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MY APPROACH TO INVESTING

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Note: Most of the contents of this chapter will not be new to the majority of experienced investors. I wrote this chapter to bring less experienced investors up to speed with the principles of value investing.

In my opinion, good investing largely is common sense, made somewhat difficult by the behavioral imperfections of man. We can start with the straightforward concept that, over the longer term, common stocks are an unusually attractive investment vehicle, even for an investor whose returns only equal the stock market's returns. During the 50-year period 1960 through 2009, the average U.S. common stock provided an average annual total return (capital gains plus dividends) of 9 to 10 percent. In addition to providing this favorable return, common stocks are highly marketable and therefore can be purchased and sold easily without high frictional costs. Also, and importantly, if selected properly, common stocks offer considerable protection against risks of permanent loss. What could be better: favorable returns, high liquidity, and relative safety! That is a home-run combination, and that is why I am a great fan of common stocks.

The 9 to 10 percent average annual return provided by common stocks over the 50-year period makes economic sense. During the period, if adjustments are made for a few outlier years,[1] the U.S. economy grew at roughly a 6 percent annual rate: about 3 percent from real growth (unit output) and about 3 percent from inflation (increases in prices). Corporate revenues during the period increased in line with the economy, and corporate earnings roughly increased in line with revenues. While the price-to-earnings (PE) ratios of U.S. common stocks have fluctuated widely during the 50-year period, they seem to fluctuate around an average of about 16 times earnings. Therefore, before consideration of corporate acquisitions and share repurchases, common stocks have appreciated at about a 6 percent average annual rate over the years due to the growth of the economy.

U.S. corporations, on average, generate considerably more cash than they require to support their growth. This excess cash can be used by corporations to pay dividends, acquire other companies, or repurchase their own shares. Over the past 50 years, dividends have provided a 2.5+ percent yield, and acquisitions and share repurchases together have increased the earnings per share (EPS) growth of publicly traded corporations by close to 1 percent per year.

Thus, an average company's EPS has grown at about a 6 percent rate "organically" and at about a 7 percent rate including acquisitions and share repurchases. If one then adds the 2.5+ percent dividend yield to this 7 percent, the result is the 9 to 10 percent total return that an average investor has received over the years from investing in common stocks.

While it is difficult to project the future, assuming that the United States continues to be reasonably prosperous and capitalistic, I see no reason why the U.S. stock market will not continue to provide average annual returns of 9 to 10 percent over the longer run, even if the U.S. economy grows at a somewhat slower pace than it has in the past. If future growth is somewhat dampened, then corporations will not need to reinvest as much of their cash flows back into their businesses to support growth. Therefore, corporations should have more free cash available to pay dividends, acquire other companies, or repurchase their shares—and the increased returns

from these uses of cash should mostly or completely offset the reduced returns from the slower growth.

In spite of the many positive attributes of common stocks, I believe that many investors shy away from owning common stocks because they are fearful of the stock market's volatility, especially sharp downturns that are accompanied by negative news from the media and from Wall Street. Many consider volatility to be a risk. Importantly, when thinking about risk, I draw a sharp distinction between permanent loss and volatility. The former is what it says it is: a loss that cannot be recovered. Permanent losses are hurtful and should be avoided at all cost—avoided like the black plague. They are decidedly detrimental to the creation of wealth. Volatility, however, is merely stocks or markets going up and down in price (not in value). Downward volatility usually is nerve-racking, but otherwise is quite harmless. Markets and stocks tend to fluctuate. They always have, and they probably always will. Importantly, every time the market has declined, it eventually has fully recovered and then has appreciated to new heights. The financial crisis during the fall of 2008 and the winter of 2009 is an extreme (and outlier) example of volatility. During the six months between the end of August 2008 and end of February 2009, the Standard & Poor's (S&P) 500 Index fell by 42 percent from 1,282.83 to 735.09. Yet by early 2011 the S&P 500 had recovered to the 1,280 level, and by August 2014 it had appreciated to the 2000 level. An investor who purchased the S&P 500 Index on August 31, 2008, and then sold the Index six years later, lived through the worst financial crisis and recession since the Great Depression, but still earned a 56 percent profit on his[2] investment before including dividends—and 69 percent including the dividends that he would have received during the six-year period. Earlier, I mentioned that over a 50-year period, the stock market provided an average annual return of 9 to 10 percent. During the six-year period August 2008 through August 2014, the stock market provided an average annual return of 11.1 percent—above the range of normalcy in spite of the abnormal horrors and consequences of the financial crisis and resulting deep recession.

