How to invest like Warren Buffet

By Gavin Ross. Chairman of Gavin Ross & Co Pty Ltd

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PORTFOLIO MANAGEMENT

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1. Buy Value
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3. Invest from a business perspective
4. Invest for the long-term
5. Ignore the market

There are probably few investors in Australia who don't recognise the name Warren Buffett. Whether it's his investment record of earning about 20 per cent a year for 50 years; his plans to donate more than $A75 billion to philanthropic causes via the Bill and Melinda Gates Foundation, or his recent decision to marry his long-standing lady companion, Buffett is rarely far from the news.

And who wouldn't feel just a little envious? He started out in May 1956 with $105,000 and today his company Berkshire Hathaway has its shares selling at around $200,000 each. Anyone who invested $10,000 in his group in 1956 would now have an invested worth of $680 million. No wonder 45,000 people went to his group's annual meeting this year to see and thank the man who has made many of them millionaires.

Today, Buffett is ranked as the second richest person in the US, after his good friend Microsoft founder Bill Gates. And yet to some, Buffett is an apparent enigma. With all his riches, he chooses to continue living in his home town of Omaha, Nebraska, in his original, modest house. Not for him an elaborate ceremony and reception for his recent wedding: it was held in his daughter's home and they celebrated at the local outlet of a seafood restaurant chain.

So there are clear indications that this is a very different man, unfussed by wealth or position who, despite his riches, is paid only $100,000 a year by Berkshire Hathaway and reportedly is the only billionaire who prepares his own tax return.

People like Warren Buffett and Bill Gates have re-defined the term millionaire. We talk about billionaires and toss around amounts like $1 billion, but most people don't have any idea of what $1 followed by nine noughts really means.

A fellow Omaha resident and stockbroker, George Morgan puts it this way: "A man gave his wife $1 million to spend at the rate of $1000 a day. In three years she returned for more. So he gave her $1 billion- and she didn't come back for 3000 years".

There's a story told by Buffett biographer Andrew Kilpatrick that in the mid 1980s, on his way into his office, Buffett noticed a one cent piece on the floor of the lift. None of the others bothered about it but Buffett reached down and picked it up. To the passengers, stunned that a billionaire would bother, Buffett chuckled and said: "The beginning of the next billion".

So how do we come to grips with such a man? Dozens of books and hundreds of articles have been written about Buffett, attempting to discover his investment philosophy. In fact, there are probably two parts to Buffett's success.

The first is a longish list of investment rules and ideas, plus dozens of his aphorisms.

Perhaps the best-known are his two concrete rules for those seeking to become rich:

> Rule No 1, never lose money.
> Rule No 2, never forget Rule No 1.

The second part of his success, however, is his attitude and state of mind as an investor. While Buffett also has given plenty of advice on this, it almost certainly requires the sort of intelligence and experience he has acquired in more than 60 years of practical, high level investing.

I've spent 30 years operating my business, attempting to invest like Buffett. So here is my view of Buffett's investment principles.

First principle

Buffett's first principle, adapted from his first teacher, Benjamin Graham, is that investors should buy shares with "a margin for safety" – that is, they should only buy a share where the market price is less than the stock's intrinsic value.

This means investors have to determine the real, current day value of the business. This is the hard part, because the intrinsic value of a business is the discounted present value of all cash that can be taken out of the business during its remaining life. Estimating future cash returns is difficult (and you need to apply mathematical techniques).

In analysing a business you need to consider the following:

Enduring competitive advantage

You need to determine the competitive advantage of a business and above all, the durability of that advantage. Most businesses are commodity businesses selling similar or identical products which inevitably mean low returns. What you want is a business with a strong franchise – a big castle with a wide moat. Sources of competitive advantage are a unique product, brand loyalty and being the low cost producer in an industry.

Return on capital

Long-term capital growth is very much a function of the compounding of retained earnings, so only invest in high return businesses. Returns on incremental capital are the key.

Management

Businesses and countries succeed because of one person who leads the way. The CEO is your business partner, so assess him or her on this basis. Buffett looks for three qualities: integrity, intelligence and energy and if you don't have the first he says, the other two will kill you.

Read

Buffett says he spends an inordinate amount of time reading. At least six hours a day. Read raw data (Buffett reads "hundreds of annual reports every year"), not analyst's summaries. Trust your own eyes.

In all this, investors have to remember one more thing: you are buying a business, not just a share. Buying a share means you become part owner of a business and, if the business does well, you do well. It's as simple as that – and Buffett says this mindset is fundamental to his success.

The alternative (and usual) approach is to look at your investments simply as stocks, as bits of paper that squiggle around on the stock exchange. So we see investors becoming fixated on daily price movements, on volatility and supposed patterns in charts. But investment is most intelligent when it is business-like.

Invest for the long term

Buffett likes to say that his favourite holding period is forever and that he wouldn't be upset if the stock market was closed tomorrow and did not reopen for five years. There are not that many great businesses in the world so when you find one, hold on to it.

When you invest long-term you focus on the essential business issues that really matter. The ever present market hype becomes irrelevant.

Focus or diversification?

