# Investing basics: How to invest like Warren Buffett

A simple set of rules and principles from the Oracle of Omaha can help you become a successful investor.

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By Morningstar.com.au

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Warren Buffett turned 90 years old last year and despite his grand age, is still a beacon for many investors, old and young.

Countless books, blogs and articles are published on the so-called Sage of Omaha and his investing skills. Morningstar is not short of them either, one of the reasons for this being that we are one of the few research firms that consistently covers **Berkshire Hathaway**.

If you're looking for the basics of how to invest like Warren Buffett, the shortest version is to look at this 1985 TV interview, his first apparently, where he candidly described some of the most important rules and principles to become a successful investor.

Buffett relies on a relatively simple set of rules and principles. Let's look at some of them:

## The first rule and the Margin of Safety

One of the most important rules that Buffett regularly cites is **"The first rule of investment [is] Don't lose money; and the second rule is: Don't forget the first rule."** That is basically his definition of risk which is the permanent loss of capital.

Simply said, if your investment loses 10 per cent, you need a 11 per cent return to recoup it. If you lose 50 per cent, you need a 100 per cent (1/0.5 – 1) return to break even.

To protect from the risk of losing money, you can use a principle set by Benjamin Graham, Buffett's mentor and long-time friend, which is called the "margin of safety". This is sort of a discount if you will, that will protect you from any mistake you might make when assessing the intrinsic value of a business.

So, if you think of a business or a stock, which is a fraction of a business, as being worth 100, you might want to wait that the stock market trades it at 80 or 70 before buying it just to be on a safe side.

As a matter of fact, this principle is also embedded in the star rating that Morningstar analyst give to stocks they cover.

## Can you "Sit on your ass"?

Buffett has two very important psychological traits: he is **disciplined** and **very patient**. In the TV interview, Buffett says that to invest "**you need a stable personality**, a temperament that neither derives pleasure from being with the crowd or against the crowd." He explains: "You're not right or wrong because a thousand people agree or disagree with you. **You are right because your facts and your reasoning are right.**" [emphasis put by me].

This means, as his long-time partner Charlie Munger said, you need to be able to "sit on [your] ass", both when you buy something (buy and hold) but also when everything is expensive and it's difficult to find a good bargain, you have to accept the idea that you will not invest for a while.

The recent history of Berkshire Hathaway demonstrates this: the company has been hoarding cash and couldn't find a company to buy in the last couple of years. Instead, it preferred buying back its own shares (a luxury only corporations have, but you can always save money and have it ready to act when the time is right).

## Use the stock market wisely

This ability for patience is related to another of Buffett's traits, which is "the lack of stimulation". In the 1985 interview, Buffett notes: "I like the lack of stimulation. We get facts and not stimulation [in Omaha]. If I stayed in Wall Street, I would probably be a lot poorer. You get over stimulated in Wall Street. You may shorten your focus and a short focus is not conducive to long progress."

Over the last 36 years, stimulation has grown exponentially. People lose hours watching continuous financial news services and check their portfolios on a daily basis and it's all too easy to get swept up in short-term noise

"I don't have to make money at every game", says Buffett. "In the securities business, you literally have every day thousands of major American corporations offered to you at a price that changes daily, and **you don't have to make a decision**. (…) **You can sit there and look at thousands of pitches and finally get one right there where you want something that you understand and then you swing**." (Buffett loves to compare investing to baseball).

In summary, the only interest of checking a company's share price is to see if it trades below or above your own appraisal of its intrinsic value. And buy when it trades significantly below, giving you that all-important margin of safety.

## Circle of competence

From this, you understand that as an investor, you need to know which turf you want to play, i.e. what is your circle of competence. You don't need to know everything when you invest. But say you have a deep interest and understanding of a specific sector or industry. That's probably where you will be good at investing as well.

If you don't have direct access to business executives, at least you can read about them (Buffett and Munger say they do **a lot of reading**). Read the annual reports of the companies you're interested in, read books about their industry or any subject you're interested in (Munger recommends reading biographies about people who failed so you can avoid their traps).

Check online interviews of their CEO, look up for transcripts of earnings calls and see how business leaders talk about their company.

You can also check their background and how their compensation is set-up. All this can tell you a lot about how decent, honest, and respectful of their stakeholders they are.

You can perceive if they are long term thinkers who are really passionate about their business or just stimulated by the stock-options and the cash they can get.

**In summary:**

- Don't forget the first rule of money investing (i.e. "Don't lose money").
- Know your circle of competence.
- Be patient and disciplined.
- Use the stock market wisely.
- Don't bother watching stock prices too often.
- "Be fearful when everyone is greedy and greedy when everyone's fearful" (another great Buffett's quote).
- Look for good companies which economic moat and high, sustainable return on capital.
- Avoid leverage.
- Read a lot and in different fields (all discipline outside finance are of interest).
- Make your own opinion first and don't rely too much of the opinion of other people.

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