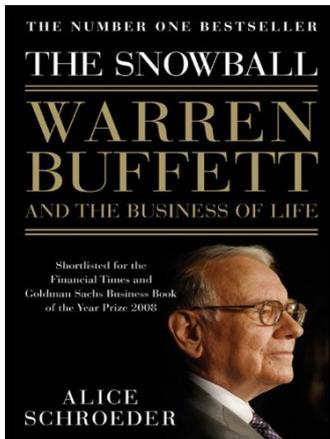


The Snowball



Warren Buffett and the Business of Life

By Alice Schroeder

I read this book over the Christmas - New Year 2008-09 period. It is by far the best book I have read about Warren Buffett. It is a very well researched, but also easy to read, biography of the greatest investor of our time.

I was interested to read the book as a way of learning about the person. However, on the way through, I marked a number of sections which threw light on what has made Warren Buffett as good as he is as an

investor.

His first investment was in a stock that had for years been recommended to clients by his father. He admits this was the only reason he chose it and that "I didn't understand the stock very well when I bought it", which should echo in all of us as where we also started on our investment journey. The stock went down, then rallied and he grabbed a small profit. Who has not also done that when they started out? He sold it at \$40 per share, but the price subsequently rose to a high of \$202. How many times has that happened to readers?

Buffett drew some lessons from this episode, which he would call the most important of his life:

1. "...not to overly fixate on what he paid for the stock."
2. "...not to rush unthinkingly to grab a small profit."
3. "...which was about investing other people's money (his sister was in the deal with him). If he had made a mistake, it might get somebody upset with him. So he didn't want to have responsibility for anyone else's money unless he was sure he could succeed."

This last point echoes with me. I am comfortable investing my own money, but feel a greater responsibility for other people's money which I manage.

The most important thing for me here is that he started where we all started. The difference between Buffett and most private investors is that he progressed beyond that to an unusually high level of excellence as an investor. As you will see, it was all about the way he thinks about investing, which is different to most private investors.

One of Buffett's earliest business ventures was to save some money and invest it in the purchase of pinball machines. This led to another early lesson: "Warren had discovered the miracle of capital: money that works for its owner, as if it had a job of its own."

What is underlying this is something of even greater importance. To have investment capital, we have to spend less than we earn. This is called saving. Buffett began this process at school and carried it on through his entire life.

Buffett became very interested in handicapping as a kid. He read everything he could get hold of through his congressman father on the subject. Not one book. Every book he could get. Isn't this the same as the way we learn investing and finetune our skills?

"The art of handicapping is based on information. The key was having more information than the other guy – then analysing it right and using it rationally. ... Handicapping horses combined two things he was very good at: collecting information and math." Here we see the key to what Buffett was later to study with Benjamin Graham as he learned the craft of investing. It is worth spending more time examining Buffett's education in this key area.

Buffett: "I would go through [old racing forms], using my handicapping techniques to handicap one day and see the next day how it worked out. I ran tests of my handicapping ability day after day, all these different systems I had in my mind."

This really resonated with me. For almost thirty years I had done just that with investing, mainly using technical analysis, but later adding the missing link of fundamental analysis. It was slow work then, because we did not have computers and did everything by hand from newspaper pages. Testing, testing, testing and testing again. This is the real key for me in the development of a sound method in which I had unshakeable faith under pressure. If readers have not undergone this process, they are not yet even at first base in the investment journey. Remembering some rules is never going to be enough. We must totally understand them and how they work in practice. Computers allow the drudgery to be done more quickly and easily, but our minds must still be engaged in detail until we develop understanding. This is a level well above knowledge, which is far more easily attained, but is only a prerequisite.

Buffett: "There are two kinds of handicappers. There are speed handicappers and class handicappers. (see page 107 of *The Snowball* for a fuller description). ... In horse racing it pays to understand both types of handicapping. But back then I was basically a speed guy. I was a quantitative guy to start with."

For investing, it is a good analogy to the two main styles, value and growth.

"As he tested, thought, and observed, Warren discovered the Rules of the Racetrack:

1. Nobody ever goes home after the first race.
2. You don't have to make it back the way you lost it.

The racetrack counts on people to keep betting until they lose. Couldn't a good handicapper turn those rules around and win?"

Buffett: "The market is a racetrack too. But I was not developing elaborate theories in those days, I was just a kid."

Yes, but he was already learning very important precepts that would stand him in good stead as a great investor. This was his process:

Buffett: "I'd get the Daily Racing Form ahead of time and figure out the probability of each horse winning the race. Then I would compare those percentages to the odds. But I wouldn't look at the

odds first, to avoid prejudicing myself. Sometimes you would find a horse where the odds were way, way off from the actual probability. ... And the trick, of course, is to be in a group where practically no one is analytical and you have a lot of data.”

There you have it. This would later morph into the techniques of the great value investor. Read it again and tick off the key similarities.

However, at first, Buffett was to learn a great lesson, when he broke his own rules and lost heavily (for him).

Buffett: “You’re not supposed to bet every race. I’d committed the worst sin, which is that you get behind and you think you’ve got to break even that day. The first rule is that nobody goes home after the first race, and the second rule is that you don’t have to make it back the way you lost it. That is so fundamental, you know.”

Schroeder: “Did he realise that he’d made an emotional decision?”

Buffett: “Oh yeah. Oh, I was sick. It was the last time I ever did anything like that.”

This is interesting. We will all make wrong moves as we learn to be good investors. The best investors learn quickly and permanently from their bad judgements. They learn quickly and learn lasting lessons because they examine what they did. They think about it in depth. Then they draw lessons that are embedded in their psyche because they understand what they did, which did not work out, and why.

