

# THE MANUAL OF IDEAS

THE PROVEN FRAMEWORK FOR FINDING  
THE BEST VALUE INVESTMENTS

JOHN MIHALJEVIC

FOREWORD BY THOMAS S. GAYNER



WILEY



# The Manual of Ideas



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*The Proven Framework  
for Finding the Best  
Value Investments*

**JOHN MIHALJEVIC**

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*To Mark,  
whose courage humbles me*





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# Foreword

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When John asked me to write the foreword to his book, I was flattered and honored and immediately agreed to do so. I agreed because I respect John's work and deeply appreciate the intellectual interchange and things I have learned from reading his *Manual of Ideas* periodicals over the years.

John brings a spirit of inquiry to his work and displays a true thirst for knowledge and understanding in his quest to be a better investor. More importantly, and very graciously, he doesn't keep it all to himself. He shares his thoughts and acts as a wonderful role model by showing us how he learns by interacting with other intelligent and dedicated investors.

As John shows us how he learns, we can figure out how to become better learners ourselves.

He also shares some of his life story and how he came to be in his present circumstances. After you read that section, I think you will agree that the quest for learning and knowledge, and creativity, defines much of what we are (and should be) as human beings.

There is a true spirit of humility in John's work. He understands that there are multiple ways to think about investing and many different approaches to gaining understanding about what a business is worth and how that might change in the future. He also understands that those answers may be different in different environments and for different amounts to invest.

As an investor, I find the single most valuable thing that I do is to read. I've been a lifelong reader and I thank my parents for instilling that into me from my earliest memories. As Charlie Munger once noted, one of the best investments you can make is buying a book. He went on to note that for just a few dollars, you

get man-years of an author's life that went into producing that book for you. I couldn't agree more.

I recommend John's book as it provides insights and models and methods to systematically think about the craft of investing. While all of us seeking to be good value based investors have different tools and approaches we bring to the task, we can and should, always continue to learn and adapt and improve our work.

This book helps you do just that. Each chapter provides specific examples and discussions of the ways that successful investors approach their work. Successful investing is hard and lonely work. All of the evidence and documentation you can find and demonstrate relates to the past. Your returns though, come in the future, and the future is a paradox of things that are similar to what they were in the past, and different at the same time.

Our challenge as investors is to sort out which is which. Reading, studying, and thinking about the concepts that John lays out in this book will help you with that task.

I hope that you enjoy the challenge!

Thomas S. Gayner  
President and Chief Investment Officer  
Markel Corporation

# Preface

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For the solitary endeavor that value investing can be at times, it has also enriched my life with many friendships and new experiences borne out of those friendships. The value investing community is diverse, vibrant, and global. I am grateful to have been deeply involved with VALUEx Zurich/Klosters, the annual gathering of value investors; ValueConferences, the series of online idea conferences for value investors; and *The Manual of Ideas*, the idea-oriented monthly research publication.

Warren Buffett's spectacularly successful investment philosophy has found devoted followers on every continent and in virtually every country. Many of them have used their special talents, cultural sensibilities, and unique circumstances to succeed at their own distinct brands of value investing, including Mohnish Pabrai in the United States, Prem Watsa in Canada, Massimo Fuggetta in the United Kingdom, Guy Spier in Switzerland, François Badelon in France, Francisco García Paramés in Spain, Ciccio Azzollini in Italy, Jochen Wermuth in Russia, Rahul Saraogi in India, Christopher Swasbrook in New Zealand, and Shuhei Abe in Japan.

We have interviewed more than 100 fund managers across the globe in preparation for this book, seeking their wisdom on the topic of idea generation. As such, the following pages feature what I've learned as managing editor of *The Manual of Ideas* and provide a glimpse into the idea-generation process of some of the most successful investors of our times. We have interviewed heavyweights like Chuck Akre, Charles de Vaulx, Jean-Marie Eveillard, Tom Gayner, Joel Greenblatt, Howard Marks, Mohnish Pabrai, Tom Russo, and Guy Spier. We have also gained insights from speaking with up-and-coming fund managers poised to comprise the next generation of value superinvestors. Many of these in-depth

interviews are available as free videos on the YouTube channels manualofideas and valueconferences.

