COMMON STOCKS & COMMON SENSE

The strategies, analyses, decisions, and emotions of a particularly successful value investor
COMMON STOCKS
AND
COMMON SENSE
To my loving wife, Sue, my four children, and my six grandchildren. After health, nothing is more important than family.

The author will donate all royalties received from sales of this book to a charitable foundation.
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INTRODUCTION

I have a passion for common stocks. For the past 30-plus years, I have studied the fundamentals of companies and industries, interviewed managements, visited offices and factories, constructed models of possible future earnings, and made thousands of decisions to purchase and sell stocks. My endeavors have been intense, exciting, fun, and successful. Thousands of other investment managers, many with higher IQs than mine, also have intensively searched for stocks that will appreciate sharply, but relatively few have been as successful as I have been. Why have I been able to succeed? There is no simple answer. If there were a simple answer, most others also would have found and adopted successful approaches to investing and would have enjoyed outsized returns. This has not happened. However, there must be reasons why some investors are better than others.

With the hope that others will benefit from my approach to investing, this book will explore what I believe to be the reasons for my relative success and will describe the reasoning behind the investment decisions that I made over the years. How will I do this? I am a product of the Harvard Business School, which teaches business via the case method. Because I believe that the case method is an interesting, relevant, and effective way to explain the strategies and thinking behind business and investment decisions, I used the method in this book. Chapters 3 through 13 in this book give an inside view of 11 investments made over the years by Greenhaven Associates, the investment management firm I founded in 1987. The explanations summarize Greenhaven’s actual investment process: our research,
our analysis, our models, and our decisions. The explanations also try to explain the behavioral sides of being in the investment business: our emotions, aspirations, hopes, elations, disappointments. These chapters are the meat of the book and should give the reader a detailed inside view of how an investment manager spends his time and makes his decisions. Also, and importantly, the chapters should give the reader a material understanding of why I have been a successful investor—of what has worked and not worked.

In order to give the reader a better understanding of the investment decisions made in Chapters 3 through 13, I have included Chapter 1, which explains Greenhaven’s basic approaches and strategies to investing. And because an investor’s success in carrying out his strategies is heavily dependent on his personality, temperament, and lifetime experiences, I have included Chapter 2 about my innate abilities and, more importantly, about my personality, emotions, and educational and professional experiences.

Chapter 14, the final chapter of this book, is a letter I wrote to Jack Elgart, a younger investor who asked for advice on becoming a successful investment manager. This chapter summarizes my investment strategies and lists a number of “do’s and don’ts” that I found useful over the years.

When I was in my teens and 20s, my father continually advised me that it is a gift to hide one’s abilities—and my father-in-law continually counseled that one should not call attention to oneself. Why, then, did I write this book? Why the disobedience to elders whom I respected and loved? Here is why. Investing in common stocks has been my life’s work, my passion, my fun, my source of income, my source of wealth. Over the years, with hopes of becoming a better investor, I have studied hard and thought intensively about why some investment ideas have worked for me and why others have not. And I have thought about the innate abilities, experiences, creativity, and mental states of those who became successful investors, and about those who did not. As a result of these efforts, I developed the psychological and analytical approaches to investing that have been successful for me. In recent years, I developed a strong desire—almost a calling—to
share these approaches and experiences with others lest they be lost to time. That is why I wrote this book.

While the basic facts behind each of the described investments in this book are accurate, I have forgotten many of the details, such as exact conversations, estimates of revenues and earnings, dates, and locations. These I approximated wherever possible—or, in some cases, pulled from my imperfect memory. In addition, I have taken the liberty of changing the names and backgrounds of some individuals in order to protect their privacy. I have also revised the original letter to Jack Elgart to include additional approaches and strategies and to expand some explanations.

I strongly hope that this book stimulates thought about the investment process. Even if the reader does not agree with parts or all of my approach to investing, if the book motivates the reader to think deeply about the science and art of investing, I will feel that the time and effort devoted to writing this book were time and effort well spent.
Note: Most of the contents of this chapter will not be new to the majority of experienced investors. I wrote this chapter to bring less experienced investors up to speed with the principles of value investing.

