



## Transcript: The Secret Of Buffett's Success

### David Kuo speaks to author LJ Rittenhouse

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**David:**

This is Money Talk, the weekly investing podcast from the Motley Fool. I am David Kuo, and it won't come as a huge shock to anyone listening when I say that Warren Buffett is probably the world's most successful investor. But why he is so successful? – what makes him so special? According to L J Rittenhouse, the key to Buffett's success is his golden rule, which is simply that he treats investors the way he would like to be treated himself. Here to talk about Warren Buffett, and the reasons why he is so successful, is L J Rittenhouse herself, President of Rittenhouse Rankings, and whose book, "Buffett's Bites", is an essential investor's guide to Warren Buffett's shareholder letters. Welcome to Money Talk.

**L J:**

Good morning.

**David:**

Good morning, L J. Now, I guess the first question has to be, what does Rittenhouse Rankings do?

**L J:**

After my career on Wall Street, I decided to set up an investor relations practice. I wanted the clients, the companies I had worked with, to get full value for their businesses by ensuring that they had the best communication possible. One of the things I did was to examine how the CEOs were presenting themselves in their shareholder letters. That's when I discovered Buffett's shareholder letter, which I think most people would agree is the granddaddy of all shareholder letters. In fact, I've used his letters to create a model, so I can evaluate the amount of content and the amount of fog in the shareholder letters of other CEOs.

Every year, my business analyses and rank orders CEO shareholder letters from top to bottom, based on the amount of candour. Finally, what we do is we compare or correlate those candour rankings with stock price, and we have found consistently, over the past eight years that we've been doing this, that companies that communicate like Buffett, with great candour and good disclosure, outperform the companies that fail important candour tests.

**David:**

Now the thing is, L J, if it is so simple, if candour is all it takes, then why don't more money managers out there, more chief executives, more chief financial officers – why aren't they more candid, and therefore become more successful?

**L J:**

It's a wonderful question, David, wonderful question. Look at the delusions - I look at the delusions that I think tend to influence the way people think about investing. For example, if you talk to professional money managers and ask them, is it important to read these shareholder letters, most will say, no, I'll go first to the numbers.

**David:**

(he laughs)

**L J:**

You're laughing!

**David:**

I think most people do that, they go straight to the balance sheet and have a look at the profit and loss accounts, and then, if they have time, they'll go back and have a look at the letter itself.

**L J:**

And what are they missing by doing that?

**David:**

I have no idea – you tell me, L J?

**L J:**

They are missing the fact that numbers are a product of the culture. Think of it, numbers are the result of the multiple judgements that are made by people in a company about what to count, when to count it, how to count it. So if you have a culture where the value system is one in which people are encouraged to be honest and accurate and prudent, if not conservative, you're going to get numbers that are going to be much more trustworthy.

**David:**

But we don't also say, L J, that you have to follow the cash? – have a look at how much cash is left in the company, that cannot lie to you, whereas a lot of other things can deceive?

**L J:**

Well, what's so interesting, David, is that I can read a shareholder letter, and I can tell you whether or not a company is cash-focused, and then I can go to the balance sheet, and I can see if my hypothesis is supported by the numbers. I don't disagree with you, but do you know that, in our sample of CEO shareholder letters, there's about 30 to 35% of the CEOs don't even mention cash?

**David:**

Now, the other thing is, L J, as a candour expert, are there degrees of candour? Can you actually get a boss who is, say, 10% candid and 90% elusive, and so on and so forth?

**L J:**

We look at candour a bit differently from that. You're looking at gradations or experiences of candour. I look at it a little more black-and-white, and it's very simple. Number one: can the CEO communicate an understanding of their business? Think of it – there are at least 50% of the letters that we read where it's not clear the CEO understands their business, and that's very shocking.

**David:**

Now the other thing, of course, is, I'm a huge follower of Warren Buffett himself, and yet I sometimes find, despite his candour, some of his decisions to be quite unfathomable. I mean, going back to about 1987, when he bought these preferred shares in Salomon Brothers, and I was scratching my head. Then I had a look at his purchase of US Air, and of course his stockpiling of silver. When you have a look at all this, despite his candour, how easy is it for people to understand the way that Buffett's mind works?

