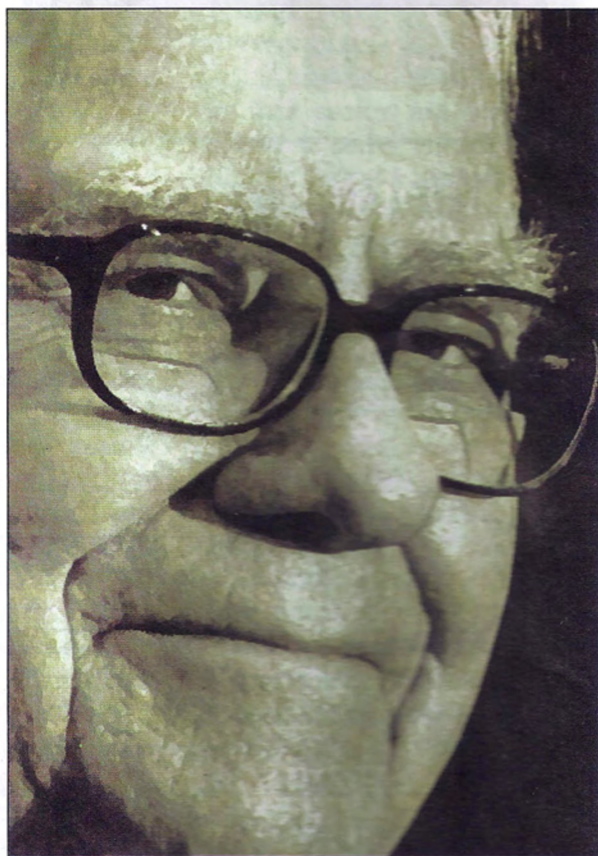
Decoding a genius

A close look at the methods that make Warren Buffett arguably the greatest investor of our times

Next year, Warren Buffett, the legendary investor who ranked third on Forbes' 2010 list of the world's richest men, comes to India. Though this is Buffett's first visit to India, he will be pleasantly surprised by the adulation that he commands in the country. Thousands of stock market investors pay daily homage to his genius by eschewing the fads of the day — day trading, technical analysis, etc. — and sticking to the time-tested value-investing approach of which Buffett is the finest apostle (if we take Benjamin Graham, his guru, to be the original prophet of this cult).

However, one fears that in the midst of the media hoopla that will inevitably accompany Buffett's visit, the real significance of what he represents will get lost. And that is: we do not need to condemn ourselves to mediocre performance in the markets. We do not even need to be content with middling results as one could get by investing in index funds. Even without his obvious genius we can produce market-beating results, provided we take time out to study his methods, and then display the discipline required in their application.

What follows is a curtain-raiser on Buffett's investment methods.



A business-like approach

Robert Hagstrom, author of *The Warren Buffett Way*, says that the first thing to understand about Buffett's approach to investing is that whether he intends to purchase a company's stocks or the entire company, he always behaves more as a business analyst rather than as an investment analyst. He examines a company on four parameters: its business, its management, its finances, and finally, its valuation.

EVALUATING THE BUSINESS

Understanding the fundamentals of the business, Buffett believes, is important because it gives you confidence in your investment decisions. You are then unlikely to get scared into selling your stocks if for some reason their prices plummet after your purchase. While evaluating a business, Buffett applies three criteria:

> Some of **Buffett's favourite** long-held stocks are simple businesses that have remained unchanged for decades, even centuries: **Coca Cola, Wells Fargo,** etc.

Simple business. If your research leads to the conclusion that the business has great prospects, you will be able to say so with greater confidence in the case of a simple business than in the case of a complex one.

Take the examples of some of Buffett's major investments. Coca Cola is a great business because of its brand strength and its worldwide distribution network. Washington Post, the newspaper, is another business that he understands very well from having owned another newspaper earlier. Wells Fargo, the bank, is also a simple business: make intelligent loans so that non-performing assets remain low, and keep a tight rein on cost of operation.

Says Veer Sardesai, a Pune-based financial planner who is an avowed practitioner of the Buffett school of investing: "Do not invest in the next new idea if you do not understand it. Buffett practised what he preached by staying away from dotcom stocks in the late nineties."

Consistent operating history. Buffett likes to invest in businesses that have remained the same for decades. He says: "Severe change and exceptional returns don't mix." Coca Cola, Gillette, etc are all businesses that have been selling the same products and growing steadily.

Buffett does not like to invest in businesses that change or get disrupted every few years due to technological or other changes. If that happens, it becomes impossible to predict future earnings growth (which is important for calculating the intrinsic value of a business with certainty). So he avoids both companies that are changing their businesses and turnarounds (they seldom turn, he believes). For the same reason, he avoids tech companies (you don't want to be in a business that competes against thousands of very smart MITians and IITians burning the midnight oil at startups to create tomorrow's new technologies that will render yours obsolete).

