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Value investing: review of Warren Buffett's investment philosophy and practice

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Abstract

This paper aims to: i. review and explore the investment philosophy of Warren Buffett and compare his investment philosophy with the theory of finance, and ii. analyze Warren Buffet's investment practices against his investment philosophy.

This article is prepared in four parts including part i. (introduction, objectives & Buffett's investment philosophy); part ii. (comparison of Buffett's investment philosophy with the theory of finance) and part iii. (comparison of Buffett's investment practices against his investment philosophy) part iv. (conclusion & recommendation).

Key Words: Warrant Buffett, Value Investing, Theory of Finance, Investment Philosophy.

1. PART I

1.1 Introduction

Warren Buffet is an American industrialist and investor who has made most of his money from investment. He is the greatest stock market investor with proven track record. Buffett was born in 1930 in Omaha, Nebraska, USA, the only son of businessman and politician Howard Buffett and his wife Leila (née Stahl). Buffett began his education at Rose Hill Elementary School in Omaha. In 1942, his father was elected to the United States Congress, he moved with his family to Washington, D.C., where Warren finished elementary school, attended Alice Deal Junior High School, and graduated from Woodrow Wilson High School in 1947. Warren was something as a child investing and building on his substantial natural skills. At the age of 10 he knew more about investing than the average American. He purchased his first stock at the age of 11. By 15 he was a businessman and a property owner, he could do his income taxes in his head (Alice Schroeder 2008).

Warren Buffett earned his bachelor of science in business administration from the University of Nebraska-Lincoln and master's degree in M.S. in economics from Columbia University. During his master's he learned investment philosophy, especially the principle of intrinsic business value from Benjamin Graham, the well-known scholar and practitioner and the author of "*Security Analysis*" and "*The Intelligent Investor*" books and chairman of GEICO. Buffett also worked for Ben Graham as investment analyst. Buffett and Graham's first differences emerged during the real work practices. Benjamin mainly cared for numbers appeared on financial statements including numbers on balance sheets and income statements while Buffett put greater weight on firm's management as one of the main factors in valuating businesses. Eventually Warren Buffett gathered enough money - about $140,000 to return to his home town and start his own business. He began with Buffett Partnership Ltd. and over short pried of time established several partnerships with different partners in different industries. He later merged all partnerships under single umbrella and made his most crucial move of taking over "Berkshire Hathaway".

In his long investment practices Warren Buffett applied value-investing principles of Benjamin Graham. He built Berkshire Hathaway Holdings as the base for his 44 billion worth of Investment Empire that includes GEICO, MidAmerican Energy Holdings, General Re, Shaw Industries, Nebraska Furniture Mart, Fruit of the Loom, CTB International, The Buffalo News, FlightSafety, NetJets, Borsheim's Fine Jewelry, MiTek Inc., and fairly large amount of American Express, Coca-Cola, Gillette, and Wells Fargo and more.

As part of his social responsibly Buffett once again surprised the world of investors taking the lead to donate $31 billion of his $44 billion fortune in annual installments of $1.7 billion to the Bill and Melinda Gates Foundation for as long as the couple lived. The Gates Foundation's contribute in global development, and global health fighting diseases such as HIV/AIDS, malaria and tuberculosis as well as improving the quality of US public education and libraries.

1.2 Objectives

The main objective of this paper is to explore the investment philosophy of Warren Buffett and compare his investment philosophy with the theory of finance, and analysis and compare Warren Buffett's investment principle with his own investment practices.

1.3 Warren Buffet's Investment Philosophy

1.3.1 **Economic reality, not accounting reality:**

Warren Buffett has stated that financial statements prepared by accountants might not represent the economic reality of a business. He indicated that accounting reality was conservative and won't cover the complete picture. Technically, accounting is governed by generally accepted accounting principles (GAAP), which is based on financial statements and doesn't consider intangible assets such as trademarks, patents, customer relationship, supply chain relationship, managerial knowledge and expertise and etc. Whereas under the economic reality these intangible assets are highly valuable assets. Buffett believed that investment decision should be based on economic reality of a business rather than its accounting records.

1.3.2 **Discounted cash flow (DCF):**

According to Buffett intrinsic value of a business is the true value of firm not accounting / book value. He said in order to arrive at intrinsic value one has to take the expected future cash flows and discount them back to their present value. Such calculation should also consider tax and margin of safety.