**L J:**

The things that you describe, David, are certainly – we could call them anomalies in that they're examples of where Buffett's investments did not necessarily work out, although ultimately he did get out of Salomon Brothers, at a great personal cost too, having to take over the company. But I think what's important to remember is that, number one, he's human, and he'll be the first to say that you can be sure that he's going to make mistakes. How many other CEOs admit that? If I'm working for a CEO who's not afraid to admit that he makes mistakes, I'm pretty sure that he's going to be making fewer mistakes. He may not make as many, but how many CEOs can say that, over the past 42 years, they have outperformed the S&P 500 in all but seven of those years?

**David:**

So what you're actually alluding to is the fact that, even if he makes mistakes, he is quite open about it, and he'll say, yes, I messed up here, guys?

**L J:**

And hopefully, he's learnt from them, and he's less likely to repeat them, but think of all the companies where mistakes are denied, they're not acknowledged, and it is more likely than not they will continue to repeat these.

**David:**

OK, so let's go back to Warren Buffett's letters, the shareholders' letters. What are these letters, and who exactly are the people who read them and download them on the internet?

**L J:**

Well, Warren has a huge following. At the most recent shareholder meeting, there were about 40,000 people from all but two of the continents of the world. So a lot of the people that download his letters are Buffettites, they're people that appreciate and value his investing philosophy, as well as his principles. I think we cannot discount the importance of Buffett's principles, which by the way are embodied in the shareholder letter, but they're actually articulated in the owner's manual that's published every year in his annual report – I don't know if you're familiar with that?

**David:**

I am familiar with those, yes – I'm one of these people, these geeks who actually downloads his letters and I read them from cover to cover.

**L J:**

And the thing about reading those letters is, not only do you learn something about his company and what he did from year to year, but you learn an awful lot about the economic environment, you learn about the investing environment. You learn about investing itself – what are the principles, how are the principles that Warren subscribes to embodied in the decisions that he makes?

**David:**

Now the thing is, L J, in one of his letters, and I think this is the one back in 2008/2009, when he said that the economy would be in a shambles. Now, it's almost certain that he is right, that the economy in 2009 was in shambles, and beyond as well, in 2010. Some fund managers would be tempted to try some kind of tactical asset allocation based on what he actually said, but not Buffett – why is that? Even though Buffett knew that things were going to happen, why didn't he try and avert it in some way?

**L J:**

Well, what's very interesting about that, David, is ... you're right, those six words were repeated throughout the blogosphere, throughout the media – "the economy will be in shambles in 2009", but they didn't quote the entire sentence. Following that phrase was, "... and that has nothing to do with whether the stock market will rise or fall".

**David:**

But for most people, they would take fright – if they knew the economy was going to be in shambles, they would actually revert to cash, wouldn't they?

**L J:**

Well, that's exactly what happened. When the market closed on the Monday after his letter was released, it closed at the lowest level since 1996. Anyone that read the entire letter, and knew that people were reacting fearfully to this soundbite, which was, in my view, was repeated very irresponsibly by the media, they would have run for the hills. People that knew the entire sentence would have gone into the market and bought just about everything that they had wanted, companies that they would have wanted to own.

**David:**

So cynics might turn round and say, was Warren Buffett in some way pre-meditating what was going on? Did he know that people were going to take that one soundbite, because as we all know, Warren Buffett is very quotable – was he trying to unsettle the market in some way?

**L J:**

I would find that very surprising. I think one of Warren's problems is that people tend to put him so high on a pedestal, that they give him superhuman powers. In reality, as my daughter said to him after we visited him in 2001, she was just nine years old, and I asked her what she thought about him, and she said, "He's more of a kid than I am."

**David:**

Now the thing about Warren Buffett, he is really so unique, because he sees opportunities where other people see threats, and he also sees strength in companies where other people only see weakness. So, as someone who knows him, do you know how he values business opportunities? How does he go around doing this?

