SECTION II

Weekend June 22/June 23 1991

Three rules for getting rich

Warren Buffett has been called the greatest investor of all time. Now a genial and bespectacled 60-year-old, he tells ***Jonathan Davis*** *the secret of making billions*

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Peter Lynch, the stock-picker who turned Fidelity's Magellan Fund into the largest mutual fund in the US, calls Buffett "the greatest investor of all time". Professor Paul Samuelson, the Nobel Laureate in economics, uses the phrase "investment genius" to describe the record of superior performance that Buffett has achieved over his 35-year career.

Buffett has earned such praise the hard way – on the strength of superior returns over a long haul. His investment vehicle, a company called Berkshire Hathaway, which he acquired for $20m in 1965, is today worth more than $9bn (about £5.52bn). Buffett owns slightly more than 40 per cent of the shares, making him the second wealthiest man in the US, according to *Forbes* magazine. Nearly all this wealth comes from successful investment in stocks and bonds.

Shareholders in Berkshire Hathaway have enjoyed a return on their investment over the past 20 years of just under 30 per cent per annum. This is more than 3½ times the total return – capital and income, combined – of an average stock market portfolio.

Buffett, the "nice guy" from Omaha, Nebraska, who likes to make friendly, long-term investments in a handful of high quality companies, only started investing through Berkshire Hathaway after winding up an earlier private investment partnership which made him an estimated $25m – and substantially more for the investors who entrusted their money to him.

In 13 years under his management (1957-69), the partnership fund grew more than 30 per cent a year, outperformed the Dow Jones Industrial Average in every year, and made money even when the market was sharply down. Put the two phases of Buffett's career – first partnership, then Berkshire Hathaway – together, and there are few, if any, other investors who can boast as good a record for so long. In the land where stock-picking is still a national pastime, Buffett is a national phenomenon. Wall Street waits with bated breath for news of his latest investment, while speculating endlessly on whether or not he is about to lose his touch. Across corporate America, chief executives hope against hope that they can get Buffett on to their share register. Buffett's annual letters to his shareholders, in which he talks frankly and amusingly about not just his investments, but the state of the investment world at large, have become so popular that the company now sends a copy to anyone who asks.

Because of his large minority shareholdings in a handful of well-known US corporations, Buffett sits on a number of boards, including Gillette, Capital Cities and Salomon Brothers. In addition, through buying controlling equity stakes in an armada of mostly parochial but highly profitable businesses in middle America, Berkshire Hathaway has become a fair-sized industrial company, with sales in 1990 of $1.58bn.

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A genial, bespectacled 60-year-old with a mind of lightning speed and a disarmingly down-to-earth approach, Buffett has managed to make his billions without, it appears, losing the things that the ultra-rich so often misplace – such as friends, marbles or peace of mind. He lives quietly, appears to have few enemies and avoids the pages of glossy society magazines. The only outward concession to his great wealth is a corporate jet, which he calls 'The Indefensible'.

This is the man who says he still "tap-dances his way to work" each morning because of the fun of it all, and who, with the exception of a short period in New York immediately after graduating from business school, spent all his working career in Omaha, the largest city in Nebraska's cattle country, far removed from the noise and financial action of New York. It is not a bad location, Buffett thinks, for someone more interested in long-term results than trading. Legend has it that Buffett still lives in the same house he bought when he was young and plans to give almost all his money back to society when he dies. Like the best legends, it is true.

I asked Buffett whether he had any plans to retire. Doesn't investing get to be a little – well – dull after a while? "Nope," he replied. "I'll do it at least to the grave, and if the seances work, some way beyond. I enjoy it. It's incredibly worthwhile. It gets more fun every year. I work with nothing but people I like. I don't have to do anything. No compromises are involved. It's a marvellous business to be in."

How does Buffett do it? How can one individual – even a genius – sustain a talent for picking investments over such a long period? Doesn't modern finance theory, which preaches that markets are "efficient," tell us that such sustained excess returns should not be possible?

Moreover, Buffett's portfolio contains nothing which could not have been acquired by an ordinary American investor – had the latter been smart enough and had the cash. Buffett does not buy exotic new securities, nor does he hunt for hitherto untapped markets. He invests only in US stocks and bonds, almost all of them well-known names. He does not dabble in futures, options, warrants or currencies; indeed, he thinks that most derivative securities should be banned. He has never owned a share in a company outside the US ("though I look a lot").

Almost 85 per cent of his entire equity holding is represented by just four companies: the *Washington Post*, Coca-Cola, Capital Cities and GEICO, an insurance company. All four are blue chips listed on the New York Stock Exchange.

Buffett calls these four his "permanent holdings," because he likes them so much that he says he has no plans to sell them. Buffett's rationale – he likes the companies and the management, he has fun with them and anyway, where could he find another investment as good? – tells you about what it means to be a genuine long-term investor.

More remarkably, Buffett has made his money without recourse to debt. The debt/equity ratio of his company has averaged 15 per cent or less throughout the 1980s. He says that he does not feel comfortable with more leverage than that, however much it might increase his potential returns.

Buffett is a so-called value investor: someone who uses fundamental analysis to seek out under-valued securities. He acquired most of his investment philosophy from two sources: Ben Graham, sometimes called the father of modern security analysis, who taught him at Columbia Business School in New York; and Philip Fisher, a West Coast investment adviser and author. Graham died in 1976, and Fisher is now in his 80s, so this is hardly mould-breaking stuff. "The secret", says Buffett "has been out for years". There are no charts, no arcane formulae, no trading strategies; just old-fashioned analysis of price and value.

