

## The GOAT

It's a daunting, albeit enjoyable, task to try to capture the key elements of Warren Buffett's investing strategy. We've made an attempt at that here, augmented by investment-case discussions with five PMs about their holdings in Berkshire-owned stocks Occidental Petroleum, VeriSign, Sirius XM, Chubb and Ally Financial. *By John Heins and John Rotonti*



If you're reading *Value Investor Insight*, chances are you have more than a passing familiarity with Warren Buffett. Through word and deed over a remarkable career he has taught an ongoing masterclass on investing, generously sharing his philosophy, strategy and tactics along the way. While the lessons are surely not over, we've tried to assemble the equivalent of an interview with the now 94-year-old Mr. Buffett, using mostly his own words to describe as best we can how he invests and why. Maybe you've heard it all before – which probably means you'll be thrilled to hear it all again.

To add to the fun, we've also asked five investors to walk through their own cases for current Berkshire Hathaway holdings, in energy, Internet technology, insurance, financial services and satellite radio.

**There's a sort of awesome** simplicity to the story of Warren Buffett as an investor. He started making money in grade school – in one case buying six packs of Coca-Cola for 25 cents and reselling them individually for a nickel apiece – and over the next nearly 90 years has basically made one good investment decision after another to build what *Forbes* calculates is the sixth-largest fortune in the world, at last count in excess of \$130 billion. His Berkshire Hathaway, which he bought as a failing textile company and where he at age 94 remains Chairman and CEO, is now the ninth-largest company by market capitalization in the U.S., valued at nearly \$980 billion.

If you ask ChatGPT to summarize Mr. Buffett's equity-investing strategy in 25 words or less, here's what you get: "Warren Buffett's strategy focuses on buying

undervalued companies with strong fundamentals, competitive advantages, and competent management, holding them for long-term growth and compound returns." While that may be an adequate summary that reflects well the current Cliff Notes version of how he invests, it's understandably lacking in context, rationale and emphasis and maybe represents more of what investors today want to believe than what Buffett has actually done.

We would never claim that what follows is a definitive description of how Buffett invests, but we've tried to hit some of the high points around what he looks for, how he thinks about valuation, and his mindset as an investor. Knowing and doing are different things, of course, but if you're looking to emulate anyone as an investor, who could possibly be a better role model?

### Measuring Up

The description of what Warren Buffett looks for in a company has obviously changed over time. He has described early on looking for "cigar butts," cheap but otherwise unremarkable companies that may have had only one or two figurative "puffs" left in them. His early portfolios, when he was unencumbered by having to put massive amounts of money to work, were populated with quirky, off-the-beaten-path companies – Marshall-Wells, a Minnesota-based hardware retailer, say, or Greif Bros., a maker of barrels and containers – where his own proprietary, shoe-leather research produced insights the rest of the market was ignoring. Berkshire Ha-

thaway itself was hardly a world-beater. As Buffett has described: “When we took over [Berkshire Hathaway] in 1965, its risks could have been encapsulated in a single sentence: ‘The northern textile business in which all of our capital resides is destined for recurring losses and will eventually disappear.’”

As his assets under management grew dramatically and his strategy evolved, Buffett – with Charlie Munger’s brilliant input – started to describe differently his ideal target company for investment. This is what most investors have come to know as gospel, with several key components. In Buffett’s own words:

### *Competitive moats*

- “The key to investing is not assessing how much an industry is going to affect society, or how much it will grow, but rather determining the competitive advantage of any given company and, above all, the durability of that competitive advantage. The products or services that have wide, sustainable moats around them are the ones that deliver rewards to investors.”
- “Long-term competitive advantage in a stable industry is what we seek in a business.”

### *Predictability*

- “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 earnings estimate. If, however, we lack the ability to estimate future earnings – which is usually the case – we simply move on to other prospects.”

