

How Buffett is playing this market

The Oracle of Omaha is riding the rails and looking at manufacturers and global growth. But he's avoiding financial stocks. Here's how you can play along.

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As oracles go, Warren Buffett doesn't talk much. The renowned value investor is famously secretive about his maneuvers.

In a round of December appearances in support of Sen. Hillary Clinton, for example, Buffett deftly dodged questions about what he'd been buying as stocks crumbled.

But actions speak louder than words. And Buffett's recent actions provide four key takeaways for investors:

- In the long run the U.S. economy will be fine, so it's time to start nibbling on cyclical names that have been hit too hard by fears of economic Armageddon, like railroad stock BNSF Railway (BNI).

- Basic manufacturing stocks may be buys here for the same reason.

- Get international exposure to benefit from the weak dollar and foreign economic growth.

- Avoid the financial sector.

Here's a closer look at the Buffett tea leaves.

All aboard!

Since early December, shares of BNSF have gone off the tracks. The stock has fallen more than 11% to trade recently at \$77 a share, roughly a 52-week low. Last week, Buffett took advantage of the weakness and pounced on the stock. You'd do well to follow his lead for three reasons.

First, a recent study by American University Kogod School of Business professor Gerald Martin examined how fast your money would grow if you simply purchased each Buffett stock a month after his investment company, Berkshire Hathaway (BRK.B), disclosed ownership. The result: You'd earn a cool 14.26% a year.

Now for some more good news. You can still buy BNSF for the same price Buffett got -- or better.

Berkshire Hathaway picked up \$228 million worth of the stock for around \$77 to \$78 a share between Jan. 10 and Jan. 18, according to InsiderScore.com. Buffett first reported a position last April, when the price was higher than it is today. Berkshire Hathaway now holds 18% of the company.

Second, BNSF has one of the key advantages that often explain Buffett's magic touch with stocks. Since it's hard to create a railroad, companies like BNSF enjoy pricing power and protection from would-be competitors.

BNSF "is a toll collector with a huge moat and high barriers to entry. You can't duplicate these franchises," says Stephen Shueh, the President of Alter Asset Management, a value investor who studies Buffett closely and owns shares of the railroad.

Third, since Buffett loves betting against the crowd, I'll take his BNSF purchase as a signal that the market may be overreacting to signs of weakness in the economy -- which at some point will return to solid growth, pushing stocks back up.

"It is the nature of capitalism to periodically have recessions," Buffett said in a CNBC interview in December. "It isn't the end of the world. As a matter of fact, for an investor it turns out to be the times when you make your best buys. The American economy is going to do fine over time."

Exposure to manufacturing abroad

In late December, Buffett plunked down \$4.5 billion to purchase 60% of a little-known industrial conglomerate called the Marmon Group. That used up nearly 10% of Buffett's cash position, no small purchase.

What can we learn about Buffett's thinking from this move? Marmon is a conglomerate that makes mundane but essential industrial products such as wire and cable, railroad tank cars, specialty pipe and tubing, metal fasteners and food-preparation equipment. It has plants in North America, Europe and China. This confirms a theme Buffett has been pursuing for a while: international exposure in basic industry.

"These are basically old-line manufacturing businesses that are really up his alley," says Todd Lowenstein, a co-portfolio manager at the HighMark Value Momentum Fund (HMVMX) who follows Buffett's moves closely. "He has wanted to get manufacturing with overseas exposure and a global platform to build on."

This makes sense because industrial growth in many foreign economies is stronger than industrial growth

in the U.S. In November, Chinese industrial production grew 17% compared with a year before, while South Korea's output rose 11%. Production growth in India and many Latin American countries has been in the single digits but still higher than in the U.S. Many economists believe this trend will last for years, even if U.S. industrial production picks up because of the weak dollar.

Marmon is a private company, so there are no publicly traded shares that allow you to piggyback on Buffett's play here. To find similar picks, I turned to value investors who follow Buffett and his investing approach.

Ed Walczak, a portfolio manager at Vontobel Asset Management's Phoenix Focused Value Fund (JVVAX), likes General Electric (GE) as a way to get inexpensive exposure to basic industrial production and foreign growth. Solid strength in the company's global infrastructure business -- which sells equipment for power generation and water systems -- offset weakness in its credit card business in the last quarter. "We believe GE stock will likely outperform in a U.S. recession," says Morgan Stanley (MS) analyst Scott Davis.

Lowenstein likes Mexican beverage maker and retailer Fomento Economico Mexicano (FMX) as a value play that offers exposure to foreign growth. Its beer division, Cerveza, makes Dos Equis and Sol beer.

Another division owns a 54% position in a Coca-Cola (KO) bottler serving Central and South America. And a third operates a Mexican convenience-store chain called Oxxo.

Lowenstein reckons the breakup value of these three divisions to be \$55 to \$60 per share, while the stock recently traded for \$34. He thinks the company could get taken over by a bigger beer producer like Heineken Holding (HKHFF). "The industry is consolidating, and this is one of the last great pieces that can be rolled up," says Lowenstein.

Credit Suisse (CS) analyst Carlos Laboy agrees and has an "outperform" rating on the Mexican company.

Graco (GGG) is another beaten-down manufacturing play in the Buffett mold. The stock, down nearly 30% since August, traded recently at \$33 a share. It has taken a hit even though it has many of the qualities that Buffett looks for, such as consistent long-term earnings growth, financial strength and above-average return on capital, according to John Reese of Validea.

Reese's money-management firm uses screens designed to replicate the investment approaches of market gurus like Buffett. And Graco, which makes products such as compressors, pumps and equipment used to apply paint, gets the highest score possible in Validea's screen that looks for stocks Buffett would like.

Avoid the financials

Buffett also recently deployed relatively small amounts of cash to create a company that insures municipal bonds and to purchase a reinsurance division from ING Groep (ING), a Dutch bank and insurance company.

Some commentators take this as a sign that Buffett thinks the financial sector has hit its low. But to really understand his view on financial stocks, it's more important to look at what he *hasn't* done.

It can take years, for example, to build a sizable business insuring municipal bonds because the debt is issued with long maturities and dribbles into the market in relatively small quantities each year, says Justin Fuller, an analyst who follows Berkshire Hathaway for Morningstar (MORN).

The logical way to get into the business would be to buy an existing player, preferably one whose stock has been crushed -- MBIA (MBI) or Ambac Financial (ABK), for example.

Instead, Buffett struck out on his own. That could be a sign he considers the balance sheets and stocks of MBIA and Ambac, and others in the sector, too toxic to touch as the subprime -mortgage mess unwinds.

And despite Buffett's penchant for putting money into sectors in distress, he's not among the financial heavyweights bailing out the big banks wounded by subprime exposure.

"Everyone has been speculating that he is going to invest in Citigroup (C), but he is not touching the financial sector," cautions Whitney Tilson, a Buffett devotee who is also co-portfolio manager of the Tilson Focus Fund (TILFX). "He has zero interest because he thinks things are going to get a lot worse."

In the December CNBC interview, Buffett was asked whether a recent bout of trouble for banking stocks might be the last shoe to drop. His response might well apply to the fresh round of write-downs we saw last week. "No, no," responded Buffett. "When people start dropping shoes, you really don't know whether they're a one-legged guy or a centipede."

At the time of publication, Michael Brush did not own or control shares of any of the equities mentioned in this column.

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