The first step in this learning process for investors is to keep good records. Not just details of the transactions, but a diary of what they knew at each point and what they were thinking. This enables us to avoid the hindsight bias (thinking we knew more at the time than we did). If there was information available, which we could have accessed, then that is a very valuable lesson to research in depth before committing money (see Jim Rogers in the previous newsletter).

The Influence of Benjamin Graham

Early in his investing career, Buffett sold many of his holdings and focussed on one stock, which was not a true “value” investment. This was totally at odds with his teacher and mentor Benjamin Graham: “Graham’s idea was to buy stocks trading for less than the value of their assets, and he did not believe in concentrating in just a few stocks.”

Clearly, this was a precursor to where Buffett’s style would take him much later, after he and the market changed away from a total focus on the value approach of Graham.

I also found this of great interest:

“Graham’s 1920’s bubble and Depression experiences had made him suspicious of earnings projections, so suspicious that while he paid lip service to this method of valuation in his teaching, he never used it himself in valuing stocks to buy for his firm.”

This is something I speak and write about often. Prediction is a black art that all of us are very bad at. Just think back to 2007 and the wild predictions of “stronger for longer” and much more.

To understand Buffett, we must understand Graham's method, which was where Buffett began in his education as an investor. Schroeder provides a good summary of Graham's method:

"If someone could buy a stock at a price which valued the company cheaper than its net worth, Graham said, eventually – a tricky word eventually – the stock's price would rise to reflect this intrinsic value. (there is more description of what is involved in *The Snowball* on page 146) ... Complicating matters, however, was the issue of eventually. Stocks often traded at odds with their intrinsic value for long periods of time. ... That was why, as well as being a detective, you had to build in what Graham and Dodd called a Margin of safety – that is, plenty of room for error."

"Graham used to talk about Class 1 and Class 2 truths. Class 1 truths were absolutes. Class 2 truths became truths by conviction. If enough people thought a company's stock was worth X, it became worth X until enough people thought otherwise. Yet that did not affect the stock's intrinsic value – which was a Class 1 truth. Thus, Graham's investing method was not simply about buying stocks cheap. As much as anything it was rooted in an understanding of psychology, enabling its followers to keep their emotions from influencing their decision-making."

"From Graham's class, Warren took away three main principles that required nothing more than the stern discipline of mental independence:

- A stock is the right to own a little piece of a business. A stock is worth a certain fraction of what you would be willing to pay for the whole business.
- Use a margin of safety. Investing is built on estimates and uncertainty. A wide margin of safety ensures that the effects of good decisions are not wiped out by errors. The way to advance, above all, is by not retreating.
- Mr. Market is your servant, not your master. Graham postulated a moody character called Mr. Market, who offers to buy and sell stocks every day, often at prices that don't make sense. Mr. Market's moods should not influence your view of price. However, from time to time he does offer the chance to buy low and sell high."

"... the margin of safety was most important. ... Graham built his margin of safety in various ways. As well as buying things for considerably less than he thought they were worth, he never forgot the danger of using debt. ...his early experiences had scarred him and given him the habit of assuming the worst. ... He kept his firm small in part because he was so risk-averse. And he rarely bought more than a tiny position in any company's stock, no matter how sound the business. ... Warren ... disagreed with his teacher about the need to buy so many stocks."

Buffett at Large in the Markets

By 1962, Buffett's investment partnership had grown to \$7.2 million. By 1966 he was spelling out his investment philosophy for his partners:

Buffett: "We diversify substantially less than most investment operations. We might invest up to forty percent of our net worth in a single security under conditions coupling an extremely high probability that our facts and our reasoning are correct with a very low probability that anything could drastically change the underlying value of the investment."

“Warren had ventured far from the worldview of his mentor, Ben Graham. The hard-nosed “quantitative” approach espoused by Graham was the world of the speed handicapper, of the cigar-butt steeper who worked from pure statistics.”

Now, Schroeder puts her finger on the reason that Buffett had departed from the pure Graham approach:

“As Buffett said of this, his favourite approach, the more sure money tends to be made on the obvious quantitative decisions. But the method had a couple of drawbacks. The number of statistical bargains had shrunk to virtually nil, and since cigar butts tended to be small companies, it did not work when large sums of money were involved.”

So, here we have something important. Graham was a child of his time. Buffett began in his time, but the world changed after the stupendous post-war expansion. Added to this, Buffett had grown his partnership so much that Graham’s world was now too small for his scale.

“Buffett had had what he would later call a “high-probability insight” about American Express [the company his partnership was then heavily exposed to] that confounded Ben Graham’s core idea. Unlike companies whose value came from cash, equipment, real estate and other assets that could be calculated and if necessary liquidated, American Express had little more than its customers’ goodwill. ...the competitive advantage that Charlie Munger had been talking about when he spoke of the great businesses. This was the method of the class handicapper, of Phil Fisher, and it involved qualitative, as opposed to quantitative, assessments.”

Buffett: ... buying “the right company (with the right prospects, inherent industry conditions, management, etc.)” means “the price will take care of itself ... this is what causes the cash register to really sing. However, it is an infrequent occurrence, as insights usually are, and of course, no insight is required on the qualitative side – the figures should hit you over the head with a baseball bat. So the big money tends to be made by investors who are right on qualitative decisions.”

Clearly, Buffett was no longer truly a value investor. He had embraced the ideas of the growth investment approach best described by Philip Fisher in *Common Stocks and Uncommon Profits*, which is a classic investment book still being reprinted today.

In doing this, Buffett had developed skills which are not shared by many investors. He totally understood what makes businesses work. He had joined and was to surpass the expert stock pickers that we would all wish to become.

