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Lessons of Warren Buffett

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Mike Galbreth

Warren Buffett Project

ABSTRACT

April 22, 1996

Warren Buffett is the most successful individual investor of all time. Starting from scratch, he has amassed a fortune of over \$16 billion, making him the richest man in America. Many investors are interested in learning Buffett's approach to investing.

Through analyzing four of Buffett's largest and most profitable investments, some basic guidelines can be determined:

- **Washington Post** - take advantage of bargain prices caused by controversy.
- **Coca-Cola** - invest in popular name brands with international goals, regardless of experts' advice that they are overpriced.
- **American Express** - invest in companies that are leading the way in societal revolutions.
- **Wells Fargo** - place emphasis on quality management, and be willing to ride out a short-term drop in stock price.

With the above suggestions in mind, a look at today's market leads to an interesting conclusion--the high technology industry satisfies every characteristic of Buffett's past winners. Buffett himself would never invest in technology, claiming that he does not understand it. Perhaps this is part of the reason that he has had trouble selecting stocks in recent years.

Lessons of Warren Buffett

Over the past forty years, investment wizard Warren Buffett has amassed his fortune by making hundreds of brilliant stock picks. A close inspection reveals how he did it--and how to emulate his approach in today's market.

by Michael Galbreth

Many of Warren Buffett's recent investments would have been impossible for the average investor to make. The convertible preferred stock he holds of Salomon Brothers and Gillette has generated excellent returns, but no other individual could have purchased these shares. His 13% stake in Cap Cities/ABC has also proven to be very lucrative, but it could have turned out differently without Buffett's personal intervention and consultation.

These situations might frustrate the average investor, who is painstakingly trying to earn superior returns without the advantages of being the richest man in the nation. However, the majority of Warren Buffett's fortune was built by purchasing common stock--securities available to everyone. Buffett was able to understand the potential in companies when few others (including the experts) could. A brief history of four of Buffett's most ingenious investments provides an excellent crash course in the

"Buffett School of Investing"--an institution we would all do well to attend.

The Washington Post

The Post was an obvious pick for Buffett in the spring of 1973. Its stock was selling at a price well below the company's liquidation value, and Buffett, a student of Ben Graham's quantitative approach to security selection, knew that this price was too low to pass up. Recalling numerous lectures back at Columbia Business School, Buffett recognized one of Graham's favorite principles--the margin of safety. Graham taught that a stock should not simply be a good value, but it should be so well-priced that, even if things did not work out perfectly, the investment would be rewarding. This margin of safety was considered by Buffett to be "the cornerstone of investment success."

The Post's stock price had been driven down by skepticism, in part regarding the appointment of a Katharine Graham as chairman--the first woman to hold such a position in a Fortune 500 company. One side effect of Buffett's interest in the Post was the growth of a close friendship between Buffett and Graham. The Post had been in the Graham family since Katharine's wealthy father had purchased the

paper out of bankruptcy in 1933. Although she had worked as a reporter for a time, Graham had no aspirations to be in charge of the family business. When her husband's suicide thrust Graham (no relation to Benjamin Graham) into control, she was unprepared and shy. Although expected to serve only as an interim president, Graham was soon making important decisions, including the publishing of controversial Watergate investigations. These actions had even President Nixon bad-mouthing the newspaper.

This pessimistic environment was ideal in Buffett's mind. Like many great investors, he welcomed pessimism-- whether it be in a specific company, an industry, or in the market as a whole: "It's optimism that is the enemy of the rational buyer." Buffett realized that fear often produces artificially low prices, or, in the words of Ben Graham, "the market is fond of making mountains of molehills and exaggerating ordinary vicissitudes into major setbacks." In the case of the Post, the numbers were obvious. Putting fears aside and following logic, Buffett bought the stock. This investment, which appears obvious in retrospect, has been one of the most lucrative ones in Buffett's career.

Coca-Cola

The Coca-Cola Company has long been recognized as one of the world's greatest franchises. However, when Buffett started buying Coke stock in 1988, securities analysts were terming it a "very expensive stock." Everyone realized the excellence of the company, but there was a feeling that it was too late to buy it now. Buffett spotted a bargain in Coke that virtually none of the experts could see. He had noticed the power of the product during the New Coke debacle, when demand for Classic Coke went through the roof. Studies had indicated that most American consumers preferred the sweeter taste of New Coke. What the company had underestimated was the power of the symbolism of Coca-Cola. The Coke name stood for American tradition, and many people had many fond memories involving Coke. When this symbol was taken away (actually, merely altered), people felt that a part of their lives was missing. The public outcry for the return of "classic" Coca-Cola was indicative of the power of the brand, which Buffett has called "the most valuable franchise in the world." Coke was a simple business with amazing customer loyalty.

