THE FOUR FILTERS INVENTION

of Warren Buffett and Charlie Munger

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This is the Abridged Version of my book. Historical, Behavioral Finance Content, Discussion, and Case Samples were removed. I think Buffett and Munger invented an amazing Behavioral Finance Formula/Process that is underappreciated by the business and academic communities. Their work in designing a mixed qualitative + quantitative formula may be worthy of a Nobel Prize in Economics and Behavioral Finance.

So, in my new self-published book "The Four Filters Invention of Warren Buffett and Charlie Munger" I examine each of the basic steps they perform in "framing and making" an investment decision. I intended to make this book a small and highly distilled look into this amazing invention within "Behavioral Finance."

In my view, the genius of Buffett and Munger's parsimonious four filters process was to <u>"capture all the important stakeholders" in a "multi-variable" equation or formula</u>. Imagine...Products, Enduring Customers, Managers, and Margin-of-Safety... all in one mixed "qualitative + quantitative" formula. <u>I think this is the real genius of the Munger and Buffett collaboration</u>. Notice the 3 qualitative stages followed by a quantitative stage. Teaching young people these “Four Filter” ideas may be more valuable than giving them “One Laptop Per Child.” Keen readers will find small gems hidden in the full text.

INTRODUCTION

How do we improve and optimize our investing decision making? How do we find that investing sweet spot like Warren Buffett and Charlie Munger? We are about to take a unique intellectual adventure describing the Four Filters invention of Warren E. Buffett and Charles T. Munger. Their four filters investing formula help us eliminate many prospects, and they help us find: *"Understandable first-class businesses, with enduring competitive advantages, accompanied by first-class managements, available at a bargain price."*

Warren Buffett and Charlie Munger invented an investing formula that is underappreciated by the business and academic communities. In my view, the Four Filters developed by Warren Buffett and Charlie Munger is an amazing intellectual achievement in both practical and Behavioral Finance. The four filters are a remarkable and important set of steps used by the world's greatest investors. The Four Filters function as an effective time-tested focusing formula for investing success. They serve as a very useful guide for assessing intrinsic value and sensible price. And, they help us prevent foolish and costly investing losses.

This formula is an innovation that uses qualitative factors and quantitative factors to help us find and insure a good stock or whole business for investment. It will raise your odds of investing success.

My deepest interest has been focused on the Behavioral Finance area I call “successful practitioner framing.” Framing in behavioral finance is the choosing of particular words to present a given set of facts. And, framing can influence our choices. Tversky and Kahneman described "Prospect Theory" in 1979 using framed questions.[1] Tversky and Kahneman found that contrary to expected utility theory, people placed different weights on gains and losses. Tversky and Kahneman found that individuals are much more distressed by prospective losses than they are happy by equivalent gains. In 1992, Takemura[2] showed that the effects of framing are likely to be lower when subjects are warned in advance that they will be required to justify their choices, and when more time is allowed for arriving at their choices. Luckily, Buffett and Munger seem to have arrived at the practical use of these optimal framing ideas earlier than most. They make good use of “justification,” “elaboration,” “elimination,” and “time.”

CHAPTER ONE OF FIVE: UNDERSTANDING

Filter Number One: Develop an Understanding of a Company and its Products.

Warren Buffett puts it this way: “Seek whatever information will further your understanding of a company's business.”[3] My goal in this chapter is to review a tiny bit of history, mention a few concepts, and stimulate a growth in your latticework of understanding businesses and situations. Example number one is a section from the 1960 Buffett Partnership Letter. Example number two shows us that the historical development of Buffett’s and Munger’s understanding of business.

In developing your understanding of a business, read, study, look, listen, and learn. Charlie Munger advises us to build an idea like a “latticework of mental models” based on facts and accurate and reality based impressions.[4] Look for popular consumer brands. We should begin to build up a mental checklist of factors we like and dislike about a company. Where did these <u>checklist influences</u> came from? Phil Carret and Philip Fisher both developed and used quality checklists.[5] Their criteria are illustrated in a table at the end of this chapter. There you can also find Charlie Munger’s list of human behavioral tendencies.[6] You will develop a better understanding of a business, its products, and its managers if you can sense it building intrinsic business value on a per-share basis. In addition, the next three filters will add to your “latticework of understanding” the nature of a business.

CHAPTER TWO OF FIVE: SUSTAINABLE COMPETITIVE ADVANTAGE

Filter Number Two: Does a Company have a Sustainable Competitive Advantage?

