18 Lessons for Investors and Managers from Warren Buffett’s 2014 Letter to Shareholders

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Introduction

Warren Buffett recently released his 2014 letter to shareholders of Berkshire Hathaway. For the first time, he included the historical stock price data for Berkshire in his letter, which has increased by—hold your breath—1,826,163% in the last 50 years. That’s same as a 14,512-bagger!

The big idea worth noting here is that the annualized return Berkshire’s stock has earned for its shareholders to achieve such magnificent result over 50 years is 21.6%—something people basking in the limelight of current bull run would discard as too less!

Anyways, the 2014 letter is special not just because it marked the completion of 50 years of Buffett being at helm at Berkshire, but also because it contains a bonus—Charlie Munger’s words of wisdom and vision for Berkshire over the next 50 years.

What follows below are 18 big lessons Buffett and Munger have outlined in the 2014 letter, which are relevant for both investors and corporate managers. Though I suggest you read the original letter in its entirety by downloading it from here—http://goo.gl/05Y9XE

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1. Lessons for Investors

1. Price Vs Value

How much should you pay for a business? Every day the stock market offers prices for thousands of businesses, but how do you know if the price for any particular business is too low or too high?

To succeed as an investor, Ben Graham suggested, you must be able to estimate a business’s true worth, or “intrinsic value,” which may be entirely separate from its stock market price.

For Graham, a business’s intrinsic value could be estimated from its financial statements, namely the balance sheet and income statement. He believed that the intrinsic, or central, value of any asset would be revealed by quantitative elements and that prices tend to fluctuate around this true value.
However, he emphasized the point that security analysis usually cannot determine exactly what is the intrinsic value of a given security. The analyst has only to establish that the value is either adequate or else that the value is significantly higher or significantly lower than the market price.

But then, you can’t overpay for a business i.e., pay much more than what its reasonably assessed value is, and expect to make a great return even in the long run. Here is what Buffett writes on the price vs value equation in his letter...

…a business with terrific economics can be a bad investment if it is bought for too high a price.

…a sound investment can morph into a rash speculation if it is bought at an elevated price.

2. Cut Your Losses

Making mistakes is normal in investing. However, more important than realizing that you made a mistake, is to accept it and cut your losses rather than trying to get your money back.
the same way you lost it. In his letter, Buffett shares his own experience in cutting his losses in the retailing giant Tesco, while stressing that there isn’t just one cockroach in the kitchen.

At the end of 2012 we owned 415 million shares of Tesco, then and now the leading food retailer in the U.K. and an important grocer in other countries as well. Our cost for this investment was $2.3 billion, and the market value was a similar amount. In 2013, I soured somewhat on the company’s then-management and sold 114 million shares, realizing a profit of $43 million. My leisurely pace in making sales would prove expensive. Charlie calls this sort of behavior “thumbsucking.” (Considering what my delay cost us, he is being kind.)

During 2014, Tesco’s problems worsened by the month. The company’s market share fell, its margins contracted and accounting problems surfaced. In the world of business, bad news often surfaces serially: You see a cockroach in your kitchen; as the days go by, you meet his relatives.

3. Stocks Better than Bonds in the Long Run

Bonds, which are often seen as ‘safe’ by investors who have never invested in the stock market, or those who have lost a lot of money in stocks, are ‘risky’ in the long run owing to the inability of their returns (interest) to beat inflation. There’s ample proof of this from
history, even in the Indian context, where people have lost purchasing power by remaining invested in bonds than stocks. On the other hand, people who have invested in good quality businesses and have sat on them for 10-20 years have reaped great rewards in terms of wealth creation. Buffett predicts in his letter that stocks will continue to remain safer than bonds in the long run.

The unconventional, but inescapable, conclusion to be drawn from the past fifty years is that it has been far safer to invest in a diversified collection of American businesses than to invest in securities – Treasuries, for example – whose values have been tied to American currency. That was also true in the preceding half-century, a period including the Great Depression and two world wars. Investors should heed this history. To one degree or another it is almost certain to be repeated during the next century.

