CHAPTER 1

Does Warren Buffett Trade?

My favorite holding period is forever.

—Warren Buffett

First, I have to apologize in advance. This book barely mentions Coca-Cola or the *Washington Post*. I also don't really talk about the many fine companies that Berkshire Hathaway has bought over the past three decades (See's Candies, the Pampered Chef, Dairy Queen, National Furniture Mart, and others). There are many excellent books that cover these topics. And while Warren Buffett has made billions of dollars from these investments, I don't think I can add to the already great dialogue that has taken place on these topics.

Nor is this book really about value investing. There are many definitions of value investing and many treatises on value versus growth. But even Buffett has stated that on the whole, the distinctions between value and growth are nonsense. This book is about the various ways that Buffett has applied the concept of "margin of safety" outside of his buy-and-hold strategies. He has had a longer and more diverse investment career than just about anybody. There are several people in the world (fewer than ten, actually) who have had more years' experience than Buffett at picking stocks, but I can think of no one who has traded and invested with a more diverse group of strategies over the past fifty years. It is these strategies that I write about. Many of them are normally thought of as "trading" strategies instead of the buy-and-hold investing for which Buffett is famous.

When I went to the Berkshire Hathaway annual meeting in 2003 I had no idea what I would encounter. I met one man who bought 200 shares of Berkshire Hathaway in 1976 for $15,000, give or take. He sold half of those shares a year later for a solid double (who can blame him?) and today the remaining shares are worth over $9,000,000. He now hangs out skiing in Tahoe for most of the year.

I asked him why he had bought those shares and he said that he had heard of Warren Buffett while growing up in the same town as him, had heard he was smart, and liked the insurance industry. One can argue that this man I had spoken to was an incredible investor. He had turned $15,000 into $9,000,000 over the course of 25 years—a 50,000 percent return!

Not everyone at the meeting was as lucky. Most of the people at the meeting were fairly recent owners of their shares and were either mildly up on their investment or flat. At the time of this writing Berkshire Hathaway is close to making an all-time high, so hopefully most of these people have held onto their shares. Throughout the meeting I asked people why they were there. After all, it was the most popular annual meeting in the company's history, with approximately 15,000 people in attendance. Some people were there because they just wanted to see Warren Buffett. What zeitgeist had he been tuned into all his life that he could start with $100 and compound it into $40 billion? While at the same time maintaining his homespun humility and simple lifestyle (he still lives in the same house he bought 40 years ago for $30,000).

Buffett supposedly found these incredible deals through the principles of value investing. Again, there are many good books out there about value investing that try to explain Buffett's value approach.[1] At the end of this

[1]The most famous of the books is Robert G. Hagstrom's *The Warren Buffett Way: Investment Strategies of the World's Greatest Investor.* Others include *How to Pick Stocks Like Warren Buffett: Profiting from the Bargain Hunting Strategies of the World's Greatest Value Investor* by Timothy Vick and *How to Think Like Ben Graham and Invest Like Warren Buffett* by Lawrence Cunningham. All of these are good books that focus on investing in companies with solid management, good corporate governance, high return on equity, a good brand, and so on.

book I try to provide a comprehensive suggested reading list of the major books written about Buffett.

However, Buffett achieved much of his early success from arbitrage techniques, short-term trading, liquidations, and so on rather than using the techniques that he became famous for with stocks like Coca-Cola or Capital Cities. In the latter stages of his career he was able to successfully diversify his portfolio using fixed income arbitrage, currencies, commodities, and other techniques. And further, in his personal portfolio he tended to stick to the style of deep value investing that marked his early hedge fund years.

This book is titled *Trade Like Warren Buffett*, and the phrase alone brings up several contradictions in the traditional mythos about Buffett.

First, Warren Buffett supposedly does not trade. He finds an undervalued gem, then buys and holds onto it forever. After all, it takes a million years to turn a piece of coal into a diamond, and a good company should always bare that in mind. For example, Buffett bought Gillette in the 1980s and, to his credit, many multiples later, he still holds onto it. After all, people will always shave, so the demographic for Gillette is approximately 3,000,000,000 citizens of this planet. How can you go wrong holding this stock forever?

