CHAPTER 1

A Highly Personal Endeavor

What Do You *Want to Own?*

Man the living creature, the creating individual, is always more important than any established style or system.

—Bruce Lee

The stock market is a curious place because everyone participating in it is loosely interested in the same thing—making money. Still, there is no uniform path to achieving this rather uniform goal. You may be only a few mouse clicks away from purchasing the popular book *The Warren Buffett Way*,[1] but only one man has ever truly followed the path of Warren Buffett. In investing, it is hard enough to succeed as an original; as a copycat, it is virtually impossible. Each of us must carve out a *personal* way to investment success, even if you are a *professional* investor.

That said, great investors like Ben Graham, Seth Klarman, and Warren Buffett have much to teach us, and we have much to gain by learning from them. One of the masters' key teachings is as important as it is simple: A share of stock represents a share in the ownership of a business. A stock exchange simply provides a convenient means of exchanging your ownership for cash. Without an exchange, your ownership of a business would not change. The ability to sell your stake would be negatively affected, but you would still be able to do it, just as you can sell your car or house if you decide to do so.

Unfortunately, when we actually start investing, we are inevitably bombarded with distractions that make it easy to forget the essence of stock ownership. These titillations include the fast-moving ticker tape on CNBC, the seemingly omniscient talking heads, the polished corporate press releases, stock price charts that are consolidating or breaking out, analyst estimates being beaten, and stock prices hitting new highs. It feels a little like living in the world of Curious George, the lovable monkey for whom it is "easy to forget" the well-intentioned advice of his friend. My son loves Curious George stories, because as surely as George gets into trouble, he finds a way out of trouble. The latter doesn't always hold true for investors in the stock market.

Give Your Money to Warren Buffett, or Invest It Yourself?

I still remember the day I had saved the princely sum of $100,000. I had worked as a research analyst for San Francisco investment bank Thomas Weisel Partners for a couple of years and in 2003 had managed to put aside what I considered to be an amount that made me a free man. Freedom, I reasoned, was only possible if one did not have to work to survive; otherwise, one was forced into a form of servitude that involved trading time for food and shelter. With the money saved, I could quit my job, move to a place like Thailand, and live on interest income. While I wisely chose not to exercise my freedom option, I still had to find something to do with the money.

I dismissed an investment in mutual funds quite quickly because I was familiar with findings that the vast majority of mutual funds underperformed the market indices on an after-fee basis.[2] I also became aware of the oft-neglected but crucial fact that investors tended to add capital to funds after a period of good performance and withdraw capital after a period of bad performance. This caused investors' *actual* results to lag significantly behind the funds' *reported* results. Fund prospectuses show time-weighted returns, but investors in those funds reap the typically lower capital-weighted returns. A classic example of this phenomenon is the Munder NetNet Fund, an Internet fund that lost investors billions of dollars from 1997 through 2002. Despite the losses, the fund reported a *positive* compounded annual return of 2.15 percent for the period. The reason? The fund managed little money when it was doing well in the late 1990s. Then, just as billions in new capital poured in, the fund embarked on a debilitating three-year losing streak.[3] Although I had felt immune to the temptation to buy after a strong run in the market and to sell after a sharp decline, I thought this temptation would be easier to resist if I knew exactly what I owned and why I owned it. Owning shares in a mutual fund meant trusting the fund manager to pick the right investments. Trust tends to erode after a period of losses.

Mutual funds and lower-cost index funds should not be entirely dismissed, however, as they offer an acceptable alternative for those wishing to delegate investment decision making to someone else. Value mutual funds such as Bruce Berkowitz's Fairholme Fund or Mason Hawkins's Longleaf Funds are legitimate choices for many individual investors. High-net-worth investors and institutions enjoy the additional option of investing in hedge funds, but few of those funds deserve their typically steep management and performance fees. Warren Buffett critiqued the hedge fund fee structure in his 2006 letter to shareholders: "It's a lopsided system whereby 2 percent of your principal is paid each year to the manager even if he accomplishes nothing—or, for that matter, loses you a bundle—and, additionally, 20 percent of your profit is paid to him if he succeeds, even if his success is due simply to a rising tide. For example, a manager who achieves a gross return of 10 percent in a year will keep 3.6 percentage points—two points off the top plus 20 percent of the residual eight points—leaving only 6.4 percentage points for his investors."[4]

A small minority of value-oriented hedge fund managers have chosen to side with Buffett on the fee issue, offering investors a structure similar to that of the limited partnerships Buffett managed in the 1960s. Buffett charged no management fee and a performance fee only on returns in excess of an annual hurdle rate. The pioneers in this small but growing movement include Guy Spier of Zurich, Switzerland-based Aquamarine Capital Management and Mohnish Pabrai of Irvine, California-based Pabrai Investment Funds. These types of funds bestow a decisive advantage, ceteris paribus, on long-term investors. Table 1.1 shows the advantages of an investor-friendly fee structure.

