No need to own the road: buy the tollbooth

By John Kay

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Last week, I described the arithmetic that has made Warren Buffett the world’s richest man. The magic of compound interest over four decades, based on steady investment outperformance and a frugal lifestyle, has transformed a modest sum into an extraordinary fortune. But the larger question lies in the business economics. What is the secret of Mr Buffett’s investment success?

Mr Buffett is often identified as the heir to his mentor, Benjamin Graham. Graham emphasised intelligent investment based on fundamental value. But in Graham’s day the ability to read a company balance sheet made an investor intelligent. Many trading companies sold in the market for much less than the realisable value of their assets. As Graham recognised by the time of his death in 1976, those days are over.

Mr Buffett’s central achievement was to recognise earlier and more clearly than others that these balance sheets no longer had their old meaning. Once, large business organisations found their rationale in the ability to finance and operate large industrial plants. The returns to shareholders were the reward for providing the plant and machinery.

Today we have capitalism without capital. Most large companies do not make things, they provide services. Few businesses own the premises in which they operate. Returns to shareholders are no longer payments for the use of their plant but rewards for risk and shares in economic rents. The capital that investors put into the stock market does not now finance productive investment but buys a share of established earnings streams.

Mr Buffett’s first big investment coup, in American Express, recognised that the company did not just possess a legendary brand name. The market position it had created was very difficult to replicate. For a customer there is little point in having any travellers’ cheque other than the most widely accepted: American Express. The company leveraged its brand into another market – plastic cards – with similar characteristics.

Not only were intangible assets crucial; their irreproducibility also determined their long-run value. The protection of American Express’s moat, as Mr Buffett would call it, gave the stock exceptional value.

Mr Buffett’s biographer reports a complaint from young Warren: his friends, the Russells, derived only noise from the traffic passing their house. “What a shame you aren’t making money from the people going by.” The schoolboy demonstrated a probably unhealthy obsession with business, but also an early recognition that you need not control an entire activity to profit from it. You do not need to own the road, only the tollbooth on the traffic artery. The brand, the business systems and the customer and supplier relationships were the business analogue of the point that all vehicles must pass.

So the Buffett empire focused on businesses with market positions that could not be replicated. Disney, with its inimitable repertoire; the Washington Post and local newspapers and broadcasters with local dominance; and businesses whose powerful consumer brands, such as Coca-Cola and Gillette, not only commanded consumer recognition but were also entrenched in distribution systems.

American Express had a secondary advantage that would also become a Buffett theme. People paid for cheques up front and cashed them later, if at all, so the business generated a float on which the corporation could earn returns. Just as there could be assets without capital, so there could be cash without assets. The concept of a float led Berkshire Hathaway into the insurance business, Graham’s central idea – that market prices varied by more than fundamental values and often independently of them – was as relevant there as in stock markets.

Mr Buffett’s success demonstrates the weakness of one economic theory, the efficient market hypothesis, and the strength of another – the central role that the pursuit and defence of economic rents plays in modern corporate life. Still, the first view remains much more popular among economists than the second. Mr Buffett became the first man in economic history to parlay an economic disputation into great personal wealth.

johnkay@johnkay.com

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