

Cheap stocks beat quality for five years. Read Buffett's rule to the end

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Maxim: *"It's far better to buy a wonderful company at a fair price than a fair company at a wonderful price."* — Warren Buffett, Berkshire Hathaway shareholder letter (1989)

India's value stocks have trounced its quality stocks since 2021. That does not refute Buffett's most quoted rule. It shows which half of it most investors forget.

A great business is not a great investment at any price, and a cheap business is rarely a bargain at all.

India's last five years seem to say otherwise. To the end of September, the Nifty500 Value 50 index, a basket of the market's cheapest shares, returned about 22% a year over five years. The Nifty200 Quality 30, built from companies with high returns on capital and little debt, managed about 6%, roughly what the Nifty 50 did, according to [NSE Indices' September dashboard](#). In this year's sell-off the cheap basket has barely moved while the quality basket is down by double digits.

Read quickly, that is a defeat for the most quoted line Warren Buffett ever wrote. Read slowly, it is the strongest case for it in a decade. The line has two halves, and the last five years punished investors who forgot the second one.

The cheap mill that taught Buffett

In December 1962 Buffett began buying shares of a New England textile maker called Berkshire Hathaway at \$7.50, well below its working capital of \$10.25 a share and its book value of \$20.20, he recalled in his [2014 letter](#). It looked like free money. It was a shrinking business in a dying industry. He spent the next eighteen years struggling with the mills and finally gave up on textiles in 1985.

He had a name for the approach. Buy a poor business cheaply enough and you may get one last free puff, like a discarded cigar butt. In the [1989 letter](#), listing the mistakes of his first 25 years, he explained why it rarely works: problems in a weak business come in clusters, because "never is there just one cockroach in the kitchen", and any discount you capture is soon eaten by poor returns. "Time is the friend of the wonderful business, the enemy of the mediocre," he wrote, and credited Charlie Munger with understanding this long before he did.

The proof arrived in a box of chocolates. In 1972 Berkshire paid \$25 million for See's Candies, a California business that needed only \$8 million of capital and earned less than \$5 million a year before tax. By 2007 See's was earning \$82 million a year before tax, and over those 35 years it had needed only \$32 million of extra capital while sending Berkshire \$1.35 billion in pre-tax profit, Buffett reported in his [2007 letter](#). Measured against the assets it owned, the price looked rich in 1972. It was the fair price for a wonderful business.

What India's last five years actually show

Look at what sits inside the two indices and the result stops looking like a verdict on quality. The quality basket is full of consumer and technology names that entered 2021 priced for years of smooth growth. The businesses mostly kept growing. The prices had simply run ahead of them. Over the

same five years the Nifty FMCG index returned under 4% a year and the Nifty IT index lost money, the NSE dashboard shows. Even now the quality index trades at about 26 times earnings, against about 10 for the value basket.

Value Research described this pattern in an October [column on growth traps](#), using Page Industries as its example: growth slowed from exceptional to merely good, and that alone was enough to pull the share price down. “Nothing broke in a growth trap,” it observed. The company stayed wonderful. Buyers had skipped the words “fair price”.

The pattern is older than India’s market. Coca-Cola, the business Buffett held up as a model, traded at about 50 times earnings in early 1998, and its shares took around 15 years to regain that peak, [The Motley Fool](#) calculated in 2014. Berkshire, which finished buying its stake in 1994 for \$1.3 billion, still did well from the same company: by the end of 2022 that holding was worth \$25 billion, Buffett wrote in his [2022 letter](#). Same wonderful company. The difference was the price paid.

The other half of the rule held up too. Cheapness alone did not win. The Nifty50 Value 20, which simply picks the cheapest large companies, returned about 4% a year over three years, behind the Nifty 50. Just Dial trades at a low multiple with a cash pile worth nearly as much as the whole company, Value Research noted, yet its shares are about a fifth lower than five years ago, [Tickertape data](#) show. A value trap, the column said, needs something real to change inside the business, because “hope is not a catalyst”. The broad value basket that did so well is led by commodity producers and state-owned companies, businesses that rise and fall with the economic cycle. When the cycle turned their way, a low starting price magnified the gain; the price alone would not have been enough.

Styles take turns. Over roughly 21 years since 2005 the quality and value indices have delivered almost identical returns, about 16.6% and 16.4% a year, according to their NSE factsheets. What separated good investors from poor ones inside each style was the price they paid for what they got.

Doing both halves of the homework

The first half is the business. A wonderful company earns high returns on the money it uses and does not need much more of it to grow, which is exactly what made See’s special. You can see this in plain numbers in any annual report: return on capital that stays high through good years and bad, profits that turn into cash, and modest debt. Most quality-factor funds screen for something similar.

The second half is the price, and it is the half investors skip when a business is admired. A useful check is to compare today’s price-to-earnings multiple with the company’s own history and with how fast profits are actually growing. When a slow-growing consumer company trades at a multiple usually reserved for fast growers, you are paying for a future that has to arrive on time. When a stock looks cheap, ask the opposite question: what would have to change for it to deserve more, and is that change already visible?

Fund investors face the same choice in a different form. A quality index fund bought at 2021 prices and a value fund bought then have produced very different five-year results, and neither style is permanently right. Holding both, or a broad index that contains both, is a reasonable answer for anyone who does not want to bet on which style leads next.

If you do one thing: Before you buy any stock, write two sentences. The first says why this business will be stronger in ten years. The second says what you are paying for that today compared with its own past. If you cannot write the second, you have done only half of Buffett's homework.

Buffett took decades to learn that a cheap mill was no bargain. Indian investors have just spent five years learning the other lesson: that an admired company bought at an extravagant price can go nowhere while it keeps doing everything right. Time is the friend of the wonderful business, as he wrote in 1989. It becomes your friend too only when you have not paid for all of that time in advance.

Sources

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