CHAPTER 1

Invest in the Business, Buy the Stock

Investment is most prudent when it is most businesslike.
—Benjamin Graham, *The Intelligent Investor*

Mention Ben Graham's quote to investors, and they all nod their heads in agreement. But for most people, that's where the understanding ends. In practice, most individuals approach investing in a very unbusinesslike fashion; they just don't realize it at the time. Often they give more attention to the stock price and what it does than to what the business itself is doing. When markets are in an upswing, this perspective might not matter much. Then again, a value-oriented investment approach is not geared toward bull markets but at bear markets. Riding out the storm relatively unscathed is the name of the game. To invest at sensible prices, it is wise to think first about the business and understanding it and its industry.

I know firsthand the value of investing in the business versus the stock because I thought this was the approach I was taking when I first starting investing in my late teens. Yet years later, I decided to go back and look at some of my investment decisions, and what I found surprised me.

I realized that while I was buying good businesses that I understood, I was letting a moving stock price instruct me as to when to buy and sell. One specific deal that crystallized these thoughts was my 2002 investment in a company called Meridian Medical Technologies. It was a good profitable business, but unfortunately, I was not around to reap the benefits of those profits. Rather, I gave in to Mr. Market at the first sign of trouble. I wrote about this experience in one of my first letters to my limited partners.

> Meridian is a manufacturer and supplier of auto-injectors, or ready to use drug delivery systems used by emergency personnel throughout the world. At the time, Meridian owned the auto-injector market—no other company had FDA approval. The company had no debt, a fair P/E multiple, and large market all to itself.
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> Meridian was a good business with a very strong competitive advantage at the time in the form of FDA approval. And the valuation implied a decent investment price.
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> I bought shares around $33 or so. Within a couple of months the stock was down to $27 . . . the next earnings announcement showed that Meridian had posted "moderate" top and bottom line growth. The stock tanked that day to $22, and I sold out. Less than a year later, Meridian was trading over $40 a share, and shortly after that, it was bought out at an even higher price by King Pharmaceuticals.

This experience taught me two very important lessons immediately. The first was to accept the fact that investment decisions should be made based on the value of the underlying business, not according to the short-term movements in the stock price. Investors have to learn to come to terms with their decisions. If you can, then assuming you understand and have properly valued the business, you aren't swayed when the stock price of your investment declines

20 percent. Business valuation is both art and skill; I go over valuing a business in greater detail later in this book. Financial markets constantly quote prices others are willing to pay on any given day for a business, usually to the detriment of most investors. Ninety percent of the time, market prices are useless. They serve to distract investors from looking at the whole business and instead lead them to focus on the day-to-day price movements of a ticker symbol. As a result, investors often confuse market value with business value, leading to poor decision making and expensive mistakes. All too often, the terms "luck" and "skill" are tossed around the investment field inaccurately. The truth is that investment skill will always lead to certain moments of luck, but in the long term, luck alone simply cannot last long enough to produce a consistent, profitable result.

The second important lesson I learned is to think independently and rely on your own data. My mistake in Meridian was very fundamental: I let the crowd dictate my decision making. My mistake was not that I was wrong but that I decided that the stock price decline implied that I was wrong. I thought I had invested in the business, but I was really invested in the stock. My analysis was sound: a good business with a good product and a market leader with a strong operating performance. But my approach toward the business was far from sound; I let the noise from the market weaken my conviction of the business value.

Warren Buffett has often said that "investing is simple, but not easy to do." I believe that one of the things he was referring to was the difficulty many people have separating the value of the business from the price of the stock. I remember a few years back, I was sitting in a hotel restaurant having a cup of coffee when I struck up a conversation with a gentleman who had spent years on Wall Street. He shared some wonderful (and not so wonderful) stories about his experiences there. At the time, I was still an undergrad student at the University of Georgia, so I was asking this gentleman as many questions as I could. When we got to the topic of the stock markets, the last thing

I expected to hear was what he said: "Stock markets are essentially obsolete places. We don't need them. They only exist to serve the needs and self-interests of the big Wall Street banks."

