CHAPTER 1

The Gurus

"Those who keep learning will keep rising in life."

—Charlie Munger[1]

The painful experience I had in the stock market during the dot-com bubble made me realize that I knew nothing about stocks. So, I started to learn. In the years that followed, I was reading everything I could find from some of the best investors. I read their books, their quarterly or annual shareholder letters, and any articles about them I could locate. I looked at their portfolios for investment ideas. And, in 2004, I started GuruFocus.com to share what I had learned. Then I learned even more, as many of the investors came to the website to share what *they* had learned.

I discovered that investing can be learned. I discovered that there is no trick to becoming a better investor. You simply need to learn, learn from the best, and learn from mistakes—mistakes of others, but mostly your own. And you need to work really hard.

The Gurus who had the most impact on me and my investing philosophy are Peter Lynch, Warren Buffett, Donald Yacktman, and Howard Marks. Lynch, Buffett, and Yacktman taught me how to think about business, companies, and their stocks. Marks made a great impression on me regarding how to think about market cycles and risks. What follows in this chapter are the important points that I gleaned from these Gurus.

Peter Lynch

Peter Lynch is the Guru from whom I learned the most about stock picking. The legendary mutual fund manager of the 1980s at Fidelity invested in thousands of companies and generated an annualized average return of 29 percent a year for 13 years. His bestselling books, *Beating the Street*[2] and *One Up on Wall Street*,[3] are the first books I read, and they helped me build the foundation for my investing knowledge. I read these books over and over and still learn something from them. I will use some of Lynch's quotes to explain the key factors in his investing.

"Earnings, Earnings, Earnings"

A company's earnings and its stock price relative to earnings are by far the most important factors in deciding if the stock is a good investment. Though stock prices can be affected by daily headlines about the Federal Reserve, the unemployment rate, the weekly jobs report, or what's going on in Europe, over the long term, the noise from the news is canceled out. As Lynch wrote:[4]

> People may wonder what the Japanese are doing and what the Koreans are doing, but ultimately the earnings will decide the fate of a stock. People may bet the hourly wiggles in the market, but it's the earnings that waggle the wiggles, long-term.

Lynch places all companies in six categories:

1. Fast growers
2. The stalwarts
3. Slow growers
4. Cyclicals
5. Turnarounds
6. Asset plays

Excluding the last category, asset plays, the companies are categorized based on what their earnings do. A fast grower can grow its earnings at above 20 percent a year. The stalwarts can grow at above 10 percent a year. The slow grower grows its earnings at single digits a year. Cyclicals are obviously the companies that have cyclical earnings. Turnarounds are those that have just stopped losing money and have started to generate earnings.

To Lynch, a company's earnings, earnings growth, and the earnings related to valuation ratios are the first things to look at before you consider a company further, unless you know it is an asset play. You can find all this information in a company's income statement. After I learned this, I went back to check the earnings of the fiber optics companies I bought. This was what I found in the 2001 annual report of Oplink:[5]

> We have incurred significant losses since our inception in 1995 and expect to incur losses in the future. We incurred net losses of $80.4 million, $24.9 million and $3.5 million for the fiscal years ended June 30, 2001, 2000 and 1999, respectively.

So, the company had been losing money all that time and was expected to lose more in the future—how *could* its stock do well? By simply looking at the earnings, investors like myself would not have bought stocks like Oplink and could have avoided a monumental mistake.

I immediately included this in my investing practice. In the plaza behind the community where I lived were a Starbucks and a Blockbuster. The two stores were next to each other. I was deciding, between them, which stock to buy. It was October 2001, and I went to visit the stores many times to observe their operations and traffic as part of my research, as suggested by Lynch. I couldn't tell the difference just by visiting the stores, however. Both stores seemed to have decent traffic, which was confirmed by pretty good sales numbers. I definitely didn't foresee that one day Blockbuster would be killed by Netflix. What made the difference is Lynch's "earnings, earnings, earnings." Starbucks has always been profitable and was growing its earnings at more than 30 percent a year, whereas Blockbuster was losing money four out of five years from 1996 to 2000. In addition, Starbucks had almost no debt and a much stronger balance sheet than Blockbuster.

The decision became simple, and I bought Starbucks in October 2001. I sold it in March 2003 for a 65 percent gain. As I learned more, I realized that Starbucks is a fast grower—which makes me wish I'd never sold.

Since earnings are the most important measure of a company's profitability, the companies that have higher profit margins beat those with lower profit margins. The ones with increasing profit margins beat the companies with declining margins; therefore, unsurprisingly, Lynch prefers companies with higher margins to those with lower margins.[6]

"Companies That Have No Debt Can't Go Bankrupt"

If earnings, earnings, earnings are the measure of a company's profitability, the above quote from Lynch references the financial strength of a company, which is reflected on the company's balance sheet.

