

Think Like Warren Buffett

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Back in 1999, Robert G. Hagstrom wrote a book about the legendary investor Warren Buffett, entitled "The Warren Buffett Portfolio". What's so great about the book, and what makes it different from the countless other books and articles written about the "Oracle of Omaha" is that it offers the reader valuable insight into how Buffett actually thinks about investments. In other words, the book delves into the psychological mindset that has made Buffett so fabulously wealthy. (For more on Warren Buffett and his current holdings, check out Coattail Investor.)

Although investors could benefit from reading the entire book, we've selected a bite-sized sampling of the tips and suggestions regarding the investor mindset and ways that an investor can improve their stock selection that will help you get inside Buffett's head.

1. Think of Stocks as a Business

Many investors think of stocks and the stock market in general as nothing more than little pieces of paper being traded back and forth among investors, which might help prevent investors from becoming too emotional over a given position but it doesn't necessarily allow them to make the best possible investment decisions.

That's why Buffett has stated he believes stockholders should think of themselves as "part owners" of the business in which they are investing. By thinking that way, both Hagstrom and Buffett argue that investors will tend to avoid making off-the-cuff investment decisions, and become more focused on the longer term. Furthermore, longer-term "owners" also tend to analyze situations in greater detail and then put a great deal of thought into buy and sell decisions. Hagstrom says this increased thought and analysis tends to lead to improved investment returns.

2. Increase the Size of Your Investment

While it rarely - if ever - makes sense for investors to "put all of their eggs in one basket," putting all your eggs in too many baskets may not be a good thing either. Buffett contends that over-diversification can hamper returns as much as a lack of diversification. That's why he doesn't invest in mutual funds. It's also why he prefers to make significant investments in just a handful of companies.

Buffett is a firm believer that an investor must first do his or her homework before investing in any security. But after that due diligence process is completed, an investor should feel comfortable enough to dedicate a sizable portion of assets to that stock. They should also feel comfortable in winnowing down their overall investment portfolio to a handful of good companies with excellent growth prospects.

Buffett's stance on taking time to properly allocate your funds is furthered with his comment that it's not just about the best company, but how you feel about the company. If the best business you own presents the least financial risk and has the most favorable long-term prospects, why would you put money into your 20th favorite business rather than add money to the top choices?

3. Reduce Portfolio Turnover

Rapidly trading in and out of stocks can potentially make an individual a lot of money, but according to Buffett this trader is actually hampering his or her investment returns. That's because portfolio turnover increases the amount of taxes that must be paid on capital gains and boosts the total amount of commission dollars that must be paid in a given year.

The "Oracle" contends that what makes sense in business also makes sense in stocks: An investor should ordinarily hold a small piece of an outstanding business with the same tenacity that an owner would exhibit if he owned all of that business.

Investors must think long term. By having that mindset, they can avoid paying huge commission fees and lofty short-term capital gains taxes. They'll also be more apt to ride out any short-term fluctuations in the business, and to ultimately reap the rewards of increased earnings and/or dividends over time.

4. Develop Alternative Benchmarks

While stock prices may be the ultimate barometer of the success or failure of a given investment choice, Buffett does not focus on this metric. Instead, he analyzes and pores over the underlying economics of a given business or group of businesses. If a company is doing what it takes to grow itself on a profitable basis, then the share price will ultimately take care of itself.

Successful investors must look at the companies they own and study their true earnings potential. If the fundamentals are solid and the company is enhancing shareholder value by generating consistent bottom-line growth, the share price, in the long term, should reflect that.

5. Learn to Think in Probabilities

Bridge is a card game in which the most successful players are able to judge mathematical probabilities to beat their opponents. Perhaps not surprisingly, Buffett loves and actively plays the game, and he takes the strategies beyond the game into the investing world.

Buffett suggests that investors focus on the economics of the companies they own (in other words the underlying businesses), and then try to weigh the probability that certain events will or will not transpire, much like a Bridge player checking the probabilities of his opponents' hands. He adds that by focusing on the economic aspect of the equation and not the stock price, an investor will be more accurate in his or her ability to judge probability.

Thinking in probabilities has its advantages. For example, an investor that ponders the probability that a company will report a certain rate of earnings growth over a period of five or 10 years is much more apt to ride out short-term fluctuations in the share price. By extension, this means that his investment returns are likely to be superior and that he will also realize fewer transaction and/or capital gains costs.

6. Recognize the Psychological Aspects of Investing

Very simply, this means that individuals must understand that there is a psychological mindset that the successful investor tends to have. More specifically, the successful investor will focus on

probabilities and economic issues and let decisions be ruled by rational, as opposed to emotional, thinking.

More than anything, investors' own emotions can be their worst enemy. Buffett contends that the key to overcoming emotions is being able to "retain your belief in the real fundamentals of the business and to not get too concerned about the stock market."

Investors should realize that there is a certain psychological mindset that they should have if they want to be successful and try to implement that mindset.

7. Ignore Market Forecasts

There is an old saying that the Dow "climbs a wall of worry". In other words, in spite of the negativity in the marketplace, and those who perpetually contend that a recession is "just around the corner", the markets have fared quite well over time. Therefore, doomsayers should be ignored.

On the other side of the coin, there are just as many eternal optimists who argue that the stock market is headed perpetually higher. These should be ignored as well.

In all this confusion, Buffett suggests that investors should focus their efforts of isolating and investing in shares that are not currently being accurately valued by the market. The logic here is that as the stock market begins to realize the company's intrinsic value (through higher prices and greater demand), the investor will stand to make a lot of money.

8. Wait for the Fat Pitch

Hagstrom's book uses the model of legendary baseball player Ted Williams as an example of a wise investor. Williams would wait for a specific pitch (in an area of the plate where he knew he had a high probability of making contact with the ball) before swinging. It is said that this discipline enabled Williams to have a higher lifetime batting average than the average player.

Buffett, in the same way, suggests that all investors act as if they owned a lifetime decision card with only 20 investment choice punches in it. The logic is that this should prevent them from making mediocre investment choices and hopefully, by extension, enhance the overall returns of their respective portfolios.

Bottom Line

"The Warren Buffett Portfolio" is a timeless book that offers valuable insight into the psychological mindset of the legendary investor Warren Buffett. Of course, if learning how to invest like Warren Buffett were as easy as reading a book, everyone would be rich! But if you take that time and effort to implement some of Buffett's proven strategies, you could be on your way to better stock selection and greater returns.