Thus, it appears that the 2008–2009 financial crisis, as scary as it was, did not have a material long-term effect on the aggregate value of U.S. common stocks. The volatility during the crisis turned out to be inconsequential for the patient long-term investor.

In fact, an investor should treat volatility as a friend. High volatility permits an investor to purchase stocks when they are particularly depressed and to sell the stocks when they are selling at particularly high prices. The greater the volatility, the greater the opportunity to purchase stocks at very low prices and then sell the stocks at very high prices. But what happens when the price of a stock falls sharply after you purchase it? No problem, assuming that the stock was an undervalued investment at the price you paid for it. Eventually, the price of the stock should recover and then appreciate well above your cost basis.

This leads me to another important positive attribute of common stocks. An investor can decide the exact times he wishes to buy and sell a stock, and the only determinants of his success are the cost of the stock at the time of purchase and the price of the stock at the time of sale. While the unfortunate schoolchild's final grade in a subject usually includes his interim grades on homework assignments, class participation, pop quizzes, and interim tests, the only grade that counts for an investor is the profit earned on a stock at the moment the investor decides to sell the stock. An investor might purchase shares of a company at $80. The price of the shares might then decline to $40 (a failing grade) and remain at the $40 level for a full year (definitely a failing grade). Then the shares might start rising, reaching a price of $160 three years after the investor made his purchase (an A+ grade). The investor might then sell the shares at $160, thereby doubling his money in three years. When the investor receives his report card, his final grade is A+. All the interim failing grades have been thrown out. It made no difference that the shares sold at $40 for a one-year period. The interim price was not relevant, unless the investor had been forced to sell the shares when they were at $40. Or unless the investor had the resources and desire to purchase additional shares when they were at $40, in which case the $40 price was a

blessing—and the extreme volatility in the price of the shares functioned as a close friend.

While many investors believe that they should continually reduce their risks to a possible decline in the stock market, I disagree. Every time the stock market has declined, it eventually has more than fully recovered. Hedging the stock market by shorting stocks, or by buying puts on the S&P 500 Index, or by any other method usually is expensive and, in the long run, is a waste of money. But how do you protect yourself if the stock market temporarily increases to excessively high levels, as it does from time to time? Then, it is likely that individual stocks in your portfolio will be sold because their prices will have increased to levels where their risk-to-reward ratios have become unattractive, and it is also likely that the level of cash held in your portfolio will increase (maybe to a very large percentage of the portfolio) because it will be difficult to find attractive new ideas in an inflated market. The cash then provides protection from a decline in the market. However, and importantly, the buildup of the cash is not a conscious effort to provide protection against a decline in an excessively priced market, but rather is a result of the height of the market.

Thus, common-stock investors of average ability should be able to earn 9 to 10 percent average annual returns without taking large risks of permanent loss. I have a thesis to explain the particularly favorable reward-to-risk attractiveness of common stocks. The return investors demand from any type of investment is a function of the perceived risk of the investment. The higher the perceived risk, the higher the demanded return. As discussed earlier, most investors incorrectly consider volatility to be a risk. These investors thus demand a higher return from common stocks than the deserved return. This error is our opportunity—and is another reason we treat volatility as a friend.