In my opinion, good investing largely is common sense, made somewhat difficult by the behavioral imperfections of man. We can start with the straightforward concept that, over the longer term, common stocks are an unusually attractive investment vehicle, even for an investor whose returns only equal the stock market’s returns. During the 50-year period 1960 through 2009, the average U.S. common stock provided an average annual total return (capital gains plus dividends) of 9 to 10 percent. In addition to providing this favorable return, common stocks are highly marketable and therefore can be purchased and sold easily without high frictional costs. Also, and importantly, if selected properly, common stocks offer considerable protection against risks of permanent loss. What could be better: favorable returns, high liquidity, and relative safety! That is a home-run combination, and that is why I am a great fan of common stocks.
The 9 to 10 percent average annual return provided by common stocks over the 50-year period makes economic sense. During the period, if adjustments are made for a few outlier years, the U.S. economy grew at roughly a 6 percent annual rate: about 3 percent from real growth (unit output) and about 3 percent from inflation (increases in prices). Corporate revenues during the period increased in line with the economy, and corporate earnings roughly increased in line with revenues. While the price-to-earnings (PE) ratios of U.S. common stocks have fluctuated widely during the 50-year period, they seem to fluctuate around an average of about 16 times earnings. Therefore, before consideration of corporate acquisitions and share repurchases, common stocks have appreciated at about a 6 percent average annual rate over the years due to the growth of the economy.

U.S. corporations, on average, generate considerably more cash than they require to support their growth. This excess cash can be used by corporations to pay dividends, acquire other companies, or repurchase their own shares. Over the past 50 years, dividends have provided a 2.5+ percent yield, and acquisitions and share repurchases together have increased the earnings per share (EPS) growth of publicly traded corporations by close to 1 percent per year.

Thus, an average company’s EPS has grown at about a 6 percent rate “organically” and at about a 7 percent rate including acquisitions and share repurchases. If one then adds the 2.5+ percent dividend yield to this 7 percent, the result is the 9 to 10 percent total return that an average investor has received over the years from investing in common stocks.

While it is difficult to project the future, assuming that the United States continues to be reasonably prosperous and capitalistic, I see no reason why the U.S. stock market will not continue to provide average annual returns of 9 to 10 percent over the longer run, even if the U.S. economy grows at a somewhat slower pace than it has in the past. If future growth is somewhat dampened, then corporations will not need to reinvest as much of their cash flows back into their businesses to support growth. Therefore, corporations should have more free cash available to pay dividends, acquire other companies, or repurchase their shares—and the increased returns
from these uses of cash should mostly or completely offset the reduced returns from the slower growth.

In spite of the many positive attributes of common stocks, I believe that many investors shy away from owning common stocks because they are fearful of the stock market’s volatility, especially sharp downturns that are accompanied by negative news from the media and from Wall Street. Many consider volatility to be a risk. Importantly, when thinking about risk, I draw a sharp distinction between permanent loss and volatility. The former is what it says it is: a loss that cannot be recovered. Permanent losses are hurtful and should be avoided at all cost—avoided like the black plague. They are decidedly detrimental to the creation of wealth. Volatility, however, is merely stocks or markets going up and down in price (not in value). Downward volatility usually is nerve-racking, but otherwise is quite harmless. Markets and stocks tend to fluctuate. They always have, and they probably always will. Importantly, every time the market has declined, it eventually has fully recovered and then has appreciated to new heights. The financial crisis during the fall of 2008 and the winter of 2009 is an extreme (and outlier) example of volatility. During the six months between the end of August 2008 and end of February 2009, the Standard & Poor’s (S&P) 500 Index fell by 42 percent from 1,282.83 to 735.09. Yet by early 2011 the S&P 500 had recovered to the 1,280 level, and by August 2014 it had appreciated to the 2000 level. An investor who purchased the S&P 500 Index on August 31, 2008, and then sold the Index six years later, lived through the worst financial crisis and recession since the Great Depression, but still earned a 56 percent profit on his investment before including dividends—and 69 percent including the dividends that he would have received during the six-year period. Earlier, I mentioned that over a 50-year period, the stock market provided an average annual return of 9 to 10 percent. During the six-year period August 2008 through August 2014, the stock market provided an average annual return of 11.1 percent—above the range of normalcy in spite of the abnormal horrors and consequences of the financial crisis and resulting deep recession.
Thus, it appears that the 2008–2009 financial crisis, as scary as it was, did not have a material long-term effect on the aggregate value of U.S. common stocks. The volatility during the crisis turned out to be inconsequential for the patient long-term investor.