4. Stock Price Volatility is NOT ‘Risk’
The only risk in investing is permanent loss of capital, which is very different from stock price volatility or fluctuation. A downward fluctuation – which by definition is temporary – doesn’t present a big problem if you are able to hold on and come out the other side. On the other hand, a permanent loss – from which there won’t be a rebound – can occur for either of two reasons: (a) an otherwise temporary dip is locked in when the investor sells during a...
downswing - whether because of a loss of conviction; requirements stemming from his timeframe; financial need; or emotional pressures; or (b) the investment itself is unable to recover for fundamental reasons.

We can ride out volatility, but we never get a chance to undo a permanent loss. In his letter, Buffett stresses on this very fact of not considering volatility a synonym for risk, and thereby not getting fearful when stock prices move up and down, especially down.

Stock prices will always be far more volatile than cash-equivalent holdings. Over the long term, however, currency-denominated instruments are riskier investments - far riskier investments - than widely-diversified stock portfolios that are bought over time and that are owned in a manner invoking only token fees and commissions.

That lesson has not customarily been taught in business schools, where volatility is almost universally used as a proxy for risk. Though this pedagogic assumption makes for easy teaching, it is dead wrong: Volatility is far from synonymous with risk. Popular formulas that equate the two terms lead students, investors and CEOs astray.

If the investor fears price volatility, erroneously viewing it as a measure of risk, he may, ironically, end up doing some very risky things. Recall, if you will, the
pundits who six years ago bemoaned falling stock prices and advised investing in “safe” Treasury bills or bank certificates of deposit. People who heeded this sermon are now earning a pittance on sums they had previously expected would finance a pleasant retirement.

If not for their fear of meaningless price volatility, these investors could have assured themselves of a good income for life by simply buying a very low-cost index fund whose dividends would trend upward over the years and whose principal would grow as well (with many ups and downs, to be sure).

5. Invest with Multi-Decade Horizon

This is the biggest lesson we investors can draw from Buffett’s 50 years at helm at Berkshire. During this period, Berkshire has compounded its shareholders’ wealth at an annualized rate of 21.6%, which is great. The performance becomes even greater considering that this has been achieved over a 50 year period.

The lesson to draw from this is that ‘t’ or ‘time’ is the most important variable in the compounding formula, even more powerful than ‘r’ or the rate of return. Of course, you must earn a decent return, but you will achieve the benefits of compounding only when you maintain this decent return over a 20-30 year period.

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Consider this simple math – If you want to multiply your money 100x in 25 years, you want your investment to return 20% every year. In other words, Rs 1 growing at 20% per annum will turn to Rs 100 after 25 years, excluding all dividends. But if you sell this stock after 20 years (instead of holding for 5 more years), you will get just Rs 40. The remaining Rs 60 would come only between the 21st and 25th years.

That’s how compounding works. The longer you let your money grow, the faster will be the incremental return you would earn. Here is what Buffett writes in his 2014 letter about the importance of having a long-term perspective...

It is true, of course, that owning equities for a day or a week or a year is far riskier (in both nominal and purchasing-power terms) than leaving funds in cash-equivalents. That is relevant to certain investors – say, investment banks – whose viability can be threatened by declines in asset prices and which might be forced to sell securities during depressed markets. Additionally, any party that might have meaningful near-term needs for funds should keep appropriate sums in Treasuries or insured bank deposits.

For the great majority of investors, however, who can – and should – invest with a multi-decade horizon, quotational declines are
important. Their focus should remain fixed on attaining significant gains in purchasing power over their investing lifetime. For them, a diversified equity portfolio, bought over time, will prove far less risky than dollar-based securities.

6. Bad Behaviour is Destructive

“A human being is a dark and veiled thing,” writes Daniel Kahneman, “…and whereas the hare has seven skins, the human being can shed seven times seventy skins and still not be able to say: This is really you, this is no longer outer shell. So said Nietzsche, and Freud agreed: we are ignorant of ourselves.”

When it comes to investing, we as investors are even more ignorant of what we really want. That’s exactly what Buffett echoes in his letter. He mentions five ways investors often destroy wealth—trading, timing, inadequate diversification, high fee, and leverage.