**L J:**

I think Warren is a relationship investor. He has a fundamental business model, and it's important that we introduce a concept that Charlie Munger, his partner, uses a lot, which is the concept of mental models. I'll tell a quick story about this – in a meeting with young people, they asked Charlie, the young men there asked Charlie, "What stocks should we buy? – we want some tips." Charlie looked at them disdainfully and said, "Well, what do you mean – what stocks should you buy, what tips? I mean, I don't just pick stocks, I have models in my head in which I look at a number of different criteria, and then I make a decision about what would be a good investment." He said, "How many of you use models?" And then he notes, "Oh, I only see one hand raised", and he said, to the gentleman who raised his hand, "Now what school did you go to?", and the man said, "MIT", and Munger said, "Well, you wouldn't expect a poetry major from Amherst to have a model."

So these models, so Buffett, Warren, and if you read the owner's manual, as you do, follow his letters, you know what those principles are. You know he likes companies that don't have strong moats about them, that lack technology risk, where you can really count on the cash flow year after year after year, because he wants to be a long-term investor, and he feels that that's the best way to create wealth. But it's important to know what the leadership and the culture and the management is all about. That's why you'll know, over the years, he'll say that, he puts an advertisement in his letter to call for private owners, owners of private businesses, privately-held businesses, to come to him if they want to sell their business, because he likes the cultures in entrepreneurial businesses.

**David:**

So why is it so difficult, L J, for people to try and replicate what he does? Why is there only one Warren Buffett?

**L J:**

I think, if you look around, you'll see that there are a number of funds, investment funds, people who very much subscribe to his approach, and are doing very well. Maybe it's because again they get overshadowed by the

Buffett aura, but over the years I've been very impressed with how many people are actually following his work. But, let's face it, it's very contrary to the way most of the capitalist system works, and the financial markets work. This idea that Warren refuses to give earnings guidance, he certainly wouldn't give quarterly earnings guidance, doesn't give quarterly reports as most companies feel compelled to do, and will tell his investors, you can expect lumpy earnings, but that's because we will choose investments based on the economic merits, not the accounting merits.

**David:**

But the thing is, L J, he's almost quite secretive in the way that he operates, because he doesn't really want his shareholders to know what he's buying. I'll give you one example: I mean, he's always made a big play about investing in American companies, but then he went out and bought PetroChina, he spent \$448 million buying PetroChina. Now he turned that into four billion dollars. The thing is, nobody can deny that he made a huge coup there, but on the one hand we say he's actually very candid, and he tells people that you don't really need to look outside America in order to find investment opportunities, and yet he goes and does something completely different.

**L J:**

Well, those are rare occurrences, you're absolutely right. I could tell you another story about how he divested PetroChina, but I think it's not an area, investing in foreign companies is not something he does very frequently, so it's not normal. But I think he's the first to say, I will not tell you what I'm going to invest in. That's his competitive edge – why would you go out and give people what your best investing secrets are, and then you lose the value of the equation.

**David:**

OK, now you mentioned Charlie Munger earlier on, and one question that many investors are asking at the moment, and rightly so, and that is, when Warren Buffett decides to call it a day, when he decides he wants to hand over the mantle to somebody else – how do you think investors will react when he does that?

**L J:**

I really don't know, but I think he's made it quite clear that there's a very clear succession plan. Several people have been identified, they would be people inside the company. He wants to have an investment officer, which is probably somebody not inside the company, and he's been testing three or four people to see what their results are, and how they approach investing, and then he would have an operating CEO, and that would be one of the people that is currently in the company. Dave Sokol, who joined the company through the utility investment, is one mentioned as a candidate. Ajit, from the reinsurance business, is also mentioned.

**David:**

Correct, yes.

**L J:**

So I think again, I know a lot more about Buffett's succession plans than I know about most publicly-held companies.

**David:**

Right, so you're saying that he's actually being quite candid there? – because if you are a Chief Executive Officer of a big organisation such as Berkshire Hathaway, I think most of the investors would want to know what is going to happen with regards to the succession plan itself, because Charlie's not a young man, is he?

**L J:**

He's not, but he's not really involved in the day-to-day operations of Berkshire. He's an advisor to Warren, and they talk about the investments and so on. And of course, Warren's created a model where he has all these self-sustaining businesses run by people that know their business, love their business. They don't need to work, they

have lots of money, but they love what they do – that's what Warren appreciates more than anything. His job is to be the principal capital allocator, and make sure that the cash that's produced in these businesses gets allocated where it can be used the best to create wealth. When you think about it, I work with lots and lots of companies, I observe lots and lots of companies, and I think capital allocation is the place where tremendous amounts of waste and value destruction occurs.

