Reprinted with permission from The Omaha World-Herald

WARREN BUFFETT

Learning Through the School of Hard Knocks

By Glen Arnold

Many people regard Warren Buffett, the greatest living exponent of the value school of investing, first as an important teacher of investment principles, and only second as a wealthy individual. Of course, the fact that he has made a tremendous amount of money adds credibility to his teaching because he has empirically proved the soundness of his philosophy. But for many, it is the acuity of his ideas and simplicity of his approach which appeal because his methods seem accessible to all.

Buffett was not born with these ideas, nor did they come to him in a flash of light early in his career. He had to keep searching, building and failing, over and over, until he was proficient. The story of his struggle is encouraging because it emphasizes that success in stock investing does not rely on genius, but rather on a continual focus on good principles.

Buffett's Early Learning

Buffett began investing when he was 11 years old. He put $120 in savings into Cities Services, and from there he slowly built his portfolio. At age 20, after many business ventures and investments, his portfolio only amounted to $15,000. In addition to being short on money, he suffered from a poverty of investing ideas.

Buffett's real education began in 1949 when, as a 19-year-old, he read Benjamin Graham's book, *The Intelligent Investor*. He later enrolled in Graham's Columbia University course and subsequently worked for him as a security analyst, from 1954–1956. In addition to learning a great deal from Graham, he also made some spectacular investment deals around this time. They included a 48% gain in a few months from GEICO shares when he was 21 years old, and the Rockwood chocolate chip bonanza, in which the 24-year-old Buffett more than doubled his investment, making $13,000 to add to his growing fund.

The Buffett family at home in Omaha, Nebraska, in 1956. Left to right: Howard (17 months), Susie (2½ years), Warren and Susan.

The Benjamin Graham School of Practical Investing

By the time Buffett met Graham in 1950, Graham was 56 years old and had been through some rough times running small investment funds. Prior to the Great Crash, Graham was a relatively cautious investor, but not cautious enough when the downturn approached. Between 1929 and 1932, 70% of the $2.5 million fund he was running for clients was lost or withdrawn.

Graham had witnessed valuations made on earning projections made in an optimistic mood, and he had seen investors buy in the hope of selling to a greater fool who would pay even more because the price had gone up. He had experienced buying based on charts, tips, no real knowledge of the business and insider information. The result of his soul searching was the foundation of the value school of investing, which so influenced Buffett and is adhered to by thousands today.

Following the Great Crash, many observers concluded that it was pointless to assess share value. After all, if in 1928 a share could be worth $100 (according to the market price), and 15 months later worth only $5, who was to know what the real value was? A far better method, they said, was to focus on assessing the mood of other share buyers. When other buyers think the price will go up, the investor should try to buy before it does. This focus on the market, rather than on the company and its performance in serving its customers, is one distinguishing feature of speculators, as opposed to investors.

Defining Investment

Graham and his co-author David Dodd provided the following contrasting definitions of investing and speculation in their book, *Security Analysis,* in 1934:

> "An investment operation is one which, upon thorough analysis, promises safety of principal and a satisfactory return. Operations not meeting these requirements are speculative."

There are three essential elements in this definition:

1. Thorough analysis: When people invest in a business, they will own a small portion of it and should, therefore, ask many of the same questions they would ask if they were buying the whole business. For example, what is the turnover and profit history? Does it have a good reputation with customers? This type of analysis requires rationality, independence of mind and a critical examination of the facts. For Graham, this analysis was primarily focused on the proven facts from the quantitative side. He recognized the importance of the qualitative, such as the power of a well-recognized brand or the quality of the managerial team, but his 1929 experience made him cautious about putting too much weight on his assessment of the business prospects and management's ability and integrity.

2. Safety of principal: It's very important to build in a margin of safety when buying shares, rather like the extra safety built into a road bridge. A bridge is not built to withstand only historically recorded wind speeds and other loads; it is built to standards well beyond that. Similarly, investors should only buy shares when there is a large margin of safety between the purchase price and their calculation of intrinsic value.

3. Satisfactory return: Investors should avoid getting caught up in over-optimism or greed, which will often lead them down a path beyond their capabilities, or stretch the risk limits they can stand. The irony is that great investors act with safety of principal in mind and aim only for a satisfactory rate of return. Yet, in the long run, they outperform those who take the path of higher risk.

