

Investment Philosophy of Warren E. Buffett vs Principle and Theory of Finance

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บทคัดย่อ

บทความนี้ศึกษาถึงปรัชญาการลงทุนของวอร์เรน อี บัฟเฟตท์ และเปรียบเทียบปรัชญาดังกล่าวกับแนวคิดและทฤษฎีทางการเงิน ทั้งนี้ปรัชญาการลงทุนของบัฟเฟตท์ ได้แก่ การใช้ข้อมูลเชิงเศรษฐศาสตร์ (ไม่ใช่ข้อมูลทางบัญชี) การคำนึงถึงต้นทุนค่าเสียโอกาส ค่าของเงินตามเวลา การเพิ่มมูลค่าให้กิจการ และการลดความขัดแย้งระหว่างผู้บริหารกับเจ้าของ ซึ่งปรัชญานี้มีความเหมือนแนวคิดและทฤษฎีทางการเงินในแง่การใช้หลักการของการเพิ่มมูลค่าทางเศรษฐศาสตร์ งบประมาณเงินทุน มูลค่าที่แท้จริง และการมีธรรมาภิบาล อย่างไรก็ตามปรัชญานี้ต่างจากแนวคิดและทฤษฎีทางการเงินตรงที่ใช้ข้อตรรกะผลตอบแทนที่ไม่มีความเสี่ยงในการคิดลดกระแสเงิน และการไม่เห็นด้วยกับสมมติฐานของตลาดทุนที่มีประสิทธิภาพ

คำสำคัญ: ปรัชญาการลงทุน วอร์เรน อี บัฟเฟตท์ แนวคิดและทฤษฎีทางการเงิน

Abstract

This paper explores the investment philosophy of Warren E. Buffett and compares his investment philosophy to the principle and theory of finance. Buffett's investment philosophy comprises applying economic information, not accounting information; taking into account the opportunity cost; focusing on the time value of money, wealth creation

and the alignment of agency problems; and investing on the basis of information and analysis. Similar to the principle and theory of finance, Buffett employs the concepts of economic value added (EVA), capital budgeting, intrinsic value, and corporate governance. Dissimilar to the principle and theory of finance, Buffett uses a risk-free discount rate to evaluate cash flows and disagrees with the efficient capital market hypothesis (EMH).

Keywords: Investment philosophy, Warren E. Buffett, Principle and theory of finance

Introduction

Warren Edward Buffett, who made most of his money from investments, is the world's second-richest man. He was born on August 30, 1930 to his father Howard, a stockbroker-turned-Congressman. Warren Buffett, for the first time, purchased stocks at the age of eleven. From this trading experience, he learned one of the basic lessons of investing: patience is a virtue.

Warren Buffett earned his bachelor's degree from the University of Nebraska-Lincoln and his master's degree from Columbia University. During his graduate study, Warren learned profound investment principles, especially the principle of "intrinsic" business value, from Ben Graham, who wrote *Security Analysis* and *The Intelligent Investor* books. Warren also worked for Ben Graham. It was during this time that the difference between the Graham and Buffett philosophies began to emerge. Ben simply wanted numbers by looking only at the balance sheet and income statement, whereas Warren was predominately

interested in a company's management as a major factor when deciding to invest. After building his personal capital up to \$140,000, Warren returned Omaha and began his next move.

Warren Buffett applied value-investing principles to build Berkshire Hathaway. Currently, the portfolio of Berkshire Hathaway comprises of utilities (MidAmerican Energy Holdings), insurance (Geico, General Re), apparel (Fruit of the Loom), flight services (Flight Safety, NetJets) as well as a fairly large amount of American Express, Coca-Cola, Gillette, and Wells Fargo.

In June 2006, Warren Buffett announced to give around 80 percent of his \$44 billion fortune in annual installments to the Bill and Melinda Gates Foundation for as long as the couple lives. The Gates Foundation's activities are concentrated on world health (fighting such diseases as malaria, HIV/AIDS, and tuberculosis) and on improving U.S. libraries and high schools.

