

SPECIAL REPORT

LEARNING FROM A LEGEND: HOW WARREN MADE HIS BILLIONS



BY ANDREW GORDON

INTRODUCTION

I was looking at Inco – a nickel-mining company – about a year ago. It had outstanding numbers, including a low price-to-earnings ratio (P/E), big margins, and a good cash flow. So – after doing my research into the company’s growth strategy and management team – I recommended it to my subscribers.

It’s now up over 80%.

What did I know that other investors missed?

It’s pretty simple. I knew that mining companies are sometimes discounted because their industry is so cyclical. What’s more, the price of the commodities they extract can also be volatile. I figured if this company could somehow remove the question marks raised by those two issues, its discounted price would have to rise.

When I found out that nickel was in serious short supply (a situation that wasn’t going away anytime soon), I realized that Inco was in a strong growth market that would also prop up nickel prices into the foreseeable future. Then I looked very carefully at the company’s balance and income sheets, its recent financial reports, production costs, capital expenditures, and current and planned mine development activity. I liked what I saw.

I also concluded that its management team was strong ... and that was all I needed to know.

I concluded it was only a matter of time before this company’s stock would rise – and if it didn’t happen right away, it would happen sooner or later. As it happened, Inco went up later rather than sooner ...

...which was no big deal. Sticking with the company didn’t take blind faith or nerves of steel. I knew its fundamentals were real. It wasn’t hard for me to sit tight, because I understood that with value companies ... with beaten down companies ... with unpopular companies ... it sometimes takes Wall Street longer to recognize the same value in a company that you saw.

But, most of all, I had confidence in the course I was taking, because I was following Warren Buffett’s investing philosophy.

Three Simple Secrets to His Success

Why would I want to invest like Buffett? Try \$34 billion. That's how much he's worth.

And while other multi-billionaires have gained their riches through the ownership of companies or through leveraged investments like derivatives trading, he's has gotten his through the stock market ... through investing in companies available to the likes of you and me ... and then by simply sitting on his investments.

Sure, he makes bigger investments than we can. But, if anything, that limits the universe of companies he can invest in. With our more limited funds, we have thousands of companies to invest in. He is limited to hundreds.

Yet, that doesn't seem to have held him back. A \$10,000 investment in his company (Berkshire Hathaway) in 1965 wound up being worth nearly \$30 million by 2005. In contrast, \$10,000 invested in the S&P 500 would have risen to roughly \$500,000.

If he can find companies that have earned him a fortune over time, what's our excuse?

The simple truth is, if you want to invest like Warren Buffett, you can.

What's the secret of his success?

- He's not afraid to invest in unpopular or unfashionable companies. In fact, he seeks them out. These are typically the stocks that are the greatest values.

Benjamin Graham – author of *The Intelligent Investor* (the classic book on value investing) and Warren's professor, mentor, and boss – called them "cigar butt" companies. No longer of interest to the market, and thus undervalued, but still with a few puffs of life in them.

- From a distance, it appears that Warren must have the magic touch. But, believe me, magic has nothing to do with it. He's known for his exhaustive research into companies.

- He has to be excited about the company. I'm talking about *the company itself* and the business it's in – not the potential returns. My friend and investment expert Porter Stansberry once told me, "You can't like a company in theory. You should be willing to give up your first-born to run a company you've been checking out."

That's the way Warren sees it. In a recent Berkshire annual report, he said, "Whenever we buy common stocks ... we approach the transaction as if we were buying into a private business." In other words, he looks at a company as if he's going to partner up with it.

The Man With a Simple Plan That Made Billions

Born and bred in the Midwest, Warren Buffett is known as the Sage of Omaha – nicknamed for that rather unremarkable Nebraska city on the banks of the Missouri river.

He is a gray-haired, no-nonsense Man of the Heartland, who dared on several occasions to *not* follow the Wall Street crowd into trendy investments that ultimately proved disappointing. He became a legend, admired for his simplicity and unpretentiousness, investing acumen, and the billions of dollars he amassed.

