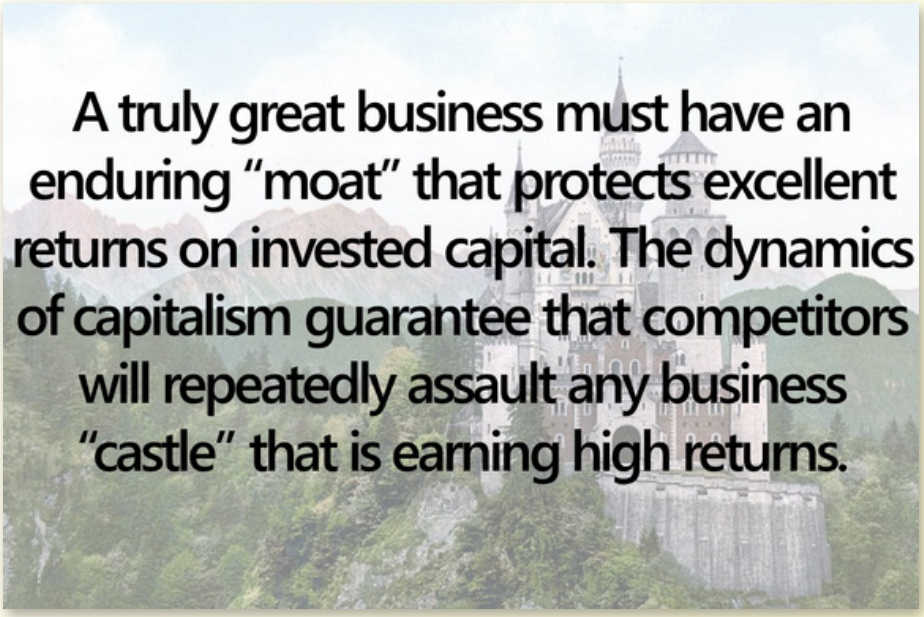
Before you make your next investment, ask yourself if that business provides true and immediate value to its customers. If it does, the odds of a owning a long-term winner tip in your favor.

Warren Buffett's Most Important Money Confession

By Patrick Morris

Warren Buffett of **Berkshire Hathaway** doesn't simply buy great stocks; it buys great businesses. And there is only one way a business can be "truly great."

Like castles, it must it must have a wide moat that protects it from attacks.



The wide moat

The 2007 letter to Berkshire Hathaway shareholders had a section titled "Businesses – The Great, the Good, and the Gruesome," where Buffett explored how businesses can gain a competitive edge.

While the "moat" analogy wasn't exactly new – he also used it in the 1986 letter to describe Geico – it's a powerful one to consider, and there are many things we can learn from it.

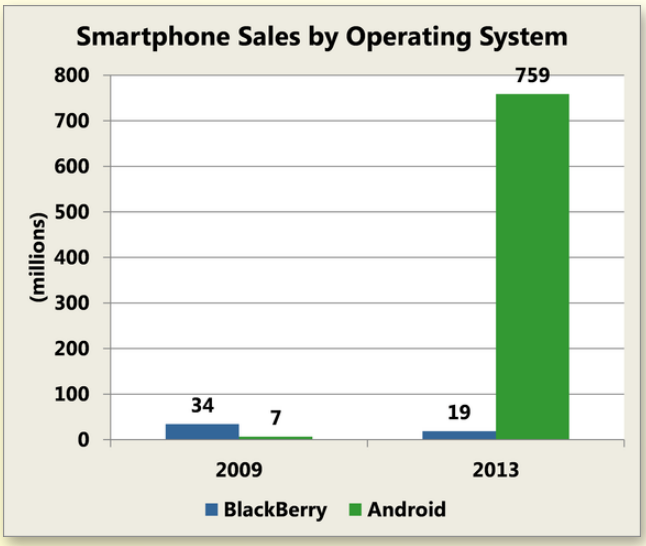
What isn't a moat

Buffett went on to say:

Our criterion of "enduring" causes us to rule out companies in industries prone to rapid and continuous change. Though capitalism's "creative destruction" is highly beneficial for society, it precludes investment certainty. A moat that must be continuously rebuilt will eventually be no moat at all.

This is a powerful reminder of the difference between societal benefits and investing benefits. After all, there have been a host of industries that have undergone rapid change since Buffett took the helm at Berkshire Hathaway in 1965.

Yet thinking of a more recent example, consider smartphones. In 2009, there were more than 34 million **BlackBerry** phones sold, representing 20% of the market. But in 2013, it sold nearly half that number, as its market share plummeted to less than 2%.



How does that compare with competitor **Google**?

Words simply don't do it justice:

Source: Gartner

Over the past five years, Google has seen an explosion in the number of phones sold that run its Android operating system, as it claimed just 4% of the market in 2009 to nearly 80% in 2013. And while it isn't a direct comparison, consider that when the iPhone was announced in 2007, Jim Balsillie, the CEO of what was then called Research In Motion, said:

It's kind of one more entrant into an already very busy space with lots of choice for consumers. ... But in terms of a sort of a sea change for BlackBerry, I would think that's overstating it.

There is perhaps no clearer example of an industry "prone to rapid and continuous change" than that of smartphones, and the dangers of an illusory moat and how quickly such a supposed castle can be overtaken. Considering BlackBerry has watched its stock plummet by more than 90% while Google has watched its rise by 150%, it's understandable why Buffett recommends we avoid those industries at all costs.

What is a moat?

So what exactly does Buffett suggest is a moat? In his own words:

Therefore a formidable barrier such as a company's being the low-cost producer (Geico, **Costco**) or possessing a powerful worldwide brand (**Coca-Cola**, Gillette, **American Express**) is essential for sustained success. Business history is filled with "Roman candles," companies whose moats proved illusory and were soon crossed.

Low costs and a powerful brand? That's all we need to find?

No. But they're certainly on the list.

Buffett suggests that each of those is an example of "a formidable barrier," but he also says there are others. For example, he said one of the reasons he enjoys See's Candies, which Berkshire acquired in 1972, is that it doesn't require continual investments, and that its

profits – standing at $1.7 billion through 2011 – have instead been used to "buy other attractive businesses."

He went on to say:

A company that needs large increases in capital to engender its growth may well prove to be a satisfactory investment. There is ... nothing shabby about earning $82 million pre-tax on $400 million of net tangible assets. But that equation for the owner is vastly different from the See's situation. It's far better to have an ever-increasing stream of earnings with virtually no major capital requirements. Ask **Microsoft** or Google.

He's also spoken to businesses that treat customers well, the importance of great managers, and countless other things through the years that will lead to success.

