By Karry Tse

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Warren Buffett Expert:

The Keys to Value Investing

Robert P. Miles, distinguished author and authority on Warren Buffett, spoke to Fundsupermart recently about the truth behind value investing, during his recent trip to Hong Kong.

Warren Buffett, the "Oracle of Omaha", is renowned for his long-term investment performance. His company, Berkshire Hathaway Inc., has significantly outperformed the S&P 500 over the last 44 years. According to Berkshire's annual report, the compounded annual gain for the S&P 500 is 8.9% between 1965 and 2008, with overall gain around 43 times. As for Berkshire Hathaway, the compounded annual gain over the same period is 20.3%. If you had invested US$ 1,000 with Berkshire Hathaway in 1964, it would have become US$ 3.623 million after 44 years, representing a growth of 3623 times!

Value Investing ≠ "Hold and Win"

The extraordinary outperformance of Buffett has made value investing strategy appealing to investors. Nevertheless, many people mistakenly equate value investing with a "hold and win" strategy, while neglecting other important factors. For instance, some investors assume that they have the ability and dedication to manage their own portfolio without knowing themselves, while others care only about growth potential but not risks, or favour price over value.

Robert P. Miles, distinguished author and authority on Warren Buffett, visited Hong Kong recently. We grasped this chance to interview him about the truth behind value investing.

Miles provides in his book "Warren Buffett Wealth: Principles and Practical Methods Used by the World's Greatest Investor" an in-depth analysis of Buffett's investment principles and practical methods. However, before going straight

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5 Buffett Investor Tips

1. "Look at **stocks as parts of businesses**. Ask yourself, 'How would I feel if the Stock Exchange was closing tomorrow for the next three years? If I am happy owning the stock under that circumstance, I am happy with the business. That frame of mind is important to investing.'
2. "The **market is there to serve you** and not to instruct you. It is not telling you whether you are right or wrong. The business results will determine that. I stole that one from Ben Graham."
3. "You can't precisely know what a stock is worth, so leave yourself a **margin of safety**. Only go into things where you could be wrong to some extent and come out OK."
4. **Borrowed money** is the most common way that smart buys **go broke**.
5. "The stock doesn't know you own it. You have feelings about it, but it has no feelings about you. The stock doesn't know what you paid. People **shouldn't get emotionally involved with their stocks.**"

Source: Robert P. Miles

into the discussion of Buffett's investment strategy, he reminds investors that "the most important thing is to ask yourself if you are a passive or active investor".

Know Yourself

While the general characteristics of active investors are a commitment to reading and research, an analytical mind and independent thinking, Miles opines that it is crucial to distinguish between active investors and active traders. "Buffett is an active investor but doesn't actively trade. He thinks about the investment business and choices available every day. He has a passion for the process and the business of investing", says Miles.

Passive investors refer to the group of investors who decide not to spend too much time on reading or researching about investment-related information. Nonetheless, readers should not be mistaken that passive investors would always have a portfolio that underperforms an actively-managed portfolio. As Miles explains, "passive or inactive investing, although not a method used by Warren Buffett, may be one of the smartest pathways to take". He further adds that a good example of passive investing are Don and Mildred Othmer, shareholders of Berkshire Hathaway since the early 1960s, who have seen their investment grow from US$50,000 to US$800 million.

As suggested by Miles, passive investors like Don and Mildred might not do additional research after they have chosen their course of action. "They may simply be delegators and have better results than those who actively work their investments on a day-to-day basis. Passive investors do not necessarily follow blindly but may instead carefully review their manager on an annual basis and make changes accordingly."

The Power of Time

Certainly, when it comes to passivity, there are different degrees – from reviewing quarterly and annual results of the mutual fund, to attending the annual meeting of companies you own, to a detailed conference with a certified financial planner every five years.

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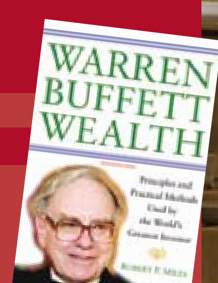
About *Robert P. Miles*

- Expert on Warren Buffett and Berkshire Hathaway
- Long-term shareholder of Berkshire Hathaway
- Publications include: "101 Reasons to Own the World's Greatest Investment: Warren Buffett's Berkshire Hathaway", "Warren Buffett Wealth: Principles and Practical Methods Used by the World's Greatest Investor" and "The Warren Buffett CEO: Secrets of the Berkshire Hathaway Managers"



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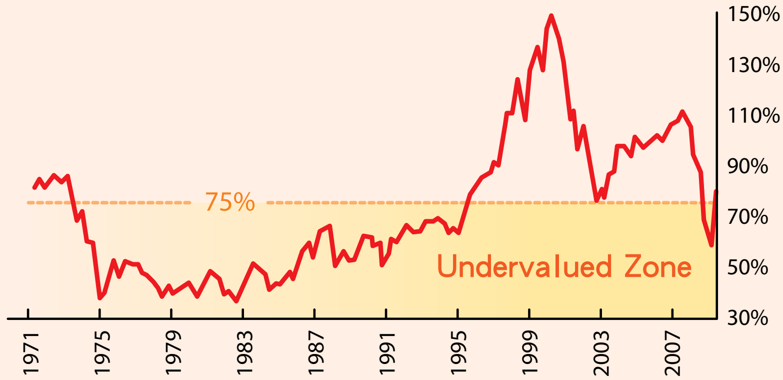
When is a good time to buy?