Exhibit 1.1 represents the holding period of some of the Berkshire Hathaway trades that Buffett held for less than five years.

Second, the world of trading usually evokes images of day traders, fingers on the trigger, ready to scalp stocks for a few ticks several dozen times a day. Seldom do people think of Warren Buffett, known for holding onto stocks for years, when the subject of day trading comes up.

However, the texture of value investing now is very different than when Warren Buffett was making his early profits, let alone when Benjamin Graham and David Dodd wrote their classic text *Security Analysis*. Back then, there was only a limited set of eyes that had the access to information, not to mention the desire, to locate companies that fit a certain deep value criterion. But today if I want to sift through six thousand stocks to find some that fit specific earnings, ROE (Return on Equity), P/E (price over earnings ratio), and other criteria, then I can easily do so with any number of stock screeners online. And, believe me, countless value investors are doing just that. The information arbitrage that existed in the 1960s and earlier is nearly nonexistent today.

Buffett would spend hours going through *Moody's* reports on each stock, sifting for the gold among the dirt. And, after spending hundreds of hours

EXHIBIT 1.1 Some Berkshire Hathaway Trades Held for Less Than 5 Years

Company	Industry	Year of Purchase	Time Held (Years)
Kaiser Aluminum	Metals and Mining	1977	4
SAFECO	Insurance	1978	4
RJ Reynolds	Tobacco	1980	4
Time	Publishing	1982	4
Guinness	Beverages	1991	3
Knight-Ridder	Publishing	1977	2
ABC	Broadcasting	1978	2
FW Woolworth	Retail	1979	2
ALCOA	Metals and Mining	1980	2
Pinkerton's	Professional Services	1980	2
Cleveland-Cliffs Iron	Metals and Mining	1980	2
General Dynamics	Aerospace	1992	2
Capital Cities	Broadcasting	1977	1
Kaiser Industries	Metals and Mining	1977	1
Amerada Hess	Oil	1979	1
National Detroit	Banking	1980	1
Times Mirror	Publishing	1980	1
National Student Marketing	Financial Services	1980	1
Arcata	Paper	1981	1
GATX	Machinery	1981	1
Crum & Forster	Insurance	1982	1
Exxon	Oil	1984	1
Northwest Industries	Diversified	1984	1
Beatrice	Food	1985	1
Lear Siegler	Aerospace	1986	1
Gannett	Publishing	1994	1
PNC Bank	Banking	1994	1
McDonald's	Restaurants	1996	1
Travelers	Financial Services	1997	1

doing that (an activity that might now take one hour, tops), he would have to then figure out how to actually buy the shares he wanted. For instance, when Buffett was trying to buy shares of Dempster Mining he had to drive to the town where they were based and convince locals to sell their shares to him. There was no liquid market out there like there is now. So when he bought the shares, he *had* to hold them for longer then he might have wanted to.

So, value investing the way Buffett and Graham practiced it no longer exists today. There are thousands of mutual funds and hedge funds competing for those arbitrage opportunities, not to mention retail investors with access to the Internet.

During Buffett's hedge fund years (between 1957 and 1969) there were some years in which more than half his profits came from what he called "workouts"—special situations, merger arbitrage opportunities, spin-offs, distressed debt opportunities, and so on. Playing with semantics, we can argue that all of those opportunities represented "value"—that is, buying something that is cheaper than what it was worth—whether it was a spread between two securities, a distressed bond, or a stub stock that everyone ignored. However, these situations are not usually described as value investing.

Instead, over the past two decades we have seen Buffett dip his investing prowess into commodities (his foray into silver in 1997), fixed income arbitrage, many instances of distressed debt through the use of *private investment in public equity* (PIPE) vehicles, merger arbitrage, relative value arbitrage, and so on. In addition, Buffett has made his first forays into technology investing, owning over the past few years a number of shares in telecommunications services company Level Three and the debt of e-commerce company Amazon; the latter is a company that had never produced a dime of earnings when Buffett first invested in it, let alone an easy means by which someone could compute future cash flows.

There are three stages to Buffett's investment career, and we will focus on techniques used inside each of those phases.