In Chapter 1, we focus on the mind-set of a value investor, distinguishing it from that of market participants who too often view stocks as squiggly lines on a computer screen and who cannot help but indulge in Keynes's beauty contest. In Chapters 2 through 10, we dissect the value investment idea-generation process, structuring the discussion around nine categories of value ideas: Graham-style deep value, Greenblatt-style magic formula, small-cap value, sum-of-the-parts or hidden value, superinvestor favorites, jockey stocks, special situations, equity stubs, and international value investments. While quite a bit of overlap exists between some of these categories, we approach ideas in each bucket slightly differently. We examine the uses and misuses of each approach to idea generation, provide insights into the screening process, look beyond quantitative screening methods, and lay out the key points of inquiry in each case. The result is both a practical guide to idea generation and an examination of core value investing principles.

It would be impossible to cite everyone who has influenced my thinking on the subject of investing. A few mentors stand out, however, starting with the late professor James Tobin, Nobel laureate in economics, who was incredibly generous in letting me access his thinking on risk and asset allocation during my time as his research assistant at Yale. David Swensen, Yale's chief investment officer, helped me advance along the path of value-oriented investing, as his seminar brought together students and fund managers in a unique setting. Guy Spier, chief executive officer of Aquamarine Capital, has shared his considerable wisdom on investing and life with me. Warren Buffett, Charlie Munger, Joel Greenblatt, Tom Gayner, and Mohnish Pabrai are role models from whom I have learned mostly through their writings or interactions via *The Manual of Ideas* and ValueConferences. I consider them key influences and thank them for sharing their wisdom with the value investing community.

On a personal note, I'd like to thank my brother and partner at *The Manual of Ideas*, Oliver Mihaljevic, who not only is a great investor in his own right but also displays a unique commitment to value investing as a discipline that deserves a more prominent place in finance curricula. Oliver constantly seeks new insights



into the art of investing, and I have been fortunate to benefit from his inquiries. My wife, Branka, has been tremendously supportive throughout the process of writing this book, alleviating me of many duties that might have interfered with its publication. My kids, Mark, Mia, and Mateo, have provided not only a reason for persisting in this endeavor but also much-needed (sometimes too much!) distraction. Enjoy!

John Mihaljevic



# CHAPTER 1

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## A Highly Personal Endeavor

*What Do You Want to Own?*

*Man the living creature, the creating individual, is always more important than any established style or system.*

—Bruce Lee

The stock market is a curious place because everyone participating in it is loosely interested in the same thing—making money. Still, there is no uniform path to achieving this rather uniform goal. You may be only a few mouse clicks away from purchasing the popular book *The Warren Buffett Way*,<sup>1</sup> but only one man has ever truly followed the path of Warren Buffett. In investing, it is hard enough to succeed as an original; as a copycat, it is virtually impossible. Each of us must carve out a *personal* way to investment success, even if you are a *professional* investor.

That said, great investors like Ben Graham, Seth Klarman, and Warren Buffett have much to teach us, and we have much to gain by learning from them. One of the masters' key teachings is as important as it is simple: A share of stock represents a share in the ownership of a business. A stock exchange simply provides a convenient means of exchanging your ownership for cash. Without an exchange, your ownership of a business would not change. The ability to sell your stake would be negatively affected, but you

would still be able to do it, just as you can sell your car or house if you decide to do so.

Unfortunately, when we actually start investing, we are inevitably bombarded with distractions that make it easy to forget the essence of stock ownership. These titillations include the fast-moving ticker tape on CNBC, the seemingly omniscient talking heads, the polished corporate press releases, stock price charts that are consolidating or breaking out, analyst estimates being beaten, and stock prices hitting new highs. It feels a little like living in the world of Curious George, the lovable monkey for whom it is “easy to forget” the well-intentioned advice of his friend. My son loves Curious George stories, because as surely as George gets into trouble, he finds a way out of trouble. The latter doesn’t always hold true for investors in the stock market.

