STRATEGY

The fatal allure of groupthink

The real lesson to be learned from Warren Buffett isn't what he's buying, but how he resists temptation

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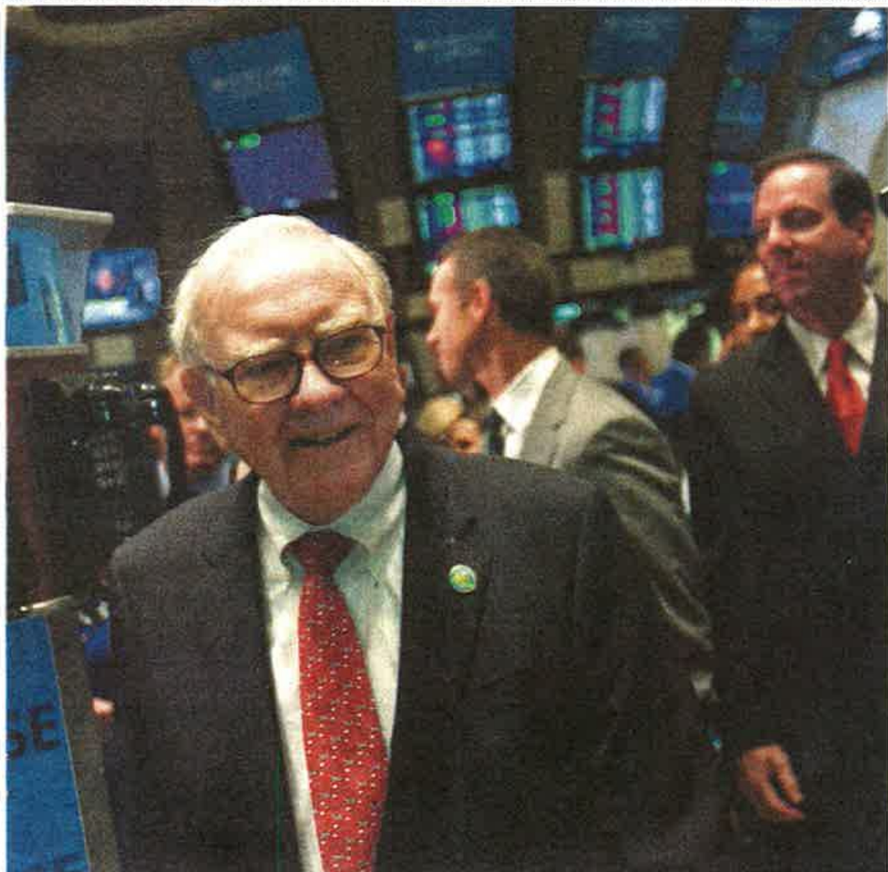
Warren Buffett has been busy of late, financing the privatization of H.J. Heinz Co. and slashing positions in long-time holdings Procter & Gamble Co., Johnson & Johnson Inc. and Kraft Foods Group Inc. – all of which has Buffett-watchers anxiously attempting to discern what the great investor's moves mean about where the market is headed next.

If history is precedent, Mr. Buffett's most important investing lessons will be lost.

Lesson No. 1: Don't worry about beating the index over the short term. As Mr. Buffett once said, for successful stock pickers "the stock market does not exist. Ignore it." While he gauges the success of his flagship Berkshire Hathaway Inc. by comparing its long-run performance to the S&P 500, he doesn't sweat if he happens to lag behind the index for a year or two.

That brings us to a second lesson: Be patient. The average investor tends to chase the market, asking themselves, "Railway stocks are up 20 per cent, is it too late to get in?" In contrast, Mr. Buffett maintains a small list of stocks that he would consider owning and then waits – sometimes for decades – until valuations fall to a level he finds attractive.

His goal – call it Lesson No. 3 – is to win by not losing. He selects stocks based on minimizing the risk of his investment instead of maximizing returns. Consistency matters more to him than growth, and he loves to buy firms able to generate steady cash flow with little or no year-over-year variation in profit margins.



Warren Buffett's patience stands in contrast to most investors' habit of chasing what's hot. SCOTT EELLS/BLOOMBERG

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The value element of the Buffett method is often overstated. Mr. Buffett prefers to buy stocks trading at valuation discounts 30 per cent below the long-term average, but he often recounts the advice of the silent half of the Berkshire stockpicking team, Charlie Munger, who said, "It's far better to buy a wonderful company at a fair price than a fair company at a wonderful price."

Mr. Buffett finds companies that fit his investing approach and then waits patiently for them to be available at the right price.

Unlike him, most investors, including many professional portfolio managers, follow the opposite approach, chasing expensive winners and selling losers just as they reach compellingly cheap valuation levels.

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Human psychology is the real culprit. Many investors are addicted to the adrenaline rush of volatile investments. Others suffer from a casino or lottery mentality, fuelled by an internal voice that keeps whispering, "Swing for the fences. The next one will make us rich enough to retire." Just about all of us like the comfort of being part of the crowd.

It's far tougher than most people think to resist the impulse to follow others. Deep in our evolutionary past, herding behaviour kept us safe from predators.

In mid-2012 it encouraged investors to buy Apple shares when they were trading above $600.

To be sure, Mr. Buffett enjoys advantages unavailable to most investors, most notably cheap financing from his vast insurance holdings. But even without this access to capital, Canadian investors would benefit from mimicking his emphasis on consistency and stability. That means holding fewer junior gold mining stocks and more Telus Corp., Shoppers Drug Mart Corp., Thomson Reuters Corp. and Metro Inc.

There are few mysteries as to how Warren Buffett chooses investments. The challenge is putting his precepts into practice. He put it best by describing his investing strategy as "simple, but not easy." Indeed.

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