What he was referring to, of course, was the existence of the actual floor exchanges like the New York Stock Exchange. With the advent of electronic exchanges like the Nasdaq Stock Exchange, having a floor exchange is essentially unnecessary.

I've always remembered that conversation, because it came from an individual who worked for one of the big Wall Street banks that supported having the floor exchanges. I include this encounter not to say that we should shut down the New York Stock Exchange but to add my own spin: You should not equate the value of businesses with the daily volatility of stock prices. For the most part, the market gets it right and generally values businesses fairly. As a value investor, you are not interested in buying fairly valued businesses; you are focused only on selecting undervalued businesses. The stock market should exist only for you to buy an undervalued business and to sell a fairly valued business. Aside from those situations, you too should consider the stock market nonexistent.

Stock Prices Are More Noise Than Information

The majority of the time, daily stock prices are simply random noise movements. Warren Buffett has said that he invests as if stock markets would be closed for years. The truth is, most investors—and their portfolios—would be a lot better off if stock markets were closed throughout the year.

Imagine if the stock market were open only once during the year. Every year on one day, investors would have the chance to buy and sell any investments they wanted. Then they would have to wait until the next year to do the same. What do you think would happen? For one thing, many people would probably cease to participate. Those are the individuals who participate in the market for more speculative reasons.

If you were looking to buy a small business, I doubt that you would buy it with the intention to sell it in a few months unless you were offered a most attractive offer. At the same time, it's doubtful you would sell it at the first hint of bad news. Stock investing should be handled the same way. If you invest and the market decides to reward you immediately, you can choose to sell a short-term investment if you feel the price reflects the company value. Conversely, don't jump to sell because you see a decline in the stock price without first determining if the business has been permanently impaired.

Most important, if markets were only open annually, investors would get really serious about which securities they would want to own. They would spend a lot more time understanding the businesses they invest in, because they would want to be absolutely sure that they were allocating their capital in the most intelligent fashion. In other words, they would invest in the business, not the stock.

Since markets are open every day with willing buyers and sellers, market participants often try to shortcut their way to investing. The shortcuts usually lead to a lot of short-term losses. One of the most "advantageous" aspects of the stock market—its liquidity—is actually also one of the worst. Knowing that you can sell your securities any time the mood strikes you is more of a detriment than a benefit. Equity markets do a great job of making smart people do some really dumb things. The idea that a security should be sold after three weeks or three months because the stock price has declined seems rather foolish. The greatest business success stories—Coca-Cola, McDonald's, General Electric—evolved over decades with plenty of periods of temporary decline. Any investor who abandoned these companies at the first sign of trouble missed out on some extraordinary returns that were to come.

It's hard for most people to ignore the useless noise that the market produces day in and day out. Even if today you gave someone a copy of the *Wall Street Journal* two years into the future, most still wouldn't profit from the information. Why not? Because even knowing with 100 percent certainty that XYZ Corp. would be worth twice what is today, people would still jump ship if the price collapsed on them in the interim.

True value investors ignore such meaningless noise. To the value investor, stock markets have one sole purpose: to allow the purchase of undervalued securities and to facilitate the sale of fairly valued securities. Security prices are there to inform, not instruct. Security prices allow investors to determine whether bargain opportunities exist once the business has been analyzed and appraised. Conversely, when the mood is euphoric, security prices offer the opportunity to dispose of an investment at prices equal to or above fair value.

A Businesslike Approach to Valuing the Business

Contrary to popular belief, most sound investments are made on the basis of very few rational decisions. The most illustrative example is the investment in the Washington Post Company made by Warren Buffett. Back in 1973, Berkshire Hathaway's Buffett began accumulating shares in the Washington Post Company. At the time, the Post owned a top-tier collection of media assets—including *Newsweek,* the *Washington Post* newspaper, and several television stations in major markets—and the entire market capitalization was approximately $80 million. Buffett concluded that the Post's assets could easily fetch some $400 million or more if they were auctioned off.

