LeadershipReview
Robert Heller's
Masterclasses

Warren Buffet 1

# Investing in Stocks

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*Buffett's teachings on investment sound deceptively simple. But there is no deception. They truly are simple. Do not allow investment advisers to persuade you that investment is a complex matter needing great expertise. Instead, learn how to assess the fundamental and financial values of a business yourself, and invest according to your convictions.*

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### IGNORING CONVENTION

To invest well you must be prepared to go against the prevailing wisdom and ignore conventional investment guidelines. So:

- Do not put your eggs in many baskets.
- Do not place small amounts in each basket.
- Do not switch holdings frequently.
- Do not avoid holding cash.
- Do not rely on outside analysis.
- Do not often, act on a hunch.
- Do not follow the crowd.
- Do not watch the market intently.
- Have fixed investment principles.

### CONTRARIAN PRINCIPLES

The conventional approach, Buffett believes, makes it difficult to beat the market and easy to do worse. Increase your chances of finding winning stocks by adhering to Buffett's contrarian principles.

**INVEST IN WINNING STOCKS**

- Invest in no more than five or 10 shares.
- Only buy if you are prepared to put at least 10 per cent of your net worth into the stock.
- Expect to hold your investments for ever.
- Only invest your cash when you can find something worth buying.
- Do your own research - and do it thoroughly.
- Always have sound, well-argued, well-researched reasons for your investments.
- Ignore the market, the crowd, and its fashions.

# 1. Assessing value

*All investors hope to find a bargain. Conventional investors measure value by looking at factors relating to the market, price. Buffett urges you to look only at the fundamental worth of the business.*

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**INVESTIGATING THE BUSINESS**

Valuing a business involves assessing the quality of its customer franchise and management, about which market rating tells nothing.

**VALUING A BUSINESS**

- Make sure you understand the business thoroughly.
- Ask whether the business has consistently increased sales and operating profits over time.
- Determine if it is reasonable to expect this consistent performance to continue into the distant future.

Are you able to rate management's quality? You have a better chance of judging how well a business is run, and its likely future performance, if you focus on firms that are within your personal knowledge - including any that you know well through direct personal contact. Do all the research you can:

- Buy a few shares in any business that interests you and attend the annual general meeting to get a look at the management.
- Read all you can about the business, especially its management, in press clippings, on the Internet, in its annual reports, etc.
- If possible, use its products and services, rate them against competitive products and services, inspect its premises, and test its responsiveness to customers.

**ASSESSING FINANCIAL VALUE**

When you are as confident as possible that the business you have studied has good long-term prospects, you move on to the next stage. How does your assessment translate into financial value? And how does that valuation compare with the market price? Remember that unless the latter is markedly below your judgement of the true, or intrinsic, value, you should not buy.

# 2. Measuring business financials

*Before investing in a business that you judge to have favourable prospects, you must assess whether its true, or intrinsic, value promises you a large enough return on your capital in the longer term. To be sure of your assessment, take Buffett's advice and thoroughly investigate the financial standing of the business before making any decision to buy.*

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### CALCULATING INTRINSIC VALUE

Your self-confidence should be increased by Buffett's insistence that sophisticated financial knowledge is not required. The definition of intrinsic value does rest on a mathematical concept - and there are technicalities involved. Putting them on one side, the basic proposition is simple: compare your proposed stock-market investment, which carries an element of risk, with a risk-free alternative. The argument is as follows:

- A top-rated government bond is as near to a risk-free investment as you will ever find.
- If the annual interest is 9 per cent, its return over 100 years is 900 per cent of a purchase price of 100.
- Unless the shares in an organization can beat this return, they are plainly not worth buying.

So Buffett looks for companies where the net cash coming into the business can be expected to grow, to all intents and purposes for ever, at a percentage appreciably above the interest on long-term government bonds. The difference between these two future streams of money determines the present-day "intrinsic value" of the shares and, therefore, whether they are worth buying.