All of this is summed up in one of Buffett's most famous quotes in 2012:

More than 50 years ago, Charlie [Munger] told me that it was far better to buy a wonderful business at a fair price than to buy a fair business at a wonderful price.

When we make investments, we must examine not just the price, but the *business*, too. And Buffett suggests that when we find those with lasting moats that will protect them from competitors selling at "sensible prices," this is what we must see:

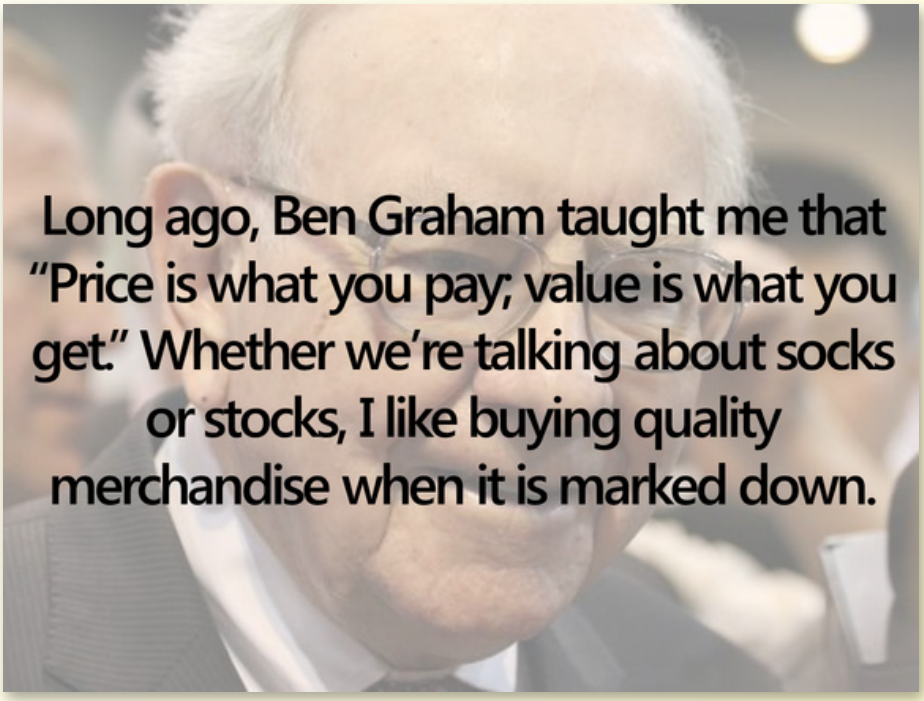
It's better to have a part interest in the Hope Diamond than to own all of a rhinestone.

Warren Buffett: Why Being Cheap With Money Is a Big Mistake

By Patrick Morris

I hate buying socks. But according to Warren Buffett, the process can actually teach us how to be a successful investor.

This perspective has allowed him to turn **Berkshire Hathaway** from a small textile company that earned just $0.15 per share in 1965 into a $500 billion picture of American success that made $11,850 per share last year.



The wisdom

Following the 2008 stock market collapse, Buffett penned the quote above in his letter to Berkshire Hathaway shareholders. This was by far the most tumultuous time Buffett has seen atop Berkshire, as the **S&P 500** tumbled by nearly 40% on the year.

Buffett began his letter honestly and painted the dim picture of what the American economy was facing in February 2009, as the S&P 500 had officially been cut in half in just 14 months. Panic was on the mind of every investor at the time. Buffett revealed:

By the fourth quarter, the credit crisis, coupled with tumbling home and stock prices, had produced a paralyzing fear that engulfed the country. A freefall in business activity ensued, accelerating at a pace that I have never before witnessed. The U.S. – and much of the world – became trapped in a vicious negative-feedback cycle. Fear led to business contraction, and that in turn led to even greater fear.

But the collapse of the market didn't deter Buffett as an investor. After he spoke about the troubles that characterized the country in 2008, the Berkshire chief said he believed, "America's best days lie ahead."

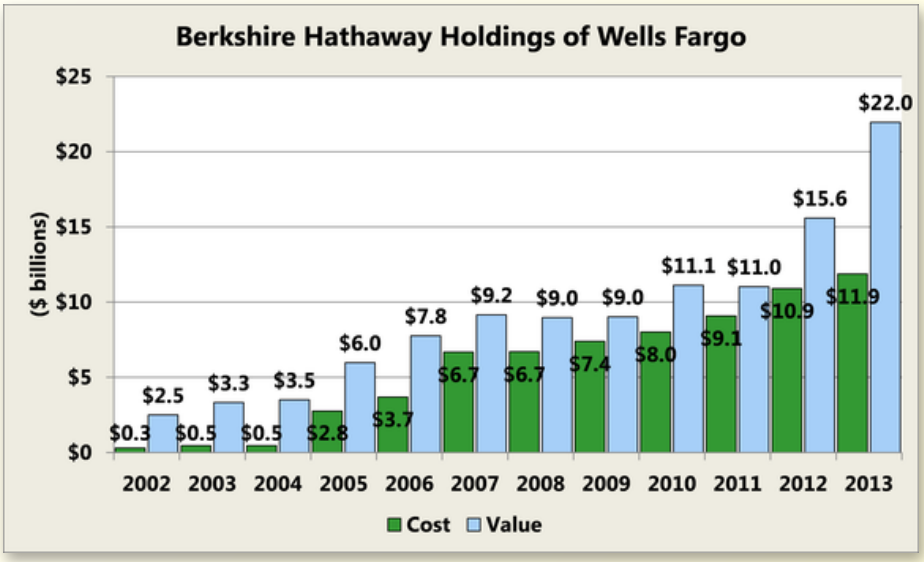
Buffett put his money where his mouth is. He poured more than $15 billion into the market in September and October 2008 by making massive investments in well-known titans. This encompassed $5 billion in **Goldman Sachs**, $3 billion in **General Electric**, and $6.5 billion into the **Wrigley** subsidiary of **Mars**.

Yet perhaps the greatest example of Buffett's wisdom – which he learned from mentor Ben Graham – is presented most clearly in his investment in **Wells Fargo**.

The well of Wells

Buffett first began buying Wells Fargo in 1989. But as the new century approached Berkshire began to slowly unload its position, which dropped from $392 million at the end of 1998 to $306 million by 2001.