## Give Your Money to Warren Buffett, or Invest It Yourself?

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I still remember the day I had saved the princely sum of \$100,000. I had worked as a research analyst for San Francisco investment bank Thomas Weisel Partners for a couple of years and in 2003 had managed to put aside what I considered to be an amount that made me a free man. Freedom, I reasoned, was only possible if one did not have to work to survive; otherwise, one was forced into a form of servitude that involved trading time for food and shelter. With the money saved, I could quit my job, move to a place like Thailand, and live on interest income. While I wisely chose not to exercise my freedom option, I still had to find something to do with the money.

I dismissed an investment in mutual funds quite quickly because I was familiar with findings that the vast majority of mutual funds underperformed the market indices on an after-fee basis.<sup>2</sup> I also became aware of the oft-neglected but crucial fact that investors tended to add capital to funds after a period of good performance and withdraw capital after a period of bad performance. This caused investors’ *actual* results to lag significantly behind the funds’ *reported* results. Fund prospectuses show time-weighted returns, but investors in those funds reap the typically lower capital-weighted returns. A classic example of this phenomenon is the Munder NetNet Fund, an Internet fund that lost investors billions

of dollars from 1997 through 2002. Despite the losses, the fund reported a *positive* compounded annual return of 2.15 percent for the period. The reason? The fund managed little money when it was doing well in the late 1990s. Then, just as billions in new capital poured in, the fund embarked on a debilitating three-year losing streak.<sup>3</sup> Although I had felt immune to the temptation to buy after a strong run in the market and to sell after a sharp decline, I thought this temptation would be easier to resist if I knew exactly what I owned and why I owned it. Owning shares in a mutual fund meant trusting the fund manager to pick the right investments. Trust tends to erode after a period of losses.

Mutual funds and lower-cost index funds should not be entirely dismissed, however, as they offer an acceptable alternative for those wishing to delegate investment decision making to someone else. Value mutual funds such as Bruce Berkowitz's Fairholme Fund or Mason Hawkins's Longleaf Funds are legitimate choices for many individual investors. High-net-worth investors and institutions enjoy the additional option of investing in hedge funds, but few of those funds deserve their typically steep management and performance fees. Warren Buffett critiqued the hedge fund fee structure in his 2006 letter to shareholders: "It's a lopsided system whereby 2 percent of your principal is paid each year to the manager even if he accomplishes nothing—or, for that matter, loses you a bundle—and, additionally, 20 percent of your profit is paid to him if he succeeds, even if his success is due simply to a rising tide. For example, a manager who achieves a gross return of 10 percent in a year will keep 3.6 percentage points—two points off the top plus 20 percent of the residual eight points—leaving only 6.4 percentage points for his investors."<sup>4</sup>

A small minority of value-oriented hedge fund managers have chosen to side with Buffett on the fee issue, offering investors a structure similar to that of the limited partnerships Buffett managed in the 1960s. Buffett charged no management fee and a performance fee only on returns in excess of an annual hurdle rate. The pioneers in this small but growing movement include Guy Spier of Zurich, Switzerland-based Aquamarine Capital Management and Mohnish Pabrai of Irvine, California-based Pabrai Investment Funds. These types of funds bestow a decisive advantage, *ceteris paribus*, on long-term investors. Table 1.1 shows the advantages of an investor-friendly fee structure.

**TABLE 1.1** Effect of Fees on the Future Wealth of a Hedge Fund Investor

	<b>Typical Hedge Fund Fee Structure: "2 and 20"</b>		<b>Buffett Partnership-Style Fee Structure</b>	
	<b>Management fee: 2%</b>		<b>Management fee: 0%</b>	
	<b>Performance fee: 20%</b>		<b>Performance fee: 20%</b>	
	<b>Annual hurdle rate: 0%</b>		<b>Annual hurdle rate: 6%</b>	
Assumed gross return	5.0%	10.0%	5.0%	10.0%
Resulting net return	2.4%	6.4%	5.0%	9.2%
Gross value of \$1 million				
... after 10 years	\$1,628,895	\$2,593,742	\$1,628,895	\$2,593,742
... after 20 years	2,653,298	6,727,500	2,653,298	6,727,500
... after 30 years	4,321,942	17,449,402	4,321,942	17,449,402
Net value of \$1 million				
... after 10 years	\$1,267,651	\$1,859,586	\$1,628,895	\$2,411,162
... after 20 years	1,606,938	3,458,060	2,653,298	5,813,702
... after 30 years	2,037,036	6,430,561	4,321,942	14,017,777
Value lost due to fees				
... after 10 years	\$361,244	\$734,156	\$0	\$182,580
... after 20 years	1,046,360	3,269,440	0	913,798
... after 30 years	2,284,906	11,018,842	0	3,431,625

