



# **RULE NUMBER 2**

**“Never Forget Rule Number 1...”**

**1. DON'T LOSE MONEY**

*The Same Methods Warren Buffett Used to Become a Billionaire*

# RULE NUMBER 2

## How to Think About Stock Investing

- Don't lose money
- Never forget to don't lose money
- Must have long-term mindset (5 years or more)
- Must be patient. Doing nothing at times is key to successful investing
- You don't get paid for activity, just for being right
- Make few bets, big bets, infrequent bets
- Research helps to develop your comfort level with a company
- Change is the enemy of investment returns
- The best businesses continue to be those that have high returns on capital and that require little incremental investment to grow
- Must be contrarian. When others are scared, you become greedy
- Must understand basic math and basic accounting principles
- Must enjoy reading and the discovery process

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## Jason Chiu – Chewing Gum Impresario

Jason, a sixth-grader, buys gum for \$.25 per pack (5 pieces). He sells gum at \$.25 per piece and earns \$1.25 in revenues per pack, \$1.00 in profit. Jason sells 4 packs a day, 5 days a week, 36 weeks a year for an annual profit of \$720. Jason will close the business in 3 years when he starts high school.

**Total Profit = \$2160** ( $\$720 \times 3$  years)

?

Jason offers to bring you in as an investor. What is the most amount of money you would pay to own 50% of Jason's business and share of profits?

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## Rule of 72

Years to Double Once	Growth Rate
2	36%
3	24
4	18
5	15
6	12
7	10
8	9
9	8
10	7

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## Additional Considerations

### **Factors that may increase my bet:**

- Jason's family owns a 7-11 and he buys gum at a discount.
- Jason is president of the Young Entrepreneurs Club.
- Jason has many friends and is well liked by all.
- Customers recognize and like Jason's brand name "Chiu Chew"
- There are no convenience stores near school.
- School vending machines don't sell gum.
- Jason plans to roll out his business to 5 other middle schools.
- Jason changes his gum flavors based on customer buying trends.

### **Factors that may reduce my bet:**

- Jason was caught cheating on a Math test last year.
- Barry and Lenny have started selling gum.
- A convenient store is opening up near the school next year.
- Kids are increasingly being seen enjoying mints.

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Double Your Money Every 3 Years...

\$\$\$	\$20K	40K	80K	160K	320K	640K	1.28M	2.56M
Year	1	3	6	9	12	15	18	21

Retirement Projection:

$\$2\text{M at } 4\% = \$80\text{K year} + 18\text{K (social security)} = \$98\text{K per year}$

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**\$400 - 500**



**RULE NUMBER 2**

**Session Two**  
**The Four M's**



# RULE NUMBER 2

## The Four M's

- **Meaning**
- **Moat**
- **Management**
- **Margin of Safety**

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## Meaning

Always buy stocks that you understand. If you work in the industry of the stocks you buy, even better. This is where your experience will give you an edge over others in analyzing the data for a given industry. Meaning can also apply to industries that are easy to understand. A company that makes and sells shoes is a whole lot easier to understand than a large multinational conglomerate that markets products and services from A to Z. Boring companies in boring industries often make the best investments.

The better you know the company and industry, the better you will be able to predict its future prospects.

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## Moat

What makes this company so special? How will it continue to dominate its peers and maintain its standing? Great companies have an enduring advantage that allows them to make great profits despite competition. Coke has a brand name recognized world wide and a secret formula that is too tough to crack. Plus, Coke controls access to distribution that further solidifies its standing. Buying companies with *large and wide moats* is key to being a successful investor. Without it, you will never be able to predict how a company will do over a given period of time.

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## Management

*If you don't know the horse, you better know the jockey.*

-Warren Buffett

Without good management, even the best company can fail. Get to know the CEO, officers, and directors of the companies you buy. A great manager can make a mediocre company great. Things to consider are:

- CEO Compensation package. Is it in scale with the company's earnings?
- Background
- History with other companies
- What percentage of the company does the CEO own?

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## Margin of Safety (MOS)

You can lose money on even the best company if you pay too much for it. As an investor you must determine the maximum price you would pay to make the return you are looking for in a given timeframe. The current price of a stock often has nothing to do with the value of the company. You've all heard buy low, sell high. Well, the only way to do that is to determine the intrinsic value first, compare that to the actual selling price and see if the value price is lower than the selling price by enough margin to satisfy your goals.

**Warren Buffett likes to buy companies at half off. - and so do I!**

MOS also provides you protection against losses in case your calculations are off. MOS is key to helping you achieve Rule Number 2.