In 2003, Buffett boosted Berkshire Hathaway's holdings of Wells Fargo by more than 50%, to $463 million, but he didn't buy any in 2004. The big buying began in 2005, as the position grew by more than five times to sit at $2.8 billion. And it's been on an astounding run ever since:

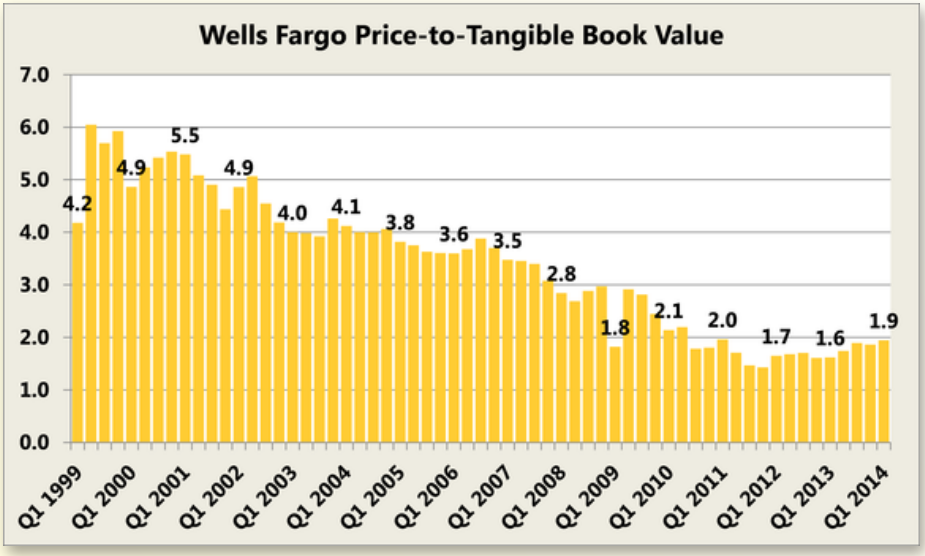


Source: Company Investor Relations

So why has Buffett aggressively added to his position of Wells Fargo during one of the most trying and difficult periods for the financial industry? Put simply, it – like the socks Buffett buys – was "marked down."

The bank worth buying

One key metric used by investors to gauge a bank's relative value is the price-to-tangible book value. Wells Fargo watched its fall as the decade progressed:



Source: S&P CapIQ

On a relative basis, Wells Fargo was put on sale nearly 10 years ago, and its price has only improved as the years have progressed. But we must see this relative discount – some banks are significantly less expensive than Wells Fargo – as only part of the equation.

Consider Buffett's quote in 2005, when the first major purchase was made:

We substantially increased our holdings in Wells Fargo, a company that Dick Kovacevich runs brilliantly.

Wells Fargo P/ TBV Average	
1999 - 2004	4.7
2005	3.7
Difference	-22%

Source: S&P CapIQ

Even though the bank's multiple was trading well below where it had for the previous five years – as shown in the chart to the right – Buffett never mentioned

the relative value. Instead, he highlighted the business and the underlying leadership.

But why has Buffett continued to buy Wells Fargo?

Sure, Wells Fargo's trading multiple has fallen in the nine years since Buffett began aggressively adding to his position. And although its profitability – as measured by its return on assets, or ROA, and return on equity, or ROE – has fallen as a result of the financial crisis, the gap isn't nearly as dramatic as the drop seen in its relative valuation.

Wells Fargo Averages

	P/TBV	ROA	ROE
1996 - 2004	4.3	1.6%	17%
2005 - 2013	2.6	1.3%	13%
Difference	-40%	-19%	-23%

The drop in its value doesn't line up with the dip in its business operations. And while the bank's multiple is still often far above its peers, remember Buffett once said:

"We try to buy into businesses with favorable long-term economics. Our goal is to find an outstanding business at a sensible price, not a mediocre business at a bargain price."

With that in mind, consider **Bank of America**, which Buffett staked a position in after the market overreacted and its stock cratered in the fall of 2011.

Why did he aggressively continue to buy Wells Fargo, but only make the one-time investment in Bank of America? The numbers don't lie:

Wells Fargo Averages

	P/TBV	ROA	ROE
1996 - 2004	4.3	1.6%	17%
2005 - 2013	2.6	1.3%	13%
Difference	-40%	-19%	-23%

Bank of America Averages

	P/ TBV	ROA	ROE
1996 - 2004	3.1	1.3%	18%
2005 - 2013	2.1	0.6%	6%
Difference	-31%	-57%	-65%

Bank of America saw its price-to-tangible book value plummet to just 0.5 in August 2011 when Buffett made his investment. So that chart doesn't tell the whole story.

But it does reveal why Buffett has continuously added to his stake in Wells Fargo, versus a one-time investment in Bank of America.

Put simply, there is perhaps no clearer picture of "a wonderful business at a fair price" than Wells Fargo over the last nine years.

The story of socks

So what does any of that have to do with socks? Let's revisit Buffett's quote:

Long ago, Ben Graham taught me that "Price is what you pay; value is what you get." Whether we're talking about socks or stocks, I like buying quality merchandise when it is marked down.

Let's say you see a pair of socks at the dollar store versus some at the neighborhood sports store. The sports store has a $25 three pack on sale for $15, while you could buy three pairs for $3 at the business next door.

Knowing one "investment" is five times more expensive, Buffett would tell you to pay $3 for the socks, right?

Wrong.

You'd have to consider so much about the socks beyond just the price. For example, what if the cheaper socks carried significant risk of injuries like blisters? Or what if they wore out after just a few months of use? And so on.

The $15 socks could in fact provide better value. If the $3 socks must be replaced every eight months – their "quality" may be anything but – and you could hold onto the $15 socks for five years, you'd end up paying more over the long term for being cheap:

The Three Sock Investment

	After Purchase	After 5 Years
$3 Socks	$3.00	$22.50
$15 Socks	$15.00	$15.00

You may say over the short term cheaper socks provide more value, but when you take the long-term perspective with purchases – years or perhaps decades – the relative quality is incredibly important to consider.

In the same way, stocks shouldn't be held for days, weeks, or months, but years or decades. When Buffett announced in 2003 that he had added to his position in Wells Fargo, he also noted:

We bought some Wells Fargo shares last year. Otherwise, among our six largest holdings, we last changed our position in **Coca-Cola** in 1994, **American Express** in 1998, **Gillette** in 1989, **Washington Post** in 1973, and **Moody's** in 2000. Brokers don't love us.

Knowing he still holds massive positions in Coca-Cola and American Express, which cost him a little over $2.5 billion but at the end of 2013 were worth more than $30 billion, there is perhaps no clearer picture of the simple beauty of "buy-and-hold" investing.

The final thing to remember

In 2012, Buffett said:

More than 50 years ago, Charlie [Munger] told me that it was far better to buy a wonderful business at a fair price than to buy a fair business at a wonderful price. Despite the compelling logic of his position, I have sometimes reverted to my old habit of bargain-hunting, with results ranging from tolerable to terrible.

