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10 LESSONS ON STOCK INVESTING FROM WARREN BUFFETT

Condensed from MSN Money by Michael Brush

Lesson No. 1: Be Frugal

If the economic downturn is forcing you to live simply, look at the bright side: It's making you more like Buffett. Buffett lives in the same modest house that he bought in Omaha, Nebraska more than five decades ago. He drives his own car. How does this make him a better investor?

- First, it gives him more money to invest.
- Second, frugal people don't need fast returns to support extravagant lifestyles.
- Third, a frugal investor is leery of corporate waste. He looks at excessive executive pay or silly perks as red flags.

Lesson No. 2: Have Patience to Wait for Cheap Buys

Resist the itch to constantly buy or sell stocks. Have the patience to wait a long time until some market turbulence brings a chance to buy great companies trading at cheap valuations.

Lesson No. 3: Be a Contrarian

A great way to make money is to go against the crowd. "We simply attempt to be fearful when others are greedy and to be greedy only when others are fearful," Buffett explained in a 1986 letter to shareholders. So be skeptical of the conventional wisdom. Not because the crowd is always wrong but because the crowd's wisdom is probably already reflected in market prices. When the investing public is extremely negative, it's usually a good time to buy stocks. When investors are confident, be careful.

Lesson No. 4: Stick with What You Know

One of Buffett's basic rules is: If you don't understand a company's product or how it makes money, avoid it. He calls this "staying within your circle of confidence." This isn't always easy. During the late 1990s boom, Buffett famously avoided tech companies, confessing that he could not understand what they did. He looked dumb until the bubble burst. "Ultimately, when it came full circle, he was proven right."

Lesson No. 5: Don't Depend On Others to Say You're Right

If you are in need of constant affirmation about your investment decisions, particularly from the stock market, you won't be able to invest like Buffett, points out Legg Mason money manager Robert Hagstrom in his book "The Warren Buffett Way." That's because Buffett makes outsized returns by purchasing disliked value stocks that are so beaten down they're often virtually ignored.

Lesson No. 6: Buy Companies Cheap

This is the essence of being a value investor.

- First, calculate what Buffett calls an "intrinsic value" for a business - either by examining what similar companies sell for or calculating the present value of all the cash that will be generated by a company in the future.
- Second, build in a "margin of safety" by purchasing a stock well below its intrinsic value.
- Third, look for companies with good return on equity, solid operating margins and reasonable or no debt. Buffett likes to see that companies generate a lot of cash and that they invest it well or return it to shareholders in the form of dividends or buybacks. He doesn't pay much attention to earnings per share, a common measure of value.
- The key throughout this analysis is to look back over five years or more. Buffett wants to see a consistent operating history; he's not into startup companies. He also prefers to gauge how well a company does in different kinds of markets, not just the good times or the latest quarter.

Lesson No. 7: Look For Companies With Economic Moats

A key characteristic supporting consistent operating history is a sustainable competitive advantage. In other words, a company should have a barrier to entry - or a kind of moat - that keeps potential competitors at bay. This could be a patent protection on drugs, high costs to get into a business or simple brand power, fund manager Lowenstein says. "Franchise" businesses like these can do well because they have the power to raise prices. In contrast, companies in "commodity" businesses have to take whatever price is set by a competitive market - which can crush profits during hard times. BNSF Railway is a great example of a "franchise" business. It's pretty hard for anyone to lay enough tracks in North America to start a competing railroad. Coca-Cola, another long-term Buffett holding, has barriers to entry in the form of a strong global brand and distribution system that is hard to replicate.

Lesson No. 8: Buy Big, Concentrated Positions

Most professional money managers protect against risk by diversifying. Buffett goes against the crowd here, too. When he finds a company he likes, he piles into it big time. This is crucial to his success. Money manager Hagstrom calculates that if you eliminate a dozen of Buffett's best investment choices over his career, he's only an average performer. Buffett thinks his risk protection comes from understanding a business better than the market does and then being patient enough to buy it at the right price.

Lesson No. 9: Hold for Life

Buffett quips that his favorite holding period is "forever." Embedded in this concept are two key Buffett tenets I've already alluded to. First, it's worth investing only in companies that are good enough to outperform for decades. Next, you have to think on your own and avoid the madness of the crowd. "Buffett believes that unless you can watch your stock holdings decline by 50% without becoming panic-stricken, you should not be in the stock market," Hagstrom says. This doesn't mean buy and forget. Buffett tracks his investments closely and gets out when he thinks that they are fully valued or that trouble is on the way, points out Pat Dorsey, the director of stock analysis at Morningstar. A few years back, Buffett sold big positions in Fannie Mae and Freddie Mac, the home mortgage companies that blew up last year.

Buffett is not infallible, however. He still owns big positions in Gannett and Washington Post even though he forecast at his 2004 annual meeting that the newspaper business would see nothing but trouble for decades. The price of his company's stock - always a major part of his wealth - dropped 31% in 2008 and continued to follow the market down early this year. However, the market has rallied strongly since then.

Lesson No. 10: Believe In America

Unlike most investors, Buffett doesn't tweak his portfolio depending on which party is coming into office or where we are in the economic cycle. This may make him seem naive. But it also has him putting money to work now, when many others have lost faith in the U.S. economic system. It's a move that will likely make him a winner down the road again. After all, the current fears about the long-term prosperity of U.S. companies make no sense, he wrote in an October 2009 column in The New York Times. That's why he was buying stocks before the current rally began. "These businesses will indeed suffer earnings hiccups, as they always have," he wrote. "But most major companies will be setting new profit records 5, 10 and 20 years from now."