The problem with Warren Buffett

The Oracle of Omaha has been taking a beating, once again raising worries he's lost his touch. The real answer, however, is simpler. Also: 6 Buffett-style stocks for right now.

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By Michael Brush

Has Warren Buffett lost his touch?

With more than a hundred investments carefully handpicked by the Oracle of Omaha and his disciples -- plus a huge cash hoard of $28 billion -- Buffett's Berkshire Hathaway (BRK.A, news, msgs) was supposed to be a bastion of safety in this turbulent market.

But Buffett, or at least Berkshire, hasn't been immune to the market's volatility. When the market rallied late last week on news of a financial-sector bailout, Berkshire shot up nearly 20%. On Monday, it gave up more than half of that advance.

Before this recent run, it was down 20% since early December, only slightly better than the 22% decline of the S&P 500 Index ($INX) over the same time frame.

Understandably, many Berkshire Hathaway investors feel shaken. They're wondering whether Buffett has finally turned into an investing has-been.

Oh, he's still wealthy enough to rank second in the latest edition of the Forbes 400. But he's down from No. 1, and his $50 billion net worth represents a $12 billion decline in the past six months, Forbes reported.

On Tuesday, Berkshire announced plans to plunk down $5 billion to take a stake in Goldman Sachs Group (GS, news, msgs), at a time when many investors are running scared from the financial sector. In market downturns past, Buffett has made smart buys at the bottom, but it remains to be seen whether this is one of those or will go the way of less fortunate investments in companies such as USAir, now US Airways Group (LCC, news, msgs).

Several theories floating around purportedly make the has-been case. But just one explanation makes sense. We'll get to it in a moment.

First, here are the three bogus theories you need to ignore if you want to play Berkshire Hathaway right -- or if you're one of the many who follow Buffett's every word of advice.

No. 1: No more 'skin in the game'

More than two years ago, Buffett generously decided to give his stake in Berkshire to charitable foundations. This means he won't personally profit from Berkshire's performance.

But it's a mistake to think this makes Buffett less motivated, analysts say, because a guy like Buffett hasn't been in it for the money for quite some time. (Read "Buy the stock Buffett's giving away.")

As for the actual stock sales to raise funds for charity, "he said a while ago that there would only be a small portion liquidated annually," says Justin Fuller, an analyst who follows Berkshire Hathaway for Morningstar (MORN, news, msgs). So his selling won't drive down the stocks.

No. 2: The 'succession issue'

Another explanation for Berkshire Hathaway's weakness is that investors are worried that Buffett, 78, could soon step aside or pass away. But Whitney Tilson, a co-portfolio manager of the Tilson Focus Fund (TILFX), which holds shares of Berkshire Hathaway, says you shouldn't worry about this.

"There is no evidence that he is mentally or physically slowing down," says Tilson. Plus, according to insurance company estimates, a healthy 78-year-old lives on average for an additional 15 years, Tilson says. He expects Buffett will be running Berkshire for the next decade.

No. 3: Buffett has lost his Midas touch

Like any good investor, Buffett readily admits he makes mistakes. But the recent numbers are shocking.

The value of unrealized gains on his stock holdings fell $7 billion by the end of the second quarter compared with the end of 2007, and unrealized losses grew to $3.9 billion from about $1 billion.

Two of his biggest turkeys are newspaper companies: Gannett (GCI, news, msgs) is down 61% in the past year, and The Washington Post (WPO, news, msgs) has shed 20%.

Do these big losses mean that Buffett's brain has actually gone into retirement without giving notice?

I doubt it. First off, Buffett's holdings are bought "for life," as he likes to say. So it's unfair to judge them over the short term. Even if you do this, you can make the case that Buffett's performance is telling us his brain is working better than ever. Because so far this quarter, Buffett has turned in an enviable performance.

As of Sept. 23, his holdings were up 9% during the third quarter, compared with a 5.9% decline for the S&P 500, according to an analysis of his portfolio by Bespoke Investment Group, an investment research shop. His best performers were Wells Fargo (WFC, news, msgs), SunTrust Banks (STI, news, msgs), Bank of America (BAC, news, msgs), Kraft Foods (KFT, news, msgs) and Lowe's (LOW, news, msgs), up anywhere from 15% to 47% so far during the quarter.

Buffett's real problem

The real reason Berkshire Hathaway stock is weak is that despite Buffett's investment prowess, his company is still mainly a property and casualty insurance business.

And that's been a terrible business of late because pricing is so weak in property and casualty insurance, as well as most other segments of the sector, says Stephen Shueh, a managing partner at Roundview Capital. Shueh is a value investor who holds Berkshire Hathaway shares.

The problem is that -- Hurricane Ike notwithstanding -- there haven't been big disasters in the recent past to force insurers to make big payouts. Insurance companies have been growing fat on excess capital from all those premiums coming in. As they gain capital strength, they can offer more insurance -- but to win business, they have to lower prices.

Over the past year, commercial insurance pricing is off 5% to 6%, says John Iten, a senior analyst in Standard & Poor's insurance group. And pricing in reinsurance is down 10%, Iten says. Reinsurance is one of Buffett's fortes. It involves offering insurance to other insurance companies who write policies against major catastrophes.

