Investing like Warren Buffett

What's behind his investment success?

This perennial topic was the subject of a recent article from *Morningstar©*, the Chicago firm that evaluates mutual funds, stocks and other investment vehicles. What follows is based on that article.

Investing like Buffett implies:

- Looking for economic moats.
- Always having a margin of safety.
- Being patient.
- Never deviating from your strategy,
  despite what others around you are doing.

It also implies acting boldly once you've made a decision; and taking a substantial position in the investment you're making. (Buffett has been quoted as saying that "…diversification is a hedge against ignorance…")

It no doubt helps that Buffett is brilliant and that he studied under famed value investor Benjamin Graham. But his investing style is deceptively simple – so simple that almost everyone misses it.

Economic moats
Buffett requires a company to have a sustainable competitive advantage, or what he calls an "economic moat." That means he looks for companies that are virtually certain to have higher earnings in five to ten years than today. Few companies meet this "virtually certain" criterion.

So, you don't find stocks like Amazon.com or Yahoo in Buffett's portfolio. Those companies may have moats around them today. But no one – not even Buffett – can predict if they'll still have that moat in five to ten years.

What he tries to do is think about the company's business as a whole, not just its financial aspects, to determine whether it will survive indefinitely. He asks questions such as, "Am I fairly certain that this company's existing products will be around in ten or twenty years" and "Does this firm have a unique advantage over others in its industry?" and "Will the health of this industry remain strong in coming decades?"

If the answer to those questions is yes, Buffett will consider the stock. If the answer to any of those questions is no, he moves on to another company.

So there are two components to an economic moat: The competitive position of an individual company within an industry, and the long-term viability of the industry itself. For this reason, it's very difficult for an airline or chemical or automobile company to develop a wide moat – these industries are probably going to get weaker over time, not stronger.

Margin of safety

Finding great companies is just the first step. Buffett realizes that the difference between a great company and a great investment is the price you pay for it. He also realizes that he's human and is prone to making valuation mistakes. To account for this, Buffett uses a technique he calls "margin of safety" which he defines (following his mentor Benjamin Graham) as buying a stock well below his calculation of its "fair value." He does this so that even if he makes a mistake in analyzing a company, he can sell the stock at a higher price than he paid for it.

Buffett says he calculates fair value by estimating the future cash flows of a business and then discounting them back to today. Using discounted cash-flow models, there are companies (like Morningstar) that calculate and publish estimates of fair values for various stocks.

Investing is like gambling, in that both rely on playing the odds. But there's one big difference between gambling and investing Buffett-style. Gambling requires you to make bets in which the odds of winning are less than fifty percent. When Buffett makes an investment, the odds of winning are always greater than fifty percent or he won't invest. He won't always be right, but the odds will always be on his side.

However, just because a stock's cheap doesn't mean Buffett will buy it. He typically avoids "cigar-butt stocks" that are cheap for a good reason: They only have one or two puffs left in them. Lately, he has purchased the debt and equity of companies in bankruptcy, but for most of his career that was not the case.

Patience is a virtue

Buffett figures that as long as he buys companies that meet the first two criteria, their stock prices are almost certain to be higher five or ten years later. And he doesn't mind waiting that long for one of his picks to pan out, provided the company still meets his investment criteria. This has to do with his nontraditional definition of risk.

Most investors, especially professional investors, define risk as volatility (of price). As Buffett sees it, if you're willing to hold a stock for many years, volatility doesn't matter. The only risk is that the stock price will underperform a "hurdle rate" over the next five or ten years. Buffett defines this hurdle rate as a ten percent pretax return, and defines risk as the probability of earning less than this on an investment. Permanent underperformance can occur in two ways: by paying too much for a

stock, or by buying a company that suffers a long-term decline in its economic moat and earnings. Because Buffett is very picky about which companies he assigns wide moats, and buys them only at prices below fair value, he comes close to eliminating the risk of permanent underperformance.

If it's so easy…

So why can't just anyone copy Buffett and beat the S&P 500 Index year in and year out? While many people have the ability to understand Buffett's investment philosophy, very few have the discipline to execute it. Buffett shows an almost superhuman ability to stick with his investment strategy no matter what's going on around him. This ability to think independently and keep emotion out of the investment process is the variable that Buffett copycats have a hard time mastering. The ability to think and act independently may be something that can't be taught, and thus can't be duplicated by many people.

In a nutshell, these four principles are what separate Warren Buffett from anyone else: Investing in companies with wide economic moats, insisting on a margin of safety, holding on to them for long periods of time, and thinking independently of what other investors are doing.

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