The nature of Capitalism is Competition. A business must have “something special” in order to lead the pack and fend off competitors. What is the nature of the business over the next twenty years? Can we predict it with a high degree of accuracy? Can we imagine an enduring competitive advantage? Is there something special here? Are we being rational and realistic about our assessment? Benjamin Graham urged his students to analyze the business. Warren Buffett is said to be the only student who ever earned an A+ from Ben Graham.

Filter number two is about “sustainable competitive advantage” or “favorable long-term prospects” or “enduring economic advantages.” Sustainable Competitive Advantage comes from things that make a company difficult to copy. It is barrier to entry. A protected brand is something unique in the mind of a consumer. A valuable patent or trademark can give a firm a period of protected advantage. There needs to be a strong barrier to entry. Of lesser businesses, Warren Buffett said: “In many industries, differentiation simply can’t be made meaningful. A few producers in such industries may consistently do well if they have a cost advantage that is both wide and sustainable. By definition such exceptions are few, and, in many industries, are non-existent. For the great majority of companies selling “commodity” products, a depressing equation of business economics prevails: persistent over-capacity without administered prices (or costs) equals poor profitability."[7]

Consider why the Coca-Cola Company is such a good business from an investor's point of view. Both Coke and Pepsi make products we enjoy. As an investor, I prefer the Coca-Cola Company. One reason is the amount of Free Cash Flow generated for every sale. Another reason is the amount of Free Cash Flow generated after expenses. Take a look at this chart from Morningstar:[8]

Coca-Cola Company KO	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	TTM
Free Cash Flow/Sales	13.66%	14.21%	13.94%	16.63%	19.89%	22.07%	23.74%	23.91%	18.89%	19.07%	19.07%
Free Cash Flow/Net Income	0.73	1.16	1.31	0.84	1.28	1.07	1.08	1.13	0.90	0.92	91.99

PepsiCo, Inc. PEP	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	TTM
Free Cash Flow/Sales	8.08%	9.37%	13.92%	10.68%	12.70%	11.06%	12.53%	12.64%	11.43%	11.41%	11.41%
Free Cash Flow/Net Income	0.91	0.93	1.30	1.08	0.96	0.84	0.87	1.01	0.71	0.80	79.60

If you were unaware of the concept of "free cash generating efficiency" prior to now, then perhaps you are beginning to like this book.

CHAPTER THREE OF FIVE: ABLE AND TRUSTWORTHY MANAGERS

Filter Number Three: Does a Company have Able and Trustworthy Managers?[9]

Able but greedy managers will steal from you. As a shareholder, and part owner of a business, do you want a manager taking more money from you than what was agreed upon in his or her contract? The recent past showed us that the non-expensing of stock options was just that. Expensing and Formulating a simple and clear reward plan based on individual performance is clearly more just.

Imagine this scenario. Someday, able but greedy investing managers will try to steal from you, the Berkshire Hathaway Shareholder. The BRK.A "market price" may be sitting calm in the market waters at say "$500,000" for a couple of years. Some enterprising and able corporate raider team, backed by sovereign funds and big complex junk bonds, may arrive at our Berkshire Hathaway castle looking for booty. They will tell a good tale. We are here to break up the kingdom and "unlock value." That will be the telltale sign. What they will really mean is this: "We are here to break up the company into pieces, drive up the market price of each piece and make a bundle of loot for ourselves." In my view, such pirates spread the cancer of fear into good businesses. So, our own managers will need to be able, trustworthy, owner-oriented, forward thinking, and strong of character.

CHAPTER FOUR OF FIVE: BARGAIN PRICE IS A MARGIN OF SAFETY

Filter Number Four: Is the Company available at a Bargain Price?

"Margin of Safety"[10] has been called the three most important words in investing by Benjamin Graham and Warren Buffett. This is the final and pivotal filter of the Four Filters Formula.

Think about the Great Depression and the bursting of tech and housing bubbles, and you get the idea. Like we warn our children: "Safety First. Safety First." Purchasing something at a bargain price gives you a "margin of safety." It opens up the opportunity of using our remaining funds to purchase something else. It also helps to protect us from market fluctuations. Warren Buffett and Charlie Munger believe this margin-of-safety principle, strongly emphasized by Ben Graham, is the cornerstone of investment success.[11]

Later in this chapter, I demonstrate an "intrinsic value" estimation for you.

