STOCK ANALYSIS WORKSHOP

The Warren Buffett Way: Investing From a Business Perspective

By Maria Crawford Scott

Probably the best-known investment "guru" today is Warren Buffett. Through his publicly traded holding company, Berkshire Hathaway, Buffett has built an impressive investment track record, as well as a personal fortune that places him consistently on the Forbes list of the wealthiest Americans.

Buffett is often identified with Benjamin Graham, with whom he studied, worked under, and maintained a long friendship. However, his own investment experience has led him to adopt the approaches of other investment pioneers, as well, in particular Philip Fisher's focus on the importance of a business's growth prospects and management. [For more on Benjamin Graham, see "Value Investing: A Look at the Benjamin Graham Approach" in the May 1996 AAII *Journal*; for more on Philip Fisher, see "It's Quality That Counts: The Fisher Approach to Stock Investing" in the September 1996 AAII *Journal*.]

Buffett has never expounded extensively on his investment approach, although it can be gleaned from his writings and explanations of holdings in the Berkshire Hathaway annual reports. Outsiders, however, have attempted to put together explanations of his investment style. One recently published book that discusses his approach in an interesting and methodical fashion is "Buffettology: The Previously Unexplained Techniques That Have Made Warren Buffett the World's Most Famous Investor," by Mary Buffett, a former daughter-in-law of Buffett's, and David Clark, a family friend and portfolio manager [the book is published by Simon & Schuster, 800-223-2336; $27.00]. This book was used as the basis for this article.

Investing in a Business: The Philosophy

Warren Buffett believes that a successful stock investment is a result first and foremost of the underlying business; its value to the owner comes primarily from its ability to generate earnings at an increasing rate each year. Buffett, in fact, views stocks as bonds with variable yields, and their yields equate to the firm's underlying earnings. If the business is good, earnings will be more predictable and will consistently grow. That, in turn, makes the stock more valuable than a credit-risk-free government bond, which has an unchanging yield.

The price at which Buffet will buy a stock is, of course, a consideration, but it is not as critical as it was for Benjamin Graham. Graham proposed that investors buy stock below their "intrinsic value"; this would provide investors with a margin of protection that could help absorb unfavorable developments, with subsequently less risk of a market overreaction on the downside.

Buffett, in contrast, views the underlying business as the investor's "margin of protection." If a business is mediocre, the stock will do poorly even if purchased cheaply because any gain will be limited to the difference between the purchase price and the company's intrinsic value, assuming the stock price eventually reaches that level—which, Buffett points out, does not always occur.

Consequently, Buffett targets successful businesses—those with expanding intrinsic values, which he seeks to buy at a price that makes economic sense.

What makes economic sense? First, he compares the price against what it can reasonably earn based on the kind of business it is in, and based on the quality of the management running the company. Then, he purchases the stock if he believes he can earn an annual rate of return of at least 15% for at least five or 10 years. However, his goal is not to sell—as long as a business continues to have earnings growth greater than alternative investments, Buffett believes it makes more sense to hold indefinitely, putting off capital gains taxes, and enjoying the fruits of compounding intrinsic value.

Stock Criteria

Buffett pays close attention to the kinds of businesses he wishes to invest in. He seeks businesses whose product or service will be in constant and growing demand; he also seeks

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businesses that are in areas that are relatively easy to understand.

In his view, businesses can be divided into two basic types:

- Commodity-based firms, selling products in highly competitive markets in which price plays the key role in a consumer's purchase decision. Examples include textile manufacturers, producers of raw food items such as corn and rice, oil and gas companies, the lumber industry, and even car manufacturers.
- Consumer monopolies, selling products in which there is no effective competitor, either due to a patent or brand name or similar intangible that makes the product unique. Examples include brand-name companies such as Coca-Cola, media and communications companies, and certain financial services firms.

Buffett does not purchase the stocks of commodity-based businesses. These industries are highly competitive and dominated by the lowest-cost producer. To compete effectively, companies must spend heavily on manufacturing improvements, which leaves less that can be spent on new product development or new enterprises. In addition, these companies must have top-notch management to survive, but profits are kept low by price competition.

How do you spot a commodity-based company? Buffett looks for these characteristics:

- The firm has low profit margins (net income divided by revenues;
- The firm has low returns on equity (net income divided by shareholder's equity);
- There is little brand-name loyalty for its products;
- The industry has multiple producers;
- The industry tends to have substantial excess production capacity;
- Profits tend to be erratic; and
- The firm's profitability depends on management's abilities to efficiently use tangible assets.

The kinds of businesses Buffett seeks are those that have a consumer monopoly. These are companies that have managed to create a product or service that is somehow unique and difficult to reproduce by competitors, either due to brand-name loyalty, a particular market niche that only a limited number of companies can enter, or an unregulated but legal monopoly such as a patent. The exceptions to the consumer monopoly rule are utilities and similar industries that have a legal monopoly but are heavily regulated.

Consumer monopolies can also typically adjust their prices quickly to inflation since there is little price competition to keep prices in check. This inflation-adjusting ability is another key factor Buffett favors in a firm.

