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Buffett's seven best stocks today

In a weak market, it makes sense to play it safe — and stocks that helped make Warren Buffett a billionaire aren't a bad place to start. Here are seven key Buffett positions that could be buys now.

With all the fear hanging over today's market, it's a good time to look to the safety of time-tested stocks — particularly those endorsed by Warren Buffett. The Oracle of Omaha favors proven companies with a competitive advantage in some simple and easy-to-understand line of business, and whose stocks are also trading cheap. In short, these stocks don't need a hot market or even a strong economic recovery to pay off over the long term.

Buffett's own company — Berkshire Hathaway — could be one such value play right now. Suppressed by weakness in its industry and exposure to troubled financial stocks, among other things, these class B shares have slipped 13 per cent from their 2011 closing high on Feb. 28 to trade recently for around $76. (Class A shares, which go for more than $110,000 each, have been equally weak.)

At current prices, the stock trades about 30 per cent below intrinsic value — the true value of all its businesses combined — estimates Whitney Tilson of T2 Partners, a hedge fund that owns Berkshire shares. "It's just about the cheapest we've ever seen it," says Tilson. Buffett himself, and his longtime investing partner Charlie Munger, have been publicly dropping hints that their stock might be a good buy now, says Pat Dorsey, director of research and strategy at Sanibel Captiva Trust.

But there are a lot of investments wrapped into Berkshire, so it's worth looking under the hood for the solid core of the master's stock portfolio. Following is a look at seven of Buffett's best stock plays, why he owns them and why they make sense as buys if a weak market lies ahead.

WELLS FARGO

Buffett loves a fat pitch — a stock priced so low that buying it almost guarantees a home run. So when worries that a recession would hit Wells Fargo (WFC) and its heavy exposure to real-estate loans hammered the bank's stock in the 1990, Buffett bought.

There's a similar scenario at play today. So the bank's stock once again looks cheap. Morningstar, a fairly strict value-stock shop, has its highest (five-star) rating on the stock, with a buy limit of $31.50. That means the stock looks like a great buy now, trading at around $28.90.

Banking is a commodity business — meaning that it's hard for bankers to distinguish their offerings enough to stand out. Buffett hates these kinds of businesses. So why does he still own Wells Fargo? Several reasons, say Buffett experts. First, Wells Fargo management gets top grades, says Todd Lowenstein, portfolio manager of the HighMark Value Momentum Fund (HMVMX). Buffett typically gravitates toward companies with outstanding management teams.
Evidence of the management strength at Wells Fargo, says Lowenstein, can be seen in its consistently above-average return on assets, a measure of how well a company produces profits.

The bank also has lower loan delinquency and foreclosure rates than competitors, another sign of prudence. And Wells Fargo management is frugal, a quality Buffett famously loves. The bank is currently working on reducing expenses by $1.5 billion a quarter. Management showed that it allocates capital wisely, a quality Buffett likes, when it bought Wachovia bank on the cheap during the credit crisis and turned itself into a national bank. Buffett owns 342.6 million shares, making it one of his largest holdings, according to Tickerspy.

WAL-MART

In retailing, it's tough to gain the kind of sustainable competitive advantage that the Oracle of Omaha likes. But Wal-Mart (WMT) has found it. The retail giant's sheer size gives it huge purchasing power, so it can routinely sell stuff at great prices. This gives the retailer a big edge, says Thomas Russo, a partner at the investment firm Gardner Russo & Gardner who studies Buffett closely.

This strategy has helped transform Wal-Mart into one of the top companies in its space. With more than $400 billion in annual sales, Wal-Mart dominates U.S. retailing, accounting for about 10 per cent of total retail sales. Buffett loves owning the top one or two companies in a sector.
All of this has helped the retailer regularly post return on equity of around 20 per cent over the past decade, according to Validea. That handily beats Buffett's minimum hurdle of 15 per cent. The retailer has posted higher earnings each year for the past decade, demonstrating the kind of consistency that Buffett likes. It's using a lot of those earnings to buy back stock, something Buffett also likes to see, points out Stephen Shueh of Roundview Capital. Over the past three years, Wal-Mart has reduced its share count by two per cent to five per cent a year, says Shueh.
Finally, Wal-Mart is expanding internationally, into high-growth markets in China, Brazil and Mexico. Buffett has regularly mentioned of late that he has developed a penchant for international exposure. Morningstar has a four-star rating on the stock, its second-highest rating. Buffett owns 39 million shares.

COCA-COLA

Buffett loves a company with an "economic moat," or some kind of durable competitive advantage that protects its business and provides the power to raise prices. Because Coca-Cola (KO) has such strong brands and a powerful global distribution network, it clearly fits the bill, says Shueh.

Evidence of Coca-Cola's solid competitive advantage turns up in several ways. First, it plans to use its power to raise prices by three per cent to four per cent in the second half of this year. That's bad news for consumers but good news for shareholders. They already benefit from Coke's consistently high return on equity. At Coca-Cola, ROE has averaged 30.8 per cent over the past decade, according to Validea, which uses stock screens to mimic investing greats like Buffett. That's more than twice the 15 per cent minimum Buffett looks for.