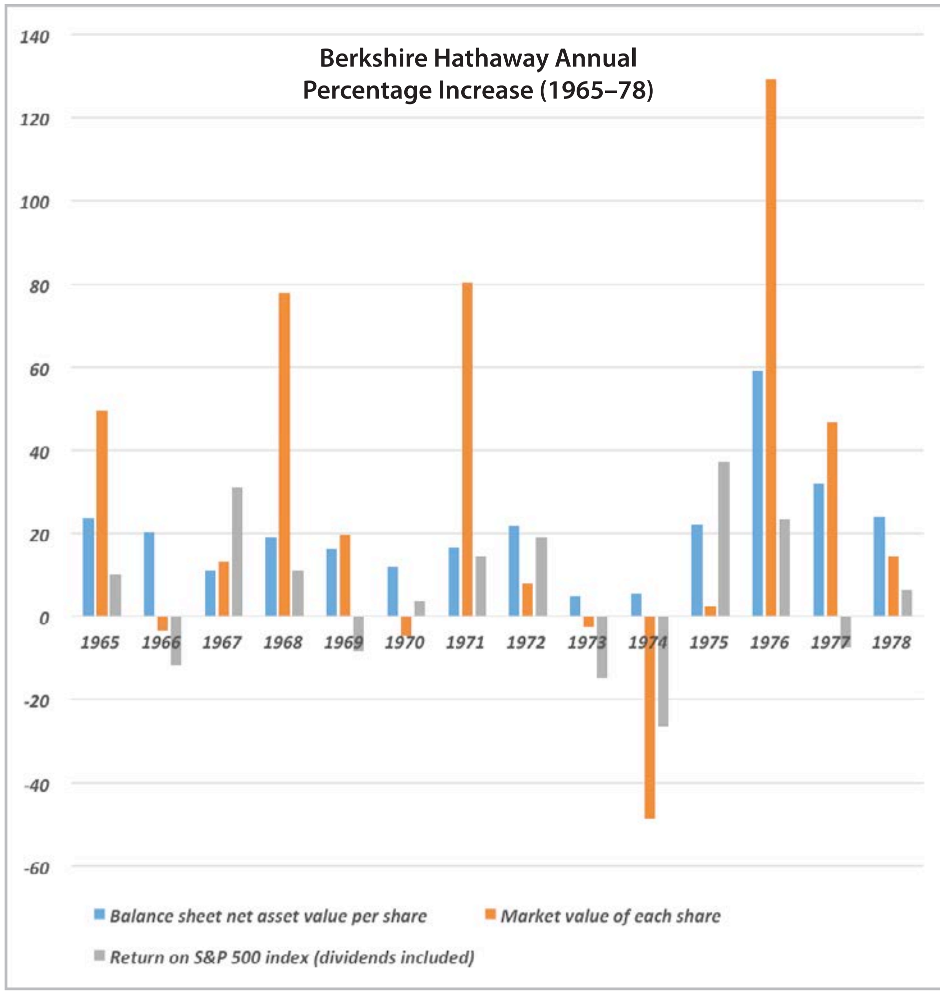
Warren Buffett's Other Lessons from Graham

Graham learned that returns depend on the investor's knowledge, experience and temperament. First, the investor needs to understand the business world and how it works. Some grasp of accounting, finance and corporate strategy is essential, though this can be enhanced and developed over time. Having a curious mind is a prerequisite, but an investor does not have to develop the level of knowledge required purely from his own experience. A lot can be learned vicariously from other people's mistakes and successes.

Temperament is more important than IQ when it comes to being a good investor. Graham taught Buffett that the most intelligent people often make poor investors because they frequently lack the right mental approach. For example, if they are highly rational, they get frustrated at the irrationality in the market and often cannot figure a way of exploiting irrationality. They may also fall in love with their predictions, thereby neglecting to build in a margin of safety. Other aspects of bad temperament for investors are the tendency to follow the crowd when it is panicking, or to become irrationally exuberant when everyone else is. Then, there are the people who can't help noticing others making money on a new idea for speculative selection, or the latest technology, and want some of the action. In short, the investor's own worst enemy is often himself.

Graham emphasized to Buffett that he must understand the focus of other people in the markets if he wanted to outperform them. For example, many investors are primarily concerned with expectations concerning the future, such as how many customers a company would have over the next 10 years, which cannot be predicted with any degree of certainty. Meanwhile, they pay little heed to more important details, such as the balance sheet, earnings history and share price. The lesson is to not become engrossed in the "story" of a business while ignoring the "facts" about it.