1.3.3 **Opportunity Cost:**

According to Buffett the returns from other opportunities could be considerable benchmark for performance. He compared the opportunities to decide on best available openings based on investment choice of either/or and not yes/no. He used the potential rate of return in his comparison between the opportunities.

1.3.4 **Risk-free approach:**

Buffett has insisted on risk-free investment approach and style. He used almost no debt financing, and preferred cheap stocks not cheap companies in his investments and mergers and acquisitions (M & A). To eliminate risk he employed risk-free rate of return with long term investment strategy. He concluded that best businesses are the ones that can employ large amount of capital and generate very high rate of return.

1.3.5 **Portfolio diversification:**

Although he has invested in many different companies in different industries he didn't seem to believe in diversification as a right approach especially diversification within the same company. He said that investors are better off to concentrate on businesses that they understand the most rather than businesses that they have no or minimum knowledge about. He also indicated that diversification is not necessary and investors should only consider it if they are not able to devote time to search on businesses they understand.

1.3.6 **Performance measurement:**

Buffett's approach is based on economic reality and intrinsic value not accounting and book value therefore his performance measurement is also based on intrinsic value rather than book value.

1.3.7 **Investment strategy:**

Learning from Benjamin Graham "Mr. Market" offers different prices every other day and too unstable to be used for investment decision. He didn't trust the financial theory of capital market efficiency and said that the inside information is not the same as information out there. Buffett preferred gathering all kinds of information and analyzing them against alternatives. He believed investing in stock is the same as investing in business therefore he preferred rational long-term investment approach.

1.3.8 **Corporate governance:**

It was learned from Buffett's practice that he didn't rely nor believed much in agency theory. Most senior managers and directors of Berkshire Hathaway and its subsidiaries are also the shareholders of the companies they manage.

2. PART II

2.1 Comparing Warren Buffett's investment philosophy with the theory of finance

In order to better understand Buffett's investment philosophy I will briefly compare the two methods in this section.

With respect to the above mentioned investment philosophy of Buffett, there are several similarities and dissimilarities between the two. Buffett's economic reality not accounting is the same as economic value added (EVA) of theory of finance used for investment decision. Both value the economic reality rather than the book value which does not consider important elements including intangible assets. His approach is also similar with regards to the intrinsic value, capital budgeting, fundamental analysis and agency problems. His philosophy is however different from the theory of finance in the domain of corporate valuation by using risk-free discount rate to assess cash flow and ignores risk-premium of weighted average cost of capital (WACC). It is also different with respect to the diversification concentrating only on businesses that their portfolio can be understood as well as efficient capital market hypothesis (EMH) by considering undervalued companies and stocks as well as unrecognized franchises.

Table 1 (see Appendix 1) summarizes the similarities and dissimilarities of Warren Buffett's investment philosophy to the principle and theory of finance.

3. PART III

3.1 Analyzing and comparing Warren Buffett's investment philosophy with his investment practices

On October 18, 2010 Warren Buffett in an interview with CNBC stated that Berkshire Hathaway was the "dumbest stock he ever bought." In the same interview he stated that back in 1962 he was running a small partnership worth of 7 million. And there was this cheap textile company stock that had been going downhill for years. He continued that he thought of buying textile stock and tender it back to them and make a small profit. After buying stocks for sometimes he decides to tender it back to them, so Buffett goes back to the company and meets with management Mr. Stanton. There he promises to tender his stock at 11.5 but few weeks later he receives an offer letter from Berkshire Hathaway for 11. Buffet gets mad and buys control of company and fires Mr. Stanton. Now, Buffett has committed major amount of money to a terrible textile business. He decides to rebuild the business and turn it to the base for all future activities. In

1976 he comes across a good insurance company and buys it for Berkshire Hathaway. In the same interview Buffett concludes that if he had invested the initial money in a good insurance company instead of textile business of Berkshire Hathaway it would have worth double by now – $200 billion, and perhaps we can simply assume a much higher return on investment as well.

Berkshire Hathaway was Buffett's first major investment which he calls it the "dumbest investment." Almost 30 years later, on August 25, 1995, Buffett's Berkshire Hathaway announced to acquire 49.6% of Government Employees Insurance Company (GEICO) at $70 per share amounting to a total of $2.3 billion. At the time GEICO's stock market value was $55.75 meaning Buffet's offered price was 25.6% premium over the stock market price per share. This is an interesting statistic for the world's leading value-based investor who is known for buying under market value or bargain assets (Calandro 2009). Professor Joseph Calandro has raised interesting points in his book "applied value investing" which will be used as a base for the purpose of this section of "comparison between Buffett's principle and practice."