Becoming an expert stock picker is not an easy thing to do. It requires enormous work and a great deal of thinking about the whole process. Most beginners in their first ten years complain that everything is so confusing. This is because they are just starting out and have not yet reached the point of consolidating in their minds a new and different way of looking at the world. It will take many years of consistent work, study and contemplation before breaking through to a view of the investment process that makes consistent sense and which they can apply with confidence. Nobody can just teach it to us, we have to actively learn. We remember what we are taught, but we do not understand it until we can operate with mastery – when we are so confident about what we need to do that we know it instinctively. As well, we can teach it – Buffett started out teaching his methods.

Graham taught his methods most of his life. It is a wonderful discipline that requires a level of understanding far above simply knowing something.

Continuing Themes

The first theme was that by 1966 Buffett experienced some turbulence in his investing which emerged because the market had changed since Buffett started out:

“But Hochschild-Kohn [department store] was the beginning of a pattern that would recur more than once in frothy markets: Buffett had lowered his standards to justify an investment. That he had done it at a time when he was having more and more trouble finding what he considered to be good investments in the stock market was no coincidence.”

Munger: “We were enough influenced by the Graham ethos ... that we thought if you just got enough assets for your dollars, somehow you could make it work out. ...we didn’t weigh heavily enough the intense competition between four different department stores in Baltimore at a time when department stores no longer had an automatic edge.”

If this idea of falling for the temptation to relax standards of stock selection and risk management does not resonate strongly with readers, then they were not awake during the 2003-2007 bull market. I saw all around me people buying unsound businesses and totally overlooking the danger in debt at all levels. Buying poor businesses, that can only succeed on high levels of debt, with the investor also leveraged to the hilt, is always an accident waiting in the wings.

Of perhaps greater long term significance was the second theme of considering the strength of the business model as more important than the value of assets purchased. In time this became the prime way in which Buffett and Munger departed from the Graham model. This theme in Buffett’s investing originated primarily for Munger, though we should see them as a like-minded pair which makes up one investing team.

A third theme, which comes along over and over again in the Buffett story, is that when he bought businesses, he looked to bring great managers with them. One of the first was Ben Rosner who ran Associated Retail Stores. This was the man who famously left a black tie function to count the sheets in a toilet roll because he suspected from a conversation that he was being cheated on his purchases. “Buffett felt as one with the Ben Rosners of the world – he saw in their relentlessness the spirit of success. ... He and Rosner shared a mutual obsession. As Buffett liked to put it, Intensity is the price of excellence.”

Another two themes that have had an enduring effect on the Buffett investment method also emerged at this time:

“...he laid out two new restrictions that would make it even harder for him to invest. ...

1. We will not go into businesses where technology which is way over my head is crucial to the investment decision. ...
2. [W]e will not seek out activity in investment operations, even if offering splendid profit expectations, where major human problems appear to have a substantial chance of developing.”

“By major human problems he meant layoffs, plant closings – and union businesses that couldn’t take a strike. This also meant he would think once, twice, three times, before smoking any more cigar butts.”

The Buffett avoidance of technology was to become a major theme in the information technology and internet bubble of the 1990s to the extent where some pundits began suggesting that Buffett had lost his touch. Of course, Buffett had the last word on this subject in his long term investment record.

The focus on human problems came from several early investments in businesses that required what is euphemistically called restructuring. Buffett’s focus on this is akin to the present focus of many people on ethical issues in investing and on a green bias in the climate debate.

Change of Objective

In the late 1960s Buffett also had to deal with the way the market had changed and his investment capital had grown way larger. He made an important declaration to the members of his partnership:

“My own personal interests dictate a less compulsive approach to superior investment results than when I was younger and leaner... I am out of step with present market conditions. On one point, however, I am clear. I will not abandon a previous approach whose logic I understand (although I find it difficult to apply) even though it may mean forgoing large, and apparently easy, profits to embrace an approach which I don’t fully understand, have not practiced successfully, and which, possibly, could lead to substantial and permanent loss of capital.”

In other words, he was easing back from the frenetic activity that had led to his superb returns in the past when he was younger, had less capital to invest and a great deal to prove to himself and the world.

However, at the same time, he was dedicated to sticking to what he knew and had proven worked well for him. He would not adapt to the wild conditions of the end of a long bull market by taking on riskier methods in which he did not believe. In this he was avoiding a mistake most new investors make in their first bull market. “Financial genius is a rising market” is a quotation from Kenneth Galbraith that is used at this point in the book to emphasise this issue that is pertinent to all first-time investors in a bull market.

“Buffett then stunned his partners by dropping his stated goal of beating the market by ten points a year to beating it by just five points a year – or earning nine percent, whichever was less.”

Here, Schroeder comments that “Beating the market by five points a year, compounded over any long-term period, would produce stupendous wealth. Even Ben Graham had beaten the market by just 2.5 percent a year. Buffett’s revised goal of nine percent put a floor on their results that was still two percent or more better than owning an average bond. That consistency, year after year, and not losing money, would lead to a stunning result. Sticking with him, an average investor who took only a modicum of risk, could achieve these extraordinary returns, and do so safely.”

A little later, Schroeder again sums up what this change was all about:

“While he lowered his investing standards in difficult environments – and would do so again – one compromise he would never make was to give up his margin of safety. This particular quality – to pass up possible riches if he couldn’t limit his risk – was what made him Warren Buffett.”

This is something which new and even experienced investors should read and re-read through the next bull market. Making great gains is of no account if much of it is yielded back to the market when the bull is replaced by the bear.

An Important Insight

“... since Buffett thought of a dollar today as the fifty or hundred dollars that it would become someday, it was as if he had lost many millions on Hochschild-Kohn because of the forgone opportunity to use the money more effectively. He drew a conclusion that he would later state as:

Time is the friend of the wonderful business, the enemy of the mediocre. You might think this principle is obvious, but I had to learn it the hard way... It’s far better to buy a wonderful company at a fair price than a fair company at a wonderful price. Charlie [Munger] understood this early; I was a slow learner. But now, when buying companies or common stocks, we look for first-class businesses accompanied by first-class managements. That leads right into a related lesson: Good jockeys will do well on good horses but not on broken-down nags.”

