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## Some thoughts on the latest letter from Warren Buffet, the Sage of Omaha

This month I would like take our minds off less relevant things (like market volatility and short term macro economic trends) and focus our attention towards what I consider the essence of the investment process. And possibly the best way to do this would be to analyse the latest investor letter from Warren Buffet. Like always there are a few insightful homilies in this letter. I have reproduced some of his words as-is from his letter as they are sometimes best not altered.

Buffet uses two investment examples from his investment history to illustrate many of the points he wants to make. One is a small piece of farm land in Nebraska and another is a retail building next to NYU in New York. The salient features of both these investments are:

1. Sustainable long term economic use of these assets. He says: *Whatever the chatter, corn would keep growing in Nebraska and students would flock to NYU.*
2. Both were bought at times of distress. The first was after the bursting of a farm land bubble and second after the bursting of a retail asset bubble. So valuations were cheap with a 10% starting cash yield.
3. Both assets had strong optionality on the upside.
4. Finally, he emphasises the high level of predictability and income generating ability of these assets. Both are points that I continue to emphasise.

Though one might not have the luxury of the multi-year time horizon that Buffet speaks of, my view is that this process of looking for assets to buy is equally suitable for a shorter 2-3 year time horizon. Buffet makes a few simple points with these investments in mind. Some of them I strongly agree with. These are Buffet's own words summarized into investment principles that I myself use.

- **Stick to what you know:** *You don't need to be an expert in order to achieve satisfactory investment returns. But if you aren't, you must recognize your limitations and follow a course certain to work reasonably well. Keep things simple and don't swing for the fences. **When promised quick profits, respond with a quick "no."***
- **Predictability of the businesses future is important:** *Focus on the future productivity of the asset you are considering. If you don't feel comfortable making a rough estimate of the asset's future earnings, just forget it and move on. No one has the ability to evaluate every investment possibility. But omniscience isn't necessary; you only need to understand the actions you undertake.*

- **Purely looking at price change is speculating:** *If you instead focus on the prospective price change of a contemplated purchase, you are speculating. There is nothing improper about that. I know, however, that I am unable to speculate successfully, and I am sceptical of those who claim sustained success at doing so. Half of all coin-flippers will win their first toss; none of those winners has an expectation of profit if he continues to play the game. And the fact that a given asset has appreciated in the recent past is never a reason to buy it.*
- **Look at the productive output of an asset and not its daily valuation:** *With my two small investments, I thought only of what the properties would produce and cared not at all about their daily valuations. **Games are won by players who focus on the playing field – not by those whose eyes are glued to the scoreboard.** If you can enjoy Saturdays and Sundays without looking at stock prices, give it a try on weekdays.*
- **In the long term the macro evens out:** *Forming macro opinions or listening to the macro or market predictions of others is a waste of time. Indeed, it is dangerous because it may blur your vision of the facts that are truly important. (When I hear TV commentators glibly opine on what the market will do next, I am reminded of Mickey Mantle’s scathing comment: **“You don’t know how easy this game is until you get into that broadcasting booth.”**)*

#### **The “moody neighbour” making a daily bid-ask on Buffet’s farm land**

Buffet, in his own folksy way, compares the daily price quotes of the stock market to a neighbouring farm owner in Nebraska, who makes a daily bid-ask on Buffet’s property. Buffet’s advice has always been to not react to the daily quotes of this man as his shouting does not affect the output from the farm. In Buffet’s words:

*It should be an enormous advantage for investors in stocks to have those wildly fluctuating valuations placed on their holdings – and for some investors, it is. After all, if a moody fellow with a farm bordering my property yelled out a price every day to me at which he would either buy my farm or sell me his – and those prices varied widely over short periods of time depending on his mental state – how in the world could I be other than benefited by his erratic behavior? If his daily shout-out was ridiculously low, and I had some spare cash, I would buy his farm. If the number he yelled was absurdly high, I could either sell to him or just go on farming.*

*Owners of stocks, however, too often let the capricious and irrational behavior of their fellow owners cause them to behave irrationally as well. Because there is so much chatter about markets, the economy, interest rates, price behavior of stocks, etc., some investors believe it is important to listen to pundits – and, worse yet, important to consider acting upon their comments.*

*Those people who can sit quietly for decades when they own a farm or apartment house too often become frenetic when they are exposed to a stream of stock quotations and accompanying commentators delivering an implied message of “Don’t just sit there – do something.” For these investors, liquidity is transformed from the unqualified benefit it should be to a curse.*

*It's vital, however, that we recognize the perimeter of our "circle of competence" and stay well inside of it. Even then, we will make some mistakes, both with stocks and businesses. But they will not be the disasters that occur, for example, when a long-rising market induces purchases that are based on anticipated price behavior and a desire to be where the action is.*

One interesting quote attributed to the late Barton Biggs (the very well respected founder of Morgan Stanley's Asset Management business, where I evolved as an investor for twelve years) is:

*"A bull market is like sex. It feels best just before it ends."*

This was used in the context of warning investors against thinking they can consistently time markets - the markets look best when they are closest to the peak.

We all hope to have the discipline and the insight that Buffet possesses and my fundamental investment principles have evolved from a similar thought process.



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