A company's debt level is the most important factor when measuring its financial strength. A company goes bankrupt if it cannot service or repay its debt, even if it may have a lot of valuable assets. A company's debt level is closely related to the nature of the business and its operations. For businesses that don't need a lot of capital to grow, the chance of accumulating a large debt load is small. One such company is Moody's. The credit rating agency is a favorite holding of Buffett. Some companies need a lot of capital investment in their operations and are therefore considered capital-intensive and asset heavy, such as mining companies and utilities.

According to the debt loads of different companies, we can categorize them into four levels (A–D):

A. No debt

This type of company has no debt or minimal debt. One example is Chipotle Mexican Grill. Chipotle has grown its earnings at 30 percent a year without incurring any debt. These are the related balance sheet items of Chipotle over the past five years (all numbers in millions):

Fiscal Period	Dec2011	Dec2012	Dec2013	Dec2014	Dec2015
Cash, Cash Equivalents, Marketable Securities	456	472	578	758	663
Current Portion of Long-Term Debt	0.133	0	0	0	0
Long-Term Debt	3.5	0	0	0	0

A large portion of Chipotle's growth is from expanding into new markets. A major risk for fast growers like Chipotle is expanding too fast and then needing to borrow money to fund the growth. This clearly wasn't the case for Chipotle. If bought at a reasonable price, which I will discuss in Chapter 5, this stock's investment risk is low.

B. Some debt, but easily serviced by existing cash or operating cash flow

Most companies have some level of debt on their balance sheet. A company may have a debt level that is less than its cash level and can be paid off easily, for instance, Agilent Technologies, the maker of test and measurement equipment. These are the related items from its balance sheet and income statement; again, all numbers are in millions:

Fiscal Year	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**
Cash	2262	1826	1429	2493	2649	3527	2351	2675	2218	2003
Current Portion of Long-Term Debt	0	0	0	1	1501	253	250	0	0	0
Long-Term Debt	1500	2087	2125	2904	2190	1932	2112	2699	1663	1655
Revenue	4973	5420	5774	4481	5444	6615	6858	6782	6981	4038
Operating Income	464	584	795	47	566	1071	1119	951	831	522
Net Interest Income	109	81	–10	–59	–76	–72	–92	–100	–104	–59

Agilent does have debt. In fact, as of October 2015, it had $1.65 billion of debt. But it also has more than $2 billion in cash. In principle, it can pay off all its debt outright with the cash in the bank. The company's past operating results further confirm that it is in a strong financial position. We can see that even during the economic recession in 2008 and 2009, the company could easily service its debt with its operating income. An investor should feel comfortable that the company can manage its debt in the future.

Some companies may not have enough cash to pay off their debt outright, but their operating cash flow can service their debt very comfortably. An example of such a company is AutoZone:

Fiscal Year	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**
Cash	92	87	242	93	98	98	103	142	124	175
Current Portion of Long-Term Debt	0	16	0	0	48	34	80	206	217	41
Long-Term Debt	1857	1936	2250	2727	2882	3318	3718	4013	4142	4625
Revenue	5948	6170	6523	6817	7363	8073	8604	9148	9475	10187
Operating Income	1010	1055	1124	1176	1319	1495	1629	1773	1830	1953
Net Interest Income	–108	–119	–117	–142	–159	–171	–176	–185	–168	–150

AutoZone has always had much more debt than cash, but the company could easily service its debt, as its operating income is many times higher than the interest payment on its debt, during good times and bad. Although it is not a balance sheet that an investor should aim to have, it seems unnecessary to worry about the financial stability of the company.

Closer examination reveals that the company has been using the cash flow generated from operations to buy back shares, which reduced the company's cash balance.

C. Low interest coverage

While I like to eat Dunkin' Donuts, I don't like the company's balance sheet. The company has far more debt than cash. Although the same is true for AutoZone, Dunkin's interest payment on its debt is a much higher percentage of its operating income. During difficult times like in 2009, the interest payment consumed more than half of its operating income.

These are related items from Dunkin's balance sheet and income statement:

Fiscal Year	2009	2010	2011	2012	2013	2014	2015
Cash	0	134	247	253	257	208	260
Current Portion of Long-Term Debt	0	13	15	27	5	4	26
Long-Term Debt	0	1852	1458	1831	1826	1803	2428
Revenue	538	577	628	658	714	749	811
Operating Income	185	194	205	239	305	339	320
Net Interest Income	–115	–113	–104	–73	–80	–68	–96

For starters, a company's interest coverage is defined as the ratio of its operating income over its interest expense on its debt. In Dunkin's case, for fiscal year 2015, it had $320 million in operating income, but $96 million in interest expense. Therefore, the interest coverage is 320/96 = 3.3.