The essence of value investing is "buy low". Warren Buffett suggests investors to be business analysts, instead of market analysts, and he talks very infrequently about the market. However, there were a few times he did talk about the US stock market. Once was in 17 October 2008 when he published an article titled "Buy America. I Am" in the New York Times to encourage investors to buy US stocks. The other time was in 2001, when he was interviewed by the Fortune magazine, and pointed out that the percentage of total market cap relative to the US GNP is "probably the best single measure of where valuations stand at any given moment."

Chart 1: The Ratio of Total Market Cap to US GDP



Source: Gurufocus.com

Since the outbreak of the financial tsunami last year, Warren Buffett and Berkshire Hathaway have been actively buying into the market. He purchased securities from Wrigley, Constellation Energy, General Electric and Goldman Sachs. According to Fortune Magazine, as at 23 January 2009, the percentage of total market cap to the US GNP is 75%, representing a reasonable valuation, and coincided with the timing when Berkshire bought into the market.

Although it may be difficult for average investors to calculate the above ratio by themselves, Gurufocus.com, a popular investment website which tracks the information of investment gurus, provides daily updated ratio (Chart 1) of US market cap to the US GDP. This would allow investors to track the attractiveness (Table 1) of the US market more easily.

Table 1

RATIO = TOTAL MARKET CAP / GDP	VALUATION
Ratio < 50%	Significantly Undervalued
50% < Ratio < 75%	Modestly Undervalued
75% < Ratio < 90%	Fairly Valued
90% < Ratio < 115%	Modestly Overvalued
Ratio > 115%	Significantly Overvalued
As at 18 September 2009	Ratio = 78.2%, Fairly Valued

Source: Gurufocus.com

>> Regardless of your level of passivity, it is crucial for investors to understand what you have in your investment portfolio. Miles suggests that mutual funds, or better yet, a low-cost index fund, would be ideal for passive investors. Investors only have to bear in mind that they have to "buy a low cost fund", and together with the use of dollar cost averaging, the portfolio would benefit from the power of compounding over time.

On the other hand, if you are of the type of active investor who is willing to spend more time on reading and doing analysis, Buffett's selection criteria on companies may be more useful. Meanwhile, although these criteria mainly focus on company selection, they are noteworthy for fund investors as well.

The Oracle's Four Investment Yardsticks

The first investment criterion of the Oracle is simple business, but this is often neglected by common investors.

Miles points out that when it comes to evaluating businesses, "most investors go through the exercise of figuring out if something works, but the very last thing they ask themselves is "what could go wrong" after they find out it works." On the contrary, Buffett inverts that – the very first thing he asks is "what could go wrong". That is why Buffett

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generally stays away from companies which he cannot figure out the future in the next 10 years, as well as technology and businesses that are constantly changing. Miles recalls that Buffett is the best friend of Bill Gates, "but he can't figure out what Microsoft is going to be in 10 years, he can't value it", so he does not invest in it.

Management quality is another important consideration for Buffett. According to Miles, the Oracle will only have his eyes on rational and candid management which could resist growth for growth sake. This ideology is reflected in Buffett's management success. As described by Miles, in all these years, none of the CEOs of Berkshire Hathaway have ever left the company to join its competitors.

photo provided by interviewee

The third yardstick is finance, including ROE (return on equity), profit margins and retained earnings, etc. Indeed, the higher the ROE, the more Buffett would be interested. Miles mentions that some businesses (like banks and insurance companies) do not enjoy high ROE due to their business nature. However, in general, Buffett's looking for high ROE. As for retained earnings, Buffett gave his measurement in 1984: "For every dollar retained by the corporation, at least one dollar of market value will be created for owners." Otherwise, shareholders should wish that the earnings be paid to them.

"Undervalued" Investment

Last but not least, the most crucial yet often neglected part by investors is "value". Value investing, to put it more precisely, is "undervalued" investing. Factors that have to be taken into consideration include: 1) the asset can be valued; and 2) the asset is priced at a discount to its intrinsic value.

Intrinsic value is the present value of cash flow generated by an investment in the future. Warren Buffett defined intrinsic value in the annual report simply as "the discounted value of the cash that can be taken out of a business during its remaining life". Miles further adds that Buffett aims at buying an asset worth \$100 at the price of \$50 – this could also be the benchmark of other value investors.

Advantages of Average Investors

For newbie investors, Miles admitted that the selection criteria of Warren Buffett are "easy to say, hard to do". Nevertheless, he points out that average investors have got four advantages over the Oracle of Omaha, which can increase their chances of winning; "One is they have the age advantage. He (Warren Buffett) just turned 79 on August 30 (this year), so they have a longer time to compound than he does. Secondly, they have a smaller portfolio, which is a huge advantage. He has a market cap of US\$150 billion, if he earns US\$15 billion, it's only 10%." On the contrary, average investors have a much smaller portfolio to manage, making it easier for them to achieve a better performance.

"Thirdly, the next advantage is your knowledge of the local market, here in Hong Kong and in Asia. It's a huge advantage over Buffett because he's now in the US, which is already at the third stage of development, whereas Asia has a lot of first stage companies, with huge growth and a lot of opportunities… and the fourth really bigger advantage, is that because of size again, Warren can only look at 200 companies in the US in order to make a US\$5 billion or more investment, whereas the average Asian investor has tens of thousands of stocks they can look at." What investors need to know is how to value the company, and how to avoid mistakes.

To achieve investment success, he encourages investors to remains rational, to control their emotions, and prevent themselves from buying when everyone is buying, and selling when everyone is selling. Finally, he emphasises the importance of patience, and shared with us a joke told by Buffett, "You can't make a baby by making nine women pregnant in one month." FSM