TABLE 1.1 Effect of Fees on the Future Wealth of a Hedge Fund Investor

	Typical Hedge Fund Fee Structure: "2 and 20"		Buffett Partnership-Style Fee Structure	
	Management fee: 2%		Management fee: 0%	
	Performance fee: 20%		Performance fee: 20%	
	Annual hurdle rate: 0%		Annual hurdle rate: 6%	
Assumed gross return	5.0%	10.0%	5.0%	10.0%
Resulting net return	2.4%	6.4%	5.0%	9.2%
Gross value of $1 million				
. . . after 10 years	$1,628,895	$2,593,742	$1,628,895	$2,593,742
. . . after 20 years	2,653,298	6,727,500	2,653,298	6,727,500
. . . after 30 years	4,321,942	17,449,402	4,321,942	17,449,402
Net value of $1 million				
. . . after 10 years	$1,267,651	$1,859,586	$1,628,895	$2,411,162
. . . after 20 years	1,606,938	3,458,060	2,653,298	5,813,702
. . . after 30 years	2,037,036	6,430,561	4,321,942	14,017,777
Value lost due to fees				
. . . after 10 years	$361,244	$734,156	$0	$182,580
. . . after 20 years	1,046,360	3,269,440	0	913,798
. . . after 30 years	2,284,906	11,018,842	0	3,431,625

I also considered investing my savings in one of a handful of public companies that operate as low-cost yet high-quality investment vehicles. Berkshire Hathaway pays Warren Buffett an annual salary of $100,000 for arguably the finest capital allocation skills in the world. Buffett receives no bonus, no stock options, and no restricted stock, let alone hedge-fund-style performance fees.[5] It certainly seems like investors considering an investment in a highly prized hedge fund should first convince themselves that their prospective fund manager can beat Buffett. Doing this on a pre-fee basis is hard enough; on an after-fee basis, the odds diminish considerably. Of course, buying a share of Berkshire is not quite associated with the same level of privilege and exclusivity as being accepted into a secretive hedge fund.

Berkshire is not the only public holding company with shareholder-friendly and astute management. Alternatives include Brookfield Asset Management, Fairfax Financial, Leucadia National, Loews Companies, Markel Corporation, and White Mountains Insurance. While these companies meet Buffett-style compensation criteria, some public investment vehicles have married hedge-fund-style compensation with a value investment approach. Examples include Greenlight Capital Re and Biglari Holdings. These hedge funds in disguise may ultimately deliver satisfactory performance to their common shareholders, but they are unlikely to exceed the long-term after-fee returns of a company like Markel, which marries superior investment management with low implied fees.

In light of the exceptional long-term investment results and low fees of companies like Berkshire and Markel, it may be irrational for any long-term investor to manage his or her own portfolio of stocks. Professional fund managers have a slight conflict of interest in this regard. Their livelihood depends rather directly on convincing their clients that the past performance of Berkshire or Markel is no indication of future results. Luckily for them, securities regulators play along with this notion, thereby doing their part in encouraging a constant flow of new entrants into the lucrative fund management business.

Rest assured, we won't judge too harshly those who choose to manage their own equity investments. After all, that is precisely what I did with my savings in 2003 and have done ever since. You could say that underlying my decision has been remarkable folly, but here are a few justifications for the do-it-yourself approach: First, investment holding companies like Berkshire and Markel are generally not available for purchase at net asset value, implying that some recognition of skill is already reflected in their market price. While over time the returns to shareholders will converge with internally generated returns on capital, the gap is accentuated in the case of shorter holding periods or large initial premiums paid over net asset value. Even for a company like Berkshire, there is a market price at which an investment becomes no longer attractive.

In addition, one of the trappings of investment success is growth of assets under management. Few fund managers limit their assets, and this is even rarer among public vehicles. Buffett started investing less than $1 million six decades ago. Today he oversees a company with more than $200 billion in market value. If Buffett wanted to invest $2 billion, a mere 1 percent of Berkshire's quoted value, into one company, he could not choose a company with a market value of $200 million. He would likely need to find a company quoted at $20 billion, unless he negotiated an acquisition of the entire business. Buffett is one of few large capital allocators who readily admit that size hurts performance. Many others evolve their view, perhaps not surprisingly, as their assets under management grow. Arguments include greater access to management, an ability to structure private deals, and the spreading of costs over a large asset base. Trust Buffett that these advantages pale in comparison with the disadvantage of a diminished set of available investments. If you manage $1 million or even $100 million, investing in companies that are too small for the superinvestors offers an opportunity for outperformance. Buffett agrees: "If I was running $1 million today, or $10 million for that matter, I'd be fully invested. Anyone who says that size does not hurt investment performance is selling. The highest rates of return I've ever achieved were in the 1950s. I killed the Dow. You ought to see the numbers. But I was investing peanuts then. It's a huge structural advantage not to have a lot of money. I think I could make you 50% a year on $1 million. No, I know I could. I guarantee that."[6] The corollary: When small investors commit capital to megacaps such as Exxon Mobil or Apple, they willingly surrender a key structural advantage: the ability to invest in small companies.