In fact, an investor should treat volatility as a friend. High volatility permits an investor to purchase stocks when they are particularly depressed and to sell the stocks when they are selling at particularly high prices. The greater the volatility, the greater the opportunity to purchase stocks at very low prices and then sell the stocks at very high prices. But what happens when the price of a stock falls sharply after you purchase it? No problem, assuming that the stock was an undervalued investment at the price you paid for it. Eventually, the price of the stock should recover and then appreciate well above your cost basis.

This leads me to another important positive attribute of common stocks. An investor can decide the exact times he wishes to buy and sell a stock, and the only determinants of his success are the cost of the stock at the time of purchase and the price of the stock at the time of sale. While the unfortunate schoolchild’s final grade in a subject usually includes his interim grades on homework assignments, class participation, pop quizzes, and interim tests, the only grade that counts for an investor is the profit earned on a stock at the moment the investor decides to sell the stock. An investor might purchase shares of a company at $80. The price of the shares might then decline to $40 (a failing grade) and remain at the $40 level for a full year (definitely a failing grade). Then the shares might start rising, reaching a price of $160 three years after the investor made his purchase (an A+ grade). The investor might then sell the shares at $160, thereby doubling his money in three years. When the investor receives his report card, his final grade is A+. All the interim failing grades have been thrown out. It made no difference that the shares sold at $40 for a one-year period. The interim price was not relevant, unless the investor had been forced to sell the shares when they were at $40. Or unless the investor had the resources and desire to purchase additional shares when they were at $40, in which case the $40 price was a
blessing—and the extreme volatility in the price of the shares functioned as a close friend.

While many investors believe that they should continually reduce their risks to a possible decline in the stock market, I disagree. Every time the stock market has declined, it eventually has more than fully recovered. Hedging the stock market by shorting stocks, or by buying puts on the S&P 500 Index, or by any other method usually is expensive and, in the long run, is a waste of money. But how do you protect yourself if the stock market temporarily increases to excessively high levels, as it does from time to time? Then, it is likely that individual stocks in your portfolio will be sold because their prices will have increased to levels where their risk-to-reward ratios have become unattractive, and it is also likely that the level of cash held in your portfolio will increase (maybe to a very large percentage of the portfolio) because it will be difficult to find attractive new ideas in an inflated market. The cash then provides protection from a decline in the market. However, and importantly, the buildup of the cash is not a conscious effort to provide protection against a decline in an excessively priced market, but rather is a result of the height of the market.

Thus, common-stock investors of average ability should be able to earn 9 to 10 percent average annual returns without taking large risks of permanent loss. I have a thesis to explain the particularly favorable reward-to-risk attractiveness of common stocks. The return investors demand from any type of investment is a function of the perceived risk of the investment. The higher the perceived risk, the higher the demanded return. As discussed earlier, most investors incorrectly consider volatility to be a risk. These investors thus demand a higher return from common stocks than the deserved return. This error is our opportunity—and is another reason we treat volatility as a friend.

While the stock market itself is attractive, my goal, hope, and prayers are to materially outperform the stock market over time. My specific objective is to achieve average annual returns of 15 to 20 percent without subjecting our portfolios to large risks of permanent loss. Happily, we have achieved these goals. Over the past 25 years, accounts that we manage
have achieved average annual returns of very close to 19 percent. I attribute a material part of this success to a strategy that I developed in the early 1980s. The strategy is to try to purchase deeply undervalued securities of strong and growing companies that hopefully will appreciate sharply as the result of positive developments that already have not been largely discounted into the prices of the securities. Our reasoning is that the undervaluation, growth, and strength should provide the protection we cherish against permanent loss, while the undervaluation, strength, growth, and positive developments should present the opportunity to earn high returns. We typically purchase shares in a company in anticipation that one or more positive developments will drive the shares within the next few years, and we then sell the shares after the positive development (or developments) has occurred and has been substantially discounted into the price of the shares. Positive developments can include a cyclical upturn in an industry, the development of an exciting new product or service, the sale of a company to another company, the replacement of a poor management with a good one, the initiation of a major cost reduction program, or the initiation of a major share repurchase program. Importantly, the positive developments we predict should not already have been predicted by a large number of other investors. We need to be creative and well ahead of the curve. If we are not early, there is a likelihood that the future positive developments already largely will have been discounted into the price of the shares.