A cautious investor should not feel comfortable holding the stock of companies with this kind of balance sheet. An interest coverage higher than 10 means that the operating income is more than ten times the interest payment on the debt, which indicates that the company can easily service its debt. If another recession hits or if interest rates go up, at least one of which will occur sooner or later, the earnings of Dunkin' will dramatically decrease. In the worst case, the company may even have a hard time servicing its debt.

Dunkin' Donuts is an example of a company with a weak balance sheet and relatively poor financial strength.

D. Cannot service its debt

Companies with even worse balance sheets cannot pass the test of bad times and are on their way to bankruptcy or have already gone bankrupt. An example of such a company is SandRidge Energy. The company always had a full load of debt on its balance sheet and far less cash. This is a similar situation to AutoZone, but SandRidge Energy barely generated enough operating income to service its interest payment for its debt even during good times, when the oil price was at an all-time high. After oil prices collapsed in 2015, the company was losing a major amount of money with operations and had no way to service its debt. It filed for bankruptcy in May 2016.

Fiscal Year	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Cash	39	63	1	8	6	208	310	815	181	436
Current Portion of Long-Term Debt	26	15	17	12	7	1	0	0	0	0
Long-Term Debt	1041	1052	2359	2581	2902	2826	4301	3195	3195	3632
Revenue	388	677	1182	591	932	1415	2731	1983	1559	769
Operating Income	37	187	–1338	–1605	–7	429	325	–169	590	–4643
Net Interest Income	–16	–112	–143	–185	–247	–237	–303	–270	–244	–321

Investors should always avoid companies that have too much debt. SandRidge was a company with $12 billion of market cap at its peak, but SandRidge shareholders could have avoided their losses if they had taken a look at its balance sheet and its earnings, earnings, and earnings! I only feel comfortable investing in a company if its operating income covers at least ten times the interest payment on its debt, through good times and bad.

Again, as Lynch said, companies that have no debt can't go bankrupt. Oplink, the little fiber optics company whose stock I bought during the tech bubble, lost money nine out of the first ten years after it went public (2000–2009). The company went through two recessions but survived both and did so simply because it didn't have debt. Oplink was later acquired by Koch Optics for $445 million. At the time of acquisition, the company had $40 million in cash and no debt. The revenue had grown to $207 million a year, but the company was still barely profitable. The bigger players in the telecom market, such as Nortel, WorldCom, and Global Crossing, are long gone and forgotten. Too much debt!

A company's debt level is closely related to the nature of the business and its operations—some businesses are just better businesses. This leads to Lynch's third point:

"Go for a Business That Any Idiot Can Run"

The complete quote is:

> Go for a business that any idiot can run—because sooner or later any idiot probably is going to be running it.[7]

There are two types of companies that any idiot can run. One has a simple product and simple operations. The growth plan is to sell more of what it makes and repeat what it has done in more places. There is no deep insight and knowledge needed to make product and business decisions. In Lynch's own words from *One Up on Wall Street*:[8]

> Getting the story on a company is a lot easier if you understand the basic business. That's why I'd rather invest in panty hose than in communications satellites, or in motel chains than in fiber optics. The simpler it is, the better I like it. When somebody says, "Any idiot could run this joint," that's a plus as far as I'm concerned, because sooner or later any idiot probably is going to be running it.

Consider Research-In-Motion, now BlackBerry, which had nearly 50 percent of the smartphone market in the United States in 2008: A few wrong product decisions and slow moves wiped out almost all of its market share. It took more than a genius to compete against companies like Apple and Google, which are run by geniuses, too.

Another type of business that any idiot can run is the kind where strong competitive advantages protect it from management missteps and leave plenty of time for the company to correct its mistakes. McDonald's made plenty of mistakes, such as being slow to react to customers' changing tastes and needs and featuring a huge menu, which led to a worse customer experience. For the three years from 2013 through 2015, the company had declining same-store sales, one of the most important indicators of restaurant operations. It went through many CEOs in a few short years and seemed to have done everything wrong. Then, McDonald's introduced all-day breakfast in October 2015 and made adjustments to its food prep. The same-store sales had surged by January 2016, and the stock rallied to an all-time high. Back in 2007, both Research-In-Motion and McDonald's had about $60 billion in market cap. The mistakes made by Research-In-Motion wiped out more than 90 percent of its total market value while McDonald's market cap has grown to more than $100 billion.