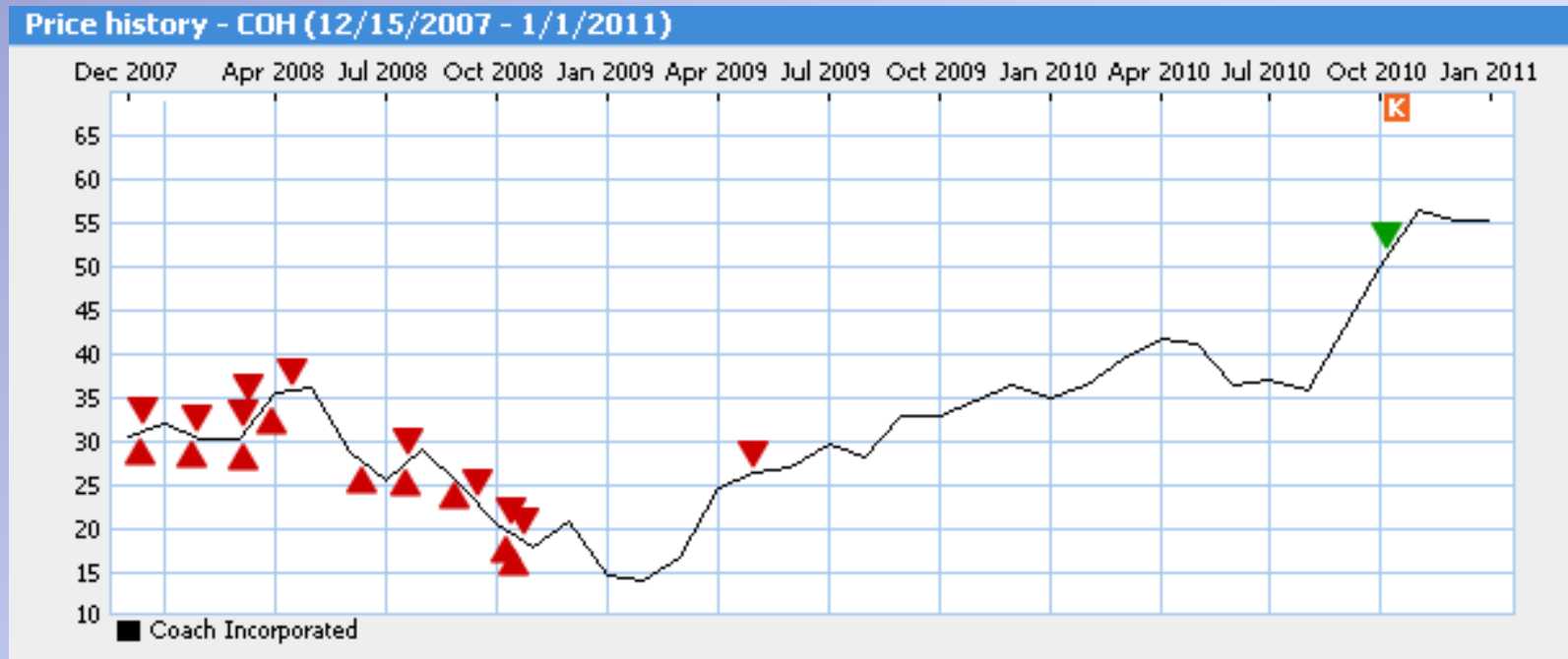
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**Session Three**

**The Nitty Gritty**

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Coach Inc. – Symbol (COH)



COH was purchased for an average price of \$25.75 beginning in January 2008. COH was sold 2 years and 10 months later on 10.26.2010 at \$50.08, creating a 94% profit. Total annualized return was 26.4%.

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## Coach Inc. – Elevator Pitch

Coach is a stalwart seller of quality affordable luxury handbags and accessories. It has a strong brand name which gives it an enduring moat. I personally own the products and have witnessed its consistency over many years. A recent visit to the store revealed how clever Coach is at weathering these trying times. Customer service is excellent, sales lines moved quickly and efficiently and products were priced attractively. Women really connected with the store and the enthusiasm was evident. I Expect the stock to double in 2 years.

### Pros

- Earnings growth remains strong and double digit
- Coach doesn't discount items, only limits inventory
- Does not sell items from retail store s in outlets. Maintains brand integrity.
- Has global reach
- Has bought back shares in '09
- Strong balance sheet and tons of cash
- Increased revenues in '09 despite economic climate
- Handbags have long shelf life, unlike clothing

### Cons

- Economic downturn will continue to limit discretionary spending worldwide



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## ITT Educational Services, Inc. – Elevator Pitch

ITT is a fast growing, highly scalable, post-secondary education company offering online and classroom options in diploma programs including healthcare, criminal justice, trades, and IT. Recent backlash from students, the media and DoE have put for profit schools under fire. However, with high unemployment, people look to education to improve their prospects and I expect this trend to continue. ITT pumps out twice as much net income on similar revenues as COCO. Has similar student size as COCO but with 40% less staff.

