The Warren Buffett Portfolio

Mastering the Power of the Focus Investment Strategy

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To Bob and Ruth Hagstrom,
who with love, patience, and support
allowed their son to find his own path.

Preface

With *The Warren Buffett Way,* my goal was to outline the investment tools, or tenets, that Warren Buffett employs to select common stocks, so that ultimately readers would be able to thoughtfully analyze a company and purchase its stock as Buffett would.

The book's remarkable success is reasonable proof that our work was helpful. With over 600,000 copies in print, including twelve foreign-language translations, I am confident the book has endured sufficient scrutiny by professional and individual investors as well as academicians and business owners. To date, feedback from readers and the media has been overwhelmingly positive. The book appears to have genuinely helped people invest more intelligently.

As I have said on many occasions, the success of *The Warren Buffett Way* is first and foremost a testament to Warren Buffett. His wit and integrity have charmed millions of people worldwide, and his intellect and investment record have, for years, mesmerized the professional investment community, me included. It is an unparalleled combination that makes Warren Buffett the single most popular role model in investing today.

This new book, *The Warren Buffett Portfolio,* is meant to be a companion, not a sequel, to *The Warren Buffett Way*. In the original work, I unwittingly passed lightly over two important areas: structure and cognition—or, in simpler terms, portfolio management and intellectual fortitude.

I now realize more powerfully than ever that achieving above-average returns is not only a matter of which stocks you pick but also how you structure your portfolio. To successfully navigate a focus portfolio, you need to acquire a higher-level understanding of price volatility and its effect on individual behavior, and you need a certain kind of personal temperament. All these ideas come together in *The Warren Buffett Portfolio*.

The two companion books fit together this way: *The Warren Buffett Way* gives you tools that help you pick common stocks wisely, and *The Warren Buffett Portfolio* shows you how to organize them into a focus portfolio and provides the intellectual framework for managing it.

Since writing *The Warren Buffett Way,* all of my investments have been made according to the tenets outlined in the book. Indeed, the Legg Mason Focus Trust, the mutual fund that I manage, is a laboratory example of the book's recommendations. To date, I am happy to report, the results have been very encouraging.

Over the past four years, in addition to gaining experience managing a focus portfolio, I have had the opportunity to learn several more valuable lessons, which I describe here. Buffett believes that it is very important to have a fundamental grasp of mathematics and probabilities, and that investors should understand the psychology of the market. He warns us against the dangers of relying on market forecasting. However, his tutelage has been limited in each of these areas. We have an ample body of work to analyze how he picks stocks, but Buffett's public statements describing probabilities, psychology, and forecasting are comparatively few.

This does not diminish the importance of the lessons; it simply means I have been forced to fill in the blank spaces with my own interpretations and the interpretations of others. In this pursuit, I have relied on mathematician Ed Thorp, PhD, to help me better understand probabilities; Charlie Munger, to help me appreciate the psychology of misjudgment; and Bill Miller, to educate me about the science of complex adaptive systems.

A few general comments about the structure of the book are in order. Imagine two large, not quite symmetrical segments, bracketed by an introductory chapter and a conclusion. The first chapter previews, in summary fashion, the concept of focus investing and its main elements. Chapters 2 through 5 constitute the first large segment. Taken together, they present both the academic and the statistical rationales for focus investing, and they explore the lessons to be learned from the experiences of well-known focus investors.

We are interested not only in the intellectual framework that supports focus investing but also in the behavior of focus portfolios in general. Unfortunately, until now, the historical database of focus portfolios has contained too few observations to draw any statistically meaningful conclusions. An exciting new body of research has the potential to change that.

For the past two years, Joan Lamm-Tennant, PhD, and I have conducted a research study on the theory and process of focus investing. In the study, we took an in-depth look at 3,000 focus portfolios over different time periods, and then compared the behavior of these portfolios to the sort of broadly diversified portfolios that today dominate mutual funds and institutional accounts. The results are formally presented in an academic monograph titled "Focus Investing: An Optimal Portfolio Strategy Alternative to Active versus Passive Management," and what we discovered is summarized, in nonacademic language, in Chapter 4.

In Chapters 6 through 8, the second large segment of the book, we turn our attention to other fields of study: mathematics, psychology, and the new science of complexity. You will find here the new ideas that I have learned from Ed Thorp, Charlie

Munger, and Bill Miller. Some people may think it strange that we are venturing into apparently unrelated areas. But I believe that without the understanding gained from these other disciplines, any attempt at focus investing will stumble.

