

Exclusive Interview with Prem Jain, Author of *Buffett Beyond Value*

By Ravi Nagarajan

Published on April 8, 2010

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This pdf file was adapted from an article that originally appeared at the following URL:
<http://www.rationalwalk.com/?p=6227>

The Rational Walk is pleased to have this opportunity to present an exclusive interview with Prem C. Jain, the author of the recently released book [Buffett Beyond Value](#) which we [reviewed](#) last week. Prem Jain is the McDonough Professor of Accounting and Finance at Georgetown University. He has previously taught at the Wharton School of the University of Pennsylvania and the Freeman School of Business at Tulane University. His research has been published in many prestigious finance and accounting journals including the *Journal of Finance* and the *Journal of Accounting Research*.



Professor Jain generously took the time to provide extensive answers to several questions regarding Warren Buffett, the evolution of behavioral finance in academia, defining an investing circle of competence, approaches for investors who wish to expand their competence over time, and much more.

Q: There are many books covering Warren Buffett's career, particularly over the past few years. What made you decide to write a book about Warren Buffett and how is your book differentiated from Buffett biographies such as [Snowball](#)?

Most authors of books on Warren Buffett spend a significant part of their books on narratives about Warren Buffett as a person. They do not analyze his investing philosophy in enough detail to develop a good sense of Buffett-style investing. I have tried to fill that gap. Having taught Buffett's principles for over twenty years and having personally benefitted from his principles, I have written a book that is primarily about Buffett's investing principles. My book is even more valuable to those who already have some background on Buffett from reading biographical books such as *Snowball*.

Q: Much of your book focuses on how investors can learn from Warren Buffett's techniques and generate market beating returns. Yet, the usual caveat is that investors must not stray from their circle of competence. Many investors have trouble precisely identifying the boundaries of this circle. How would you suggest that investors go about defining their circle of competence?

An investor should start with analyzing one industry that the investor knows the most about. The investor is in his circle of competence if he is not often surprised by the developments in

that industry. Else, he needs to study it more. As a professor, I have benefited from investing in education stocks as I understood the business models of several of those companies. Furthermore, to precisely identify the boundaries of one's circle of competence, one must also test one's knowledge in several additional stocks in the same industry.

It is often the case that an investor would invest in one company in an industry (say, Wal-Mart) and would not know much about other companies in the same industry (say, Costco and others). To understand Wal-Mart well, they should study and monitor other similar companies as well. This is how I came across Wal-Mart de Mexico (a Wal-Mart subsidiary in Mexico that trades independently). Only after developing a good understanding of one industry, the investor should start investigating in other industries.

Q: You identify Warren Buffett as a “renaissance investor” because he was one of the first to blend the “growth” and “value” styles into a model that has produced consistently superior results over many decades. Part of Mr. Buffett’s shift toward “growth + value” was due to the influence of Charlie Munger and others such as Philip Fisher, but part of this was due to size. As Berkshire grew, the small “cigar butt” opportunities were not able to “move the needle” for Berkshire. Portfolio size is not an issue for most small investors. In early 2009, there were many small stocks selling under “net-net current assets” as defined by Graham. Does it make sense for small investors to pursue the “cigar butt” style advocated by Graham or does it make more sense to emulate Buffett’s “growth + value” approach?

Buffett's investing philosophy has evolved over time. An investor can similarly become a better investor over time. In 1963, Warren Buffett invested in American Express because American Express's stock price had declined in the wake of the infamous Salad Oil Scandal in which American Express lost money. However, the American Express charge card business was not affected. After a year or two, Buffett sold those shares as the price recovered. In this investing approach which is usually classified as “cigar butt” investing, the focus is on finding stocks when declining stock prices can be attributed more to market psychology than to fundamentals.

The “cigar butt” investing is based on examining numbers such as P/E ratios or other quantitative metrics. However, even as far back as 1967, Buffett wrote in his letter to his partners that really big money tends to be made by investors who are right on qualitative (as opposed to quantitative) decisions. Clearly, Buffett's investing style was evolving.

