CHAPTER 1

It's Easy to Invest like Warren Buffett

Buying shares of Berkshire Hathaway is the easiest way to invest like Warren Buffett. While the A shares cost around $70,000 apiece as of this writing, the B shares sell for only around $2,300 each—roughly $^{1}/_{30}$ of the A shares. The B shares do have their disadvantages. For example, holders have less in the way of voting rights and aren't entitled to indicate where Berkshire charitable contributions go. (Berkshire is unusual in allowing shareholders to recommend how Berkshire's charity money should be allocated.) And while you can convert A shares into B, it doesn't work the other way around.

Which to buy? Berkshire is nothing if not shareholder friendly, and Buffett has given this advice: Buy the A shares, if you can afford them, unless the B shares are trading cheaply. "In my opinion, *most* of the time the demand for B will be such that it will trade at about $^{1}/_{30}$ of the price of the A. However, from time to time, a different supply–demand situation will prevail and the B will sell at some discount. In my opinion, again, when the B is at a discount of more than, say, 2 percent, it offers a better buy than A. When the two of them are at parity, however, anyone wishing to buy 30 or more B should consider buying A instead."

An investor might dollar-cost-average into Berkshire's B shares using a discount broker. So, for example, in order to build a $13,200 position, he or she might buy two shares six times a year. Or, if the buyer is less patient, two shares for three straight months.

It is also a good idea to check whether two leading newsletters, The Value Line Investment Survey and Standard & Poor's "The Outlook," give the stock a decent rating at the time of purchase, and perhaps either wait a bit or buy energetically depending on their views. (Hardly any other analysts cover Berkshire.) As of this writing, Value Line rated Berkshire, at $70,000 a share, average; "The Outlook"—whose Berkshire analyst, David Braverman, is probably the very best—above average.

Another guide: Consider whether the stock is closer to its yearly high or low. Buying Berkshire low is certainly appropriate for someone intending to be a follower of Warren Buffett's value-oriented investment strategy.

Buying Individual Stocks

Another practical possibility for Buffett followers is to buy the publicly traded stocks that Berkshire owns—like Coca-Cola, Gillette, H&R Block, and General Dynamics. (Berkshire is also the sole owner of various companies, like See's Candy and GEICO, the insurance company, but these companies are not publicly traded.) Because of Buffett's history of purchasing reasonably priced stocks, these stocks should still be worth buying.

A danger, of course, is that Berkshire may have begun unloading those stocks, the way it began quietly bailing out of Disney in 2000, as you are just beginning to purchase them. Another danger is that your portfolio will be askew: You will have more exposure to certain stocks and industries than Berkshire itself has. As a result, your portfolio might be a riskier version of Berkshire.

You can balance out your Buffett-like portfolio with stocks from the holdings of mutual funds that invest roughly the way Buffett does, such as Sequoia, Tweedy, Browne Global Value and American Value, Legg Mason Focus Trust (omitting from the last any technology stocks, which Buffett tends to avoid), Third Avenue Value, Clipper, Longleaf Partners, Torray, and Vontobel U.S. Value. You can examine a list of these funds' recent holdings either by going to their web sites or by consulting Morningstar Mutual Funds, a newsletter to which most large libraries subscribe. The list of holdings will be somewhat outdated, but, again, most of these value stocks should remain reasonably priced.

You might also balance your portfolio by concentrating on stocks in industries outside the ones you already have covered in your Buffett-like portfolio, along with foreign stocks, which Buffett also tends to avoid. For suggestions of foreign stocks to buy, check those in the portfolio of Tweedy, Browne Global Value.

For U.S. stocks, I would single out health-care stocks because Berkshire has tended to ignore this entire industry, perhaps because the stocks have almost always been high-priced or because they are outside Buffett's "circle of competence."

You can also balance out your Buffett-like portfolio with stocks chosen from the list compiled at Quicken.com by Robert Hagstrom. He derives this list using his criteria for picking Buffett-type stocks, Hagstrom being an authority on Buffett's strategy. (See Chapter 20.)

For more on Sequoia, see Chapter 21; for Legg Mason Value Trust, Chapter 22; for Tweedy, Browne, Chapter 24; for Third Avenue Value, Chapter 25; for Torray, Chapter 27; for Vontobel, Chapter 28; and for Clipper, Chapter 29.

Buying Buffett-like Mutual Funds

Instead of buying individual stocks, you could buy one or more Buffett-like mutual funds—in effect, having someone else buy Buffett-type stocks for you. Even granting that Buffett is in a class by himself, cheap imitations—cheap in the sense of your being able to buy many shares for a low minimum—aren't to be sneezed at. These funds, in some cases, do not deliberately emulate Buffett's strategy. For example, Third Avenue Value, under Martin J. Whitman, doesn't. Others, to a certain extent, do—notably, Sequoia, Tweedy, Browne

Getting Into Closed Funds

With a fund closed to new investors, you can ask a current shareholder to sign over just one share to you and use that one share to obtain more shares on your own. Unfortunately, owners of Sequoia shares have, in my experience, never evinced any interest in selling shares.

American Value, Legg Mason Focus Trust, Torray, Longleaf Partners, and Vontobel U.S. Value.