Echoing Buffett's sentiments on the unique advantages of a small investable asset base, Eric Khrom, managing partner of Khrom Capital Management, describes the business rationale he articulated to his partners early on: "The fact that we are starting off so small will allow me to fish in very small pond where the big fishermen can't go. So although I'm a one man shop, you don't have to picture me competing with shops that are much larger than me, because they can't look at the things I look at anyway. We will be looking at the much smaller micro caps, where there are a lot of inefficiencies. . . ."[7]

The last argument for choosing our own equity investments leads to the concept of capital allocation. Contrary to the increasingly popular view that the stock market is little more than a glorified casino, the market is supposed to foster the allocation of capital to productive uses in a capitalist economy. Businesses that add value to their customers while earning acceptable returns on invested capital should be able to raise capital for expansion, and businesses that earn insufficient returns on capital should fail to attract funding. A properly functioning market thereby assists the process of wealth creation, accelerating the growth in savings, investment, and GDP. If the role of the market is to allocate capital to productive uses, it becomes clear that a few dozen top investors cannot do the job by themselves. There are simply too many businesses to be evaluated. By doing the work the superinvestors must forgo due to limited bandwidth, we put ourselves in a position to earn the just reward of good investment performance. This idea of capital allocation ties in with the previous point regarding our ability to invest in companies that are too small for the superinvestors. We may safely assume that Buffett and the others will allocate capital to mega-caps such as Coca-Cola, if those companies deserve the money. On the other hand, companies such as Strayer Education and Harvest Natural Resources may be left without capital even if they can put it to productive use. Smaller investors can fill this void and make money, provided that they make the right capital allocation judgments.

Cast Yourself in the Role of Capital Allocator

It is little surprise that the world's richest investor is a capital allocator rather than a trend follower, thematic investor, or day trader. Buffett is famous for his buy-and-hold strategy, which has been the hallmark of Berkshire's portfolio investments and outright purchases of businesses. Buffett looks to the underlying businesses rather than stock certificates to deliver superior compounding of capital over the long term. Buying businesses cheaply has not generated his long-term returns—it has merely accentuated them.

Buffett raised eyebrows in the investment community many years ago when he bought Coca-Cola at a mid-teens multiple of earnings. Most value investors could not understand why Buffett considered it a bargain purchase. Buffett was allocating capital to a superior business at a fair price. He knew that Coca-Cola would compound the capital employed in the business at a high rate for a long time to come. Buffett did not need P/E multiple expansion to make the investment in Coca-Cola pay off.

Similarly, famed value investor Joel Greenblatt paid roughly 20 times earnings for Moody's when it went public in 2000. Greenblatt was allocating capital to a superior business, one that could grow earnings at a high rate without requiring additional capital, thereby freeing up large amounts of cash for share repurchases. Despite trading at a relatively high earnings multiple at the time of the initial public offering (IPO), Moody's shares more than quintupled in the subsequent six years. Of course, the company ran into major trouble when the U.S. housing bubble burst a few years ago. Despite the steep decline, Moody's traded at $48 per share in early 2013, up from a comparable price of $12.65 per share the day it was spun off from Dun & Bradstreet in October 2000.

Role versus Objective: A Subtle but Important Distinction

Our role in the stock market may at first glance seem like a trivial issue. It is hardly a secret that rational investors seek to maximize risk-adjusted after-tax returns on invested capital. What is our role, therefore, if not to make the most money by identifying investments that will increase in price? This question is misplaced because it confuses objective (making money) and role.

We typically view our role in the market as insignificant. While most investors do have a negligible impact on the overall market, the accompanying small fish mind-set does not lend itself to successful investing. Even when I invested a tiny amount of money, I found it helpful to adopt the mind-set of chief capital allocator. I imagined my role as distributing the world's financial capital to activities that would generate the highest returns on capital.

Consider the following subtle difference in how investors may perceive their portfolios in relation to the available investment opportunities. Many of us inappropriately consider the scale of our portfolio ahead of the scale of potential investments. To illustrate this, imagine we wanted to invest $100,000 in one of the stocks in Table 1.2 in late 2001.