THE EARLY YEARS

Buffett's hedge fund years were when he built his fortune from essentially nothing to about $25 million at the time he was interviewed by Adam Smith for his 1971 classic, *SuperMoney.* During this time Buffett had three techniques:

1. The cigar butt technique, into which category Berkshire Hathaway (in its original form) fell. This meant buying stocks that were selling for less than tangible assets. Buffett would sometimes accumulate enough shares that eventually a change of control would occur, giving him direct power over how the assets of the company would be disposed.

2. Value investing, but combined with some of his partner Charlie Munger's ideas on growth and the potential of brands. This resulted in Buffett's American Express play, among others.
3. Special arbitrage situations, workouts, distressed debt, merger arbitrage, spin-offs, and so on.

THE MIDDLE YEARS

The 1970s and 1980s were the decades when Buffett made the full transition from successful hedge fund manager to operator, asset allocator, and insurance company magnate. Why the insurance business? And why did he leave the hedge fund business? We know now in retrospect that he was a very good market timer, although prone to being early, just as Bernard Baruch said, "I always sold too soon." So it could be argued that Buffett's departure from the hedge fund business right before an essentially flat decade was a sign of good market timing. However, I don't believe this.

I believe that Buffett did anticipate a potentially horrendous decade for stock market returns, and in fact, 1973–74 was the worst downturn since the 1930s. But I don't think that Buffett would have stopped his hedge fund for fear of poor market returns. Rather, he was always more enthusiastic in his annual letters to his partnership investors when the market was doing its poorest. He prided himself more on outperformance than absolute performance. A return of 20 percent in a year when the market was up 30 percent would have been a disaster for him. Far better would be to return five percent, with the market returning –20 percent for the year. So the fact that the market was about to make a strong downturn would not have been the impetus to cause him to wind down his hedge fund and go into the insurance business.

Rather, I think he saw an opportunity unlike any he had encountered in the past and he wanted to pounce on it. The way Buffett's partnership was structured, he took a 0 percent management fee and 25 percent of all profits. As an example, if his fund had $5 million in it and he returned 20 percent, or $1 million, for his investors, then he would take 25 percent of that, or $250,000 of that, as his fee.

However, an insurance company is much more attractive to a master asset allocator like Buffett. An insurance company works like a hedge fund except Buffett gets to keep 100 percent of the profits. People "invest" their money when they pay their premiums and only get to take their money out again upon illness or disaster. In a well-run insurance business the "cost of float" is ideally zero; that is, you spend no more in payouts than you take in premium. In this way, all profits go to the owners of the business. If the cost of float is zero, then the economics of the insurance business are much better than the economics of a hedge fund.

Rather than retire to a lifetime of bridge playing, Buffett ended up buying for $40/share most of the Berkshire Hathaway shares that he had originally bought for his investors (profitably for them at prices ranging from $7 to $16 per share). Then, while Buffett used Berkshire as his base, the rest of the 1970s became a rollup of insurance companies, regional banks, and other cash-producing assets ranging from the Nebraska Furniture Mart to See's Candies.

It was during this period that he became less focused on his workout plays and more focused on his "control" plays like the insurance companies, furniture companies, and chocolate companies he was buying and his "generals"—the big value plays like Coco-Cola and Gillette that ultimately created billions of dollars in investment profits for Berkshire.

There is no one way to sum up Buffett's investment style during this period. Early on, he was certainly interested in buying companies for less than their book value. The Washington Post is a great example, where he began accumulating shares at a fraction of their liquidation value. Later on, however, particularly in the 1980s, his methods were much less quantitative and bordered on highly subjective. A case in point is Coca-Cola, which Buffett began accumulating in 1988; he ultimately became the largest shareholder. Coke was trading at 13 times earnings, hardly a discount to the market at that time, which was trading around 10 times forward earnings. That said, Buffett was convinced, and he was right, that Coke was trading at a huge discount based on the future earnings of the company.

"The Middle Years" are perhaps the least interesting period for me. However, this period (the 1970s and 1980s) is the subject of countless books on Buffett. Hagstrom's book *The Warren Buffett Way*[2] set the tone and documents Buffett's stock picks during this period.

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[2]*The Warren Buffett Way*, Robert Hagstrom (Wiley, 1993).

