SUMMARY
BY ALYSSA BURNETTE

Warren Buffett's Ground Rules

By Jeremy C. Miller

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Summary of Warren Buffett's Ground Rules by Jeremy C. Miller

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Learn about Warren’s words of wisdom for your finances.

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Introduction

Have you ever been around people who had a lot of money and not realized it? Maybe you were chatting to the new couple down the block or a guy in your local coffee shop and thought, “They’re just an average Joe!” Until, that is, you found out something like where they work, who their family is, or how much their house is worth and discover that they’re actually a millionaire! If you have ever had this experience, then undoubtedly, you remember feeling incredibly surprised. Maybe you wondered why they didn’t behave in a more ostentatious manner or why you didn’t see a fancy car parked in their driveway. Maybe you even felt like their house wasn’t that nice.

But, above all, if you’ve discovered that a friend or acquaintance was a secret millionaire, it’s highly likely that you had one big question on your mind: how? How did they get their money? How did they hang on it? How come they don’t act like a millionaire? And-- perhaps the most pressing question of all-- how can you emulate their wealth and success? Well, question no longer! Warren Buffett is one of these people himself and he makes money management look easy. (So easy, in fact, that as of 2020, he has an estimated net worth of $75 billion dollars-- and that’s not counting his personal fortune or the money he has available to spend!) So, over the course of his summary, we’ll investigate Buffett’s insights into his success and learn how you can get rich off the stock market just like he did.

Slow and Steady Wins the Race

If you know anything about the stock market, you know that change is its only constant. Because stocks are constantly rising and decreasing in value in the blink of an eye, it's easy for investors to grow stressed and frantic as they race to stay on top of an ever-changing market. However, Warren Buffett knows a secret that many Wall Street investors don't. (It's also a secret that high-level investors don't want the average person to know!) You see, Warren Buffett understands that chaotic investing is NOT the way to go! Many people fall into the trap of assuming that you have to act very quickly if you want to profit from the stock market. And it's easy to see why someone would arrive at that conclusion; when the stock market can plummet at the drop of a hat, it's understandable that one might feel the need to monitor it at all times. This is the logic that motivates people to buy and trade stocks at a frenetic pace in the hopes of beating the stock market and reaping a significant reward from their investments. In fact, for quite a while, this has been the widely accepted standard for using the stock market.

But Warren Buffett discovered that this strategy is actually not quite as effective as one might think. So, in order to understand what he discovered and why it makes sense, we need to start by unpacking the principles of the stock market, beginning with the basics. The first basic principle we should understand is investing. Already, we've discussed investing at length, but it's important to understand what that term really means. Warren Buffett defines investing as "…the process of laying out money now to receive more money in the future." So, now that we have a solid definition for investing, let's unpack the inner workings of the stock market and how to invest in it. We'll start with this simple and accessible explanation from professional investor and financial analyst Chad Langager.

To begin to understand the stock market, we first need to know what stocks are. Langager begins by providing a simple definition of stocks: "stocks, or shares of a company, represent ownership equity in the firm, which give shareholders voting rights as well as a residual claim on corporate earnings in the form of capital gains and dividends. Stock markets are where individual and institutional investors come together to buy and sell shares in a public venue. Nowadays these exchanges exist as electronic marketplaces. Share prices are set by supply and demand in the market as buyers and sellers place orders. Order flow and bid-ask spreads are often maintained by specialists or market makers to ensure an orderly and fair market."

So, now that we know more about investing and stocks, we can move forward and develop a better understanding of the stock market and how it works. Langager adds that "the prices of shares on a stock market can be set in a number of ways, but the most common way is through an auction process where buyers and sellers place bids and offers to buy or sell. A bid is the price at which somebody wishes to buy, and an offer (or ask) is the price at which somebody wishes to sell. When the bid and ask coincide, a trade is made.

The overall market is made up of millions of investors and traders, who may have differing ideas about the value of a specific stock and thus the price at which they are willing to buy or sell it. The thousands of transactions that occur as these investors and traders convert their intentions to actions by buying and/or selling a stock cause minute-by-minute gyrations in it over the course of a trading day. A stock exchange provides a platform where such trading can be easily conducted by matching buyers and sellers of stocks. For the average person to get access to these exchanges, they would need a stockbroker. This stockbroker acts as the middleman between the buyer and the seller. Getting a stockbroker is most commonly accomplished by creating an account with a well established retail broker."

This explanation helps us to understand how the stock market works and how the average person can buy and sell stocks. But this information doesn't tell us why someone would want to invest in the stock market. If it's so complicated and unstable, why would anyone want to put their money in the stock market? The short answer is that, when you make smart investments, you can make a lot of money. Langager explains that "numerous studies have shown that, over long periods of time, stocks generate investment returns that are superior to those from every other asset class. Stock returns arise from capital gains and dividends. A capital gain occurs when you sell a stock at a higher price than the price at which you purchased it. A dividend is the share of profit that a company distributes to its shareholders. Dividends are an important component of stock returns—since 1956, dividends have contributed nearly one-third of total equity return, while capital gains have contributed two-thirds.19

While the allure of buying a stock similar to one of the fabled FAANG quintet—Facebook, Apple Inc. (their share abbreviation is AAPL if you're interested in buying stock in this company), Amazon.com Inc. (AMZN), Netflix Inc. (NFLX), and Google parent Alphabet Inc. (GOOGL)—at a very early stage is one of the more tantalizing prospects of stock investing, in reality, such home runs are few and far between. Investors who want to swing for the fences with the stocks in their portfolios should have a higher tolerance for risk; such investors will be keen to generate most of their returns from capital gains rather than dividends. On the other hand, investors who are conservative and need the income from their portfolios may opt for stocks that have a long history of paying substantial dividends."