When selecting a company from this list, we might analyze financial statements and consider various valuation measures. But even before embarking on a detailed analysis, some of us may think, "I have $100,000 to invest, which will buy me a tiny stake in one the above companies. It looks like I can buy a few thousand

TABLE 1.2 "Mind-Set A"—Selected Investment Opportunities, November 2001[8]

Ticker	Company	Stock Price	Market Value	$100,000 Buys . . .
AET	Aetna	$30.52	$4.4 billion	3,277 shares
DAL	Delta Air Lines	29.31	3.6 billion	3,412 shares
F	Ford Motor	17.88	32.4 billion	5,593 shares
GM	General Motors	47.69	26.5 billion	2,097 shares
LMT	Lockheed Martin	45.01	19.8 billion	2,222 shares
NYT	New York Times	45.15	6.8 billion	2,215 shares
TIF	Tiffany & Co.	29.17	4.3 billion	3,428 shares
TM	Toyota Motor	53.71	99.0 billion	1,862 shares

shares of any of these stocks" ("mind-set a"). Without realizing it, we are committing the fallacy of considering the scale of our portfolio ahead of the scale of potential investments.

On the flip side, if we adopted an asset allocator's mind-set, we might ask, "If I could buy one of the above companies, which would I choose?" This question focuses attention on the relative scale of the potential investments rather than the size of our portfolio. By applying this mind-set even before embarking on in-depth analysis of the various companies, we might make the observation shown in Table 1.3.

Toyota alone was valued more highly than all the companies on the left combined (based on market value rather than enterprise value, which in this case would have been a more appropriate measure). The investor with mind-set b might wonder: "Would I rather own Toyota or Aetna, Delta, Ford, GM, Lockheed Martin, the *New York Times*, and Tiffany combined?" While after careful analysis the answer might indeed be Toyota, it is obvious that we would need well-founded reasons for that choice. Had we kept a small fish mentality, however, we might have completely missed this issue of relative scale and invested in Toyota, ignorant of the severity of the implied relative value bet.

In Table 1.4, we revisit the previous comparison as of late 2004.

As a comparison of the market values shows, Toyota outperformed a portfolio of the companies on the left over the three-year

TABLE 1.3 "Mind-Set B"—Selected Investment Opportunities, November 2001

Ticker	Company	Market Value	Ticker	Company	Market Value
AET	Aetna	$4.4 billion	TM	Toyota Motor	$99.0 billion
DAL	Delta Air Lines	3.6 billion			
F	Ford Motor	32.4 billion			
GM	General Motors	26.5 billion			
LMT	Lockheed Martin	19.8 billion			
NYT	New York Times	6.8 billion			
TIF	Tiffany & Co.	4.3 billion			
		$97.8 billion			$99.0 billion

TABLE 1.4 "Mind-Set B"—Selected Investment Opportunities, October 2004[9]

Ticker	Company	Market Value	Ticker	Company	Market Value
AET	Aetna	$12.8 billion	TM	Toyota Motor	$125.3 billion
DAL	Delta Air Lines	0.4 billion			
F	Ford Motor	23.7 billion			
GM	General Motors	21.4 billion			
LMT	Lockheed Martin	23.8 billion			
NYT	New York Times	5.7 billion			
TIF	Tiffany & Co.	4.1 billion			
		$91.9 billion			$125.3 billion

period ending in late 2004.[10] While this may come as a surprise, it simply means that mind-set b is not a sufficient condition for investment success: Good decision making requires thorough analysis of underlying fundamentals. (Giving the previous table another thought, it is interesting that, in theory, by selling short all of Toyota in late 2004, we could have bought not only the companies on the left but also 93 percent of McDonald's.)

The Buck Stops Here

Once I had put aside my small fish mentality and embraced a capital allocator's mind-set, I started making better investment decisions. I found it easier to conclude, for example, that auto companies might not make good investments despite their recognized brands, large sales, and low P/E ratios. The capital allocator mind-set helped me realize I did not have to pick a winner in the auto industry when many companies outside the auto industry had better business models and were available at reasonable prices.

The new mind-set also raised the hurdle for investments in unprofitable companies because I knew intuitively that I would be forgoing current profits and the reinvestment of those profits in expectation of a future windfall. This seemed a rather speculative proposition. Many market participants, especially growth investors, exhibit a high tolerance for money-losing companies. An even more common trait is a willingness to ignore nonrecurring charges, even though such expenses reduce book value in the same way as recurring expenses. While no one would buy shares in a money-losing company unless he or she believed in a profitable future or in a favorable sale or liquidation, it seems that many investors' tolerance for losses is exaggerated by the subconscious reassurance that their investment amount is limited and they cannot be forced to commit more capital to a company even if it continues to lose money. Though our exposure is indeed legally limited to the initial investment, any impression that someone else will take care of a company's losses is an illusion:

- If other investors end up funding the losses of a company we own, they will either (1) dilute our interest or (2), if they lend money to the company, increase its interest expense and leverage. Both scenarios are blows to our prospects for a decent return on investment.
- If the company is able to fund losses with the liquidity available on the balance sheet, our percentage stake will not get diluted, but book value per share will decline. As Figure 1.1 shows, the impact of losses, whether recurring or not, on book value is perverse because, for example, a 20 percent drop in book value requires a 25 percent subsequent increase just to offset the decline.

