Warren Buffett's Key Investing Principles

A summary compiled by the Farnam Street team, drawn from his letters to Berkshire Hathaway shareholders over the decades.

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The Four Filters of a Great Investment & The Principle of Concentration (1978)

We get excited enough to commit a big percentage of insurance company net worth to equities only when we find:

(1) businesses we can understand

(2) with favorable long-term prospects

(3) operated by honest and competent people

(4) priced very attractively.

[…]

Our policy is to concentrate holdings. We try to avoid buying a little of this or that when we are only lukewarm about the business or its price. When we are convinced as to attractiveness, we believe in buying worthwhile amounts.

Our experience has been that pro-rata portions of truly outstanding businesses sometimes sell in the securities markets at very large discounts from the prices they would command in negotiated transactions involving entire companies. Consequently, bargains in business ownership, which simply are not available directly through corporate acquisition, can be obtained indirectly through stock ownership. When prices are appropriate, we are willing to take very large positions in selected companies, not with any intention of taking control and not foreseeing sell-out or merger, but with the expectation that excellent business results by corporations will translate over the long term into correspondingly excellent market value and dividend results for owners, minority as well as majority.

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Why Stocks Are Simply Bonds with an Uncertain Coupon (1992)

Our equity-investing strategy remains little changed from what it was fifteen years ago, when we said in the 1977 annual report: "We select our marketable equity securities in much the way we would evaluate a business for acquisition in its entirety. We want the business to be one (a) that we can understand; (b) with favorable long-term prospects; (c) operated by honest and competent people; and (d) available at a very attractive price." We have seen cause to make only one change in this creed: Because of both market conditions and our size, we now substitute "an attractive price" for "a very attractive price."

But how, you will ask, does one decide what's "attractive"? In answering this question, most analysts feel they must choose between two approaches customarily thought to be in opposition: "value" and "growth." Indeed, many investment professionals see any mixing of the two terms as a form of intellectual cross-dressing.

We view that as fuzzy thinking (in which, it must be confessed, I myself engaged some years ago). In our opinion, the two approaches are joined at the hip: **Growth is always a component in the calculation of value, constituting a variable whose importance can range from negligible to enormous and whose impact can be negative as well as positive.**

In addition, we think the very term "value investing" is redundant. What is "investing" if it is not the act of seeking value at least sufficient to justify the amount paid? Consciously paying more for a stock than its calculated value—in the hope that it can soon be sold for a still-higher price—should be labeled speculation (which is neither illegal, immoral nor—in our view—financially fattening).

Whether appropriate or not, the term "value investing" is widely used. Typically, it connotes the purchase of stocks having attributes such as a low ratio of price to book value, a low price-earnings ratio, or a high dividend yield. Unfortunately, such characteristics, even if they appear in combination, are far from determinative as to whether an investor is indeed buying something for what it is worth and is therefore truly operating on the principle of obtaining value in his investments. Correspondingly, opposite characteristics—a high ratio of price to book value, a high price-earnings ratio, and a low dividend yield—are in no way inconsistent with a "value" purchase.

Similarly, business growth, per se, tells us little about value. It's true that growth often has a positive impact on value, sometimes one of spectacular proportions. But such an effect is far from certain. For example, investors have regularly poured money into the domestic airline

business to finance profitless (or worse) growth. For these investors, it would have been far better if Orville had failed to get off the ground at Kitty Hawk: The more the industry has grown, the worse the disaster for owners.

Growth benefits investors only when the business in point can invest at incremental returns that are enticing— in other words, only when each dollar used to finance the growth creates over a dollar of long-term market value. In the case of a low-return business requiring incremental funds, growth hurts the investor.

In The Theory of Investment Value, written over 50 years ago, John Burr Williams set forth the equation for value, which we condense here:

> *The value of any stock, bond or business today is determined by the cash inflows and outflows—discounted at an appropriate interest rate—that can be expected to occur during the remaining life of the asset.*

Note that the formula is the same for stocks as for bonds. Even so, there is an important, and difficult to deal with, difference between the two: A bond has a coupon and maturity date that define future cash flows; but in the case of equities, the investment analyst must himself estimate the future "coupons." Furthermore, the quality of management affects the bond coupon only rarely—chiefly when management is so inept or dishonest that payment of interest is suspended. In contrast, the ability of management can dramatically affect the equity "coupons."