- “Just because Charlie and I can clearly see dramatic growth ahead for an industry does not mean we can judge what its profit margins and returns on capital will be as a host of competitors battle for supremacy. We will stick with businesses whose profit picture for decades to come seems reasonably predictable.”
- “Though the mathematical calculations required to evaluate equities are not difficult, even an experienced and intelligent analyst can easily go wrong in estimating future ‘coupons.’ 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.”

### *Pricing Power*

- “We like buying businesses with some untapped pricing power. When we bought See’s Candies for \$25 million, I asked myself, ‘If we raised prices by 10 cents per pound, would sales fall off a cliff?’ The answer was obviously no. You can determine the strength of a business over time by the amount of agony they go through in raising prices.”

### *High returns on capital*

- “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. Share-

holders of such a business usually will benefit if it pays out most of its earnings in dividends or makes significant stock repurchases.”

### *Good free cash flow conversion*

- “However attractive the earnings numbers, we remain leery of businesses that never seem able to convert such pretty numbers into no-strings-attached cash.”

### *Able, shareholder-friendly management*

- “We look for three things [in our managers]: intelligence, energy and integrity. If they don’t have the latter, then you should hope they don’t have the first two either. If someone doesn’t have integrity, then you want him to be dumb and lazy.”
- “We haven’t tried to evaluate, before they have a record, who will be superstar managers. Instead, we find people who have batted .350 for 10 to 50 years. We take people who play the game very well and allow them to play.”
- “I do not hire people I would not want as friends or as neighbors. I work with people who make my life easier. You can’t work with people who make your stomach grind.”

### *High returns of capital*

- “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.”
- “When we buy stock in a company that is repurchasing shares, we hope for two events: First, we hope that earnings of the business will increase at a good clip for a long time; and second, we also hope that the stock underperforms in the market for a long time as well.”

- “We like increased dividends, and we love repurchases at appropriate prices.”
- “The obvious point involves basic arithmetic: major repurchases at prices well below per-share intrinsic business value immediately increase, in a highly significant way, that value. When companies purchase their own stock, they often find it easy to get \$2 of present value for \$1.”
- (Regarding Berkshire Hathaway) “We like making money for continuing shareholders, and there is no surer way to do that than by buying an asset – our own stock – that we know to be worth at least x for less than that – for .9x, .8x or even lower. (As one of our directors says, it’s like shooting fish in a barrel, after the barrel has been drained of water and the fish have quit flopping.)”

#### *Berkshire’s Acquisition Criteria*

- “We are eager to hear from principals or their representatives about businesses that meet all of the following criteria: (1) Large purchases (at least \$75 million of pre-tax earnings unless the business will fit into one of our existing units); (2) Demonstrated consistent earning power (future projections are of no interest to us, nor are “turn-around” situations); (3) Businesses earning good returns on equity while employing little or no debt; (4) Management in place (we can’t supply it); (5) Simple businesses (if there’s lots of technology, we won’t understand it); (6) An offering price (we don’t want to waste our time or that of the seller by talking, even preliminarily, about a transaction when price is unknown).”

To take nothing away from the foregoing, it’s worth mentioning that “buy great

businesses and hold them forever” doesn’t capture adequately Buffett’s approach. We can probably all agree that top-ten Berkshire holdings like Apple [AAPL], American Express [AXP], Coca-Cola [KO] and Moody’s [MCO] are high-quality businesses. But what about others in that same top ten? Are Occidental Petroleum [OXY] and Chevron [CVX] superior businesses? Does insurer Chubb [CB] have a wide moat? Is Kraft Heinz [KHC] a prototypical compounder? The risk in any attempt to summarize is oversimplification – do so when investing with great caution.