Which fund most resembles Berkshire? No doubt Sequoia, which was started by a Columbia Business School friend of Buffett's and which invests a big chunk of its assets in Berkshire. (Unfortunately, Sequoia is closed to new investors.) Table 1.1 shows Sequoia's recent holdings.

Sequoia suffered a dismal 1999, along with Berkshire itself and with many other value funds. But its long-term record is splendid. Over the past 10 years it has outperformed the S&P 500 by 2.31 percentage points, returning 17.56 percent a year.

Which of the other funds most resembles Sequoia? Buffett has reportedly said that the Clipper Fund is close to his investing style.

A lesser-known fund that has much in common with Berkshire is Vontobel U.S. Value, run by Edwin Walczak. He readily acknowledges Buffett's influence; his portfolio recently had a 5 percent exposure to Berkshire, its fifth largest position. Other stocks in Walczak's portfolio that have overlapped with Berkshire: Mercury General, Gannett, McDonald's, Gillette, Wells Fargo. The fund is classified by Morningstar as mid-cap value.

One possible way to search for other funds that imitate Buffett's

TABLE 1.1 Sequoia's Holdings (3/31/00)

STOCK	% OF ASSETS
Berkshire Hathaway A	31.43
U.S. Treasury note 6.125%	14.98
Freddie Mac	13.09
First Third Bancorp	10.23
Progressive	7.88
U.S. Treasury note 5.5%	6.51
Harley-Davidson	4.00
U.S. Bancorp	2.47
Household International	1.79
National Commerce Bancorp	0.58
Mercantile Bankshares	0.27

Data Source: Morningstar

strategy is to compare their R-squareds, numbers indicating how closely a fund follows an index.

You might search for a fund with an R-squared close to Sequoia's. (If A is equal to B and B is equal to C, then A is equal to C.) The Vanguard Index 500, which mirrors the Standard & Poor's 500 Stock Index, has an R-squared of 100. The higher the R-squared, the more closely a fund mirrors an index. (Table 1.2 lists the R-squareds of some Buffett-like funds.)

TABLE 1.2 R-Squareds of Buffett-like Funds

FUND	R-SQUARED
Sequoia	37
Tweedy, Browne American Value	70
Legg Mason Focus Trust	79
Torray	71
Third Avenue Value	52
Clipper	63
Longleaf Partners	49
Vontobel U.S. Value	27

Data Source: Morningstar

Understanding R-Squared

R-squared measures how much of a mutual fund's performance is explained by its similarity to an entire market. If a fund owns large-company stocks, both growth and value, and they are well diversified by industry, it should have a high R-squared compared to the Standard & Poor's 500 Stock Index. Fidelity Disciplined Equity has an R-squared of 93. A fund that deliberately attempts to duplicate the Standard & Poor's 500 might have an R-squared of 99. (The Vanguard Index 500 Fund, which mirrors the S&P 500, actually has an R squared of 100.) A fund that is nowhere near as well diversified by industry, or that buys small-company stocks or foreign stocks, might have a very low R-squared (compared to the S&P 500, but not compared to other indexes). The Fasciano Fund, which specializes in small companies, has an R-squared of 64. Vanguard Emerging Markets Stock Index has an R-squared of 54 compared with the S&P 500, but 78 when compared to a foreign-stock index.

Apparently R-squared is simply not a useful guide to identifying Buffett-like mutual funds, perhaps because the concentrated nature of some Buffett-like funds loosens their ties to the S&P 500.

Now let's look at the same funds, zeroing in on (1) concentration, (2) low turnover, (3) low price-earnings ratios, and (4) low price-book ratios. (See Table 1.3.) Even with these criteria, it's hard to tell which fund is most similar to Sequoia.

Value funds differ from one another because their criteria for assessing what a company is worth may be different. Many managers, like Buffett, use the current value of future cash flow; others may check the prices paid for similar companies recently taken over. Some managers are "deep value"; others, further along the continuum toward growth. Value versus growth investing will be covered in Chapter 6.

In any case, Buffett-like stocks or mutual funds might constitute only a portion of your portfolio. Value funds do tend to underperform during long stretches of time, and you might do well to own some good growth stocks and growth mutual funds, along with Buffett-like stocks, just to keep your portfolio more stable over the years.

TABLE 1.3 Statistics of Buffett-like Funds

FUND	CONCENTRATED?	TURNOVER	AVERAGE P/E RATIO	AVERAGE P/B RATIO
Sequoia	Yes	12	24.6*	4.9
Tweedy, Browne American Value	No	19	20.6	4.1
Legg Mason Focus Trust	Yes	14	33	9.6
Torray	No	33	25.1	4.5
Third Avenue Value	No	5	25.8	2.9
Clipper	Yes	63	18.4	4.7
Longleaf Partners	Yes	50	19.3	3.2
Vontobel U.S. Value	Yes	67	19.3	3.6

*Based on 50% or less of stocks.
Data Source: Morningstar

A Sensible Solution

All in all, a sensible solution for a Warren Wannabe is to own:

- Some shares of Berkshire Hathaway
- Some of the individual stocks that Berkshire owns, or other Buffett-like stocks
- A mutual fund or two that seem Buffett-oriented