In Buffett's view, the real value of consumer monopolies is in their intangibles—for instance, brand-name loyalty, regulatory licenses, and patents. They do not have to rely heavily on investments in land, plant, and equipment, and typically the products are low-tech. As a result of all of these factors, they tend to have large cash flows and low debt.

In determining whether a company has a consumer monopoly, Buffett poses the question: If he had access to billions of dollars and the top 50 managers in the country, could he start a business and compete with the business in question? If the answer is no, the company is most likely protected from competition by some kind of strong consumer monopoly.

Consumer monopolies can be businesses that sell products or services. They include:

- Businesses that make products that wear out or are used up quickly and have brand-name appeal that merchants must carry to attract customers. The best example, according to the book, is Coca-Cola, a favorite Buffett holding for more than 20 years. The product is an item that grocery stores, restaurants, and other retailers simply must carry. In addition, the brand name loyalty exists worldwide, not just in the U.S. Other examples include leading newspapers, drug companies with patents and brand-name prescription drugs, and popular brand-name restaurants such as McDonald's.
- Communications firms that provide services businesses must use to reach consumers. All businesses must advertise their wares to potential consumers, and many of the available media face little competition. These include worldwide advertising agencies, magazine publishers, newspapers, and telecommunications networks.
- Businesses that provide consumer services that are always in demand. Most of these services require little in the way of plants and equipment, so the company does not require heavy capital expenditures, and they do not tend to require highly paid workforces. Examples include tax preparers H & R Block; ServiceMaster, which provides professional cleaning, maid service and lawn care; and credit card companies such as American Express and Dean Witter Discover.

Other Characteristics

Buffett believes that a consumer monopoly is a key ingredient of an excellent company. Another key ingredient, however, is a capable management that can exploit the company's unique advantage.

How do you judge management's ability? Buffett looks for the following characteristics:

- **A *strong upward trend in earnings*:** Buffett seeks not only a strong upward trend in earnings over a long-term time period, but he seeks year-by-year increases as well, providing an indication that management is able to turn the company's consumer monopoly advantage into shareholder value.
- ***Conservative financing*:** Consumer monopolies tend to have strong cash flows, with little need for long-term debt. Coca-Cola, for instance, has long-term debt of less than one times current net earnings. Buffett does not object to the use of debt for a good purpose—for example, if a company adds debt to purchase another consumer monopoly (for example, when Capital Cities acquired ABC television and radio). However, he does object if the added debt is used in a way that will produce mediocre results—such as pur-

chasing a commodity-type business.

- **A *consistently high return on shareholder's equity*:** Since the average return on equity for U.S. firms over the last 40 years has been about 12%, Buffett seeks firms with returns on equity of 15% or higher, providing a good indication that management can make money from its existing business and can profitably employ retained earnings.
- **A *high level of retained earnings*:** Buffett believes that the real growth in stock value comes from reinvesting earnings to expand operations or purchase new ventures. Thus, he prefers companies that tend to reinvest retained earnings rather than those that are committed to paying out a high percentage of profits in dividends.
- ***Low level of spending needed to maintain current operations*:** Retained earnings must first go to maintain current operations at competitive levels, so the lower the amount required to maintain current operations, the more retained earnings can be used to finance expansions or new ventures.
- ***Profitable use of retained earnings*:** Buffett considers this one of the most important questions in analyzing a company's management. The nature of the business will tend to dictate a company's ability to retain earnings and the need to spend those earnings to maintain current operations; putting those retained earnings to profitable use, however, requires managerial talent. Retained earnings can be used to buy profitable business ventures, to expand existing operations, or to repurchase existing shares from shareholders; it is management's responsibility to determine which alternative offers the greater investment return to

The Warren Buffett Approach

Philosophy and style

Investment in stocks based on their intrinsic value, where value is measured by the ability to generate earnings and dividends over the years. Buffett targets successful businesses—those with expanding intrinsic values, which he seeks to buy at a price that makes economic sense, defined as earning an annual rate of return of at least 15% for at least five or 10 years.

Universe of stocks

No limitation on stock size, but analysis requires that the company have been in existence for a considerable period of time.

Criteria for initial consideration

Consumer monopolies, selling products in which there is no effective competitor, either due to a patent or brand name or similar intangible that makes the product unique. In addition, he prefers companies that are in businesses that are relatively easy to understand and analyze, and that have the ability to adjust their prices for inflation.

Other factors

- A strong upward trend in earnings
- Conservative financing
- A consistently high return on shareholder's equity
- A high level of retained earnings
- Low level of spending needed to maintain current operations
- Profitable use of retained earnings

Valuing a Stock

Buffett uses several approaches, including:

- *Determining firm's initial rate of return and its value relative to government bonds:* Earnings per share for the year divided by the long-term government bond interest rate. The resulting figure is the relative value—the price that would result in an initial return equal to the return paid on government bonds.
- *Projecting an annual compounding rate of return based on historical earnings per share increases:* Current earnings per share figure and the average growth in earnings per share over the past 10 years are used to determine the earnings per share in year 10; this figure is then multiplied by the average high and low price-earnings ratios for the stock over the past 10 years to provide an estimated price range in year 10. If dividends are paid, an estimate of the amount of dividends paid over the 10-year period should also be added to the year 10 prices.