As a result, his company's annual meeting has become something of a pilgrimage. Every May, it attracts thousands (14,000 for the last one) to Omaha to catch the Sage's latest take on the "Buffet Way" and – by contrast – the tomfoolery of Wall Street. Warren himself has called the occasion the "Woodstock of capitalism." Some people buy a Berkshire Hathaway share (by no means an inexpensive proposition) just to be able to attend.

For one of the richest men in the world, he lives quite modestly. He still resides in the same gray stucco house he bought for \$31,500 back in 1956, and everyone in Omaha knows where it is.

Warren's straightforward and commonsensical approach to investing has given hope to millions of ordinary investors that at least some measure of his success can be emulated.

How to Shop for Value, Quality, and Growth

Warren doesn't depend on algorithmic models, sophisticated software programs that mine and manipulate data, or secret formulas. Far from it.

In many ways, he approaches investing the way we approach shopping for a car. So let's take a look at how we do that.

But before we do, I want to describe a commercial about insurance that I've been hearing on the local radio these days. It starts out: "I just bought a car. And I got a great price!"

"What model?" a second voice asks. "I don't know," the first voice answers.

"What manufacturer?" the second voice then asks. "I don't know."

"Is it new or used?"

"I don't know."

The point of the commercial is that it's silly to buy a car without knowing exactly what you're getting for your money – and it's just as silly to buy insurance that way.

You could say the exact same thing about buying stock.

We all know that before we dish out more than a few grand for a car, we need to figure out if we're getting a good price. It's all about the car. How does it perform? How often does it need repairs? What's its resale value going to be? These questions can readily be answered only if our particular model has been in production for several years.

That's fine with us, because we wouldn't want a first-year model anyway. Besides coming with no information as to how they might perform over time, first-year models are never completely debugged.

If we wanted a good car at a good price, we also wouldn't choose the most popular model (which would probably be going for a premium). We'd choose a slightly out-of-favor model. If we *really* wanted to save money, we'd choose a car everybody hates.

And, being the cautious buyers we are, we'd look only for a car from a manufacturer with a reputation for making quality vehicles that last. If we

play our cards right, we'll get the first two years of the car practically for free. But we'll need to get a great price on the car to be able to sell it two years later for only slightly less than we paid.

If this is how you buy a car, you're well on your way to understanding several of the factors Warren considers when investing. Let's start by going over the factors touched upon in the above car-buying example. Then we'll address a few more.

Buying Quality

A car is only as good as the manufacturer that makes it, and a company is only as good as the people who run it. Apart from good management, you'd want quality products and services and a company you understand. Let's take these one at a time.

- **Management.** Warren puts strong management on the top of his list. He likes to meet them in person and get to know them. That's a little too much to ask of you. But, at minimum, you should read the CEO's bio (which is typically provided on a company's website).

And google the CEO's name. Nine times out of 10, you'll get plenty of instant reading material. If you can, go to the company's annual meetings and listen to the CEO and other executives speak. Or – if that's not possible – listen to their called-in quarterly earnings report.

Just remember that there's no such thing as too much direct and up-close exposure to the companies you're investing in. The more you know about them, the better buy/sell decisions you will make.

- **Quality products.** As a general rule, the more high-end its products are, the better margins a company makes. Companies charge a premium for new technology, sleeker designs, more features, better packaging – which all go into high-end products ... and customers gladly pay. The less high-end, the easier it is for China and other countries to make cheap copies and put your company out of business. 'Nuf said.
- **Understand the company.** What does this have to do with quality? Not much. But it has everything to do with your ability to judge whether a company is in a class by itself or classless.

You need to know at least *something* about the business. This is a relative requirement, because this kind of knowledge often falls somewhere between knowing nothing and knowing it all. But if you don't have a clue about what makes a company's business tick, STAY away. Whether or not a company can grow its profits should not be a guessing game.

Nor should it be a "follow the leader" game. Even if everybody in your bridge club is flocking to this business or a company in this business, still STAY AWAY. Who knows what they're following or why? Bad advice is the ruination of many an investor.

Is looking into all this really necessary? Can so many people get it wrong? Warren, in fact, counts on so many people not getting it. That's why he loves "cigar-butt" companies that are so out-of-favor nobody will touch them.

