

# IS EMULATING WARREN BUFFETT IMPOSSIBLE FOR RETAIL INVESTORS?

**Andrew Quinn, Managing Director of Wren Research, argues that, rather than attempting to emulate Warren Buffett's success in the market, you might be better off simply buying Berkshire Hathaway shares.**

Nearly everyone has heard of investment billionaire Warren Buffett. The chairman of Berkshire Hathaway is widely regarded as the world's greatest value investor and is almost as well known for his witty anecdotes, down-to-earth manner and frugal lifestyle.

His investment record speaks for itself. When he took over the struggling textile firm Berkshire Hathaway in May 1965, its shares were trading at US\$18. They are now worth US\$97,699. Or to put it another way, an initial investment of US\$10,000 would have grown in value to US\$54.3 million today. No wonder many of his admirers talk about him with an almost religious awe. But after acknowledging this amazing investment track record, what should we do?

## How to become a billionaire

One strategy is obviously to copy him. In the US, there are several fund managers that do exactly this. Their strategy is to mimic Warren Buffett's portfolio based on publicly available information. Each time Buffett files a regulatory return, they copy the trades. Others invest large chunks of their funds directly in Berkshire Hathaway shares, which makes you wonder why their investors are paying management fees. Perhaps surprisingly, this copycat approach seems to work although the returns are below what you could achieve by investing in Berkshire Hathaway shares yourself.

## Value is in the eye of the beholder

Of course, copying Buffett's trades is not easy if you live in Australia. So many people think that adopting Buffett's style of investing is the way to go. But the value investor tag is used much too freely when it comes to Warren Buffett. Indeed, not only is it overused, it's just plain wrong.

A study published in 2005 by U.S. academics Gerald Martin and John Puthenpurackal found that only 15% of the stocks in the Berkshire Hathaway portfolio fell into the value category and only 19% were small. If you had to assign him a label, we believe Buffett is more correctly described as a large cap, growth investor. He tends to buy big stocks with a dominant market position and holds them for long periods of time. The Berkshire Hathaway investment portfolio clearly reflects this with huge shareholdings in Coca-Cola, Gillette (now part of Procter & Gamble), American Express and Wells Fargo.

For serious Buffett followers, the key issue is how he invests rather than what he invests in. This makes sense because if you can figure out how Buffett analyses stocks, you can apply it in your own market.

## *Each person seems to divine a slightly different message from his annual letter to shareholders.*

Yet once again, there is a glitch with this theory because Buffett is not black and white on exactly how he analyses stocks, for obvious reasons, and he doesn't always practice what he preaches. Likewise, although there are some common threads, each person seems to divine a slightly different message from his annual letter to shareholders.

At a recent ASX luncheon, Clime Capital boss Roger Montgomery was hammering the importance of return on equity as Buffett's key criterion. That's fair enough because Buffett highlights it in nearly every report. But on other occasions, he seems to argue that return on capital (i.e. equity plus debt) is more insightful. Earnings stability and market dominance often receive special mentions too. So where does that leave budding billionaires? The obvious answer is

that Buffett looks at lots of things. Perhaps some measures are more important than others. Perhaps it depends on the industry. Perhaps it varies on a case-by-case basis. In all, there seem to be at least half a dozen factors that he takes into consideration. The upshot is that while this kind of analysis will slim down the potential stock universe, it still leaves many questions unanswered. The only 'Buffett stocks' we know for sure are those that he already owns.

While it's natural to be curious about someone who became a billionaire via investing, Warren Buffett and the investment landscape have changed almost beyond recognition since 1965 and attempting to replicate his investment success now is arguably a difficult exercise.

For a start, describing Warren Buffett simply as an investor is almost a misuse of the word. It's like saying Rupert Murdoch is an investor in News Corporation or the Packer family are investors in Publishing & Broadcasting. Maybe Buffett was an investor forty years ago but today he is an investment phenomenon. The hero worship he attracts has been the subject of several academic studies and it is now clear that he can move market prices to a significant degree. Some people in the U.S. have even called for special laws to deal with Berkshire Hathaway's regulatory filings given their power to affect security prices. But what's even more interesting, is that the 'Buffett effect' seems to be getting stronger as his following becomes more cult-like.

Contrary to popular belief, Warren Buffett is not just a stock picker who runs Berkshire Hathaway like a managed fund. The company directly controls nearly 70 operating entities, many of which are industry leaders, and employ over 192,000 people. This distinction is important. Very few investors have the resources to buy whole companies and retain them as operating entities like Buffett does. Even without full ownership, his investment clout can provide access to the board of directors and senior management who are probably as keen as anyone for an audience with the Oracle from Omaha.

## So how does Buffett do it?

In my view, Buffett's success is based on three factors. The first and least well-known is that Buffett is a very skillful arbitrageur. That's perhaps not so surprising given his stockbroking background. In the Martin and Puthenpurackal study mentioned earlier, the authors found that 23% of Berkshire Hathaway's investments were categorised by the company itself as arbitrage investments and 77% were long-term investments. While Berkshire Hathaway's overall portfolio produced a stellar average return of 39.4% per annum between 1980 and 2003, the arbitrage investments produced a truly stunning average gain of 81.3%. By comparison the company's long-term investments, those typically cited by Buffett devotees, generated a healthy though less spectacular 27.0% per annum.

The second element in Buffett's success is Berkshire Hathaway's policy of not paying dividends. With the company consistently earning 20-30% returns on equity, this has been a great decision for its shareholders and has turbocharged the company's share price.

And finally, it is hard to over-emphasise the power of the Buffett name. He is a demi-god in the investment world with a Midas touch reputation that is without peer. Research shows that a stock purchased by Berkshire Hathaway goes up by about 2.95% on average purely due to the Buffett effect. That's an amazing investment edge given that the historical return on U.S. shares is around 10.2% per annum.

Combine that with his access to information and financial muscle and you have a formidable investment advantage that is essentially Buffett-specific. It also means that replicating his success is near enough to impossible. Rather than reading books which idolise his achievements, you might be better off using about \$4,000 of your hard earned to buy some Berkshire Hathaway B shares directly. 🌟