Warren Buffett’s Concentration and 3 of His Top 5 holdings

Graham vs Buffett.

Both value investors, but both incredibly different.

Not just in terms of the stocks they purchased and the way they thought about businesses, but also diversification.

The main thing that comes to mind when you compare Graham and Buffett side by side is their investment style.

Graham loved net nets and buying/selling companies based on strict criteria.

Buffett is a value growth investor, buying companies with ever expanding and impenetrable moats.

Although Graham made most of his money in via growth orientated stocks like GEICO, he is best remembered for his quantitative style.

But there is one other difference that isn’t discussed as often.

Diversification vs Concentration

With any quant or numbers based strategy, you need to diversify widely.

But you know that Buffett loves to concentrate.

> *“Diversification is protection against ignorance. It makes little sense if you know what you are doing.” – Warren Buffett*

However, the beauty of investing is that it’s highly subjective, regardless of what strategy you use.

There is no one size fits all.

It’s hard to argue whether diversification or concentration is correct because both work. It just depends on your temperament.

Investing is an extension of your personality and it’s foolish to think that just because somebody thinks differently, they are wrong.

After all, value investors think day trading is a fools game.

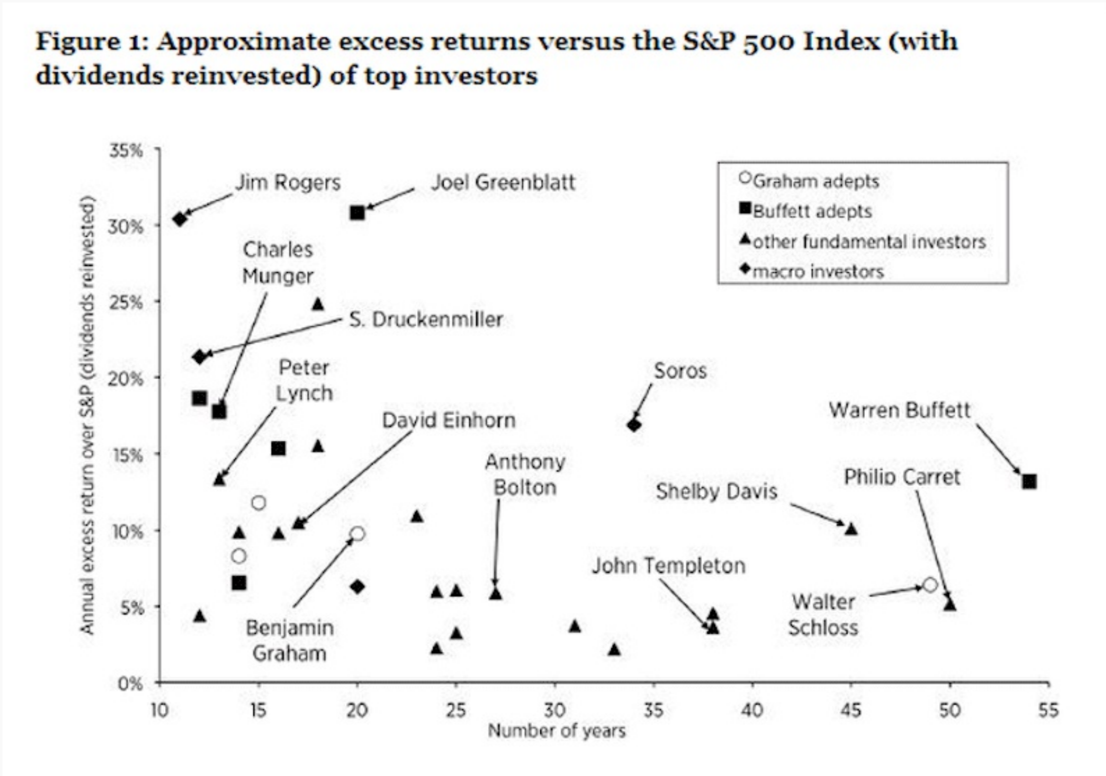
At the same time, day traders think value investors are fools.

But numbers tell the deeper story.

Graham killed the market with net nets and Walter Schloss amassed an annualized return of 20% over 47 years.