#### **Mindset**

All great investors, including Warren Buffett, describe the mind game involved as one of the most difficult – but also differentiating – aspects of investing. Even the sharpest analytical thinking goes for naught when decision-making is unduly influenced by hidden biases or uncontrolled emotions. Buffett speaks to this in recounting Sir Isaac Newton’s experience as an investor: “Long ago, Sir Isaac Newton gave us three laws of motion, which were the work of genius. But Sir Isaac’s talents didn’t extend to investing: He lost a bundle in the South Sea bubble, explaining later, ‘I can calculate the movement of the stars, but not the madness of men.’” Among additional words of wisdom from Buffett on the subject:

#### *Patience*

- “We try to exert a Ted Williams kind of discipline. In his book *The Science of Hitting*, Ted explains that he carved the strike zone into 77 cells, each the size of a baseball. Swinging only at balls in his ‘best’ cell, he knew, would allow him to bat .400; reaching for balls in his ‘worst’ spot, the low outside corner of the strike zone, would reduce him to .230. In other words, waiting for the fat pitch would mean a trip to the Hall of Fame; while swinging indiscriminately would mean a ticket to the minors.”

“Unlike Ted, we can’t be called out if we resist three pitches that are barely in the strike zone. The trick in investing is just to sit there and watch pitch after pitch go by and wait for the one right in your sweet spot, and if people are yelling, ‘Swing, you bum!’ ignore them.”

#### *Controlling emotions*

- “To invest successfully over a lifetime does not require a stratospheric IQ, unusual business insights, or inside information. What’s needed is a sound intellectual framework for making decisions and the ability to keep emotions from corroding that framework.”
- (On Benjamin Graham’s metaphorical construct from his seminal book, *The Intelligent Investor*, of Mr. Market) “Sad to say, the poor fellow has incurable emotional problems. At times he is euphoric ... at other times he is depressed. Mr. Market has another endearing characteristic: He doesn’t mind being ignored. If his quotation is uninteresting to you today, he will be back with a new one tomorrow. Transactions are strictly at your option. Under these conditions, the more manic-depressive his behavior, the better for you.

But, like Cinderella at the ball, you must heed one warning or everything will turn into pumpkins and mice: Mr. Market is there to serve you, not to guide you. It is his pocketbook, not his wisdom, that you will find useful. If he shows up some day in a particularly foolish mood, you are free to either ignore him or to take advantage of him, but it will be disastrous if you fall under his influence. Indeed, if you aren’t certain that you understand and can value your business far better than Mr. Market, you don’t belong in the game.

In my opinion, investment success will not be produced by arcane formulae, computer programs or signals flashed by the price behavior of stocks and markets. Rather an investor will succeed by coupling good business judgment with an ability to insulate his thoughts and behavior from the super-contagious emotions that swirl about the marketplace. In my own efforts to stay insulated, I have found it highly useful to keep Ben's Mr. Market concept firmly in mind."

- "If I own a good business privately, am I worried about what the headlines are tomorrow? If I've got the best auto-repair shop in town, I'm not worried about the headlines tomorrow, I'm worried about taking care of my customers. I don't know what the stock market is going to do, but nobody else does either. Forget about it. Just own good assets, run by decent and honest people. The volatility is good for you. Stocks overreact all the time and that's why a guy who can keep his senses about him can get very rich."

### Contrarianism

- "[O]ccasional outbreaks of those two super-contagious diseases, fear and greed, will forever occur in the investment community. The timing of these epidemics will be unpredictable. And the market aberrations produced by them will be equally unpredictable, both as to duration and degree. Therefore, we never try to anticipate the arrival or departure of either disease. Our goal is more modest: we simply attempt to be fearful when others are greedy and to be greedy only when others are fearful."
- (On institutional fund managers' then-reticence to buy stocks) "A[n] argument is made that there are just too many question marks about the

near future; wouldn't it be better to wait until things clear up a bit? You know the prose: 'Maintain buying reserves until current uncertainties are resolved,' etc. Before reaching for that crutch, face up to two unpleasant facts: The future is never clear [and] you pay a very high price for a cheery consensus. Uncertainty actually is the friend of the buyer of long-term values."