The investment shown by the discounted-flows-of-cash calculation to be the cheapest is the one that the investor should purchase—irrespective of whether the business grows or doesn't, displays volatility or smoothness in its earnings, or carries a high price or low in relation to its current earnings and book value. Moreover, though the value equation has usually shown equities to be cheaper than bonds, that result is not inevitable: When bonds are calculated to be the more attractive investment, they should be bought.

Leaving the question of price aside, the best business to own is one that over an extended period can employ large amounts of incremental capital at very high rates of return. The worst business to own is one that must, or will, do the opposite—that is, consistently employ ever-greater amounts of capital at very low rates of return. Unfortunately, the first type of business is very hard to find: Most high-return businesses need relatively little capital. Shareholders of such a business usually will benefit if it pays out most of its earnings in dividends or makes significant stock repurchases.

Though the mathematical calculations required to evaluate equities are not difficult, an analyst—even one who is experienced and intelligent—can easily go wrong in estimating future "coupons." At Berkshire, we attempt to deal with this problem in two ways. First, we try to stick to businesses we believe we understand. That means they must be relatively simple and stable in character. If a business is complex or subject to constant change, we're not smart enough to predict future cash flows. Incidentally, that shortcoming doesn't bother us.

> *What counts for most people in investing is not how much they know, but rather how realistically they define what they don't know. An investor needs to do very few things right as long as he or she avoids big mistakes.*

Second, and equally important, we insist on a margin of safety in our purchase price. If we calculate the value of a common stock to be only slightly higher than its price, we're not interested in buying. We believe this margin- of-safety principle, so strongly emphasized by Ben Graham, to be the cornerstone of investment success.

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How to Actually Evaluate Risk in an Investment (1993)

In our opinion, the real risk that an investor must assess is whether his aggregate after-tax receipts from an investment (including those he receives on sale) will, over his prospective holding period, give him at least as much purchasing power as he had to begin with, plus a modest rate of interest on that initial stake. Though this risk cannot be calculated with engineering precision, it can in some cases be judged with a degree of accuracy that is useful.

The primary factors bearing upon this evaluation are:

1) The certainty with which the **long-term economic characteristics** of the business can be evaluated;

2) The certainty with which **management** can be evaluated, both as to its ability to realize the full potential of the business and to wisely employ its cash flows;

3) The certainty with which management can be counted on to **channel the rewards from the business to the shareholders** rather than to itself;

4) The **purchase price** of the business;

5) The levels of **taxation** and **inflation** that will be experienced and that will determine the degree by which an investor's purchasing-power return is reduced from his gross return.

These factors will probably strike many analysts as unbearably fuzzy, since they cannot be extracted from a data base of any kind. But the difficulty of precisely quantifying these matters does not negate their importance nor is it insuperable. Just as Justice Stewart found it impossible to formulate a test for obscenity but nevertheless asserted, "I know it when I see it," so also can investors—in an inexact but useful way—"see" the risks inherent in certain investments without reference to complex equations or price histories.

Is it really so difficult to conclude that Coca-Cola and Gillette possess far less business risk over the long term than, say, any computer company or retailer? Worldwide, Coke sells about 44% of all soft drinks, and Gillette has more than a 60% share (in value) of the blade market. Leaving aside chewing gum, in which Wrigley is dominant, I know of no other significant businesses in which the leading company has long enjoyed such global power.

Moreover, both Coke and Gillette have actually increased their worldwide shares of market in recent years. The might of their brand names, the attributes of their products, and the strength of their distribution systems give them an enormous competitive advantage, setting up a protective moat around their economic castles. The average company, in contrast, does battle daily without any such means of protection. As Peter Lynch says, stocks of companies selling commodity-like products should come with a warning label: "Competition may prove hazardous to human wealth."

The competitive strengths of a Coke or Gillette are obvious to even the casual observer of business. Yet the beta of their stocks is similar to that of a great many run-of-the-mill companies who possess little or no competitive advantage. Should we conclude from this similarity that the competitive strength of Coke and Gillette gains them nothing when business risk is being measured? Or should we conclude that the risk in owning a piece of a company— its stock—is somehow divorced from the long-term risk inherent in its business operations? We believe neither conclusion makes sense, and that equating beta with investment risk also makes no sense.

The theoretician bred on beta has no mechanism for differentiating the risk inherent in, say, a single-product toy company selling pet rocks or hula hoops from that of another toy company whose sole product is Monopoly or Barbie. But it's quite possible for ordinary investors to make such distinctions if they have a reasonable understanding of consumer behavior and the factors that create long-term competitive strength or weakness. Obviously, every investor will make mistakes. **But by confining himself to a relatively few, easy-to-understand cases, a**

reasonably intelligent, informed and diligent person can judge investment risks with a useful degree of accuracy.