But Buffett is the best investor hands down in terms of longevity and performance.

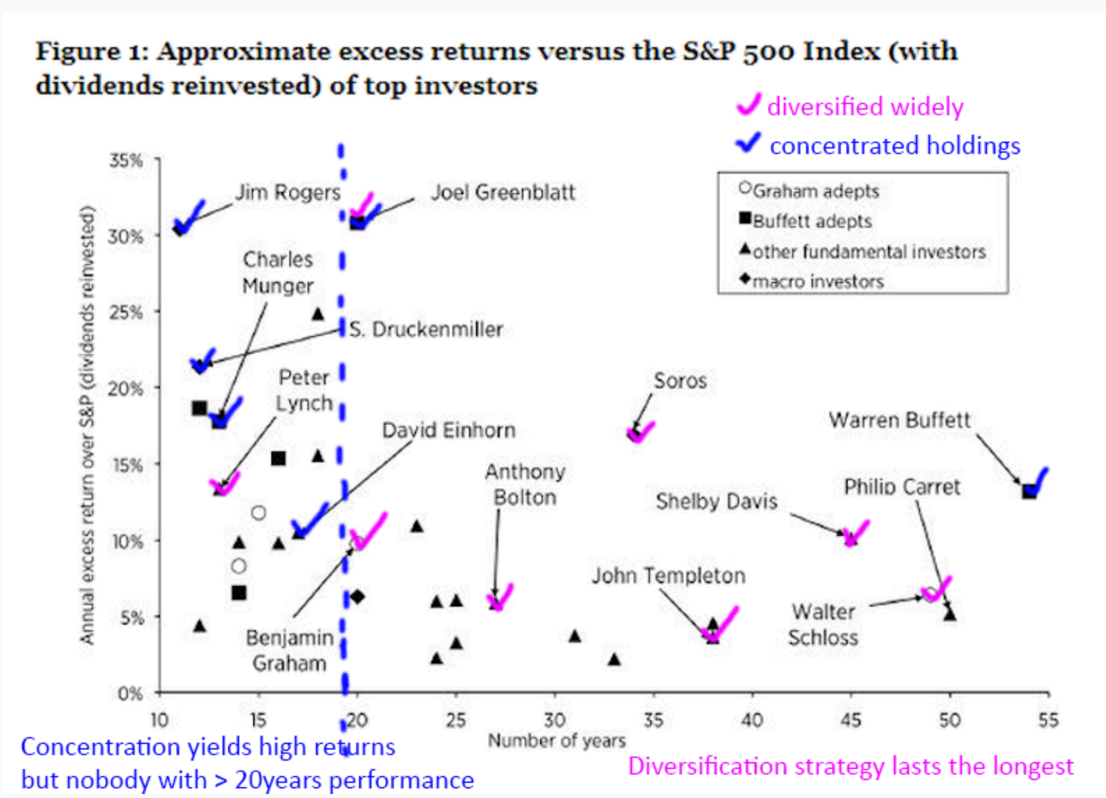
Take a look at this chart.



Guru Performance

At first glance, it's easy to look at the names and be wowed by Buffett's absolute dominance.

But I applied some high tech analysis and pulled out my 3rd grade color coding skills to differentiate the performance of the gurus that diversified and those that concentrated.



Concentration vs Diversification

I simply looked up the portfolio strategies of the gurus to determine whether they concentrated or diversified.

And the thing that jumped out to me is depicted by the blue dashed line.

Maybe investors like Jim Rogers made so much money by beating the market by 30% for 12 years that he had nothing else to prove and that's why he started opening up different funds.

But what is clear is that Buffett is one in a billion and he became what he is by thinking on his own.

The True Reason Investors Concentrate

This isn't earth shattering news, but the only reason people concentrate is to make big returns.

To make a difference in their portfolio so that they can enjoy an earlier retirement, or to supplement their income to enjoy life.

And it sure changed Buffett's life and the people who invested with him.

That's the true reason for concentration.

Whenever you hear about people talking about diversification, they are only scratching the surface.

It's all well and good to talk about the "features" of concentration, but what's forgotten are the "benefits".

Do you want your investments to change your life?