- (From an article in *The New York Times* in the midst of the 2008 financial crisis) "Let me be clear on one point: I can't predict the short-term movements of the stock market. I haven't the faintest idea as to whether stocks will be higher or lower a month – or a year – from now. What is likely, however, is that the market will move higher, perhaps substantially so, well before either sentiment or the economy turns up. So if you wait for the robins, spring will be over. Today people who hold cash equivalents feel comfortable. They shouldn't. They have opted for a terrible long-term asset, one that pays virtually nothing and is certain to depreciate in value. Those investors who cling now to cash are betting they can efficiently time their move away from it later. In waiting for the comfort of good news, they are ignoring Wayne Gretzky's advice: 'I skate to where the puck is going to be, not to where it has been.'"

### Valuation

No one has been a stronger advocate for value investing than Warren Buffett. The investor's task is to arrive at an estimate of a company's intrinsic value – which he defines simply as "the discounted value of the cash that can be taken out of a business during its remaining life" – and then compare that intrinsic value to the market value currently on offer from Mr. Market. Having done that – by all accounts he doesn't formally do DCF models himself,

other than maybe in his head – he requires a margin of safety:

### Margin of safety

- "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."
- "You have to have the knowledge to enable you to make a very general estimate about the value of the underlying businesses. But you do not cut it close. That is what Ben Graham meant by having a margin of safety. You don't try and buy businesses worth \$83 million for \$80 million. You leave yourself an enormous margin. When you build a bridge, you insist it can carry 30,000 pounds, but you only drive 10,000-pound trucks across it. And that same principle works in investing."

Genial as he is, one doesn't become an investing legend without the consistent willingness and ability to drive a hard bargain. If you have an intelligently derived sense of what something is worth, you want to pay as much below that as you can. We're betting this anecdote, told by former *Barron's* Roundtable investment manager Marc Perkins in an interview with *TheStreet.com*, provides an example of Buffett's buying discipline:

I used to trade with Warren Buffett when I was at Salomon Brothers. He was a customer of Salomon's back in the early 1970s and I can remember when he was buying bank stocks in 1971 – the doggy banks, not the growth-stock banks. He was buying Harris Trust and the Manufacturers Hanover trust department called and said it had a big block of stock

in Harris Trust for sale. Buffett had a trader by the name of Bill Scott in his office in Omaha. We called him and said, "We've got a block of Harris Trust for sale." The stock was around \$49 and he said, "I'll pay \$47." So we called Manny Hanny back and told them he'd pay \$47 and they said, "That's ridiculous, down two points. That's crazy." Of course, Harris Trust didn't trade very much, so Buffett was the only buyer around.

We called Bill Scott back and said, "The seller won't go below the market – they'll sell it for \$48.50." Buffett's response was, "Tell them we're not interested." So, we call Manny Hanny back and say, "There are no bids." "What do you mean no bids?" they say. "Tell 'em we'll sell at \$47." So Buffett's guy says, "\$47 is no good anymore. We've gone on to something else and we're just not interested." So the Manny Hanny guy couldn't believe that somebody just walked away. So he now starts calling everybody on the Street trying to sell and the next thing you know, the stock is around \$44. He called us back and asked, "Can you buy it now?" Buffett's response was, "I'll pay \$42."

That's his whole deal. Iron-willed discipline. People who know what they know and what they're good at survive over time.

Which brings us to three quotes – two from Buffett and one from Charlie Munger – that we would argue have been the most misinterpreted by the current generation of investors. Here they are:

1. "It's far better to buy a wonderful company at a fair price than a fair company at a wonderful price."
2. "Over the long term, it's hard for a stock to earn a much better return than the business which underlies it earns. If the business earns six percent on capital over forty years

and you hold it for that forty years, you're not going to make much different than a six percent return – even if you originally buy it at a huge discount. Conversely, if a business earns eighteen percent on capital over twenty or thirty years, even if you pay an expensive looking price, you'll end up with one hell of a result." [Charlie Munger]

3. "Time is the friend of the wonderful business; it is the enemy of the lousy business. If you are in a lousy business for a long time, you will get a lousy result even if you buy it cheap. If you are in a wonderful business for a long time, even if you pay a little bit too much going in you will get a wonderful result if you stay in a long time."

