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"Buffett's Cigar Butt"

To Focused Compounding Free Members:

Anyone who has spent much time hunting for deep value stocks knows that the decision to buy or not buy often comes down to the question of durability. Will this stock survive? How long will it survive?

Warren Buffett calls these kinds of investments *"cigar butts".*

In fact, Buffett's investment in Berkshire Hathaway – the New England textile mill company he eventually turned into a diversified holding company – was one such *"cigar butt"* investment. Here is what he wrote about that *"cigar butt"* back in 2014:

"I purchased (my) first shares of Berkshire in December 1962…The stock was then selling for $7.50, a wide discount from per-share working capital of $10.25 and book value of $20.20. Buying the stock at that price was like picking up a discarded cigar butt that had one puff remaining in it. Though the stub might be ugly and soggy, the puff would be free. Once that momentary pleasure was enjoyed, however, no more could be expected."

Berkshire Hathaway offered to buy back Buffett's shares at $11.38 a share. That was 50% higher than the price he bought in at about 18 months earlier. In other words, Buffett was sitting on something like a 30% annualized return in his Berkshire Hathaway *"cigar butt"*. That's not what he made though. Buffett didn't sell his shares back to the company. He took the board over instead. And – under Buffett's control – Berkshire went on to stay in the textile business for another 20 years. During that time, the textile business was a drag on Berkshire's performance and the compounding of Buffett's net worth. Buffett has estimated that if *"…growth would not have been impeded for nearly two decades by the unproductive funds imprisoned in the textile operation…"* he'd be many billions of dollars richer today. So, did Buffett make a mistake in ***buying*** Berkshire Hathaway?

Buffett hasn't ***quite*** said that. What he's said is that not selling his Berkshire stock back to the company was a mistake. And he has a point there. Like I said above, Buffett's partnership could have actually made something like 30% a year over 1-2 years in that stock. And you, of course, could do likewise in *"cigar butts"* today. Let's look at the price Buffett paid for his Berkshire shares. He paid $7.50 for a company with $10.25 a share in net current assets and $20.20 in book value. Ben Graham suggested buying stocks whenever they traded at two-thirds of their net current assets. Buffett didn't get his Berkshire shares at quite that price. He paid just under 75% of net current assets and about 50% of book value. There are some stocks in some places of the world that do trade at those levels today. Should you buy them? The quick answer is: yes. Net-nets outperform more expensive stocks. The cigar butt approach isn't wrong. And it isn't outdated. It still works today. But, you need to apply common sense. If you think a stock may be a cigar butt – ask yourself this key question: ***is this an asset I want to own long-term?*** Buffett would've been right to "flip" his Berkshire shares after 2 years. But, he was wrong to stay in the textile business for 2 decades. His mistake wasn't buying Berkshire. It was holding Berkshire.

Sincerely,

Geoff Gannon