Then concentrate.

If you want to sleep well and perform slightly above average, diversify.

Buffett is a Concentration Master

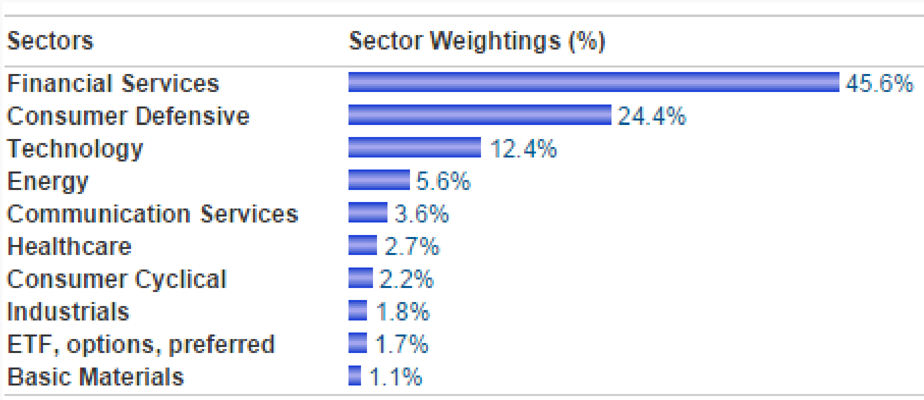
Buffett Partnership Yearly Performance

Year	Dow Jones	Partnership	Ltd Partners
1957	-8.4%	10.4%	9.3%
1958	38.5%	40.9%	32.2%
1959	20.0%	25.9%	20.9%
1960	-6.2%	22.8%	18.6%
1961	22.4%	45.9%	35.9%
1962	-7.6%	13.9%	11.9%
1963	20.6%	38.7%	30.5%
1964	18.7%	27.8%	22.3%
1965	14.2%	47.2%	36.9%
1966	-15.6%	20.4%	16.8%
1967	19.0%	35.9%	28.4%
1968	7.7%	58.8%	45.6%

Cumulative or Compounded Basis

Year	Dow Jones	Partnership	Ltd Partners
1957	-8.4%	10.4%	9.3%
1957-58	26.9%	55.6%	44.5%
1957-59	52.3%	95.9%	74.7%
1957-60	42.9%	140.6%	107.2%
1957-61	74.9%	251.0%	181.6%
1957-62	61.6%	299.0%	215.1%
1957-63	94.9%	454.5%	311.2%
1957-64	131.3%	608.7%	402.9%
1957-65	164.1%	943.2%	588.5%
1957-66	122.9%	1156.0%	704.2%
1957-67	165.3%	1606.9%	932.6%
1957-68	185.7%	2610.6%	1403.5%
Compound Rate	**9.1%**	**31.6%**	**25.3%**

Warren Buffett Performance Portfolio



Berkshire Sector Holdings | Source: gurufocus

The top 5 Berkshire holdings are:

That's a huge amount of concentration in the top 4 alone. The difference between the 4 and 5 spot (IBM and WMT) is more than double.

What Are They Worth?

With so much at stake in the top 5, what are the holdings worth?

Financial stocks are outside my circle of competence so I'm only quickly looking at 3 of the 5. WFC and AXP will be skipped.

Coca-Cola (KO)

KO looks to be worth between $30 to $40 at the moment.

Their consistent cash flows makes using the **DCF method** an easy choice and even when you cross check with other **stock valuation methods**, the range comes out to be in the 30′s.

Here are the inputs I'm using for the discounted cash flow.

Other valuations I'm getting.

The concern for KO is the dropping ROIC and ROE. Keep an eye on these two numbers in the coming years.