I also considered investing my savings in one of a handful of public companies that operate as low-cost yet high-quality investment vehicles. Berkshire Hathaway pays Warren Buffett an annual salary of \$100,000 for arguably the finest capital allocation skills in the world. Buffett receives no bonus, no stock options, and no restricted stock, let alone hedge-fund-style performance fees.<sup>5</sup> It certainly seems like investors considering an investment in a highly prized hedge fund should first convince themselves that their prospective fund manager can beat Buffett. Doing this on a pre-fee basis is hard enough; on an after-fee basis, the odds diminish considerably. Of course, buying a share of Berkshire is not quite

associated with the same level of privilege and exclusivity as being accepted into a secretive hedge fund.

Berkshire is not the only public holding company with shareholder-friendly and astute management. Alternatives include Brookfield Asset Management, Fairfax Financial, Leucadia National, Loews Companies, Markel Corporation, and White Mountains Insurance. While these companies meet Buffett-style compensation criteria, some public investment vehicles have married hedge-fund-style compensation with a value investment approach. Examples include Greenlight Capital Re and Biglari Holdings. These hedge funds in disguise may ultimately deliver satisfactory performance to their common shareholders, but they are unlikely to exceed the long-term after-fee returns of a company like Markel, which marries superior investment management with low implied fees.

In light of the exceptional long-term investment results and low fees of companies like Berkshire and Markel, it may be irrational for any long-term investor to manage his or her own portfolio of stocks. Professional fund managers have a slight conflict of interest in this regard. Their livelihood depends rather directly on convincing their clients that the past performance of Berkshire or Markel is no indication of future results. Luckily for them, securities regulators play along with this notion, thereby doing their part in encouraging a constant flow of new entrants into the lucrative fund management business.

Rest assured, we won't judge too harshly those who choose to manage their own equity investments. After all, that is precisely what I did with my savings in 2003 and have done ever since. You could say that underlying my decision has been remarkable folly, but here are a few justifications for the do-it-yourself approach: First, investment holding companies like Berkshire and Markel are generally not available for purchase at net asset value, implying that some recognition of skill is already reflected in their market price. While over time the returns to shareholders will converge with internally generated returns on capital, the gap is accentuated in the case of shorter holding periods or large initial premiums paid over net asset value. Even for a company like Berkshire, there is a market price at which an investment becomes no longer attractive.

In addition, one of the trappings of investment success is growth of assets under management. Few fund managers limit their assets,

and this is even rarer among public vehicles. Buffett started investing less than \$1 million six decades ago. Today he oversees a company with more than \$200 billion in market value. If Buffett wanted to invest \$2 billion, a mere 1 percent of Berkshire's quoted value, into one company, he could not choose a company with a market value of \$200 million. He would likely need to find a company quoted at \$20 billion, unless he negotiated an acquisition of the entire business. Buffett is one of few large capital allocators who readily admit that size hurts performance. Many others evolve their view, perhaps not surprisingly, as their assets under management grow. Arguments include greater access to management, an ability to structure private deals, and the spreading of costs over a large asset base. Trust Buffett that these advantages pale in comparison with the disadvantage of a diminished set of available investments. If you manage \$1 million or even \$100 million, investing in companies that are too small for the superinvestors offers an opportunity for outperformance. Buffett agrees: "If I was running \$1 million today, or \$10 million for that matter, I'd be fully invested. Anyone who says that size does not hurt investment performance is selling. The highest rates of return I've ever achieved were in the 1950s. I killed the Dow. You ought to see the numbers. But I was investing peanuts then. It's a huge structural advantage not to have a lot of money. I think I could make you 50% a year on \$1 million. No, I know I could. I guarantee that."<sup>6</sup> The corollary: When small investors commit capital to megacaps such as Exxon Mobil or Apple, they willingly surrender a key structural advantage: the ability to invest in small companies.

