What Is Warren Buffett's Investing Style?

If you want to emulate a classic value style, Warren Buffett is a great role model. Early in his career, Buffett said, "I'm 85% Benjamin Graham." Graham is the godfather of value investing and introduced the idea of intrinsic value - the underlying fair value of a stock based on its future earnings power. But there are a few things worth noting about Buffett's interpretation of value investing that may surprise you. (For more on Warren Buffett and his current holdings, check out Coattail Investor.)

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First, like many successful formulas, Buffett's looks simple. But simple does not mean easy. To guide him in his decisions, Buffett uses 12 investing tenets, or key considerations, which are categorized in the areas of business, management, financial measures and value (see detailed explanations below). Buffett's tenets may sound cliché and easy to understand, but they can be very difficult to execute. For example, one tenet asks if management is candid with shareholders. This is simple to ask and simple to understand, but it is not easy to answer. Conversely, there are interesting examples of the reverse: concepts that appear complex yet are easy to execute, such as economic value added (EVA). The full calculation of EVA is not easy to comprehend, and the explanation of EVA tends to be complex. But once you understand that EVA is a laundry list of adjustments - and once armed with the formula - it is fairly easy to calculate EVA for any company.

Second, the Buffett "way" can be viewed as a core, traditional style of investing that is open to adaptation. Even Hagstrom, who is a practicing Buffett disciple, or "Buffettologist," modified his own approach along the way to include technology stocks, a category Buffett conspicuously continues to avoid. One of the compelling aspects of Buffettology is its flexibility alongside its phenomenal success. If it were a religion, it would not be dogmatic but instead self-reflective and adaptive to the times. This is a good thing. Day traders may require rigid discipline and adherence to a formula (for example, as a means of controlling emotions), but it can be argued that successful investors ought to be willing to adapt their mental models to current environments. (It's not always bad to copy someone, especially when it's one of the greatest investors ever. Check out *Emulate Buffett For Fun And Profit - Mostly Profit*.)

Business

Buffett adamantly restricts himself to his "circle of competence" - businesses he can understand and analyze. As Hagstrom writes, investment success is not a matter of how much you know but rather how realistically you define what you don't know. Buffett considers this *deep understanding of the operating business* to be a prerequisite for a viable forecast of future business performance. After all, if you don't understand the business, how can you project performance? Buffett's business tenets each support the goal of producing a robust projection. First, analyze the business, not the market or the economy or investor sentiment. Next, look for a consistent operating history. Finally, use that data to ascertain whether the business has favorable long-term prospects.

Management

Buffett's three management tenets help evaluate management quality. This is perhaps the most difficult analytical task for an investor. Buffett asks, "Is management rational?" Specifically, is management wise when it comes to reinvesting (retaining) earnings or returning profits to shareholders as dividends? This is a profound question, because most research suggests that historically, as a group and on average, management tends to be greedy and retain a bit too much (profits), as it is naturally inclined to build empires and seek scale rather than utilize cash flow in a manner that would maximize shareholder value. Another tenet examines management's honesty with shareholders. That is, does it admit mistakes? Lastly, does management resist the institutional imperative? This tenet seeks out management teams that resist a "lust for activity" and the lemming-like duplication of competitor strategies and tactics. It is particularly worth savoring because it requires you to draw a fine line between many parameters (for example, between blind duplication of competitor strategy and outmaneuvering a company that is first to market).

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Financial Measures

Buffett focuses on return on equity (ROE) rather than on earnings per share. Most finance students understand that ROE can be distorted by leverage (a debt-to-equity ratio) and therefore is theoretically inferior to some degree to the return-on-capital metric. Here, return-on-capital is more like return on assets (ROA) or return on capital employed (ROCE), where the numerator equals earnings produced for all capital providers and the denominator includes debt and equity contributed to the business. Buffett understands this, of course, but instead examines leverage separately, preferring low-leverage companies. He also looks for high profit margins.

His final two financial tenets share a theoretical foundation with EVA. First, Buffett looks at what he calls "owner's earnings," which

is essentially cash flow available to shareholders, or technically, free cash flow to equity (FCFE). Buffett defines it as net income *plus* depreciation and amortization (for example, adding back non-cash charges) *minus* capital expenditures (CAPX) *minus* additional working capital (W/C) needs. In summary, net income + D&A - CAPX - (change in W/C). Purists will argue the specific adjustments, but this equation is close enough to EVA before you deduct an equity charge for shareholders. Ultimately, with owners' earnings, Buffett looks at a company's ability to generate cash for shareholders, who are the residual owners.

Buffett also has a "one-dollar premise," which is based on the question: What is the market value of a dollar assigned to each dollar of retained earnings? This measure bears a strong resemblance to market value added (MVA), the ratio of market value to invested capital.

Value

Here, Buffett seeks to estimate a company's intrinsic value. A colleague summarized this well-regarded process as "bond math." Buffett projects the future owner's earnings, then discounts them back to the present. Keep in mind that if you've applied Buffett's other tenets, the projection of future earnings is, by definition, easier to do, because consistent historical earnings are easier to forecast.

Buffett also coined the term "moat," which has subsequently resurfaced in Morningstar's successful habit of favoring companies with a "wide economic moat." The moat is the "something that gives a company a clear advantage over others and protects it against incursions from the competition." In a bit of theoretical heresy perhaps available only to Buffett himself, he discounts projected earnings at the risk-free rate, claiming that the "margin of safety" in carefully applying his other tenets presupposes the minimization, if not the virtual elimination, of risk.

The Bottom Line

In essence, Buffett's tenets constitute a foundation in value investing, which may be open to adaptation and reinterpretation going forward. It is an open question as to the extent to which these tenets require modification in light of a future where consistent operating histories are harder to find, intangibles play a greater role in franchise value and the blurring of industries' boundaries makes deep business analysis more difficult. (If you appreciate the fundamentals of value investing, you'll want to study this: *The Value Investor's Handbook*.)

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