Investors, of course, can, by their own behavior, make stock ownership highly risky. And many do. Active trading, attempts to “time” market movements, inadequate diversification, the payment of high and unnecessary fees to managers and advisors, and the use of borrowed money can destroy the decent returns that a life-long owner of equities would otherwise enjoy.
Decades ago, Ben Graham pinpointed the blame for investment failure, using a quote from Shakespeare: “The fault, dear Brutus, is not in our stars, but in ourselves.”

7. Avoid Borrowing to Invest

Buying stocks with borrowed money doesn’t make anything a better investment or increase the probability of gains. It merely magnifies whatever gains or losses may materialize. And then, leverage brings destruction if things go bad... really bad. And they often do.

Nassim Taleb says that we should judge people by the costs of the alternative, that is if history played out in another way. As he wrote in his brilliant book Fooled by Randomness—“Clearly, the quality of a decision cannot be solely judged based on its outcome, but such a point seems to be voiced only by people who fail (those who succeed attribute their success to the quality of their decision).”

In the same way, be very careful of judging your stock market success by the outcome you achieve, but by the decision you made. “Leverage can help me magnify my returns” is a great statement to make. But more often now, leverage—which is a result of arrogance created by good short-term returns or a result of survivorship bias, which is concentrating on the people...
or things that “survived” some process and inadvertently overlooking those that did not – will not only your destroy your savings and sleep, it will also destroy your reputation.

Buffett writes this about using leverage in investing...

\[\text{...borrowed money has no place in the investor’s tool kit: Anything can happen anytime in markets. And no advisor, economist, or TV commentator – and definitely not Charlie nor I – can tell you when chaos will occur. Market forecasters will fill your ear but will never fill your wallet.}\]

8. **Big Investors, Small Investors - All Are Same**

Small investors often get enamoured by jargon-spitting stock market experts and big investors who appear on business TV to dispel their next predictions. The reason is often ‘authority bias’ – we consider someone an authority, when he/she is dressed or speaks like one. But Buffett reiterates what he has been saying for years – that all investors behave the same, and big investors behave more badly due to the great number of biases that they suffer from, as compared to the small investor.

So, before you trust a big investor with your time and money, remember what Buffett says...

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The commission of the investment sins is not limited to “the little guy.” Huge institutional investors, viewed as a group, have long underperformed the unsophisticated index-fund investor who simply sits tight for decades.

A major reason has been fees. Many institutions pay substantial sums to consultants who, in turn, recommend high-fee managers. And that is a fool’s game. There are a few investment managers, of course, who are very good — though in the short run, it’s difficult to determine whether a great record is due to luck or talent. Most advisors, however, are far better at generating high fees than they are at generating high returns. In truth, their core competence is salesmanship. Rather than listen to their siren songs, investors — large and small — should instead read Jack Bogle’s The Little Book of Common Sense Investing.

9. What to Look for in an Investment

Buffett outlines six key points of Berkshire’s acquisition criteria in his 2014 letter, something he has done several times in the past as well. While the first point can be immaterial for you, the next five points must be core to your investment philosophy, if you want to be a sensible long term investor.
We are eager to hear from principals or their representatives about businesses that meet all of the following criteria:

(1) Large purchases (at least $75 million of pre-tax earnings unless the business will fit into one of our existing units),
(2) Demonstrated consistent earning power (future projections are of no interest to us, nor are “turnaround” situations),
(3) Businesses earning good returns on equity while employing little or no debt,
(4) Management in place (we can’t supply it),
(5) Simple businesses (if there’s lots of technology, we won’t understand it),
(6) An offering price (we don’t want to waste our time or that of the seller by talking, even preliminarily, about a transaction when price is unknown).

10. Cigar Butt Approach - Does It Work Anymore?
Shortly after Ben Graham’s death in 1976, Buffett became the designated steward of the former’s value approach to investing. Indeed, he himself became synonymous with value investing. It is easy to see why. Buffett was the most famous of Graham’s dedicated students and never missed an opportunity to acknowledge the intellectual debt he owed to his teacher. Even today, he considers Graham to be the one individual, after his father, who had the most influence on his investment life.
This is despite the fact that, as early as 1965 and while working under Graham, Buffett was becoming aware that the latter’s strategy of buying cheap stocks (what Graham called ‘cigar-buts’, or companies selling for less than their net working capital) was not ideal, for it did not consider the quality of businesses, and just a stock’s cheapness. In fact, following Graham’s approach, Buffett bought some genuine losers.