Investing shouldn't be a gauge of just the price as we look for bargains. Nor should it be a consideration of just the business, as Buffett has also argued that "a business with terrific economics can be a bad investment if the price paid is excessive."

Berkshire Hathaway has been so successful is because Buffett considers both the business and the price. Only by gauging the prospect of the business and the relative price can we determine the true value of the investment.

And when we do this, we'll inch closer to realizing the same success Warren Buffett has had.

Warren Buffett's $48 Billion Treasure Chest

By Patrick Morris

"We customarily keep at least $20 billion on hand so that we can both withstand unprecedented insurance losses ... and quickly seize acquisition or investment opportunities, even during times of financial turmoil."

— Warren Buffett, 2010

Warren Buffett has shown us much through the nearly 50 letters he's written to **Berkshire Hathaway** shareholders through the years. But it turns out one thing we quickly forget are the remarks above he wrote in 2010, which show us how strongly he clings to the power of cash.

Times of prospering

Much has been made of the "elephant gun" analogy Buffett has used to describe the acquisitions Berkshire Hathaway may make. In 2010 he said of the future success of Berkshire Hathaway:

We will need both good performance from our current businesses and more major acquisitions. We're prepared. Our elephant gun has been reloaded, and my trigger finger is itchy.

Even after Berkshire bought a 50% stake in **Heinz** for $12.1 billion in 2013, Buffett noted he and Charlie Munger still "search for elephants" as they seek businesses which will cost them between $5 and $20 billion. And when you consider Berkshire had more than $48 billion in cash on hand at the end of the year, he may be on the lookout for more than one elephant.

And Buffett doesn't only use his cash when times are good –the S&P 500 was up 33% in 2013 – but also when times are troubling as well.

In the 25 days after Lehman Brothers collapsed in 2008 Buffett made $15.6 billion in investments.

Later, after the stock of **Bank of America** fell nearly 40% during the first 23 days of the month, Buffett poured more than $5 billion into in August 2011. To say nothing of the dividends which have been collected, Buffett's return has already doubled.

With that in mind, it's no wonder Buffett said this year:

Indeed, tumbling markets can be helpful to the true investor if he has cash available when prices get far out of line with values. A climate of fear is your friend when investing; a euphoric world is your enemy.

But the thing to know about the cash Buffett insists on holding is the reality he doesn't only use it prosper Berkshire Hathaway, but he knows cash can be used to prosper *and* protect Berkshire Hathaway.

Times of protection

The critical word to see in Buffett's quote surrounding the $20 billion in cash is "both," as that cash is used for two critical things. It isn't intended to just allow Berkshire to "quickly seize acquisition or investment opportunities," but also to protect it from "unprecedented insurance losses."

While we may not face the prospect of "insurance losses" like Berkshire does – it paid $3 billion as a result of the disastrous Hurricane Katrina – in our lives we too will face moments and seasons in which unexpected major costs arise.

We can take steps to ensure we live in ways that are safe and the likelihood of incredible fiscal losses are minimized, but as Buffett's grandfather said, there are "a great many people who at some time or another have suffered in various ways simply because they did not have ready cash."

This is why emergency savings – three to six months' of living expenses – is so critical if something simply *happens*. Whether it be an annoyance like a heater breaking, a distressing job loss, or a devastating health tragedy, Buffett provides an important example of someone who forsakes potential benefits to make sure safety is guaranteed.

With any major financial decision, consider the costs and benefits. And while the cost of missing out on possible gains from unmade investments is real, the benefits of rainy day savings are so much greater.

And maybe if we're lucky, we'll have enough cash to be like Buffett, who has been able to protect and prosper, when times are both good and bad.

The Reason Warren Buffett and Berkshire Hathaway Inc. Made This $15 Billion Energy Bet

By Patrick Morris

This "what-will-they-do-with-the-money" factor must always be evaluated along with the "what-do-we-have-now" calculation in order for us, or anybody, to arrive at a sensible estimate of a company's intrinsic value. That's because an outside investor stands by helplessly as management reinvests his share of the company's earnings. If a CEO can be expected to do this job well, the reinvestment prospects add to the company's current value; if the CEO's talents or motives are suspect, today's value must be discounted. The difference in outcome can be huge."

— Warren Buffett, 2010

Warren Buffett recently revealed that **Berkshire Hathaway** has "poured billions and billions and billions of dollars" into his energy business and said "we're going to keep doing that as far as the eye can see."

For $2 billion in 1999, Berkshire Hathaway acquired a 76% stake in MidAmerican Energy, which it just renamed to Berkshire Hathaway Energy a few months ago. At the time Buffett said:

We buy good companies with outstanding management and good growth potential at a fair price, and we're willing to wait longer than some investors for that potential to be realized. This investment is right in our sweet spot.

And when discussing the acquisition in the annual letter to Berkshire Hathaway shareholder, he added:

Though there are many regulatory constraints in the utility industry, it's possible that we will make additional commitments in the field. If we do, the amounts involved could be large.

Just this year, Buffett said, the business will have made investments totaling $15 billion in its renewable energies portfolio that and perhaps *another* $15 billion could be made in the years to come. There's no denying that Berkshire's "additional commitments" have been "large."

But when you consider that these investments came from the same man who once said his preference was to find businesses that require "a minimum of new capital investment," questions surrounding the massive investments begin to rise.

But the aforementioned Buffett quote provides a helpful clue to why the investment has been so big.

The huge difference in outcome

The quote found at the top of the article was made in the 2010 letter to shareholders.Buffett wants us to see that smart investors consider the "what-will-they-do-with-the-money" factor when making an investment in a business.

A company can really only do only five things with the money it earns: invest in existing operations, acquire other businesses, pay down debt, buy back shares, or issue dividends. And of course, how well companies allocate their capital is the critical wheel that drives the return shareholders see.

And as it relates to Buffett, he prefers to invest in his own business or acquire other businesses.

So why is he pouring all this money back into his energy business instead of acquiring others?

Not only does he believe that this "reinvestment" will "add to the company's current value," but early evidence indicates that it already has, and as a result, the "difference in outcome" was "huge."

The reason for the reinvestment

Buffett had an almost identical paragraph in both the 2012 and 2013 letters to shareholders that read:Our confidence is justified both by our past experience and by the knowledge that society will forever need massive investments in both transportation and energy. It is in the self-interest of governments to treat capital providers in a manner that will ensure the continued flow of funds to essential projects. It is meanwhile in our self-interest to conduct our operations in a way that earns the approval of our regulators and the people they represent.