Some Wisdom

Here are a few gems which are dropped along the way in Snowball:

“He helped her understand that it was always a mistake to pay too much for something you wanted. Impatience was the enemy.”

I must remember that the next time a new investor remarks to me that psychology is not a factor in investing. It is, just as it is in the whole of life.

“He was always interested in what made sense rather than what had been done in the past.”

This is very powerful the more we think about it. How often have you queried something and been told simply that it is what has always been done? Knowing that this is the wrong answer is a vital step to becoming a good investor. Yes, examine the past and understand it, but the key question is always to ask whether it is still a sensible approach to a problem.

“He taught me to think of a business as a whole...”

This comes straight out of Buffett’s idea that when you buy a stock, you become a part owner of the company. We must not become so enmeshed in the different parts of the company that we lose sight of the whole. An owner is looking for a return based on the end result of the way all the parts have played their part. When looking at any part of the business, always relate it back to its relevance to the reason the whole company exists. Never, ever fall in love with some warm and cuddly part of a business that makes us feel good, but is so costly that the profit of the business is reduced. We may still want to see that aspect of the business continue, but it can only make sense if

it makes a positive contribution to the whole. If the whole company fails, we lose that aspect of the business anyway.

The Essential Buffett

In 1979, Buffett wrote something in Forbes that should resonate with students of his philosophy:

“The future is never clear... you pay a very high price in the stock market for a cheery consensus. Uncertainty actually is the friend of the buyer of long-term values.”

Ask yourself whether this is relevant to the current market we are in. There are endless arguments about whether we have seen the bottom or not and how it may all play out in the shape of various letters of the alphabet. I call it alphabet soup. Nobody knows where the exact bottom will be and only liars ever buy there. My analysis is that we are in the first phase of a bull market. That is all I need to know. I have started buying, moving towards being fully invested. I am moving a little more urgently than I was, but I am not in any great rush (did you read “Impatience was the enemy” in the previous newsletter?). My experience over forty years that being early and in a disciplined way is what is required. This applied to getting out of the last bull market and it applies equally to getting set for the next one. It requires patience to find good opportunities and discipline to know them from the more marginal cases. Then more discipline to cut the losers and feed the winners.

In the 1980s, Buffett surged to become one of the richest men in the world. Berkshire Hathaway and Blue Chip (which together now housed the greater part of his portfolio) flew:

“Buffett’s hunt for things to buy had become more ambitious, free of the cigar butts and lawsuits of the decades before. The great engine of compounding worked as a servant on his behalf, at exponential speed and under the gathering approval of a public gaze. The method was the same: estimate an investment’s intrinsic value, handicap its risk, buy using margin of safety, concentrate, stay in the circle of competence, let it roll as compounding did the work. Anyone could understand these simple ideas, but few could execute them.”

There is more in this extract than in hundreds of pages in the book. The basic Buffett method is there. Readers should write it out and expand each element and think about them in depth. This should be the basis of any sound investment plan. This will not come easily as is noted in the final sentence. It may take most beginners many years to fully appreciate every aspect of this summary. It will take a lot of study, a great deal of thinking, patient development of actual experience and an ability to teach it because of the depth of understanding that is required.

“The managers... who ran the businesses that Berkshire Hathaway and Blue Chip owned were lucky because Buffett largely left them alone, his trick of management being to find obsessed perfectionists like himself who worked incessantly; then ignore them except for ... attention [and] admiration ... every now and again.”

Understanding Leverage

Through the 2003-2007 bull market, just like 1982-1987, I had many people pooh-pooh my concern about leverage. Everybody seemed to be doing it, whether through margin loans or CFDs or mortgaging their house. So, pay attention to this extract:

“Leverage ... was like gasoline. In a rising market, a car used more of it to go faster. In a crash, it was what made the car blow up.”

“... Buffett and Munger considered [that] defining risk as volatility to be twaddle and bullshit ... They defined risk as not losing money. To them, risk was inextricably bound up in your time horizon for holding an asset. Someone who could hold an asset for years could afford to ignore its volatility. Someone who was leveraged did not have that luxury – leverage costs; moreover the lender’s (not the borrower’s) time horizon defines the length of the loan. Thus a risk of leverage is that it takes away choices. The investor may not be able to wait out a volatile market; she is burdened by the carry (that is, the cost) and she depends on the lender’s goodwill.”

“But betting on volatility seemed to make sense when the market rose as predicted. When enough time passes and nothing bad happens, people who are making a lot of money tend to think it is because they are smart, not because they are taking a lot of risk.” (my emphasis)

“The rules of the racetrack said... you don’t have to make it back the way you lost it. The reason is the math of losing money, which works like this: If someone has a dollar and she loses fifty cents, she has to double her money to make back what she’s lost. That’s difficult to do. It is tempting to borrow another fifty cents for the next bet. That way you only have to make fifty percent (plus the interest you have on the loan) to get back whole – much easier to do. But borrowing the money doubles your risk. If you lose fifty percent again you’re history. The loss has wiped out your capital.”

On the crisis that led to the failure of Long-Term Capital Management: [Buffett] “was only interested as [a potential] owner... Long-Term was behaving as though it could raise capital to wait out the crisis and profit from its turnaround. But with the kind of leverage it had taken on, it didn’t have that option. This was the fallacy of defining risk as anything other than losing money... no investor would put in money to save it without taking control.”

This helps understand many of the 2007-2009 company failures in Australia and overseas: leverage – got that?