Buffett was also very impressed with Coca-Cola's management--a feature of a company that he finds extremely

important. Chairman Roberto Goizueta was emphasizing the overseas market, where Coke's name was already well-known. If Coke became more available internationally, whole new markets would be opened up. Per capita consumption rates in the United States are extraordinarily high, and major growth in this market is unlikely. However, if Coke can experience even a fraction of U.S. consumption in other countries, the potential is amazing. Studies have shown that Coca-Cola is extremely popular with the populations of many foreign countries, and Goizueta was on a mission to make Coke available everywhere.

Despite all these factors, most analysts (and investors) felt that it was too late to invest. Everyone knew that Coke was an excellent company, and most felt that the price had already adjusted. Additionally, entering foreign markets is risky, and huge losses were feared. Buffett realized Coke's potential and kept his nerve-- although he had admired the company for 52 years, he did not feel that now was too late to invest. Buffett often points out that he plans to recognize great investments in the future with more speed than he had with Coke. However, even after 52 years, Buffett was still not too late--since 1988, Coke stock has been appreciating at over 28% annually, plus dividends.

American Express

AMEX was one of Buffett's first really brilliant picks, and it might be the most instructive one for today's investor. In 1963, AMEX was a symbol of a new era in America. Travel was becoming less expensive, and Americans were taking advantage. American Express Traveler's Checks were the symbol of this new mobility. The American Express Card was also the symbol of a change--the move toward a cashless society. Credit cards were growing in popularity, and the AMEX card was the premiere plastic. In 1963, American Express was the leader in a major societal move, and its name was its greatest asset. In the words of Buffett biographer Roger Lowenstein, "a revolution was at hand, and American Express was its beacon."

When the company experienced fraud losses of \$150 million in 1963, Wall Street screamed SELL. Warren Buffett bought. He realized the insignificance of short-term events, and he noticed that the scandal had not affected the use of the AMEX card or checks. To test the loyalty of AMEX customers, Buffett hung out by the cash register of a local restaurant for an evening. As far as he could determine, not a single customer seemed to care about AMEX's legal

problems--they were still using their cards and traveler's checks.

Buffett made his first predominantly qualitative decision when he invested in American Express. Instead of recognizing favorable numbers, he recognized favorable circumstances. Buffett was determined to share in the profits of the revolution that AMEX was leading, and he did. His common stock investment has consistently produced excellent returns over the past 33 years.

Wells Fargo

1990 was the worst year for banks since the Great Depression. In particular, California banks were thought to be approaching a major slump. That year, Warren Buffett bought 10% of Wells Fargo, the California bank with the bleakest outlook of them all.

Fargo had lent large sums to California real estate, and these loans were projected to be troublesome over the next few years. However, what appealed to Buffett, as usual, was not the next few years. He realized the strength of the Wells Fargo name in California, and he noticed that the bank had extremely high profit margins. But these two strengths were not what really sold Buffett on the bank.

Carl Reichardt, chairman of Fargo, was Buffett's kind of manager--a cost-cutter. Decisions like fixing top salaries and selling the corporate jet indicated that he was focused on increasing shareholder wealth. Buffett knew that with its solid financials and Reichardt at the helm, Wells Fargo could survive its impending strife.

Very few experts agreed with Buffett about Fargo in the early 1980's. *Business Week* called the stock a "lemon" and implied that Buffett had lost his touch. Buffett's reaction to this pessimism was predictable--he increased his stake to 14%. Several bad years for banking followed, but Buffett had confidence in his choice. Finally, the real estate recession ended, just as Buffett had known it would. As soon as this happened, Fargo's earnings went through the roof, and its stock price followed. Shares that Buffett acquired for an average of \$62 are now worth \$251 each. By simply waiting out a temporary industry lull and choosing a well-managed representative from this industry, Buffett was able to quadruple his money in less than six years.

LESSONS

The above cases reveal Buffett's genius for seeing the obvious when no one else can. True, bargains like the Post are rare at best in today's market. However, Coke, AMEX,

and Fargo prove that, despite his emphasis on quantitative analysis, Buffett realizes that a stock does not have to be a quantitative bargain to be a brilliant investment. Coke was a popular brand name with good management and global aspirations. Fargo was a well-managed, financially solid company in an unpopular industry. AMEX was the symbol of an societal revolution.

Few would argue with the assertion that we are in the midst of another revolution right now--one more pervasive than any in recent history. The information revolution is transforming society, and specific companies are emerging as leaders in this movement. Some of these companies have strong brand names and are taking their products global, despite pessimism about foreign markets. Does this sound familiar? Many readers will probably recall that technology industry stocks are not highly recommended by the experts right now, due in part to their short-term volatility. Others will argue that it is too late to invest in the most established tech companies--their prices have already risen. Now this is very familiar.

Admittedly, Warren Buffett would never invest in technology--it would go against his rule of investing only in things he understands. However, Buffett has been very open recently about his difficulty in finding stocks he likes. Could this be because, in 1996, the next great

"Buffett picks" lie in the high-tech industry? The irony is irresistible--many experts have argued that the information revolution has rendered stock picking useless, but it may be the very force that has created today's brilliant long-term buys.

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