And when asked why MidAmerican Energy continues to pour money into its operations at the latest meeting for shareholders, its CEO provided a remarkable bit of insight:

Generally we are the lowest-cost provider. We rarely have rate increases. Thus, regulators are very supportive of our projects.

At its core, the investments made by Berkshire Hathaway have been used to satisfy customers and regulators, the two essential groups that dictate the success of its energy operations.

What this all means to investors

I know what you may be thinking: This sounds great in theory, but how has it all worked out in practice, and what does it mean to the bottom line at Berkshire Hathaway?

A simple calculation of pre-tax earnings over revenues reveals that since 2009, profit margins have risen from 13.4% to 14.2%, netting an extra $100 million to Berkshire's bottom line.

In this, we can learn that Buffett may have been wrong – or at least misleading – as it's not just customers and regulators that should be happy with these investments. Berkshire Hathaway shareholders need to be happy as well.

The 2 Things Warren Buffett Would Never Spend a Dime On

By Patrick Morris

Investors focus a lot of attention on what Warren Buffett buys through **Berkshire Hathaway**. But it can be equally as informative to understand what he *doesn't buy*.

The two scary investments

In his 2011 annual letter to Berkshire Hathaway shareholders, Buffett devoted nearly 2,000 words of commentary in a section named "The Basic Choices for Investors and the One We Strongly Prefer."

What were those choices?

- "currency-based investments," which included deposits, money market funds, and also, more broadly, bonds
- physical assets, like gold, that don't make anything on their own
- assets that produce things, like "businesses, farms, or real estate."

So which two did Buffett suggest were dangerous and that he would avoid – and suggested that we should, too?

The currency-based assets and the nonproductive ones. And it wasn't even close.

The danger of currency

Buffett said that while the safety of investments in things like bonds are often lauded – U.S. Treasury bonds had a yield of 5.7% since he took the helm at Berkshire 47 years ago – he suggested that in reality "they are among the most dangerous of assets." The principal concern

is inflation, the reality that with almost every passing day, little by little a dollar loses its value. In the letter Buffett said in the same 47 years, the value of a dollar had fallen by a stunning 86%, meaning that "it takes no less than $7 today to buy what $1 did at that time."

A bond – or an investment like it – would need to return 4.3% just to maintain its purchasing power over that time. And while government bonds averaged a 5.7% yield, it's critical to remember that was *pre-tax*. As a result, an investor who fell in the 25% tax bracket would've lost the remaining 1.4% in tax payments.

All of this is to say that the return would've effectively been nothing.

While Buffett suggested there are times when investing in bonds made sense, he also believed "right now bonds should come with a warning label."

Buffett concluded his commentary on bonds by adding:

Today, a wry comment that Wall Streeter Shelby Cullom Davis made long ago seems apt: "Bonds promoted as offering risk-free returns are now priced to deliver return-free risk."

The hazard of gold

Moving beyond bonds, the second type of asset Buffett cautions against are those "that will never produce anything, but that are purchased in the buyer's hope that someone else – who also knows that the assets will be forever unproductive – will pay more for them in the future."

The principal one is gold. And the value of gold, and those "investments" like it, is that its value isn't determined by what it can capably produce or yield, but instead an investor hopes that someone will simply be willing to pay more for it in the future.

In Buffett's words:

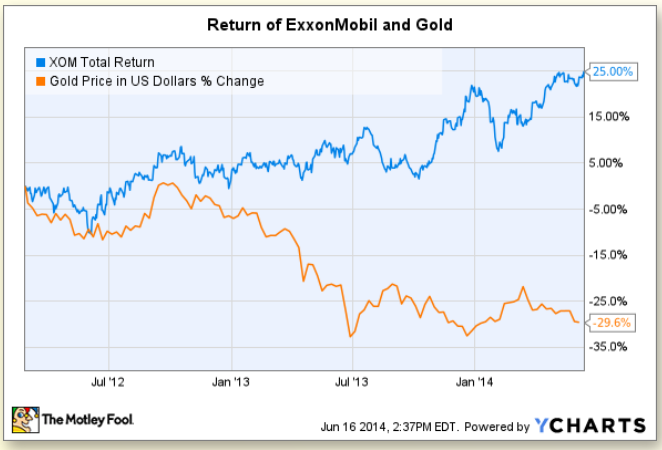
This type of investment requires an expanding pool of buyers, who, in turn, are enticed because they believe the buying pool will

expand still further. Owners are not inspired by what the asset itself can produce – it will remain lifeless forever – but rather by the belief that others will desire it even more avidly in the future.

Buffett goes on to contrast the value of every ounce of gold on the planet – worth $9.6 trillion in total – against an investment in every acre of cropland in America and 16 – yes, sixteen – **ExxonMobil**s, which would amount to $8.6 trillion.

Given that perspective, he suggests no one would sensibly select the gold – which would fit inside a baseball infield – against every acre of farmland and an investment in 16 ExxonMobils.

And based on the return of ExxonMobil versus gold since the letter was written in February 2012, it's tough to disagree with him:



The adoration of businesses

With all that in mind, it should come as no surprise Buffett explains why investing in productive assets is so fundamental and valuable. Unlike the first two, their value isn't predicated by what people are willing to pay for them in times of booms and busts, but instead an ability to create valuable goods or services people desire.

No matter how the underlying value is determined, Buffett suggests that "people will forever exchange what they produce for what others produce."

He concludes by saying:

Berkshire's goal will be to increase its ownership of first-class businesses. Our first choice will be to own them in their entirety – but we will also be owners by way of holding sizable amounts of marketable stocks. I believe that over any extended period of time this category of investing will prove to be the runaway winner among the three we've examined. More important, it will be by far the safest.

Buffett wants us to see that investing in first-class business won't only deliver the best returns, but it will also provide the least risk.

Warren Buffett Bought This Company for $25 Million. Now It Makes Nearly $100 Million Every Year

By Patrick Morris

"Buy commodities, sell brands" has long been a formula for business success. It has produced enormous and sustained profits for Coca-Cola since 1886 and Wrigley since 1891. On a smaller scale, we have enjoyed good fortune with this approach at See's Candy since we purchased it 40 years ago." –Warren Buffett, 2011

Warren Buffett wants us to see that the formula for a business's success isn't difficult to understand. But it's mighty hard to do.

Berkshire Hathaway invested in **Coca-Cola** in the late 1980's and finally stopped buying shares in 1994. Since then the value of Coca-Cola has more than tripled, as Buffett saw his position – which cost $1.3 billion – grow from being worth $5.1 billion at the end of 1994 to $16.5 billion today.