Again consider Moody's, one of Buffett's favorite holdings. The rating agency enjoys a duopoly with S&P Global in the credit and bond rating markets. During the housing bubble of the mid-2000s, the company abused its power as a rating agency and assigned AAA ratings to the mortgage-backed securities that were actually very risky. The company was partially responsible for the housing crisis, and that cost it its credibility. Following the housing crisis, government agencies across the United States and Europe set up regulations to reduce the power of Moody's and S&P Global by pushing bond issuers to their smaller competitors, but this move didn't do much to the market share of Moody's. The company now has record sales and near-record profits. Its stock has also made new highs.

Therefore, if everything else is equal, buy the company that can grow by copying what it is doing in more places, or buy the ones that are protected from competition by their strong competitive advantages.

Warren Buffett

If Peter Lynch taught me investing methodologies, Warren Buffett influenced my business understanding and investing philosophy. I read through all of Buffett's partnership and shareholder letters from the 1950s to the present, which completely changed the way I think about business and the philosophy of investing. An investor should forever remember the following three quotes from Buffett.

"It's Far Better to Buy a Wonderful Company at a Fair Price Than a Fair Company at a Wonderful Price"[9]

Lynch placed companies in six categories and taught us what to do with each. Buffett tells us to invest only in the good ones and to buy them at reasonable prices.

Granted, Buffett had tremendous success in his early years by buying marginal businesses on the cheap. But he made most of his money over the long term by investing in wonderful companies at attractive prices. These wonderful companies include the likes of See's Candy and GEICO Insurance. He called GEICO "The Security I Like the Most" more than 60 years ago,[10] and he still calls it that today.

So, there are two questions to answer:

1. What kinds of companies does Warren Buffett consider "wonderful"?
2. What is "fair price"?

Wonderful Companies

These are, according to Buffett, the characteristics of wonderful companies:

1. *A broad and durable competitive advantage, or economic moat*

An economic moat protects a company from its competitors and prevents others from entering its market. It gives the company significant pricing power so that the company can increase its earnings over time.

One indication that a company has a strong economic moat is that it has high profit margins and can maintain, or even grow, its profit margins over the long term. An example, once more, is Moody's. The debt issuers need Moody's more than Moody's needs the debt issuers. They can charge the issuers at their set prices, or the issuers will have to pay even more in the debt market without the ratings. As we described before, even with the help of the governments across the United States and Europe, competitors cannot take away Moody's market share. With this moat, Moody's could maintain high profit margins. Here is the comparison between the operating margins of Moody's and the other two best-run and most profitable companies in the past decade, Apple and Google.

For starters, operating margin is the profit that a business makes before paying interest on its debt and tax. For an example, if a retailer sold $100 of goods that it bought for $60, its gross margin is \$100 – \$60 = \$40. The retailer has to pay business expenses such as rent, salary, and Internet, which costs him \$15. His operating profit will be \$40 – \$15 = \$25. So, the operating margin will be \$25/\$100 = 25%. Operating margin is a good indication of how profitable a business is.

Here are the operating margins (%) of Apple, Google, and Moody's:

Fiscal Year	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Apple	13%	18%	19%	27%	28%	31%	35%	29%	29%	30%
Google	33%	31%	30%	35%	35%	31%	25%	23%	25%	26%
Moody's	62%	50%	43%	38%	38%	39%	39%	42%	43%	42%

Moody's, over the past decade, has consistently had much higher operating margins.

2. *Low capex requirement and high returns on invested capital*

An indication of companies that have low capital requirement is that they have high capital turnover and can generate high returns on invested capital. As a result, only a small portion of earnings has to be reinvested in the business.

See's Candy was earning \$4 million a year in 1972. But by 2015 it had earned \$1.9 billion, pretax. Better yet, its growth has required added investment of only \$40 million. Over more than 40 years under the ownership of Berkshire Hathaway, See's needed only \$40 million in capital expenditure and has earned Berkshire \$1.9 billion. This results in a ratio of capex/pretax income of just over 2 percent.

I have calculated the ratio of capex/pretax income of Moody's, Apple, and Google; the result:

Fiscal Year	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Apple	23%	20%	17%	10%	11%	22%	17%	18%	18%	16%
Google	47%	42%	40%	10%	37%	28%	24%	51%	63%	50%
Moody's	2%	16%	12%	14%	11%	8%	4%	4%	5%	6%

Clearly, Moody's needs much less capital expenditure for its growth than Apple and Google. The company only needs to buy more furniture and computers for its growth. Capital spending accounted for a mere 6 percent of its net income in 2015; the remaining 94 percent can be used for rewarding shareholders in dividends and share buybacks after paying tax.