Finally, Chapter 9 gives consolidated information about the characteristics of focus investors, along with clear guidance so that you can initiate a focus investment strategy for your own portfolio.

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WAYNE, PENNSYLVANIA
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One—
Focus Investing

Robert, we just focus on a few outstanding companies. We're focus investors.
—Warren Buffett

I remember that conversation with Warren Buffett as if it happened yesterday. It was for me a defining moment, for two reasons. First, it moved my thinking in a totally new direction; and second, it gave a name to an approach to portfolio management that I instinctively felt made wonderful sense but that our industry had long overlooked. That approach is what we now call focus investing, and it is the exact opposite of what most people imagine that experienced investors do.

Hollywood has given us a visual cliché of a money manager at work: talking into two phones at once, frantically taking notes while trying to keep an eye on jittery computer screens that blink and blip from all directions, slamming the keyboard whenever one of those computer blinks shows a minuscule drop in stock price.

Warren Buffett, the quintessential focus investor, is as far from that stereotype of frenzy as anything imaginable. The man whom many consider the world's greatest investor is usually described with words like "soft-spoken," "down-to-earth," and "grandfatherly." He moves with the clam that is born of great confidence, yet his accomplishments and his performance record are legendary. It is no accident that the entire investment industry pays close attention to what he does. If Buffett characterizes his approach as "focus investing," we would be wise to learn what that means and how it is done.

Focus investing is a remarkably simple idea, and yet, like most simple ideas, it rests on a complex foundation of interlocking concepts. If we hold the idea up to the light and look closely at all its facets, we find depth, substance, and solid thinking below the bright clarity of the surface.

In this book, we will look closely at these interlocking concepts, one at a time. For now, I hope merely to introduce you to the core notion of focus investing. The goal of this overview chapter mirrors the goal of the book: to give you a new way of thinking about investment decisions and managing investment portfolios. Fair warning: this new way is, in all likelihood, the opposite of what you have always been told about investing in the stock market. It is as far from the usual way of thinking about stocks as Warren Buffett is from that Hollywood cliché.

The essence of focus investing can be stated quite simply:

> Choose a few stocks that are likely to produce above-average returns over the long haul, concentrate the bulk of your investments in those stocks, and have the fortitude to hold steady during any short-term market gyrations.

No doubt that summary statement immediately raises all sorts of questions in your mind:

How do I identify those above-average stocks?
How many is "a few"?
What do you mean by "concentrate"?
How long must I hold?

And, saved for last:

Why should I do this?

The full answers to those questions are found in the subsequent chapters. Our work here is to construct an overview of the focus process, beginning with the very sensible question of why you should bother.

Portfolio Management Today: A Choice of Two

In its current state, portfolio management appears to be locked into a tug-of-war between two competing strategies: active portfolio management and index investing.

Active portfolio managers constantly buy and sell a great number of common stocks. Their job is to try to keep their clients satisfied, and that means consistently outperforming the market so that on any given day, if a client applies the obvious measuring stick—"How is my portfolio doing compared to the market overall?"—the answer is positive and the client leaves her money in the fund. To keep on top, active managers try to predict what will happen with stocks in the coming six months and continually churn the portfolio, hoping to take advantage of their predictions. On average, today's common stock mutual funds own more than one hundred stocks and generate turnover ratios of 80 percent.

Index investing, on the other hand, is a buy-and-hold passive approach. It involves assembling, and then holding, a broadly diversified portfolio of common stocks deliberately designed to mimic the behavior of a specific benchmark index, such as the Standard & Poor's 500 Price Index (S&P 500).

Compared to active management, index investing is somewhat new and far less common. Since the 1980s, when index funds fully came into their own as a legitimate alternative strategy, proponents of both approaches have waged combat to determine which one will ultimately yield the higher investment return. Active portfolio managers argue that, by virtue of their superior stock-picking skills, they can do better than any index. Index strategists, for their part, have recent history on their side. In a study that tracked results in a twenty-year period, from 1977 through 1997, the percentage of equity mutual funds that have been able to beat the S&P 500 dropped dramatically, from 50 percent in the early years to barely 25 percent in the last four years. Since 1997, the news is even worse. As of November 1998, 90 percent of actively managed funds were underperforming the market (averaging 14 percent *lower* than the S&P 500), which means that only 10 percent were doing better. [1]

Active portfolio management, as commonly practiced today, stands a very small chance of outperforming the S&P 500. Because they frenetically buy and sell hundreds of stocks each year, institutional money managers have, in a sense, become the market. Their basic theory is: Buy today whatever we predict can be sold soon at a profit, regardless of what it is. The fatal flaw in that logic is that, given the complex nature of the financial universe, predictions are impossible. (See Chapter 8 for a description of complex adaptive systems.) Further complicating this shaky theoretical foundation is the effect of the inherent costs that go with this high level of activity—costs that diminish the net returns to investors. When we factor in these costs, it becomes apparent that the active money management business has created its own downfall.