While I am certain that Buffett was armed with a lot more information on the company, the major compelling reason for making the investment was that the assets were worth a whole lot more than the current price. Buffett made the investment based on the merits of the business; the stock price informed him that the current valuation was way too low. Interestingly, the market value of the Post continued to decline after Buffett's investment. Looking at the company through the mind-set of a businessman enabled Buffett to ignore the noise of the declining stock price. So what was the end result? Buffett's company, Berkshire Hathaway, still owns its shares in the Washington Post and considers it one of its "permanent equity holdings." The $11 million investment was worth $1.367 billion at the end of 2007.[1]

Investing in the business is a simple task that gets complicated as the focus shifts away from the business's performance and fixates on the day-to-day fluctuating stock price. Investors should approach buying a single share of stock using the same process they would apply to buying the entire business. A simple example illustrates my point. It demonstrates the businesslike approach of investing in a business; it is not necessarily indicative of an actual business with actual numbers.

Suppose you are interested in buying your hometown bicycle shop that is up for sale. The owner is selling the business for $100,000. Is this price a good value?

Your first approach is very general in nature to allow you to get a feel for the place. This would be akin to reading the annual report of a public company. You look at the location of the shop, find out how long it has been in business and if there are any other competitors in the area.

After this general investigation, you want to determine if the business is a worthy investment based on the sales price. You start looking at the numbers. Sales figures are nice, profits are even better, but at the end of the day, you want to know how much cash is left over after paying the bills. In other words, how much free cash flow does this bicycle shop produce? Looking over the last five years of operation, you see these figures for free cash flow:

Year	Free Cash Flow
1	$10,000
2	$11,000
3	$12,500
4	$13,500
5	$15,000

Based the on the past five years, the business appears to be doing well. It's growing its free cash flow at a nice rate, but that was the past. You are buying the business based on the future anticipated cash flows. And when it comes to predicting future results, there is always an element of uncertainty involved. Looking back at the past five years, you realize that the business has increased cash flow by approximately 10 percent a year.

Going forward, you might be inclined to think that this same rate of growth will occur for the next five years, but I don't think most rational individuals would buy a business based solely on the past. For one, as businesses expand, the law of large numbers kick in. It's a lot easier to grow from $100,000 to $110,000 than to go from $1,000,000 to $1,100,000—although both figures represent a growth rate of 10 percent.

So, you decide to assume that over the next five years, the business will grow its cash flow by 6 percent a year. A bicycle shop is generally a local business, so at some point market saturation will cause a decline in sales level as the number of bike owners increases in your city. However, the business generates revenue doing repairs and selling accessories, so you can expect to make up for slowing sales growth. You predict that, over the next five years, the business will deliver these numbers:

Year	Free Cash Flow	Present Value at 10% Discount Rate
1	$15,900	$14,450
2	$16,850	$13,930
3	$17,860	$13,420
4	$18,940	$12,940
5	$20,000	$12,400
Total		$67,140

Remember that money earned in the future is not worth the same as it would be in your hand today, so we have to discount the future sum back to the present. Why use 10 percent? I used it simply for illustrative purposes. The discount rate should be customized to the specific business. If you are buying a start-up, then you would use a much higher discount rate to account for the higher degree of uncertainty involved in the business's future operating performance. A higher discount rate will, of course, decrease the present value of the future cash flows, implying a lower business valuation. Conversely, a more established business—which might have lower rates of cash flow growth—will command a lower discount rate to account for the relative consistency of the cash flows and its more established competitive position. (Think of Coca-Cola or the Procter & Gamble Company.)

The total value of discounted cash flows comes to $67,140. Of course, the business is also worth something as well as it will continue to exist and operate beyond five years. You figure you can easily sell it for five to seven times the free cash flow in year 10, or around $60,000 to $85,000. This sales figure is referred to as the terminal value of a business, a very important concept that is used hand-in-hand with the discounted cash flow analysis to assess the present value of a firm. The terminal value calculation is used to determine the value of the firm for all the years beyond which one can reliably project cash flow using the discounted cash flow. The terminal value can be calculated in several ways. One calculation assumes the liquidation of the firm's assets in the final year of the discounted cash flow analysis. This method estimates what the market would pay for the firm's assets at this point. The other two methods assume the firm will continue operations for an indefinite time period. The terminal value is determined either by applying a multiple to earnings, revenues, or book value, or by assuming an indefinite, constant growth rate. Add this figure to the sum of the discounted cash flows ($67,140) and you get a value for the business of approximately $127,000 to $150,000. With this information, you can make an intelligent decision on whether to purchase the business, negotiate a lower price, or simply walk away.