In many industries, of course, Charlie and I can't determine whether we are dealing with a "pet rock" or a "Barbie." We couldn't solve this problem, moreover, even if we were to spend years intensely studying those industries.

Sometimes our own intellectual shortcomings would stand in the way of understanding, and in other cases the nature of the industry would be the roadblock. For example, a business that must deal with fast-moving technology is not going to lend itself to reliable evaluations of its long-term economics. Did we foresee thirty years ago what would transpire in the television-manufacturing or computer industries? Of course not. (Nor did most of the investors and corporate managers who enthusiastically entered those industries.) Why, then, should Charlie and I now think we can predict the future of other rapidly-evolving businesses? We'll stick instead with the easy cases. **Why search for a needle buried in a haystack when one is sitting in plain sight?**

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Finding Predictable Businesses & Your Goals as an Investor (1996)

Inactivity strikes us as intelligent behavior. Neither we nor most business managers would dream of feverishly trading highly-profitable subsidiaries because a small move in the Federal Reserve's discount rate was predicted or because some Wall Street pundit had reversed his views on the market. Why, then, should we behave differently with our minority positions in wonderful businesses? The art of investing in public companies successfully is little different from the art of successfully acquiring subsidiaries. In each case you simply want to acquire, at a sensible price, a business with excellent economics and able, honest management. Thereafter, you need only monitor whether these qualities are being preserved.

When carried out capably, an investment strategy of that type will often result in its practitioner owning a few securities that will come to represent a very large portion of his portfolio. This investor would get a similar result if he followed a policy of purchasing an interest in, say, 20% of the future earnings of a number of outstanding college basketball stars. A handful of these would go on to achieve NBA stardom, and the investor's take from them would soon dominate his royalty stream.

> *To suggest that this investor should sell off portions of his most successful investments simply because they have come to dominate his portfolio is akin to suggesting that the Bulls trade Michael Jordan because he has become so important to the team.*

In studying the investments we have made in both subsidiary companies and common stocks, you will see that we favor businesses and industries unlikely to experience major change. The reason for that is simple: **Making either type of purchase, we are searching for operations that we believe are virtually certain to possess enormous competitive strength ten or twenty years from now.** A fast-changing industry environment may offer the chance for huge wins, but it precludes the certainty we seek.

I should emphasize that, as citizens, Charlie and I welcome change: Fresh ideas, new products, innovative processes and the like cause our country's standard of living to rise, and that's clearly good. **As investors, however, our reaction to a fermenting industry is much like our attitude toward space exploration: We applaud the endeavor but prefer to skip the ride.**

Obviously all businesses change to some extent. Today, See's is different in many ways from what it was in 1972 when we bought it: It offers a different assortment of candy, employs different machinery and sells through different distribution channels. But the reasons why people today buy boxed chocolates, and why they buy them from us rather than from someone else, are virtually unchanged from what they were in the 1920s when the See family was building the business. Moreover, these motivations are not likely to change over the next 20 years, or even 50.

We look for similar predictability in marketable securities. Take Coca-Cola: The zeal and imagination with which Coke products are sold has burgeoned under Roberto Goizueta, who has done an absolutely incredible job in creating value for his shareholders. Aided by Don Keough and Doug Ivester, Roberto has rethought and improved every aspect of the company. But the fundamentals of the business—the qualities that underlie Coke's competitive dominance and stunning economics—have remained constant through the years.

I was recently studying the 1896 report of Coke (and you think that you are behind in your reading!). At that time Coke, though it was already the leading soft drink, had been around for only a decade. But its blueprint for the next 100 years was already drawn. Reporting sales of $148,000 that year, Asa Candler, the company's president, said: "We have not lagged in our efforts to go into all the world teaching that Coca-Cola is the article, par excellence, for the health and good feeling of all people." Though "health" may have been a reach, I love the fact that Coke still relies on Candler's basic theme today—a century later. Candler went on to say,

just as Roberto could now, "No article of like character has ever so firmly entrenched itself in public favor." Sales of syrup that year, incidentally, were 116,492 gallons versus about 3.2 billion in 1996.

I can't resist one more Candler quote: "Beginning this year about March 1st . . . we employed ten traveling salesmen by means of which, with systematic correspondence from the office, we covered almost the territory of the Union." That's my kind of sales force.