He stays away from the buzz-generators. As a "life-long technophobe" (as he confesses on the Berkshire website), he stayed away from the high-tech companies when they were the rage in the 1990s.

How dare he?

"Warren Buffett should say 'I'm sorry,'" fumed Harry Newton, publisher of *Technology Investor Magazine*, in early 2000. "How did he miss the silicon, wireless, DSL, cable, and biotech revolutions?"

That was the year AOL stock rose six-fold and Amazon.com had rocketed by 1,000%, while shares in Berkshire had climbed only 11%.

But, as history proved, the "Buffett Way" won out in the end. The dot-com bubble exploded, leaving millions of Americans poor and in shock.

Buying Discount

As the radio commercial above not-so-subtly points out, you have to know something about a company and/or product before you even look at the price. Lousy companies will be priced low because low quality fetches low prices. You want good companies at low prices. Now that you know

something about what makes a good company, let's see what makes a good price.

One of the most commonly used metrics is the price-to-earnings ratio, or P/E. You can find the P/E on most financial websites that cover individual companies. P/E refers to price per share over earnings (also known as net income) per share.

Any company with a P/E below 10 is worth looking into. But P/E isn't the end-all be-all of judging a company's price. First of all, you have to be sure of what the P/E signifies. Usually, price refers to the current price and earnings refer to the earnings of the company in the past 12 months. Sometimes this will be called a "trailing" P/E.

The problem with a trailing P/E is that it's backward-looking. It's also worth it to look up a company's future (or forward) P/E or its price compared to projected earnings over the next 12 months. If earnings (the denominator) are going up, the P/E ratio will be going down compared to its trailing P/E. That's what you like to see.

Another way to get a peek into the future prospects of a company is by looking at its PEG or price-to-earnings-to-growth ratio. Anything under 1 is great, although staring at a 1.1 or 1.2 isn't going to steer me away from a company.

How does PEG work? Let's say a company has a P/E of 12. And that company has projected annual earnings over the next five years of 12% per year. It would then have a 12:12 PEG ratio or a ratio of 1. If its projected growth rate is 15% per year instead of 12%, its PEG ratio would be less than 1. Companies would die for such a ratio ... and here's why.

A P/E of 12 is just okay. Remember, I just said that I like a P/E that's under 10. The S&P 500's average ratio is about 18. So you could argue that I'm being fussy. Darn right. I think the S&P 500 is way overpriced – and it is, compared to its historical P/E average. I believe the S&P 500's overall P/E average is heading down, and I don't want my companies to have a good P/E only by today's standards but by tomorrow's also.

So we're back to a P/E of 12 being just okay, and now you know why. On the other hand, double-digit growth is better than okay. And I say that even though companies have been reporting double-digit growth on average for 16 quarters in a row.

THAT'S THE PAST, THOUGH.

It's going to become a lot more difficult to achieve double-digit growth in the next five years than it was in the past five years. If investors love double-digit growth and are willing to pay a premium for it *now*, just wait. That premium is about to get a lot bigger.

I consider a company priced at a P/E of 12 (just over my cutoff point of 10) as slightly overpriced – or, another way of saying it, that it's going for a slight premium over fair value. But if it also sports a PEG of 12:15 (an impressive less-than-1), the small premium becomes justified and the company goes from overpriced to fairly priced.

But the PEG's strength is also its weakness. It's great that it allows you to peek into a company's future, but it does so at the cost of becoming a little speculative. Remember, the "G" part of PEG projects growth over a five-year period. The PEG ratio is only as good as this projection. If the company underperforms the "G" part of the PEG ratio, you've probably hitched your wagon to the wrong star. Future P/E is less speculative, since it only projects earnings 12 months out.

And it's not only the "G" in PEG which muddies the waters. The "E" for earnings is a fairly muddy category unto itself. It includes all kinds of nonsense, such as tax write-offs, depreciation, one-time charges, and sales. At the end of the day, it bears little resemblance to a company's actual operational earnings.