Notice what you don't do. You don't spend much time trying to forecast the individual price of bicycles and basing your decision on lots of moving inputs. The more moving parts you add to your analysis, the more complex and likely inaccurate your valuation will become. Stick to what counts: cash generation.

Apply the same general approach to buying shares in public companies. Get a general feel for the business by reading its annual reports. Understand the business, get a feel for the competitive landscape, and assess the quality of the folks running the ship. Then go over the numbers and see if they offer you a potential investment. Then you can decide to invest, wait for a lower market price, or simply move on.

If you end up deciding to invest, and you've looked at the business in the way I've explained, chances are slim that you will have any concern about the short-term movement in the stock price. Similar to buying the bicycle shop, you won't dump the business because you experience a few months of lower sales. Another way to think about it using the bicycle shop example is this: Suppose you bought the bicycle business for $100,000 and, a year later, you experienced a slow selling season due to the weather. The next day, someone walks into your shop and offers to buy your business for $75,000. Would you simply hand over the keys and take the check? I doubt it. You are not going to justify a lowball offer based on a few months of slow results. Why not wait until you have a prosperous period and sell to the guy who offers you $150,000?

Unfortunately, many investors do the exact opposite. They invest in a company and then, a few months later, when the stock is down 25 percent, they can't sell quick enough. They can't handle "looking" at the lower market price. Instead, they sell the stock so they no longer have to see a lower stock price. Such investors throw any consideration regarding the underlying business out the window. To make matters worse, once market conditions improve and the market price begins to climb, they eagerly jump back in without any discipline or analysis for fear of missing any climb in stock price. Without realizing it, these investors have just sold their "bicycle shop" for $75,000 only to by it back later for $150,000. The price they pay for a happy consensus is very steep indeed.

The value-seeking investor, however, is looking through the lenses of a businessperson. One of my all-time favorite quotes from Warren Buffett is "I am a better investor because I am a businessman and a better businessman because I am an investor."[2] There's tremendous wisdom in this concept. A successful long-term investor must be able to grasp the main value drivers for a business and have the discipline to ignore the remaining noise. Conversely, by going through the process of investing—learning about businesses and industries, analyzing the competitive landscape, assessing the quality of management—you develop a more astute mind-set for running and operating a business.

The stock market is just like any other market. It is a place where you can show up when you feel like it to buy or sell items; in this case, ownership interests in a business. Yet instead of being treated like a market that exists to serve you, many people view the stock market as a place of instruction. True, the thousands of market participants provide information in the form of prices, but this information is not perfect, and it should not be relied on exclusively as the sole determinant of value. When you visit the grocery store, you don't go there looking for someone to tell you what to buy. You also don't go there looking to pay full price for groceries because everyone else is. You visit the grocery store when you need to and seek out items on sale. Approach the stock market with the same perspective. Use it only when it affords you bargains.

The Making of a Legend

Many readers of this book are familiar with the Buffett Partnership, but it nonetheless deserves a mention. Buffett's phenomenal investment track record from 1956 to 1969 is why most are familiar with the success of the Buffett Partnerships, but that success had as much to do with *what Buffett didn't do as much as with what Buffett did do.* I will explain what I mean shortly, but first a brief background on the Buffett Partnership so we are all on the same page.