Objectives

The main objectives of this paper are to identify the investment philosophy of Warren Buffett since he started his own company in 1956 until 2002 when he bought some Wells Fargo shares and to analyze how similar/dissimilar his investment philosophy is when compared to principle and theory of finance.

Warren Buffett's Investment Philosophy

1. Economic reality, not accounting reality

Warren Buffett stated that financial statements prepared by accountants conformed to rules that might not adequately represent the economic reality of a business. Accounting reality was conservative, backward-looking, and governed by generally accepted accounting principles (GAAP). However, investment decisions should be based on the economic reality of a business.

Under GAAP, intangible assets such as patents, trademarks, special managerial expertise, and reputation would be carried at little or no value, but they might be very valuable in economic reality. GAAP measured results in terms of net profit, whereas, in economic reality, the results of a business were its flows of cash. Warren Buffett also defined economic reality at the level of business itself, not the market, the economy, or the security.

2. The opportunity cost

Warren Buffett compared an investment opportunity against the next best alternative, the lost opportunity. He made his business decisions by framing his choices as either/or decisions rather than yes/no decisions. In addition, he employed the potential rate of return from investing in the common stocks of other companies as an important standard of comparison in testing the attractiveness of an acquisition. He also used the comparison of an investment against other returns available in the market as a significant benchmark of performance.

3. The time value of money

Warren Buffett defined intrinsic value as the discounted value of the cash that can be obtained from a business during its remaining life. To calculate intrinsic value, it is necessary to exhibit a highly subjective figure that will change when estimates of future cash flows are modified and interest rates alter. In spite of its uncertainty, intrinsic value is important because it is the only logical way to assess the relative attractiveness of investments and businesses.

4. Measure performance on the basis of gain in intrinsic value, not accounting profit

Warren Buffett's long-term economic goal is to maximize Berkshire's average annual

rate of gain in intrinsic business value on a per-share basis. He does not measure the economic significance or performance of Berkshire by its size, but by per-share progress. In addition, he will be disappointed if the rate of per-share progress does not exceed that of the average large American corporation.

5. Risk and discount rates

Warren Buffett defined risk as “the possibility of loss or injury.” His company used almost no debt financing. To avoid risk, he also put a heavy weight of investments on certainty by focusing on companies with predictable and stable earnings. Thus, the idea of a risk factor does not make sense to him so that he utilized a “risk-free” discount rate such as the rate of return on the long-term (for example, 30-year) U.S. Treasury bond.

6. Diversification

Warren Buffett suggested that investors typically purchased far too many stocks rather than waiting for one exceptional company. Investors should pay attention to only businesses that they understand. Therefore, the need for diversification decreases substantially.

7. Invest on the basis of information and analysis

With respect to Ben Graham, Warren

Buffett agreed that, instead of following Mr. Market’s opinion, it would be wiser for investors to form their own ideas of the value of their holdings, based on full reports from the company about its operation and financial status.

Warren Buffett did not believe in the stock market. When he invested in stocks, he invested in businesses. He behaved according to what is rational rather than according to what is fashionable. He didn’t try to “time the market” (i.e., trade stocks based on expectations of changes in the market cycle). Instead, he employed a strategy of patient, long-term investing.

8. Alignment of agents and owners

To explain his ownership interest in Berkshire Hathaway, Warren Buffett claimed that “he is a better businessman because he is an investor. And he is a better investor because he is a businessman.”

More than 50 percent of the family net worth of four of Berkshire’s six directors contained shares in Berkshire Hathaway. Moreover, the senior managers of Berkshire Hathaway subsidiaries held shares in the company, or were compensated under incentive plans that related to the potential returns from an equity interest in their business unit.

Comparison between Buffett's Investment Philosophy and Principle and Theory of Finance

Economic Value Added Versus Market Value Added

Warren Buffett's method of evaluating a firm's performance is similar to the method of Economic Value Added (EVA), not Market Value Added (MVA). EVA is calculated by subtracting the annual cost of all the capital a firm uses from the firm's after-tax operating profit. If the EVA is positive, management has created shareholder value. If the EVA is negative, management has destroyed shareholder value.