CHAPTER FIVE OF FIVE: SUMMARY

As significant as the refinement of the microscope by Antonie van Leeuwenhoek.[12]

Warren Buffett and Charlie Munger invented an investing formula that is underappreciated by the business and academic communities. In my view, the Four Filters developed by Warren E. Buffett and Charles T. Munger is an amazing intellectual achievement in both practical and Behavioral Finance. The Four Filters are a remarkable and important set of steps used by the world's greatest investors. The Four Filters function as an effective time-tested focusing formula for investing success. They serve as a very useful guide for assessing intrinsic value and sensible price.

Behavioral Finance[13] and Common Sense have shown us that we all have human tendencies to frame ideas that are affected by our emotions. Ideally, we would use the best of our emotional and intellectual energies in the right way. In my view, the Four Filters reduce the risk of investment failure by helping us steer a better path to a quality bargain.

Through the conscientious process of Elaboration and Elimination, the Four Filters illuminate the most important factors for business and investing success. The Four Filters highlight and reveal the good prospects and eliminate the bad prospects for investment. They encompass four clusters that are vitally important to investing success: 1. Products 2. Customers 3. Management 4. Margin of Safety. In each of these four clusters, imagine the influence of Ben Graham, Philip Fisher, Charles Munger, and John Burr Williams. Business students can also imagine the ideas of Porter and Greenwald in these filters. In my view, the development of this Four Filters Formula has been an evolutionary process. And, by 1977, the Four Filters were being used like a "checklist" by our pilots, Warren Buffett and Charlie Munger.

Used as a sequential set of filters, the Four Filters Formula is remarkably effective in preventing loss. It is an elegant algorithm that combines the use of important qualitative and quantitative decision steps.

As significant as the refinement of the microscope, I believe that Warren Buffett and Charlie Munger invented an investing formula that has worked effectively for over 31 years. The Four Filters process incorporates their owner-oriented business principles into an easy to remember "four steps guide." In my view, the Four Filters will help you get closer to your own "happy zone." Used carefully, it will help us avoid losing money. It has helped me greatly in my own investment decision thinking and my own investment decision making. And, I hope it helps you make better investing decisions. As Ben Graham said in the introduction of his book, *The Intelligent Investor*: "No statement is more true and better applicable to Wall Street than the famous warning of Santayana: "Those who do not remember the past are condemned to repeat it." I hope you find value in my book.

ENDNOTES

[1] Daniel Kahneman and Amos Tverksy, "Prospect Theory: An Analysis of Decision Under Risk," Econometrica, 47: 263-291 (1979).

[2] Takemura, K. (1992) Effect of decision time on framing of decision: A case of risky choice. behavior. Psychologia, 35, 180-185.

Takemura, K. (1994). Influence of elaboration on the framing of decisions. Journal of Psychology, 128, 33–39.

[3] Berkshire Chairman's Letter to Shareholders, 1993.

[4] Charlie Munger: USC Business School, 1994 Speech: A Lesson on Elementary, Worldly Wisdom As It Relates To Investment Management & Business.

[5] Fisher and Carret, 0000.

[6] The Psychology of Human Misjudgment by Charles T. Munger, Kaufman, Peter D., Poor Charlie's Almanack, Virginia Beach, VA: PCA Publication, LLC, 2005.

[7] Berkshire Chairman's Letter to Shareholders, 1982.

[8] Morningstar.com, http://quicktake.morningstar.com/stocknet/CashFlowRatios10.aspx?Country=USA&Symbol=KO

[9] "Able and honest people", Berkshire Chairman's Letter to Shareholders, 2002.

[10] Benjamin Graham Lecture Number Four, These lectures are from the series entitled Current Problems in Security Analysis that Mr. Graham presented at the New York Institute of Finance from September 1946 to February 1947. The book provides an abridged version of this content. The full text of the transcripts are contained within this website.
http://www.wiley.com/legacy/products/subject/finance/bgraham/benlec4.html
The Rediscovered Benjamin Graham: Selected Writings of the Wall Street Legend, by Janet Lowe.

[11] Berkshire Chairman's Letter to Shareholders, 1992.

[12] Anton van Leeuwenhoek is generally recognized as an innovator in advancing the microscope, and pioneer of microbiology. (en.wikipedia.org/wiki/Anton_van_Leeuwenhoek)

[13] Behavioral Finance