

# Munger's Investment Evaluation Process

*“The number one idea is to view a stock as an ownership of the business and to judge the staying quality of the business in terms of its competitive advantage. Look for more value in terms of discounted future cash-flow than you are paying for. Move only when you have an advantage. It's very basic. You have to understand the odds and have the discipline to bet only when the odds are in your favor. We just keep our heads down and handle the headwinds and tailwinds as best we can, and take the result after a period of years.”*

As we've noted, Charlie doesn't make a lot of investments. His approach is perhaps best summarized by Thomas Watson Sr., the founder of IBM: *“I'm no genius. I'm smart in spots, and I stay around those spots.”* If Charlie knows anything, he knows his “spots”: his carefully identified circles of competence. To stay within these circles, he first applies a basic, overall screen, designed to limit his investment field to only “simple, understandable candidates.” As he says, “We have three baskets for investing: yes, no, and too tough to understand.” To identify potential “yes” candidates, Charlie looks for an easy to understand, dominant business franchise that can sustain itself and thrive in all market environments. Understandably, few companies survive this first cut. Many investor favorites such as pharmaceuticals and technology, for example, go straight to the “too tough to understand” basket. Heavily promoted “deals” and IPOs earn immediate “no's.” Those that do survive this first winnowing are subjected to the screens and filters of Charlie's mental model approach. The process is intense and Darwinian, but also efficient. Charlie detests “placer mining,” the process of sifting through piles of sand for specks of gold. Instead, he applies his “Big Ideas from the Big Disciplines” to find the large, unrecognized nuggets of gold that sometimes lie in plain sight on the ground.

Throughout his exhaustive evaluation, Charlie is no slave to a database: He takes into account all relevant aspects, both internal and external to the company

## Circles of Competence

*“If we have a strength, it is in recognizing when we are operating well within our circle of competence and when we are approaching the perimeter.”*

—Warren Buffett

*“If you have competence, you pretty much know its boundaries already. To ask the question [of whether you are past the boundary] is to answer it.”*

—Munger



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