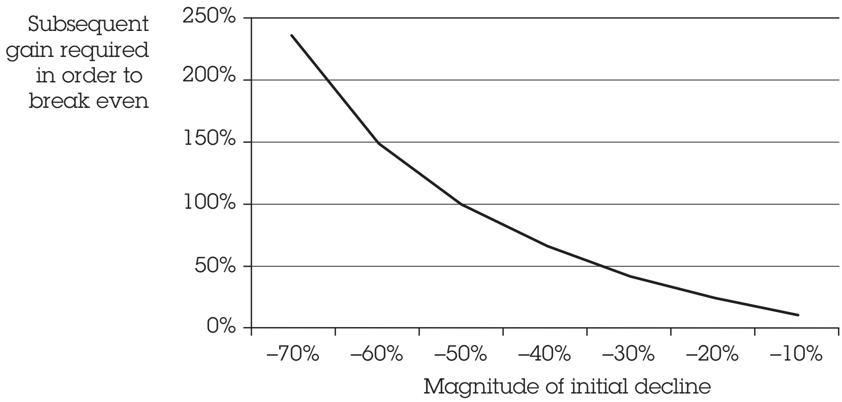


FIGURE 1.1 The Perverse Impact of Losses—Subsequent Gain Required to Break Even
Source: The Manual of Ideas.

Perhaps most important, the capital allocator mind-set enabled me to draw a sharp distinction between value and price, echoing Ben Graham's teaching, "Price is what you pay; value is what you get."[11] If I directed the allocation of the world's capital, I would not be able to rely on the market to bail me out of bad decisions. The greater fool theory of someone buying my shares at a higher price breaks down if the buck stops with me. Successful long-term investors believe their return will come from the investee company's return on equity rather than from sales of stock. This mind-set produces a very different process of estimating value than if we rely on the market to establish value and then try to gauge whether a company is likely to beat or miss quarterly earnings estimates.

Acting as a capital allocator rather than a speculator or trader required tremendous discipline at first, as I sometimes felt the temptation to outsmart other investors by betting that an earnings report would beat consensus estimates or an acquisition rumor would prove correct. Trading on such tenuous propositions required tacit agreement with the market's underlying valuation of a business, as I would have been betting on an incremental change in the stock price and not necessarily buying a fundamentally undervalued business. I learned that self-restraint was crucial, as buying an overvalued company in expectation of positive news could backfire. There is simply no way to know how an overvalued stock will react to an apparent earnings beat. Investors may be impressed by the strong earnings but disappointed by future guidance. The market may also have already priced in an earnings beat, with investors having bought the rumor, only to sell the news. Asset allocator Jeremy Grantham, chief investment strategist of GMO, agrees that investors have a hard time restraining themselves from playing the market: "Most professionals, including many of the best, prefer to engage in Keynes's 'beauty contest,' trying to guess what other investors will think in the future and 'beating them to the draw' rather than behaving like effective components of an efficient market; spending their time and talent seeking long-term values."[12] A money manager volunteered his outlook for energy investing in the *Wall Street Journal* in late 2005: "I think the sector is probably a little overvalued, but I wouldn't be surprised to see a run for energy stocks as we get to year-end. . . . People who are behind will go there to catch up."[13] The manager could not have been referring to investors who view themselves as capital allocators.

The Scale of Investments: How Much Is a Billion Dollars, Really?

In a world in which the valuations of many firms stretch into the billions or even hundreds of billions of dollars, developing intuition for the scale of such mind-boggling figures is critical. In late 2004, I came across Sirius Satellite Radio, which was valued at more than $8 billion, having reported revenue of $19 million and a net loss of $169 million in the previous quarter. Was $8 billion too much to pay for a company with little revenue and a net loss of more than eight times revenue? Since no traditional valuation measure could be used to arrive at an $8 billion valuation, why should the company not be worth $4 billion, or $16 billion? When a valuation appears to get out of hand, it helps to ask what else an equivalent sum of money would buy. At $50 per barrel of crude oil, $8 billion would have been enough to meet the oil demand of India for almost three months. Or assuming U.S. per capita GDP of $37,800, it would have taken the lifetime GDP of 4,200 Americans to equal $8 billion. It would have taken the lifetime savings of a *multiple* of 4,200 Americans to buy Sirius. Does it make sense that possibly tens of thousands of Americans would have had to spend their lives working and saving just so they could buy a money-losing company? While this question did not tell me how much Sirius was worth, it alerted me to a situation in which the company's per-share value might have deviated from the market price.