Graham created a wonderfully simple parable of "Mr. Market," which goes something like this: You are in a business partnership with Mr. Market. You own 50%, the same as he. Every day, Mr. Market comes to you offering either to buy your half of the business, or to sell his half to you. He is very obliging indeed — in fact he'll offer prices throughout the day. The thing is, Mr. Market has moods. Sometimes he is very optimistic and offers you a high price for your share of the business. Other times he is down in the dumps and just wants out; he will sell his half to you at a low price. So, what you have to ask yourself is whether you should value your shares based on the prices that Mr. Market is currently offering. Of course, true investors will carry out their own analysis and compare their intrinsic value calculation with Mr. Market's offer.



Source: Letter from the Chairman of Berkshire Hathaway (2016)

The Graduate from Graham and Doddsville

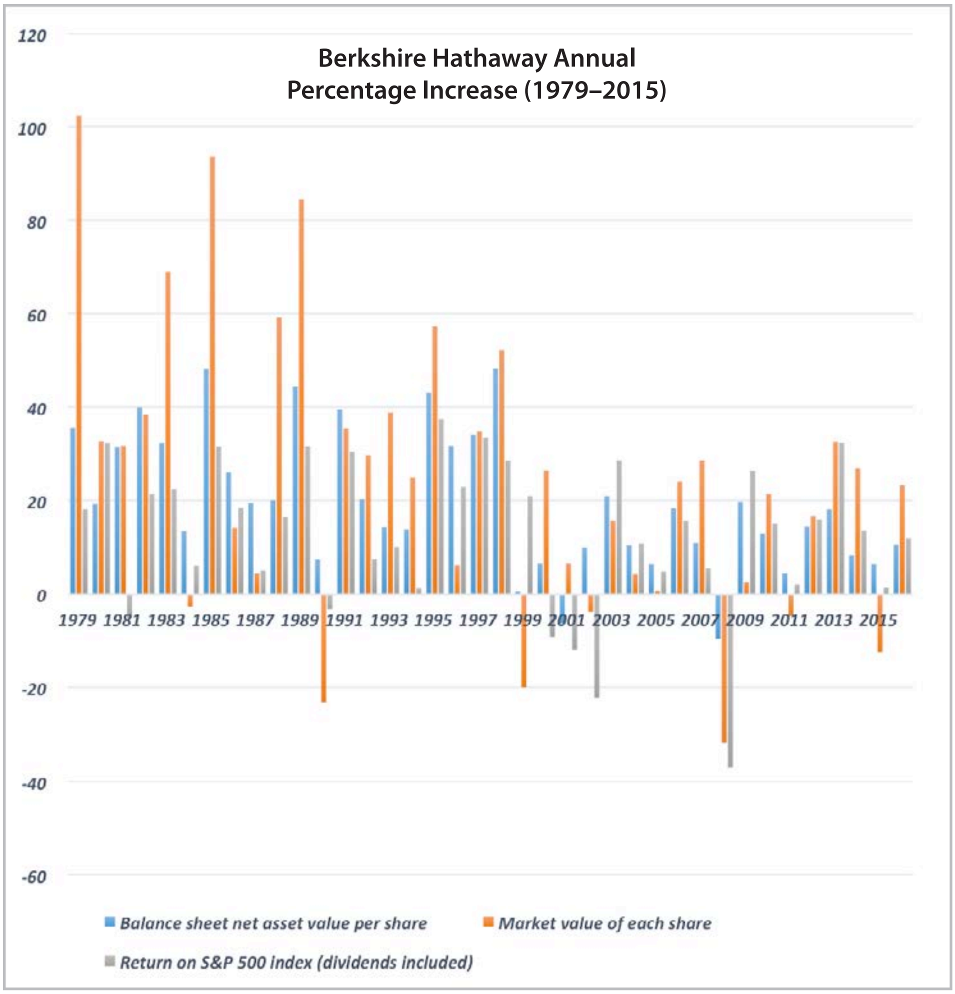
Upon returning home to Omaha, Nebraska, following Graham's retirement, 25-year-old Buffett set up an investment partnership with seven relatives and friends. They had $105,000 available, and Buffett made the investment decisions. The partnership's returns far exceeded the stock market, as Buffett found bargain after bargain — such as Sanborn Maps, which was sitting on net assets (mostly tradable securities) — worth much more than its share price. Buffett's partners made about a 50% return on that investment when Buffett was 29 years old.