Coca-Cola has made Berkshire Hathaway a lot of money, but Buffett's "dream business" of See's Candy has been wildly more profitable. Not surprisingly, the "formula for business success" mentioned above – which Buffett said in 2011 – has been the same for both.

Source: Flickr / Bob n Renee

The little business that could

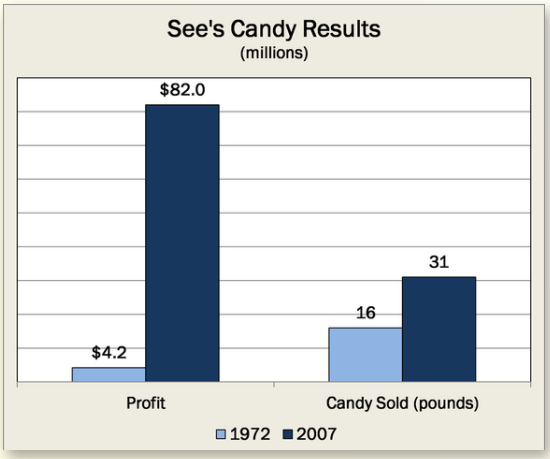
Berkshire Hathaway bought See's Candy for $25 million in 1972, the year it had roughly $30 million in sales and brought in $4.2 million of profit. As a result of its small size, we can't track its results over the decades, but 35 years later, in 2007, Buffett noted sales had risen nearly 13 times to stand at $383 million.Even more impressive, Buffett revealed profits were up nearly 20 times and stood at $82 million. That means Berkshire now earns nearly three times the cost of its original investment *each year*.

But perhaps what is even more remarkable is that, in 2011, Buffett said See's had brought in a staggering $1.65 billion in total profits since he bought it 40 years ago.

So how has See's been so successful? Let's see what Buffett has to say.

Buy commodities

In 1972, See's sold 16 million pounds of candy, and 35 years later, it stood at 32 million, meaning it gained just 2% a year, but it's profit rose by 9% a year:



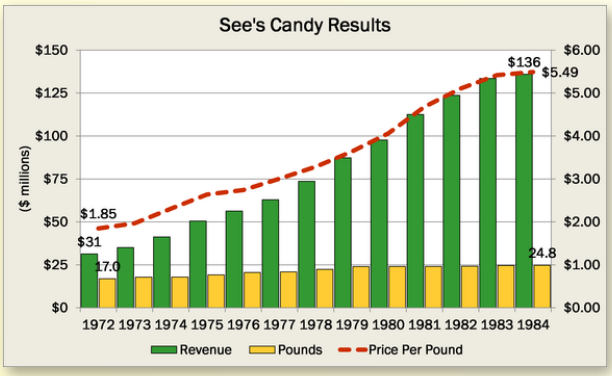
Source: Berkshire Hathaway Annual Letters

So how'd See's do it? It's easy to think it made massive investments to boost sales. But Buffett revealed, in that 35-year period, only $32 million worth of money had been put back into See's. Instead, Berkshire Hathaway benefited as Buffett "used the rest to buy other attractive businesses."

The reason behind this is simple. At its core, See's is a commodities business. It sells products made from peanuts, sugar, chocolate, and more, and it can raise its prices little by little with each passing year. While what it costs to buy the ingredients used to make the candy will rise, it has the ability to continuously raise its prices too.

In 1972, it sold 17 million pounds of candy, and by 1984, that number had grown to 25 million pounds, a gain of roughly 50%. Yet it went from having $31 million in revenue to $136 million, an increase of 333%.

How did it do it? Little by little, it raised its price per pound:



Source: Berkshire Hathaway Annual Letters

Of course, these 12 years saw major inflation, but the thing is, even after factoring that in, if prices had stayed the same, the $1.85 per pound of See's Candy in 1972 should've cost $4.60 by 1984. Yet instead

it stood at $5.49 per pound, showing how much of an advantage operating in a commodity business can be.

As a result, the growth in profits was the most impressive result, jumping by 540%, from $2 million to nearly $13.5 million.

Sell brands

Operating in a commodity business can be treacherous if that's the only thing going for it. But See's not only had favorable underlying business dynamics, but it had a powerful brand that allowed it to slowly raise its prices and boost its profitability year after year.

In Buffett's own words, when they bought it in 1972:

What we did know was that they had share of mind in California. There was something special. Every person in California has something in mind about See's Candy and overwhelmingly it was favorable...If we can get that in the minds of people, we can raise prices.

Investing in an industry that has favorable dynamics can seem like the key to success. But in the case of See's Candy, countless other candy firms have fallen by the wayside.

Buffett wants us to know the key to success for any business – whether it's one we've started or one we're investing in – isn't just the opportunity for profits, but a strong brand to ensure they're realized.

How Warren Buffett's Luck Changed

By Patrick Morris

Warren Buffett has taught us countless things through the years resulting from his major acquisitions. But one company that made his luck change reveals all we need to know about where we put our money.

The major purchase

Warren Buffett of **Berkshire Hathaway** has long made known his desire "buy a wonderful business at a fair price," and 2012 was one year where he was disappointed about his progress. Yet, that changed quickly as the calendar turned to 2013. In conjunction with private equity firm 3G Capital, it was announced on Valentine's Day

that the firms had partnered to buy Heinz in a deal that valued the beloved food company at $28 billion.

When the deal was made, Buffett said:

"Heinz has strong, sustainable growth potential based on high quality standards, continuous innovation, excellent management and great tasting products. Their global success is a testament to the power of investing behind strong brand equities and the strength of their management team and processes. We are very pleased to be a part of this partnership."

By the time the dust settled, and the official terms of the agreement were finalized, Berkshire had a 50% stake in Heinz worth $12.25 billion. The $28 billion figure contained the bonds and other debt it has outstanding, which included an $8 billion stake in preferred stock that pays a 9% dividend. With that in mind, it's no wonder Buffett was "pleased" with the purchase.

But the natural question becomes, why exactly did Buffett make Heinz his second-largest acquisition, trailing only the $44 billion purchase of railroad Burlington Northern Santa Fe?

Buffett once remarked:

"Buy commodities, sell brands' has long been a formula for business success. It has produced enormous and sustained profits for Coca-Cola since 1886 and Wrigley since 1891. On a smaller scale, we have enjoyed good fortune with this approach at See's Candy since we purchased it 40 years ago."

At first glance, it's easy to see how Heinz clearly fits into the prototypical mold mentioned above. In fact, Buffett himself noted the brand first in his prepared statement. But the critical thing for investors to see isn't only the power of strong brands, but his second point, which is the power of strong management.