For these reasons, I like EBITDA (Earnings before Interest, Taxes, Depreciation, and Amortization) much better – and I believe EV (enterprise value) to EBITDA is a much better ratio than P/E.

EV is simply the market capitalization of a company plus its cash minus its debt. It's called "enterprise value" because that's what you would pay for the company if it were up for sale. The Yahoo financial Web page lists an EV/EBITDA ratio for all the companies it covers. (Just click on the "key statistics" link.)

In addition to P/E, PEG, and EV/EBITDA, there's one more ratio you should look at: price-to-book (P/B). The "book" refers to net assets or assets minus liabilities. A P/B less than 1 either means you're getting a great buy on the company or its assets are worth as much as shares in Pan Am.

Think about it. At a P/B of 1, the price per share you're paying is the same as the value of the net assets per share. That means everything else you're getting with the company is free. The business – and the profits it

generates – IS FREE. The future growth of the company? Free too. A P/B of 1 or less is a phenomenal ratio. But anything less than 2 is still considered good.

This is what works for me. I first look at EV/EBITDA. Then I look at trailing and future P/Es. And then I take in the PEG and P/B at about the same time. The more ratios you throw at a company's price, the better feel you get for how much – if anything – it's discounted.

Of course, it stands to reason that the riskier you think the company is, the greater the discount should be.

Buying Safety

What kind of companies are least likely to tank and are most insulated when the economy heads south? Companies going for a big discount ... companies with fat margins ... and companies with wide moats. Let's take these things one at a time.

- **Big Discounts.** Warren's mentor, Ben Graham, insisted on margins of safety as the best way to protect investors against a loss.

We've already talked about the measurements to use in determining whether a company is going for a good price. But just how good a price should you go for?

Graham lived through the "Great Depression" of the 1930s. He observed firsthand the stock market crash and its awful consequences on shareholders who found themselves impoverished practically overnight. Graham figured a discount or "margin of safety" of at least 25% would be necessary to protect investors from such future market shocks.

For Graham and Buffett, it's not about the feel-good sensation of getting a bargain. It's more about getting real protection, and a "margin of safety" accomplishes that to a certain degree.

Consider the following scenario.

Assume that a fairly valued market drops some 25% overall. It's now priced at 25% below fair value – the level at which you bought your

stocks if you had followed Graham's and Buffett's lead. Because of the built-in discount of your stocks, chances are they didn't drop nearly as much... and perhaps not at all.

If the market is overvalued, like it is today, a 25% drop would have stopped short of the 25% discount you bought your stocks at. Your stocks would still have room to move up to reach the overall market's level of valuation.

When the market is falling and you have a 25% margin of safety on your stocks, one of two things is likely to happen.

Either your stocks will drop ... but not nearly as far as the market.

Or, when the market bounces back, your stocks will be among the first to recover.

Why? Other stocks may have been knocked down to their fair value or just below. Their price is not so out of whack. But your stocks are WAY BELOW their fair value. With a little good news or a little bullish activity, they're primed to bounce back up in a hurry.

And knowing this – that almost just as surely as water seeks its own level, stocks seek their own fair price – why sell when your stocks are down?

If you adopt the "Buffett Way" of investing, there's no reason to. Mr. Market is simply posting you the latest prices of your stocks, not telling you to sell. That decision is entirely yours to make.

Warren is patient with his stocks. He picks them and holds them and waits for the years to turn into decades. And it's paid off for him. It's a package deal. If you pick 'em like Buffett, you have to hold 'em like Buffett.

- **Fat Margins.** This is a favorite metric of Buffett's, and a big favorite of mine.

Margins tell you how much profit a company makes from its revenues. Gross margins factor in very basic costs. Operational margins factor in a host of additional costs to "operate" the business.

I look for operational margins of at least 15%. I go gaga over operational margins of 25% (and gross margins of 50%).

Big margins give a company a badly needed cushion when things go awry – as they sometimes do with even the best of companies. It could be the cost of raw materials going up or the price of their products going down. Or a plant needing maintenance and shutting down. Or an accounting “mistake.”