Mohnish Pabrai makes an eloquent case against investing in companies that become too large.[14] He compares companies to mammals, echoing Charlie Munger's latticework approach. According to Pabrai, nature seems to have imposed a size limit on mammals and companies alike. There have never been mammals much larger than an elephant, perhaps because mammals are warm-blooded and need energy to survive. It gets progressively more difficult for the heart to circulate blood to the extremities as a mammal grows bigger. Similarly, the top management of a large and growing corporation becomes progressively more removed from the multiplying touch points with customers, suppliers, and partners. This reduces management effectiveness, eventually causing scale to become a disadvantage and providing competitors with an opportunity to beat the incumbent. Pabrai observed nearly 10 years ago that no company on the Fortune 500 list of the most valuable corporations had net income much in excess of $15 billion (this changed in 2005 when Exxon Mobil posted record profits due to rising oil prices). It seems that any company successful enough to make much more than a billion dollars per month triggers a particularly fierce competitive response and sometimes piques the interest of trustbusters.

Owner Mentality

You have to give Wall Street credit. It was not easy to start with the simple concept of business ownership and end up in a world of quarterly earnings guidance, credit default swaps, and high-frequency trading. Wall Street was supposed to foster the allocation of capital to productive uses while minimizing frictional costs and enabling other industries to deliver the goods and services demanded by consumers. In the case of Wall Street and the broader economy, the tail really has come to wag the dog.

You have probably heard a wide range of reasons for buying a stock over the years: "This company has a great management team." "I love its products." "It will take over the world." Those three examples are among the more palatable justifications, even if they contain no mention of the price paid for the business. Other arguments include: "This company operates in an industry with huge growth potential." "This company is just one of many I'm buying because I think the market will go up." "This is a small-cap stock, and today is December 31st—I'm betting on the 'January effect.'" "This company is a great acquisition candidate." "A taxi driver gave me a hot tip from a man he drove to 11 Wall Street." "This company's name starts with 'China.'"

While it may be in the interest of bankers and brokers to complicate matters to boost demand for financial guidance and trading, those of us concerned primarily with investment performance might do best to follow the advice of Henry David Thoreau in *Walden:* "Simplify, simplify." But how do we simplify the complicated and treacherous game investing has become? The only way to do it reliably may be to focus on what a share of stock actually gives us, legally speaking. If the stock market shut down tomorrow, how would we estimate the value of the stock we own? We might try to figure out the financial profile of the business in which we are part owners. How much cash could this business pay out this year, and is this amount more likely to increase or decrease over time? Somewhat counter-intuitively, the recipe for evaluating a business purchase is the same whether the stock market is open or closed. A functioning market offers one unique source of value, however: It occasionally provides an opportunity to buy a business at well below fair value. Those who take advantage of this opportunity may want to write a few thank-you notes to those on Wall Street who put career risk ahead of investment risk and put duty to their own pocketbooks ahead of fiduciary duty. On second thought, "a few" notes may not be enough.

Adopting the Right Mind-Set

Thinking like a capital allocator goes hand in hand with thinking like an owner. Investors who view themselves as owners rather than traders look to the business rather than the market for their return on investment. They do not expect others to bail them out of bad decisions.

Investment professionalization has had unintended consequences, as the ultimate owners of capital (households and endowments) have become increasingly detached from security selection. Short-term-oriented security holders, such as mutual funds and hedge funds, have displaced long-term owners. The results have been a greater tendency to choose portfolios that reduce occupational risk rather than investment risk, increased trading mentality, and less participation in company affairs. As Vanguard founder John Bogle pointed out, "The old own-a-stock industry could hardly afford to take for granted effective corporate governance in the interest of shareholders; the new rent-a-stock industry has little reason to care."

The incentive structure of the asset management industry discourages fund managers from standing up to corporate executives, as funds prize access for business and social reasons. When Deutsche Asset Management, a large Hewlett-Packard shareholder in 2002, voted for the contentious HP-Compaq merger, it may have been due to pressure from HP executives. According to a report, "Merger opponent Walter Hewlett has sued HP, saying its management threatened to lock Deutsche Bank, Deutsche Asset Management's parent company, out of future HP investment-banking business if it had voted against [the deal]. Because of that pressure . . . Deutsche Bank, which previously had indicated it would vote against the deal, at the last minute switched its votes in favor of it. . . ." Disintermediation of ownership has placed massive amounts of stock in the hands of mutual funds, weakening corporate governance, sustaining excessive executive pay, and tolerating imperialistic mergers and acquisitions.

In hindsight, was there a way to profit from knowing that Deutsche's vote for the HP-Compaq deal might be influenced by factors other than its merits to HP shareholders? Perhaps we could have used a cynical view of Deutsche's incentives as a reason to invest in Compaq, which traded at a wider-than-typical merger arbitrage spread, reflecting investors' belief that the unsound merger might be called off. The bigger lesson may be to avoid giving money to entities that have less than their clients' or shareholders' best interests in mind.