Buffett, as a professional investor, has a very focused view on a portfolio, and departs from the usual approach of seeking the protection of diversification by spreading a portfolio.

He defines diversification as “protection against ignorance”. His view is that you reduce risk by investing in what you know a lot about.

If you are a know-nothing investor, diversification is fine, he says. But if you are a know-something investor, you’ll make more money by concentrating on your top picks.

At Gavin Ross & Co we have a 10/10 rule – if we can’t convince ourselves to invest a minimum of 10 per cent of our net worth for a minimum of 10 years, we don’t invest because the business must be too risky.

There aren’t too many great businesses in the world so, if you find one, it pays to concentrate on it. Why invest in stock No. 20 when stock No.1 is your first choice?

Wait for the fat pitch and then swing

Using a baseball analogy (Buffett is a part owner of the Omaha Royals baseball team); he says investors should be patient and wait for the “fat pitch” rather than swing wildly at every ball.

But most people are lucky if they find one really outstanding investment during their life – a Microsoft or a Berkshire Hathaway. His rule is: bet big when you have big odds in your favour; otherwise, don’t bet at all.

Incidentally, this is the favourite rule of Buffett’s influential deputy Charlie Munger – and a view shared by several other successful money managers.

Ignore the market

The stockmarket is irrelevant and a distraction. The daily changes in the stock price don’t make you richer or poorer. Only a change in the intrinsic value of the business can do that. Despite this and the fact that the stock price is the least useful information you can track, the market spends most of its time tracking stock prices.

Once you look to the market for advice or believe the market is telling you something, you are in trouble. The market is there to serve you, not guide you. Buffett describes the stockmarket as a manic depressive. He treats it as a partner – Mr Market.

Some days, Mr Market is wildly optimistic and will offer you a high price for your share of the business; other days he swings to pessimism and offers to sell his share at a low price.

You can take advantage of Mr Market or ignore him; the worst thing is to fall under his spell.

The nice thing about Mr Market, Buffett says, is that if you ignore him, he isn't offended and still turns up the next day with a new offer.

Similarly investors should ignore the economy. The truth is that no one knows where the economy will be in one, three or five years.

Consider all the worries in the last few years – the 1987 crash, the Gulf War, the Asian crisis, the Y2K bug, the tech wreck, 9/11, another Iraq war, the global financial crisis, the Euro crisis – and yet business has done well. If you had listened to the dire economic forecasters, you might never have invested and missed out on one of the greatest periods of economic and investment growth in our history.

Welcome volatility

If you follow Buffett, you look on market fluctuations as your friend rather than an enemy and you can profit from the folly rather than participate in it. If you have this attitude, Buffett says you have an enormous advantage over perhaps 99 per cent of other investors.

In volatile times, the market can put irrationally low prices on solid businesses. Buffett says "the sillier the market's behaviour, the greater the opportunity for the business-like investor."

Use common sense

During the technology boom Buffett refused to buy the hot, dot.com stocks that entranced everyone else. His reasoning was simple: he didn't understand a lot of what was being claimed and he only invests "within my circle of competence" – that is, in what he knows and understands. He sticks to simple propositions. This also involves admitting when you don't know something.

Stay rational

One of Buffett's greatest attributes is that he is rational. Temperament is more important than intellect in investment, he says.

Investors shouldn't let their emotions control their mind. The investor's chief problem – and even worst enemy – is likely to be himself.

Avoid over-stimulation from the stockmarket. Knowing what the market did yesterday

doesn't help you make money – but it can hype you up.

Investors also need to be psychologically prepared because anything can happen in the market. Buffett's rule of thumb is that if a 50 per cent decline in the price of your stocks would cause you severe psychological or financial stress, you shouldn't own stocks.

Think independently

Investors need to think for themselves to avoid the herd mentality or "group think." Great investment opportunities come along when excellent companies are surrounded by unusual circumstances that cause investors to mid-price the stock.

Remember, Buffett says, you're neither right nor wrong because the crowd agrees or disagrees with you. You are right because your data and reasoning are right.

Have the courage of your convictions

If you can think rationally and independently, you then need the courage of your convictions and a willingness to act. What else does an investor need? Here's a list: wisdom, judgment, confidence, courage, fortitude, resilience, patience, determination, intensity, energy, willpower, humility, a willingness to risk being wrong (and an ability to acknowledge this) and, equally, an ability to know when you are right – even if you are heading in a different direction to the crowd.

In summary, to invest like Warren Buffett, you need to know how to value a business and how to think about the market. And you need a business gene that knits all of the above principles together.

About Gavin Ross & Co

At Gavin Ross & Co we provide a boutique service to high net worth investors. You are special and important to us, and never one of a crowd. Our dedicated professional staff has been with us for years and you are assured of continuity of service from people you know and who know you.

We are entirely independently owned and operated. We are not linked to any bank, broker, or financial planning institution; we have no conflict of interest or hidden agenda.

We do not charge or accept brokerage or commission. You are therefore assured that our advice, at all times, is strictly in your best interest, and not aimed at generating a commission for us. Our minimum portfolio for management is $1,000,000.

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