Here are the returns on invested capital for these three companies:

Fiscal Year	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**
Apple				192%	92%	70%	59%	38%	35%	40%
Google	76%	53%	46%	54%	62%	57%	44%	37%	34%	33%
Moody's	11,770%		639%	267%	307%	219%	253%	280%	195%	158%

Though both Apple and Google had very high returns on invested capital, Moody's has been higher.

For starters, return on invested capital (ROIC) measures how well a company generates cash flow relative to the capital it has invested in its business. The invested capital is the total of the shareholders' equity and the debt less the cash it has. The higher ROIC is, the more efficient the business is with its capital.

Moody's is better than both Apple and Google in terms of economic moat and capital requirement. But this doesn't guarantee better stock performance, even in the long term, because another factor plays an important role. This constitutes the third characteristic for wonderful companies: growth.

3. *Profitable growth*

This table represents the year-over-year earnings-per-share growth rate (%) of the three companies. The last column is the average growth rate over the past ten years.

Fiscal Year	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**Average**
Apple	45%	73%	37%	69%	67%	83%	60%	–10%	14%	43%	55%
Google	98%	34%	0%	53%	29%	13%	9%	18%	10%	9%	27%
Moody's	40%	0%	–28%	–10%	27%	16%	22%	18%	28%	0%	19%

Both Apple and Google grew much faster than Moody's. The faster growth of these two companies has contributed tremendously to the growth of their intrinsic values, or fair prices. That is the main reason why Apple stock gained almost 1,000 percent over the past decade while Google stock gained about 280 percent and Moody's gained just 80 percent.

Fair Price/Intrinsic Value

Every share of stock represents partial ownership in the company. So, the fair price of the stock is whatever that portion of business is worth, or its "intrinsic value." In principle, the intrinsic value is equal to the discounted value of the cash flow that can be generated by the business during its remaining life, as explained by Buffett.

As history's most successful value investor, Buffett was misunderstood quite often on growth. Many people believed that he didn't care about it, but growth is one of the most important components of his definition of wonderful companies. In his 1951 article, "GEICO: The Security I Like the Most," he determined that GEICO is a growth company.[11] He wrote:

> GEICO qualifies as a legitimate growth company . . . . In GEICO's case, there is reason to believe that major portion of growth lies ahead.

Of course, he was talking about profitable growth. In his 1992 shareholder letter, he wrote:[12]

> Growth is always a component in the calculation of value, constituting a variable whose importance can range from negligible to enormous and whose impact can be negative as well as positive.

When a company grows profitably and generates positive returns on its invested capital, its intrinsic value grows, too. A wonderful company can grow its value over the long term and reward its shareholders with more earning power over time. In comparison, a marginal business will probably not be able to create value over time. More likely is that it will destroy value. Even if an investor can buy it at a wonderful price, as Buffett did with his textile companies, the results can still be disastrous.

Wouldn't it be better if an investor could buy a wonderful company at a wonderful price? Ideally, yes. But because of the market condition and its size, Buffett changed his requirement on valuation from "a very attractive price" in 1977 to "an attractive price" in 1992, then to "a fair price" in recent years.

I will discuss valuation in depth in Chapter 9.

For most investors who don't have the portfolio-size problems of Buffett, the chance of finding wonderful companies at wonderful prices is far greater. This is one of the many advantages that small investors enjoy.

"It's Crazy to Put Money in Your Twentieth Choice Rather Than Your First Choice"

After all the hard work of finding the wonderful company in which to invest, isn't it obvious that an investor should bet big on it? It's difficult enough to find one good investment idea, let alone 20. Why would an investor put money in his or her twentieth choice instead of his or her first choice?

This quote from Buffett strikes me as obvious, but it is hard to do, and not many investors have the guts to keep a concentrated portfolio. If an investor has confidence in his or her research, he or she won't have difficulty putting as much money as possible in the investment idea, just as Buffett did with GEICO in 1951. After a four-hour meeting with Lorimer Davidson, the then-future CEO at GEICO's headquarters, and learning all he could about GEICO and the insurance industry, Buffett made the stock 75 percent of his $9,800 investment portfolio. "Even so, I felt over-diversified," he wrote.[13] This successful investment would get him off to a great start with his investment career and also jumpstart his net worth. He later wrote:

> Diversification is protection against ignorance. It makes little sense if you know what you are doing . . . . Wide diversification is only required when investors do not understand what they are doing.
>
> We believe that a policy of portfolio concentration may well decrease risk if it raises, as it should, both the intensity with which an investor thinks about a business and the comfort-level he must feel with its economic characteristics before buying into it.