It is hard to overstate how important owner mentality is when investing in stocks. Management works for the shareholders, not the other way around. There is no law that prevents owners from asserting their rights, regardless of whether they own one share of stock or a million. Of course, there are practical limits to influencing management as a small shareholder, but we need to think big to succeed. If our analysis shows a company would be a great investment if only we could get management to pay a special dividend, repurchase stock, spin off a division, or remove an underperforming CEO, chances are good that someone with the power to effect such a change (read: a large shareholder or hedge fund) agrees with us. I am surprised by how often I have invested in companies that ended up announcing seemingly unexpected actions to unlock shareholder value. The only way to find such companies consistently is to think about what changes we would make if we had the power and how much value such changes would create. If the latter is sufficiently high, we may get rewarded, even though someone else will do the hard work.

Stock Selection Framework

In this book, we examine equity idea generation in nine categories, each of which requires a slightly different approach to idea generation and evaluation. However, it also makes sense to think about an overarching approach to choosing equity investments. In this regard, we consider a stock selection framework that is (1) flexible enough to allow for analysis of any stock, regardless of company size or industry, yet (2) concrete enough to be useful in making informed investment decisions. To achieve both objectives, the framework needs to go far beyond the basic dividend-discount model of equity value, which fails miserably at the second objective. Perhaps it is precisely the lack of real-world applicability of that basic model that compels so many investors to select stocks based on such subjective criteria as first-mover advantage and technology leadership without understanding how those criteria fit into a more holistic view of stock valuation.

Notwithstanding the complexity inherent in a universal stock selection framework, developing a holistic approach to stock selection is an eminently achievable task. After all, the stock market itself is a holistic framework that ranks all companies along the same dimension—market value. Biotech companies are not valued in biotech dollars that are not convertible into construction dollars. On the contrary, because market value is a variable that is defined in the same way for every public company, investors know exactly what percentage of a biotech firm they could own in exchange for a piece of a construction company. Similarly, biotech investors do not commit capital because they like the sound of biotech companies' names or because they are fascinated with furthering DNA research. They invest for the same reason as all other investors: to make a buck. Consequently, we ought to have a model that boils all companies down to the same dimension—equity value. By comparing that value with market value, we can make informed investment decisions.

Figure 1.2 outlines an approach that may be able to handle, at least in principle, the vast array of equity investment opportunities available in the public markets. Although the following framework may not be practicable for most small investors, it does illustrate how we may think about security selection if we adopt the mind-set of chief capital allocator.

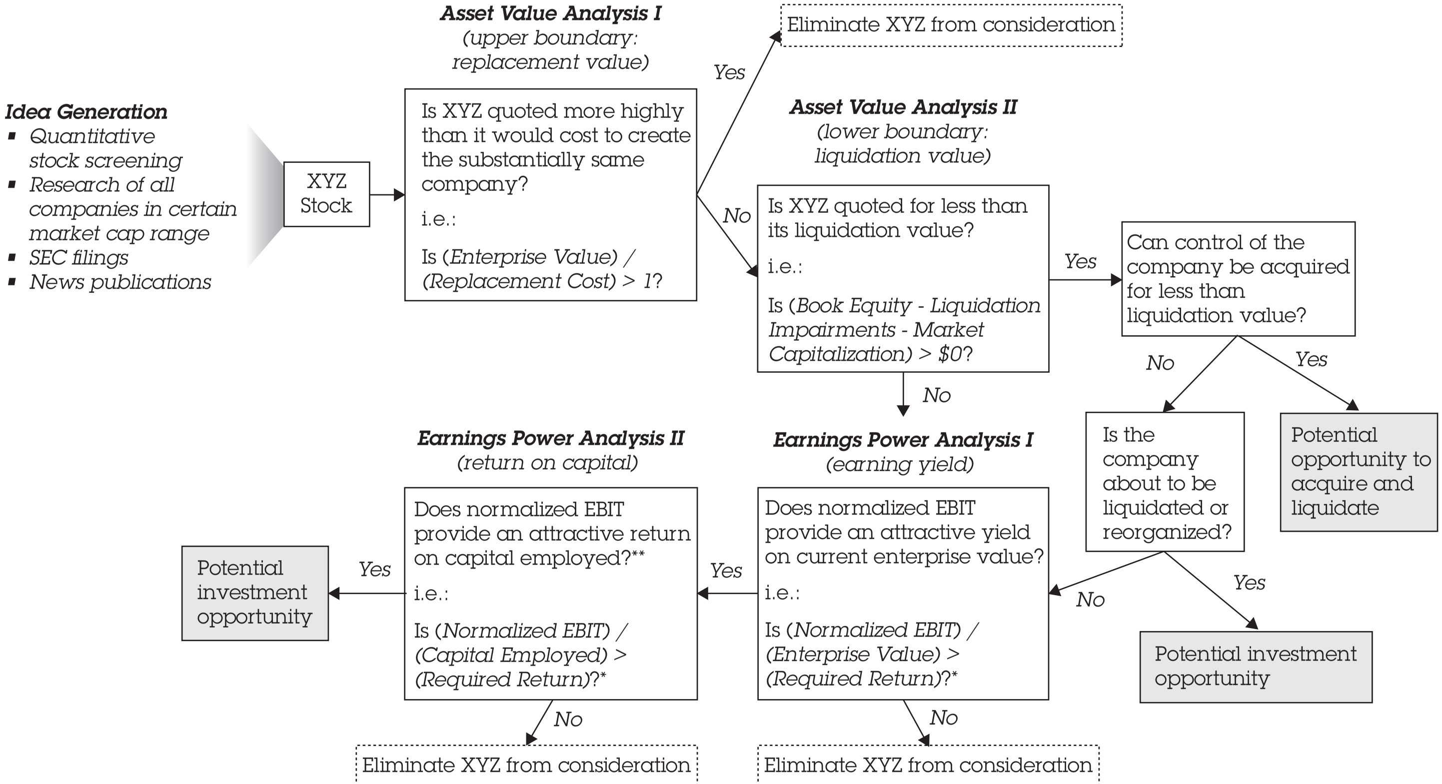
The stock selection framework begins by asking whether the net assets are available for purchase for less than replacement cost. If this is not the case, we exclude the company from consideration because it might be cheaper to re-create the equity in the private market. If the equity is available for less than replacement cost, then we consider whether it is so cheap that liquidation would yield an incremental return. If this is the case, we may consider liquidating the equity. In the vast majority of cases, an equity will trade far above liquidation value, in which case we turn our attention to earning power.