Some investors like to see margins improve from quarter to quarter, or at least from year to year. That’s important if operational margins are below 15%. It’s much less important for companies with margins over 20%. Companies build up margins to give them a bigger share of the profit and also to weather storms that will see margins fall, though not to critically low levels.

In fact, some of the best buying opportunities come when investors punish companies with margins that have fallen from – let’s say – 30% to 27%. If the other fundamentals look good, I scoop up these stocks at their lower prices. But first, I make sure this isn’t the third or fourth quarter in a row that margins have slid. I don’t want to invest in a company with margins that are slowly but surely deteriorating.

- **Wide moats.** How much distance can a company put between it and its competitors by being a technology, brand, or marketing leader? This is an easy concept to understand but a hard one to put it into practice.

Intel probably thought it had a nice moat with its leading technology and brand recognition. (A chipmaker marketing itself to consumers was a first when they started to do it about a decade ago.) But Intel found out that its moat didn’t protect it from serious market encroachments by newcomer Advanced Micro Devices (AMD).

Ford and GM probably once thought their brand recognition gave them a wide and deep moat over their obscure Japanese competition like Honda (more known for motorcycles or lawnmowers than cars at that time).

Sony once had a sizable moat. But between a problematic Playstation 3 launch and a few exploding batteries, its moat now isn’t nearly as wide as it was not so long ago.

Moats are in the eye of the beholder. Recognize them when you see them, but don’t take them for granted and don’t overestimate them.

Remember, these companies probably have some very smart competitors whose number one goal is to bridge those moats. You have to decide for yourself just how effective a company's moat is.

But this is what I've seen many times. When things go wrong for a company, its moat dries up as the company wrestles with its problems. And much of the protection it offered disappears fast.

There's also another kind of moat – one that protects a company from the downside of business and economic cycles.

Warren's Berkshire Hathaway bought a utility last year. It bought American Express 30 years ago. It also bought a beer company one and a half years ago.

In addition, Berkshire owns GEICO and General Re – an insurance and re-insurance company, respectively.

These companies all provide a substantial measure of protection against a slowing economy.

They are very safe investments, because when the bears move in, they are minimally affected.

This is very important, because investors typically lose half the gains they made during a market bull in the following bear market. So if you can avoid most of the adverse effects of a bear market, you'll be making about twice as much as other investors over time.

- **Debt.** Warren is partial to companies with little or no debt, and I can't blame him. Paying interest on loans lowers net earnings. And it can add substantial uncertainty to a company's risk profile.

If a company can't pay its loans, that can be the beginning of a slide into bankruptcy. But even if a company can pay off its loans, it can find itself in serious trouble with the bank. It's not just about the money, but about the terms.

Banks can impose many conditions on loans – for instance, specifying how much cash flow the company has to generate to meet its debt and interest obligations. Such conditions are called covenants. And they can make the CFO of a company go gray faster than Bill Clinton.

Financially conservative companies expand by using their retained earnings rather than getting bank loans. Or they issue shares. A company's debt-to-equity ratio (or D/E) can tell you how much debt burden it has. (Equity is net assets plus retained earnings.) Debt should be less than 50% of equity. A company's total debt and shareholder's equity can be found on the balance sheet of a company's financial report.

For banks, real estate companies, and REITs (real estate investment trusts), debt is unavoidable given the nature of these businesses, so this metric can't be used quite the same way.

Regardless of a company's D/E, you should always delve into its annual and/or quarterly reports and look up how well its loan repayments are spaced out in future years. They're never perfectly even. And for those years when loans mature and become due, there can be dramatic jumps in a company's debt service burden.

A big jump can be a red flag, depending on when it is (the further away, the better), the company's ability to pay, and the lending climate as the deadlines grow nearer.

- **Cash Flow.** Given his druthers, Warren likes companies that make more than they spend. And he figures the less they spend, the more they'll make. And the more money that is left over after all the spending and paying bills, the more gains there will be for shareholders.

So you can cross capital-intensive businesses off his list. That is one big hunk of the stock market that Warren could care less about. It's difficult for a company to generate cash that amounts to 10% or more of its market capitalization.