Valuation

Current Price	$	42.20
NCAV	$	(6.28)
Total Net Reprod. Cost	$	16.41
Earnings Power Value (EPV)	$	20.88
Discounted Cash Flow (DCF)	$	34.94
EBIT Multiple Valuation	$	32.01
Katsenelson Absolute PE	$	49.17
Ben Graham Formula	$	31.35

KO Valuation as of Sep 28

The Coca-Cola Company (KO)
9/28/2014

	2010	2011	2012	2013	TTM	5YR Min	Median	5YR Max
ROE	38.1%	27.1%	27.5%	25.9%	24.6%	24.6%	**27.3%**	38.1%
ROA	16.2%	10.7%	10.5%	9.5%	8.8%	8.8%	**10.6%**	16.2%
ROIC	22.9%	14.9%	14.4%	12.8%	11.8%	11.8%	**14.6%**	22.9%
CROIC	13.4%	10.9%	12.0%	11.4%	11.5%	10.9%	**11.8%**	16.9%

KO's Declining Performance to Watch

International Business Machines (IBM)

Probably the cheapest stock out of the top 5.

With IBM expanding to more B2B services and the cloud, they are adapting to the times and increasing their moat in the IT space.

ROE easily shows the power of IBM with ROE hitting the 90% range. Their use of shareholders equity and allocating assets is being proven with the uptick in their profitability ratios.

CROIC is consistently at 30% and consistency is something Buffett regards highly.

Check out **how Buffett interprets financial statements** to see more of the things he looks at.

On the valuation front, it looks like it's worth something in the low to mid 200's with its value increasing every year.

IBM has a FCF yield of 6.8% and a magic formula earnings yield of 8.9% which shows that IBM isn't in expensive territory yet.

If these numbers drop to below 5%, then it's an indication of things starting to get expensive.

Valuation

Current Price	$	190.06
NCAV	$	(58.90)
Total Net Reprod. Cost	$	103.13
Earnings Power Value (EPV)	$	148.44
Discounted Cash Flow (DCF)	$	209.93
EBIT Multiple Valuation	$	179.37
Katsenelson Absolute PE	$	247.35
Ben Graham Formula	$	294.81

IBM Valuation as of Sep 28

Wal-Mart (WMT)

Wal-Mart dominates the retail space, but the market is expecting about 9% to 12% growth from them going forward which I find to be too high.

With an owners earnings of $15.1b and a 7% discount rate, 9% growth puts them at fair value territory.

But when you consider their **EBIT multiples**, they are trading at the highest level since 2005.

One indication of Wal-Mart's pricing and power is their net income.

Over 10 years, WMT barely deviates from 3.3%. Other retails fall into the negative during tough times or they stick around 1-2% the good times, but regardless of what the economy does, they are there are 3.3%.

Then factor in their median inventory turnover of 8.5 and you are an extremely well oiled machine.

I don't see Berkshire getting rid of WMT anytime soon.

Worth between $65 to $70.

Valuation		
Current Price	$	76.49
NCAV	$	(21.71)
Total Net Reprod. Cost	$	69.87
Earnings Power Value (EPV)	$	54.27
Discounted Cash Flow (DCF)	$	64.38
EBIT Multiple Valuation	$	70.19
Katsenelson Absolute PE	$	74.95
Ben Graham Formula	$	82.26

WMT Valuation as of Sep 28

Wal-Mart Stores Inc. (WMT)
9/29/2014

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%old school value
Figures in Millions except per share values
Watch Tutorial

Normalized Rev Period	Projection	EPS
3YR	Normalized EPS	$5.11

Current Price	Conservative	Normal	Aggressive
$76.49	$61.72	$70.19	$78.66
M.o.S	0.0%	0.0%	2.8%

WMT EBIT valuation Range

Summing Up

Graham and Buffett differ significantly when it comes to the topic of diversification, but there is no right or wrong.

Do what is comfortable for you based on what you want to achieve.

KO and AXP changed Buffett’s life because of his conviction and willingness to hold on forever.

Are you diversifying or concentrating?

Additional Reading

- http://greenbackd.com/2013/01/09/examining-benjamin-grahams-record-skill-or-luck/
- http://www.forbes.com/sites/investor/2012/12/18/ben-grahams-60-year-old-strategy-still-winning-big/
- http://basehitinvesting.com/warren-buffett-ben-graham-on-diversification-investment-philosophy-differences/
- http://www.cnbc.com/id/102028790

About Jae Jun

Jae Jun is the founder of Old School Value. He is on a mission to provide practical and actionable value investing tools, tutorials and educational material to help empower the individual investor. Keep in touch with Jae via any of the methods linked below.