Favourable long-term prospects. Buffett likes to invest in companies that possess what he refers to as "economic moats". A moat is a clear competitive advantage that protects the company against competitors. The best of companies have deep and wide moats: advantages that enable them to earn a lot of money every year; and their advantages endure for a long time span.

A strong brand name, a patent, a high entry barrier, and high cost of replace-

ment (in terms of both time and money, which makes it difficult for a customer to replace one supplier with a rival) are some of the factors that create an economic moat.

Such companies are also referred to as franchises or consumer monopolies. Companies that do not possess competitive advantages are referred to as commodities. A franchise has the following additional characteristics: one, there is high demand for its goods and services; two, it has no close substitute; and three, it belongs to an industry that is not regulated.

The vast majority of companies are commodities; very few are franchises.

Franchises have many advantages: because of the goodwill that they enjoy among their customers they can increase the prices of their products without fear of losing market share. This in turn allows them to weather inflationary pressures (which raise input costs and erode margins of lesser players) better.

Commodity businesses can compete only on price. The only way a commodity business can be profitable is by being the lowest-cost provider. This kind of competitive advantage can be hard to sustain. Commodity businesses do well only when demand is high and supply fails to keep pace. But when such periods will arrive, and how long they will last, is extremely difficult to predict. Moreover, such periods are few and far between.

Sardesai cites the examples of three stocks in India which he believes possess these above-mentioned characteristics: "Using Buffett's criteria, I have invested in three companies. The first is Colgate. In many parts of India toothpastes are often referred to as 'Colgate'. That is a testimony to the power of this brand. It is a simple business of selling toothpastes and tooth brushes. Another company is Housing Development Finance Corporation (HDFC), which is synonymous with home loans. Every home loan customer will consider HDFC in his or her list of institutions for a home loan. And the third is Indian Tobacco Company (ITC), the cigarette giant. It has a number of established brands like Wills, India Kings, and so on. ITC can increase the prices of these brands without facing a dip in demand."

> Buffett believes **evaluating management is important because** it will provide you advance warning of what will eventually show up in the financial results

EVALUATING THE MANAGEMENT

Buffett likes to invest in companies that are led by management that possesses both character and competence, and which takes decisions that are in the interests of shareholders. Here are some of the criteria on which he judges management:

Is it rational? Buffett believes that one of the most important functions that management performs is that of allocator of capital. How rationally it performs this task determines its quality. As businesses mature, their investment needs decline and they begin to yield a lot of cash. According to Buffett, whether to distribute this surplus or retain it should be decided in a rational manner.

If the company can deploy these earnings to earn a high rate of return, then it should retain these earnings. But if it cannot, then it should return this money to shareholders either in the form of a dividend or through buy back of shares (the latter, by reducing the number of shares outstanding, increases earnings per share even without an increase in profit after tax, and hence leads to

appreciation in share price).

Sardesai cites the example of Colgate's management in this regard: "The shareholder friendly management of this company recently returned excess capital to its shareholders."

Instead of adopting one of these approaches, management often tries to buy growth. However, acquisitions are hard to pull off. Often the price paid is excessive and the difficulties involved in assimilating the new company, and its corporate culture, are underestimated. More often than not, such takeovers do not yield the desired synergy. Thus, a lot of money is spent without adding to the parent's intrinsic value.

Many managers feel compelled to do what rivals are doing. Wise management avoids the **institutional imperative** even at the cost of losing business

Is management candid and honest? Buffett believes that management must report fully both the company's successes and failures. Berkshire's Hathway's annual reports are themselves a model of candour. When problems occur, he discusses them at length in the annual report.

Commenting on the need for management that has shareholders' interests at its heart, Sardesai says: "It is vital that the management is honest and transparent with its shareholders. In India, this is absolutely imperative given the large number of fly-by-night operators in the past." He cites the examples of the management of HDFC and ITC which, he says, are known for their honest and transparent dealings with shareholders.

Does management avoid the institutional imperative? A lot of failures in business occur because managers feel compelled to do what their competitors are doing. Such mindless imitation eventually spells doom. For instance, in the insurance business, when competition intensifies, premiums can fall to such levels where it is no longer remunerative to do business. In such cases, wise management refrains from writing policies.

EVALUATING THE FINANCES

These are some of the financial numbers that Buffett looks at:

Return on equity. RoE is the ratio of oper-

How to evaluate management

Buffett believes that evaluating management is important. Doing so, he says, gives you early warning signals about eventual performance. Following closely the words and actions of the management team will help you evaluate what they are doing long before it shows up in the financial results.

How should you go about getting information about a company's management? One way is to collect the annual reports of a few years earlier. See what were the management's aims, goals and strategies then. Compare them with today's results. It will tell you whether the management has strong execution capabilities.

