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This Is What Buffett Looks For

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At one of **Berkshire Hathaway**'s (NYSE: BRK-B) "Woodstock for Capitalists" events (also known as the annual shareholder meeting), Warren Buffett described the perfect business like this:

> The ideal business is one that earns very high returns on capital and that keeps using lots of capital at those high returns. That becomes a compounding machine. So ... if you could put a hundred million dollars into a business that earns twenty percent on that capital -- twenty million -- ideally, it would be able to earn twenty percent on a hundred twenty million the following year and on a hundred forty-four million the following year and so on. You could keep redeploying capital at [those] same returns over time. But there are very, very, very few businesses like that.

Why so few? Think about a top-quality business like **Cisco** (Nasdaq: CSCO). If Cisco reinvested all of its earnings into the business (which it doesn't), for a time it might be able to continue to deliver high returns on capital and compound its capital base.

But as a company gets increasingly large and has an ever-growing amount of available capital to deploy, finding high-rate-of-return opportunities to put capital to work can become difficult.

So in searching for Buffett's ideal stocks, we need to look for two things: high current returns on capital and plenty of opportunities to put new capital to work at similarly high returns.

Meet the returns royalty
Let's look at which companies are actually earning high returns on capital. To get us started, I ran a stock screen for companies with average five-year returns on capital above 15%. Here are five of the stocks that I came up with.

Company	Market Cap	Capital Base	Average 5-Year Return on Capital
Johnson & Johnson (NYSE: JNJ)	$166 billion	$62 billion	19.4%
Altria (NYSE: MO)	$38 billion	$16 billion	19.3%
Dell (Nasdaq: DELL)	$29 billion	$8 billion	39.9%
Freeport-McMoRan (NYSE: FCX)	$34 billion	$15 billion	27.9%
Amazon.com (Nasdaq: AMZN)	$55 billion	$4 billion	19.0%

Source: Capital IQ, a Standard & Poor's company.
Capital base = total shareholder equity plus total debt.

These are almost certainly names you immediately recognize, and these are all great businesses that produce very attractive returns on capital.

However, the sheer size of these behemoths makes the continued reinvestment of earnings and compounding of sizable returns increasingly difficult. As with Cisco above, it can be difficult for them to find high-return homes for all the money that's pouring in.

That's why most large companies deploy their earnings in ways other than reinvestment. Johnson &

Johnson, for instance, has put nearly $46 billion toward dividends and share buybacks over the past five years. Dell gave more than $17 billion back to shareholders through share buybacks over roughly the same period.

So where can we find companies with high returns *and* the opportunity to reinvest new capital for high returns?

It's not the size of the company ... or is it?
The companies above could make great investments, but they're unlikely to be able to continue to compound their capital by reinvesting in the business. For that, we need to put on our reading glasses and look smaller.

While smaller, and often younger, companies aren't as established or stable as their huge counterparts, they typically have a greater ability to compound their capital through reinvesting in the business.

For many of these companies, the opportunity comes either from having only a small amount of capital to invest in a much larger market or from operating in a new, fast-growing market. The very best small caps combine market opportunity with a business that is head and shoulders above competitors.

For example, **Ebix** is meeting the need for software and e-commerce solutions in the insurance industry and has produced average returns on capital of 15% over the past five years while expanding its capital base from under $23 million to more than $185 million.

Fashionista **True Religion**, meanwhile, has been taking on the Goliaths in the jeans world with its fashion-forward styles. True Religion has delivered a whopping 53% average return on capital while boosting its capital base by 500%.

Ebix and True Religion aren't the only companies with excellent businesses and room to run. The crew at *Motley Fool Hidden Gems* spends their time tracking down the very best small-cap stocks. **Hurco Companies**, for instance, is a *Hidden Gems* portfolio candidate and would definitely fit Buffett's model. It's returned an average of 17% on its capital annually while more than doubling its capital.

You can check the *Hidden Gems* real-money portfolio, as well as all of the team's other recommendations by taking a free 30-day trial of the newsletter.

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Fool contributor Matt Koppenheffer owns shares of Berkshire Hathaway and Johnson & Johnson, but does not own shares of any of the other companies mentioned. Ebix is a Motley Fool Rule Breakers *pick. Amazon.com and Berkshire Hathaway are* Stock Advisor *recommendations. Johnson & Johnson is an* Income Investor *recommendation. Berkshire Hathaway and Dell are* Inside Value *choices. The Fool owns shares of Berkshire Hathaway and Ebix. The Fool's disclosure policy is impressed that Matt* finally *made it through Buffett's biography.*

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