Stock monitoring and when to sell

Does not favor diversification; prefers investment in a small number of companies that an investor can know and understand extensively.

Favors holding for the long term as long as the company remains "excellent"—it is consistently growing and has quality management that operates for the benefit of shareholders. Sell if those circumstances change, or if an alternative investment offers a better return.

shareholders. Buffett views share repurchases favorably, since they cause per share earnings increases for those who don't sell, resulting in an increase in the stock's market price. Thus, Buffett examines management's use of retained earnings, looking for managements that have proven they are able to employ retained earnings in new moneymaking ventures, or for stock buybacks when they would offer a greater return.

Valuing a Share

Identifying a company that he wants to own is only the first step in Buffett's investment approach. The next step is to determine whether the purchase price makes economic sense.

Buffet uses a number of different methods to evaluate share price, including sophisticated and detailed analyses of a company's various operations. The book provides several of these approaches in a simplified format, but with plenty of examples.

One approach is to examine a prospective firm's initial rate of return and its value relative to government bonds by taking the earnings per share for the year and dividing it by the long-term government bond interest rate. For instance, Buffett started buying Gannett Corp., a newspaper holding company, in 1994. In that year, 1994 earnings per share were estimated to be $3.20 a year, and long-term government bonds were yielding 7%. Dividing $3.20 by 7% produces a relative value of $45.71 per share. In other words, if you paid $45.71 for Gannett, you would be getting an initial return equal to that of government bonds. If you paid a higher price, you would receive an initial return lower than the government bond yield—for instance, if you paid $50, your initial return would be $3.20 ÷ $50, or 6.4%. However, the stock's earnings per share are growing each year, so the initial return will increase as well. Would you prefer to invest $45.71 in government bonds and earn a static 7% each year, or would you prefer to invest $45.71 in the stock and earn 7% the first year, but a higher yield in subsequent years based on the earnings per share increase?

Another approach Buffett uses is to project the annual compound rate of return based on historical earnings per share increases. For example, earnings per share at Gannett had increased at a compound average annual rate of return of 8.6% for the prior 10 years when Buffett considered his purchase. If the 1994 earnings per share of $3.20 increased each year for the next 10 years at that annual rate, earnings per share in year 10 would be $7.30. This estimated earnings per share figure can then be multiplied by the average high and average low price-earnings ratios for the stock over the past 10 years to provide an estimated price range in year 10. If dividends are paid, an estimate of the amount of dividends paid over the 10-year period should also be added to the year 10 prices.

Once future prices are estimated, estimated rates of return can be determined over the 10-year period based on the current selling price for the stock. Buffett requires a return of at least 15%.

Buffett will certainly take advantage of "bargains"—for instance, if a bear market drives all prices down or if an unfavorable short-term outlook by the market causes a particular stock that Buffett has identified as an "excellent" business to drop in price. However, his valuation methods focus on earnings growth, and he is not adverse to buying stocks at somewhat higher valuations if he is confident of earnings expansion.

Stock Monitoring and When to Sell

Buffett does not favor extensive diversification, since it is difficult to sufficiently analyze and understand a large number of companies. In addition, he does not diversify based on industry sectors; his avoidance of commodity-type businesses, in fact, leads to the exclusion of certain groups. Instead, Buffett's method of controlling risk within a portfolio is to seriously address the major factors of his approach: to make sure he is investing in expanding businesses, to thoroughly understand and analyze the nature of the businesses in which he invests, and to make sure he does not pay too much for the shares.

Buffett is also a long-term investor, and some of his holdings have been in his portfolio for over 20 years. While his mentor, Benjamin Graham, favored a sale when a company's share price reached its intrinsic value, Buffett will continue to hold as long as the company's growth prospects are better than alternative investments. The time to sell, in Buffett's view, is never, if he has bought an excellent company that is consistently growing and that has quality management that operates for the benefit of shareholders. If those circumstances change—the nature of the business changes or management changes, for example—then Buffett would sell. He would also consider selling if an alternative investment offered a better return.

Buffett in Summary

Warren Buffett's approach identifies "excellent" businesses based on the prospects for the industry and the ability of management to exploit opportunities for the ultimate benefit of shareholders. He then waits for the share price to reach a level that would provide him with a desired long-term rate of return.

Sound easy? For individual investors who want to duplicate the process, it requires a considerable amount of time, effort, and judgment in perusing a firm's financial statements, annual reports, and other information sources to thoroughly analyze the business and quality of management. It also requires patience, waiting for the right price once a prospective business has been identified, and the ability to stick to the approach during times of market volatility. But for individual investors willing to do the considerable homework involved, the Buffett approach offers a proven path to investment value.