Buffett also thinks that you should read the annual reports of several companies within the same industry. Evaluating relative performance in this way will, he believes, yield insights into the quality of management.

Next, create a file on the company that you are interested in. Collect newspaper and magazine articles about the company. Read what the management says, and what others say about them. If the management of the company makes a presentation, study it carefully. Keep visiting the company's website for the latest information. If you do this for a while, your evaluation of management will improve.

ating earnings to shareholders' equity. Most analysts pay a lot of attention to how much the earnings per share (EPS) has increased over the previous year. Buffett does not regard this as a good measure. His logic: most companies retain a portion of their previous year's earnings. In effect, more capital is deployed each year and this helps to boost next year's EPS. A truer test of economic performance, according to him, is whether the company manages to increase its RoE, that is, whether the management is able to deploy the extra resources to earn a higher rate of return. Buffett also believes that the mark of a good business is that it should be able to achieve a high RoE without taking on excess debt.

Book value. Buffett's annual letters to Berkshire Hathaway shareholders always begin with a reference to how much the company's per share book value has grown during the year. Buffett believes that the percentage change in book value (shareholders' equity less intangible assets) in any year corresponds closely with the change in the intrinsic value of the company during the year. Hence, if per share book value grows at a rapid rate, earnings will also grow rapidly, and so will the stock price.

> What is so great about a company retaining earnings and then showing a higher EPS next year? A better measure of performance is **growth in RoE**

Earnings per share. According to Mary Buffett and David Clark, authors of *Buffettology*, Buffett looks at the long-term (10-year) trend in EPS growth. EPS must be robust every year and should show an upward trend. Above all, avoid firms with erratic EPS trends. Admittedly, very few companies will meet this criterion of a high and rising EPS over a 10-year span. So when you come across one, grab it.

Owner earnings. Another measure that Buffett looks at is whether the company is able to grow, what he calls, owner earnings. This is defined as its cash flow (net profit plus depreciation, depletion, amortisation, and other non-cash charges) less the amount of capital expenditure and working capital the company may have used up.

It is not a mathematically precise measure since calculating future capital expenditures requires some amount of estimation. But Buffett argues that he would rather be vaguely right than precisely wrong.

Even if a company has a high net profit, it is not a very good investment if its capital expenditure is high. Around 95 per cent of US companies require capital expenditure that is roughly equal to their depreciation rate. Buffett prefers companies that have low capital expenditures and which throw off a lot of cash surpluses.

Profit margins. Buffett prefers high profit-margin companies as it indicates that management has good control over costs and can convert revenues into profits.

Market value to retained earnings. Buffett believes that every dollar of retained earnings must result in the creation of a dollar or more of market value. If additional capital is employed, and it fetches above-average return, it will result in the company's market value rising. This test, conducted over time, tells you whether management has used the additional capital well.

THE QUEST FOR VALUE

According to Mumbai-based financial

planner Vishal Dhawan, the one Buffett lesson he has taken to heart is: "It's far better to buy a wonderful business at a fair price than a fair business at a wonderful price." Let us now turn to how Buffett unearths attractively-valued stocks.

Comparing stocks with bonds. According to author Timothy Vick, one of the first hurdles that a stock must cross before Buffett will consider it is that the yield from it must exceed the current yield on a 10-year treasury bond. For instance, the current yield on 10-year paper in India is 7.51 per cent. Now, the inverse of yield (earnings divided by market price) is the PE ratio. A yield of 7.51 percent amounts to a PE of 13.32. Therefore, in the current scenario Buffett will only consider stocks trading at a PE of less than 13.32. In fact, he will look at even lower PE stocks in order to provide himself with a margin of safety since stock earnings are not as predictable as the coupons from a bond.

He will consider paying a higher valuation only if he is fairly confident that EPS will grow rapidly.

Don't invest in the next new idea unless you understand it. Buffett practised what he preached by staying away from dotcom stocks. And in India evaluate management carefully.

VEER SARDESAI
Pune-based financial planner

Discounted cash flow approach. The discounted cash flow method was developed by John Burr Williams and explained in his book *The theory of investment value.* According to this theory, the value of a business is the total of net cash flow expected over its life discounted by an appropriate interest rate. (Buffett uses owner earnings as the cash flow stream: owner earnings is net cash flow less capital expenditures).

In this calculation, there are several uncertainties, say, regarding future earnings. Buffett tries to minimise this by selecting companies that have a consistent earnings history, and whose earnings are hence expected to grow in a predictable manner in future as well.

As for the discount rate, Buffett uses the current risk-free interest rate. For many years, he used the yield of the 30-year treasury bond. When interest rates fell below 7 per cent, he began to use a 10 per cent discount rate. Academicians argue that Buffett should use a discount rate higher than that of risk-free government bonds. Buffett disagrees. He argues that since he only selects companies whose earnings are highly predictable, using the risk-free rate is fine. If the stock is trading at around 75 per cent or less than the intrinsic value, he buys it.