Therefore, the key to maintaining a concentrated investment portfolio is to understand as much as possible about the business of the company and the industries in which it operates in order to build enough confidence to bet big. With certainty in one's research and compelling long-term convictions, betting big is much easier to do—and guts won't be a requirement.

Buffett continued to write in his 1993 shareholder letter:[14]

> On the other hand, if you are a know-something investor, able to understand business economics and to find five to ten sensibly-priced companies that possess important long-term competitive advantages, conventional diversification makes no sense for you. It is apt simply to hurt your results and increase your risk. I cannot understand why an investor of that sort elects to put money into a business that is his 20th favorite rather than simply adding that money to his top choices—the businesses he understands best and that present the least risk, along with the greatest profit potential. In the words of the prophet Mae West: "Too much of a good thing can be wonderful."

The message is straightforward: Stick to your best ideas. It is improbable for a single person to have unique insights and understanding of dozens of companies across many industries and keep up with the development of these companies over time.

One can argue that investors like Ben Graham, Walter Schloss, and Peter Lynch had a diversified portfolio but still did extremely well. Graham and Schloss invested strictly according to certain key parameters on stock prices and didn't pay much attention to the companies' business and management.[15] Therefore, diversification was needed. Lynch himself owns thousands of stocks. But his advice to part-time stock pickers is to follow 8 to 12 companies because "owning stocks is like having children—don't get involved with more than you can handle."[16] With a concentrated portfolio, Buffett had a much easier life; he can continue to enjoy investing in his eighties and still manages a portfolio that is many times larger than Lynch's.

And, more importantly, betting big is more rewarding. Buffett has run a concentrated portfolio throughout his career, which is a significant reason he had the best track record for so long. To this day, Buffett runs an equity portfolio of more than $128 billion;

70 percent of the portfolio, or almost $90 billion, is concentrated on the top five positions. As of September 30, 2016, these positions are exclusively the wonderful companies at fair prices: Kraft Heinz, Wells Fargo, Coca-Cola, IBM, and American Express.

After finding the handful of wonderful companies at reasonable prices and concentrating investment practices on them, the next thing to do is be patient, which brings up the third key point I learned from Buffett:

"Our Favorite Holding Period Is Forever"

One common mistake investors make is to sell the winners for a quick profit and hang onto the ones that did poorly. Lynch calls such behavior cutting the flowers and watering the weeds. It is hard to find the wonderful companies at reasonable prices, so now it is time to hang onto them as long as the fundamentals hold and the valuation is reasonable. This is the complete Buffett quote, from his 1998 shareholder letter, about holding time:[17]

> In fact, when we own portions of outstanding businesses with outstanding managements, our favorite holding period is forever.

During the holding time, two things happen.

1. The gap between the intrinsic value and the price paid closes over time.
2. The intrinsic value of the business grows over time.

Over the long term, the contribution from the growth of the value can be so high that the price would no longer be that critical. Consider Buffett's purchase of See's Candy in 1972: The family controlling See's wanted $30 million, but Buffett didn't want to pay more than $25 million. Luckily, the sellers took his $25 million bid, or Berkshire would have missed out on the $1.9 billion in earnings for the $5 million difference.[18]

Buying a stock with the intention of holding for a long time also works conversely. If you think long term during your research, the noise that pervades will no longer matter. You can focus on the things that matter over the long term, such as the quality of the business, the industry in which it operates, and its intrinsic value.

Donald Yacktman

Peter Lynch could find good ideas in all six of his categories; Warren Buffett tells us to invest in the good ones among them. Donald Yacktman goes a step further and says that we should simply invest in the good companies that are not cyclical.

Yacktman is probably not as well-known as Lynch and Buffett. He is the founder of the firm that bears his name, Yacktman Asset Management, which manages more than $17 billion as of 2016. Yacktman built his reputation in the 1980s by producing outstanding results as a fund manager at American Shares Fund. He started his own fund in 1992, and the fund's assets grew to $1.1 billion by 1997. The tech bubble was then speeding up, but Yacktman was still investing in the old-fashioned way of buying undervalued profitable companies. His fund was lagging in the market so much that investors started to quickly pull their money. In 1998, some of the fund's directors wanted him to go, and only a fierce proxy fight kept Donald Yacktman at Yacktman Asset Management. By 2000, the fund's assets shrank to a mere $70 million, and finally his strategy of value investing started to work again. In 2000, Yacktman's fund outperformed the S&P 500 by 20 percent; in 2001, by 31 percent; and in 2002, by 33 percent. His fund continued to do extremely well during the financial bubble in 2008 and 2009, beating the S&P 500 by 11 percent during the market crash in 2008 and 33 percent during the market recovery in 2009. I extend my sympathy to those shareholders who withdrew from the fund and put their money into high-flying technology funds.