But what if we are wrong about a stock and the predicted positive development fails to occur (which does happen)? Then, the undervaluation, strength, and growth of the stock still provide the opportunity to earn a reasonable return. If we cannot have the icing, we can at least have the cake.

The above strategy of predicting positive changes makes common sense. At any one time, the price of a stock reflects the weighted opinion of the majority of investors. In order to earn outsized returns, we need to hold opinions about the future that are different and more accurate than those of the majority of other investors. In fact, it can be said that successful
investing is all about predicting the future more accurately than the majority of other investors.

Previously, I stated that common stocks, if selected properly, offer considerable protection against the risks of permanent loss. But what criteria do we use to select stocks that offer that protection? Of course, there are no formulas for analyzing the risks of permanent loss. It is said that if investing could be reduced to formulas, the richest people in the world all would be mathematicians. However, there are several signs to look for. A company that has a leveraged balance sheet (large quantities of debt relative to its cash flows and assets) may not have sufficient cash during difficult times to pay the interest it owes on its debt, in which case it might have to file for bankruptcy (in bankruptcy proceedings, the common shareholder usually loses most of his investment). A company whose value is dependent on a single technology might permanently lose most of its value if the technology becomes obsolete. For example, digital cameras have obsoleted Kodak’s chemical-based films, with the result that Kodak has permanently lost most of its value. An investor also can suffer a permanent loss if he pays far too high a price for a stock.

To help minimize the risks of permanent loss, I look for a margin of safety in the stocks that we purchase. The concept of a margin of safety is that an investor should purchase a security at a price sufficiently below his estimate of its intrinsic value that he will have protection against permanent loss even if his estimate proves somewhat optimistic. An analogy is an investor standing on the 10th floor of a building, waiting for an elevator to carry him to the lobby. The elevator door opens. The investor notices that the elevator is rated for 600 pounds. There already are two relatively obese men in the elevator. The investor estimates their weights at about 200 pounds each. The investor knows that he weighs 175 pounds. The investor should not enter the elevator. There is an inadequate margin of safety. Maybe he underestimated the weights of the two obese men. Maybe the elevator company overestimated the strength of the elevator’s cable. The investor waits for the next elevator. The door opens. There is one skinny old lady in the elevator. The investor says hello.
to the lady and enters the elevator. On his ride to the lobby, he will enjoy a large margin of safety.

I note that our quest for a margin of safety makes us “value” investors as opposed to “growth stock” investors. As a value investor, we pay great attention to the price we pay for a security relative to our estimate of its intrinsic value. However, a growth stock investor pays considerable attention to the growth rate of a company and less attention to the price he pays for the growth. If a growth-stock investor purchases shares in a company that is growing at a 15 percent rate and if he holds the shares for many years, most of his returns will come from the growth as opposed to any change in the share’s price-to-earnings (PE) ratio. Therefore, most growth investors are willing to pay a high PE ratio for a security. I have a problem with growth-stock investing. Companies tend not to grow at high rates forever. Businesses change with time. Markets mature. Competition can increase. Good managements can retire and be replaced with poor ones. Indeed, the stock market is littered with once highly profitable growth stocks that have become less profitable cyclic stocks as a result of losing their competitive edge. Kodak is one example. Xerox is another. IBM is a third. And there are hundreds of others. When growth stocks permanently falter, the price of their shares can fall sharply as their PE ratios contract and, sometimes, as their earnings fall—and investors in the shares can suffer serious permanent loss. Many investors claim that they will be able to sell the shares of a faltering growth stock before the price of the shares declines sharply, but, in practice, it is difficult to determine whether a company is facing a temporary threat that it will overcome or whether it is facing a permanent adverse change. And when it becomes apparent to an audience that there is a fire in a theater, only a small fraction of the audience can be among the first to flee through an exit door. Therefore, many growth-stock investors do suffer permanent losses.

In addition to shying away from paying high multiples for growth stocks, I tend to avoid the shares of weaker companies, even if their shares are selling at distressed prices. Some value investors are attracted to the deeply depressed shares of poorly positioned companies that have uncertain