Companies such as Coca-Cola and Gillette might well be labeled "The Inevitables." Forecasters may differ a bit in their predictions of exactly how much soft drink or shaving-equipment business these companies will be doing in ten or twenty years. Nor is our talk of inevitability meant to play down the vital work that these companies must continue to carry out, in such areas as manufacturing, distribution, packaging and product innovation. In the end, however, no sensible observer—not even these companies' most vigorous competitors, assuming they are assessing the matter honestly—questions that Coke and Gillette will dominate their fields worldwide for an investment lifetime. Indeed, their dominance will probably strengthen. Both companies have significantly expanded their already huge shares of market during the past ten years, and all signs point to their repeating that performance in the next decade.

Obviously many companies in high-tech businesses or embryonic industries will grow much faster in percentage terms than will The Inevitables. But I would rather be certain of a good result than hopeful of a great one.

Of course, Charlie and I can identify only a few Inevitables, even after a lifetime of looking for them. Leader- ship alone provides no certainties: Witness the shocks some years back at General Motors, IBM and Sears, all of which had enjoyed long periods of seeming invincibility. Though some industries or lines of business exhibit characteristics that endow leaders with virtually insurmountable advantages, and that tend to establish Survival of the Fat- test as almost a natural law, most do not. Thus, for every Inevitable, there are dozens of Impostors, companies now riding high but vulnerable to competitive attacks. Considering what it takes to be an Inevitable, Charlie and I recognize that we will never be able to come up with a Nifty Fifty or even a Twinkling Twenty. To the Inevitables in our portfolio, therefore, we add a few "Highly Probables."

You can, of course, pay too much for even the best of businesses. The overpayment risk surfaces periodically and, in our opinion, may now be quite high for the purchasers of virtually all stocks, The Inevitables included. **Investors making purchases in an overheated market need to**

recognize that it may often take an extended period for the value of even an outstanding company to catch up with the price they paid.

A far more serious problem occurs when the management of a great company gets sidetracked and neglects its wonderful base business while purchasing other businesses that are so-so or worse. When that happens, the suffering of investors is often prolonged. Unfortunately, that is precisely what transpired years ago at both Coke and Gillette. (Would you believe that a few decades back they were growing shrimp at Coke and exploring for oil at Gillette?) Loss of focus is what most worries Charlie and me when we contemplate investing in businesses that in general look outstanding. All too often, we've seen value stagnate in the presence of hubris or of boredom that caused the attention of managers to wander. That's not going to happen again at Coke and Gillette, however—not given their current and prospective managements.

...Let me add a few thoughts about your own investments.

> *Most investors, both institutional and individual, will find that the best way to own common stocks is through an index fund that charges minimal fees. Those following this path are sure to beat the net results (after fees and expenses) delivered by the great majority of investment professionals.*

Should you choose, however, to construct your own portfolio, there are a few thoughts worth remembering. **Intelligent investing is not complex, though that is far from saying that it is easy.** What an investor needs is the ability to correctly evaluate selected businesses. Note that word "selected": You don't have to be an expert on every company, or even many. You only have to be able to evaluate companies within your circle of competence. The size of that circle is not very important; knowing its boundaries, however, is vital.

To invest successfully, you need not understand beta, efficient markets, modern portfolio theory, option pricing or emerging markets. You may, in fact, be better off knowing nothing of these. That, of course, is not the prevailing view at most business schools, whose finance curriculum tends to be dominated by such subjects. In our view, though, investment students need only two well-taught courses—How to Value a Business, and How to Think About Market Prices.

Your goal as an investor should simply be to purchase, at a rational price, a part interest in an easily- understandable business whose earnings are virtually certain to be materially higher five, ten and twenty years from now. Over time, you will find only a few companies that meet these standards—so when you see one that qualifies, you should buy a meaningful amount of stock. You must also resist the temptation to stray from your guidelines: If you aren't

willing to own a stock for ten years, don't even think about owning it for ten minutes. Put together a port- folio of companies whose aggregate earnings march upward over the years, and so also will the portfolio's market value.

Though it's seldom recognized, this is the exact approach that has produced gains for Berkshire shareholders: Our look-through earnings have grown at a good clip over the years, and our stock price has risen correspondingly. Had those gains in earnings not materialized, there would have been little increase in Berkshire's value.

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On a Batting a High Average in Stocks (2002)

In stocks, we expect every commitment to work out well because we concentrate on conservatively financed businesses with strong competitive strengths, run by able and honest people. If we buy into these companies at sensible prices, losses should be rare. Indeed, during the 38 years we have run the company's affairs, gains from the equities we manage at Berkshire (that is, excluding those managed at General Re and GEICO) have exceeded losses by a ratio of about 100 to one.