Indexing, because it does not trigger equivalent expenses, is better than actively managed portfolios in many respects. But even the best index fund, operating at its peak, will only net exactly the returns of the overall market. Index investors can do no worse than the market—and no better.

From the investor's point of view, the underlying attraction of both strategies is the same: minimize risk through diversification. By holding a large number of stocks representing many industries and many sectors of the market, investors hope to create a warm blanket of protection against the horrific loss that could occur if they had all their money in one arena that suffered some disaster. In a normal period (so the thinking goes), some stocks in a diversified fund will go down and others will go up, and let's keep our fingers crossed that the latter will compensate for the former. The chances get better, active managers believe, as the number of stocks in the portfolio grows; ten is better than one, and a hundred is better than ten.

An index fund, by definition, affords this kind of diversification if the index it mirrors is also diversified, as they usually are. The traditional stock mutual fund, with upward of a hundred stocks constantly in motion, also offers diversification.

We have all heard this mantra of *diversification* for so long, we have become intellectually numb to its inevitable consequence: mediocre results. Although it is true that active *and* index funds offer diversification, in general neither strategy will yield exceptional returns. These are the questions intelligent investors must ask themselves: Am I satisfied with average returns? Can I do better?

A New Choice

What does Warren Buffett say about this ongoing debate regarding index versus active strategy? Given these two particular choices, he would unhesitatingly pick indexing. Especially if he were thinking of investors with a very low tolerance for risk, and people who know very little about the economics of a business but still want to participate in the long-term benefits of investing in common stocks. "By periodically investing in an index fund," Buffett says in his inimitable style, "the know-nothing investor can actually outperform most investment professionals." [2]

Buffett, however, would be quick to point out that there is a third alternative, a very different kind of active portfolio strategy that significantly increases the odds of beating the index. That alternative is focus investing.

Focus Investing: The Big Picture

"Find Outstanding Companies"

Over the years, Warren Buffett has developed a way of choosing the companies he considers worthy places to put his money. His choice rests on a notion of great common sense: if the company itself is doing well and is managed by smart people, eventually its inherent value will be reflected in its stock price. Buffett thus devotes most of his attention not to tracking share price but to analyzing the economics of the underlying business and assessing its management.

This is not to suggest that analyzing the company—uncovering all the information that tells us its economic value—is particularly easy. It does indeed take some work. But Buffett has often remarked that doing this "homework" requires no more energy than is expended in trying to stay on top of the market, and the results are infinitely more useful.

The analytical process that Buffett uses involves checking each opportunity against a set of investment tenets, or fundamental principles. These tenets, presented in depth in *The Warren Buffett Way* and summarized on page 8, can be thought of as a kind of tool belt. Each individual tenet is one analytical tool, and, in the aggregate, they provide a method for isolating the companies with the best chance for high economic returns.

The Warren Buffett tenets, if followed closely, lead you inevitably to good companies that make sense for a focus portfolio. That is because you will have chosen companies with a long history of superior performance and a stable management, and that stability predicts a high probability of performing in the future as they have in the past. And that is the heart of focus investing: concentrating your investments in companies that have the highest probability of above-average performance.

Probability theory, which comes to us from the science of mathematics, is one of the underlying concepts that make up the rationale for focus investing. In Chapter 6, you will learn more about probability theory and how it applies to investing. For the moment, try the mental exercise of thinking of "good companies" as "high-probability events." Through your analysis, you have already identified companies with a good history and, therefore, good prospects for the future; now, take what you already know and think about it in a different way—in terms of probabilities.

"Less Is More"

Remember Buffett's advice to a "know-nothing" investor, to stay with index funds? What is more interesting for our purposes is what he said next:

Tenets of the Warren Buffett Way

Business Tenets

Is the business simple and understandable?

Does the business have a consistent operating history?

Does the business have favorable long-term prospects?

Management Tenets

Is management rational?

Is management candid with its shareholders?

Does management resist the institutional imperative?

Financial Tenets

Focus on return on equity, not earnings per share.

Calculate "owner earnings."

Look for companies with high profit margins.

For every dollar retained, make sure the company has created at least one dollar of market value.

