Buffett:
The Making of an American Capitalist
by Roger Lowenstein

All credits to Roger Lowenstein, commentary provided by Leo Schreven

This is a big book of over 500 pages. But I thought it would be good to focus together on learning from the wealthiest man in the world. So this month is more like a biography. We all need role models of successful people and Buffet is one of the best.

I personally like Warren because he is so down to earth. He lives in the same Omaha house he bought for $31,500 in 1958. He drives his own car, prepares his own taxes, wears inexpensive suits and does not employ servants beyond an “every other week” housekeeper. Buffett is a simple man with simple tastes. He likes hamburgers, cherry cokes and peanuts.

Roger Lowenstein does a masterful job of reporting on Buffett’s life in this book and explaining his straightforward, common sense investing approach without speculation, fancy charts or complex technical analysis like you see in so many other books. So as you go through this outline, read it with an eye to pick out Buffet’s strategies and role model what he does.

Buffett focuses on three basics:

1. Tolerable risk.

2. A company’s value.

3. The stock price. (If the price is well below the true value, he’s interested.)

Buffett used this easy-to-understand formula to build his fortune. And, it obviously works. Buffett has a net worth of $64 billion.

That is what makes Warren Buffett the world’s greatest investor. No one else even comes close. He is simply astute at analyzing the financial value of companies. His principal investment rule is: “Never lose money.” Probably more than any other investor, Warren understands that the market always “catches up” with value, so he is a master of spotting companies with real value, especially a business’ long-term value.

His shareholders have the same priority. He usually holds on to investments for years, just as he does his friends. He treats his investors as partners, not as faceless shareholders. This runs counter to most CEOs treatment of shareholders. Most CEOs treat their investors as changeable entities, like diners at a restaurant. But Warren has a different view of genuine care.

The good news is that anyone can use Buffett’s stock selection strategy. It requires an understanding of business, and careful review of annual reports and similar information. Like all investing, you have to do homework rather than watch TV.

Warren Buffett has a saying that has become famous.

“I will tell you the secret of getting rich on Wall Street...You try to be greedy when others are fearful and you try to be very fearful when others are greedy.”

This is probably one of the most important lessons in the book. It is easy to get caught up in the “herd” mentality and panic when people panic, and get greedy when every one else is. Look at the examples in just the last few years the tech bubble, the housing bubble, etc. But to be a good investor you have to break out of the herd and see what is really going on, and what opportunities are there.

To see how truly superior Warren Buffett is at picking stocks, envision a chart depicting the value of his company, Berkshire Hathaway, compared to the Dow Jones Industrial Average. Over the course of many years, Berkshire’s line on the chart begins to shoot straight up. During the same period the Dow’s line meanders in a slow vertical direction.

The difference is not surprising. When Buffett invested in Berkshire Hathaway in 1962, its stock was valued at $7.60. By 2007, a single share cost $141,600. No one in history has been better at analyzing stock values and making investment decisions. If you had invested $10,000 in Buffett's portfolio partnership in 1956 and stayed with it, your money would have grown to $550 million. A good return on investment? There has never been anything like it.

Maybe we can learn something simple about this guy that will reveal his genius. Maybe it is simply common sense. I want you to read the next few paragraphs and see what you pick up. Read each paragraph carefully and highlight each point you see that Buffet took to become what he is today. I've taken the liberty to highlight a few points in bold letters so you can think about them and how to apply the same principles to your life.

Buffett was born in Omaha, Nebraska, on August 30, 1930. His father, Howard, sold stock and bonds. His pretty, petite mother, Leila, was a former college girl who joked that she had "majored in marrying." Buffett was a kid who was **excellent with numbers** and who enjoyed charting stock prices. From his earliest days, **he planned to be a millionaire by age 30.** His proudest possession as a young boy was a metal coin changer. **Very early, Buffett started building his assets.** At age six, he sold Cokes door to door. When he was 11, Buffett made his first investment: His **favorite book** was *One Thousand Ways to Make $1,000*.

During high school, **Buffett had numerous businesses,** including magazine sales and newspaper deliveries (he had five routes). He sold errant golf balls that **he paid neighborhood children to find**. The Buffetts started out in a $65-a-month, three-room apartment so run-down that mice crawled into their shoes at night.