While the stock market itself is attractive, my goal, hope, and prayers are to materially outperform the stock market over time. My specific objective is to achieve average annual returns of 15 to 20 percent without subjecting our portfolios to large risks of permanent loss. Happily, we have achieved these goals. Over the past 25 years, accounts that we manage

have achieved average annual returns of very close to 19 percent. I attribute a material part of this success to a strategy that I developed in the early 1980s. The strategy is to try to purchase deeply undervalued securities of strong and growing companies that hopefully will appreciate sharply as the result of positive developments that already have not been largely discounted into the prices of the securities. Our reasoning is that the undervaluation, growth, and strength should provide the protection we cherish against permanent loss, while the undervaluation, strength, growth, and positive developments should present the opportunity to earn high returns. We typically purchase shares in a company in anticipation that one or more positive developments will drive the shares within the next few years, and we then sell the shares after the positive development (or developments) has occurred and has been substantially discounted into the price of the shares. Positive developments can include a cyclical upturn in an industry, the development of an exciting new product or service, the sale of a company to another company, the replacement of a poor management with a good one, the initiation of a major cost reduction program, or the initiation of a major share repurchase program. Importantly, the positive developments we predict should not already have been predicted by a large number of other investors. We need to be creative and well ahead of the curve. If we are not early, there is a likelihood that the future positive developments already largely will have been discounted into the price of the shares.

But what if we are wrong about a stock and the predicted positive development fails to occur (which does happen)? Then, the undervaluation, strength, and growth of the stock still provide the opportunity to earn a reasonable return. If we cannot have the icing, we can at least have the cake.

The above strategy of predicting positive changes makes common sense. At any one time, the price of a stock reflects the weighted opinion of the majority of investors. In order to earn outsized returns, we need to hold opinions about the future that are different and more accurate than those of the majority of other investors. In fact, it can be said that successful

investing is all about predicting the future more accurately than the majority of other investors.

Previously, I stated that common stocks, if selected properly, offer considerable protection against the risks of permanent loss. But what criteria do we use to select stocks that offer that protection? Of course, there are no formulas for analyzing the risks of permanent loss. It is said that if investing could be reduced to formulas, the richest people in the world all would be mathematicians. However, there are several signs to look for. A company that has a leveraged balance sheet (large quantities of debt relative to its cash flows and assets) may not have sufficient cash during difficult times to pay the interest it owes on its debt, in which case it might have to file for bankruptcy (in bankruptcy proceedings, the common shareholder usually loses most of his investment). A company whose value is dependent on a single technology might permanently lose most of its value if the technology becomes obsolete. For example, digital cameras have obsoleted Kodak's chemical-based films, with the result that Kodak has permanently lost most of its value. An investor also can suffer a permanent loss if he pays far too high a price for a stock.

To help minimize the risks of permanent loss, I look for a margin of safety in the stocks that we purchase. The concept of a margin of safety is that an investor should purchase a security at a price sufficiently below his estimate of its intrinsic value that he will have protection against permanent loss even if his estimate proves somewhat optimistic. An analogy is an investor standing on the 10th floor of a building, waiting for an elevator to carry him to the lobby. The elevator door opens. The investor notices that the elevator is rated for 600 pounds. There already are two relatively obese men in the elevator. The investor estimates their weights at about 200 pounds each. The investor knows that he weighs 175 pounds. The investor should not enter the elevator. There is an inadequate margin of safety. Maybe he underestimated the weights of the two obese men. Maybe the elevator company overestimated the strength of the elevator's cable. The investor waits for the next elevator. The door opens. There is one skinny old lady in the elevator. The investor says hello

to the lady and enters the elevator. On his ride to the lobby, he will enjoy a large margin of safety.

I note that our quest for a margin of safety makes us “value” investors as opposed to “growth stock” investors. As a value investor, we pay great attention to the price we pay for a security relative to our estimate of its intrinsic value. However, a growth stock investor pays considerable attention to the growth rate of a company and less attention to the price he pays for the growth. If a growth-stock investor purchases shares in a company that is growing at a 15 percent rate and if he holds the shares for many years, most of his returns will come from the growth as opposed to any change in the share’s price-to-earnings (PE) ratio. Therefore, most growth investors are willing to pay a high PE ratio for a security. I have a problem with growth-stock investing. Companies tend not to grow at high rates forever. Businesses change with time. Markets mature. Competition can increase. Good managements can retire and be replaced with poor ones. Indeed, the stock market is littered with once highly profitable growth stocks that have become less profitable cyclic stocks as a result of losing their competitive edge. Kodak is one example. Xerox is another. IBM is a third. And there are hundreds of others. When growth stocks permanently falter, the price of their shares can fall sharply as their PE ratios contract and, sometimes, as their earnings fall—and investors in the shares can suffer serious permanent loss. Many investors claim that they will be able to sell the shares of a faltering growth stock before the price of the shares declines sharply, but, in practice, it is difficult to determine whether a company is facing a temporary threat that it will overcome or whether it is facing a permanent adverse change. And when it becomes apparent to an audience that there is a fire in a theater, only a small fraction of the audience can be among the first to flee through an exit door. Therefore, many growth-stock investors do suffer permanent losses.