An evaluation of Buffett's writings and decisions over decades suggests that he has maintained the principle of not paying excessively as a value investor (or as a “cigar butt” investor), he is now willing to pay a fair price as a growth investor. If we were to think of him as a pure value investor, it would be difficult to explain him paying about market P/E for several of his stock acquisitions such as BYD and Burlington Northern Santa Fe or even Wal-Mart. He has clearly evolved into a value + growth investor over time and has specifically mentioned that value and growth are two sides of the same coin. An investor should not ignore “cigar butts” but in this day and age when information is ubiquitous, cigar butts are not easily found. However, an

investor incorporating the principles of both value investing and growth investing together is more likely to earn large returns.

Q: Professional familiarity in a field does not necessarily extend to investment competence. For example, many doctors have a reputation as terrible investors because they mistakenly believe that knowledge of technical details of drugs or medical devices makes them qualified to pick investments. The same can be true for many in technology and software fields. But at the same time, it seems natural to invest in areas that professionals know the best. How can a doctor, for example, develop an investment circle of competence that would allow for intelligent investment in companies related to his profession?

This is a good example of an investor not making good returns even when he may have a good understanding of a particular product. The reason is that investment circle of competence requires not only the knowledge of the products but also the ability to understand the financial statements and to project future earnings. Many investors can not translate success of a product into financial success of the company.

I recommend the following to doctors and others who are interested in investing. Investor should think whether the company and not just a product will be successful for a long time. They should forecast sales and earnings in dollar terms and not only evaluate a product's technical ability. If they are financial-statements-challenged, they should join hands with others who know some accounting and finance. This may prove to be a fruitful partnership.

Q: Over the past decade, behavioral finance has attracted much more attention than in the past, perhaps due to several events over the past 25 years that could not be easily explained by the Efficient Market Hypothesis. I recall as an undergraduate student majoring in Finance in the early 1990s that there were few mentions of Warren Buffett or other investors who have routinely achieved market beating returns. Most references to Mr. Buffett tended to dismiss his record as an aberration unlikely to be replicated. Do you see this attitude changing in Finance departments today?

Warren Buffett has had tremendous influence on the academia. In 2003, I invited him to Georgetown University to conduct a question-answer session and the response from the students and the faculty was overwhelming. The finance discipline now acknowledges that professors during the 1970s to 1990s overemphasized the market efficiency paradigm. Fortunately, we have people like Buffett who constantly reminded the academia that the professors had much to learn. And professors have learned. For example, in one of the courses at Georgetown, the first class of the course centers on what we may learn from Warren Buffett. Thanks to Buffett that we do not claim that markets are efficient all the time. It is not easy but if investors work hard, they can beat the indexes and possibly earn very high returns.

Q: How can investors prepare themselves to mentally deal with temporary declines in the market value of their investments? Even if an investor finds undervalued companies, it is obviously possible for market prices to suffer material declines. We have seen this in

Berkshire Hathaway, for example, over the past two years. Is the ability to deal with temporary declines a matter of inherent temperament or personality that cannot be changed, or can investors find ways to improve their investment temperament over time?

Knowledge is the best antidote to making bad decisions. For example, if you know about jewelry and diamonds, all that glitters is not gold for you. Your knowledge will allow you to pick diamonds in the rough and hold on to them. In investing, if you know a lot about certain companies and their managers, you will not become nervous and sell the stock at the wrong time or when the market declines. No wonder, Buffett suggests that you should invest only in companies you understand. Both in 2000 and 2009 when Berkshire stock prices went down by about 50%, I added to my Berkshire holdings.

Q: Most individual investors attempt to pick stocks on a part time basis. How much time per week do you think is required for part time investors to dedicate to this pursuit? It seems like spending a couple of hours each weekend reading Barron's or The Wall Street Journal simply wouldn't be sufficient, yet most people do not have 15 to 20 or more hours per week to delve in more deeply. How should investors think about the time investment required to actively pursue undervalued opportunities?

This is related to an earlier question. If a person has a full time day job, he should study only one industry at a time. Only after he understands one industry, he should move to studying other industries. If he does that, he would not need more than a few hours a week. After several years, he should end up with 20 stocks to invest about 5% in each. In the meantime, he can invest partly in an index fund and partly in individual stocks. An average investor need not hold more than 20 stocks in a portfolio. Buffett does not invest in a large number of stocks and most of his holdings are for the long term. In Berkshire, five of the top stocks have often constituted 50% of its total stock holdings. Finally, if a person is very busy and does not have any time to find good stocks, he should simply invest in an index fund such as the Vanguard S&P 500 index fund.