In 1945, at age 14, he **invested his savings in a 40-acre Nebraska farm.** After graduation from high school, he briefly attended the University of Pennsylvania, but he transferred back to his home state and later graduated from the University of Nebraska

After Nebraska, Buffett attended Columbia University's Business School. In New York, he studied under investment guru Benjamin Graham. Graham was famous for his idiosyncratic investment philosophy. He did not "watch the tape"; instead, **he looked for**

companies with low stock prices. He invested only in viable businesses with good "earnings, assets, future prospects and so forth." He focused on "intrinsic value that was independent of...market price." Graham bought stocks when their prices were lower than the business's basic value. He trusted that, over time, the market prices would catch up with the value. Graham was an exceedingly cautious investor. His primary goal was not to "make money – it was to avoid losing any."

Buffett soaked up this sensible philosophy. To him, Graham's concepts were the Rosetta stone. In 1951, Buffett received his M.S. in economics. After graduation, he worked for Graham in New York City. When Graham retired and moved to Beverly Hills, Buffett returned to Omaha.

By this time, Buffett had married Susan Thompson and they had started a family. When Buffett gave his kids a loan, they had to sign a loan agreement. Buffett launched his own investment firm, Buffett Associates Ltd., and **ran it from his bedroom**. He developed an investment pool for his friends and family. He started with $105,000 in capital and, as general partner, put up only $100 of his own cash. At 26, **he was confident** he would become rich quickly. An **avid reader** of annual reports, Moody's analyses and the financial pages, **Buffett "was familiar with virtually every stock and bond in existence."**

Buffett set a personal goal of beating the Dow "by an average of 10 points a year." With this in mind, he set exacting terms for his partners. He refused to disclose his investment options. He would provide only an annual summary of his results. Partners could add or withdraw money just one day each year. Otherwise, Buffett invested their capital as he saw fit. He did not charge a management fee, but he got a percentage of the returns he realized for his partners. **If he had failed to earn profits for them, he would have made no income.**

Buffett achieved a strong 10% return in his first year, a period when the Dow suffered an 8% drop. By his third year, Buffett had doubled his partners' initial investments. After five years, the partnership's returns were up 251% (whereas the Dow went up 74.3%). With such stunning results, Buffett had no problem picking up new investment partners. By 1962, the partnership had $7.2 million in investment capital. Buffett did his own research and trusted his own judgment, using Graham’s formula of choosing low-priced stocks of companies with good fundamentals.

Soon, Buffett added another partner, Charlie Munger, a brilliant west coast lawyer with a degree from Harvard Law. After they started doing business, Munger began running his own investment partnership. Buffett found it “spooky” that he and Munger were so similar in philosophy and thought. The two men worked closely together for many years. They co-invested in extensive enterprises, including Buffett’s crown jewel, Berkshire Hathaway.

Berkshire Hathaway

Over the years, Buffett continued to make superbly smart investment decisions. In the process, he made his partners wildly rich. He invested in many companies, including American Express (he loved its brand), GEICO (he liked its plentiful cash) and Disney (he understood the value of its library of classic animated features). Buffett expanded on Graham’s philosophy. **Rather than looking at companies as just accumulations of numbers, as Graham did, Buffett looked at them qualitatively in terms of their growth potential.** This approach worked. By 1963, Buffett was a millionaire four times over.

Berkshire Hathaway, a manufacturer of men’s suit liners based in New Bedford, Massachusetts, caught Buffett’s eye. In 1962, its stock sold for $7.60 per share, but it had “$16.50 of working capital.” Buffett quickly invested. By 1963, the Buffett Partnership was Berkshire Hathaway’s largest shareholder. Over time, Buffett bought more Berkshire stock. He became a director of the firm, then chairman of its executive committee. By 1965, he was fully in charge. In 1967, he bought another promising firm, National Indemnity, in Omaha. Buffett loved insurance companies because they sat on huge pools of funds. He could use National Indemnity’s cash to invest in other businesses. By this time, Buffett was plowing Berkshire’s capital into investments in publishing, banking and other fields.

Then, in 1969, at the peak of a bull market, Buffett liquidated his partnership, although he allowed his partners to keep their proportional holdings in two investments, one of which was Berkshire Hathaway. Buffett had become suspicious of the highly speculative nature of the stock market at the time. Plus, he was tired of the “rat race” of portfolio management. Instead, he wanted to focus exclusively on “long-term, controlled companies, such as Berkshire.” Right after Buffett got out of the market, it crashed. Once again, the **Oracle of Omaha had timed things perfectly.**

During the early 1970s, stocks were remarkably cheap. Buffett, who had invested most of the money he controlled in bonds, began to buy stocks again. Seeing great bargains everywhere, he bought extensively. His initial purchases included California Water Service, General Motors, Omaha National and Scripps-Howard Investment. He was elated about **making incredibly valuable purchases at deep discounts.** Some mornings, he would wake and “want to tap-dance.”