To begin I will briefly go through GEICO background and then I will review Calandro's valuation approach for better understanding and further studies.

3.1.1 The GEICO

Like many other firms GEICO had seen its ups and downs over the decades. In 1972 the company's stock price reached its highest traded at $61 per share. However didn't take long before company's stock price declined to as low as $7 per share putting the company at the edge of bankruptcy. This was due to management's mistake in change of strategy. In 1976 company's new CEO John J. Byrne brought the company back to its high performance. In 1985 Byrne left GICO and once again the company's stock declined due to change of strategy by the new management. In 1993 Ozla took over the management and led the company to its core and made it profitable by 1995 attracting Berkshire Hathaway for its acquisitions. Interestingly, Berkshire Hathaway tendered for $70 per share which was 25.6% above its market price.

3.1.2 GEICO Valuation

Warren Buffett became interested in GEICO while he was studying under Benjamin Graham. At the time Graham was also the chairman of GEICO. Buffett bought shares, wrote article on company and followed GEICO over the years till its acquisition 1995 (Calandro 2009).

Calandro (2009) introduces the Graham & Dodd's practitioners value investor approach that is designed to buy stocks below intrinsic value. This approach results in a "*margin of safety"*. The approach is illustrated in figure1.

An investment is an "o*pportunity"* if it is offered below its intrinsic value and an investment is a "*risk"* if it is offered at or above its intrinsic value. Risk in this framework means that there is no financial buffer, or "margin of safety" between the value of an investment and the price it is offered. Therefore, such an investment is risky because the only way to profit from business is through its future growth, which is extremely intangible and is influenced by a variety of internal and external factors (Calandro 2009). In above framework Graham and Dodd have listed General Electric 1939 as risky and according to Professor Greenwald and his coauthors, it is quite impossible to accurately forecast Microsoft's earnings at 10 years from 2000 to 2010. Therefore it is impossible to justify Microsoft as a value investment business (Calandro 2009).

Calandro (2009) also uses Professor Greenwald and his coauthors "modern Graham & Dodd value continuum" approach for GEICO valuations. The approach is illustrated in figure 2. The diagram begins with the most tangible level of value (Net Asset Value). Then continues with Earnings Power Value (EPV) and franchise value and ends with Growth Value (GV) which is the least level of framework value.

With respect to the above approach Calandro (2009) begins GEICO valuation with Net Asset Value (NAV) before moving to the right side of the diagram. For the purpose of this valuation Calandro reconstructs company balance sheet on a reproduction basis. Table 2 (see Appendix 1) highlights NAV for GEICO.

Considering the aims and objectives of this study there is no need to cover detailed valuation procedure. However we need to know whether Net Asset Value was the main drive for acquisition. NAV is equal to $1,486,742, or $44.15 per share. From the other hand company market value is $55.75 per share and purchased value of $75 per share, therefore Net Asset Value of $44.15 is way below margin of safety and therefore couldn't be the main drive for acquisition.

Next is valuation in accordance to the next bar of EPV. Calandro (2009) further describes GEICO's Earnings Power Value (EPV) as per table 3 (see Appendix 1).

Again, on a sustainable operating income GEICO's Earnings Power Value (EPV) is expected to drive at almost acquisition price of $69.00 per share compared against the purchased price of $70 per share. This means the EPV is yet to satisfy margin of safety.

The last and final valuation is the Growth Value (GV). Professor Calandro (2009) valuates the GEICO's GV as per table 4 (see Appendix 1).

The 49.6% of GEICO's stocks were acquired at $2.3 billion or $70 per share. According to above table on a sustainable operating income GEICO's Growth Value is expected to go as high as $3,588,388 or $106.55 per share. This means GEICO's Growth Value would have been the main drive for its acquisitions, unless Buffett had used different level of margin of safety and intrinsic value calculation and valuation which is highly subjective.

4. PART IV

4.1 Conclusion & Recommendation

Buffett's M & A activities have been a valuable source for both value investing practitioners and researchers. He is the greatest value investing leader with proven record of alternatives to WACC, CAPM and EMH of theory of finance. There has been a great deal of studies in the domain of value investing and Buffett's approach, however with all the efforts so far there are gaps and rooms for more research and findings which is the key suggestion of this study.

