Ten lessons from Buffett for investors

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King of cash Who believes cash is king - Christopher Goodney

From simplicity to diversity and the ability to admit errors — strategies that have worked for the Oracle of Omaha

Berkshire Hathaway released its 53rd annual report on February 23, 2018 along with Warren Buffett's legendary letter to the company's shareholders. It would be worthwhile for those of us who are unable to make it to the annual meeting on May 5 and listen to the Oracle of Omaha address investors in person, to ponder about the ten lessons that may be deduced from Buffett's investment style.

Start early: Most of us are stupefied by Buffett's $86.60 billion networth as of March 4, 2018. While Buffett is certainly a very astute investor, investors ought to recognise that he began investing in 1944, at the age of 14, with a corpus of $5,000.

His net worth grew to $$1 million in 16 years, half a billion dollar in 38 years, more than a billion in 42 years and to the current $86.60 billion in 74 years. He and Berkshire exemplify Einstein's maxim, “Compound interest is the eighth wonder of the world. He who understands it, earns it. He who doesn't…

pays it.”

You can’t beat the market all the time: Even successful investors like Buffett do not consistently outperform the market. The annual percentage change in Berkshire’s per share market value has been lower than the annual percentage change in S&P500 with dividends included for 17 of the 53 years during which Buffett has been the chairman of Berkshire. This implies that the Berkshire stock underperformed the S&P500 approximately in one of every three years. However, during the 53-year (1965 to 2017) period, Berkshire’s share registered a compound annual gain of 20.9 per cent; more than double S&P500’s 9.9 per cent gain.

Understand your investments: The Berkshire annual report releases its percentage stake, cost and market value of its 15 largest investments. Berkshire chose to invest in companies that operate in relatively uncomplicated industries such as banking, insurance, food and beverage, personal and household care products and airlines. Buffett reportedly eschewed investing in technology companies as he was unable to understand the industry. But he has had a change of mind and was invested in IBM for some time. Apple, as of December 31, 2017, is the largest investment in Berkshire’s portfolio with a market value of $28 billion (16.5 per cent of the portfolio’s market value)

Diversify your portfolio: During the 10-year period, 2008 to 2017, Berkshire’s 15 largest investments accounted for 85 per cent to 90 per cent of the portfolio’s market value with the five largest stocks accounting for around 65 per cent of the market value. While Berkshire has remained invested for at least a decade in four stocks — American Express, Coca Cola, US Bancorp and Wells Fargo, it has also been nimble in exiting investments in industries facing existential risks such as retailers (Tesco and Wal-Mart) and print media (*Washington Post*).

Benefit from rupee cost averaging*:* An interesting insight into Berkshire’s investment and divestment patterns is that both have been predominantly gradual. The 11.6-per cent stake increase in the Philips66 stock occurred over a five-year period, while the 4.5 per cent stake increase in the American Express stock occurred over a decade.

Similarly, the sale of ConocoPhilips and Procter & Gamble stakes took place over approximately five and nine years, respectively. The lesson for retail investors is clear. Systematic Investment Plans (SIPs) and Systematic Withdrawal Plans (SWPs) exist for a reason — to facilitate modest and recurring investments over a long period of time to combat asset price volatility and to benefit from compounding if investors opt to invest in mutual fund plans that provide for reinvestment of interest and dividends.

Focus on cash*:*In his 2017 letter to shareholders, Buffett bemoans the new accounting (GAAP) rule that requires companies to include unrealised investment gains and losses in stocks in the income statement, which “will severely distort Berkshire’s net income figures and very often mislead commentators and investors… For analytical purposes, Berkshire’s “bottom-line” will be useless”.

He hilariously but truthfully states, “I expect considerable confusion among shareholders for whom accounting is a foreign language”. Understanding accounting is an uphill task given the pressures of our day jobs. So, investors could consider completely ignoring the statement of profit and loss and monitoring cash flow statements instead.

Keep your day job: The widespread perception is that Berkshire is an investor that holds and trades stocks and bonds. The truth is that Berkshire is a conglomerate, the decennial share of whose insurance, railway, energy and manufacturing, service and retailing businesses was around 67 per cent of profit after tax and minority interests (PATMI) during the last decade. The investment portfolio's share in PATMI was 33 per cent. Moral of the story: Our day jobs are unlikely to make us billionaires unless we make it to the C-suite. But our salaries provide us stable, recurring cash flows to pay our bills and a modest surplus that may be consistently and sensibly invested to build a sizeable portfolio in the long run.

Limit indebtedness and recognise; cash is king: The global economic climate will be far more stable if sovereigns, corporates and individuals adopted Buffett's debt policy — "it is insane to risk what you have and need in order to obtain what you don't need".

While most corporates are averse to accumulating cash as it entails a negative carry i.e., the interest earned on cash is lower than the operating profit margin, Berkshire has demonstrated no such qualms. Cash as of end-2017 was $31.6 billion.

Acknowledge your mistakes: Buffett too makes mistakes, which he has been honest in admitting. These include his initial investment in Berkshire Hathaway when it was a failing textile company in 1962, investing in Tesco, issuing shares to buy General Reinsurance, investing in ConocoPhilips and many more. Investing involves an element of judgement and making mistakes is natural. But acknowledging these mistakes and divesting from such investments is the hall mark of an astute investor.

Keep it simple: The simplicity of Berkshire's businesses strike you as you review the company's annual reports since 1995 available on the company's website. Conspicuous by their absence are exposures to complex derivatives, investments in commodity trading firms, start-ups, unicorns, hedge funds and private equity partnerships.

In fact, Buffett recommends that investors stick to investing in exchange traded funds as active investment strategies (read stock picking) are unlikely to outperform the market in the long run.

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