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Which Types of Businesses to Invest in and Which to Avoid (2007)

Let's take a look at what kind of businesses turn us on. And while we're at it, let's also discuss what we wish to avoid.

Charlie and I look for companies that have:

a) a business we understand;

b) favorable long-term economics;

c) able and trustworthy management;

d) a sensible price tag.

We like to buy the whole business or, if management is our partner, at least 80%. When control-type purchases of quality aren't available, though, we are also happy to simply buy small portions of great businesses by way of stock- market purchases.

It's better to have a part interest in the Hope Diamond than to own all of a rhinestone.

A truly great business must have an enduring "moat" that protects excellent returns on invested capital. The dynamics of capitalism guarantee that competitors will repeatedly assault any business "castle" that is earning high returns. Therefore a formidable barrier such as a company's being the low- cost producer (GEICO, Costco) or possessing a powerful world-wide brand (Coca-Cola, Gillette, American Express) is essential for sustained success. Business history is filled with "Roman Candles," companies whose moats proved illusory and were soon crossed.

Our criterion of "enduring" causes us to rule out companies in industries prone to rapid and continuous change. Though capitalism's "creative destruction" is highly beneficial for society, it precludes investment certainty. A moat that must be continuously rebuilt will eventually be no moat at all.

Additionally, this criterion eliminates the business whose success depends on having a great manager. Of course, a terrific CEO is a huge asset for any enterprise, and at Berkshire we have an abundance of these managers. Their abilities have created billions of dollars of value that would never have materialized if typical CEOs had been running their businesses.

But **if a business requires a superstar to produce great results, the business itself cannot be deemed great**. A medical partnership led by your area's premier brain surgeon may enjoy outsized and growing earnings, but that tells little about its future. The partnership's moat will go when the surgeon goes. You can count, though, on the moat of the Mayo Clinic to endure, even though you can't name its CEO.

Long-term competitive advantage in a stable industry is what we seek in a business. If that comes with rapid organic growth, great. But even without organic growth, such a business is rewarding. We will simply take the lush earnings of the business and use them to buy similar businesses elsewhere. There's no rule that you have to invest money where you've earned it. Indeed, it's often a mistake to do so: Truly great businesses, earning huge returns on tangible assets, can't for any extended period reinvest a large portion of their earnings internally at high rates of return.

Let's look at the prototype of a dream business, our own See's Candy. The boxed-chocolates industry in which it operates is unexciting: Per-capita consumption in the U.S. is extremely low and doesn't grow. Many once-important brands have disappeared, and only three companies have earned more than token profits over the last forty years. Indeed, I believe that See's, though it obtains the bulk of its revenues from only a few states, accounts for nearly half of the entire industry's earnings.

At See's, annual sales were 16 million pounds of candy when Blue Chip Stamps purchased the company in 1972. (Charlie and I controlled Blue Chip at the time and later merged it into Berkshire.) Last year See's sold 31 million pounds, a growth rate of only 2% annually. Yet its durable competitive advantage, built by the See's family over a 50-year period, and strengthened subsequently by Chuck Huggins and Brad Kinstler, has produced extraordinary results for Berkshire.

We bought See's for $25 million when its sales were $30 million and pre-tax earnings were less than $5 million. The capital then required to conduct the business was $8 million. (Modest seasonal debt was also needed for a few months each year.) Consequently, the company was earning 60% pre-tax on invested capital. Two factors helped to minimize the funds required for operations. First, the product was sold for cash, and that eliminated accounts receivable. Second, the production and distribution cycle was short, which minimized inventories.

Last year See's sales were $383 million, and pre-tax profits were $82 million. The capital now required to run the business is $40 million. This means we have had to reinvest only $32 million since 1972 to handle the modest physical growth – and somewhat immodest financial growth – of the business. In the meantime pre-tax earnings have totaled $1.35 billion. All of that, except for the $32 million, has been sent to Berkshire (or, in the early years, to Blue Chip). After paying corporate taxes on the profits, we have used the rest to buy other attractive businesses. Just as Adam and Eve kick-started an activity that led to six billion humans, See's has given birth to multiple new streams of cash for us. (The biblical command to "be fruitful and multiply" is one we take seriously at Berkshire.)

There aren't many See's in Corporate America. Typically, companies that increase their earnings from $5 million to $82 million require, say, $400 million or so of capital investment to finance their growth. That's because growing businesses have both working capital needs that increase in proportion to sales growth and significant requirements for fixed asset investments.