The post-acquisition valuation of GEICO in recent years is the indicator of company's stock price growth beyond Calandro's Growth Value estimation. GEICO manages to gain through strategic plans including aggressive marketing and advertisement campaign. Professor Calandro (2009) argues that company's aggressive growth depend on its value drivers listed in figure 3 as well as its strong intangible assets such as brands.

GEICO was also enabled to enjoy and benefit from Berkshire Hathaway brand of unparalleled, its capital strength and corporate governance. The company also gained from its own brand, strategic management and aggressive marketing. However, its margin of safety at the time of acquisition seemed to heavily rely on future growth which was highly risky. The company stocks were also purchased at 25.6% above their market value raising concern and question whether the firm's real value especially the intangible assets worth above purchased price of $70 per share and Buffett was still within the "margin of safety" or he had ignored his own value investing principles? In addition the acquisition of parent company (Berkshire Hathaway) itself was called by Buffett the "dumbest investment" which again leads us to a different conclusion of possible gap between Buffett's investment philosophy and some of his investment practices? One other possibility is that the identified philosophy and principle of him is not the entire approach for his M & A? The two investments and acquisitions mentioned in this study (Berkshire Hathaway and GEICO) are the indicator of differences between the value investing principles of at least: i. investment strategy; ii. risk and return; and iii. opportunity cost, and Buffet's actual practices. However we should also consider that no one entirely knows about Buffett's valuation method, he still might be within his own value investing philosophy and principle by applying sophisticated and unique techniques and calculations when valuating firm's intrinsic values. Obviously value investing is the right strategic approach and more findings on Buffett's valuation methods and techniques is the key factor and a significant input for Graham and Dodd value investing practitioners and researchers.

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Appendix 1

Table 1. summary of comparison of Buffett’s and theory of finance

Warren. Buffett’s Investment Philosophy	The Theory of Finance	
	Similarities	Dissimilarity
1. Economic Reality not Accounting	Economic Value Added (EVA)	
2. Discounted Cash Flow	Intrinsic value as discounted value of cash	
3. The Opportunity Cost	Capital budgeting and framing of either/or rather then yes/no when making decision	Using potential Rate of Return rather then WACC (Weighted Average Cost of Capital) recommended by theory of finance

Table 2. GEICO Net Asset Value

	$000s			
	1994	Adjustment	Value	Notes
Liabilities				
Policy liabilities:				
P&C loss reserve — Note G	$1,704,718	$100,400	$1,805,118	(1A)
Loss adjustment expense reserve — Note G	$307,606	105%	$322,986	(2A)
Unearned premiums	$747,342	100%	$747,342	
Life benefit reserves & policyholders' funds	$101,298	105%	$106,363	(2A)
	$2,860,964		$2,981,809	
Debt — Note I				
Corp. and other	$340,378	100%	$340,378	
Finance company	$51,000	100%	$51,000	
	$391,378		$391,378	
Amounts payable on purchase of securities	$8,408	105%	$8,828	(3A)
Other liabilities	$291,413	105%	$305,984	(3A)
Total liabilities	**$3,552,163**		**$3,687,999**	
Assets and Equity				
Investments	$4,102,866	100%	$4,102,866	
Cash	$27,580	100%	$27,580	
Loans receivable, net — Note E	$59,448	$1,500	$60,948	(4A)
Accrued investment income	$67,255	100%	$67,255	
Premiums receivable	$238,653	100%	$238,653	
Reinsurance receivable	$127,189	100%	$127,189	
Prepaid reinsurance premiums	$10,361	100%	$10,361	
Amounts receivable from sales of securities	$2,022	100%	$2,022	
Deferred policy acquisition costs — Note F	$72,359	100%	$72,359	
Federal income taxes — Note J	$98,975	0.8992	$88,996	(5A)
Property and equipment	$141,741	$85,209	$226,950	(6A)
Other assets	$49,656	100%	$49,656	
Goodwill	$0	$100,022	$100,022	(7A)
Total assets	**$4,998,105**		**$5,174,857**	
Net Asset Value (NAV)	**$1,445,942**		**$1,486,858**	(8A)

All adjustments have been rounded and are the author's.
Data source: GEICO Form 10-K, 1994.