Profit by applying these methods in a disciplined way to your stock picking.

Best tomes on Buffett

Nowadays, writing on Buffett has turned into a cottage industry. In our quest for authoritative texts, we found two worthy of recommendation: *The Warren Buffett Way* by Robert G. Hagstrom and *How to pick stocks like Warren Buffett* by Timothy Vick. And finally, of course, there are Warren Buffett's own annual letters to shareholders, which Mumbai-based financial planner Vishal Dhawan calls "the closest that you get to a Bible on 'How to manage your investments.... and your life'. These newsletters contain timeless principles that can guide investors through all markets and circumstances."

Buffett-like spread of Indian stocks

Here we have offered a selection of Buffett-type companies applying some of the quantitative parameters that Buffett favours. The original universe was BSE 500. We looked for companies that in the past 10 years have shown steady, predictable earnings growth (i.e., EPS has either grown year after year; if it has dropped, the drop has not exceeded 45 per cent of the previous year's EPS). Their long-term debt can be paid back within five years or less. We sought at least 20 per cent RoE and 15 per cent return on total capital. We also sought companies with positive free cash flows. Lastly, we only kept companies that yielded more than 12 per cent return on retained earnings for past 10 years. We have not applied valuation parameters. Apply those filters yourself using this list as a starting point. Stocks in bold are ones that met Buffett's parameters in the strictest sense.

Company	Industry	10-yr CAGR in EPS (%)	Debt/PAT	10-yr average RoE (%)	10-yr average RoTC (%)	Utilisation of Retained Profit (%)
Asian Paints	Paints & Varnishes	14.96	0.18	30.88	26.06	30.68
Aventis Pharma	Drugs & Pharma	17.20	0.00	24.11	23.20	17.47
Berger Paints	Paints & Varnishes	15.85	0.99	23.59	17.69	22.21
Bharat Electronics	Electronic Equipts.	21.13	0.00	24.86	23.80	21.59
Blue Star	ACs & Refrigerators	28.27	0.13	32.00	26.43	45.76
Bosch	Auto Ancillaries	22.51	0.48	21.97	19.90	16.96
Britannia Industries	Bakery & Milling Prod.	16.22	0.15	28.97	23.26	14.78
Castrol India	Lubricants	6.42	0.00	44.28	43.70	22.08
Colgate-Palmolive	**Cosmetics & Toiletries**	**18.40**	**0.02**	**57.83**	**56.56**	**258.61**
Container Corpn. Of India	Transport Support Services	15.94	0.13	25.78	24.31	18.37
Crisil	Business Consultancy	29.71	0.00	23.28	23.28	45.76
Cummins	Electrical Machinery	16.44	0.05	20.96	20.45	34.82
Dabur	Cosmetics & Toiletries	18.04	0.37	37.91	32.53	35.48
FDC	Drugs & Pharma	13.86	0.03	23.12	22.40	16.53
GAIL	Crude Oil & Natural Gas	13.81	0.43	21.77	17.26	16.78
GSK Consumer Healthcare	Dairy products	8.50	0.00	22.71	21.87	12.99
Gujarat Gas Co.	Storage & Distribn.	23.91	0.00	29.25	22.33	20.87
Hero Honda	Two & Three Wheelers	27.80	0.06	48.45	43.41	30.57
Hindustan Unilever	Cosmetics & Toiletries	7.85	0.17	73.23	63.19	62.99
ITC	Tobacco Prod.	17.34	0.05	26.21	24.61	22.36
Infosys	Computer Software	34.02	0.00	35.32	35.32	27.63
Marico	Vegetable oils	19.75	2.18	35.97	25.68	20.57
Navneet Publications	Books & Newspapers	11.12	1.10	23.59	19.66	18.38
Nestle	Dairy products	18.20	0.00	83.11	77.41	125.19
Pidilite Industries	Thermoplastics	19.77	3.81	22.41	17.27	16.62
P&G Hygiene & Health Care	Cosmetics & Toiletries	12.14	0.00	40.07	39.96	24.74
Siemens	Switching Equipment	39.37	0.00	29.49	29.00	20.71
Sun Pharmaceutical Inds.	**Drugs & Pharma**	**29.54**	**0.02**	**27.82**	**22.21**	**34.23**
Tata Elxsi	Computer Software	19.44	0.23	39.82	35.99	36.17
Torrent Pharmaceuticals	Drugs & Pharma	14.00	2.61	20.73	15.35	23.29
Unichem Laboratories	Drugs & Pharma	22.85	0.20	24.51	19.59	26.09
Wipro	Computer Software	31.30	1.69	29.23	27.31	23.90