Buffett: “anything times zero is zero... A total loss is a zero. No matter how small the likelihood of a total loss on any given day, if you kept betting and betting, the risk kept stacking up and multiplying. If you kept betting long enough, sooner or later, as long as a zero was not impossible, someday a zero was one hundred percent certain to show up.” (my emphasis). Nassim Taleb took two books to say this. Buffett has put it clearly in one sentence.

“Investors were fleeing anything risky in favour of anything safe, to a point that Long-Term’s models had never considered possible because it made no economic sense to them.”

“Buffett and Munger felt that using models to make investment decisions was like driving a car on cruise control. The driver might think he was fully alert and attentive, but would find out differently when the road turned winding, rain-slicked and full of traffic.”

Moreover, Buffett said: “Derivatives are like sex. It’s not who we’re sleeping with, it’s with who they’re sleeping with that’s the problem. ... Accept no excuses from anyone who doesn’t post collateral or make a margin call. Accept no excuses.”

Brokers

Buffett: “I never talk to brokers or analysts. You have to think about things yourself... Wall Street is the only place people ride to in a Rolls-Royce to get advice from people who take the subway.”

Some Keys

Buffett: “Then at dinner, Bill Gates Sr. Posed the question to the table: What factor did people feel was the most important in getting to where they’d gotten in life? And I said Focus. And Bill [Jr] said the same thing.”

Schroeder: “It is unclear how many people at the table understood focus as Buffett lived that word. This kind of innate focus couldn’t be emulated. It meant the intensity that is the price of excellence. It meant ... discipline and passionate perfectionism... It meant single-minded obsession with an ideal.

“Munger often attributed much of Buffett’s success to the fact that he was a learning machine.”

Bill Gates and Buffett: “...their shared intellect, interests, and way of thinking gave them considerable common ground. They shared the same intensity... It was the way Buffett had learned to think in models that impressed Gates most.”

“If Buffett could have found more great businesses, he would have bought them all. He never stopped looking for them. The town where the Superinvestors of Graham-and-Doddsville lived was getting crowded, however... there were fewer and fewer odd pockets of overlooked opportunity... as the [nineteen] nineties progressed, the deals became larger – but more sporadic.”

“... [Buffett] cared far more about avoiding excessive risk. ... Even if he had been of the temperament to do so, Buffett didn’t need to make risky bets. Decisions made years ago were still compounding for him. ... The old days of scouring the Moody’s Manuals for teeny companies were long gone... But the mistakes were few and the home runs many...”

Many readers might be tempted to now think the game is easy. Just find some great companies and buy them. While the objective is sound, it is never easy to do. Buffett himself says that private investors should not even try to do it themselves. As I remarked earlier, superior stock pickers are a very rare breed. Some of these extracts should point readers to the level of focus and intensity with which they need to learn that game. Many will start out, but few will ever be prepared to really pay the price. It cannot be done with wishful thinking.

A Puzzle

Buffett and others in his group were very interested to explore “What gave a business a durable competitive advantage? What gave companies an edge, and why didn’t they keep it? – because most didn’t. ... What was it you couldn’t see that prevented you from remaining the leader? Most of

the proposed answers, regardless of the company, revolved around arrogance, complacency and what Buffett called Institutional Imperative – the tendency for companies to engage in activity for its own sake and to copy their peers instead of trying to stay ahead of them. Some companies didn't bring in young people with fresh ideas. Sometimes managements weren't attuned to tectonic shifts in their industry. Nobody suggested these problems were easy to cure."

On Reality and Forecasting

"Big companies are not going to increase their earnings in the high teens over long periods of time. For a while you can do it, but it just isn't in the cards to keep it up forever."

And later: In his shareholder letter, Buffett "... had written that stocks were not overvalued – if interest rates stayed below average and if businesses kept delivering extraordinary returns on capital – in other words, if the unlikely continued to occur. This statement was oblique enough to avoid looking like a forecast. Buffett thought those who were always out prophesying some turn in the market's direction usually would up being wrong ten times out of two. So, he rarely made statements about the market, and often played coy when he did. Still, it was unusually clever of him to work the words not overvalued into a sentence that said the market was overvalued. People could read this message any way they wanted, but if they were smart, they got it."

"Thus, if Buffett was reshuffling his portfolio and focussing on bonds, perhaps it meant that he thought that it was now easier to make a living in bonds than stocks, and it was going to get easier still."

Allow me one moment to repeat my consistent rant here. I never make forecasts if I can help it and deny that what looks like a forecast is intended by me to be one. A forecast is nothing but an opinion about something. Forecasters can dredge up endless data to support their forecast (while consciously or unconsciously ignoring data that does not support it), but no amount of past data makes a forecast correct.

My approach to this is not unlike Buffett's, in the sense that I try not to even read forecasts or listen to them (it can't be helped sometimes out of sheer courtesy). Instead, I try to think through the strategy appropriate to the situation and get about quietly implementing it.

Buffett sees it similarly when asked whether it concerned him that people thought he was a has-been: "Never. Nothing bothers me like that. You can't do well in investing unless you think independently. And the truth is, you are neither right nor wrong because people agree with you. You're right because your facts and reasoning are right. In the end, that's what counts.

And when asked "... if being in the public eye for decades helped keep the criticism in perspective, Buffett paused for a long while. No. It never gets easier, he said soberly. It always hurts just as much as the first time. But he could not do a thing about it."

I would add that what is perhaps worse is when that criticism is prefaced by misrepresenting what has been said or written. These people are setting up a rag doll that they say is someone's ideas and then sticking needles through it.

“No matter how much money [Buffett] had made and no matter how long he kept it up, sooner or later he would have a bad year or the momentum would slow down. He knew that. Over and over he had warned investors that trees don’t grow to the sky. But that had never stopped him from climbing as fast as he could. And he loved to climb – but somewhat to his surprise, there was no blue ribbon waiting at the top.”