So, now that we have a crash course in the basics of the stock market, we can understand the necessary terminology to appreciate the author's advice. In the next chapter, we'll use our new knowledge of the stock market to explore Warren Buffett's top tips for making your fortune through wise investments.

How to Really Get Rich From Your Investments

In the previous chapter, we established that Warren Buffett believes in a “slow and steady wins the race” style of investing. But now we’ll take a closer look at what that means. If we understand that stocks or shares represent a small portion of a business, then we can understand that a stock’s price represents the financial success of that company. This means that many people want to buy stocks in big, established companies like Google or Facebook; because these companies are doing well financially, we assume that buying stocks in these companies will bring us a lot of money. However, Buffett understands a little-known trick: if you buy stocks in small companies that are not very popular yet, you can expect a sizable profit when that company eventually takes off and its share price skyrockets.

To put this into context, just imagine investing in Facebook before it was Facebook. Today, the social media network is an international sensation. But before it became the Facebook we know and love today, it was a little social media platform started in one guy’s college dorm. When it first started out, Facebook might not have looked like a very big deal to prospective investors. But the investors who bought shares in Facebook at that stage were later rewarded by its spectacular growth. And the same could be true for you if you invest in an undervalued business! This might mean that you’re playing the long game with your investments, but Warren Buffett has first-hand experience with the benefits of the long game. He’s learned that you should stop worrying about when your stocks will become profitable. Avoid making rushed decisions or focusing on when your stocks’ value will rise. Instead, know your stocks, know your market, and wait. Trust that the market will do what you know it should do and then wait for it to do its thing.

It might take longer than you want and the value of your stocks might fall at times, but don’t panic and sell your shares prematurely! Many people make this mistake because they think investing in the stock market means making split-second decisions. But remember that slow and steady wins the race. If you’ve made a smart investment, you’ll see a return on that investment; it just might take a little while. Buffett also observes that when you play the long game, you receive compound interest on your investment. Financial analyst Jason Fernando provides a simple explanation of compound interest that asserts: “compound interest (or compounding interest) is the interest on a loan or deposit calculated based on both the initial principal and the accumulated interest from previous periods. Thought to have originated in 17th-century Italy, compound interest can be thought of as "interest on interest," and will make a sum grow at a faster rate than simple interest, which is calculated only on the principal amount.

The rate at which compound interest accrues depends on the frequency of compounding, such that the higher the number of compounding periods, the greater the compound interest. Thus, the amount of compound interest accrued on $100 compounded at 10% annually will be lower than that on $100 compounded at 5% semi-annually over the same time period. Since the interest-on-interest effect can generate increasingly positive returns based on the initial principal amount, it has sometimes been referred to as the "miracle of compound interest." Fernando also observes that if considering the principle of compound interest in practical application can help us understand more about the return we can realistically see from investments.

For example, he writes that “compound interest can significantly boost investment returns over the long term. While a $100,000 deposit that receives 5% simple annual interest would earn $50,000 in total interest over 10 years, the annual compound interest of 5% on $10,000 would amount to $62,889.46 over the same period. If the compounding period were instead paid monthly over the same 10-year period at 5% compound interest, the total interest would instead grow to $64,700.95.” Put simply, compound interest helps your investment to get bigger over a shorter amount of time. If you follow these strategies, we can’t guarantee that you’ll become a billionaire like Warren Buffett. That’s determined by you, your investments, and the choices you make. But if you follow Warren Buffett’s top tips, you will definitely make smarter investments that will likely lead to a profitable return.

Final Summary

Warren Buffett is a household name in the finance and business industries. Thanks to his success as a professional investor, he has become the fourth-richest person in the world. A lot of factors went into his success, including his personality, his unique business acumen, and the state of the stock market in his day. So, while it's impossible to guarantee that everyone who follows his advice will emulate his success exactly, we can all benefit from financial advice that comes from such a great mind.

Therefore, if you want to put Warren Buffett's advice into practice, you should avoid hasty investments, be patient, and keep a close eye on your shares. It's also important to make decisions based on what the market will do rather than when it will do something. If you know the stock market well, you can make reasonable predictions and stick it out for the long haul. Playing the long game with your investments is profitable because, for one thing, it prevents you from making snap decisions and selling stocks that might benefit you in the future. But endurance and persistence are also helpful because it means that, if you stick it out and earn compound interest, your investments can generate a better profit than they would have if you bought and sold them too quickly.