Source: Applied Value Investing

Table 3. GEICO Earning Power Value

	$000s	**Notes**
Expected sustainable EBT	$298,761	(1E)
Depreciation and amortization adjustment*	$11,979	(2E)
Interest on cash	$1,023	(3E)
Pretax earnings	**$309,717**	**(4E)**
Tax rate	16.9%	(5E)
Taxes	$52,252	(6E)
Earnings	**$257,465**	**(7E)**
Earnings power	**$2,296,104**	**(8E)**
Cash	$27,580	(9E)
Earnings Power Value (EPV)	**$2,323,684**	**(10E)**

All calculations have been rounded and are the author's.
* Calculations are illustrated in Table 3-3.
Data source: GEICO Form 10-K, 1994.

Source: Applied Value Investing

Table 4. GEICO Growth Value

Calculation		*$000s*	**Source**
(a)	Earnings	$257,465	Table 3-2
(b)	Net asset value	$1,486,858	Table 3-1
(c) = (a)/(b)	Return on net asset value	17.3%	
(d)	Cost of equity	11.2%	Table 3-5
(e) = (c)/(d)	Growth multiple	1.5	
(f)	Earnings power value	$2,323,684	Table 3-2
(g) = (e) × (f)	**Growth Value (GV)**	**$3,588,388**	

All calculations are the author's and have been rounded. Calculations assume all earnings are invested at the above return on net asset value.

Source: Applied Value Investing

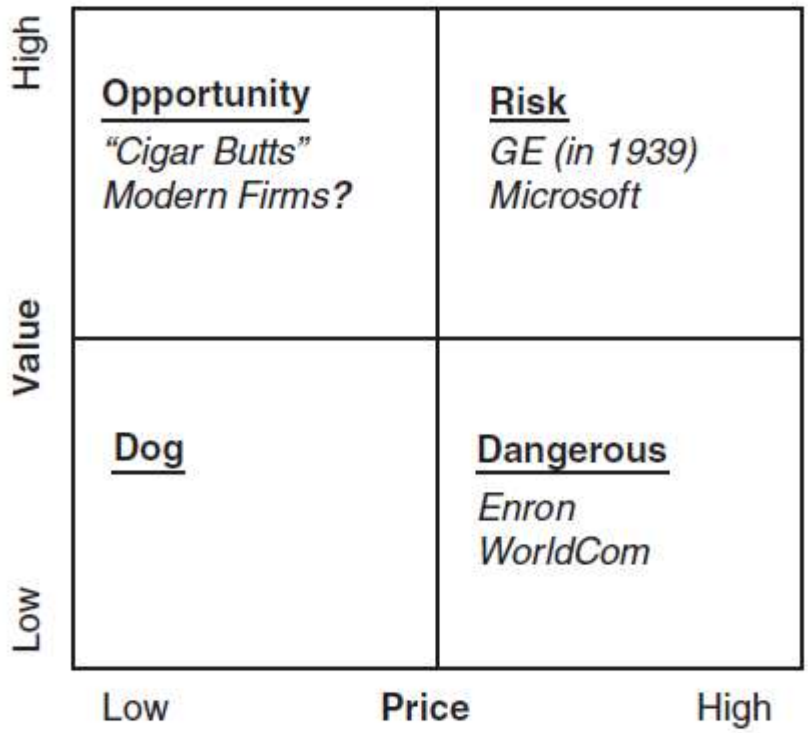
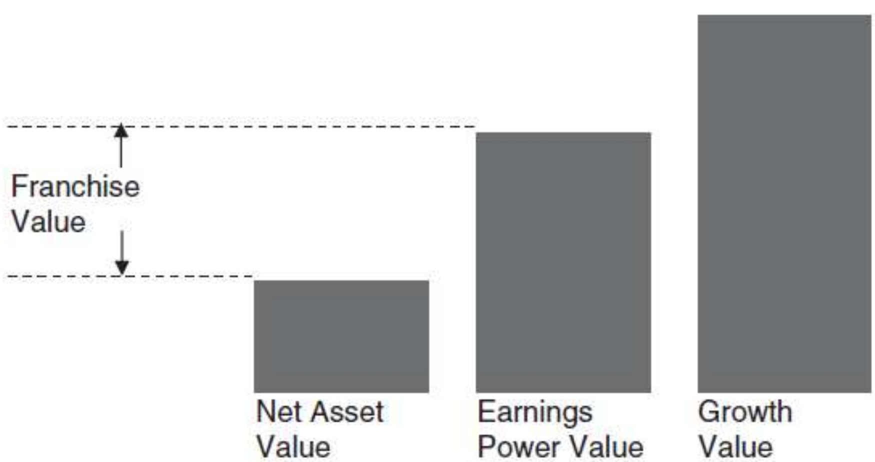