"The strength of their management team"

Buffett is considered – rightfully so – as a "value investor," who is keenly aware of the price he is paying for any business. Yet, one of

the things that often goes undiscussed is his careful consideration of the folks atop the businesses he invests in.

In his 2007 letter to shareholders, when he discussed how he carefully considered investments, he himself showed price actually fell behind management when evaluating companies: "Charlie [Munger] and I look for companies that have a) a business we understand; b) favorable long-term economics; c) able and trustworthy management; and d) a sensible price tag."

This is important to remember because reviewing Buffett's lengthy discussion on why he made the Heinz deal reveals that much of it focuses on the strength of Heinz itself; but he also praises the management team at 3G Capital.

Consider his quote on CNBC when discussing the purchase:

"Well, we always prefer to buy businesses, and that's what we consider Heinz to be. Well, we'll – we'll be in Heinz forever and – if a few of our partners decide to sell out at some point, I hope they sell to us. So, this – this – you know, we – we'd like to buy – we'd like to have bought 100 percent of Heinz, but we – we love the idea of Jorge Paulo Lemann being our partner. So – if it takes 50 percent of the equity to bring him in – that's fine with us."

In effect, Buffett is saying the business and economics of the deal were absolutely something he approved of, but he was happy to reduce his stake thanks to the strong management offered by 3G Capital. He even went on to say in the six-hour 2013 question-and-answer session with Berkshire shareholders: "Charlie and I paid more than if we were doing the deal ourselves because Jorge Paulo Lemann is a great manager, because he's so classy, so we stretched a little. I like the business."

So does this mean we should only look for strong management? As you might suspect, Buffett thoroughly refutes that notion, too. In 2007, when he remarked about the four things he looks for, he went on to say:

Additionally, this criterion eliminates the business whose success *depends* on having a great manager. Of course, a terrific CEO is a huge asset for any enterprise, and at Berkshire we have an abundance of these managers. Their abilities have created billions of dollars of value that would never have materialized if typical CEOs had been running their businesses. But if a business requires a superstar to produce great results, the business itself cannot be deemed great.

We must see both the critical distinction between management and manager, as well as the reality any company with command of a singular point on Buffett's checklist – sensible business, strong economics, capable management, and a reasonable price – doesn't mean it's a great investment.

As it relates to management, although Buffett once said, "it's hard to overemphasize the importance of who is CEO of a company," we must see Buffett has highlighted the management *team* of 3G – including the "talented associates" of Heinz's new CEO Bernardo Hees, as well as its Chairman Alex Behring – not just Lemann in isolation. So we cannot only focus on the ability of one singular manager.

And we must also remember that even an easy-to-grasp, great business with strong management like Heinz isn't a great investment if it is overvalued, as Buffett has also said, "a business with terrific economics can be a bad investment if the price paid is excessive."

The key distinction

So with all that in mind, the natural question of course becomes, just how well is the new management at Heinz doing? As Brooklyn Investor reveals, after excluding for various costs associated with the acquisition, the team at Heinz "increased operating earnings 47% in less than a year."

That is to say, Buffett clearly evaluated both Heinz as a company, as an investment and as an organization run by individuals remarkably well.

The reality is, at times we can so easily be trapped into thinking just one of Buffett's key considerations when making an investment is worthwhile, but we must see there is a delicate balance of all four. And when we make the right decisions with the four of those, we too can find a Heinz, or if we're lucky, two or three or ten.

The Truth Behind Warren Buffett's Billion-Dollar Railroad Bet

By Patrick Morris

Railroads break down. They cost billions to maintain. Questions about their future abound.

Yet in 2009 Warren Buffett decided to make an "all-in wager on the economic future of the United States," as **Berkshire Hathaway** acquired railway **Burlington Northern Santa Fe** (BNSF) for $44 billion.

And in this major move we can see one critical truth that is often undiscussed when we consider where Warren puts his money.

The massive costs

Take a step back and consider in 2007 Buffett revealed his "dream business," See's Candy, required investments worth $32 million in total over the previous 35 years. But in "the meantime" its earnings came in at $1.4 billion. He went on to say:

Source: Flickr / Greg Gjerdingen

> It's far better to have an ever-increasing stream of earnings with virtually no major capital requirements. Ask **Microsoft** or **Google**.

BNSF touts last year it made "a record $4 billion" in capital investments and it expects to make another $5 billion this year.

You'd be hard-pressed to say $9 billion spent over two years would describe a business as having "virtually no major capital requirements."

So has Buffett contradicted himself? Has he lost his touch?

The answer, of course, to both of these questions, is no. As it turns out, Buffett's billion-dollar bet in BNSF has been a stroke of pure genius, and the quote in the picture above from his mentor Benjamin Graham helps explain why Berkshire Hathaway is poised to reap billions from its investment.

The intelligent investment

Let's revisit the words of Buffett's mentor, which Buffett reminded us of this year:

Investment is most intelligent when it is most businesslike.

Buffett loves cheap stocks, but he has also said, the price is simply "what you pay."

There are always stocks which are deemed to be trading at discount. For example at the end of 2005, **Radio Shack** was trading at a staggeringly low 9.4 price-to-earnings ratio whereas the **S&P 500** ratio nearly doubled it, hovering at 18. A simple glance would say it's a worthwhile buy when considering only the relative price.

Yet since then, even with the Great Recession, the S&P 500 has delivered a total return of nearly 90%, but the price of Radio Shack has plummeted nearly 95%, from $17.78 to $1.38. Radio Shack offered a compelling price, but the underlying business was bound to fail.

Price was surely a consideration when Berkshire Hathaway bought BNSF, what Buffett really clung to was the *business* prospects offered by the railway. In 2010, Buffett described why he and Charlie Munger were excited about the future of BNSF, noting:

Both of us are enthusiastic about BNSF's future because railroads have major cost and environmental advantages over trucking, their main competitor. Last year, BNSF moved each ton of freight it carried a record 500 miles on a single gallon of diesel fuel. That's three times more fuel-efficient than trucking is, which means our railroad owns an important advantage in operating costs. Concurrently, our country gains because of reduced greenhouse emissions and a much smaller need for imported oil. When traffic travels by rail, society benefits.

Buffett didn't make the investment simply because the price was attractive. In fact, there's no mention of it. Instead, he saw the business offered by BNSF both was, and is incredibly valuable.

Since 2011, its revenue has grown by 13% to $22 billion. And its net earnings growth is even more impressive, rising by nearly 30% to $3.8 billion.

But it isn't just the bottom and topline results which are eye-opening. Buffett also noted in the 2010 letter; "A little math will tell

you that more than 11% of all inter-city ton-miles of freight in the U.S. is transported by BNSF. Given the shift of population to the West, our share may well inch higher."