A company that needs large increases in capital to engender its growth may well prove to be a satisfactory investment. There is, to follow through on our example, nothing shabby about

earning $82 million pre-tax on $400 million of net tangible assets. But that equation for the owner is vastly different from the See's situation. It's far better to have an ever-increasing stream of earnings with virtually no major capital requirements. Ask Microsoft or Google.

One example of good, but far from sensational, business economics is our own FlightSafety. This company delivers benefits to its customers that are the equal of those delivered by any business that I know of. It also possesses a durable competitive advantage: Going to any other flight-training provider than the best is like taking the low bid on a surgical procedure.

Nevertheless, this business requires a significant reinvestment of earnings if it is to grow. When we purchased FlightSafety in 1996, its pre-tax operating earnings were $111 million, and its net investment in fixed assets was $570 million. Since our purchase, depreciation charges have totaled $923 million. But capital expenditures have totaled $1.635 billion, most of that for simulators to match the new airplane models that are constantly being introduced. (A simulator can cost us more than $12 million, and we have 273 of them.) Our fixed assets, after depreciation, now amount to $1.079 billion. Pre-tax operating earnings in 2007 were $270 million, a gain of $159 million since 1996. That gain gave us a good, but far from See's-like, return on our incremental investment of $509 million.

Consequently, if measured only by economic returns, FlightSafety is an excellent but not extraordinary business. Its put-up-more-to-earn-more experience is that faced by most corporations. For example, our large investment in regulated utilities falls squarely in this category. We will earn considerably more money in this business ten years from now, but we will invest many billions to make it.

Now let's move to the gruesome. **The worst sort of business is one that grows rapidly, requires significant capital to engender the growth, and then earns little or no money.** Think airlines. Here a durable competitive advantage has proven elusive ever since the days of the Wright Brothers. Indeed, if a farsighted capitalist had been present at Kitty Hawk, he would have done his successors a huge favor by shooting Orville down.

The airline industry's demand for capital ever since that first flight has been insatiable. Investors have poured money into a bottomless pit, attracted by growth when they should have been repelled by it. And I, to my shame, participated in this foolishness when I had Berkshire buy U.S. Air preferred stock in 1989. As the ink was drying on our check, the company went into a tailspin, and before long our preferred dividend was no longer being paid. But we then got very lucky. In one of the recurrent, but always misguided, bursts of optimism for airlines, we were

actually able to sell our shares in 1998 for a hefty gain. In the decade following our sale, the company went bankrupt. Twice.

> *To sum up, think of three types of "savings accounts." The great one pays an extraordinarily high interest rate that will rise as the years pass. The good one pays an attractive rate of interest that will be earned also on deposits that are added. Finally, the gruesome account both pays an inadequate interest rate and requires you to keep adding money at those disappointing returns.*

...About the time of the See's purchase, Tom Murphy, then running Capital Cities Broadcasting, called and offered me the Dallas-Fort Worth NBC station for $35 million. The station came with the Fort Worth paper that Capital Cities was buying, and under the "cross-ownership" rules Murph had to divest it. I knew that TV stations were See's-like businesses that required virtually no capital investment and had excellent prospects for growth. They were simple to run and showered cash on their owners.

Moreover, Murph, then as now, was a close friend, a man I admired as an extraordinary manager and outstanding human being. He knew the television business forward and backward and would not have called me unless he felt a purchase was certain to work. In effect Murph whispered "buy" into my ear. But I didn't listen.

In 2006, the station earned $73 million pre-tax, bringing its total earnings since I turned down the deal to at least $1 billion – almost all available to its owner for other purposes. Moreover, the property now has a capital value of about $800 million.

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The Intelligent Approach to Investing – Examples & Summary (2013)

"*Investing is most intelligent when it is most business-like.*" -Ben Graham, The Intelligent Investor

It is fitting to have a Ben Graham quote open this discussion because I owe so much of what I know about investing to him. I will talk more about Ben a bit later, and I will even sooner talk about common stocks. But let me first tell you about two small non-stock investments that I made long ago. Though neither changed my net worth by much, they are instructive.

This tale begins in Nebraska. From 1973 to 1981, the Midwest experienced an explosion in farm prices, caused by a widespread belief that runaway inflation was coming and fueled by the

lending policies of small rural banks. Then the bubble burst, bringing price declines of 50% or more that devastated both leveraged farmers and their lenders. Five times as many Iowa and Nebraska banks failed in that bubble's aftermath than in our recent Great Recession.