In addition to shying away from paying high multiples for growth stocks, I tend to avoid the shares of weaker companies, even if their shares are selling at distressed prices. Some value investors are attracted to the deeply depressed shares of poorly positioned companies that have uncertain

futures. I call these "cigar butt" investments. They are good for a few more puffs, but that is all. I strongly prefer purchasing undervalued shares of strong and well-positioned companies. My experience is that it sometimes takes a number of years for the prices of undervalued shares to increase to their intrinsic values or to be buoyed by positive events. During the time an investor owns a poorly positioned company, its intrinsic value might increase slowly, or, in some cases, might even decline to the level where the investor faces a permanent loss. However, the intrinsic value of a well-positioned company should increase in excess of 7 percent per year.[3] This is why we say that time is a friend of a good business and an enemy of a poor business.

Investors often are faced with the choice of purchasing a riskier stock with particularly large upside potential or a much less risky stock with less upside potential. Our proclivity is to purchase the less risky stock because we are great believers in Warren Buffett's two rules to being a successful investor. The first rule is to avoid serious permanent loss, and the second rule is to never forget the first rule. There are good reasons for this emphasis on risk avoidance. If an investor sells one stock at a 50 percent loss and reinvests the proceeds in a second stock, the second stock would have to appreciate by 100 percent before the investor recovers his loss in the first stock. Furthermore, large permanent losses can dampen the confidence of an investor—and I strongly believe that a good investor needs to be highly confident about his ability to make decisions, because investment decisions seldom are clear and usually are muddled with uncertainties and unknowns.

Our strategies of being risk averse (but being indifferent to volatility) and of purchasing undervalued stocks of strong and growing companies that hopefully will appreciate sharply as a result of positive changes are important reasons for our success over the years. But most other investors, including many who are highly intelligent and experienced, also have sensible investment strategies and yet are unable to materially outperform the S&P 500 Index. Why? My strong answer—and a key point in this book—is that a successful investor also needs certain other abilities that

are more behavioral than analytical. In particular, I believe that a successful investor must be adept at making contrarian decisions that are counter to the conventional wisdom, must be confident enough to reach conclusions based on probabilistic future developments as opposed to extrapolations of recent trends, and must be able to control his emotions during periods of stress and difficulties. These three behavioral attributes are so important that they merit further analysis.

BEING A CONTRARIAN

Because at any one time the price of a stock is determined by the opinion of the majority of investors, a stock that appears undervalued to us appears appropriately valued to most other investors. Therefore, by taking the position that the stock is undervalued, we are taking a contrarian position—a position that is unpopular and often is very lonely. Our experience is that while many investors claim they are contrarians, in practice most find it difficult to buck the conventional wisdom and invest counter to the prevailing opinions and sentiments of other investors, Wall Street analysts, and the media. Most individuals and most investors simply end up being followers, not leaders.

In fact, I believe that the inability of most individuals to invest counter to prevailing sentiments is habitual and, most likely, a genetic trait. I cannot prove this scientifically, but I have witnessed many intelligent and experienced investors who shunned undervalued stocks that were under clouds, favored fully valued stocks that were in vogue, and repeated this pattern year after year even though it must have become apparent to them that the pattern led to mediocre results at best. One such example is a gentleman with whom I periodically dine to discuss investment ideas. I will call him Danny Dinner Date. Danny has a high IQ and has been in the investment business for more than 40 years. He graduated near the top of his class from a rigorous private high school and attended an Ivy League college. He worked for many years as a securities analyst and portfolio manager, and eventually headed up a sizable investment management