Market Tenets

What is the value of the business?

Can the business be purchased at a significant discount to its value?

"If you are a know-something investor, able to understand business economics and to find five to ten sensibly priced companies that possess important long-term competitive advantages, conventional diversification [broadly based active portfolios] makes no sense for you." [3]

What's wrong with conventional diversification? For one thing, it greatly increases the chances that you will buy something you don't know enough about. "Know-something" investors, applying the Buffett tenets, would do better to focus their attention on just a few companies—"five to ten," Buffett suggests. Others who adhere to the focus philosophy have suggested smaller numbers, even as low as three; for the average investor, a legitimate case can be made for ten to fifteen. Thus, to the earlier question, How many is "a few"? the short answer is: No more than fifteen. More critical than determining the exact number is understanding the general concept behind it. Focus investing falls apart if it is applied to a large portfolio with dozens of stocks.

Warren Buffett often points to John Maynard Keynes, the British economist, as a source of his ideas. In 1934, Keynes wrote to a business associate: "It is a mistake to think one limits one's risks by spreading too much between enterprises about which one knows little and has no reason for special confidence. . . . One's knowledge and experience are definitely limited and there are seldom more than two or three enterprises at any given time in which I personally feel myself entitled to put full confidence."[4] Keynes's letter may be the first piece written about focus investing.

An even more profound influence was Philip Fisher, whose impact on Buffett's thinking has been duly noted. Fisher, a prominent investment counselor for nearly half a century, is the author of two important books: *Common Stocks and Uncommon Profits* and *Paths to Wealth Through Common Stocks*, both of which Buffett admires greatly.

Phil Fisher was known for his focus portfolios; he always said he preferred owning a small number of outstanding companies that he understood well to owning a large number of average ones, many of which he understood poorly. Fisher began his investment counseling business shortly after the 1929 stock market crash, and he remembers how important it was to produce good results. "Back then, there was no room for mistakes," he remembers. "I knew the more I understood about the company the better off I would be." [5] As a general rule, Fisher limited his portfolios to fewer than ten companies, of which three or four often represented 75 percent of the total investment.

"It never seems to occur to [investors], much less their advisors," he wrote in *Common Stocks* in 1958, "that buying a company without having sufficient knowledge of it may be even more dangerous than having inadequate diversification."[6] More than forty years later, Fisher, who today is ninety-one, has not changed his mind. "Great stocks are extremely hard to find," he told me. "If they weren't, then everyone would own them. I knew I wanted to own the best or none at all."[7]

Ken Fisher, the son of Phil Fisher, is also a successful money manager. He summarizes his father's philosophy this way: "My dad's investment approach is based on an unusual but insightful notion that less is more."[8]

"Put Big Bets on High-Probability Events"

Fisher's influence on Buffett can also be seen in his belief that when you encounter a strong opportunity, the only reasonable course is to make a large investment. Like all great investors, Fisher was very disciplined. In his drive to understand as much as possible about a company, he made countless field trips to visit companies he was interested in. If he liked what he saw, he did not hesitate to invest a significant amount of money in the company. Ken Fisher points out, "My dad saw what it meant to have a large position in something that paid off." [9]

Today, Warren Buffett echoes that thinking: "With each investment you make, you should have the courage and the conviction to place at least 10 percent of your net worth in that stock."[10]

You can see why Buffett says the ideal portfolio should contain no more than ten stocks, if each is to receive 10 percent. Yet focus investing is not a simple matter of finding ten good stocks and dividing your investment pool equally among them. Even though all the stocks in a focus portfolio are high-probability events, some will inevitably be higher than others and should be allocated a greater proportion of the investment.

Blackjack players understand this tactic intuitively: When the odds are strongly in your favor, put down a big bet. In the eyes of many pundits, investors and gamblers have much in common, perhaps because both draw from the same science: mathematics. Along with probability theory, mathematics provides another piece of the focus investing rationale: the Kelly Optimization Model. The Kelly model is represented in a formula that uses probability to calculate optimization—in this case, optimal investment proportion. (The model, along with the fascinating story of how it was originally derived, is presented in Chapter 6.)

I cannot say with certainty whether Warren Buffett had optimization theory in mind when he bought American Express stock in late 1963, but the purchase is a clear example of the concept—and of Buffett's boldness. During the 1950s and 1960s, Buffett served as general partner in a limited investment partnership in Omaha, Nebraska, where he still lives. The partnership was allowed to take large positions in the portfolio when profitable opportunities arose, and, in 1963, one such opportunity came along.