In 1986, I purchased a 400-acre farm, located 50 miles north of Omaha, from the FDIC. It cost me $280,000, considerably less than what a failed bank had lent against the farm a few years earlier. I knew nothing about operating a farm. But I have a son who loves farming and I learned from him both how many bushels of corn and soybeans the farm would produce and what the operating expenses would be. From these estimates, I calculated the normalized return from the farm to then be about 10%. I also thought it was likely that productivity would improve over time and that crop prices would move higher as well. Both expectations proved out. I needed no unusual knowledge or intelligence to conclude that the investment had no downside and potentially had substantial upside.

There would, of course, be the occasional bad crop and prices would sometimes disappoint. But so what? There would be some unusually good years as well, and I would never be under any pressure to sell the property. Now, 28 years later, the farm has tripled its earnings and is worth five times or more what I paid. I still know nothing about farming and recently made just my second visit to the farm.

In 1993, I made another small investment. Larry Silverstein, Salomon's landlord when I was the company's CEO, told me about a New York retail property adjacent to NYU that the Resolution Trust Corp. was selling. Again, a bubble had popped – this one involving commercial real estate – and the RTC had been created to dispose of the assets of failed savings institutions whose optimistic lending practices had fueled the folly.

Here, too, the analysis was simple. As had been the case with the farm, the unleveraged current yield from the property was about 10%. But the property had been undermanaged by the RTC, and its income would increase when several vacant stores were leased. Even more important, the largest tenant – who occupied around 20% of the project's space – was paying rent of about $5 per foot, whereas other tenants averaged $70. The expiration of this bargain lease in nine years was certain to provide a major boost to earnings. The property's location was also superb: NYU wasn't going anywhere.

I joined a small group, including Larry and my friend Fred Rose, that purchased the parcel. Fred was an experienced, high-grade real estate investor who, with his family, would manage the property. And manage it they did. As old leases expired, earnings tripled. Annual distributions now exceed 35% of our original equity investment. Moreover, our original mortgage was

refinanced in 1996 and again in 1999, moves that allowed several special distributions totaling more than 150% of what we had invested. I've yet to view the property.

Income from both the farm and the NYU real estate will probably increase in the decades to come. Though the gains won't be dramatic, the two investments will be solid and satisfactory holdings for my lifetime and, subsequently, for my children and grandchildren.

I tell these tales to illustrate certain fundamentals of investing:

- **You don't need to be an expert in order to achieve satisfactory investment returns.** But if you aren't, you must recognize your limitations and follow a course certain to work reasonably well. Keep things simple and don't swing for the fences. When promised quick profits, respond with a quick "no."

- **Focus on the future productivity of the asset you are considering.** If you don't feel comfortable making a rough estimate of the asset's future earnings, just forget it and move on. No one has the ability to evaluate every investment possibility. But omniscience isn't necessary; you only need to understand the actions you undertake.

- **If you instead focus on the prospective price change of a contemplated purchase, you are speculating.** There is nothing improper about that. I know, however, that I am unable to speculate successfully, and I am skeptical of those who claim sustained success at doing so. Half of all coin-flippers will win their first toss; none of those winners has an expectation of profit if he continues to play the game. And the fact that a given asset has appreciated in the recent past is never a reason to buy it.

- With my two small investments, I thought only of what the properties would produce and cared not at all about their daily valuations. **Games are won by players who focus on the playing field – not by those whose eyes are glued to the scoreboard.** If you can enjoy Saturdays and Sundays without looking at stock prices, give it a try on weekdays.

- **Forming macro opinions or listening to the macro or market predictions of others is a waste of time.** Indeed, it is dangerous because it may blur your vision of the facts that are truly important. (When I hear TV commentators glibly opine on what the market will do next, I am reminded of Mickey Mantle's scathing comment: "You don't know how easy this game is until you get into that broadcasting booth.")

- My two purchases were made in 1986 and 1993. What the economy, interest rates, or the stock market might do in the years immediately following – 1987 and 1994 – was of no importance to me in making those investments. I can't remember what the headlines or pundits were saying at the time. Whatever the chatter, corn would keep growing in Nebraska and students would flock to NYU.

There is one major difference between my two small investments and an investment in stocks. Stocks provide you minute-to-minute valuations for your holdings whereas I have yet to see a quotation for either my farm or the New York real estate.