“Buffett repeated constantly... the ideas that had made him famous: the margin of safety, the circle of competence, Mr. Market’s vagaries. He still maintained that a stock is a piece of a business, not a bunch of numbers on a screen.”

Investing in a Fish-Bowl

“In February 2000, the SEC had denied Berkshire Hathaway’s request to keep some of its stockholdings confidential... From now on, acquiring entire businesses – which had always been his favourite way to use capital, anyway – would be the main use of money at Berkshire. It was going to become much harder to put large amounts of money to work in stocks.

The Information Technology and Internet Boom

[Buffett] “... and Munger carried on their regular dialogue with Berkshire shareholders, saying that while the market was overvalued, they could not predict how long it would last. Finally, for the record but as a warning and a way of teaching, Buffett explained his views once and for all and predicted that the market would fall for short of investors’ hopes for two decades...”

“... to ... commit himself to such a forecast in the face of years of criticism and ridicule, took a different kind of courage, making the internet bubble one of the greatest personal challenges of his career.”

“He simply reframed investors’ expectations, writing that, because of its enormous size, Berkshire was now likely to grow in value only modestly better than the market.”

“Separately, Buffett announced that BRK was so cheap that Berkshire would now entertain offers from investors to buy its own stock. ... For the second time, Buffett was publicly announcing what he wanted to buy in advance. ... Once again investors had to ask themselves which side to play. This time, many people understood the message. His willingness to put up money for Berkshire stock made such a statement that, before he could buy a single share, BRK rose twenty-four percent.”

Buffett: “Investing in the internet is laying out the bird in the hand – money today – to get birds in the bush.”

Buffett: “Speculation is most dangerous when it looks easiest.”

“Anything that cannot go on forever will end. – Herb Stein” (used in a Buffett speech).

General Thoughts

“ ... [Buffett] explained his Twenty Punches approach to investing. You’d get very rich ... if you thought of yourself as having a card with only twenty punches in a lifetime, and every financial

decision used up one punch. You'd resist the temptation to dabble. You'd make more good decisions and you'd make more big decisions."

"Berkshire's best opportunities always came at times of uncertainty, when others lacked the insight, resources, and fortitude to make the right judgements and commit. Cash combined with courage in a crisis is priceless, said Buffett."

"Buffett had always said he'd rather have a lumpy fifteen percent return than a steady ten percent."

"... [Buffett] was still buying mainly in the United States. Most foreign stocks, he said, were not in his circle of competence."

This is one quote I must remember the next time someone asks me why I do not invest overseas. It isn't in my book as a reason directly, but underlies some of my own rationale.

However, note that Buffett said "most" foreign stocks. See the next page.

"The ideal business is one that earns very high returns on capital and that keeps using lots of capital at those high returns. That becomes a compounding machine, Buffett said. You could keep redeploying capital at [those] same returns over time. But there are very, very, very few businesses like that... we can move that money around from those businesses to buy more businesses. ... It explained why Berkshire was structured as it was... It explained why he was always looking for new businesses to buy, and [as an example] what he was planning to do with Clayton Homes. He expected to invest part of Berkshire's extra capital in Clayton so that it could survive to take market share away from its bankrupt competitors and to buy and service their portfolios of loans."

Buffett: "Fault me for dithering. (Charlie calls it thumb-sucking.) When a problem exists, whether in personnel or in business operations, the time to act is now."

This made me wonder why so many people sat on falling stocks as the bear market began in late 2007 and early 2008. Maybe we should have this quote stuck up near our computer somewhere to remind us. It is akin to the US Marine precept that if you come under fire, go forward or go back, but do not stay frozen under fire. So, in any investment situation, if a stock has gone past our sell stop (the price at which we know we are wrong about it), either sell it quickly, or put it in the bottom drawer for five to ten years (if it is a sound business, otherwise only the first option applies). We must know this instinctively before we start to manage our own money, or we will tend to suck our thumbs and then panic and sell much later at the worst possible time, when the Buffetts of this world are buying.

Munger Wisdom

Munger's favourite construct was to invoke Carl Jacobi: Invert, always invert. Turn a situation or problem upside down. Look at it backward. What's in it for the other guy? What happens if all our plans go wrong? Where don't we want to go, and how do you get there? Instead of looking for success, make a list of how to fail instead – through sloth, envy, resentment, self-pity, entitlement, all kinds of mental habits of self-defeat. Avoid these qualities and you will succeed. Tell me where I'm going to die, that is, so I don't go there."

Earlier in the book and slightly differently: “They liked to ponder the reasons for failure as a way of deducing the rules of success. I had long looked for insight by inversion, in the intense manner counselled by the great algebraist Carl Jacobi, Munger said.”

Note the use of the words in the intense manner. This is not something done in a moment or easily. It requires a great deal of hard thinking work over a long time. This seems akin to Buffett’s manner of thinking in models. He and Munger developed models for failure and inverted them to gain insight into what were the models of success.

Buffett Overseas

In 2004, Buffett looked around the world for undervalued markets. He hit on Korea and obtained listings of all stocks there. “... he began sifting and sorting... through hundreds of pages of numbers...” and “he could pick out which were important and how they fell into a coherent pattern. ...he quickly pared it down to a workable number... [and] he kept going, ... looking for the gems amid the dreck – until he finally arrived at a much shorter list... which consisted of at most a couple of dozen companies. A few were large – among the world’s largest – but most were very small.”

Buffett: “These are good companies and yet they’re cheap. The stocks have gotten cheaper than five years ago, and yet the businesses are more valuable... They make basic products like steel and cement and flour and electricity, which people will still be buying in ten years. They have a big market share in Korea... Look, this flour company has more than its market value in cash, and it sells at three times earnings. ... The main risk, and part of the reason why the stocks are cheap, is North Korea. ... When you invest you have to take some risk. The future is always uncertain. I think a group of these stocks will do very well for several years. Some of them may not do well, but as a group, they should do very well. I could end up owning them for several years.”