company. Danny's resume is A+. Yet Danny's investment results are only mediocre—maybe C or C+. Danny will listen intently when I describe an undeservedly depressed stock that likely should appreciate sharply in response to the expected easing of a temporary problem, and he frequently will appear interested in purchasing the stock. However, in follow-up conversations, Danny often will mention that he is waiting for some signal that the problem has eased before purchasing the stock. Of course, by the time such a signal becomes apparent to Danny Dinner Date, it is likely that the easing already has become apparent to many other investors and that the price of the shares already has discounted part or all of the forthcoming change. Danny, therefore, is prone to purchasing stocks that already have appreciated sharply. Because Danny is fully aware of his mistimings, I readily conclude that his inability to purchase stocks that are under a cloud is habitual. He simply lacks the ability to be a contrarian leader and instead becomes a follower of the herd.

HAVING CONFIDENCE

Investment decisions seldom are clear. The information an investor receives about the fundamentals of a company usually is incomplete and often is conflicting. Every company has present or potential problems as well as present or future strengths. One cannot be sure about the future demand for a company's products or services, about the success of any new products or services introduced by competitors, about future inflationary cost increases, or about dozens of other relevant variables. So investment outcomes are uncertain. However, when making decisions, an investor often can assess the probabilities of certain outcomes occurring and then make his decisions based on the probabilities. Investing is probabilistic.

In my opinion, reaching rational decisions in a probabilistic world requires confidence. I have observed that investors who lack confidence often delay making decisions in quest of additional information that supports their views. Sometimes the delays become permanent and opportunities are permanently lost. Warren Buffett says that investors do not have

to swing at every pitch. But an investor who lets too many good pitches go by because he possesses the confidence to swing only at particularly "fat" pitches may be called out on strikes before he ever sees a particularly fat pitch.

During my career, I purchased many stocks that I should not have and failed to purchase other stocks that I should have. I often have been asked how I can maintain my investment confidence in light of the many decisions that did not turn out as predicted. I have an answer to this question. To maintain my confidence and to guard against decision regret (becoming distraught over opportunities that were missed or over purchases that were unsuccessful), I draw a large distinction between the correctness of my decisions and the outcomes of my decisions. If I carefully analyze a security and if my analysis is based on sufficiently large quantities of accurate information, I always will be making a correct decision. Granted, the outcome of the decision might not be as I had wanted, but I know that decisions always are probabilistic and that subsequent unpredictable changes or events can alter outcomes. Thus, I do my best to make decisions that make sense given everything I know, and I do not worry about the outcomes. An analogy might be my putting game in golf. Before putting, I carefully try to assess the contours and speed of the green. I take a few practice strokes. I aim the putter to the desired line. I then putt and hope for the best. Sometimes the ball goes into the hole, but most often it misses. I do not worry about missing or the misses. By removing worry from the decision-making process in golf and in investing, I can think more rationally and act more confidently—and therefore make better decisions, especially when investment decisions are counter to the conventional wisdom or otherwise are difficult. And I can sleep at night!

CONTROLLING EMOTIONS

I have observed that when the stock market or an individual stock is weak, there is a tendency for many investors to have an emotional response to the poor performance and to lose perspective and patience. The loss of

perspective and patience often is reinforced by negative reports from Wall Street and from the media, who tend to overemphasize the significance of the cause of the weakness. We have an expression that airplanes take off and land every day by the tens of thousands, but the only ones you read about in the newspapers are the ones that crash. Bad news sells. To the extent that negative news triggers further selling pressures on stocks and further emotional responses, the negativism tends to feed on itself. Surrounded by negative news, investors tend to make irrational and expensive decisions that are based more on emotions than on fundamentals. This leads to the frequent sales of stocks when the news is bad and vice versa. Of course, the investor usually sells stocks after they already have materially declined in price and usually purchases stocks after they already have materially increased in price. Thus, trading the market based on emotional reactions to short-term news usually is expensive—and sometimes very expensive. John Maynard Keynes said the following about trading the market: "Most of those who attempt it sell too late, buy too late, and do both too often."[4]