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## ITT Educational Services, Inc. – Elevator Pitch Cont.

### Pros

- There aren't enough non-profit schools to meet demand
- Low current P/E relative to historic levels
- Highest ROIC of all for-profit colleges
- Report from DoE did not reveal any overly heinous discoveries
- Industry expected to continue to grow during present economic downturn/slow recovery
- Current high uncertainty regarding COCO's future presents attractive investment opportunity
- Has \$3.48 in net cash per each share
- Sales, BVPS, and EPS at double digit growth over past 10 years
- Due to student loan option, tuition increases are met with little resistance
- CEO compensation is tied to free cash flow targets, student enrollment, graduate employment rates
- Veteran Administration will be a new source of income despite any Gov legislation changes
- 2020 Federal college graduate goals will keep for-profit schools necessary.

### Cons

- Industry has been under pressure for alleged crooked recruiting practices
- Sallie Mae is reviewing and may adjust its student loan structure for for-profit colleges
- ITT may be forced to self finance student's loans, taking on more default exposure
- Credit markets have strained access to student loans
- Prolonged unemployment could increase student default rates

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## Important Resources - Websites

**Rule 1 Investor:** <http://ruleoneinvestor.com>

Has great calculators for determining the intrinsic value of a company.

**Magic Formula Investing:** <http://www.magicformulainvesting.com>

Great resource for doing initial search of companies selling at a discount.

**MSN Money:** <http://moneycentral.msn.com/home.asp>

Best place get data for intrinsic value calculations. Also has a watchlist and portfolio you can personalize.

**Yahoo Finance:** <http://finance.yahoo.com/>

Great place to do industry research and learn about the companies in an industry.

**Berkshire Hathaway:** <http://www.berkshirehathaway.com/>

Be sure to read Warren's letters to Berkshire Shareholders to learn everything you need to know about how to approach investing. Warren's stories and insights are both funny and priceless as far as value investing goes.

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## Important Resources – Books & Publications

### **The Dhandho Investor – Mohnish Pabrai**

Excellent book for learning about how to approach value investing. The stories are entertaining and insightful. Pabrai also teaches you how to quantify how much of your bankroll to invest on any particular company. He also shares his own investing experiences.

### **The Little Book That Beats the Market – Joel Greenblatt**

Another great book about how to approach value investing. Greenblatt also provides a formula for investing, by providing a list of highly profitable businesses selling below their value. The book is best used in conjunction with his [website](#).

### **Rule #1 – Phil Town**

This book boils down Buffett's approach to investing in an easy to understand way. Phil's book also shows you how to calculate the intrinsic value of a company and where to get the data needed to do it. The exercises and company examples are very helpful.

### **One Up on Wall Street – Peter Lynch**

Although written in the 80's, this book is still very relevant. Lynch is an astute and successful investor and he imparts much wisdom in this book. I especially like the way he breaks down the different stock categories: stalwarts, cyclicals, slow growers, fast growers, turnaround plays, asset plays.

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## Important Resources – Books & Publications cont.

### **The Wall Street Journal**

The gold standard as far as US company business news goes. Reading the WSJ daily will keep you abreast of business news, trends, filings, politics, world events, etc. You will also get investment ideas from WSJ and learn how companies operate and keep their edge. WSJ also does a good job of profiling financial crooks, which is always important if you want to honor Rule #2.

### **Standard and Poor's Industry Survey**

One industry report can cost \$700. It's better to access this great resource at the library reference section. You can learn everything you need to know about a particular industry and the leading companies in those industries.

### **Morning Star and Standard and Poor's Ratings**

These reports, usually provided by your online broker, are written by analysts and help you understand the company and the industry it's in. Used with other research, these reports help solidify your findings and best course of action.

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## Final Thoughts

### **Security Analysis**

- Read 2 or 3 different Company annual reports to understand the industry and the best companies
- Read trade magazines of industry
- Read analyst reports (from brokerage account)
- Read Standard and Poor's Industry Reports (library reference material)
- Research suppliers
- Google the news on company, industry, and CEO

Remember, research develops your comfort level with the company.

### **How to Develop Ideas**

- Read publications like The Wall Street Journal, Forbes, Financial Times, etc.
- Use Joel Greenblatt's Magic Formula Investing website
- Be observant to trends happening around you
- Look at companies trading at 52 week lows
- Screen your own stocks at [Market Watch](#)