https://www.youtube.com/watch?v=lDACUr5RneM

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The Oracle of Omaha

Picking Stocks Like Buffett

Presented by GuruFocus.com

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Warren Buffett

- Born in 1930 to a U.S. Congressman
- Bought his first stock at age 11 (Cities Service preferred shares)
- Buying pinball machines at age 15
- Received a Masters from Columbia studying under mentors Ben Graham & David Dodd
- At age 20, after learning of Graham's board position with Geico, knocked on door of headquarters where he met VP Lorimer Davidson

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Warren Buffett

- Worked as a stockbroker after college and taught "Investment Principles" night class at the University of Nebraska-Omaha
- Took a job at Graham's partnership in 1954 where he worked closely with Walter Schloss
- Graham closed partnership in 1956
- Buffett took his $174,000 savings ($1.47 million today) & started an investment partnership
- Eventually running 7 LP's before merging all of them into Berkshire Hathaway in 1962

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Investment Philosophy

- Believes in a margin of safety above all else
- Only buys top-quality businesses at fair prices
- Thinks that no price is cheap enough for a bad company
- Does not believe in excessive leverage or derivatives, aka “weapons of mass destruction”
- Prefers investments that he can hold forever
- Analyzes stocks as if he were buying the entire business
- Buys only when price is at a discount to intrinsic value

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The Four Filters Method

"We select our marketable equity securities in much the same way we would evaluate a business for acquisition in its entirety. We want the business to be (1) one that we can understand, (2) with favorable long-term prospects, (3) operated by honest and competent people, and (4) available at a very attractive price."

1. Simple Business
2. Favorable Long-Term Economics
3. Able and Trustworthy Management
4. Offers a Margin of Safety

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Famous Quotes

- "I'm 15 percent Fisher and 85 percent Benjamin Graham."
- "The basic ideas of investing are to look at stocks as business, use the market's fluctuations to your advantage, and seek a margin of safety. That's what Ben Graham taught us. A hundred years from now they will still be the cornerstones of investing."
- "Be fearful when others are greedy and greedy when others are fearful."
- "Risk comes from not knowing what you're doing."
- "You never know who's swimming naked until the tide goes out."

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Owner Earnings

"Owner earnings represent (a) reported earnings plus (b) depreciation, depletion, amortization, and certain other non-cash charges…less (c) the average annual amount of capitalized expenditures for plant and equipment, etc. that the business requires to fully maintain its long-term competitive position and its unit volume."

-Berkshire Hathaway Shareholder Report

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Owner Earnings Formula

	Net Income
+	Depreciation, Depletion, Amortization
+	Other Non-Cash Items
-	Average Maintenance CapEx
=	Owner Earnings

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Valuing Berkshire Hathaway

Two-Column Evaluation Method

Year	Per-Share Investments	Per Share EBIT	EBIT Multiple of Market	Per Share EBIT Value
2010	**$95,000**	**$6,000**	**10**	**$60,000**
2011	**$98,500**	**$6,500**	**10**	**$65,000**

Investments + Business Value = Intrinsic Value

2010: $95,000 + $65,000 = **$160,000 per share**

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Is the business simple and understandable?

"An investor needs to do very few things right as long as he or she avoids big mistakes."

Above-average returns are often produced by doing ordinary things exceptionally well.

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Does the business have favorable long-term prospects?

Buffett sees the economic world as being divided into franchises and commodity businesses. He defines a franchise as a company providing a product or service that is (1) needed or desired, (2) has no close substitute, and (3) is not regulated.

Look for the franchise business.

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Is management candid with shareholders?

"What needs to be reported is data - whether GAAP, non-GAAP, or extra-GAAP - that helps the financially literate readers answer three key questions: (1) Approximately how much is this company worth? (2) What is the likelihood that it can meet its future obligations? and (3) How good a job are its managers doing, given the hand they have been dealt?"

"The CEO who misleads others in public may eventually mislead himself in private."

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Does management resist the institutional imperative?

According to Buffett, the institutional imperative exists when "(1) an institution resists any change in its current direction; (2) just as work expands to fill available time, corporate projects or acquisitions will materialize to soak up available funds; (3) any business craving of the leader, however foolish, will quickly be supported by detailed rate-of-return and strategic studies prepared by his troops; and (4) the behaviour of peer companies, whether they are expanding, acquiring, setting executive compensation or whatever, will be mindlessly imitated."

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Is focus on Return on Equity?

"The primary test of managerial economic performance is the achievement of a high earnings rate on equity capital employed (without undue leverage, accounting gimmickry, etc.) and not the consistent gains in earnings per share."

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What is the rate of Owner Earnings?

Buffett prefers to modify the cash flow ratio to "owner earnings" - a company's net income plus depreciation, depletion and amortization, less the amount of capital expenditures and any additional working capital that might be needed. Owner earnings are not precise, however, and calculating future capital expenditures requires rough estimates.

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Is there a high profit margin?

In Buffett's experience, managers of high-cost operations continually add to overhead, whereas managers of low-cost operations are always finding ways to cut expenses. Berkshire Hathaway is a low-cost operation with after-tax overhead corporate expense of less than 1 percent of operating earnings, compared to other companies with similar earnings but 10 percent corporate expenses.

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Has the company created at least one dollar of market value for every dollar retained?

Buffett explains, "Within this gigantic (stock market) auction arena, it is our job to select a business with economic characteristics allowing each dollar of retained earnings to be translated into at least a dollar of market value."

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What is the value of the business?

Price is established by the stock market. Buffett tells us the value of a business is determined by the net cash flows expected to occur over the life of the business, discounted at an appropriate interest rate, and he uses the rate of the long-term U.S. government bond or a substitute minimum rate of return.

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Can it be purchased at a significant discount to its value?

Having put a value on the business, Buffett then builds in a margin of safety and buys at prices far below their indicated value.

The Warren Buffett Way, by Robert Hagstrom

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What is Buffett-Munger Screener? Click to Show / Hide

Warren Buffett said on Bloomberg TV in a July 2011 interview that he may look at Archer Daniels Midland Co. (ADM) as Berkshire Hathaway (BRK.A)(BRK.B) seeks more acquisitions. General Dynamics Corp. (GD) and Exelon Corp. (EXC) are also the types of companies he finds attractive. Interestingly, out of the three companies he mentioned, two of them, Archer Daniels Midland Co. and General Dynamics Corp., are listed in this Buffett-Munger screener. As put by Fortune, this is an unintentional endorsement from Buffett.

"Buffett-Munger Screener" can be used to find companies with high quality business at undervalued or fair-valued prices:

1. Companies that have high Predictability Rank, that is, companies that can consistently grow its revenue and earnings.
2. Companies that have competitive advantages. It can maintain or even expand its profit margin while growing its business
3. Companies that incur little debt while growing business
4. Companies that are fair valued or under-valued. We use PEPG as indicator. PEPG is the P/E ratio divided by the average growth rate of EBITDA over the past 5 years.

From the back testing study from 1998-2008 we have found strong correlations between the Predictability of Businesses and the long term return of stocks, the group of undervalued highly predictable companies performed the best. This group had **an annualized gain of 20%**, while the market just averaged 2.7% a year.

For details, go to: What Worked In The Market From 1998-2008? Part II. Under-Valued Predictable Companies And Buffett-Munger Screener

We can clearly see that companies with higher Predictability Rank had much better stock performances. The possibility of losing money with long term holding period is also greatly reduced.