Q: If an investor decides that he has no particular circle of competence or lacks the time to dedicate to the pursuit, does it make more sense to invest in index funds or in mutual funds such as Fairholme that are run by proven value oriented managers? In your book, you recommend against investing in hedge funds due to the asymmetry that is common in the "2 and 20" compensation models. Does the same caveat apply to value oriented mutual funds? Although they are more cost efficient, certainly index funds remain far cheaper.

For a person who has no particular circle of competence but has decided to invest in the stock market, I recommend investing an index fund and not in mutual funds. An investor is less likely to sell an investment in an index fund when the market goes down than if he were to invest in a mutual fund. I am afraid that the investor would blame the manager for not performing well in a down market and sell all his holdings at the wrong time. It may not be the manager's fault at all but the investor may not be able to see through the effect of the market on an otherwise well run mutual fund. Even the best of managers do not outperform the market in all the years.

The only time a busy investor should invest in a mutual fund is when the investor is extremely comfortable with the manager's style of investing and has examined it in great detail. It is not enough to simply examine a manager's past performance and invest with the manager.

Q: One of the most difficult decisions involves when one must sell an investment at a loss. You cover this topic in the book and suggest that investors should be willing to sell at a loss if subsequent events lead the original investment thesis to be invalid. This is perhaps the most difficult aspect of investing for most people because selling at a loss involves admitting a mistake and making it "permanent". Is this just a matter of inherent "stubbornness" or can investors take any steps to mentally allow them to sell at a loss with more philosophical detachment?

I think we are hard-wired not to admit mistakes. Selling at a loss is indeed difficult. Or, we are optimistic and hope for an improvement in the stock price. I recommend two specific steps. First, one should write detailed notes whenever a purchase decision is made. Periodically, as the company makes earnings announcements or other important announcements, the notes should be updated. I have benefited from this practice a lot. When individuals are forced to write their thoughts on the paper, they can more easily see the right thing to do. For example, if one has a good knowledge of the company's products, managers and financial statements, a decline in the stock market may be a good time to invest more in the stock market. Second, they should compute a stock's intrinsic value periodically. I discuss the concept of intrinsic value in detail in my book. When the intrinsic value is below the current stock price, they may find it easier to sell.

Q: Berkshire Hathaway is often misunderstood by the media and characterized as Warren Buffett's "hedge fund". This leads many investors to worry about succession at Berkshire. Do you have any views regarding who Mr. Buffett's successor will be and how confident are you that the success will (a) be able to retain Berkshire's unique culture and (b) continue Mr. Buffett's capital allocation track record? It seems like the next CEO will have impossible shoes to fill. Could this result in a "shooting for the moon" attitude that could introduce greater risk at Berkshire?

If the Berkshire board decides to have only one person at the top, I think Ajit Jain is the right person. After all, Buffett talks to him every day, insurance is the most important part of Berkshire, and he has been at Berkshire for about 25 years. (This has nothing to do with the fact that I have the same last name. I don't know him at all.) The two other names often mentioned are those of Tony Nicely of GEICO and David Sokol of MidAmerican and NetJets. It will however not matter much if any one of the three is the CEO. After all, the Berkshire CEO does not interfere with the subsidiary CEOs.

Yes, the culture! What is the culture at Berkshire, I have often asked myself. Once we reflect on some of the unique features of the Berkshire culture, we are less likely to be concerned about the future of Berkshire even if the next CEO is not as good as Warren Buffett. There are at least two important features of the Berkshire culture. First, the subsidiary CEOs (and employees) are

compensated according to what is most meaningful. Buffett has often talked about compensation based on return on assets or other appropriate metrics. This creates a sense of fair play resulting in high productivity. Second, subsidiary CEOs are given independence to make all decisions at the subsidiary level. Hence, Berkshire will continue to do well after Buffett because of its decentralized management structure. The capital allocation process may not be as good as it is today under Buffett but there are many people who have been close to Buffett and my guess is that the new CEO will continue to do a good job for a long time to come.

Professor Jain, this has been very insightful. Thank you very much.