All of this helps explain why Berkshire Hathaway's insurance earnings -- before taxes -- fell 20% in the second quarter and net income fell 7.6% to $2.88 billion. Both fell sharply in the first quarter as well.

To anyone who pays attention to Buffett, none of this is a surprise. In his most recent letter to shareholders, in February, Buffett warned investors that the "party is over." He told them straight out it was "a certainty that insurance-industry profit margins, including ours, will fall significantly in 2008."

The other problem, of course, is that Buffett has collected a lot of companies with direct exposure to the housing sector. These include Shaw Industries, the world's largest carpet manufacturer, and Star Furniture, as well as Clayton Homes, Acme Building Brands, Benjamin Moore and Johns Manville, which sell manufactured homes, bricks, paint and insulation, respectively.

Buffett also has a lot of exposure to consumer-facing businesses like apparel, through companies such as Fruit of the Loom and H.H. Brown Shoe Group.

These businesses have been hit hard by weakness in the economy.

Buy or sell Buffett?

Because of the grim outlook for insurance pricing and the weak economy, analysts such as Gary Ransom of Fox-Pitt Kelton are not enthusiastic about Berkshire Hathaway's stock.

But for long-term investors, the stock looks like a good buy-and-hold and sleep-at-night investment.

"We still believe the conglomerate will do well by its shareholders for decades to come," says Morningstar's Fuller, who has a five-star rating on Berkshire Hathaway, Morningstar's highest rating.

Here are three reasons:

- Berkshire Hathaway looks cheap. "It is trading below intrinsic value, and it always returns to intrinsic value sooner or later," says Tilson, of the Tilson Focus Fund. By tallying the value of cash per share and investments, and putting a reasonable valuation on Berkshire operating businesses, Tilson calculates intrinsic value to be as much as $160,000 per share. That suggests a potential gain of 19% just for getting back to a fair valuation for Buffett's stock.
- Buffett has the best managers in the business. Buffett doesn't put much value on résumés. Instead, he looks for a good track record and passion. Most of the chiefs running his operating businesses no longer have any financial need to work. They sold their businesses to Buffett but continue working for him because they love it. "They have exactly the job they want for the rest of their working years. I think our rare and hard-to-replicate managerial structure gives Berkshire a real advantage," Buffett told shareholders in his most recent letter to them.
- Buffett has the cash to take advantage of the train wreck in the market. "As the markets get more and more chaotic, that works to Buffett's benefit," Tilson says. While others panic, Buffett will pick up bargains. Last week, for example, Buffett stepped up and bought Constellation Energy Group (CEG, news, msgs) after its shares swooned because of concerns about its financial strength. "It would be hard to find a better example of why this market is so perfect for Buffett," Tilson says.

Undervalued or not, a share of BRK.A at more than $130,000 may be beyond the average investor's means. The other option is BRK.B, now trading around $4,400.

- ## 6 Buffett stock picks

If you want to try your hand instead at individual holdings in the Berkshire Hathaway portfolio, consider these stocks. Three are positions that Berkshire added to during last quarter. Three others are holdings favored by value investors and Buffettologists around current levels.

Berkshire Hathaway took on one new position last quarter when it bought 3.24 million shares of NRG Energy (NRG, news, msgs), a utility. At $30 a share, NRG trades about 30% below where Berkshire probably bought last quarter.

Berkshire also added to Sanofi-Aventis (SNY, news, msgs), a pharmaceutical company with most of its sales in the U.S. and Europe, and Ingersoll-Rand (IR, news, msgs), which sells industrial equipment such as climate control and security systems. Morningstar analysts have five-star ratings on both companies. Each stock trades at or near lows for the second quarter. So if you buy now, you'll get about the same price that Berkshire Hathaway got, or even better.

Wells Fargo looks like a buy because as a financially sound survivor, it will likely benefit from the banking mess by making acquisitions or expanding, says Todd Lowenstein, a co-portfolio manager of the HighMark Value Momentum Fund (HMVMX). Wells Fargo is one of Buffett's top five holdings.

Tilson thinks American Express (AXP, news, msgs) looks "very attractive" at current levels. Fears about weak consumer spending and losses on credit card debt could hold the stock down for a while. "But they will emerge from this with a brilliant franchise intact and incredible earnings power," Tilson says. "This is one of the world's great businesses."

Just be patient, and don't expect gains right way, as there is no known near-term catalyst for the stock. American Express is also one of Buffett's top five holdings.

Another Buffett holding in the financial sector, M&T Bank (MTB, news, msgs) also looks attractive around current levels, says Ed Walczak, a portfolio manager at Vontobel Asset Management's Phoenix Focused Value Fund. The stock is weak this year with the rest of the group. But this doesn't make sense because it has "a lot less exposure to the bad stuff that is out there, like residential mortgages," Walczak says.

The faint of heart may find comfort in the fact that half of the float of M&T Bank stock is held by Buffett and other serious long-term investors, Walczak says, which means there may be "less craziness" in terms of stock price.

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