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March 2012

Behind Warren Buffett's Investing Success

In his recently released Annual Letter to shareholders of Berkshire Hathaway, Warren Buffett discussed the mistakes made in 2011 as well as the investment philosophy underlying the many successes over the years. Not surprisingly, Wall Street turned its laser-like focus on the former and not the latter.

Now 81 years old, Mr. Buffett has run Berkshire Hathaway, a financial holding company, since 1965 -- a 47-year record few investors can match. His equity investing is rooted in a practical, common-sense approach -- light-years away from the esoteric, theory-of-the-day style all too popular on Wall Street. On this, we at David Wendell Associates see eye-to-eye with Mr. Buffett.

Berkshire Hathaway has equity positions in a number of companies familiar to our clients, including Coca-Cola, IBM, Johnson & Johnson and Wal-Mart, among others. Like us, Buffett views his positions in these companies as "partnership interests in wonderful businesses, not as marketable securities to be bought or sold based on their near-term prospects." The earnings of these companies are of huge importance to Berkshire because the managers of these businesses will use them "in a variety of ways to increase future earnings and dividends." In other words, the earnings of these companies will be reinvested in the businesses in order to keep them growing far into the future.

We have long advocated that it is retained earnings, earnings reinvested in a company, which drives the future growth of the business -- its revenues, earnings and dividends. Companies with high earnings retention rates tend to grow at faster rates than companies with low earnings retention rates. Over the thirty-plus years since our firm's founding, we have seen a number of companies with high earnings retention rates turn into successful long-term investments for our clients.

Similar to our view, Mr. Buffett's favorite category of assets is productive assets. These "should have the ability in inflationary times to deliver output that will retain its purchasing-power value while requiring a minimum of new capital investment." Mr. Buffett notes that while certain types of farms and real estate meet this test, so do many businesses. He highlights Coca-Cola and IBM -- two of our favorites as well.

Finally, Mr. Buffett notes that "investing is often the process of laying out money now in the expectation of receiving more money in the future." Or, "more succinctly, investing is forgoing consumption now in order to have the ability to consume more at a later date." Words well written, to be sure.

We recommend the reading of Mr. Buffett's 2011 Annual Letter. It can be found on Berkshire Hathaway's website at www.berkshirehathaway.com, or if you like, we would be happy to send you a copy.

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