Five Lessons from the Master

Human evolution is an amazing process but it has delivered some downsides – particularly for investors.

Take for example how we process information. We regularly slice through limited information and draw quick conclusions to complex questions. Our brains do this by drawing heavily on prior experience. It's great if this experience is based on solid facts; but it leads to some spurious conclusions if it isn't.

Commonly referred to as bias; it's rife in the world of investing.

For proof look no further than the multitude of disparate and often conflicting views held by any sample of investment "experts". What each claims to be definitive investment wisdom is about as consistent as Melbourne's weather.

So, faced as I am now with writing an article on investment principles, I've chosen to play it safe. I'm not claiming the following views as my own, rather as those of a man who investors worldwide acknowledge as one of the most logical and successful investors ever – Warren Buffett.

No! Not Again!

I know what you're thinking – please, no more Buffettisms – I've heard them all before.

Yes, I know that he likes companies with low or no debt, that deliver a high return on equity, that have a "moat" around their business operations (to help protect against the onslaught of competition) and that are run by honest and capable management. Oh – I nearly forgot – and that are also selling for a cheap price.

Yes, just like many of you, I've also read all that stuff in books. But you might be surprised to know that reading it still hasn't stopped me from travelling to Omaha for five consecutive years to attend the AGM of the company that Buffett has led for the past 51 years, Berkshire Hathaway.

It's been well worth clocking up all those frequent flyer points because it's delivered me the opportunity to hear Buffett speak on a variety of investing topics; all up for a total of over 20 hours. It's also allowed me to interact directly with the CEOs of some of Berkshire's fully owned subsidiaries, to meet with friends of Buffett and even to chat with one of his three children.

But the biggest payoff from my visits to Omaha is that it's hammered home the principle that successful investing isn't rocket science. Rather it relies on the consistent application of some basic investment truths. So let's now take a look at five of Buffett's investment truths that the books have devoted few words to:

Patience Grasshopper

Patience is a word that crops up throughout financial history as a characteristic common to the world's greatest investors. At a small Omaha gathering, which I attended a few years back, Buffett's daughter, Suzie, was asked by the gentleman sitting next to me, "What qualities best describe your father? Suzie didn't hesitate in responding: "Integrity and Patience." Buffett has both in spades. He has earned his "patience" tag because money never burns a hole in his pocket. Rather he sits on a large war chest of cash waiting for investment opportunities to come his way. Right now is no exception - Berkshire currently has $US53 billion in "readies" – just waiting for the next opportunity.

It's about effort, not genius

Many imagine that Buffett's success relies on some secret investing technique or some magic valuation formula that only he possesses. Neither is the case. His success relies on application. He has devoted his life to a deep understanding of business models. It means that he can quickly identify opportunities when they arise by drawing on his solid, deep (and logical) knowledge base. It's no different to the success one can attribute to an elite sportsman or entertainer. Observers see the success but never the hard work that led to that success.

It's not the formula that matters; it's the inputs!

As stated, Buffett doesn't possess a secret formula enabling him to come up with better stock valuations than the rest of us. He uses the same formulae as we do. What separates him is the inputs he puts into the formulae. It's also interesting to note that the valuation formulae he uses are simple ones. This is clearly demonstrated by the absence of a computer or calculator on his office desk. Instead his desk is littered with copious volumes of reading material.

Ditch the crystal ball

Many believe that investing success is dependent upon superior powers of prediction. So it might surprise you to know that Buffett ignores the predictions of "market experts". He doesn't employ any economists at Berkshire nor does he pay any attention to those economists that he doesn't employ. To quote him directly, "Forecasts may tell you a lot about the forecaster; they tell you nothing about the future."

And Finally …….The three "C's"

Corporate Compounding

Buffett is a fan of the late great economist, John Maynard Keynes (it's important to note that Keynes' investment success didn't rely on economic forecasting either!). In his famous 1936 book, *The General Theory of Employment Interest and Money*, Keynes reminds us that stock market prices are driven my two main forces – business enterprise and market psychology. And while profits (and the dividends that follow) are closely aligned with business enterprise the capital gains (which come from gains in stock prices) are a product of both enterprise and market psychology. Reflecting Keynes' views Buffett prefers to measure success by growth in Berkshire's book value rather than by growth in its stock price.

You should also embrace this enterprise focus when investing. Many investors seem to forget that there's actually a company under that share price!

Consistency

Stock markets love the latest thing whether it's a dot.com revolution or a mining boom that punters reckon will last forever. Investment fads come and go but Buffett's investment principles have remained consistent throughout the years.

I recall a December 1999 article in *The Australian Financial Review* which carried the headline: "Buffetted by the winds of change". It posed the question: "Is Buffett losing his touch". At the time Buffett was staying right out of the dot.com comedy and Berkshire's stock portfolio was suffering (if measured in terms of the market prices of the stocks it held). Despite mounting criticism Buffett remained true to his long-held beliefs. He wasn't about to compromise his investing principles to suit current fashion. Time showed his was the correct course to take. In the wake of the dot.com crash Berkshire (which owned real businesses) powered ahead while most of the dot.com duds evaporated into thin air.

Consistency is a common characteristic among successful investors. Market writer, Garfield Drew, recognized this when several decades ago he wrote: "In fact, simplicity or singleness of approach is a greatly underestimated factor of market success".

Culture

Berkshire Hathaway is a huge company by any measure. It has a market capitalization of $US350 billion, has about 90 fully owned subsidiaries, and employs over 360,000 people. But despite the magnitude of these numbers Buffett, as Berkshire's CEO, pays himself a small, but sufficient, salary of $100,000 per year.

In terms of remuneration he also dislikes the now common corporate practice of gifting options and shares to senior management. If Berkshire's top brass want to own Berkshire stock then they have to buy it with their own money, just like everyone else.

Buffett also likes to treat Berkshire shareholders as his partners. When reporting to them in the annual report his communication style is transparent and open.

So what's the take home message regarding culture? It's essential to Buffett and he looks for the same characteristics of integrity and transparency in the people running the businesses that he invests in.

And, if his investing track record is anything to go by, so should you.

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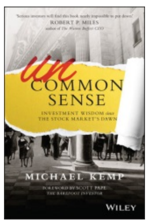

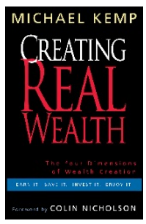

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Michael Kemp is the chief analyst for the Barefoot Blueprint and author of "Uncommon Sense". Published under the Wiley label "Uncommon Sense" delivers a deeply considered and logical approach to the otherwise complex world of investing.