But CF measures cash flow *before* capital expenditure. Free cash flow measures CF *after* capital expenditure. Only companies with extremely modest capital expenditure (capex) budgets can get their free CF yield to average over 10%. But these are precisely the companies that would most interest Warren.

Buying Growth

In the music industry, they're called one-hit wonders. I'm talking about groups that had one big hit, and that's it. Needless to say, they don't make a whole lot of money for themselves, their managers, or their record companies.

Some companies are like that. They have a good year or two, and then it's downhill from there. Warren avoids these companies like the plague. How? By not even taking a passing glance at these 1-year or 2-year wonders.

Warren is only interested in the 10-year (or more) wonders. He likes a 10-year minimum track record of growth. Not because it *proves* a company can continue to grow. The only thing it proves is that the company grew during the past 10-year period. But if the company had the same management then as it has now, they should know how to squeeze growth out of the company going into the future.

Whether or not they can do it remains a big question. But it is a question that a track record of length helps answer. Ten years of leaving its footprints in a market can reveal a great deal about a company.

A Portfolio for the Ages

If you can buy quality, safety, and growth at a discount, Warren would no doubt tell you to go for it. Buy that stock.

It certainly worked for him and his company. Shares of Berkshire hit the landmark \$100,000 mark in late October of 2006. They've come a long way since March 10, 2000 when they hit a low of \$41,300. That was the same day the Nasdaq composite hit its high of 5048.62. Since then, the Nasdaq is down 53%, while Berkshire is up 142%.

Berkshire's portfolio of 38 stocks (worth \$45.3 billion) was bought over a long period, beginning in 1967. Shares of its "big four" companies – American Express, Coca-Cola, Gillette, and Wells Fargo – started to be acquired back in 1988.

Of the 38 stocks, five are relatively new investments: Home Depot (HD), Lexmark International (LXK), Tyco International (TYC), Anheuser-Busch (BUD), and Kingfisher (KGFHY).

But don't go rushing out to buy these five companies. The Budweiser stock, for example, showed surprising weakness when Berkshire bought it and its price has risen only slightly over Berkshire's purchase price of roughly \$45.

And scandal-ridden Tyco is still sorting out its mess. It's a complicated situation. I consider that investment to be too speculative at this point.

Nor is it going to do you much good if I list the remaining 30 stocks in the Berkshire portfolio ... except to satisfy your curiosity about which stocks are in this top-performing portfolio.

Instead, you could invest in a mutual fund that mimics the investments made by Berkshire Hathaway – the Wisdom Fund (WSDVX). It invests in the 33 public stock holdings of the Berkshire portfolio. While it can't invest in those companies that Berkshire owns outright, it does the next best thing. It invests in companies that share many of their same characteristics.

The problem with this is that, for many companies in the portfolio, their best growth days are behind them. It makes sense for Berkshire to keep holding them as long as their shares don't start to decline. But it makes much less sense for you to buy these stocks across the board.

Of course, if you have \$100,000 handy, you could buy a share of Berkshire. If you can't afford that modest sum, you can buy class "B" shares for \$3,333 per share.

BONUS! The Best Three of the 33 Buffet Stocks

Still, Buffet's Berkshire portfolio – which has made him one of the richest people in the world – includes some very enticing companies that deserve a closer look. I've chosen three of the most impressive ones. They still have outstanding value and growth potential. Here's why I like them so much:

- **M&T Bank Corp. (MTB)** Berkshire Hathaway owns 6,708,760 shares of this company – making it the second-largest institutional

shareholder of this regional banking company. (It serves the NY/DL/PA/MD/DC area.) Its P/E and price P/B are fairly average. That makes M&T neither cheap nor expensive. But I like this bank because it's overcome shrinking earnings from net interest (the difference between the interest of borrowing short and lending long) by growing the loan and bank deposit side of its business. And it keeps a tight lid on expenses. It's still going strong with its earnings per share growing rapidly. Bank executives also own a large piece of this bank. Warren would approve.