How many readers do this sort of analysis on our market? I do, using my technical analysis and fundamental analysis scans and subsequent analysis. If readers want to become good stock pickers, what they have to do is in the previous paragraph. It requires hard work because we do not have the insights and skills that Buffett has developed over half a century. That is no excuse, though, to give up trying.

On 2008 and the Global Financial Crisis

Buffett: “... you just cannot be sure of anything. You have to think about things that have never happened before. You always want to have plenty of money around.”

Here he meant having a big cash reserve to deal with the crisis and to take advantage of opportunities.

Buffett: “...Charlie and I looked at the downside, and nobody else did very much.”

Schroeder: “Deleveraging could be a painful process... the whole economy withdrew – fast and painfully or slow and painfully – from the intoxicant of cheap debt. Asset returns could well stay sub-par for a long time... there sat Buffett, whose thinking about value and risk had not changed in

nearly sixty years... There are always people who say that the rules have changed. But it only looks that way, he said, if [their] time horizon is too short.”

This last bit resonated very strongly with me. I always cringe when someone says that it is different this time. It will be in detail, but rarely in principle. Through 2008 I read story after story (probably feeding off each other) saying that 2008 was “unprecedented” (do they know what that word means?) and as bad as 1929. This came from people who were not alive then. Yet to me it was just like 1974 and I was alive then and active in the market - almost the same number of consecutive months closing lower. It felt just the same, but maybe I am fooling myself, who knows? Memory is a tricky thing.

Buffett: “The same fund will trade at the same time on the same day from the same dealer at interest rates of 5.4 percent and 8.2 percent.... If this is an efficient market, dictionaries will have to redefine efficient.”

Buffett: “But the most immediate and doable opportunity is weird things in the credit market. And the biggest opportunity is in mortgages. But I don’t understand them well enough, although I’m learning them so that I can understand them. And if I think I’ve got enough margin of safety, I’ll do it.” Schroeder: “but the average person should not do it.”

Advice to Average Investors

Buffett: “... Stocks are the things to own over time. Productivity will increase and stocks will increase with it. There are only a few things you can do wrong. One is to buy or sell at the wrong time. Paying high fees is the other way to get killed. The best way to avoid both of these is to buy a low-cost index fund over time. Be Greedy when others are fearful, and fearful when others are greedy, but don’t think you can outsmart the market.”

“If a cross-section of American industry is going to do well over time, then why try to pick the little beauties and think you can do better. Very few people should be active investors.”

Schroeder: “If there is any lesson the life of Warren Buffett has shown, it is the truth of that.”

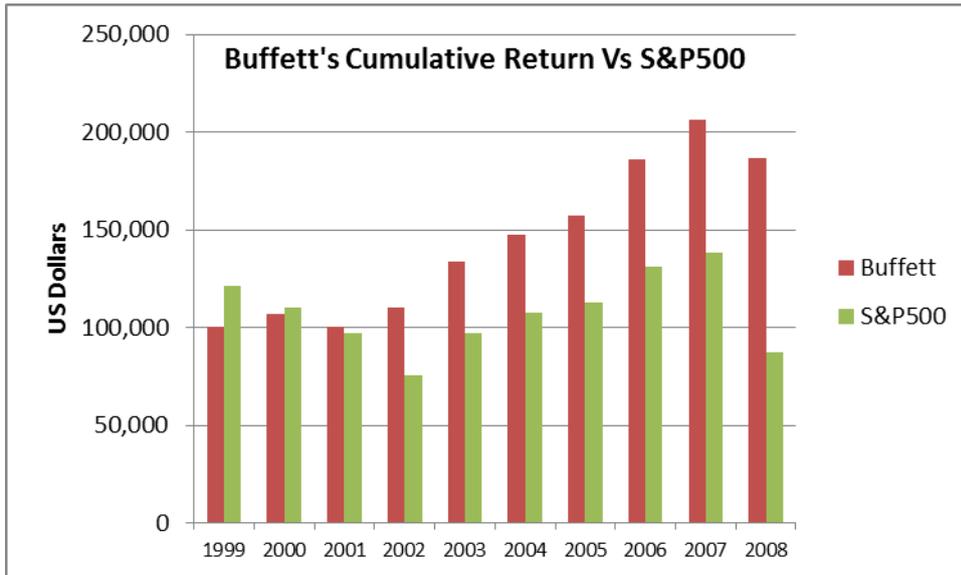
A Summary

From page 825 to page 830, Schroeder pulls it all together in a summary of Buffett’s investing style and how it developed. I will leave my readers to discover and absorb this.

Assessment of Buffett Returns

One of my readers queried Buffett’s return over the last ten years on the basis of an article, from which it was difficult to ascertain the source of the data on which the claim was made. The latest data Buffett has published on the Berkshire Hathaway website are up to calendar 2008. Remember that Buffett’s objective in this period was to beat the S&P500 index by an average of five points a year.