The core investing philosophy of Yacktman is viewing stocks as bonds, which means thinking in terms of the rate of return from the stock, just like with bonds. The key points of his strategy are related to the business type, the management, and the investment hurdle.

Buy Good Businesses That Are Not Cyclical

Like Buffett, Yacktman tells investors to commit only to good businesses. But he goes into more detail and says to invest only in good businesses that are not cyclical and to invest only in companies whose products have a short customer repurchase cycle and long product cycles. Good examples of such products are mostly consumer staples such as toothpaste, baking soda, and condoms. The products are consumed daily by customers and will need to be purchased again quickly, no matter how the economy is doing. Also, consumers usually purchase them with cash instead of credit. These companies don't have to continually invent new technologies and keep competing with new generations of products. Coca-Cola has been selling the same drink for many decades, which represents the long product cycle.

Such companies are clearly evidenced in his portfolio in the Yacktman Fund, as his largest holdings at the time of this writing are Procter & Gamble, PepsiCo, and Coca-Cola. Coca-Cola is also one of Buffett's largest holdings.

And like Buffett, Yacktman prefers companies with a low capital requirement for growth. This kind of company can generate cash while growing, and due to low capital investment, there is no need for borrowing, and the overall business risk is much lower.

Therefore, an investor should avoid companies that have long customer repurchase cycles, such as automakers. These businesses are highly cyclical and immensely competitive, and customers tend to buy cars only when the economy is good. The companies must develop new car models to stay competitive, and they also need to invest in their manufacturing facility to keep abreast of the latest technology, which requires large capital investments for growth.

Consider my former employer, a telecom equipment maker. Its products are a lot like cars: Customers only buy when the economy is good; and it takes a tremendous amount of capital and at least five years to develop a new generation of product, but the product rarely lasts more than a generation before it is obsolete. Bad business! I'm glad to be out of there.

Management

The capability of management is a key factor for the long-term success of a company, especially for the business that requires more than an idiot to run. Buffett has written many times that he looks for "honest and capable management" in the companies he buys, but hedge fund manager Mohnish Pabrai once said that all CEOs are good salespeople. It is hard to know if they are capable just from listening to how they talk.

Yacktman looks at what the management does and does not do with the cash the company generates. A shareholder-oriented management team will do the following, as Yacktman described during his keynote address at the 2016 GuruFocus Value Conference: The management will *not* overcompensate themselves; they will spend the cash earned by the company in these areas and in this order:

1. *Reinvest:* They will reinvest cash back into the business for growth.
2. *Acquisitions:* If they still have more cash than needed, they will grow the business by making acquisitions. An investor needs to be careful here, looking at their past track record with acquisitions. Most of the big acquisitions don't work out as expected.
3. *Buyback:* They buy back stocks if they still have more money than they can spend. The investor wants to make sure he or she doesn't pay too much buying back their own stocks, which destroys value for the remaining shareholders.
4. They reduce debt.
5. They pay more dividends.

Buffett also described in detail how management should spend excess cash in his 2012 shareholder letter.[19] His thinking is in line with what Yacktman believes.

Therefore, in judging the quality of the management, the investor should watch carefully how they allocate capital and disregard how they talk. For businesses like those that could be run by an idiot, the skills of the management have a lesser impact on the business. Take McDonald's, as I referenced earlier. The company went through many CEOs during the past decade and had some hiccups, but it still does very well. However, for the businesses that have more complex products and operations, the management capability can make a huge impact on results.

Set Your Hurdle Rate

A key factor of Yacktman's long-term success is that he set a hurdle rate to act on. He didn't buy tech stocks during the tech bubble because the potential rate of return didn't make sense. His cash positions were higher than normal before the burst of the financial bubble in 2006 because not many stocks can hit his hurdle rate. As the financial bubble burst in 2008 and 2009, many of the stocks he had wanted to buy for a long time were positioned to generate much higher returns than his hurdle rate, so he poured all his cash into stocks. With this discipline regarding his hurdle rate, he outperformed the market in both ways during the market crash in 2008 and the market recovery in 2009. In 2008, when the S&P 500 lost 37 percent, his fund did better by 11 percent because he held more cash. In 2009, when the S&P 500 gained 26.5 percent, his fund gained 60 percent because he bought into beaten-down stocks with the cash that had stayed on hand.

The hurdle rate is based on valuation or dividend yield or the expected return for the stocks. In Yacktman's case, he uses a term called "forward rate of return," which is the annual average return that the stock is expected to generate in the next seven to ten years. I will detail the calculation and application of Yacktman's "forward rate of return" in Chapter 9.