It should be an enormous advantage for investors in stocks to have those wildly fluctuating valuations placed on their holdings – and for some investors, it is. After all, if a moody fellow with a farm bordering my property yelled out a price every day to me at which he would either buy my farm or sell me his – and those prices varied widely over short periods of time depending on his mental state – how in the world could I be other than benefited by his erratic behavior? If his daily shout-out was ridiculously low, and I had some spare cash, I would buy his farm. If the number he yelled was absurdly high, I could either sell to him or just go on farming.

> *Owners of stocks, however, too often let the capricious and often irrational behavior of their fellow owners cause them to behave irrationally as well. Because there is so much chatter about markets, the economy, interest rates, price behavior of stocks, etc., some investors believe it is important to listen to pundits – and, worse yet, important to consider acting upon their comments.*

Those people who can sit quietly for decades when they own a farm or apartment house too often become frenetic when they are exposed to a stream of stock quotations and accompanying commentators delivering an implied message of "Don't just sit there, do something." For these investors, liquidity is transformed from the unqualified benefit it should be to a curse. A "flash crash" or some other extreme market fluctuation can't hurt an investor any more than an erratic and mouthy neighbor can hurt my farm investment. Indeed, tumbling markets can be helpful to the true investor if he has cash available when prices get far out of line with values. A climate of fear is your friend when investing; a euphoric world is your enemy.

During the extraordinary financial panic that occurred late in 2008, I never gave a thought to selling my farm or New York real estate, even though a severe recession was clearly brewing. And, if I had owned 100% of a solid business with good long-term prospects, it would have been foolish for me to even consider dumping it. So why would I have sold my stocks that were small participations in wonderful businesses? True, any one of them might eventually disappoint, but

as a group they were certain to do well. Could anyone really believe the earth was going to swallow up the incredible productive assets and unlimited human ingenuity existing in America?

...When Charlie and I buy stocks – which we think of as small portions of businesses – our analysis is very similar to that which we use in buying entire businesses. We first have to decide whether we can sensibly estimate an earnings range for five years out, or more. If the answer is yes, we will buy the stock (or business) if it sells at a reasonable price in relation to the bottom boundary of our estimate. If, however, we lack the ability to estimate future earnings – which is usually the case – we simply move on to other prospects. In the 54 years we have worked together, we have never foregone an attractive purchase because of the macro or political environment, or the views of other people. In fact, these subjects never come up when we make decisions.

It's vital, however, that we recognize the perimeter of our "circle of competence" and stay well inside of it. Even then, we will make some mistakes, both with stocks and businesses. But they will not be the disasters that occur, for example, when a long-rising market induces purchases that are based on anticipated price behavior and a desire to be where the action is.

Most investors, of course, have not made the study of business prospects a priority in their lives. If wise, they will conclude that they do not know enough about specific businesses to predict their future earning power. I have good news for these non-professionals: The typical investor doesn't need this skill. In aggregate, American business has done wonderfully over time and will continue to do so (though, most assuredly, in unpredictable fits and starts). In the 20th Century, the Dow Jones Industrials index advanced from 66 to 11,497, paying a rising stream of dividends to boot. The 21st Century will witness further gains, almost certain to be substantial. The goal of the non-professional should not be to pick winners – neither he nor his "helpers" can do that – but should rather be to own a cross-section of businesses that in aggregate are bound to do well. A low-cost S&P 500 index fund will achieve this goal.

That's the "what" of investing for the non-professional. The "when" is also important. The main danger is that the timid or beginning investor will enter the market at a time of extreme exuberance and then become disillusioned when paper losses occur. (Remember the late Barton Biggs' observation: "A bull market is like sex. It feels best just before it ends.") The antidote to that kind of mistiming is for an investor to accumulate shares over a long period and never to sell when the news is bad and stocks are well off their highs. Following those rules, the "know-nothing" investor who both diversifies and keeps his costs minimal is virtually certain to get satisfactory results. Indeed, **the unsophisticated investor who is realistic about his**

shortcomings is likely to obtain better long term results than the knowledgeable professional who is blind to even a single weakness.

If "investors" frantically bought and sold farmland to each other, neither the yields nor prices of their crops would be increased. The only consequence of such behavior would be decreases in the overall earnings realized by the farm-owning population because of the substantial costs it would incur as it sought advice and switched properties.

Nevertheless, both individuals and institutions will constantly be urged to be active by those who profit from giving advice or effecting transactions. The resulting frictional costs can be huge and, for investors in aggregate, devoid of benefit. So ignore the chatter, keep your costs minimal, and invest in stocks as you would in a farm.