### PREDICTING FUTURE PROFITS

Buffett always does these calculations before investing. You will see that they rest on prediction, which is always a dodgy business. But you must also turn your favourable view of the company's prospects into hard numbers. What are you actually hoping for, and how realistic is that hope? Buffett's concept carries a powerful lesson you dare not ignore:

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| Always do your sums before investing. |

### FINDING THE FIGURES

Some of the figures that you need to assess a company's financial prospects must be dug out of the published accounts. Buffett seeks the answers to four critical questions:

**FOUR KEY FINANCIAL QUESTIONS**

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

### EARNINGS TO EQUITY RATIO

The first question is the easiest to answer; many companies publish the figure. Equity is the company's capital minus its long-term debt. Divide that into the profits after tax to find the percentage return. This must be significantly higher than the return on long-term bonds. As a rule-of-thumb, a company with a 15 per cent return on equity can be expected to grow its value by 15 per cent per annum.

### SHAREHOLDER EARNINGS

Working out "owner-earnings" means adding to after-tax profits the funds set aside for financial reasons - above all, depreciation. While the company must allow for the eventual replacement of its plant and equipment, etc., the cash is not being spent now. Adding back depreciation, plus the company's share of any profits from interests in other companies, gives you a truer picture of its earning power.

### PROFIT MARGINS

To answer the third question, you need to measure the strength of the company's "franchise" (its customer base) and its business model (in other words, the relationship between its costs and its prices). Look at operating profits as a percentage of sales. Analyze the results carefully; too low a figure (under 5 per cent) is a discouraging sign, while too high a figure (over 20 per cent) could be unsustainable.

### MARKET VALUE

The fourth question is absolutely vital to your overall assessment of the fundamental value of the business. Add back the "retained" profits that were not paid out in tax and dividends over, say, three years. Compare the company's market value at the start of the period with that at the end. Does the difference add up to more than the retained profits? That is the only way in which management can demonstrate its ability to use shareholders' money wisely and well.

### EXERCISING CAUTION

You are of necessity relying on published accounts. Buffett warns that these often contain misleading figures, sometimes deliberately so. Look carefully at the cashflow. If it is heading down when the profit is going up, be very wary. Remember that a company's accounts will nearly always juggle profits upwards rather than downwards. That being the case, discouraging answers to the link:[four key questions] are even more worrying than they seem at first sight.

### BUYING BELOW MARKET VALUE

There is another rule-of-thumb that will help you to evaluate a business. In the case of Mrs. Blumkin and the Nebraska Furniture Mart, Buffett bought a successful business with capable management for substantially less than the value of its annual sales. Unless there is a sinister explanation, a low ratio of market value to sales is an encouraging sign.

## MISLEADING FIGURES

You cannot bank the profits shown in the accounts. You can only bank the cash coming in. If that is less than the cash going out, bankruptcy may result.

Rolls-Royce, Britain's most famous company, announced decent profits year after year, despite heavy spending on aero-engine research and development. The spending, however, was not charged in the accounts against profits, but added to them as "the value of R&D recoverable from sales resulting from existing orders".

The company still had to find the cash to pay for all the R&D. Re-examination of the accounts showed that the cashflow was negative, and Rolls-Royce could only pay the dividend by raising money from the shareholders!

Eventually, the company ran out of cash and just went bankrupt.

# 3. Investment management

*If your research indicates that the shares are available below their intrinsic value, you have a "margin of safety". You can make the investment. Now you have to manage it successfully.*

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**HOLDING STOCKS**

Buffett has no use for investment management in the usual sense: the active buying and selling of shares across a large number of holdings on a day-to-day basis. Rather, he points out the advantages of investing so wisely that you never have to sell a share.

**THE ADVANTAGES OF NOT SELLING:**

– No dealing costs.

– No taxation on your capital gains.

– The magic of compound interest.

The third advantage is the most important in the argument for keeping shares long-term. In The Warren Buffett Portfolio, Robert G. Hagstrom illustrates these advantages by setting out two outcomes from a brilliant $1,000 investment that doubles in value every year:

*** REGULARLY SELLING A WINNING INVESTMENT**

If you sell the shares at the end of the year, pay the tax, reinvest the net proceeds, then repeat the process every year for 20 years, you will have a clear profit of $25,200,000.

*** NOT SELLING A WINNING INVESTMENT**

If you do not sell the shares until 20 years have passed, by the time you do eventually sell, you will end up with a stupendous after-tax profit of $692,000,000.

This, of course, is a fairy-tale exercise. But the principle is absolutely real. Never forget it. Remember "Mr. Market"', who is always ready to buy or sell. You are only interested in him when he wants to sell to you at well below market value or to buy well above it. In the first case, you buy. In the second, you seriously consider taking your profit.