

Apple: From Classic Ben Graham Deep Value Idea to Buffett-Style Compounder

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One of the key takeaways for many shareholders who attended the 2018 Berkshire Hathaway (BRK) meeting in Omaha last weekend (including me) is the growing importance of Apple Inc. within BRK's equity portfolio. After buying 75 million more shares during the first quarter of 2018, Apple is by far Berkshire's largest equity holding in a public company. It was already Berkshire's second largest position at the end of 2017, but now valued at approximately \$45 billion, Apple is almost twice as big as its next largest position, Wells Fargo (~\$24 billion).

This isn't too difficult to fathom for those who are familiar with Warren Buffett and Charlie Munger's investment style, although their recent foray into technology stocks might be (first IBM, which is no longer, and now Apple). Their preference for superior companies with defensible businesses (competitive "moats") generating high returns on capital has typically meant investing in companies such as Coca-Cola, Kraft Heinz and many others, buying when their shares trade below intrinsic value. Very seldom does this quality-at-a-discount approach lead Berkshire to invest in average companies trading in deep-value territory. Apple is certainly not just an average company today, but for those with a long memory, Apple in 2003 was a classic deep-value idea that might have appealed more to Benjamin Graham than Warren Buffett.

For me, all the talk about Apple this past weekend in Omaha was a reminder of one of the greatest mistakes of my own investing career when I decided in 2003 that Apple's new captive retail store distribution model was likely to burn a prodigious amount of its net cash, deserving of a further 10% discount to its then prevailing stock price before I felt we had a sufficient margin of safety. As Charlie Munger aptly said during a Berkshire Hathaway meeting many years ago, great ideas are too scarce to be parsimonious with, once found. I hadn't yet learned that lesson.

As in life, mistakes in investing can be either sins of commission or sins of omission. Sins of omission in the investment management business are simply missed opportunities in companies that create significant value for shareholders over the long term. As an absolute return-oriented investor, I have always preferred to miss an opportunity than to experience a permanent loss of capital (a cardinal sin for value investors). In 2003, while working in Short Hills, NJ as Portfolio Co-manager of the Franklin Mutual Beacon Fund, we were picking through the wreckage of the technology, media and telecom (TMT) bust looking for interesting investment ideas. Keith Koefel, one of the brightest investors with whom I've worked, brought Apple Inc. to my attention. The company had a relatively small market share in personal computers – a business that was experiencing rapid commoditization at that time, and I vastly underappreciated Apple's devoted customer base and the genius of its visionary CEO and product development team.

If my memory serves me, Apple's products in 2003 consisted primarily of Apple's iMac, PowerBook and Macintosh personal computers and servers, and a new personal digital music

device called the iPod was brand new. As a music lover, more than as an early adopter of technological gadgets (I'm far from it), I even owned an iPod back then, and I loved it.

Shares in Apple at that time traded near \$12 per share, down from \$70 at the peak of the TMT bubble three years earlier, and were backstopped in part by an estimated \$10 per share in net cash and real estate value (our conservative valuation of its Cupertino, CA headquarters and land). This implied only a \$2 per share valuation on Apple's operating businesses.

Our offices were across the street from one of New Jersey's upscale shopping malls, the Short Hills Mall. Keith and I decided to walk over for lunch to see the brand new Apple store there first hand. I remember my dismay when we arrived to find a very expensive and modern-looking Apple store staffed with many cheerful and eager employees, but not one single customer. This might have qualified as the old-fashioned "shoe leather research" that Mr. Buffett referenced during the Q&A in Omaha on Saturday, and I felt it was important to factor our findings into the valuation and appraisal. I determined, somewhat subjectively, that at \$11 per share, or \$1 per share implied value of Apple's computer business would allow for a sufficient margin of safety against a permanent loss. Apple shares never got there.

With the benefit of hindsight, we were simply too early (and dead wrong) in our assessment of Apple's retail strategy. The primary driver of Apple's meteoric success has always been their products and brand loyalty. The loss-leading Apple stores were an unfortunate distraction from the more important innovative products they were developing and the compelling economics of their business.

In the period since 2003, Apple effected two stock splits - a 2-for-1 split in 2005 and a 7-for-1 split in 2014. This means the split-adjusted stock price of Apple in 2003 when I decided to pass on the idea was less than \$1 per share. At today's closing price of \$190 per share, Apple continues to provide me with an important lesson about parsimony when evaluating great investment ideas.

Lastly, Apple serves as an excellent (and rare) investment case study that bridges the gap between the differing value investing styles of Benjamin Graham and Warren Buffett.

Nota bene: Fortunately, inefficient markets granted me an opportunity in mid-2006 to establish a meaningful position in AAPL on behalf of clients in the Lazard Classic Value - Global strategy, and again at the inception of the 1949 Global Value strategy in mid-2015.