An investor education initiative

Edelweiss MUTUAL FUND

3 stock analysis insights from Buffett

Warren Buffett's wisdom is timeless.
Here we visit just three aspects when looking at a business.

In Buffett & Munger - A Study in Simplicity and Uncommon, Common Sense, author Peter Bevelin has done the hard work of poring over Warren Buffett's and Charlie Munger's speeches, interviews, annual meetings and shareholder reports. And he has brilliantly distilled it into an extremely engaging format.

Here are (just) three insights that explain Warren Buffett's philosophy. In the next post, we shall look at what Charlie Munger has to say.

If you are a businessman think like an investor. If you are an investor, think like a businessman.

The last section (A Final Word) of the last chapter of The Intelligent Investor by Benjamin Graham begins with 'Investment is most intelligent when it is most business-like'.

Being an investor, you are buying pieces of a business, so you better understand business. Being a businessman, you better understand alternatives for money in terms of allocating capital – and therefore you are partially an investor because investments are simply business decisions in terms of capital allocation.

The only reason for making an investment and laying out money now is to get more money later on. The question is how much you will get back, when you expect to get it back, and how sure you are that you will get it back. This is true whether you are buying a farm, an apartment house, oil in the ground, or any financial asset.

The first law of capital allocation is that what is smart at one price is dumb at another.

A cheap business may be cheap for the right reason – so full of problems that it turns out to be no bargain at all – so ask if it is cheap for the right or wrong reason.

If you are in a lousy business, you will get a lousy result even if you buy it cheap. If you are in a wonderful business, even if you pay a little too much going in, you will get a wonderful result if you stay in a long time.

Our goal is to find an outstanding business at a sensible price, not a mediocre business at a bargain price.

Focus on the absence of change.

Seeing the future is impossible in many cases, difficult in others. But sometimes it is relatively easy. And those are the ones we are looking for. That means they must be relatively stable and simple in character. If a business is complex or subject to constant change, we are not smart enough to predict future cash flows.

A fast-changing industry environment may offer the chance for huge wins, but it precludes the certainty we seek.

All businesses change to some extent. See's Candy is different in many ways from what it was in 1972 when we bought it. It offers a different assortment, employs different machinery and sells through different distribution channels. But the reasons why people buy boxed chocolates, and why they buy them from us, are virtually unchanged.

I can understand Wrigley's chewing gum. I know what the chewing gum business will look like 10 years from you. The internet isn't going to change the way people chew gum. I can understand Gillette. I don't think the Internet is going to change whether people shave or how they shave. I can understand Coca-Cola. When I say I can understand it, it means I have a pretty good idea of what they're going to look like 10 or 15 years from now. That's understanding a business. Risk comes from not knowing what you are doing.

The single and most important decision in evaluating a business is pricing power.

If you've got the power to raise prices without losing business to a competitor, you've got a very good business. You can almost measure the strength of a business over time by the agony its managers go through in determining whether a price increase can be sustained. You can learn a lot about the durability of the economics of a business by observing the price behaviour.

Every year for 19 years, I've raised the price of candy on December 26. And everyone keeps buying candy.

Every 1o years I tried to raise the price of linings a fraction of a cent, and they'd throw the linings back at me. Nobody ever went into a men's clothing store and said, 'I'd like to buy a pinstriped suit with a Hathaway lining.' Never. They say 'I want a coat'. The product was undifferentiated. The candy product is differentiated.

See's Candies creates a moat in the minds of consumers. We bought it in 1972. What we did know was that they had share of mind in California. Every person in California has something in mind about See's

Candy and overwhelmingly it was favourable. It's not share of market, but share of mind, that counts.

How did Coca-Cola build their moat? They deepened the thought in people's minds that Coca-Cola is where happiness is. The moat is what's in your mind. Coca-Cola is associated with people being happy around the world. Happiness and Coke go together.

You also see pricing power in efficiencies. For example, Burlington Northern rail transport compared to truck transport is three times more cost efficient and competitive. Products that are more cost efficient are able to demand higher prices. Their product has pricing power because their consumers are willing to pay more to capture those efficiencies.

The key to investing is not assessing how much an industry is going to affect society, or how much it will grow, but rather determining the competitive advantage of any given company and the durability of that advantage. The products or services that have wide, sustainable moats around them are the ones that deliver rewards to investors.

An investor education initiative by Edelweiss Mutual Fund

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