Other people observed what Buffett was doing and wanted him to invest their money, so he set up other partnerships, eventually bringing them together in one group, the Buffett Partnership Limited (BPL). He found some solid companies that were temporarily out of favor with Wall Street, such as American Express (a tripling of share price) and Walt Disney (a 55% return).

Between the start of the partnership phase of Buffett's investing career (first full year 1957) and near its end in 1968, the Dow grew by 185.7%, but a dollar invested with Buffett went up by 2,610.6%. After Buffett's fees, a typical partner who had invested $1,000 in 1957 would have over $15,000 within 12 years. In contrast, each $1,000 invested in the Dow in 1957 increased to only $2,857.

Berkshire Hathaway Enters the Scene

In 1962, Buffett used a portion of his partners' money to buy shares in a down-at-heel New England textile company, Berkshire Hathaway (BH). The price of each share averaged $7.50. By May 1964, BPL held 7% of the shares of BH. The dominant shareholder and executive was Seabury Stanton. He made a deal with Buffett for Berkshire Hathaway to buy BPL's BH shares for $11.50 — 50% more than Buffett had paid to acquire them. Then, Stanton thought he'd chisel Buffett. In a petty way,



Source: Letter from the Chairman of Berkshire Hathaway (2016)

he pitched the formal offer at only $11.375. Buffett bristled at Stanton's behavior and chose not to sell.

Instead, Buffett made what he later called "a monumentally stupid decision." It was plain to see that New England textile mills were going out of business, as they rarely made profits due to cheap imports. BH itself had closed most of its mills as it failed to compete. But Buffett was upset, and so he began to aggressively buy more shares (great investors are not perfectly rational). By April 1965, BPL held 39% of BH and formally took control of the company, using one-quarter of the funds under Buffett's command to do so.

Buffett's self-confessed "childish behavior" resulted in him having to organize "a terrible business." As a result of losses and share repurchases, Berkshire's balance sheet net worth was only $22 million. It had no excess cash and $2.5 million of debt. Buffett put strict limits on further investment in textile machinery and other assets. He gradually moved the capital of the original business to other areas. Because he was a capital allocator with a knowledge of many types of businesses, and not a textiles man specifically, he was able to spot better investment opportunities than those who were focused on only the textile industry.

Transforming Berkshire

In 1967, Buffett made a great leap for BH by getting it to buy the insurance company National Indemnity in his home town of Omaha for $8.6 million. For Buffett, one of the attractions of insurance companies was the pile of cash (the "float") sitting within the firm, created because policyholders pay up front, but claims occur later. This float could be invested. Buffett later bought many more insurance companies and made very good use of their floats too. The National Indemnity acquisition was followed by another masterstroke: the purchase of a chain of branded candy stores in 1972 for $25 million. See's Candies has since generated more than $2 billion for BH to invest elsewhere, and it is still pumping out money today.

Many other brilliant investments were to follow, resulting in extraordinary growth for Berkshire. Between 1965 and 1978, the annual compound rate of growth of the S&P 500 was 4.63%. But for Berkshire, the compound rate of growth in per share book value was 21%. It is not until you see the effect of that differential on final dollar amounts that you really appreciate the truly stunning performance of Buffett. Whereas the S&P 500 rate of return resulted in a $1,000 investment in 1965 being turned into $1,885 by December 1978, in that same time a $1,000 investment in BH shares grew to be worth over $14,000.

Buffett's Early Mistakes

All investors make mistakes. A key characteristic of Buffett is that he continues to learn from his investing mistakes. Some of his early errors include:

GEICO Buffett invested about 65% of his net worth ($10,282) in GEICO in 1951, and he sold his shares in 1952 for $15,259. Not a bad return, but consider this: if he had held onto those shares for the next 20 years, he could have sold them for $1.3 million in the late 1960s. The painful lesson was in the *inadvisability of selling a stake in an identifiably wonderful company.*

Cleveland Worsted Mills Cleveland Worsted Mills' share price was less than half the business' net current asset value in 1951, so market capitalization was under half the amount tied up in the current assets after deduction of all liabilities. And it paid a high proportion of its earnings in dividends. After buying in, Buffett discovered that the company faced intense competition from textile plants in the southern US states and from synthetic fibers. It made large losses, cut its dividend and its share price dropped. Buffett *learned the importance of strategic competitive positioning and pricing power.*

