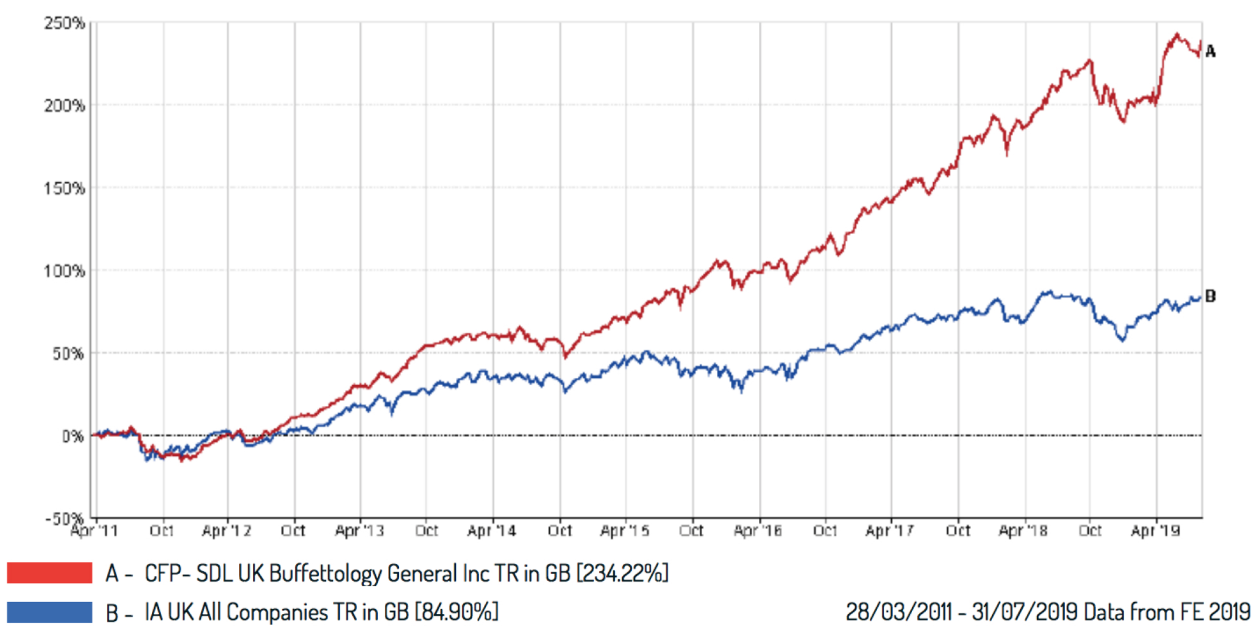
How to find high quality shares that might pass the Warren Buffett test

8:49 am by Ben Hobson

Opinions are divided on how Britain's Brexit-inspired political rollercoaster will play out in the the stock market. But one thing's for sure, the active fund management industry is already feeling the effects. Risk-wary investors have been pulling their cash from active funds at a rapid rate this summer... but not everyone is feeling the effects.

Over the past six months **Keith Ashworth-Lord** has seen the size of his **Sandford Deland UK Buffettology Fund** nearly double to **£1.13 billion**. In that time, the number of holdings in the fund has risen from 30 stocks to just 34. That's a big clue about the careful stock selection and high conviction that lies behind Ashworth-Lord's strategy.



When I interviewed him three years ago, the fund had just crossed the £50 million mark - and then, just as now, he was insisting that 30-or-so stocks was adequate diversification.

As the name suggests, Ashworth-Lord's Buffettology Fund takes its cues from the investing approach of the legendary investor, Warren Buffett. And while it's easy to see why Buffett's multi-billion dollar fortune is enviable, a big part of his appeal is his consistent common-sense approach to the stock market. His attitude to buying and holding stocks seems perfectly logical - so it's understandable that others try to copy it.

Mimicking the success of a billionaire is perhaps easier said than done. But some of the most important lessons to take from Buffett's journey as an investor come from how his thinking changed over time.

In his early career, Buffett was (literally) a student of Ben Graham's deep value investing philosophies. Some of his early money was made in the kind of 'cigar butt' stocks that most investors wouldn't touch. But as he said at the time: *"A cigar butt found on the street that has only one puff left in it may not offer much of a smoke, but the bargain purchase will make that puff all profit."*

It was only when he teamed up with business partner Charlie Munger that Buffett's value focus started to soften. Munger was insistent that it was worth paying a fair price for quality. From there you can see why Buffett arrived at the view that his favourite holding period was "forever".

A focus on long-term quality

Whether it was stocks like Coca-Cola and IBM, or private companies that their Berkshire Hathaway conglomerate bought outright, Buffett and Munger were focused on the long term. They were seeking firms with ‘economic moats’ that had durable competitive advantages and the capacity to compound returns over long periods.

Buffett, of course, had a few structural advantages over the average investor. For a start he had a vast pool of cash from the floats in his wholly-owned insurance companies that was available to invest. But that doesn’t mean that individual investors can’t learn and apply some of his investment rules.

There are various interpretations of his approach, but one strategy that has held up well in the current market conditions (when many other strategies have suffered) is one that uses what’s called ‘sustainable growth’.

This concept was first outlined in a book called The New Buffettology, written by David Clark and Mary Buffett (a divorced former daughter in law of Warren Buffett). To start with, it looks for all the classic features that Buffett likes in a ‘consumer monopoly’ type of business:

- Earnings should be strong and growing
- It should be conservatively financed
- It should earn a high rate of return on shareholders’ equity
- It should generate a consistently high return on total capital
- It should no need to constantly reinvest in capital
- The stock should be good value

In this strategy, a key part of assessing whether the stock is good value is to consider its expected sustainable growth. This is the growth rate the company can sustain without having to take on debt or issue new shares. This calculation brings together the 10 year rate of return on equity and the dividend payout ratio and gives you a percentage expected sustainable growth rate. Ideally, a Buffett-inspired investor would be looking for a rate of more than 15 percent.

We model this strategy at Stockopedia (you can find the screen here) and these are some of the stocks currently passing the screen rules.

Name	Mkt Cap £m	EPS Gwth Streak (years)	Return on Equity % 5y Avg	Return on Capital Employed% 5y Avg	Earnings Yield % Last Yr	Expected Return (Sustainable Gwth)
Right-move	4,795	9	1,618	2,078	4.18	1,132
WH Smith	2,116	9	72.0	66.0	5.81	45.8
Quix-ant	206.6	8	30.3	27.3	6.09	43.6
Britvic	2,337	6	66.0	18.6	5.46	41.0
How-	3,269	9	45.7	42.8	7.87	36.9

den Joinery						
Hays	2,125	6	30.0	34.7	11.7	33.1
4imprint	800.4	7	86.7	67.0	4.79	30.7
FDM	866.5	7	50.5	59.9	5.66	27.2
Robert Walters	399.4	6	21.1	27.8	11.6	25.8
Redrow	1,965	8	20.6	19.2	20.5	23.6

These shares generally have solid growth records, but that doesn't always reflect in their price charts. This is a strategy that prioritises financial quality, but it doesn't guarantee that they'll be in favour with the market. So this is very much a starting point in isolating the type of quality share that someone like Keith Ashworth-Lord would then research in much more detail.

Generally, sustainable earnings growth, high profitability and efficiency can be clues to the types of companies that have well-protected competitive advantages. These are the moat-like qualities that Warren Buffett is known be so fond of. So for an investor looking for the kinds of long-term compounded returns that have been so successful for Buffett, a focus on quality could be a good place to start.

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