Echoing Buffett's sentiments on the unique advantages of a small investable asset base, Eric Khrom, managing partner of Khrom Capital Management, describes the business rationale he articulated to his partners early on: "The fact that we are starting off so small will allow me to fish in very small pond where the big fishermen can't go. So although I'm a one man shop, you don't have to picture me competing with shops that are much larger than me, because they can't look at the things I look at anyway. We will be looking at the much smaller micro caps, where there are a lot of inefficiencies. . . ."<sup>7</sup>

The last argument for choosing our own equity investments leads to the concept of capital allocation. Contrary to the increasingly popular view that the stock market is little more than a glorified casino, the market is supposed to foster the allocation of capital



to productive uses in a capitalist economy. Businesses that add value to their customers while earning acceptable returns on invested capital should be able to raise capital for expansion, and businesses that earn insufficient returns on capital should fail to attract funding. A properly functioning market thereby assists the process of wealth creation, accelerating the growth in savings, investment, and GDP. If the role of the market is to allocate capital to productive uses, it becomes clear that a few dozen top investors cannot do the job by themselves. There are simply too many businesses to be evaluated. By doing the work the superinvestors must forgo due to limited bandwidth, we put ourselves in a position to earn the just reward of good investment performance. This idea of capital allocation ties in with the previous point regarding our ability to invest in companies that are too small for the superinvestors. We may safely assume that Buffett and the others will allocate capital to mega-caps such as Coca-Cola, if those companies deserve the money. On the other hand, companies such as Strayer Education and Harvest Natural Resources may be left without capital even if they can put it to productive use. Smaller investors can fill this void and make money, provided that they make the right capital allocation judgments.

## Cast Yourself in the Role of Capital Allocator

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It is little surprise that the world's richest investor is a capital allocator rather than a trend follower, thematic investor, or day trader. Buffett is famous for his buy-and-hold strategy, which has been the hallmark of Berkshire's portfolio investments and outright purchases of businesses. Buffett looks to the underlying businesses rather than stock certificates to deliver superior compounding of capital over the long term. Buying businesses cheaply has not generated his long-term returns—it has merely accentuated them.

Buffett raised eyebrows in the investment community many years ago when he bought Coca-Cola at a mid-teens multiple of earnings. Most value investors could not understand why Buffett considered it a bargain purchase. Buffett was allocating capital to a superior business at a fair price. He knew that Coca-Cola would compound the capital employed in the business at a high rate for a long time to come. Buffett did not need P/E multiple expansion to make the investment in Coca-Cola pay off.

Similarly, famed value investor Joel Greenblatt paid roughly 20 times earnings for Moody's when it went public in 2000. Greenblatt was allocating capital to a superior business, one that could grow earnings at a high rate without requiring additional capital, thereby freeing up large amounts of cash for share repurchases. Despite trading at a relatively high earnings multiple at the time of the initial public offering (IPO), Moody's shares more than quintupled in the subsequent six years. Of course, the company ran into major trouble when the U.S. housing bubble burst a few years ago. Despite the steep decline, Moody's traded at \$48 per share in early 2013, up from a comparable price of \$12.65 per share the day it was spun off from Dun & Bradstreet in October 2000.

### Role versus Objective: A Subtle but Important Distinction

Our role in the stock market may at first glance seem like a trivial issue. It is hardly a secret that rational investors seek to maximize risk-adjusted after-tax returns on invested capital. What is our role, therefore, if not to make the most money by identifying investments that will increase in price? This question is misplaced because it confuses objective (making money) and role.

We typically view our role in the market as insignificant. While most investors do have a negligible impact on the overall market, the accompanying small fish mind-set does not lend itself to successful investing. Even when I invested a tiny amount of money, I found it helpful to adopt the mind-set of chief capital allocator. I imagined my role as distributing the world's financial capital to activities that would generate the highest returns on capital.

