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Wisdom From Warren

We take a break from our normal market commentary this month to review some wisdom of the *Oracle of Omaha,* **Warren Buffett**. Unless you totally ignore *everything* financial, you already know Buffett sits at the head of the class when it comes to legends on Wall Street. As CEO of **Berkshire Hathaway**, he has compiled an unsurpassed record as an astute, successful money manager. Buffet's annual *Letter to Shareholders* in the Berkshire annual report is always a treasure of investment wisdom and very entertaining as well.

This year marks Buffet's 50th anniversary managing Berkshire Hathaway so his letter, dated February 28, 2015, includes more history, interesting anecdotes and investment wisdom than normal. Below, we summarized a few of his thoughts which we felt most useful or interesting. For the full impact, we strongly suggest you read the entire letter at www.berkshirehathaway.com.

First, the track record: The first page of the letter lists investment returns for each of Buffet's 50 years. Over the fifty years, he has compiled an average annual return of 21.6%. Compare that to the healthy 9.9% return the S&P 500 has averaged over the same period—and keep in mind that very few investors are able to beat the S&P over long periods. Hidden within that performance number are additional benefits to investors such as lower volatility than the market and very low turnover (i.e. low tax consequences).

Price versus Value: One of Buffet's main tenets is to buy at the ***"right price."*** He provides a detailed discussion about valuing a stock relative to the intrinsic value of the business. He is not interested in the daily fluctuation of the stock market but he wants to buy a company at a price that reflects the true value of the operating business. He assumes the stock market will eventually recognize that value as well—over the long-term. Specifically, Buffet says, "*a business with terrific economics can be a bad investment if it is bought for too high a price."* And, *"…a sound investment can morph into a rash speculation if it is bought at an elevated price."*

Making Mistakes is Normal: Not only is it normal, it is part of investing. The key for successful investing is to realize a mistake, accept it and cut your losses rather than trying to get your money back the same way you lost it. In his letter, Buffett shares an early experience in cutting his losses in a bad investment. Stressing how bad often leads to worse, Buffet says, *"**…**bad news often surfaces serially: You see a cockroach in your kitchen; as the days go by, you meet his relatives."*

Stocks are Better than Bonds in the Long-Run: Bonds, *theoretically*, are safer than stocks because you have a "promise" to get your money back in bonds but Buffet explains that bonds, historically, have lost **purchasing power** relative to inflation. Stocks, he points out, will fluctuate and will suffer periods of decline. But buying stocks of good quality businesses has reaped great rewards in terms of wealth creation over the long-term (i.e. 10 years or longer). Buffett predicts in his letter that stocks will continue to remain safer than bonds in the long run as he says, *"The unconventional, but inescapable, conclusion to be drawn from the past fifty years is that it has been far safer to invest in a diversified collection of American businesses than to invest in [bonds, CD's or cash]…To one degree or another it is almost certain to be repeated during the next century."*

Stock Price Volatility is *Not* Risk: According to Buffett, the only risk in investing is permanent loss of capital, which is very different from stock price volatility or fluctuation. Downward fluctuation doesn't present a big problem if you are able to hold on and come out the other side. On the other hand, a permanent loss can occur for either of two reasons: (a) an otherwise-temporary dip is locked in when the investor sells, or (b) the investment itself is unable to recover for fundamental reasons. Buffett stresses that one should not consider volatility a synonym for risk, and thus not become fearful when stock prices move up and down, especially down.

Invest for the Long-Term: Buffett's definition of the long-term is very long. Although he doesn't specifically identify when "long-term" begins, he speaks of buying companies for the returns they will generate over ten years or more and he suggests one buy Berkshire Hathaway stock only if it will be held at least five years. About the importance of having a long-term perspective, he writes,*"It is true, of course, that owning equities for a day or a week or a year is far riskier (in both nominal and purchasing-power terms) than leaving funds in cash-equivalents. That is relevant to certain investors…[who] might be forced to sell securities during depressed markets. For the great majority of investors, however, who can - and should - invest with a multi-decade horizon, quotational declines are unimportant. Their focus should remain fixed on attaining significant gains in purchasing power over their investing lifetime. For them, a diversified equity portfolio, bought over time, will prove far less risky than dollar-based securities."*

Avoid "Bad" Behavior: Buffett discusses how investors, by their own behavior, make stock ownership risky. He mentions five ways investors often destroy wealth - trading, timing, inadequate diversification, high fees, and leverage. Specifically, he says, *"Investors, of course, can, by their own behavior, make stock ownership highly risky. And many do. Active trading, attempts to "time" market movements, inadequate diversification, the payment of high and unnecessary fees to managers and advisors, and the use of borrowed money can destroy the decent returns that a life-long owner of equities would otherwise enjoy."*

Buffet's Criteria for a Good Investment: Buffett outlines six key points of Berkshire's acquisition criteria. The first point may be immaterial for the rest of us but the other five are importantfor all sensible, long term investors. From the letter:
(1) Large purchases (at least $75 million),
(2) Demonstrated consistent earning power (future projections are of no interest to us, nor are "turnaround" 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).

Investment Psychology: Throughout his letter, Buffet makes numerous references to the psychology that affects investors. In various ways, he talks about the fear and greed that roil investors' emotions. He also gives much credit to his partner, Charlie Munger, for helping him manage emotions over the years. Generally, his message is to focus on the long-term prospects of each business as well as the American economy, and avoid being swayed by the daily fluctuation, both up and down, or the stock market.

This is just a brief summary of many bits of wisdom and interesting stories Buffett covered in his letter. Hopefully, this summary will whet your appetite enough to read the full letter yourself where you will see Buffett is much more detailed—and eloquent—than we have been here. Meanwhile, we will work to emulate Buffet's principals, and success, in our investment work for you!

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Questions or comments?
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