François Rochon: Three wealth lessons I learned from Warren Buffett

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What can be more futile than trying to predict the unpredictable? FOTOLIA

"We will continue to ignore political and economic forecasts, which are an expensive distraction for many investors and businessmen. Thirty years ago, no one could have foreseen the huge expansion of the Vietnam War, wage and price controls, two oil shocks, the resignation of a president, the dissolution of the Soviet Union, a one-day drop in the Dow of 508 points, or Treasury Bill yields fluctuating between 2.8% and 17.4%.

But, surprise – none of these blockbuster events made the slightest dent in Ben Graham's investment principles. Nor did they render unsound the negotiated purchases of fine businesses at sensible prices. Imagine the cost to us, then, if we had let a fear of unknowns cause us to defer or alter the deployment of capital. Indeed, we have usually made our best purchases when apprehensions about some macro event were at a peak. Fear is the foe of the faddist, but the friend of the fundamentalist.

A different set of major shocks is sure to occur in the next 30 years. We will neither try to predict these nor to profit from them. If we can identify businesses similar to those we have purchased in the past, external surprises will have little effect on our long-term results."

— Warren Buffett (Berkshire Hathaway annual letter 1994)

Luckily for me, I read these sentences early in my investment career. It encouraged me to not worry about short-term macroeconomic factors and focus my energy and time on finding great businesses available at attractive valuations in the stock market.

Warren Buffett's teachings have done wonders for me and my portfolio has done much better than the S&P 500 over the years. I owe this satisfying result to three very simple factors all learned from that little passage written by Warren Buffett some 21 years ago:

1. I don't let macroeconomic/market forecasts be a distraction.
2. I focus on finding great businesses to acquire for the long term
3. I look at market drops (and the pessimism that comes with them) as opportunities to acquire such businesses at great prices.

I have come to accept that market corrections (or their bigger brothers, bear markets) do occur on a regular basis. How do I react to them? First, since I've accepted from the start that market corrections are unpredictable, I don't try to predict them. What can be more futile than trying to predict the unpredictable?

The good news is that market corrections (and bear markets) all have one thing in common: they end at some point, and then the stock market reaches new highs. So

you have to think of “market drops” as “market opportunities” instead. Remember: there is one simple reason that stocks get cheap; it’s because most investors are pessimistic. You can’t have great bargains and general optimism at the same time. The reason behind pessimism varies from one market correction to the other, but it is the necessary ingredient for attractive valuations.

So how do I look at the early 2016 market correction? The S&P 500 has fallen from a high of 2135 to 1829. Earnings estimates for 2016 are at around 124. So the P/E ratio of the S&P 500 has come down from 17.2x to 14.8x.

If we look at the 30-year treasury bonds that yield 2.5%, that means that long-term bonds trade at an equivalent P/E of 40x. Now you may argue that bond yields are unsustainable over the long term (and I would agree). Let’s double that rate to a full 5% for comparison purposes. That would be the equivalent of a 20x P/E. So at 17x, stocks would still be reasonably priced. At 15x, stocks are simply 15% cheaper. That also means that your future potential returns have just increased.

Let’s say that companies grow their earnings per share by about 6-7% per year. By 2021, the earnings of the S&P 500 group of companies should be at about 170 (up from 124 this year). If the P/E ratio goes back to 17x, the level of the S&P 500 would then be 2888. From present level, this would represent a 9.6% annualized return. If you add the dividend yield, you get a total annual return of 12%.

So I believe that the potential return of U.S. stocks over the next five years is far far above the returns available from bonds.

François Rochon is the head of wealth-management firm Giverny Capital, which he founded in 1998.