Consider the following subtle difference in how investors may perceive their portfolios in relation to the available investment opportunities. Many of us inappropriately consider the scale of our portfolio ahead of the scale of potential investments. To illustrate this, imagine we wanted to invest \$100,000 in one of the stocks in Table 1.2 in late 2001.

When selecting a company from this list, we might analyze financial statements and consider various valuation measures. But even before embarking on a detailed analysis, some of us may think, "I have \$100,000 to invest, which will buy me a tiny stake in one the above companies. It looks like I can buy a few thousand

**TABLE 1.2** “Mind-Set A”—Selected Investment Opportunities, November 2001<sup>8</sup>

Ticker	Company	Stock Price	Market Value	\$100,000 Buys . . .
AET	Aetna	\$30.52	\$4.4 billion	3,277 shares
DAL	Delta Air Lines	29.31	3.6 billion	3,412 shares
F	Ford Motor	17.88	32.4 billion	5,593 shares
GM	General Motors	47.69	26.5 billion	2,097 shares
LMT	Lockheed Martin	45.01	19.8 billion	2,222 shares
NYT	New York Times	45.15	6.8 billion	2,215 shares
TIF	Tiffany & Co.	29.17	4.3 billion	3,428 shares
TM	Toyota Motor	53.71	99.0 billion	1,862 shares

shares of any of these stocks” (“mind-set a”). Without realizing it, we are committing the fallacy of considering the scale of our portfolio ahead of the scale of potential investments.

On the flip side, if we adopted an asset allocator’s mind-set, we might ask, “If I could buy one of the above companies, which would I choose?” This question focuses attention on the relative scale of the potential investments rather than the size of our portfolio. By applying this mind-set even before embarking on in-depth analysis of the various companies, we might make the observation shown in Table 1.3.

Toyota alone was valued more highly than all the companies on the left combined (based on market value rather than enterprise value, which in this case would have been a more appropriate measure). The investor with mind-set b might wonder: “Would I rather own Toyota or Aetna, Delta, Ford, GM, Lockheed Martin, the *New York Times*, and Tiffany combined?” While after careful analysis the answer might indeed be Toyota, it is obvious that we would need well-founded reasons for that choice. Had we kept a small fish mentality, however, we might have completely missed this issue of relative scale and invested in Toyota, ignorant of the severity of the implied relative value bet.

In Table 1.4, we revisit the previous comparison as of late 2004.

As a comparison of the market values shows, Toyota outperformed a portfolio of the companies on the left over the three-year

**TABLE 1.3** "Mind-Set B"—Selected Investment Opportunities, November 2001

<b>Ticker</b>	<b>Company</b>	<b>Market Value</b>	<b>Ticker</b>	<b>Company</b>	<b>Market Value</b>
AET	Aetna	\$4.4 billion	TM	Toyota Motor	\$99.0 billion
DAL	Delta Air Lines	3.6 billion			
F	Ford Motor	32.4 billion			
GM	General Motors	26.5 billion			
LMT	Lockheed Martin	19.8 billion			
NYT	New York Times	6.8 billion			
TIF	Tiffany & Co.	4.3 billion			
		<u>\$97.8 billion</u>			<u>\$99.0 billion</u>

**TABLE 1.4** "Mind-Set B"—Selected Investment Opportunities, October 2004<sup>9</sup>

<b>Ticker</b>	<b>Company</b>	<b>Market Value</b>	<b>Ticker</b>	<b>Company</b>	<b>Market Value</b>
AET	Aetna	\$12.8 billion	TM	Toyota Motor	\$125.3 billion
DAL	Delta Air Lines	0.4 billion			
F	Ford Motor	23.7 billion			
GM	General Motors	21.4 billion			
LMT	Lockheed Martin	23.8 billion			
NYT	New York Times	5.7 billion			
TIF	Tiffany & Co.	4.1 billion			
		<u>\$91.9 billion</u>			<u>\$125.3 billion</u>

