



The Secret of Warren Buffett's (and Prem Watsa's) Success

Description

It's little wonder why people everywhere love Warren Buffett. Over the past 60 years, the man has turned a modest amount of savings from a childhood of hustling into a fortune worth more than \$50 billion. Unlike his contemporaries, who all started and grew huge businesses, Buffett's fortune was amassed from nothing more than hard work, intelligent investing, and years of letting compound interest do its thing.

Prem Watsa has a similar success story. He was born in India in 1950, eventually starting **Fairfax Financial Holdings Ltd** ([TSX: FFH](#)) in 1985. Since then, his success has been nothing short of exemplary. The company is worth nearly \$11 billion, and Watsa's success in finding undervalued stocks has earned him the nickname "Canada's Warren Buffett."

Both Watsa and Buffett give the average investor hope that they, too, can earn these outsized returns. Stocks on both sides of the border will often pop on news that either **Berkshire Hathaway Inc.** (NYSE: BRK.A)(NYSE: BRK.B) or Fairfax has taken a position in the company, but the lift is often short-lived, giving investors a chance to invest alongside their idols at the same (or an even better) price.

If it's so easy to replicate the positions of the smartest in the business, why aren't there more rich investors? There are a few reasons, actually. Watsa often takes positions in unloved, contrarian names. Since many investors are short-term thinkers, they want nothing to do with the market's latest whipping boy. Other investors are happy to invest in a downtrodden name, but then hit the sell button too early, erasing a lot of potential gains.

These days, it's difficult for investors to follow Buffett at all, since the man's best acquisitions are *entire companies*. The easiest way for investors to copy Buffett is to simply buy shares in Berkshire.

However, the biggest reason why the returns of Buffett and Watsa can't be matched is because they have a huge advantage, one that just can't be replicated by the average investor: They're in the insurance business.

The advantages of the insurance industry

Why is this such a big advantage? Because both Berkshire Hathaway and Fairfax have millions of customers who pay each and every month for various kinds of insurance coverage. As long as an insurer keeps an adequate amount of capital on hand to pay out any surprise claims, it's free to do what it wants with the remainder. This is called "the float".

Most insurers don't take much risk with the float. Management knows that the easiest way to send the share price reeling is to disclose that a big investment went wrong, so it sticks with the less risky stuff. This is the main reason why **Manulife Financial Corp.** ([TSX: MFC](#))([NYSE: MFC](#)) and **Sun Life Financial Inc** ([TSX: SLF](#))([NYSE: SLF](#)) struggled after interest rates dropped. Most of their floats were invested in government bonds, and these bonds just weren't yielding enough to keep up with claims.

Assume that both Berkshire Hathaway and Fairfax Financial can invest their float at an 8% annual return, while the average insurance company gets only 4%. After 30 years of compounding, Berkshire and Fairfax will have floats that are three times larger than their competitors. Sure, they're taking on risk, but that's why each is famous for holding a large cash position as well.

This is exactly why the average investor can't get close to competing with Buffett and Watsa. The float is essentially interest-free leverage, which enhances the return of the intelligent investor. As they pour their profits back into their businesses by not paying dividends, both Buffett and Watsa make sure that they *really* compound their returns. In contrast, regular investors will commonly raid their investment accounts for all sorts of things, because life happens.

This isn't to say you shouldn't invest like two of the best. Both men have incredible records, and still have much to teach investors. Recognize, though, that without the same free leverage as Buffett and Watsa enjoy, investors are doomed to fall short.

CATEGORY

1. Investing

TICKERS GLOBAL

1. NYSE:BRK.B (Berkshire Hathaway Inc.)
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3. TSX:FFH (Fairfax Financial Holdings Limited)
4. TSX:MFC (Manulife Financial Corporation)
5. TSX:SLF (Sun Life Financial Inc.)

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