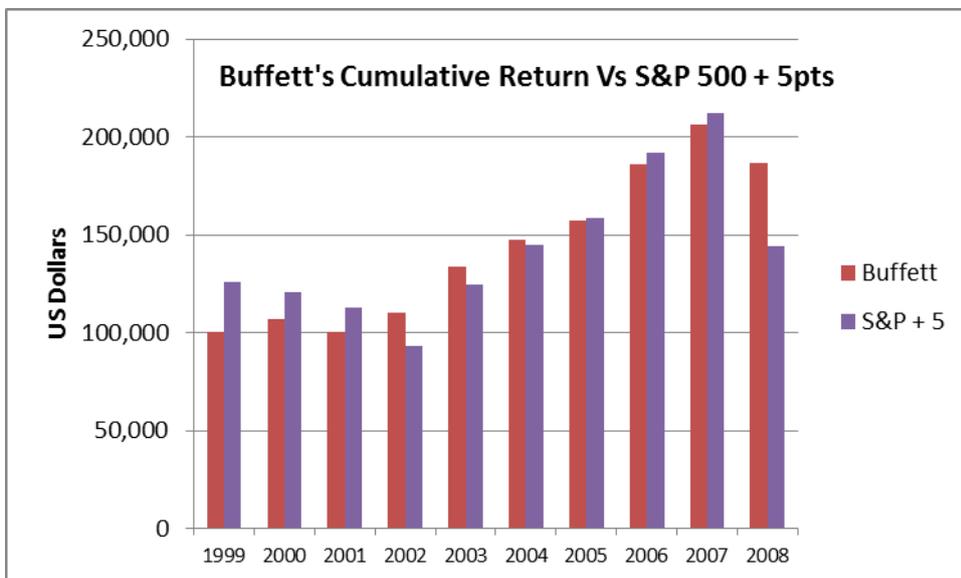
The first chart below shows a comparison between Buffett’s cumulative return for the last ten years assuming \$100,000 was invested at the beginning of 1999.



So, over the last ten years he has beaten the market by quite a margin.

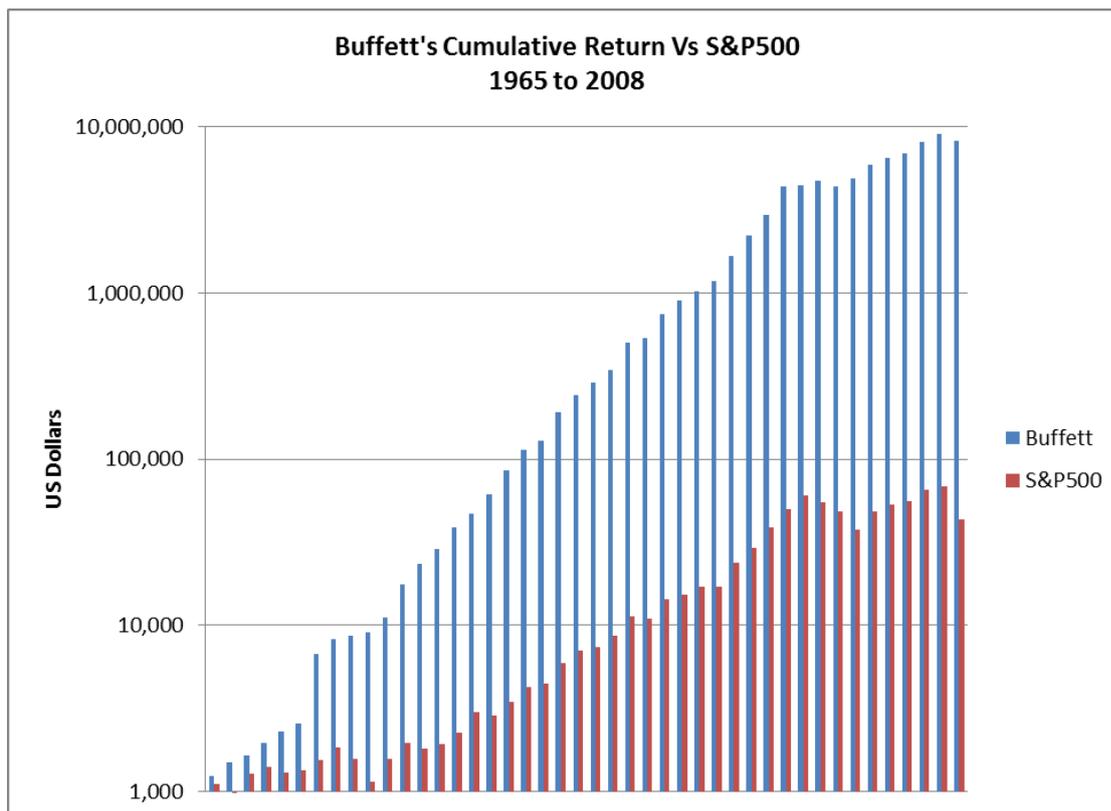
However, that was not his objective, so we need a different chart. In the chart on the next page, I have compared his cumulative return for the last ten years to the S&P500 index plus five points. This shows that Buffett has exceeded his target over that last ten years.

It should be noted that ten years is a short timeframe for Buffett.



The really interesting thing here is how Buffett's return has held up better than the index in bear markets. I feel that this is a tribute to his superior stock-picking skills. Great companies tend to hold up better in tough times.

The third chart below shows Buffett's return 1965 to 2008 versus the S&P500 index assuming \$1,000 was invested at the start of 1965. This is a semi-log chart, unlike the first two charts which were linear.



Final Remarks

I hope this review has been of assistance to my readers. I have had some critical emails after the previous newsletter saying that what Buffett has done is the opposite of what my investment plan is. This is only partly true and comes from a misunderstanding of both what I do and what Buffett really does. However, I will say this:

1. The objective of this two-part review has been to give readers a taste and basic understanding of the book *The Snowball*. I hope it will encourage many of my readers to buy and read this book.
2. Those who want to compare methods are probably still at stage one of their investing education – when they are looking for the guru or the perfect method. The truth is that there are no gurus and no perfect methods in my experience. Instead there are many ways to make money in the markets, whether as an investor, a speculator or a market maker and so on. Trying to say which one is the best is to misunderstand the problem.

What we must all seek to do is to understand that the last frontier in learning to master the market is psychology – our own psychology in particular. Every one of us is different, so our investment or speculation plan must be different. Which method gives the best return is the wrong question to be asking. The important question is to find which method is best for each of us. It is only when we reach this point of having a method that is comfortable for us that we start to do really well in the markets.