ADVICE FROM THE ORACLE-(NOT ME --WARREN BUFFETT)

THE MONEY MARATHON BY ED DOUGLAS CFP®

While waiting in an office to see a client of mine, I picked up a Fortune magazine to read an article written by Warren Buffett. Even though the article was nearly two years old, the advice was so timeless that I thought I would summarize his main points in my column. (Stocks Beat Gold and Bonds, Fortune, February 27, 2012.)

In the article, Buffett defines investing as the process of transferring purchasing power to others now with the reasoned expectation of receiving more purchasing power (after taxes) in the future. He says this is more demanding than the typical definition of just laying out money now with the expectation of getting more back in the future, (because if it is worth less after inflation and taxes an investor has still not benefited enough).

Buffett mentions that the typical definition of risk is measured in “beta” which measures volatility and is sometimes used as a synonym of risk. He doesn’t like using beta because an asset with little or no volatility can still cause its owner a loss of purchasing power.

He then defines investments in three categories. The first category he calls investments that are denominated in a given currency, like money market accounts, bonds and bank deposits. Although these investments are considered “safe” they are really far from safe in that over time an investor can lose purchasing power as governments print money which depreciates the currency. He points out that since 1965 the dollar has lost 86% of its purchasing power (as of 2012) which means it takes $7 dollars today to buy $1 worth of 1965 goods and services. Although there have been times that bonds and deposits have paid enough to offset this currency risk, this period of time is not expected to be one of those periods with interest rates at historic lows. He says “Bonds promoted as offering risk-free returns are now priced to deliver return-free risk.”

The second major category of investment involves assets that will never produce anything but are purchased in the hope that someone else will pay more in the future. Tulips in the 17th century Europe are an example of this. Gold is another major item in this category. Gold has very little utility and its value is based on “the belief that the ranks of the fearful will grow.” When prices of assets like this go up new buyers or bandwagon investors come in to buy more which causes the asset to go up –until it doesn’t-a bubble occurs and breaks. “What the wise man does in the beginning, the fool does in the end.” He points out that all the gold stock in the world (170,000 tons) would fit into a 68 foot cube, about the size of a baseball field. This cube wouldn’t produce anything but based on 2012 values would be worth $9.6 trillion. For that same amount of dollars, a person could buy all US cropland, (400 million acres that produces $200 billion annually) plus 16 Exxon Mobils, each producing $40 billion annually. This would still leave $1 trillion of cash left over. Buffett says that he would much rather own the farmland and the 16 Exxon Mobils because they produce a valuable bounty, crops and oil that are needed. He is confident that 100 years from now the farmland and the Exxons will be worth much more than the pile of nonproducing gold.

Although currency denominated assets and nonproducing assets (the first two classes) are very popular during times of fear, in the long run Buffett prefers investments in his third class which are productive assets, businesses, farmland or real estate. He says these assets should have ability in inflationary times to deliver output while maintaining purchasing power without requiring much new capital. (Interestingly enough, he is eliminating businesses that require heavy capital expenditures like utilities.) He uses Coca Cola as an example, which is one of his long time holdings in Berkshire Hathaway. He believes people all over the world will continue to consume more and more Coke which will continue to produce value and expand the purchasing power of his investment. He compares our country’s businesses to cows that continue to produce milk, which everyone needs and which can compound for the owners of the milk as the milk is sold. He points out that the Dow Jones Industrial has gone from 66 at the beginning of the 20th century to over 15,400 today.

I should like to note two main traits of Buffett. First, as mentioned, he tries to buy and hold first class businesses, like Coke and it has been very successful for him. Owners of Berkshire Hathaway stock (which is Buffett’s company that holds many of his stock holdings) who bought the stock in the mid 60’s could have seen $2000 grow to over $16 million (a return of over 20% annualized). Secondly, not only does he buy good quality companies, many times he buys them at huge discounts when others panic and are selling, as he did most recently during the financial crisis.

What really is the investment for the long run? According to the Oracle from Omaha (Buffett), the best investment in the long run is owning the stock of good quality companies.

Ed Douglas is a Certified Financial Planner CFP®/Consultant, Chairman Emeritus of Citizens Bancshares, and author of three books: *Making a Million With Only $2000-Every Young Person Can Do It, The Money Marathon: 7 Simple Steps to Financial Freedom* and *25 Truths: Life Principles of the Happiest and Most Successful Among Us*, available at www.eddouglas.com and on Amazon. Ed may be contacted for financial planning services or seminars based on his books at ed@eddouglas.com or at his office at 660-646-2066