

# Chapter 1

## The Thrill of Investing in Common Stocks

It's not that I want money. It's the fun of making money and watching it grow.<sup>1</sup>

—Warren Buffett

**W**arren Buffett has often mentioned that he enjoys running Berkshire Hathaway and has fun making money. I assume that you too want to earn high rates of return on your investments while having fun doing it. It is not difficult to do if you master certain principles that Buffett follows. You play baseball, golf, bridge, or the stock market because it is enjoyable. But you enjoy the game even more when you defeat the opponent, especially when you beat a seemingly superior player. Can you win in the game of investing? Yes, you can, so long as you are willing put some effort into it. And not only can you win; the thrill of the game arises because you can win often. You have weak opponents: “Mr. Market,” who suffers from up-and-down moods, and professional money managers, who can be outperformed just as easily.<sup>2</sup> This game is not as difficult as most people think. It is as much fun as a treasure hunt. Berkshire Hathaway is just one of the treasures I have discovered. This introductory chapter will convince you that the rewards from becoming a better investor are enormous. Later in

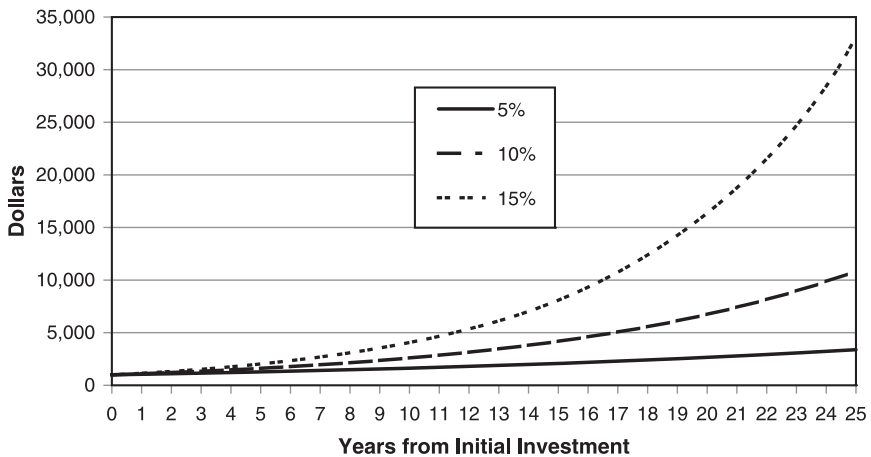
the book, I explain Buffett's principles and why they work, so that you may use them to earn those rewards by investing in the stock market.

## **How a 1 Percent Advantage Becomes a 100 Percent Gain**

Only one in five actively managed mutual funds beats the Standard & Poor's (S&P) 500 index. Thus, if you invest in actively managed mutual funds, your odds of beating the market are only one-in-five. These odds are indeed low. A very simple approach to improve your odds is to invest in index funds because their returns will be close to the market returns. By investing in index funds instead of mutual funds, your odds of beating the market improve from one-in-five to four-in-five. But why stop there? If you have some money to invest for the long run, why not invest in common stocks? With common stocks, you can improve your returns even more, especially if you enjoy the process and put some effort into learning the principles that master investors like Buffett have laid out. Another great investor, Peter Lynch, echoes this viewpoint: "[A]n amateur who devotes a small amount of time to study companies in an industry he or she knows something about can outperform 95 percent of the paid experts who manage the mutual funds, plus have fun doing it."<sup>3</sup>

How much skill do you need to be much better off than investing in actively managed mutual funds? In the long run, not much! Let me explain. Based on a long historical record, the expected return on the market is about 7 percent to 10 percent per year. For simplicity, let's use 10 percent as a benchmark. Then, your return from an average mutual fund will be only 8 percent because about 2 percent goes toward expenses in running the mutual fund, which includes the management fees. If you invest \$1,000 with a mutual fund and the mutual fund gives you a return of 8 percent per year, your initial investment of \$1,000 will become \$6,848 in 25 years; that is, you will have a net gain of \$5,848.