The hurdle rate works for investors in both directions of the market. When the market is going up, the hurdle rate will protect investors from buying overvalued stocks. When the market is going down, those who stick to the hurdle rate will know when to pull the trigger.

Have I made it sound too easy? It certainly is not easy. When the stock market keeps going up, no stocks meet your hurdle rate and you remain on the sidelines. But the market continues its uptrend. It is extremely hard to watch your portfolios underperform and miss all the gains, and this can go on for years and years; this is especially true for the professional investors, as their performances are watched monthly, if not daily. Those who stick to their hurdle rates will see themselves underperforming when the market valuation is high and continues to go higher. Look no further than Yacktman. After delivering great performances from 2007 through 2011, his fund is again underperforming. He just holds too much cash to match the performance of the S&P 500, which is always fully invested. At this time, even Buffett is underperforming.

It is not easy to stick to your hurdle rate during the downward market, either. Finally, the market is going down and many of the stocks you always wanted to buy have hit your hurdle rate. But it is scary because the market is crashing. The stock market always goes down faster than it goes up. It takes much longer to blow a bubble than to burst it. The stock you want to buy is going down quickly; if you buy it now, you will soon find that you have lost 10 percent, 20 percent, or even more in a few short days. But if you don't buy and wait for a better price, you may find that you have missed the opportunity—again.

Therefore, setting a hurdle rate and sticking to it is very hard to do, but it is extremely important for the long-term success of investors. Only those who are willing to, and have the luxury of being able to, sacrifice short-term performance can outperform in the long term.

What to do when no stock meets your hurdle rate? This is a good time to do research. It is a good time to build a watch list for the wonderful-business companies you would buy at a lower price so that you are ready when the time comes.

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Although I summarized what I learned from Peter Lynch, Warren Buffett, and Donald Yacktman in three distinct areas, all three have touched on all areas. Many other investors have inspired me through their writings, too; I have also been reading the letters of Howard Marks of Oaktree Capital, Jeremy Grantham of GMO, Bill Nygren of Oakmark Funds, Robert Rodriguez of FPA Capital, and Steven Romick of FPA Crescent Fund. The list goes on and on.

I have learned tremendously. As I have mentioned, investing *can* be learned.

Buffett, the genius and the most successful investor of all time, has covered every topic related to business and investing in his letters to Berkshire Hathaway shareholders. These topics range from the economy to business operations such as corporate governance, management qualities, accounting, tax, and mergers and acquisitions. He offers insight into the businesses of insurance, banking, retail, airlines, newspapers, and utilities—and of course, investing. His shareholder letters should be recommended reading for all students in business schools and for anyone who is serious about business management and investing. If you haven't done so, I highly recommend you get started reading immediately after you finish this book.

My learning changed me, and I now look at everything in life, even if it is not related to business and investing, from a totally different angle. Of course, I apply what I learned in my own practice of investing research, and in the following chapters I will detail how to apply this knowledge in your investing. I hope to establish the right investing framework so that you can invest in one with a solid foundation and avoid many of the mistakes that investors could have averted, and ultimately achieve long-term success.

As I was reading and rereading Buffett's shareholder letters, I was consistently amazed at how much Buffett knows about business and investing. Buffett has said many times that he "was wired at birth to allocate capital," and that the value investing concept of "buying dollar bills for 40 cents takes immediately to people."[20] But, even if the value investing concept takes you immediately, you still need to know how to find that dollar bill selling for 40 cents. Perhaps Buffett was wired at birth to be a great investor, but the knowledge certainly didn't come at birth. He learned from his father, Howard Buffett, and from Benjamin Graham, Philip Fisher, Charlie Munger, and many others, and from the many books and reports he's read. He is "one of the best learning machines on this earth," as his long-term partner Charlie Munger puts it. Munger continued:

> Warren was lucky that he could still learn effectively and build his skills, even after he reached retirement age. Warren's investing skills have markedly increased since he turned 65.[21]

When he was once asked how one could get to know so much, Buffett pointed to a stack of books and reports and said, "Read five hundred pages like this every day. That's how knowledge builds up, like compound interest."[22] It is now reported that Todd Combs, one of Buffett's successors, is reading up to 1,000 pages a day![23]

I want to finish this chapter with a quote from Munger that echoes the one at the beginning:

> I constantly see people rise in life who are not the smartest, sometimes not even the most diligent, but they are learning machines. They go to bed every night a little wiser than they were when they got up and boy does that help, particularly when you have a long run ahead of you.[24]