Buffett invested heavily in the Washington Post Co., Interpublic, Coca-Cola, GEICO (for the second time) and Salomon Brothers. In 1991, Buffett temporarily became Salomon’s chairman amid an infamous U.S. Treasury Bond scandal that nearly killed the prestigious Wall Street investment firm. Buffett also bought the U.S.’s largest furniture retailer, the Nebraska Furniture Mart, which had annual sales of $100 million. Rose Blumkin, then an 89-year-old dynamo, owned and ran it. “Mrs. B” was still working at the Mart seven days a week when she reached age 99.

The 1990s were a perfect time for an investor like Buffett who focused not on macro-economic trends, or stock ups and downs, but on the fundamental value of businesses. “Now is the time to invest and get rich,” Buffett told *Forbes*. And so he did. Buffett became a billionaire, then a multibillionaire, then a multi-multibillionaire – and, eventually, the richest man in the world.

Another amazing thing about Buffet is that his business structure is small. Here is what he says about it.

“A compact organization lets all of us spend our time managing the business rather than managing each other.”

It is another lesson we can learn from.

Buffett and his wife set up their charitable organization, the Buffett Foundation, in the 1970s. By 2006, in his 70s, Buffett began to plan for his eventual death. He decided to give five-sixths of his fortune to the Bill and Melinda Gates Foundation, which fights diseases in third-world nations, among many other activities. Why not donate his fortune to his own foundation? Buffett's generous, humble gesture is typical of his unassuming personality. Bill Gates and Buffett were close friends, but more than anything else, Buffett believes in working inside of his own "circle of competence" – which does not include charitable giving. Buffett is sure the Gates Foundation will do a better job of donating his money to worthwhile causes than he would have. This again goes back to a fundamental principle. Surround yourself with people who know more than you do, and build a team that is stronger than you are and you can only be successful.

All his life, Buffett eschewed the latest Wall Street fads, investment strategies, complex technical analyses (charting) and assorted voodoo approaches for picking stocks. Buffett's method is simple (but not easy), straightforward and logical: Search for stocks with inherent long-term value that substantially exceeds their current market prices. Of course, doing this in an informed, effective manner requires a solid understanding of business, as well as a discerning eye. The idea is to see a stock "as a share of a business, rather than as a blip on a screen."

To emulate Buffett, the potential investor must pore over annual reports, trade publications and other background materials to secure the most reliable, revealing information. Buffett loved doing such research, though others may find it tedious.

Can the average investor get results with this approach? Absolutely, says Munger, Buffett's long-term partner and alter ego. "Hundreds of thousands can perform quite well – materially better – than they otherwise might," said Munger, who calls Buffett's system "perfectly learnable." So, what does it require?

- **Ignore analysts' forecasts** – Also, don't worry about macro-economic trends. Pay close attention to one bedrock characteristic:

“long-term business value.”

• **Don’t buy what you don’t understand** – Invest in what you know, that is, your own circle of competence. You cannot correctly valuate a stock you do not understand.

• **Strong management counts** – Seek companies where the executives put their shareholders’ interests above their own. This does not include firms where CEOs pay themselves obscene salaries, and take immense benefits and other gilded perks.

• **Study the competition** – Learn the field comprehensively. Don’t get mired in analysts’ summaries. Trust what you learn independently, your instincts and your common sense.

• **Select the gold, not the dross** – Merrill Lynch could always recommend for or against any stock. Not Buffett. He focuses his research on only a few potential winners.

• **Don’t buy a stock until you are certain you are ready** – Then buy as much of it as you can. After his 1985 Cap Cities purchase, Buffett did not buy common stock for three years. But when Coca-Cola’s price became attractive, Buffett quickly purchased a block of its stock equal to about 25% of Berkshire Hathaway’s market value.

That is it in a nutshell. As we get together for this month’s call, I want you all to take a few minutes to look at this strategy and come up with a few companies you think will fit the Buffet strategy. Let’s discuss these together.

I’ll give you an example. We have recently discovered the huge oil and natural gas deposits in the northern USA and also recently developed the technology to achieve deep oil drilling. There is a 300-year supply down there. There are two long term investments I see here. One is the companies that build drilling rigs. Every drilling rig in the world is currently booked for the next 50 years. They can’t make enough of them or make them fast enough. So the companies that supply the materials for these and build them have outstanding opportunities—the same for natural gas. It is so plentiful and costs 1/3 of oil. I believe we will see a huge use of this in cars and all other modes of transportation in the next 10 years.

Think in similar lines and let’s see what you come up with when we talk.

Leo