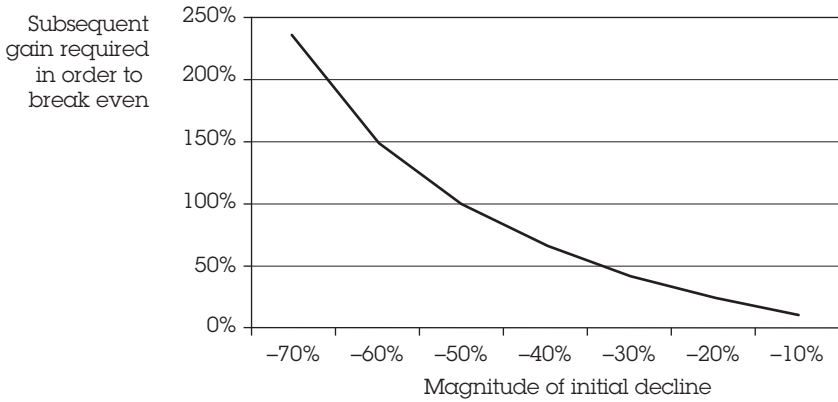
period ending in late 2004.<sup>10</sup> While this may come as a surprise, it simply means that mind-set b is not a sufficient condition for investment success: Good decision making requires thorough analysis of underlying fundamentals. (Giving the previous table another thought, it is interesting that, in theory, by selling short all of Toyota in late 2004, we could have bought not only the companies on the left but also 93 percent of McDonald's.)

## The Buck Stops Here

Once I had put aside my small fish mentality and embraced a capital allocator's mind-set, I started making better investment decisions. I found it easier to conclude, for example, that auto companies might not make good investments despite their recognized brands, large sales, and low P/E ratios. The capital allocator mind-set helped me realize I did not have to pick a winner in the auto industry when many companies outside the auto industry had better business models and were available at reasonable prices.

The new mind-set also raised the hurdle for investments in unprofitable companies because I knew intuitively that I would be forgoing current profits and the reinvestment of those profits in expectation of a future windfall. This seemed a rather speculative proposition. Many market participants, especially growth investors, exhibit a high tolerance for money-losing companies. An even more common trait is a willingness to ignore nonrecurring charges, even though such expenses reduce book value in the same way as recurring expenses. While no one would buy shares in a money-losing company unless he or she believed in a profitable future or in a favorable sale or liquidation, it seems that many investors' tolerance for losses is exaggerated by the subconscious reassurance that their investment amount is limited and they cannot be forced to commit more capital to a company even if it continues to lose money. Though our exposure is indeed legally limited to the initial investment, any impression that someone else will take care of a company's losses is an illusion:

- If other investors end up funding the losses of a company we own, they will either (1) dilute our interest or (2), if they lend money to the company, increase its interest expense and leverage. Both scenarios are blows to our prospects for a decent return on investment.
- If the company is able to fund losses with the liquidity available on the balance sheet, our percentage stake will not get diluted, but book value per share will decline. As Figure 1.1 shows, the impact of losses, whether recurring or not, on book value is perverse because, for example, a 20 percent drop in book value requires a 25 percent subsequent increase just to offset the decline.



**FIGURE 1.1** The Perverse Impact of Losses—Subsequent Gain Required to Break Even

Source: *The Manual of Ideas*.

Perhaps most important, the capital allocator mind-set enabled me to draw a sharp distinction between value and price, echoing Ben Graham’s teaching, “Price is what you pay; value is what you get.”<sup>11</sup> If I directed the allocation of the world’s capital, I would not be able to rely on the market to bail me out of bad decisions. The greater fool theory of someone buying my shares at a higher price breaks down if the buck stops with me. Successful long-term investors believe their return will come from the investee company’s return on equity rather than from sales of stock. This mind-set produces a very different process of estimating value than if we rely on the market to establish value and then try to gauge whether a company is likely to beat or miss quarterly earnings estimates.

Acting as a capital allocator rather than a speculator or trader required tremendous discipline at first, as I sometimes felt the temptation to outsmart other investors by betting that an earnings report would beat consensus estimates or an acquisition rumor would prove correct. Trading on such tenuous propositions required tacit agreement with the market’s underlying valuation of a business, as I would have been betting on an incremental change in the stock price and not necessarily buying a fundamentally undervalued business. I learned that self-restraint was crucial, as buying an overvalued company in expectation of positive news could backfire. There is simply no way to know how an overvalued stock will react to an apparent earnings beat. Investors may be