Investing Lessons from Warren Buffett

“Time is the friend of the wonderful company, the enemy of the mediocre.” – Warren Buffett

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Published: Nov 28, 2016

Category: Finance

Known as the "Oracle of Omaha", Warren Buffett is an investment Guru and one of the richest and most respected businessmen in the world. Buffett is the Chairman, CEO and largest shareholder of Berkshire Hathaway, and he is consistently ranked among the world's wealthiest people amassing a fortune of nearly $60 billion. He is currently ranked as the third wealthiest man in the world by the *Forbes magazine*. In 2012, *Time Magazine* also named Buffett one of the World's Most Influential People.

Buffett is noted for his adherence to value investing and his personal frugality despite his immense wealth. Buffett’s investment philosophy is no secret, and he has shared priceless wisdom which has made him one of the most successful investors of all time. His investment advice is timeless, which has helped him garner dedicated followers all over the world. Each nugget of wisdom is supported by at least one of Warren Buffett's quotes and is helpful for investors seeking to find value in stocks.

1. “Price is what you pay; value is what you get.”

In the present day, the name Warren Buffett is synonymous to value investing. Value investing is an investment philosophy of investing in a security when its share price is below its intrinsic value. The supply and demand changes prices of securities, but they do not change what you are actually getting. Buffett refers to the true value as an intrinsic value. One of the common methods for calculating the intrinsic value is through discounted cash flow or net profit using the risk-free rate where, risk free rate implies the rate of government bonds.

The logic behind value investing is that if you know the true value of something, you can save a lot of money if you only buy things when they're on sale. In Buffett’s terms, it is like buying winter clothes in summer season and vice-versa. Just because one buys winter clothes in summer season, it doesn’t make the apparel less warm or cold. The winter clothes have the same value – it gives equal warmth during summer as it would in the winter season. But instead of paying full price to buy the winter clothes in winter season, when its demand is highest, value investors buy winter clothes in summer season, when demands as well as prices plunge. The same logic applies to stocks. Buy stocks when they are underpriced or undervalued.

Value investors do not believe in the Efficient Market Hypothesis, which says that stock prices already take all the information about a company into account. Instead, they believe that stocks sometimes tend to be overpriced or underpriced. As a result, these investors may decide to invest in a particular company due to its sound fundamentals, but may wait long periods of time if the stock is overpriced. Value investment is a long-term strategy, and it may not provide instant gratification like many investors wish for. Value investing is a bit like an art – you simply cannot use a value-investing formula to pick the right stocks which fits the desired criteria. You must have the patience and diligence to stick with your investment philosophy even though you will occasionally lose money.

2. "Never invest in a business you cannot understand."

The concept of "Circle of Competence" has been used over the years by Warren Buffett as a way to advise the investors to operate only in those areas they know best. According to him, the first and foremost step is to correctly analyze the business – not the market, the economy or investor sentiment. Buffett considers this deep understanding of business to be a prerequisite for a viable forecast of its future business performances. Looking for a consistent operating history and using that data to ascertain whether the business has favorable long term prospects is a must. As Buffett eloquently puts it, we do not necessarily need to understand these more esoteric areas to invest capital. Far more important is to honestly define what we do know and stick to those areas.

The core belief is that if one does not have a thorough understanding of the business, one will never be able to predict what the business may look like in five or ten years. It is not to say that one needs to know every bit of detail about the business, however, having a strong grasp of the business model and how the business operates is crucial. In Nepal's stock market, it has been proven time and again that there is high tendency among market participants to follow the 'herd' behavior i.e. buy a stock simply because everybody else is buying and vice-versa. Many tend to simply ignore the performance of the company or even the understanding of how the business functions. As a result, there is a serious lack of knowledge about the value of the company or how expensive or cheap the stock price is relative to its intrinsic value.

The basic takeaway here is simple. If you want to improve your odds of success in investing, it is better to define your perimeter and operate inside it. Over time, gradually work to expand that circle, however, never be afraid to say "I don’t know". This is not to say that we should never invest capital in these areas, instead that we should approach with caution. The circle can be widened but only slowly and over time. Mistakes are most often made when straying away from this discipline.

