Conscious Investing™
an investment revolution

Top 3 Mistakes Made by Warren Buffett Wannabes

Margie Baldock
Investment Education

Conscious Investing
www.conscious-investor.com/

The Top 3 Mistakes Made By Warren Buffett Wannabes

By Margaret Baldock
Research by Paul Shanahan

The *Oracle of Omaha*, as Warren Buffett has long been dubbed, just can't seem to put a foot wrong following his accurate prediction of the current stock market malaise.

But you don't have to have a very long memory to recall when most market "experts" were calling the oracle a "has been".

Just three years ago, at the height of the tech boom, Buffett's fixation on value and long-term business performance was deemed "irrelevant".

While Buffett's investing genius is undisputed, his true genius lies in his attitude. Buffett repeatedly points to his willingness to "*think independently*" as the single most important key to his success. He says,

> You can't do well in investments unless you think independently. And the truth is you're neither right nor wrong because people agree with you. You're right because your facts and your reasoning are right. In the end that's all that counts.

There is no doubt that learning how to make quality independent decisions is the single most important investment that any of us can make in our financial future.

Learning to invest wisely may not necessarily be easy, but for the small few willing to do it, will be hugely profitable.

Expecting to be able to invest like Warren Buffett overnight or without making a few mistakes long the way is simply unreasonable, and will only set you up for failure and disillusionment.

This article looks at the three most common mistakes investors make when trying to emulate Warren Buffett's investment strategies.

<u>1) Biggest Buffett Mistakes: Thinking that you and Buffett are in the same boat</u>

Being seriously rich has at least one major downside that the average private investor simply does not have to deal with.

The sheer size of Berkshire Hathaway means that Buffett faces the immensely difficult task of employing roughly $100 billion and producing better than index returns, consistently over time.

"Size is the anchor of performance," he said when discussing Berkshire Hathaway. "There is no question about it. It doesn't mean you can't do better than average as you get larger, but the margin shrinks."

And while Buffett's goal for Berkshire is to increase the company's economic value at 15% pa, he also says that if he had "just" $1 million to invest, that he could make 50% a year.

Why? Because the universe of stocks available for consideration would be so much larger than that which he can consider when he manages a behemoth like Berkshire[1].

<u>2) Biggest Buffett Mistakes: Mimicking Buffett's Investment Decisions:</u>

Buffett has long preached the idea of developing your own "circle of competence".

To blindly follow Buffett's movements (or anyone else for that matter) is perhaps the single greatest mistake made by Buffett fans.

In a talk at Columbia University in 1984, Warren Buffett discussed the influence of his mentor, Ben Graham on himself and other phenomenally successful investors such as Walter Schloss, Tom Knapp, Ed Anderson (founder of Tweedy Brown Partners), Bill Ruane (Sequoia Fund), Stan Perlmeter and Charlie Munger.

While each of these investors had been hugely successful, there was virtually no duplication in their portfolios holdings.

The single thing that each had in common was that they understood the difference between ***price*** and ***value.*** They all looked for discrepancies between the two but found them in very different places.

The key is that they all thought *independently* and therefore they did not need to hold the same stocks in order to achieve great success. In fact, it is highly likely that if they had attempted to imitate each other they would have failed simply because they would have lacked the courage of their convictions.

Mindless imitation may seem like the easy way to wealth, but financial freedom is the price you pay for it!

As Buffett says about Walter Schloss:

> ***He knows how to identify securities that sell at considerably less than their value to a private owner: And that's all he does. He owns many more stocks than I do and is far less interested in the underlying nature of the business; I don't seem to have very much influence on Walter. That's one of his strength's; no one has much influence on him.***

<u>3) Biggest Buffett Mistakes: Using the Discounted Cash Flow (DCF) valuation methodology:</u>

It may just be the greatest Buffett valuation debate: does he use DCFs or not? Here's the real truth: no one knows for sure. Even Charlie Munger says that he has never seen Buffett doing any DCF calculations. In any case, quite frankly who really cares?

One thing we know for sure. Buffett does not consider himself to be in the business of providing investment education. As valuations are at the very heart of Buffett's success, he clearly states that he has no intentions of revealing how he values businesses.

[1] Buffett's best decade ever was in the very early years of his career when his capital was limited, when he did in fact achieve a ten-year average annual growth rate of around 50%.

> *Despite our policy of candor, we will discuss our activities in marketable securities only to the extent legally required. Good investments are rare, valuable and subject to competitive appropriation just as good product or business acquisition ideas are. Therefore we normally will not talk about our investment ideas. — Warren Buffett, Letter to Shareholders, 2002*

Buffett has however referred to the intrinsic value of a business as “the discounted value of the cash that can be taken out of a business during its remaining life”.

While the theoretical intrinsic value of a business is indeed the net present value (NPV) of its future cash flows, calculating such a value is fraught with inherent difficulties.

For starters, a key input into NPV calculations is the growth rate out to *infinity*! Of course, this is complete nonsense. How you could ever verify that you were right. But even if we talk about five or ten years, most investors would have very little chance of forecasting this with any confidence or accuracy.

A second key input into the NPV calculation is a “discount rate” so that you can equate the future cash flows into today’s dollars.

As the discount rate by its nature must reflect the risk associated with the individual company, an important question to be able to answer is: which discount rate should you use? 9%, 10%, 11%?

You’d better be sure, because a small change in the inputs (the discount rate or growth rate) can result in vast variations in the final value that you assign to any company.

To understand more about the inherent instability of the commonly used NVP or DCF flow model, refer to Professor Price’s article *“Why Value Systems Have No Value”* below: www.conscious-investor.com/articles/articles/ar04value.asp.

The result of the instability of the DCF model is that virtually any valuation can be achieved.

So what is more important than the DCF model debate, is asking yourself whether you currently use a valuation methodology that:

1) you can fully understand,
2) that is based upon common sense principles (rather than theoretical concepts),
3) only requires you to forecast inputs that a reasonably intelligent, independently minded investor would be able to estimate with relative ease and confidence,
4) allows you to test the impact on your investment returns of different business performance (simulating worst case, most likely and best case scenarios), thereby allowing you to calculate a “margin of safety” in your decisions.

Conscious Investor® uses a methodology that was designed with the investor’s confidence, rather than some textbook theory, in mind.

Rather than estimating cash flows out to *infinity* and “discounting” these back to some theoretical value, Conscious Investor instead provides a “Forward Value” (FV) calculation through our “What If Analysis” screens.

The calculation starts with the premise that we want to know what a company's business performance will be over the next 5 or 10 years time. We then look at the current stock price, in relation to the future performance, to forecast a likely return that we can expect to achieve.

When doing your "What If" analysis in Conscious Investor, we suggest that you factor in minimal growth in earnings, and use a low Price Earnings Ratio. A figure that is at least the lowest in three years, or even longer if you seek a higher "margin of safety", is a good place to start. If, after factoring in minimal growth and a low Price Earnings Ratio, you can still expect to get a decent upfront return (say around 15%), then you're probably looking at a stock that can provide good value in relation to its asking price.

In short, perhaps you may never achieve the success of Buffett. But with a reasonable commitment to acquiring common sense knowledge, a desire for independent thinking, and a focus on businesses that you understand, you will be able to use Conscious Investor as a powerful tool to quickly identify immediate and obvious investment value.