Once we focus on the earning power of a going concern, the key consideration becomes whether the business will throw off sufficient income to allow us to earn a satisfactory return on investment. Many related considerations enter the picture here, including the relationship between net income and free cash flow, the ability of the business to reinvest capital at attractive rates of return, and the nature of management's capital allocation policies.

Key Takeaways

Here are our top 10 takeaways from this chapter:

1. In investing, it is hard enough to succeed as an original; as a copycat, it is virtually impossible. Each of us must carve out a *personal* way to investment success, even if you are a *professional* investor.
2. One of the masters' key teachings is as important as it is simple: A share of stock represents a share in the ownership of a business.
3. Investors tend to add capital to investment funds after a period of good performance and withdraw capital after a period of



*Required return depends on conviction regarding normalized EBIT and other factors.
**Additional considerations: Can capital be reinvested at the normalized return on capital? Are above-average returns on capital sustainable?

FIGURE 1.2 Illustrative Stock Selection Framework
Source: The Manual of Ideas.

bad performance, causing their actual results to lag behind the funds' reported results.

4. Those considering an investment in a hedge fund may first wish to convince themselves that their prospective fund manager can beat Warren Buffett. Doing this on a prefee basis is hard enough; on an after-fee basis, the odds diminish considerably.
5. It is little surprise that the world's richest investor is a capital allocator rather than a trend follower, thematic investor, or day trader. Buffett looks to the underlying businesses rather than the stock certificates to deliver superior compounding of capital over the long term.
6. While most of us have a negligible impact on the stock market, the accompanying small fish mind-set does not lend itself to successful investing. Instead, we benefit from casting ourselves in the role of the world's chief capital allocator.
7. Although our exposure to the losses of the companies in which we invest is legally limited to our initial investment, any impression that someone else will take care of a company's losses is an illusion.
8. Losses have a perverse impact on long-term capital appreciation, as a greater percentage gain is required to get us back to even. For example, a 20 percent drop in book value requires a 25 percent subsequent increase to offset the decline.
9. Mohnish Pabrai makes an eloquent case against investing in companies that become too large, echoing Charlie Munger's latticework approach. According to Pabrai, nature seems to have imposed a size limit on mammals and companies alike.
10. Thinking like a capital allocator goes hand in hand with thinking like an owner. Investors who view themselves as owners rather than traders look to the business rather than the market for their return on investment.

Notes

1. See Hagstrom (2005).
2. Multiple studies have been published on mutual fund performance, including Brown and Goetzmann (1995), Malkiel (1995), Carhart (1997), and Khorana and Nelling (1997). Carhart concludes: "The results do not support the existence of skilled or informed mutual

fund portfolio managers." Malkiel finds: "In the aggregate, funds have underperformed benchmark portfolios both after management expenses and even gross of expenses."

3. See Ferri (2003).
4. See Buffett (2007).
5. See Berkshire Hathaway (2010).
6. See Stone (1999).
7. *The Manual of Ideas* interview with Eric Khrom, New York, 2012.
8. Source of price and market value information: Yahoo! Finance, http://finance.yahoo.com, accessed November 23, 2001.
9. Source of price and market value information: Yahoo! Finance, http://finance.yahoo.com, accessed October 22, 2004.
10. A more accurate gauge of Toyota's outperformance would be an analysis based on stock price (including paid dividends) rather than market value, which can be affected by events such as mergers and acquisitions that do not necessarily improve the per-share return to an investor.
11. See Buffett (2009).
12. See Grantham (2005).
13. See McDonald (2005).
14. See Pabrai (2002–2004).