Coca-Cola also ranks high as a Buffettesque stock at Validea for its financial strength. The company has enough in annual earnings to pay off its debt in well under two years, one of Buffett's hurdles. Coca-Cola also has the stable and predictable earnings that Buffett favours.
Buffett originally bought Coca-Cola in 1988-89, demonstrating another Buffett principle — that the best holding period for a stock is "forever." But Buffett's history of making money on Coca-Cola actually goes back much further. At the age of six, he bought six-packs of Coke for 25 cents from his grandfather's grocery store and then resold Cokes in his neighbourhood for a nickel each, according to "The Warren Buffett Way," by Robert Hagstrom Jr.

Buffett might not be a buyer today, but he owns 200 million shares, making it one of his largest holdings. And Validea's systems, which often beat the markets, currently give Coca-Cola very high marks — a 92 out of 100.

PROCTER & GAMBLE

With powerful brands such as Tide, Crest and Gillette, and more billion-dollar brands than any other household-product manufacturer, Procter & Gamble (PG) has the kind of sustainable competitive advantage Buffett likes to see. A huge global manufacturing and distribution network also contributes to its moat.

That broad foreign reach gives Procter & Gamble strong international exposure, which Buffett favours. "We continue to believe that there are few safer ways to play the pent-up spending of the emerging market consumer than an investment in P&G," says Morningstar analyst Lauren DeSanto.

Procter & Gamble stock has gone virtually nowhere since the start of 2010. But that doesn't bother a patient investor like Buffett. It shouldn't bother you, either, because sooner or later the consumer products giant's strengths will pay off for investors. DeSanto has a four-star rating on the stock. Buffett owns 76.8 million shares.

AMERICAN EXPRESS

As a global credit card giant, American Express (AXP) takes a small piece of every single transaction made by its affluent consumer and corporate account cardholders. This makes American Express a "toll bridge" — a quality that Buffett loves to see in companies, says Russo, of Gardner Russo & Gardner.

The benefits of toll collecting pay off big when spending rebounds. In the second quarter, American Express earnings rose 31 per cent to $1.3 billion, as consumer spending by Amex cardholders outside the U.S. jumped 27 per cent and spending by U.S. cardholders increased 14 per cent. Because American Express can deliver more-affluent cardholders, it has pricing power with merchants, another quality Buffett likes. It's also shareholder friendly in that it returns a significant amount of free cash flow to shareholders through dividends and share buybacks — another quality on Buffett's checklist.

Buffett's original purchases of American Express were in the mid-1960s, when a scandal drove its stock unreasonably low, turning it into the kind of fat pitch that Buffett likes to see. However, the stock has been strong for the past two years. At $51, it's definitely no longer a fat pitch. Morningstar analyst Michael Kon suggests waiting for pullbacks to $32.40 to buy. But Morningstar is a pretty conservative shop, so I feel comfortable suggesting you add a few dollars to that buy limit. Wall Street analysts have a consensus 12-month price target of $60, according to Thomson One Analytics. Buffett owns 151.6 million shares.

UNITED PARCEL SERVICE

As the world's largest package delivery company, United Parcel Service (UPS) is the kind of toll-bridge operator that Buffett likes to invest in. When a business ships something, UPS gets a cut. Plus the sheer size of its global shipping network give UPS the kind of economic moat that Buffett likes to see. So do high customer-satisfaction ratings and conscientious drivers — even if they do have to wear shorts.

"This is not a business that you can re-create overnight," says Lowenstein. In fact, competitors

have a tough time because UPS is so strong. DHS left the U.S. shipping market in 2009, and the U.S. Postal Service is struggling financially.

That economic moat and broad reach also give UPS the pricing power, high profit margins and steady earnings growth favoured by Buffett, whose Berkshire Hathaway owns 1.4 million shares. Here's another quality the Oracle of Omaha likes: UPS is shareholder friendly, returning excess capital through dividend hikes, share buybacks and debt retirement. "They are good capital allocators. They are not destroying value by doing dumb things," says Lowenstien.

Despite these strengths, UPS looks cheap, because with a price-to-earnings ratio of 14.9, it has traded about 30 per cent below its average since 2000. In short, that means today's price is relatively low. "UPS is on sale due to concerns about the economy," says Lowenstein. And like Buffett, Lowenstein is a patient value investor who believes that sooner or later those concerns will blow over. When that happens, UPS stock will deliver for investors who buy now.

JOHNSON & JOHNSON

The world's largest health care company, Johnson & Johnson (JNJ) owns popular brands you've no doubt heard of and used regularly — such as Tylenol and Band-Aid. But what you might not know is that the company has the No. 1 or No. 2 position in more than half of its product lines. Beyond consumer products, Johnson & Johnson has a strong pharmaceutical division supported by a solid research pipeline, and it is a leader in medical devices.

All of this has helped Johnson & Johnson produce the kind of steady, long-term earnings growth and profitability that Buffett likes. Earnings have risen in all but two of the past 10 years. And, over the past decade, Johnson & Johnson has produced an average 25.7 per cent return on equity, according to Validea.

That's well above the 15 per cent minimum Buffett likes — and a reason he owns 42.6 million shares. Morningstar is bullish on Johnson & Johnson, giving it a four-star (of a possible five) rating.

By Michael Brush, July 27, 2011