On the other hand, MVA is the difference between the market value of the firm (which is the sum of the market value of common equity, the market value of debt, and the market value of preferred stock) and the book value of the firm's common equity, debt, and preferred stock.

In general, EVA is the measure that is typically used when assessing managerial performance because of two main reasons. First, EVA shows the value added during a given year, whereas MVA reflects performance over the company's entire life. Second, EVA can be applied to individual divisions or other units of a large corporation, whereas MVA

must be applied to the entire corporation.

Capital Budgeting: The Benchmark

The way Warren Buffett evaluated his investment opportunity is similar to the process of analyzing projects and deciding which ones to include in the capital budget, which is called capital budgeting.

In capital budgeting, six key methods are used to rank projects and to decide whether or not they should be accepted for inclusion in the capital budget. These six methods include payback period (accept the project when payback period is less than the project's life), discounted payback (accept the project when discounted payback is less than the project's life), net present value (accept the project when NPV is positive), internal rate of return (accept the project when IRR is greater than weighted average cost of capital of the project), modified internal rate of return (accept the project when MIRR is greater than weighted average cost of capital of the project), and profitability index (accept the project when PI is greater than one).

However, for Warren Buffett, there is one important dissimilarity. Instead of using weighted average cost of capital (WACC), the potential rate of return from investing in the common stocks of other companies is employed as an important standard of

comparing investment opportunity. He also used other returns available in the market as a significant benchmark of performance.

Intrinsic Value

Evaluating businesses based on their intrinsic values as executed by Warren Buffett is consistent with the intrinsic value hypothesis. According to the intrinsic value hypothesis, asset prices are systematically related to their future payouts. Unlike the rational expectations hypothesis (which believes that a rational expectations market is an efficient market), the intrinsic value hypothesis does not consider assets' resale value to other individuals.

Additionally, Warren Buffett also utilized the concept of time value of money. He said that book value, which is the value of a firm's equity as recorded on the firm's balance sheet, is meaningless as an indicator of intrinsic value. Thus, he assessed intrinsic value as the present value of future expected performance.

Risk and Return

Conventional academic and practitioner thinking held that the more risk one took, the more one should get paid. Therefore, discount rates used in deriving intrinsic values should be determined by the risk of the cash flows being valued. The capital asset pricing model (CAPM) is the conventional model for estimating

discount rates. It added a risk premium to the long-term risk-free rate of return, such as the U.S. Treasury bond yield.

Nevertheless, Warren Buffett differed from conventional thinking by using only the rate of return on the long-term U.S. Treasury bond to discount cash flows. He ignored a risk-premium component of CAPM because he invested in only businesses that have predictable and stable earnings. Thus, there was no risk involved because risk comes from not knowing what you are doing.

Academics define risk as the volatility of a stock or a portfolio of stocks as compared to the volatility of a large universe of stocks. These academics compute with precision the "beta" of a stock by employing databases and statistical skills. Then, they allocate investment and capital accordingly. Warren Buffett argued that besides a single statistic to measure risk (beta), the academics forget a fundamental principle: it is better to be approximately right than precisely wrong.

Portfolio Diversification

An asset held as part of a portfolio is less risky than the same asset held in isolation. Most financial assets are actually held as parts of portfolio. Even individual investors generally hold portfolios, not the stock of only one firm. Thus, the risk and return of an

individual security should be analyzed in terms of how that security affects the risk and return of the portfolio in which it is held. According to portfolio theory, the risk of a portfolio will decline as the number of stocks in the portfolio increases.

However, Warren Buffett disagreed with conventional wisdom that investors should hold a broad portfolio of stocks in order to get rid of company-specific risk. He disputed that diversification is necessary only when investors do not search for businesses that they understand and focus on those businesses.

Fundamental Analysis

Like conventional wisdom, Warren Buffett emphasized on awareness and information as the foundation for investing. He stated that investing strategy should be driven by information, analysis, and self-discipline, not by emotion or guess. Furthermore, he was a fundamental analyst of the business. His analysis focused on the simplicity of the business, the consistency of its operating history, the attractiveness of its long-term prospects, the quality of management, and the firm's capacity to create value.

