

Hagstrom, Robert G. – The Warren Buffett Way

John Wiley & Sons, 2nd ed 2005, [Equity Investing] Grade ★★★★★

This is probably the most widely read book on the way Warren Buffett invests. And there are good reasons why. The Warren Buffett Way is a perfect introduction to this subject for the targeted audience of laymen and recent professionals. Even very seasoned investors will be reminded of some of the important philosophical thoughts behind Buffett's investment process, and this makes reading the book worthwhile.

Robert G. Hagstrom began his professional career as an investment broker at Legg Mason. At the orientation on the first day, he received a copy of the *Intelligent Investor* by Graham and the previous year's annual report from Berkshire Hathaway. He got hooked. He decided to learn everything about the world's greatest investor, Warren Buffett, in order to help his new clients improve their returns. His reading, understanding and implementing eventually made him write this book. I wish all brokers were like this. Nowadays he is a successful portfolio manager using the same concepts, working with legendary value investor Bill Miller.

The book's content and outline is no surprise for the faithful Buffett follower. It begins with some of the learning Buffett got from his role models and friends: Ben Graham (Margin-of-Safety), Philip Fisher (high Return on Equity), John Burr Williams ("A cow for her milk; a hen for her eggs; and a stock, by heck, for her dividends") and long-time partner Charlie Munger (eg. avoid complexity).

We also get a brief overview on the early days of Berkshire Hathaway, the important cash generating insurance business, and the background as to why Buffett believes in "buying a business" and not just stocks. He doesn't even have a quoting machine.

The main part of the book is about Buffett's investment guidelines according to Hagstrom. Together, they create a strong, disciplined investment process for the long-term investor that

focuses on absolute return and is able to stand the pressure of sometimes quite high volatility and occasionally vastly negative relative return to a benchmark.

Buffett's business tenets are to answer these three questions: Is the business simple and understandable? Does the business have a consistent operating history? Does the business have favorable long-term prospects? I believe these questions are the key to Buffett's success. Without major failures the return increases dramatically.

Management is extremely important for Buffett, a lesson learned from Fisher. He is looking for these traits: Is management rational? Is management candid with the shareholders (if you have missed Buffett's letters to shareholders, I envy you a great experience)? Does management resist the institutional imperative? This last question was probably the most fascinating for me re-reading the book after roughly 15 years. It is amazing how often managements copy currently trendy actions from competitors even though it's a bad risk-reward proposition. Avoiding criticism today is preferred to long-term value creation.

For his financial tenets, Buffett ponders long-term averages instead of some impressive yearly results. According to Hagstrom, he focuses on return on equity, not earnings per share. He calculates "owner earnings" to get a true reflection of value. He looks for companies with high profit margins. And he analyzes if, for every dollar retained, the company has created at least a dollar of market value.

Sometimes, when "Mr Market" is stressed, value and price differ. Buffett's value tenets are simple, but not easy to implement: Determine the value of the business and buy only when the price is right – when the business is selling at a significant discount to its value. Finally, we get Buffett's thoughts on portfolio management: Stay focused! A diversified portfolio is a divided mind...

Michael Persson, October 1, 2012