And this year, he revealed he was *exactly* correct about its market share being able to "inch higher," as it stood at nearly 15% of all inter-city freight.

The price was compelling, but clearly the business – like that offered by See's Candy – was even more captivating.

The key takeaways

Does this mean Buffett suggests we should blindly make an investment simply because a company has a great businesses? Of course not, for Buffett himself has said, "a business with terrific economics can be a bad investment if the price paid is excessive."

What we must see when we make an investment, it that we shouldn't think we're simply buying a stock, but instead a business. And we must try to determine the relative value of both.

In Buffett's own words:

In the end, what counts in investing is what you pay for a business – through the purchase of a small piece of it in the stock market – and what that business earns in the succeeding decade or two.

Ultimately, we're buying businesses. Not stocks.

Warren Buffett's Billion-Dollar Gift That Keeps On Giving

By Patrick Morris

Warren Buffett has a business that has made him billions throughout the years, but the surprising secret to its success is simple.

Berkshire Hathaway fully acquired Geico in 1996, but Buffett's history with the insurer dates long before that.

The storied history

Buffett's history with Geico dates to when he was a student under his mentor Ben Graham. When he was just 20 years old in 1950, he learned Graham was the chairman of Government Employees Insurance Co., or Geico as we like to call it.

Shortly thereafter, Buffett decided to make a visit to the Geico headquarters on a Saturday afternoon. He happened to meet Lorimer Davidson, or "Davy," who proceeded to spend the next four hours telling him about not only Geico the company, but also about the insurance business in general.

When you consider Buffett has used insurance to propel Berkshire Hathaway into unimaginable success, it's no wonder he called that Saturday his "lucky moment."

And while he first began investing in Geico shortly thereafter, the biggest moves came after he built the Berkshire Hathaway empire we know it as today.

Through Berkshire Hathaway, Buffett began to aggressively acquire Geico as its stock price plummeted nearly 95% in the 1970s, after Davy – who became CEO seven years after Buffett met him – retired and troubles assailed it. As a result of his willingness to hold on to the company, the owner-ship of roughly one-third of Geico that cost $46 million would ultimately translate to a 50% stake. And Buffett bought the remaining half of Geico in 1995 for $2.3 billion.

A little back-of-the-envelope math reveals the original $46 million investment therefore represented a return of 5,000% over 20 years.

And considering Geico brought in $1.1 billion of underwriting profit just last year, it should come as no surprise that Buffett once said that *"when I count my blessings, I count Geico twice."*

The gift that gives and gives

In the less than 20 years Berkshire Hathaway has controlled Geico, the popular insurer has seen incredible growth. When it was first

acquired, it controlled just 2.5% of the market and had $2.6 billion in of policies. At last count, its market share now stands at 10.2% and its premiums have risen to a staggering $18.6 billion.

So how has Geico managed to have such remarkable success? Let's re-examine Buffett's quote from his most recent letter to Berkshire Hathaway shareholders:

No one likes to buy auto insurance. But almost everyone likes to drive. The insurance needed is a major expenditure for most families. Savings matter to them – and only a low-cost operation can deliver these.

The first thing we can see is that Geico offers a product to its customers that isn't simply something they want, but instead it's something they *need*. Unlike companies in areas like the clothing industry, it doesn't have to concern itself with worries about not keeping up with the latest market trends or falling victim to the mysterious and often fickle tastes of consumers. Instead, it provides a product that its customers, by law, must have.

Buffett also understands people will always seek the lowest prices. Or as the woman who founded Nebraska Furniture Mart taught him, "[I]f you have the lowest price, customers will find you at the bottom of a river."

But good investments aren't just made by finding businesses that meet those two qualities. The true key to success at Geico is the ability of its management – including often-praised CEO Tony Nicely – to ensure that it operates efficiently and in a cost-effective way.

Consider Buffett's quote from nearly 30 years ago in 1986:

The difference between Geico's costs and those of its competitors is a kind of moat that protects a valuable and much-sought-after business castle.

In 1995, after it had been purchased entirely, Buffett added:

But the ultimate key to [Geico's] success is its rock-bottom operating costs, which virtually no competitor can match.

In addition, after Geico significantly lowered its costs while boosting its productivity in 2005, Buffett said:

When we drive unit costs down in such a dramatic manner, we can offer ever-greater value to our customers. The payoff: Last year, Geico gained market share, earned commendable profits, and strengthened its brand.

Low costs don't just characterize the policies Geico offers to its customers, they extend to its corporate operations as well. Geico's ability to effectively manage its own costs and in turn deliver those savings to its customers has allowed it to have such astounding success.

When looking for stocks to buy, we can't just look at the external things a company offers to its customers, but we, too, must consider the ability of its management to ensure it's run in a way that is efficient and in turn delivers results to its shareholders as well.

And when we find companies that deliver on all of these fronts – providing customers essential products at low costs while being run by remarkable management in an efficient way – we, too, will find investments that end up being, as Buffett once described Geico, "the gift that keeps on giving."

Authors

Adam Levine-Weinberg is a senior Industrials/Consumer Goods specialist with The Motley Fool. He is an avid stock-market watcher and a value investor at heart. He holds a BA in Political Science from Swarthmore College and an MA in Political Science from the University of Chicago, and lives in New Haven, Connecticut

John Maxfield is a writer and senior bank specialist with The Motley Fool, where he's authored over 2,000 articles on a wide range of topics. In addition to being regularly featured on fool.com, his work has been syndicated to USA Today and AOL's Daily Finance, among other places, and cited by prominent financial commentators. John graduated with honors from Southern Methodist University's Dedman School of Law and received a bachelor's degree with honors in economics from Lewis and Clark College.

Isaac Pino is a writer and manufacturing specialist with The Motley Fool, where he's penned hundreds of articles on a wide range of topics. In addition to writing for fool.com, he's made guest appearances on PBS Nightly Business Report, CNBC, and Fox 5 News DC. Isaac completed his undergraduate and graduate degrees in accountancy at the University of Oklahoma. He is a licensed CPA in Texas.

Patrick Morris After stints in banking and corporate finance, Patrick joined the Motley Fool as a writer principally covering the financial sector. Always a fan of things that provide great value – not necessarily things that are simply cheap – he's been quite thankful for Warren Buffett's willingness to share his insights on how to find value in investments. Patrick attended college at the University of South Carolina majoring in Finance and Economics where he was a YoungLife leader and a writer for student newspaper covering Gamecock football and the national champion baseball team. He currently lives in Richmond, Virginia.