On October 19, 1987, the S&P 500 Index declined by 20.9 percent due to panic selling. There were no apparent fundamental reasons for the sharp decline. That evening, the faces of my co-commuters on the train to Rye, New York, were ashen. As I exited the train, I said hello to a friend who managed a medium-sized investment management firm. My friend, who looked most upset, commented that the day's collapse in the market was the worst financial disaster since the Great Depression—that most investors likely would lose confidence in the equity markets, triggering further declines in the prices of stocks, and that it would take years for the markets to recover. My friend said that he had sold some stocks that day and intended to sell more on the following day. I was dismayed by my friend's logic—or, rather, lack of logic. Let us assume that my friend owned stock X on October 18 because he believed it was worth $14 versus its then selling price of $10. Let us further assume that the stock fell in line with the market on October 19 and closed the day at $7.90. My friend now intended to sell the stock at $7.90 even though the day earlier he believed it was worth $14. Such a sale would be nonsensical. My friend had acted

on emotion, not on reason. And my friend's mistake was costly. During the next two years, the S&P 500 Index appreciated by more than 50 percent.

Seth Klarman, the founder of the Baupost Group, once said that "people don't consciously choose to invest with emotion—they simply can't help it."[5] Based on my observations, it would be easy for me to agree with Seth Klarman. I have continually seen intelligent and experienced investors repeatedly lose control of their emotions and repeatedly make ill-advised decisions during periods of stress. Surely, these intelligent and experienced investors must realize that their emotions are central to their mistakes. Why haven't they learned from the mistakes and tamed their emotions? Is their inability to think and act unemotionally during periods of stress habitual, ingrained in their personality? I cannot be sure of the answers to these questions, but I am not giving up on the notion that human beings, through effort and thought, can repress their emotions sufficiently to make rational decisions during periods of stress. All it takes is self-discipline—maybe a lot of self-discipline, but not an insurmountable amount for investors who are willing to be challenged. Here is one approach. When an investor is barraged with particularly bad or good news, he can reread the memos, notes, and models he wrote before the occurrence of the news. He then can ask himself three questions: What really has changed? How have the changes affected the value of the investments under consideration? Am I sure that my appraisal of the changes is rational and is not being overly influenced by the immediacy and the severity of the news? By being aware of one's emotions and by consciously trying to control them, investors should be able to make better decisions. This is important because, in my opinion, overreactions to current news are a major cause of underperformance in the stock market.

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I believe that the readers of Chapters 3 through 13 will conclude that my abilities to be a contrarian, to invest with confidence, and to control my emotions are the principal reasons for my success over the years. Yes, the techniques of analysis that most books emphasize are important, but

the importance is relevant only if an uncluttered, logical, confident, and unemotional mind has the ability to use the techniques to make successful investment decisions. That is the crux of this book.

Therefore, if an individual believes that he has the behavioral traits, plus the analytical skills and knowledge,[6] to be a successful investor, I recommend that he should go for it and become an active investor who analyzes and owns common stocks. Active investing should work for him and provide above-average returns. And an active investor should enjoy the thrill and the intellectual satisfaction of analyzing, selecting, and owning stocks.

However, if an individual believes that he does not have the ability to become a successful investor, he should invest passively—in index funds or in broadly based exchange-traded funds (ETFs) that are designed to roughly equal the market's performance. The recent proliferation of index funds and ETFs is evidence that many investors have concluded that they cannot outperform the stock market over time. For the sake of our nation, I applaud this trend. Most individuals should not try to compete against talented professional investors any more than most weekend tennis players should try to play matches against world-ranked professional tennis players. They will lose, usually badly.

NOTES

1. Inflation rates during the years 1973 to 1982 were abnormally high.
2. In this book, every time I refer to "his" or "he," I am also referring to "her" or "she."
3. Intrinsic values should increase in line with the growth of EPS. As indicated previously, over the past 50 years, the EPS of an average company has grown at a 7 percent or so annual rate.
4. John Maynard Keynes, "Memorandum for the Estates Committee." Paper presented to the Estates Committee, Kings College at Cambridge University, May 8, 1938.
5. Barton Biggs, *Hedgehogging* (Hoboken, NJ: Wiley, 2008), 259.
6. Access to information can be an important competitive edge for an investor—and, admittedly, professional investors usually have access to more information than nonprofessionals do.