At the risk of over-simplification, the approach is as follows: buy a few heavily under-valued securities, put a lot of money into them, and hold on to them. Over time – and it may be a long time – the price of the securities will move towards their intrinsic value. The combination of sound fundamental analysis – picking the right stock in the first place – and patience almost guarantees exceptional returns in the long term, Buffett believes.

The other key feature is how selective he is. While many investors tend to trade more than they should, enriching brokers and market-makers but rarely themselves, Buffett's objective is to make at most a handful of investment decisions each year.

Ideally, he likes to invest only in companies he knows a lot about – and then only when he has such a good idea that the buying opportunity "shouts" at him from the market-place. The ideal Buffett investment is a business with a strong franchise, some pricing or monopoly power, positive cash flows and an owner-oriented management – all selling for less than it is worth.

It sounds easy – until you try it. In practice, even Buffett admits, life is not that orderly. Cash comes in and has to be invested, regardless of market opportunities. Some years, says Buffett, he may have no good ideas. In others, the market may not throw up worthwhile opportunities – and investments that meet his criteria are by definition rare. Yet self-discipline is fundamental to his success. More than half his personal net worth can be attributed to fewer than a dozen investment decisions.

The average number of large equity holdings in his portfolio in the 1980s was just nine – and half of those were his four "permanent" holdings. In the last few years, his portfolio has become more rather than less diversified – the bets have become bigger. In 1990 Buffett's average equity holding was $900m. As the largest shareholder in Berkshire Hathaway, a lot of this money is Buffett's, but it does not seem to worry him.

Perhaps the biggest surprise, given Buffett's carefully-crafted image as a friendly supporter of management, is that he has long been an active participant in risk arbitrage – the practice of betting on the outcome of takeover battles. In 1987, Buffett told his shareholders he reckoned he had made at least 25 per cent pre-tax return from arbitrage activities over the years.

Looking at his below-average diversification and the arbitrage activities, it is tempting to say – as academic theory might seem to imply – that Buffett has been able to achieve his exceptional returns only because he takes on more risk than the market as a whole. But that is too simple. Like his mentor Graham, who developed the concept of a "margin of safety" for prudent investors, Buffett claims to be highly risk-averse – "Rule No 1; never lose money. Rule No 2; never forget rule No 1" – and thinks that it is the academics who have got it wrong.

Among the things which distinguish him from the academics are: that risk is too complex to be captured solely by the statistical measures which underpin modern financial theory; that markets are not always efficient; and that diversification, while a sound principle for an average investor, may be more of a hindrance than a help to those who know what they are doing.

Like all great artists, there is also more technique than appears. It is no accident, for example, that most of his investments are channelled through an insurance company. The cash flow from the insurance business is a source of cheap finance subsidised by the policy-holders. Buffett is also a master of tax-effective investing: the effective tax rate he has paid on the investment income which goes through the insurance company has averaged 15 per cent or less in recent years.

But there is no single answer to the riddle of Buffett's extraordinary record. Hard work, self-discipline and a love of the investment game for its own sake clearly all play a part. Most investors, Buffett believes, either want too much or try too hard. Institutional pressures and human nature's preference for a quick profit are often enemies of successful long-term investment – just imagine the fate of a pension fund manager who admitted (as Buffett did in 1985) that he had "no good ideas this year".

Warren Buffett FT Article that Changed My Investment Life â€“ Warren Buffettâ€™s Three Rules for Getting Rich

Description

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Long ago now, Warren Buffet provided the Financial Timeâ€™s Mr. Jonathan Davis with these important insights for his investing success.

I read and studied this article from the Financial Times during a business trip I made to Ireland on the weekend of June 22, 1991. It completely changed how I thought about stock investing and gave me hope.

Listed below were the key â€œtake awayâ€™sâ€• for me. Importantly, these ideas prepared me to be able to invest heavily in companies that made complete sense to me and that I had analyzed and waited patiently for the correct price.

Later, I had to combine Warren Buffetâ€™s ideas with growth stock investing principles of â€œbuying high, and selling higherâ€•, in order to purchase shares of stocks like Apple Inc. and others that appeared expensive from a value investing standpoint, but are often inexpensive when factoring in upcoming earnings growth.

I learned to exercise patience for the correct entry price, from a technical analysis perspective (price and volume breakouts) with close-in logical stops to protect my investment capital.

a. Whatâ€™s the secret for Warren Buffet? Old fashioned analysis of price and value.

b. 3 Rules = 1. Buy a few heavily under-valued securities; 2. Put a lot of money into them ; 3. Hold on to them.

c. Sound fundamental analysis, resulting in picking the right stock combined with patience resulted in Buffettâ€™s long term exceptional returns.

d. Make â€“ at most â€“ a handful of investment decisions per year.

e. Invest in companies you only know a lot about.

f. The ideal Buffett investment is a business with a strong franchise, some pricing or monopoly power, positive cash flows, and an owner oriented management â€“ all selling for less than its worth.

g. Some years, you many not have any good ideas. Other years, the market may not deliver the opportunities.

h. Self discipline is fundamental to your success.

i. Keep diversification low.

j. Rule No. 1 = Never lose money. Rule No. 2 = Never Forget Rule No. 1

k. Enemies of success = Investorâ€™s preference for a quick profit.

l. Most investors want too much or try too hard.

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