Several companies that he had bought at cheap prices (they met Graham’s test for purchase) were cheap because their underlying businesses were suffering (so they were “value traps”). As such, Buffett began moving away from Graham’s strict teachings of focusing only on the price and a few balance sheet numbers, and not on the underlying quality of the business.

“I evolved,” he admitted, “but I didn’t go from ape to human or human to ape in a nice even manner.”

In his 2014 letter, Buffett outlines when the cigar-butt strategy worked for him, and when it didn’t, and why buying stocks just because they are priced ‘cheap’ can be a dangerous strategy.
My cigar-butt strategy worked very well while I was managing small sums. Indeed, the many dozens of free puffs I obtained in the 1950s made that decade by far the best of my life for both relative and absolute investment performance.

Even then, however, I made a few exceptions to cigar butts, the most important being GEICO...Most of my gains in those early years, though, came from investments in mediocre companies that traded at bargain prices. Ben Graham had taught me that technique, and it worked.

But a major weakness in this approach gradually became apparent: Cigar-butt investing was scalable only to a point. With large sums, it would never work well.

In addition, though marginal businesses purchased at cheap prices may be attractive as short-term investments, they are the wrong foundation on which to build a large and enduring enterprise. Selecting a marriage partner clearly requires more demanding criteria than does dating.
11. Listen to Charlie Munger

Buffett’s discourse on investments is incomplete without his praise for his business partner and best friend Charlie Munger. After all, without any doubt, it was Munger who was responsible for moving Buffett toward focusing on business quality than just cheap price.

From the start, Munger had a keen appreciation of the value of a better business, and the wisdom of paying a reasonable price for it. Through their years together, he has continued to preach the wisdom of paying up for a good business.

In one important respect, however, Munger is also the present-day echo of Ben Graham. Graham had taught Buffett the twofold significance of emotion in investing— the mistakes it triggers for those who base irrational decisions on it, and the opportunities it thus creates for those who can avoid falling into the same traps. Munger, through his readings in psychology, has continued to develop that theme. He calls it the “psychology of misjudgement.”

Here is more praise Buffett has showered, and deservedly so, on Munger in his 2014 letter...
Charlie has a wide-ranging brilliance, a prodigious memory, and some firm opinions. I’m not exactly wishy-washy myself, and we sometimes don’t agree. In 56 years, however, we’ve never had an argument. When we differ, Charlie usually ends the conversation by saying: “Warren, think it over and you’ll agree with me because you’re smart and I’m right.”

What most of you do not know about Charlie is that architecture is among his passions. Though he began his career as a practicing lawyer (with his time billed at $15 per hour), Charlie made his first real money in his 30s by designing and building five apartment projects near Los Angeles. Concurrently, he designed the house that he lives in today – some 55 years later. (Like me, Charlie can’t be budged if he is happy in his surroundings.) In recent years, Charlie has designed large dorm complexes at Stanford and the University of Michigan and today, at age 91, is working on another major project.

From my perspective, though, Charlie’s most important architectural feat was the design of today’s Berkshire. The blueprint he gave me was simple: Forget what you know about buying fair businesses at wonderful prices; instead, buy wonderful businesses at fair prices.
12. Beware of Companies Making Acquisitions

Would you risk your life savings on a coin toss? Of course you wouldn’t. But over the past few years, CEOs of many Indian companies – large, mid, or small – have risked their business with the same odds – by making disastrous acquisitions. They have shown what thrill for action when combined with cheap money can destroy shareholder wealth in such huge scales.

Acquisitions are often misused as the universal, over-simple growth formula, or just as a quick fix. As buying companies also boosts egos of managers making acquisitions, the essential questions can end up being dismissed as irrelevant, boring, or too mundane to be answered properly. This is exactly what Buffett captures when he writes about companies making expensive acquisitions and investment bankers justifying the same.

Too often CEOs seem blind to an elementary reality: The intrinsic value of the shares you give in an acquisition must not be greater than the intrinsic value of the business you receive.