When read a particular way, many conclude that Buffett over time has become less worried about the price he pays – as long as you're buying a compounder business, what you have to pay for it is a secondary concern. We would wholeheartedly challenge that presumed assertion, and argue instead that **he has almost never "paid up" for a great company**. Aside from an admitted mistake when Berkshire Hathaway paid 19x estimated forward earnings for Precision Castparts in 2016 – "I was wrong in judging the average amount of future earnings and, consequently, wrong in my calculation of the proper price to pay for the business," he said – we are hard pressed to come up with examples where Buffett has paid more than 15x after-tax earnings for anything.

At the risk of overstating the point, based on his own words, our research and that of others like investment manager John Huber and long-time value investing blog *The Brooklyn Investor*, here's a rundown of what Buffett appears to have paid for some of his higher-profile holdings over the years:

**Disney:** 4.3x operating earnings

**See's Candies:** 6x pre-tax earnings

**Wells Fargo:** 5x after-tax earnings

**Coca-Cola:** 14.6x after-tax earnings

**American Express:** 6.9x pre-tax earnings

**Clayton Homes:** 14x after-tax earnings

**Apple:** 11-12x forward EPS

**Occidental:** 8-12x forward EPS

**Pilot Travel:** 15x after-tax earnings

**Japan's Sogo Sosha:** 7x after-tax earnings

### *Hurdle Rate*

Berkshire Hathaway's Todd Combs, who joined the company in 2010 as one of Buffett's two putative successors (along with Ted Weschler) on the company's investment side, described in a 2022 interview some specifics on what the Oracle of Omaha looked for in a prospective investment. Combs described often going to Buffett's house on Saturdays to talk, when he regularly asked, "How many names in the S&P 500 are going to be 15x earnings in the next 12 months? How many are going to earn more in five years (using a 90% confidence interval), and how many will compound earnings at 7% (using a 50% confidence interval)?"

Parsing that comment, it appears Buffett wants to believe he's getting a roughly 7% earnings yield – and likely free-cash-flow yield as well, given his emphasis on free-cash conversion – for a company he believes can increase earnings at least 7% per year. That implies a 14% hurdle rate, which is right around what Buffett biographer Alice Schroeder concluded from all her time studying Buffett's body of work: "Warren always wants a mere 15% day-one return on investment and then it compounds from there. That's all he's ever wanted."

### **Legacy**

What can get lost sometimes in our quest to understand how Warren Buffett

– or any successful investor, for that matter – plies his craft is that success in the end ultimately comes down to consistently skillful execution. We can follow the basics of his strategy to a T, but that doesn't mean we'll do as good a job as he's done in assessing competitive moats, understanding industry dynamics, judging management, estimating a company's intrinsic value, or controlling emotions. That's not to say we can't be much better investors for following his lead, or that we don't owe him a considerable debt of gratitude for being such a fabulous teacher. But it's important to recognize that he's just been very, very good at all of this for a very, very long time. We've been lucky to witness that – it's exceedingly unlikely we'll ever see anything like it again.

An investor we interviewed years ago at the outset of his career had written to Buffett asking if he might be considered

for a job as an investment assistant at Berkshire Hathaway. First of all, it's telling that Buffett responded, but here also was his advice in politely turning the young man down:

- “Our operation has to be seen to be believed. There are no meetings, discussions, investigations, or interactions of any kind. I just read and think. This is more effective for obtaining the kinds of ideas I need than anything that interacts with Wall Street, consultants or even assistants. As a practical matter, everything I know has been put down in my annual reports or in my few speeches or television appearances. There are no 'secrets' and with a little reading you can know everything I know. Good luck with your career.”

As it should be, we leave the last word on Buffett and his legacy to the great man himself:

- “An example is the best thing you can leave behind. If what I've done with Berkshire – running a unique and independent company in true pursuit of shareholder value – persists and people learn from it to improve the way they invest and run their companies, that would be a fine legacy to leave.”