RAJESH BHATIA
Chief investment officer,
Simto Investment Company

WHAT I LEARNT FROM WARREN BUFFETT

Focusing on a few good stocks and consistent positive returns yield better long-term gains

How would you like to be happy every moment, every day, for the rest of your life? If you thought the only thing you can learn from Warren Buffett, arguably the world's greatest investor, is how to pick stocks — think again! Buffett, unfailingly, always comes across as a cheerful, witty, down to earth and an intellectually charged person. While most of us bemoan the drudgery of work, Buffett is so joyful about his job that he can't have enough of it. Even at 86 years, this multi-billionaire has no plans of retiring — he says he still "tap dances" to work every day. So what gives?

Buffett's success is the end product of his deep thinking and intense pursuit of "rationality". Over the years, he has generously shared his wisdom on life and work through his writings and speeches. It would be unusual not to be struck by the creativity, clarity and consistency of his thoughts. All told, it pays to observe Warren Buffett.

Of course, there is a lot to learn about investing too. The success of Berkshire Hathaway, his investment vehicle, defies normal standards. Berkshire, today the world's fifth largest public company, has compounded its net worth (return on equity or ROE) at 19.2% over the last 51 years. What makes this performance even greater is that it was achieved while employing low or no leverage and retaining all of its earnings. In fact, Berkshire's performance could probably be the best for any company in the world in this period. So, is there a Buffett rule book to success? Here's what I learnt from the master investor:

Buy stocks: Buffett places enormous faith in stocks to generate and compound wealth. A characteristic of equities is that unlike bonds, they can re-invest their retained earnings (corporate profits not paid out as dividends). Over time, this incremental capital results in even higher earnings and value for a company. In fact, a century of data shows that stocks have outperformed bonds for the most part.

Recognising that stock returns over the long-term mirror the returns generated by the business, Buffett likes to buy and hold businesses with strong competitive advantages (moats), which have the ability to earn and sustain a high return on capital over the long term. Not surprisingly, he only buys businesses where he is able to reasonably forecast the sustenance of these moats (and high returns on capital) 10-20 years out. This means gravitating to unique franchises such as Coke, Gillette or Wrigley's chewing gum where the rate of change in business dynamics is low as compared to say the technology business.

Rule number one: Don't lose money; Rule number two — Never forget rule number one. Protecting capital and avoiding losses is paramount for Buffett. Berkshire in its 51-year history has registered a decline in its book value only twice (in 2001 by 6.2% and 2008 by 9.6%). Also, the highest increase that Berkshire has witnessed is 59.3% in 1976. Berkshire's performance thus has more do with achieving consistent positive returns rather than extraordinarily high annual returns.

A basic math calculation shows that sharp declines in investment values affect the compounding rate (As

Seth Klarman says in his book *Margin of Safety*, a fund manager who compounds money at 16% for a decade will be better off than a fund manager who compounds at 20% for nine years, but loses 15% in the tenth year). In other words, an investor is more likely to do well by achieving consistently good returns with limited downside risk than by achieving volatile and sometimes even spectacular gains with considerable risk to principal.

So while evaluating an individual investment opportunity, Buffett focuses more on the risk than the potential return. The probability of a loss is far higher in case of a company that is innovating with a new product compared to an established franchise investing in expanding its facilities, even though the returns from the former could be far superior. Likewise, he is careful to avoid business risks arising out of a highly-leveraged or an opaque balance sheet, commoditised nature of the business, vulnerability to technology changes etc.; risks which can lead to a permanent loss of capital.

Buffett likes to buy when the price paid is at a discount to what he believes should be the fair value of purchase (or "margin of safety"). Such a bargain, for instance, could be available when emotional and pessimistic investors are selling in fear of further losses.

Read and think: How should an investor unearth investing opportunities? Talk to brokers, sell-side analysts or listen to experts? Buffett's preference is to sit alone in a room, read from the original sources and think independently. He is a vociferous reader and is said to read an average of 500 pages a day. An avid student of business, he is keen to learn how companies and businesses evolve and succeed, but even keener to learn why they fail. Over time, he has developed an encyclopaedic database of business insights. So, how does that help his investing?

Buffett recognises that good ideas come in clusters — by time, sector or asset class — and mispricing in the markets doesn't last long. This accumulated knowledge helps him move swiftly. As he points out "Noah did not start building his ark when it started raining". Often, he can make an investment decision within five minutes. It is also remarkable how much he relies on plain common sense to arrive at investment decisions.

Buffett is a zealous disciple of value investing, an approach championed by his mentor, Benjamin Graham, in the 1930s. Value investors, typically, buy stocks when they believe the market is temporarily and irrationally valuing a company below its intrinsic value. While value investing is unlikely to become ineffectual, investments methods do as they become too popular. For instance, one is unlikely to find attractive opportunities below net working capital, as espoused by Graham, because too many people are aware of this approach.

Superior investment performance is likely only when one is able to buy differently and ahead of the crowd. What is remarkable about Buffett is his ability to continuously learn about the changing dynamics and economics of several businesses and evolve. This helps him exploit new opportunities. His recent bets on the improved economics of the American railway business or identifying the option value in IBM's stock are examples.

Superior investment performance is likely only when one is able to buy differently and ahead of the crowd. What is remarkable about Warren Buffett is his ability to continuously learn and evolve

Temperament: It is in the nature of markets to be volatile. Everyone seeks to "Buy low and sell high". But, often, investors become their own enemies and allow themselves to be governed by the fear of falling prices or the greed of rising prices. There is extraordinary discomfort in going against the crowd. Yet lower stock prices are on offer only when the world view (even that of experts) is negative and vice-versa. Temperament thus makes a substantial difference to the performance of an investor.

Patience and discipline: Buffett believes that activity is the enemy of good investing. He encourages investors to make fewer investment decisions — 20 in their lifetime — and hold on patiently to a concentrated portfolio over the long term. Good businesses bought at a fair price can reward an investor substantially over the long term. Also, one must keep in mind that markets are frequently prone to extreme degrees of fluctuations and unusual opportunities arise from time to time. For instance, Buffett loves to make an entry when a good company falls in temporary trouble and the market price declines sharply. His investments in American Express, GEICO etc are examples. Otherwise, he is happy to sit on cash until an opportunity arises. The greatest challenge then for investors is to avoid the short-term frenzy, the over stimulation and the herd mentality that engulfs most market participants.

To conclude, Buffett is an unmatchable investment genius, who has contributed exceptionally to the field of security analysis and investments. One can be certain that Buffett and how he built Berkshire will be studied closely for generations to come.