- **Mueller Industries (MLI)** Mueller Industries makes refrigeration valves, as well as copper, brass, aluminum, and plastic fittings and shapes. Mueller recently started a manufacturing operation in China, which will help keep costs down. And its recent purchase of Mexican and UK companies will boost sales in those two key regions of the world. Most important to its future profitability, Mueller has been able to pass on rising raw material costs to its customers while still expanding sales. And you can buy this stock at a nice discount. Its P/E is under 10, less than half what the industry averages. And its P/B is a third lower than the industry average.
- **PetroChina Co. Ltd. (PTR)** Can't make up your mind whether to do a China play or an oil play? Why not do both with this company? Berkshire Hathaway owns a grand total of 0.37% of the shares of this behemoth. That still comes out to a hefty \$54,940,830 investment. What is Buffet getting for his money? A lot of capital appreciation, for one. The stock climbed from \$53 to \$82 in 2005. It hasn't slowed down in 2006, and it's not done growing. In a big, growing, oil-starved country, PetroChina still remains a company with lots of upside. And I love its margins – double the industry average.

There is one last thing you need to know about Warren: His investing approach is much easier to understand than it is to follow.

First, he understands a lot of businesses. He knows the insurance business from his days as a 21-year-old discussing GEICO with Ben Graham (who was GEICO's chairman at the time). He also knows how the manufacturing business works. And he's had a lot of experience in retail and banking.

Whatever kind of business it is that you know very well, Warren wants you to stick to only that kind of business. That's going to be hard to do, because it's going to narrow your choices dramatically. You can, however, take comfort from Warren's conviction that diversification is vastly

overrated. If it's just one business you know, that's good enough in his book.

Second of all, he's super-careful and cautious in his investing approach. He has shown on a number of occasions that if he can't find good companies, he's more than willing to sit on his enormous pile of cash.

In doing so, he has to answer to shareholders who are looking for generous returns on their investment in Berkshire. But you only have to answer to yourself. That's a lot easier. If Warren can do it, surely you can find the discipline to *not* pull the trigger on companies that come up shy when measured against the "Buffett Way."

Third, he knows where to find the kind of companies he's looking for. And hey don't grow on trees.

Most of the financial websites have search engines. Some have preset "value" search engines where all you have to do is click on the "search" link. Try out Yahoo/Finance's "Bargain Growth" preset search (<http://screen.finance.yahoo.com/newscreener.html>).

This screen searches for stocks with a PEG ratio less than or equal to 0.5 and total D/E ratios of less than or equal to 0.5. It also looks for earnings growth estimates for the next five years that are greater than or equal to 25%.

There are other searches that you can customize yourself by putting in your own criteria by P/E, CF, margins, etc.

In fact, [I created a custom chart using all of Warren Buffett's search criteria, which you can access by clicking here](#)

If you want to do it yourself, using the same Yahoo site as above, click on "Launch Yahoo! Finance Stock Screener" and begin building your own. It's easy. This is all you have to do.

- For P/E, key in valuation, then "<=" and then "12."
- For forward P/E, key in valuation, then "<=" and then "10."
- For PEG, key in valuation, then "<=" and then "1."
- For Cash Flow, key in valuation, then EV/Operating CF, then "<=" and then "10."
- For Margins, key in Margins, then "operating margins," then ">=" and then "20."

- For Debt, key in Balance Sheet, then "total debt to equity," then "<=" and then ".50."

Ask for the top 25 companies, and then click on "run."

Once the search engine spits out a list of companies, that's when the fun begins. Sometimes you get more than 25, and sometimes you get fewer. When I last did a search like this, I got 19 companies.

Now you get to lay bare the companies' strengths and weaknesses. It's not hard, but it does take a certain amount of time and effort. Their annual reports are required reading – as are at least their last two quarterly reports. And, of course, crunching the numbers, looking at them in historical context, and projecting them into the future are all necessary tasks.

After you've researched and qualified your list, you could end up with anywhere between one and five "Buffett Way" companies to invest in.

Warren rarely veers off the path he's trodden over and over through the years with so much success. Put on your hiking boots. You're next.

Welcome to the world of Warren Buffett.

Good Investing,
Andrew M. Gordon