3. ***“Only buy something that you’d be perfectly happy to hold if the market shut down for 10 years.”***

A stock is not just a ticker symbol or an electronic blip; it is an ownership interest in an actual business, with an underlying value that does not depend on its share price. This is why Buffet has stated on numerous occasions that he believes stockholders should think of themselves as "part owners" in the business in which they are investing. While saying "no" to complicated business and industries is fairly straightforward, identifying high quality business is much more challenging. Many investors are surprised to learn that Berkshire Hathaway, a name that resonates with Warren Buffett, is one of his worst investments. Buffett was enticed to buy the textile company which looked cheap at the time but did not have great long-term prospects. This eventually backfired as it generated low returns for years to come.

One of Buffett’s mantra has been to own portions of outstanding business with outstanding management. Buffet is very careful when it comes to selecting his business partners and managers as they decide the fate of the company. He believes investment must be made in companies that can survive even during bad times. First, it is essential to identify characteristics of good companies. Generally, such companies have consistent operating history, high return on equity, high free cash flow, good long term prospects, high-quality management team, and durable competitive advantage. Buffett's investment philosophy has evolved over the last 50 years to focus almost exclusively on buying high quality companies with promising long-term opportunities for continued growth. Investing in such companies leave investors less to worry about when the market tumbles, for these businesses tend to withstand the test of time. According to him, it is far better to buy a wonderful company at a fair price than a fair company at wonderful price.

4. ***"Be fearful when others are greedy and greedy only when others are fearful."***

Investors' approach towards stock market can at times leave even behavioral finance experts scratching their heads. When stock prices increase two or threefold within a short span of time, traders and speculators immediately jump on the bandwagon and go on a buying spree. It is not uncommon for stocks of companies with strong fundamentals and consistent performance to trade at a higher level compared to its weaker counterparts. However, blind faith on a stock regardless of the price tag tends to push prices to levels that are far higher than its intrinsic value, at which point demand subsides. Instead, Buffett recommends doing the opposite – buying stocks when there is panic in the market or stock, and selling when there is abundance of overconfidence among market participants.

The 'herd mentality' is often witnessed in stock markets all over the world, and recent example of microfinance sector can be taken into context. Though at first, stocks were rising buoyed by astounding financial performance; unrealistic expectations of high returns caused many to flock into this sector, causing a bubble-like scenario. Microfinance companies, which had relatively low quantity of shares being traded in the market (due to small capital base), saw its stock prices jump multifold to unsustainable levels.

Hence, to succeed, Buffett recommends having a long-term as well as value-based opportunity outlook. Investors must understand there is an appropriate time and place when both greed and fear should be acted upon. For instance, when stock price are dropping, fear causes the majority of people to want to escape and pull their money out of the market immediately. To the contrary, Buffett sees this moment as an opportunity when fear should be converted to greed for long-term success. For undervalued investments, Warren Buffett would see this as the perfect opportunity to take on new positions for the long haul - particularly if the stock fundamentals are sound.

5. ***"Someone's sitting in the shade today because someone planted a tree a long time ago."***

Warren Buffett clearly embraces a buy-and-hold strategy, and has even gone on to say that his favorite holding period is 'forever'. Hence, it is no wonder he has held some of his positions for many decades. Why? Buffett has a firm belief that businesses earn high returns and increases in value over time. The compounding growth of business is enough of a reward besides capital gain. So when he searches for a business to invest in, Buffett seeks out businesses that exhibit a favorable long-term prospect. Similarly, he believes frequent trading is the worst enemy of investment returns as constantly buying and selling stocks eats away the return in the form of taxes and commissions. The above quote by Buffett encompasses the ideology of long-term financial success through patience as well as tenacity in the market.

Reinvesting the profits is one of the best ways to maximize wealth. Similar to how reinvesting is crucial to a company's continued growth and success for a business owner, the same is important for long-term success in the stock market. It's worth noting that investing isn't just about a sudden influx of cash but rather the length of holding period as well as valuable experiences gained over the investment horizon.

Many investors view the stock market as a way to make quick money rather than as a way to invest capital and earn compounded return over time. Anyone would enjoy quick money and easy profit, and the prospect of an effortless gain incites greed among investors. As a result, they even leverage themselves and act on hot tips for quick gain. Buffett strongly advises against such form of trading and recommends investing in companies with strong fundamentals as well as good long term prospects.

These are a few important lessons from Buffett's investing handbook which are as relevant today as it was 50 years ago. His advices are timeless and many investors all over the world attempt to follow his footsteps. Anyone wishing to replicate Buffett's success can start by following his core principles that reverberate through his world famous quotes. His time-tested strategies, if followed correctly, can make a significant impact on any investor's portfolio.