I repeat the following refrain throughout the book: It is not possible to trade exactly like Warren Buffett. The goal is to use whatever means possible to approximate his trading by attempting to quantify the term "margin of safety".

THE LATER YEARS

The 1990s and then the 2000s created an interesting dilemma for Buffett, one that no other company has ever faced. He simply had too much cash to put to work. As much as he loved finding quality companies and stocks, the world was just too small for him at this point. In lectures that he occasionally gave to college students he would often sentimentally reflect that if he had less money he could still return 50 percent a year in arbitrage situations. But with $50 billion to put to work this was just impossible. Nor is it easy to go through the market and find the slim pickings. Let's say a $1 billion company is trading at a cheap price and Buffett is able to buy 10 percent of it. Assume that it then goes up 100 percent for him over the next year—a truly remarkable return. It would still only increase the book value of Berkshire Hathaway by 0.2 percent.

Instead, the 1990s saw several trends developing in Buffett's style. First there was a flight to safety. In the late nineties, when the world was haphazardly buying everything with dot-com written all over it (author disclosure: I was, too), Buffett was diversifying into bonds, into silver, fixed income arbitrage, and ultimately foreign currencies.

So given the fact that Buffett's investment career has spanned five decades and multiple styles and disciplines, is it possible to "trade like Warren Buffett"?

IT'S TOO LATE

It is not possible to trade exactly like Warren Buffett. The best we can do is approximate his approach, plead in each trading situation for the margin of safety that Buffett always demands, and try to develop our own approaches that are, if not exact replicas, at least Buffett-like. But why can't we trade like him? To summarize the three main reasons:

1. **The Internet has changed everything.** Every SEC filing, every news report, every inside transaction, and every earnings release is instantly posted to the Internet and available to the tens of thousands of investors who are looking for low price to book, high return on equity companies. Although many studies have come to the conclusion that too many retail investors are naive, the reality is that there are many good investors out there who know how to make use of the information at their fingertips. No longer does an investor have to dig through tattered old filings to find the next Dempster Mining and then drive around Nebraska to find random shares in it.
2. **Arbitrage spreads have narrowed.** The "workout" trades that Buffett mastered in his hedge fund days are no longer as easy to accomplish as they once were. When Buffett started out, only a handful of hedge funds existed that were attempting to use those techniques. Now there are over 7,000 hedge funds trying to squeeze the blood out of every arbitrage situation. While the opportunities still exist—opportunities that we will examine in depth in later chapters—they are of a much different breed then what Buffett first encountered.
3. **People don't give us money.** Warren Buffett has enormous deal flow. Every day opportunities are placed in front of him, and often the types of deals are not those that are available to the average investor. The flipside to this is that he also has a lot of bad deals put in front of him, and it takes acumen to sift through these questionable opportunities to find the gems. However, his gems might be 10-carat diamonds, whereas the average investor needs to settle for a few inclusions and work his or her way up from there.

IT'S NOT TOO LATE

But don't despair. The key thing to focus on is Buffett's constant desire for a margin of safety. With each style of investing that he delves into, he consistently requires a certain degree of safety; investors who attempt to apply his techniques should do the same. Also, the average investor has several advantages over Warren Buffett, both the Buffett from his early hedge fund years and the Buffett of the 1990s and 2000s.

1. **The Internet.** The same phenomenon that was listed as a disadvantage above is also an advantage. The reality is that it is easier to research any investment possibility under the sun. It is also easier to quantify and back-test various approaches to verify that an approach has at least been statistically sound in the past. Buffett has a great appreciation for the quantifiable side of investing; it would be interesting to see what he could have done had he had the capabilities of the Internet behind him when he started.

2. **Size is important.** Buffett is simply too big. He cannot enter into a position easily without causing the entire world to react accordingly. For instance, when he started buying up silver he wasn't simply making a small investment. He ended up becoming the largest investor in silver since the Hunt Brothers, controlling not just a small amount, but 25 percent of the entire world's above-ground supply. And still this was just a tiny, miniscule drop in the bucket for the Berkshire Hathaway portfolio. Getting into and then out of this market was no easy task for Buffett either. Silver, which had been in a slump for years, jumped 30 percent when it was discovered that Buffett was making an investment.