In 1956, Warren Buffett started an investment partnership with capital from family and friends. Over the next 13 years, the annualized return clocked in at over 30 percent a year. More amazing, in the 13 years of operation, Buffett never recorded a down year. The length and consistency of this performance makes it one of the best performances by any investor. In 1969, Buffett closed down shop and walked away. Instead of taking in the loads of additional capital that would surely follow such a performance, Buffett instead wrote a letter to his partners telling them he no longer felt it was prudent to participate in the market:

> The investing environment . . . has generally become more negative and frustrating as time has passed. Maybe I am merely suffering from lack of mental flexibility . . . ,
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> However it seems to me that: (1) opportunities for investment that are open to the analyst who stresses quantitative factors have virtually disappeared, after rather steadily drying up over the past twenty years; (2) our $100 million of assets further eliminates a large portion of this seemingly barren investment world, since commitments of less than about $3 million cannot have a real impact on our overall performance, and virtually rules out companies with less than about $100 million of common stock at market value; and (3) a swelling interest in performance has created an increasingly short-term oriented and (in my opinion) more speculative market.
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> Therefore before year end, I intend to give all limited partners the required formal notice of my intent to retire . . .
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> Quite frankly . . . I would continue to operate the Partnership in 1970, or even 1971, if I had some really first class ideas.

> Some of you are going to ask, "What do you plan to do?" I don't have an answer to that question.[3]

In this modern age of money management, no money manager walks away after a year in which his performance beat the market and leaves all new potential capital on the side. Instead, many fund managers are forced to shut down after poor results made even worse by excessive use of leverage. But Buffett felt that market valuations were vastly exceeding business values, so he put his money into bonds and walked away. While I'm sure Buffett was keeping up with markets, he didn't seriously reappear until 1974. For five years, he simply ignored the stock market. He probably spent a lot of time playing bridge, his favorite card game. Bridge, much like investing, requires making bets based on odds. It's a fun and intellectually challenging game enjoyed by many investors.

The key point is this: Sometimes success from investing comes from the fact that you are not investing at all. It's a true sign of discipline to avoid the market if it doesn't provide you with favorable risk/reward bets. Being an investor does not mean always being invested. Being an investor means taking action if and when your data and analysis tell you of quality businesses selling at valuations that, with a high degree of probability, will result in satisfactory returns over a period of years. The most expensive lessons in investing are typically a result of making too many investments, not too few.

Value investors know how to be at peace with their decisions. Trying to invest through the rearview mirror is unproductive. In hindsight, everything to everyone seems obvious. Value investors understand that they will rarely invest at the absolute bottom price, nor will they sell at the absolute top price. As will be detailed in the next chapter, value investors seek to invest in a business only when it is undervalued and to sell it when it exceeds fair value. Any other approach is speculative in nature and often leads to expensive consequences.

Case in point: Between 2001 and 2003, shares in Apple traded between $7 and $13 a share. Yet during those years, sales were slowly climbing, the company was paying off its debt, and cash flow was growing. In addition, Steve Jobs was introducing the iPod and revamping the product line with a slick, modern computer. Restless investors who were frustrated with the dormant stock price or, worse, sitting on paper losses, abandoned ship. They were blinded by the stock price movements. As a result, they failed to see the progress *that the business was making*. Businesses cannot control the economy; all they can do is keep operating soundly during the good and bad cycles. Over the next four years, shares in Apple leapt to a high of $203 a share. Frustrated investors paid an expensive price indeed.

A Simple Idea, Really

It's going to sound redundant, but if you look at investing as buying a piece of a business, then the task of prudently investing your money is not that difficult. Avoid what you do not know and pay a sensible price. As Buffett quips, "Invest like you're buying groceries, not perfume."

The rest of this book articulates the notion that to be a successful investor, whether professionally or individually, you need to do only a few things right. It begins with the most important thing, developing a sound investment philosophy. Once you have truly developed a mental framework that seeks to buy good businesses at low prices, you are significantly ahead of the pack. The notion that the stock market is the place to get rich quick causes a lot of grief for investors and leads to sloppy results.

The value investing approach has been tried and tested for decades. It works. For those who are willing to exert the effort and patience, the stock market offers the greatest forum for wealth accumulation. The chapters to come illustrate the framework and approach to participating in equities in a logical, businesslike fashion.

The late Ben Graham, widely regarded as the creator of the school of thought that is value investing, astutely remarked in *The Intelligent Investor*: "Investment is most prudent when it is most businesslike." I would add a corollary to Graham's statement: Investment is most foolish when it is unbusinesslike.