The #1 Trait Warren Buffett Looks for in Every Stock

Description

When Warren Buffett is evaluating a company, he values this trait above almost all others.

In fact, he has directly or indirectly mentioned it in every single one of his letters to shareholders. However, you will never find it listed on a company's financial statements. Its value is hard to quantify. Yet that doesn't keep it from being a firm's most valuable asset. Companies that possess this characteristic vastly outperform their peers.

So, what is the number one trait Buffett looks for in every single company?

It's the integrity of the people actually running it

If you read through Buffett's shareholder letters, you're likely to be struck by how often he raves about the people who work in his organization. Yes, balance sheets and earnings are important. However, Buffett puts are remarkable emphasis on intangible factors when evaluating a business.

When we invest in a company, we are entrusting our capital to the management team. It stands to reason that the performance of the business will only be as good as the people running it. As current or prospective shareholders, we must constantly ask ourselves whether management is running the business in our interests.

But how do you really tell?

Of course, evaluating management is one of those mushy qualities to grade. It's a bit like baseball. You can always justify keeping any player on your roster by claiming, he's a great guy. But how many runs does that really put on the scoreboard?

No executive will ever come out and say that they're running the company to line their own pockets at the shareholders' expense. So how do we separate the great management teams from the losers?

Fortunately, Buffett offers some guidance: "All managements say they're acting in the shareholders' interests. What you'd like to do as an investor is hook them up to a machine and run a polygraph to see whether it's true. Short of a polygraph, the best sign of a shareholder-oriented management —assuming a stock is undervalued—is repurchases. A polygraph proxy, that's what it is."

So many companies fritter away shareholder wealth on overpriced acquisitions or wasteful investments. While leading a larger corporate empire may stoke boardroom egos, merry managers never funded anyone's retirement.

Great executive teams, in contrast, are disciplined in their capital allocation. They choose to invest only in ventures that generate a sufficient return for shareholders. And if such opportunities are unavailable, honest managers will return their excess capital to shareholders through dividends and share buybacks.

Let me give you an example…

In **Berkshire Hathaway's** (NYSE:BRK.B) 2011 letter to shareholders, Buffett explains that capital allocation has been a major consideration behind the decision to invest in **IBM** (NYSE:IBM). First, he praises chief executives Lou Gerstner and Sam Palmisano for transforming the company from a decaying business into an IT superpower. But then he focuses on capital allocation, "I can think of no major company that has had better financial management, a skill that has materially increased the gains enjoyed by IBM."

Since 1995, IBM has reduced its share count by more than half. This has allowed investors to double their stake in a wonderful business tax free.

Screenshot 2014-03-16 at 3.23.42 PM

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Source: Ycharts.com

What makes the executive team at IBM truly exceptional is that they put profitability above expansion. It's not about growing the company but rather generating value for shareholders. That's a rare characteristic in the investment universe.

Imperial Oil (TSX:IMO) is another example of expectational capital allocation in action.

For decades the company has chosen to fund only its highest returning projects. If management cannot find enough ventures that meet a very high bar for profitability, they have consistently returned excess capital to shareholders through dividends and buybacks.

What has been the consequence of this policy? As the chart below demonstrates, it has resulted is vastly superior returns for investors over the long haul.

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Source: Imperial Oil investor presentation

What does Imperial has that its competitors don't? Discipline.

The company's rivals, as evident in the chart above, are a little too eager to redeploy their capital into lower return ventures. While these companies have certainly grown faster in size, this strategy has proven costly for investors.

Of course, Buffett does not own shares of Imperial. However, he does own a large indirect stake in the company through his investment in **ExxonMobil** (NYSE:XOM).

Foolish bottom line

Investing in a great management team is no guarantee that a stock will outperform. There are plenty of other factors to consider. But if the world's greatest investor has made billions of dollars investing in great management teams, don't you think you should too?

CATEGORY

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