Assume that you are able to develop just a 1 percent return advantage over the market in the game of investing or picking stocks. Remember that you also do not incur the 2 percent expenses in fees and charges when you invest in mutual funds. With 1 percent above the market, or



**Figure 1.1** Growth of \$1,000 after 25 or Intermediate Years at Different Rates of Return

11 percent per year, your initial \$1,000 investment will become \$13,585 at the end of 25 years, which is a net gain of \$12,585. Thus, your net gain is more than twice what you would have had if you had invested in mutual funds. It is almost unbelievable, but the numbers do not lie. Even if you decide not to put all your money under your own management and invest all of it in individual stocks, you may find it worthwhile to take charge of some of your own investments. If nothing else, it will be a great learning experience and a new source of excitement.

An additional advantage of investing in individual stocks is that you will pay lower taxes. If you pick your investments carefully and do not sell them for a long time, you pay substantially less in taxes than if you had invested in mutual funds. Thus, even if you do not develop a 1 percent advantage over the market, you will come out substantially ahead when you judiciously invest in individual stocks rather than mutual funds.

Figure 1.1 shows what \$1,000 will become in 10, 15, 20, and 25 years if you earn 5 percent, 10 percent, or 15 percent per year. Note that if you can earn 15 percent per year, your advantage over the market is enormous. A \$1,000 initial investment will become \$32,919 in 25 years at a 15 percent annual rate of return.

The 2008–2009 stock market crash may have made you pessimistic about investing. However, history tells us that you have an advantage.

This event actually offers you a great opportunity to find good stocks to invest in. Buffett recently wrote in the *New York Times* that for his personal account, he is buying common stocks in this market.<sup>4</sup> Another legendary investor with an outstanding record over several decades writes, “One principle that I have used throughout my career is to invest at the point of maximum pessimism.”<sup>5</sup> So, spend some time learning to invest wisely. Let’s first look at returns you would have earned if you had invested in Buffett’s company, Berkshire Hathaway.

### **How Much Would You Have Earned If You Had Invested with Buffett?**

In the past 30 years ending in 2008, Berkshire Hathaway has given an annualized return of over 23 percent per year. This is twice the rate of return you would have earned with the Dow Jones Industrial Average or the S&P 500 index. Obviously, Warren Buffett’s performance is incredible. In terms of dollar amounts, if you had invested \$1,000 in Berkshire Hathaway about 30 years ago, your investment today would amount to about \$500,000. The lesson is clear: Learn from Warren Buffett’s investment philosophy, which is described throughout this book. You may not be able to attain his level of success, but you do not have to be Warren Buffett to earn respectable returns in the stock market. If you can replicate even, say, one-fourth or one-third of the advantage he has over the market, you will earn very high long-term returns. The average investor is likely to be a relatively small investor. It is easier to beat the market with smaller amounts of money than with large investments. When Buffett ran his partnerships in the late 1950s to late 1960s, his returns were even larger. Now, Buffett cannot invest in smaller companies because the Berkshire portfolio is so large. But a small investor has the advantage of being able to invest in smaller companies. For Berkshire as a whole, returns were higher when the company was smaller, but even over the past 15 years, the average annualized return has been 12 percent compared with only about 6 percent for the S&P 500 index.

You never know: You might have the skills to pick the right stocks and become as good an investor as Warren Buffett. As long as you are not reckless, there is little downside in trying to find out whether you

have some of the skills to be successful. One great thing about Buffett is that he has written generously about what he does and how he does it. If you have patience and the willingness, let's start learning about businesses and investing from the master.

## **Conclusions**

Buffett has often described his investing philosophy as simple but not easy. It is simple in the sense that all you need to do is to identify outstanding businesses that are run by competent and honest managers and whose common stock is selling at a reasonable price. But how do you do that? This book makes the process of discovering those businesses as easy as possible.