I’ve yet to see an investment banker quantify this all-important math when he is presenting a stock-for-stock deal to the board of a potential acquirer. Instead, the banker’s focus will be on describing “customary” premiums-to-market-price that are currently being paid for acquisitions – an absolutely asinine way to evaluate the
attractiveness of an acquisition – or whether the deal will increase the acquirer’s earnings per-share (which in itself should be far from determinative).

In striving to achieve the desired per-share number, a panting CEO and his “helpers” will often conjure up fanciful “synergies.” (As a director of 19 companies over the years, I’ve never heard “dis-synergies” mentioned, though I’ve witnessed plenty of these once deals have closed.) Post mortems of acquisitions, in which reality is honestly compared to the original projections, are rare in American boardrooms. They should instead be standard practice.

13. Wait for Fat Pitches

Given that stocks go up and down, the best way to win at the investing game is to have the discipline to form your own opinions and the right temperament, which is more important than IQ. All you have to do is sit there and wait until something is really attractive that you understand.

But by listening to everybody talk on television, especially because everybody sounds authoritative, investors often turn this fundamental advantage into a disadvantage. There’s no easier game than stocks, if and only if you don’t play it too often. And you play only when you get the fat pitches inside your circle of competence.
Here is what Buffett writes on the need to avoid listening to financial experts, and especially when the tide is rising and everyone is rising with it...

Periodically, financial markets will become divorced from reality – you can count on that. More Jimmy Lings will appear (Lings was a 1960s-era US businessman who founded the company LTV, and invented what he called “redeployment.” During an era when most companies made products and sold them, he saw the future of business: acquisitions and mergers).

They will look and sound authoritative. The press will hang on their every word. Bankers will fight for their business. What they are saying will recently have “worked.” Their early followers will be feeling very clever. Our suggestion: Whatever their line, never forget that 2+2 will always equal 4. And when someone tells you how old-fashioned that math is --- zip up your wallet, take a vacation and come back in a few years to buy stocks at cheap prices.
11. Lessons for Managers

14. Cash is King

One of the characteristics that define a great business is its ability to constantly generate more cash than it consumes. Cash is after the lifeblood of a business, and the biggest wealth creators in history have been companies that have managed this asset well. Buffett has always stressed on the importance of cash, and here is what he reiterates in his 2014 letter...

Financial staying power requires a company to maintain three strengths under all circumstances: (1) a large and reliable stream of earnings; (2) massive liquid assets and (3) no significant near-term cash requirements.

Ignoring that last necessity is what usually leads companies to experience unexpected problems. Too often, CEOs of profitable companies feel they will always be able to refund maturing obligations, however large these are. In 2008-2009, many managements learned how perilous that mindset can be.

At a healthy business, cash is sometimes thought of as something to be minimized — as an unproductive asset that acts as a drag on such markers as return on equity. Cash, though, is to a business as oxygen is to an individual: never thought about
when it is present, the only thing in mind when it is absent. American business provided a case study of that in 2008. In September of that year, many long-prosperous companies suddenly wondered whether their checks would bounce in the days ahead. Overnight, their financial oxygen disappeared.

15. Respect Alternative Histories
One peculiar but common way our brain works is that we often remember what’s easily available to us, and see what’s easily visible. So, we conclude that the stock trader who is rich must know what he is doing. In the same way, an investor who uses leverage to increase his bets and in the process magnifies his returns is also considered a role model.

In business, a CEO who borrows a lot of money to make acquisitions and in process turns his business bigger in quick time, also seem to be doing the right things (at least when times are euphoric).

In effect, the general belief is that if the outcome is good, the process and decisions made to arrive at that outcome must have been sound. Right?
Well, I hope if life were that easy and followed such straight patterns. But that's not the case especially when randomness and 'external factors' play a role and in investing they do play a significant role.

At least, if you were to believe what Nassim Taleb has to say about “alternative history” in his amazing book “Fooled by Randomness” – “Imagine you are offered $10 million to play Russian roulette, i.e., to put a revolver containing one bullet in the six available chambers to your head and pull the trigger. Each realisation would count as one history, for a total of six possible histories of equal probabilities. Five out of these six histories would lead to enrichment; one would lead to a statistic, that is, an obituary with an embarrassing (but certainly original) cause of death.”