   No wonder Buffett likes to tell people to buy and hold. If investors feel like selling something that Buffett owns, there is almost zero chance Buffett can get out before the other interested sellers do. Clearly, if everyone had a philosophy of "buy and hold forever," it would be much better for Buffett's investments, since he can't really sell. The reality is that during his career he has done much selling and has held even some core value plays (McDonald's and Disney are great examples) for short periods of time.

The fact that the average investor is much more nimble is a huge advantage, although it is an advantage that cannot be treated lightly due to the damage it can cause. Many studies have been done that show that the average retail investor is damaged by too high a turnover in his or her portfolio. Ultimately, though, it is better to have the option than to not have it at all.

The remainder of this book is mostly broken down by investment style.

THE INVESTMENT STYLES

Merger Arbitrage

Buffett made significant use of merger arbitrage (buying the stock of a company being acquired and selling short the acquirer) in his hedge fund days from 1957 to 1969. As recently as the 1998 Berkshire Hathaway conference he stated that if he only had a small amount to play with he could still earn 50 percent a year using merger arbitrage techniques.

Relative Value Arbitrage

"Relative value" is a catch-all phrase that takes advantage of any discrepancy between the spread in values between two assets. A great example (which Buffett did not play as far as I know) was when 3COM (Nasdaq: COMS) spun out Palm (Nasdaq: PALM) and the shares 3COM owned in PALM were worth significantly more than the entire market cap of 3COM. Buying 3COM and shorting PALM was a straightforward exploitation of that discrepancy and had a fair amount of margin of safety associated with it. Of course, the spread could get worse before it gets better. For example, Eifuku, a hedge fund in Japan that was wiped out in less than two weeks in 2003 from applying these techniques), but hey, that's what makes it so much fun.

Bonds

Buffett has spoken several times over the past 40 years about the merits of the Federal Reserve model in market timing. More recently, when the economy was slowing and the market was getting significantly overvalued relative to interest rates, Buffett made the impressive move of switching his portfolio so he was heavily weighted in bonds. Masterfully, he did this without incurring any tax penalty at all (that is, he didn't have to allocate out of stocks and into bonds).

We will look at the merits of various applications of the Fed model and some studies that have been done in this area; included in this book are interviews with several managers who focus on investing in bonds.

Fixed Income Arbitrage

As much as Buffett has a distaste for derivatives and leverage, he does dip his toes into the world of fixed income arbitrage, the idea of buying and selling different interest rate derivatives with different time payoffs. What is fixed income arbitrage, how does Buffett invest in it, what are the advantages and disadvantages? While this is normally considered a very solid and safe way to invest, it should be pointed out here that Long-Term Capital Management, the highly pedigreed hedge fund that lost billion of dollars in 1998, also felt this was a very safe way to invest the money of their investors.

Stocks

I didn't want this to be a book "like all the others," and most other books about Warren Buffett focus on his stock-picking techniques. However, the reality is that this topic cannot be ignored in any work about Buffett. What I hope to offer to the dialogue is an examination of studies done on the techniques that Buffett supposedly uses for his stock picking.

And finally, we will examine and study the principle of mean reversion. The commonly quoted aphorism is to "buy when there is blood in the streets." Buffett and Graham both recount the story of Mr. Market, who is always buying when things are too expensive, and selling when things are too cheap. Mr. Market is often crushed by the idea of mean reversion. Without focusing specifically on value investing, can the average investor quantify an approach to mean reversion that still carries with it the concept of margin of safety?

Commodities

Buffett has never been a big fan of investing commodities. However, he has several times made the plunge, most recently with silver. Many people who trade commodities do so based on the technicals, chart reading, and pure systems trading. It is interesting to see how Buffett applies his principles of value investing to commodities.

Currencies

Currencies have never been a popular Buffett investment. In fact, Buffett only began buying currencies in the past year. “Buy what you know” is the slogan of Buffett fans, and Buffett knows the United States better than he knows any other country. We will explore what made him finally invest in foreign currencies later in this book.

Finally, the book concludes with a suggested readings section that catalogs the primary books that discussed or influenced Buffett.