Figure1. The Price-Value Paradox

Source: Applied Value Investing



Adapted from Bruce Greenwald, Judd Kahn, Paul Sonkin, and Michael van Biema, *Value Investing: From Graham to Buffett and Beyond* (New York: Wiley, 2001), p. 44.

Figure 2. The Modern Graham and Dodd Value Continuum

Source: Applied Value Investing

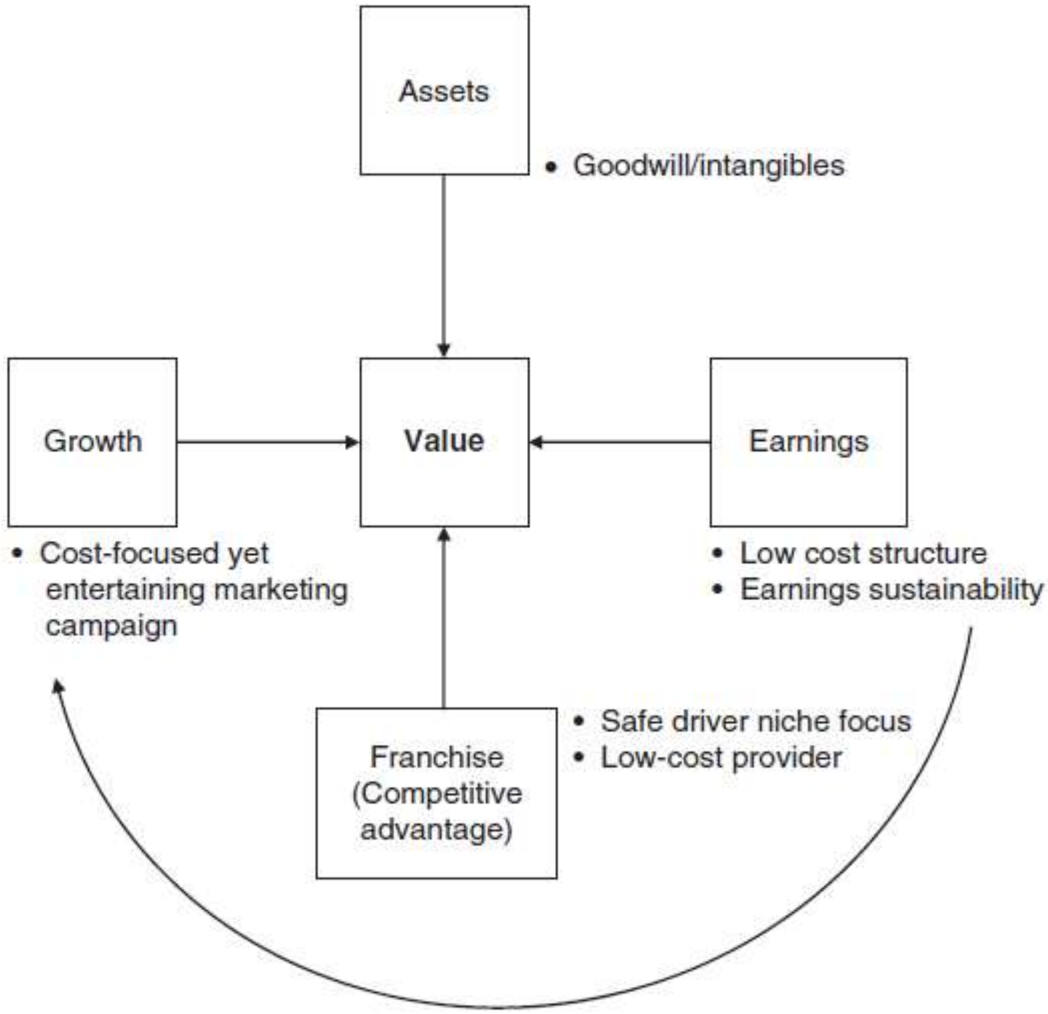


Figure 3. GEICO Value Drivers

Source: Applied Value Investing