The Gas Station Buffett bought an Omaha gasoline station in partnership with a friend. Unfortunately, it was sited opposite a Texaco station which consistently outsold them. Amazingly, Buffett even took up physical work to help out—on weekends he actually served customers. He learned lessons in competitive advantage: the Texaco station "was very well-established and very well-liked…customer loyalty…a clientele… Nothing we could do to change

From the Omaha World-Herald Photograph Collection at Durham Museum

Photograph of Warren Buffett, dated July 1, 1965.

that." With this lesson absorbed, it later led to some of his best buys as he sought companies with the most pronounced customer loyalties in their industries, such as Coca-Cola. But, at the time, the 22-year-old was smarting from losing $2,000 on petrol.

Dempster Mill Based in Beatrice, Nebraska, Dempster Mill supplied agricultural irrigation systems. Buffett began acquiring shares in 1956 at $16–$18. It had a net worth (book value) of about $4.5 million, or $75 per share. Net current asset value was about $50 per share and annual sales about $9 million. The price was so low because it kept making small profits or losses, and the management seemed clueless as to how to correct this miserable pattern. Also, it had high debt and was in an industry with very poor economics.

BPL became the 70% shareholder in mid-1961, spending $1 million at an average price of $28. Buffett was appointed chairman. The company engaged in a lot of unprofitable business ventures, using large amounts of shareholders' money in inventory and receivables. The logical thing to do was to cut drastically, releasing cash for deployment elsewhere, especially the purchase of other stock market quoted value shares. The managers nodded when Chairman Buffett spoke about reducing inventory on his monthly visits from Omaha—and then promptly did nothing. The cash shortage was so worrying that Dempster's bankers considered closing the company down, and in 1962 it was months away from disaster. Buffett faced the prospect of explaining to his partners that 21% of their assets had disappeared.

Then, Harry Bottle was put in charge. He quickly identified loss-making areas, fired people, sold equipment, introduced a cost data system, slashed inventory, closed five branches and raised prices for the rump business (for items where they were the sole suppliers, they increased prices by up to 500%). The value of the BPL stake rose threefold to $3.3 million.

Buffett learned the *value of excellent managers,* exhibiting competence and integrity. He also learned that *many businesses use too much money* in operations (40% of the capital was taken from operations for Buffett to invest elsewhere) and that *patience can be rewarded*—it took seven years to realize this investment.

Hochschild-Kohn In 1966, Hochschild-Kohn (HK) was uncompetitive and needed investment. Buffett knew he was buying "a second-class department store at a third-class price." Still, he liked the look of the net asset level, which was more than the market capitalization, and the hidden assets: unrecorded real estate values and a significant LIFO (last-in-first-out) inventory cushion. It was sold at $12 million, and BPL bought 80%. In 1968, sales plummeted. It was sold in December 1969, leaving Buffett with a loss.

Buffett learned about *the dangers of retailing*. The managers are usually under constant attack from competitors. If they come up with a good idea, it is usually not long before rivals copy. In other industries the managers do not destroy the business even if they perform in a mediocre fashion for a period. Thus, brands such as Gillette, Wrigley and Disney maintain the largest part of their franchises (their position in customer's minds) even if they have poor managers for a year or two.

The HK episode also helped crystalize in Buffett's mind that quantitative investment factors were not sufficient to make a great investment. He increasingly began to *focus on qualitative factors* as his career developed. He particularly *looked for strong economic franchises,* being willing to offer a fair price for a wonderful company rather a low price for a mediocre business. If the economic characteristics of the business and its industry are poor, then managers—even if excellent—will not succeed in generating high rates of return on capital.

Buffett's early years show the wisdom of the imperative to fail fast, and fail young, for that way lies insight and the knowledge to create future success. $

Despite holding the position of Professor of Investment, Glen Arnold concluded that academic life was not nearly as much fun (nor as intellectually stimulating) as making money in the markets. As a wealthy investor, he now spends most of his time running his equity portfolio from an office in rural Leicestershire, far from the noise of the City of London. His main research focus explores the question, "What works in investment?" drawing on the ideas of the great investors, academic discoveries and corporate strategic analysis. He is the author of the UK's best-selling investment book and best-selling corporate finance textbook. His most recent book is The Deals of Warren Buffett, Volume 1: The First $100m, *published by Harriman House, from which this article has been adapted. See: www.glen-arnold-investments.co.uk*