Efficient Markets Hypothesis (EMH)

The efficient markets hypothesis (EMH) states that stocks are always in equilibrium

and that it is impossible for an investor to consistently “beat the market.” The EMH assumes that all important information regarding a stock is impounded in the price of that stock. As a result, a stock price is fair in reflecting what is known about the company. Under EMH, there are no bargains to be had and trying to outperform the market will be useless.

Warren Buffett does not respect the academic theory of capital-market efficiency. He mentioned that investing in a market where people believe in efficiency is like playing bridge with someone who has been told it does not do any good to look at the cards. For him, he used a method developed by Ben Graham (which focuses on the value of assets such as cash, net working capital, and physical assets) to identify undervalued stocks and then invested in those stocks. Eventually, Warren Buffett modified the approach of Ben Graham to focus also on valuable franchises that were unrecognized by the market.

Corporate Governance

Warren Buffett also concerned about corporate governance. He diminished the conflict of interests between managers and shareholders (an agency problem) by giving shares of Berkshire Hathaway to both directors and senior managers. In addition, he set in

place at Berkshire Hathaway two governance reforms, including regular meetings of directors and a whistleblower line for employees.

Table 1 Summary of Similarities and Dissimilarities of Warren E. Buffett’s Investment Philosophy as Compared to Principle and Theory of Finance

Warren E. Buffett’s Investment Philosophy	Principle and Theory of Finance	
	Similarities	Dissimilarities
1. Economic reality, not accounting reality	Economic Value Added (EVA): basing investment decisions on economic reality of a business	
2. The opportunity cost	Capital Budgeting: framing investment choices as either/or decisions rather than yes/no decisions	Investment Opportunity Comparison: using the potential rate of return from investing in the common stocks of other companies, instead of using WACC
3. The time value of money	Time Value of Money: defining intrinsic value as the discounted value of the cash that can be obtained from a business during its remaining life, or defining intrinsic value as the present value of future expected performance	
4. Performance measurement	Intrinsic Value: basing on gain in intrinsic value, not accounting profit	
5. Risk and discount rates		Capital Asset Pricing Model (CAPM): using a risk-free discount rate and ignoring a risk-premium component of CAPM
6. Diversification		Portfolio Diversification: diversification is necessary only when investors do not search for businesses that they understand and focus on those businesses.

Table 1 (Cont.)

Warren E. Buffett's Investment Philosophy	Principle and Theory of Finance	
	Similarities	Dissimilarities
7. Investment strategy	Fundamental Analysis: basing investment decisions on information and analysis, not trying to time the market	Theory of Capital-Market Efficiency: searching for undervalued stocks and investing in them
8. Alignment of agents and owners	Corporate Governance: giving shares of Berkshire Hathaway to both directors and senior managers; setting regular meetings of directors	

Conclusions

To become the world's second-richest man, Warren E. Buffett employed his own investment philosophy including: applying economic reality, not accounting reality; accounting for the opportunity cost; focusing on the time value of money; concentrating on wealth creation; investing on the basis of information and analysis; and paying attention to the alignment of agents and owners.

Table 1 summarizes the similarities and dissimilarities of Warren E. Buffett's investment philosophy as compared to principle and theory of finance. His investment philosophy is similar to principle and theory of finance in the use of economic value added (EVA) in making investment decisions, the use of capital budgeting in evaluating investment opportunities, the use of time value of money

in calculating intrinsic value, the use of intrinsic value in measuring performance, the use of fundamental analysis in assessing investments, and the use of corporate governance in alleviating agency problem.

However, his investment philosophy is dissimilar to principle and theory of finance in many areas such as investment opportunity evaluation (use the potential rate of return from investing in the common stocks of other companies, instead of using WACC), CAPM (use a risk-free discount rate to assess cash flows and ignore a risk-premium component of CAPM), portfolio diversification (hold only stocks of companies that their businesses can be understood), and the efficient capital market hypothesis (EMH) (search for undervalued stocks and invest in them).

Additionally, Warren Buffett is also an

excellent example of successful people because he gives back to the society through many charities and foundations worldwide. Applying his investment philosophy as well as having a good luck, one day, you may become the new richest man/woman in the world.

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