

Chapter 1

The Purpose of This Book—Your Journey

The purpose of this book is simple. It is written so that you, dear reader, can very easily develop your own set of portfolios, which should outperform most of the professional money managers of the world. It is written with the K.I.S.S. principle in mind: Keep It Simple, Silly!

Since the last publication of this book, we have proven that our growth strategy works as well as the doctoral research said it should. Our model portfolio has outperformed the S&P 500 Index by more than two to one over a 12-year compounded rate of return. Our model portfolio has also outperformed Buffett's Berkshire Hathaway by almost two to one over this same time period. This outstanding performance was achieved without taking on more than market risk. And now, we show you how to hedge (insure) those portfolios in order to lower risk to a very manageable level.

During the interim between the first edition and this book, we've developed a dividend growth and income portfolio, which uses the Clean

Surplus method as the basis for our stock selection. We want to select stocks with a 7 percent expected growth in dividends and another 8 percent anticipated growth in stock appreciation. This is a great portfolio, which all of us should have going into the future. We will show you how to structure your own dividend and income portfolio in Chapter 21.

We have added Chapter 25, which will discuss insuring our portfolios. Portfolio insurance costs money, but we will discuss how to generate extra money in our portfolios (enhanced income) in order to pay for that insurance.

The basis for our stock selection in both portfolios is our new computer program. Talk about making life easier in a manner that saves us hundreds and even thousands of hours. When I began my research, I had several classes of finance students who helped me with the original research. But they all eventually graduated, and I began to spend less time teaching and more time developing intellectual property. The answer, of course, was to find someone who could write a computer program that followed our proprietary algorithms. We will go over the use of the computer program we developed so that those who use it can structure their own portfolios. We've always had a computer program, but in the past several years we had a professional put his extensive touch on it, so even I can use it with great ease.

Finally, for folks who do not want to develop and monitor their portfolios themselves, we can direct you to professionals who are certified to use the Buffett and Beyond stock selection method to develop portfolios. This is one reason we developed our website, appropriately addressed as www.BuffettAndBeyond.com.

Please allow me some time to tell you what this book is not. This book is certainly not an accounting book. However, it does discuss Clean Surplus Accounting, which is very possibly the simplest accounting method based upon the easiest-to-understand principle in the world. It will be very easy for you to understand because you actually use it every day and so does someone who is admired by the entire investing world.

We will find out how Warren E. Buffett, the world's greatest investor, utilizes this method. We will learn that a very simple ratio developed from this method (which you also use all the time) will tell us almost all we need to know about a company's operating efficiency. We will then use this ratio to compare one company's operating efficiency with another

company's operating efficiency. Following operating efficiency, the discussion will focus in great depth on why the most widely used ratio of comparison, return on equity (ROE), is so misused and misunderstood. Next, we will discuss why investors who use the traditional accounting ROE are doomed to underperform the averages.

The traditional accounting ROE *cannot* be used as a comparison ratio between companies. However, the ROE as configured by Clean Surplus is another story. In fact, it is our story.

Our next step will be to venture *one step beyond* and discuss my in-depth research on portfolio construction and how we can attempt to predict the future returns of our newly developed portfolios.

In other words, we will discover not only how to structure a superior performing portfolio, but we will also learn how to determine the predictability (or not) of the future total returns of that portfolio.

We will finally develop two very simple buy-and-hold portfolios. A buy-and-hold portfolio helps keep the taxman from becoming a partner in our everyday decisions, because it does not require everyday trading decisions. However, there are definitely rules on when to sell some of our portfolio positions.

I will always remember what a well-seasoned money manager told me just as I was beginning my education in the stock market. He wisely said that most times it was much better taking your client out to lunch rather than sitting in front of a computer screen trying to make those few extra dollars.

What he was trying to tell me was forget about short-term gains and concentrate on developing great long-term investment portfolios for the clients. Then you can spend all the extra time telling the clients about the merits of the superior portfolios you built for them instead of trying to trade those portfolios.

Thirty years later, this lesson helped me remember that I cannot single-handedly balance the U.S. budget deficit by paying extra taxes on those short-term gains that, to tell the truth, elude me to this day.

Warren Buffett has also formulated some pretty sound investment principles over the years. Let's learn from "the great one" and try not to reinvent the investing wheel. The man doesn't hide his thoughts or actions from us. It would be a foolhardy person who ignores Buffett's proven method of success.

SUMMARY

1. This book will show you a very simple system designed to exhibit the predictability (or not) of a company's operating performance.
2. We will learn how to structure a superior growth portfolio.
3. We will learn how to structure a superior dividend and growth portfolio.
4. You will learn how Warren Buffett, known as the world's greatest investor, uses this very simple system.
5. We will then discuss the research, which shows how to use the predictability of the simple accounting system called Clean Surplus in order to obtain superior portfolio performance.
6. We will later discuss some of the aspects of a company that Buffett looks for, which have earned his proven and successful results.