Course 329: Buffett Seminar 5/5/78 at Stanford Graduate Business School-Prof. Jack McDonald

The game of making money in the stock market is deceptively simple. It is one of the few businesses where one makes offensive decisions and is not forced into making defensive ones. You play the game only when and where you wish to. You need only swing at the fat pitches which are over the plate and belly-button height.

The stock market is manic-depressant which is ideal. Stocks become severely over and under priced based on non-economic factors. With large institutions handling greater percentages of the money in the market, the market has more of a tendency to over-react on the upside. Always when the stocks dropped the little stockholder would be driven to sell out of fear of losing everything. Now, in addition, when the market moves up the institutions jump in in large numbers because they fear what their clients will say if they miss a major move.(i.e., the fear of losing accounts is the driving force behind institutions).

Institutions are basically marketing organizations. They have learned how to evaluate their clients desires and manage the $ the way the client would like to see it managed. The biggest enemy of money managers is too much money under management.

There is absolutely no correlation between hours worked or intelligence and money management success, although there may be an inverse correlation (i.e., 80 hours/work + 200 IQ = 0). There is a tremendous correlation between **approach and temperament**, and investment success. The record is clear that money can be made if:

1. One resists the temptation to be in every game all the time.

2. One maintains an even temperament

3. One has a reasonable knowledge of the subject and interest in it.

4. One is disciplined

5. One keeps a distance between himself and the market (i.e., Buffett believes he benefits tremendously by being in Omaha than in Wall Street.).

Review of Funds

Graham – Newman Fund

- Compensation = 20% of performance
- Bought only stocks which were quantitatively undervalued.
- He did not visit companies or even care about qualitative evaluations.
- Graham was an intelligent, academic man.

- The fund did best relatively in down market years. Held a bit of a lot of quantitatively undervalued companies.
- Overall gain = **17.6% per year** compounded after expenses but before Graham-Newman's %.

WJS Partnership (Walter Schloss)

- Run by one man who once worked for the Graham-Newman Fund
- Not too bright, knows little about investing.
- Works 2-3 hours per day.
- Looks for statistically undervalued companies.
- Has owned 700 securities in last 22 years
- Presently owns 150 securities
- Compensation 25% of performance.
- Overall gain 17.2% per year compounded.
- This example is given because it proves that *anybody* can make money if they are disciplined and consistent. Personally, **Buffett finds the ease repulsive.**

Buffett Partnership, Ltd.

- Compensation: gives client first 6% and takes 25% of performance after that.
- Used quantitative criteria as first screen.
    - Both balance sheet and income statement orientation.
    - Likes "cookie-cutter" companies
    - Companies that jump out at you quantitatively
    - Does the business have the potential of being a good business?
    - Held approximately 25 securities in every year (many of those securities may be related in that they are built around the same idea)
    - 15 good ideas during the 13 years of the partnership
    - Buffett put more emphasis on the qualitative and managerial aspects of the business.
    - He prefers to find businesses at cheap prices.
    - Buffett buys good cigars at a substantial discount and gets many fine puffs. WJS picks up cigar butts for nothing and gets one puff each. Important--He gets them for nothing.
    - Annual Compounded Rate = **29.5% per year** after expenses but before Buffett's percentage.

Berkshire – Hathaway Portfolio

- Now managed by Buffett
- $170 million in total
- $130 million in 8 stocks
- Other $40 million in 15 stocks.
- Again, 1 idea can be represented by more than one stock.

A farmer only sells or buys a farm once. Therefore, he must be right when he does. In contrast, the stock market gives tremendous choices. Most people turn this vast array of choice into a disadvantage rather than an advantage. **Be patient and wait for the right buy.**

When you buy a stock, think of buying the company as though there was no exchange. Don't look at EPS. **Look at total earnings compared to total price.** Example, would you pay $442 Billion for ITT's ABC million in earnings, DEF billion in assets etc?

Know the economics of owning a business. Learn a lot about valuing businesses. Learn what you can't value. (for Buffett that is a LARGE Percentage). Look at proxy statements and understand what businesses are sold for. When in doubt, avoid.

Understanding market psychology generally is important. Understanding day to day market psychology is impossible.

Technical analysis is bunk. Buffett tried it for 6 years.
Whether you get the best possible buy or not is not important. Just get good value for a steal.

Buffett presently finds himself in larger companies ($200 to $300 million in sales). Some people spread too much time looking for the needle in the haystack and then the needle is worthless. **He would absolutely never invest in any of the largest 50 companies in the U.S. The market is incredibly efficient at this level.** If you invest in any of these companies (which obviously can't be understood), then you are playing market swings. Buffett can't predict market swings.

Wall Street is too preoccupied with next week. How about 1980 or 1981--3 to 4 years from now?

With the present rash of acquisitions there has developed a great discrepancy between auction prices and negotiated prices. Companies are paying (do pay) too much for acquisitions. Managements love money to expand and acquisitions are exciting—thus, the temptation to over-pay. In a bad market, 3 out of 4 acquisitions are over-priced. In a good market almost all acquisitions are over-priced.

How to locate industries:

- Stay away from technology or anything difficult to understand.
- May have a natural interest in the industry.
- Likes to think about how different businesses work and this can lead him to a good industry.

The Company:

- Potential for being a good business?

- Look at the whole business. Would you pay market capitalization for the whole business?
- Look behind the numbers.

  - ✓ Leverage
  - ✓ What is the ROE? Why? How?
  - ✓ Pretend you are buying a Ford Dealership.

None of us can foretell the future, so allow plenty of buffer.

Know what you're doing and why.

"I bring good tidings: the inefficient market is alive and well."

END