This thought is echoed by Buffett in his letter when he writes about CEOs taking undue risks to grow their businesses...

A CEO who is 64 and plans to retire at 65 may have his own special calculus in evaluating risks that have only a tiny chance of happening in a given year. He may, in fact, be “right” 99% of the time. Those odds, however, hold no appeal for us. We will never play financial Russian roulette with the funds you’ve entrusted to us, even if the metaphorical gun has 100 chambers and only one bullet. In our view, it is madness to risk losing what you need in pursuing what you simply desire.
16. CEOs and Character

Buying companies run by ethical managers has always been Buffett’s key criteria of investing. In the 2014 letter, he expands on what he looks at in CEOs, which serves some great lessons for companies who are searching for their own CEOs...

...rational, calm and decisive individual who has a broad understanding of business and good insights into human behavior. It’s important as well that he knows his limits. (As Tom Watson, Sr. of IBM said, “I’m no genius, but I’m smart in spots and I stay around those spots.”)

Character is crucial: A Berkshire CEO must be “all in” for the company, not for himself. (I’m using male pronouns to avoid awkward wording, but gender should never decide who becomes CEO) He can’t help but earn money far in excess of any possible need for it. But it’s important that neither ego nor avarice motivate him to reach for pay matching his most lavishly-compensated peers, even if his achievements far exceed theirs. A CEO’s behavior has a huge impact on managers down the line. If it’s clear to them that shareholders’ interests are paramount to him, they will, with few exceptions, also embrace that way of thinking.
... one other particular strength: the ability to fight off the ABCs of business decay, which are arrogance, bureaucracy and complacency. When these corporate cancers metastasize, even the strongest of companies can falter.

17. Why Did Berkshire Under Buffett Do So Well?
As I mentioned at the start, one reason Buffett’s 2014 letter is very special is because his business parent and best friend Charlie Munger has shared his thoughts and vision for Berkshire. While Munger’s entire write up is worth reading, here is what he writes on what makes Berkshire so special and why the business did so well under the stewardship of Buffett...

Only four large factors occur to me:

(1) The constructive peculiarities of Buffett,
(2) The constructive peculiarities of the Berkshire system,
(3) Good luck, and
(4) The weirdly intense, contagious devotion of some shareholders and other admirers, including some in the press.
I believe all four factors were present and helpful. But the heavy freight was carried by the constructive peculiarities, the weird devotion, and their interactions. In particular, Buffett’s decision to limit his activities to a few kinds and to maximize his attention to them, and to keep doing so for 50 years, was a lollapalooza.

Buffett succeeded for the same reason Roger Federer became good at tennis. Buffett was, in effect, using the winning method of the famous basketball coach, John Wooden, who won most regularly after he had learned to assign virtually all playing time to his seven best players. That way, opponents always faced his best players, instead of his second best. And, with the extra playing time, the best players improved more than was normal. And Buffett much out-Woodened Wooden, because in his case the exercise of skill was concentrated in one person, not seven, and his skill improved and improved as he got older and older during 50 years, instead of deteriorating like the skill of a basketball player does.
18. Can Berkshire Model be Replicated?

Here's one more amazing dose of wisdom on whether the Berkshire model can be replicated by others...

The answer is plainly yes. In its early Buffett years, Berkshire had a big task ahead: turning a tiny stash into a large and useful company. And it solved that problem by avoiding bureaucracy and relying much on one thoughtful leader for a long, long time as he kept improving and brought in more people like himself.

Compare this to a typical big-corporation system with much bureaucracy at headquarters and a long succession of CEOs who come in at about age 59, pause little thereafter for quiet thought, and are soon forced out by a fixed retirement age.

I believe that versions of the Berkshire system should be tried more often elsewhere and that the worst attributes of bureaucracy should much more often be treated like the cancers they so much resemble. A good example of bureaucracy fixing was created by George Marshall when he helped win World War II by getting from Congress the right to ignore seniority in choosing generals.
Book Recommendations
Buffett has recommended the following books in his 2014 letter:

- The Little Book of Common Sense Investing ~ Jack Bogle
- Where Are the Customers' Yachts? ~ Fred Schwed
  [http://bit.ly/1wDCg2R](http://bit.ly/1wDCg2R)