**David:**

And that is because people are buying and selling the equities all the time, and incurring costs that you wouldn't necessarily need to?

**L J:**

Well, that's exactly right – the friction costs in trading. We say, people invest, but really most of the investing going on today is trading. But I also mean the decisions made in large corporations about how to allocate the cash that they generate. They'll give some back in dividend share, repurchases, but then what do they do with the rest? I think the model that we have in economics today, and capitalism, is one in which large companies, we all know, do not support innovation. So here are these big companies generating lots and lots of cash, but it's not going back into innovative, productive uses. I think that's where I see a lot of the wasted capital.

**David:**

And yet surprisingly, Warren Buffett is somebody who is actually very focused on dividends themselves. So therefore he is almost advocating that it's great for a company to pay him dividends, but at the same time, he's not actually prepared to pay out dividends to his shareholders?

**L J:**

Ah, but ...

**David:**

Yes!

**L J:**

... he addressed that very clearly in the shareholder meeting this year, and also in his letter, and it's one of the owner's manual principles, that he has said, for every dollar of cash that he gets, he can invest that at a dollar plus, then he will not pay out dividends. But when it comes to be that time, and as the company gets bigger, it's probably coming closer to that time, because it's really hard to move the needle when you are a larger and larger company, when that time comes, he will be paying out dividends. So he's buying the stocks of companies that have reached that point, where they lack – it's kind of counter-intuitive, isn't it? – that these big companies, with all these resources, would lack the wherewithal to be able to effectively deploy capital in ways that would create more wealth than giving it back to shareholders.

**David:**

And in one word, L J – would you say that Berkshire Hathaway is one company that will carry on going on forever?

**L J:**

Who's to say? I think already it's very important to point out that the Burlington Northern Santa Fe deal that began this merger acquisition, whatever you want to call it, has very much changed the company. It's now in the index, and it's trading more like a "normal", or less like a Berkshire company. As the B shares have gotten into the range of people who would like to own a piece of Berkshire, in the past it was \$3,000 or so to earn a share, now that's substantially less. So I think the company has changed already, and I think what's really important for everyone to remember is that the company will continue to live by the principles that Buffett has espoused.

**David:**

But by splitting off those shares, L J? – is he likely to cause more volatility in Berkshire Hathaway's shares?

**L J:**

Of course, and as I say in my book, the reason that Warren can tap dance to work every day is because he has enjoyed tremendous loyalty from his investors, who hold on to, they buy the stock and just hold it, and put it away in a desk, and they've been rewarded for that over the years.

**David:**

And will future shareholders be as loyal, when they're only paying a fraction of the price that previous shareholders were paying for Berkshire Hathaway's shares?

**L J:**

I think that's a big question. I think that remains to be seen.

**David:**

OK, we'll leave that tale hanging. Now, before we end today, I have a copy of your book to give away to the lucky listener who can tell me the name of (and this was mentioned during the podcast) – if you can tell me the name of Warren Buffett's business partner. If you know the answer to the question, who is Warren Buffett's business partner, please email your answers to [moneytalk@fool.co.uk](mailto:moneytalk@fool.co.uk) for your chance to win a copy of L J Rittenhouse's book, "Buffett's Bites".

Now, L J, I end each podcast with a quote, and it's only right and fitting that today's quote comes from the very quotable Warren Buffett. My quote today is, "If past history was all there is to the game, the richest people would be librarians." Have you got a favourite Warren Buffett quote to end today's podcast? I'm putting you on the spot here.

**L J:**

I think a corollary to that is, "Beware of geeks bearing formulas."

**David:**

That's wonderful. Now thank you for joining me today, L J. This has been Money Talk, and my guest today has been L J Rittenhouse, author of "Buffett's Bites". If you have a comment about today's show, please email me at [moneytalk@fool.co.uk](mailto:moneytalk@fool.co.uk), and if you have a suggestion for future shows, you can also email me at [moneytalk@fool.co.uk](mailto:moneytalk@fool.co.uk). Until next week, everybody, have a great week, and happy investing.