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The World's Greatest Investor

Every year, *Forbes* magazine publishes a list of the 400 richest Americans, the elite Forbes 400. Individuals on the list come and go from year to year, as their personal circumstances change and their industries rise and fall, but some names are constant. Among those leading the list year in and year out are certain megabillionaires who trace their wealth to a product (computer software or hardware), a service (retailing), or lucky parentage (inheritance). Of those perennially in the top five, only one made his fortune through investment savvy. That one person is Warren Buffett.

In the early 1990s, he was number one. Then for a few years, he seesawed between number one and number two with a youngster named Bill Gates. Even for the dot-com-crazed year 2000, when so much of the wealth represented by the Forbes 400 came from the phenomenal growth in technology, Buffett, who smilingly eschews high-tech anything, was firmly in fourth position. He was still the only person in the top five for whom the "source of wealth" column read "stock market." In 2004, he was solidly back in the number two position.

In 1956, Buffett started his investment partnership with $100; after thirteen years, he cashed out with $25 million. At the time of this writing (mid-2004), his personal net worth has increased to $42.9 billion, the stock in his company is selling at $92,900 a share, and millions of investors around the world hang on his every word.

To fully appreciate Warren Buffett, however, we have to go beyond the dollars, the performance accolades, and the reputation.

INVESTMENT BEGINNINGS

Warren Edward Buffett was born August 30, 1930, in Omaha, Nebraska. His grandfather owned a grocery store (and once employed a young Charlie Munger); his father was a local stockbroker. As a boy, Warren Buffett was always fascinated with numbers and could easily do complex mathematical calculations in his head. At age eight, he began reading his father's books on the stock market; at age eleven, he marked the board at the brokerage house where his father worked. His early years were enlivened with entrepreneurial ventures, and he was so successful that he told his father he wanted to skip college and go directly into business. He was overruled.

Buffett attended the business school at the University of Nebraska, and while there, he read a new book on investing by a Columbia professor named Benjamin Graham. It was, of course, *The Intelligent Investor.* Buffett was so taken with Graham's ideas that he applied to Columbia Business School so that he could study directly with Graham. Bill Ruane, now chairman of the Sequoia Fund, was in the same class. He recalls that there was an instantaneous mental chemistry between Graham and Buffett, and that the rest of the class was primarily an audience.[1]

Not long after Buffett graduated from Columbia with a master's degree in economics, Graham invited his former student to join his company, the Graham-Newman Corporation. During his two-year tenure there, Buffett became fully immersed in his mentor's investment approach (see Chapter 2 for a full discussion of Graham's philosophy).

In 1956, Graham-Newman disbanded. Graham, then 61, decided to retire, and Buffett returned to Omaha. Armed with the knowledge he had acquired from Graham, the financial backing of family and friends, and $100 of his own money, Buffett began a limited investment partnership. He was twenty-five years old.

THE BUFFETT PARTNERSHIP, LTD.

The partnership began with seven limited partners who together contributed $105,000. The limited partners received 6 percent annually on their investment and 75 percent of the profits above this bogey; the remaining 25 percent went to Buffett, who as general partner had essentially free rein to invest the partnership's funds.

Over the next thirteen years, Buffett compounded money at an annual rate of 29.5 percent.[2] It was no easy task. Although the Dow Jones Industrial Average declined in price five different years during that thirteen-year period, Buffett's partnership never had a down year. Buffett, in fact, had begun the partnership with the ambitious goal of outperforming the Dow by ten points every year. And he did it—not by ten—but by twenty-two points!

As Buffett's reputation grew, more people asked him to manage their money. For the partnership, Buffett bought controlling interests in several public and private companies, and in 1962 he began buying shares in an ailing textile company called Berkshire Hathaway.

That same year, 1962, Buffett moved the partnership office from his home to Kiewit Plaza in Omaha, where his office remains today. The next year, he made a stunning purchase.

Tainted by a scandal involving one of its clients, American Express saw its shares drop from $65 to $35 almost overnight. Buffett had learned Ben Graham's lesson well: When stocks of a strong company are selling below their intrinsic value, act decisively. Buffett made the bold decision to put 40 percent of the partnership's total assets, $13 million, into American Express stock. Over the next two years, the shares tripled in price, and the partners netted a cool $20 million in profit. It was pure Graham—and pure Buffett.

By 1965, the partnership's assets had grown to $26 million. Four years later, explaining that he found the market highly speculative and worthwhile values increasingly scarce, Buffett decided to end the investment partnership.

When the partnership disbanded, investors received their proportional interests. Some of them, at Buffett's recommendation, sought out money manager Bill Ruane, his old classmate at Columbia. Ruane agreed to manage their money, and thus was born the Sequoia Fund. Others, including Buffett, invested their partnership revenues in Berkshire Hathaway. By that point, Buffett's share of the partnership had grown to $25 million, which was enough to give him control of Berkshire Hathaway.

What he did with it is well known in the investment world. Even those with only a passing interest in the stock market recognize Buffett's name and know something of his stunning success. In the following chapters, we trace the upward trajectory of Berkshire Hathaway in the forty years that Buffett has been in control. Perhaps more important, we also look beneath the surface to uncover the commonsense philosophy on which he founded his success.

THE MAN AND HIS COMPANY

Warren Buffett is not easy to describe. Physically, he is unremarkable, with looks often described as grandfatherly. Intellectually, he is considered a genius; yet his down-to-earth relationship with people is truly uncomplicated. He is simple, straightforward, forthright, and honest. He displays an engaging combination of sophisticated dry wit and cornball humor. He has a profound reverence for all things logical and a foul distaste for imbecility. He embraces the simple and avoids the complicated.

When reading Berkshire's annual reports, one is struck by how comfortable Buffett is quoting the Bible, John Maynard Keynes, or Mae West. The operable word here is *reading.* Each report is sixty to seventy pages of dense information: no pictures, no color graphics, no charts. Those who are disciplined enough to start on page one and continue uninterrupted are rewarded with a healthy dose of financial acumen, folksy humor, and unabashed honesty. Buffett is candid in his reporting. He emphasizes both the pluses and the minuses of Berkshire's businesses. He believes that people who own stock in Berkshire Hathaway are owners of the company, and he tells them as much as he would like to be told if he were in their shoes.

When Buffett took control of Berkshire, the corporate net worth was $22 million. Forty years later, it has grown to $69 billion. It has long been Buffett's goal to increase the book value of Berkshire Hathaway at a 15 percent annual rate—well above the return achieved by the average American company. Since he took control of Berkshire in 1964, the gain has been much greater: Book value per share has grown from $19 to $50,498, a rate of 22.2 percent compounded annually. This relative performance is all the more impressive when you consider that Berkshire is penalized by both income and capital gains taxes and the Standard & Poor's 500 returns are pretax.

Table 1.1 Berkshire's Corporate Performance versus the S&P 500

	Annual Percentage Change		
Year	In Per-Share Book Value of Berkshire (1)	In S&P 500 with Dividends Included (2)	Relative Results (1)–(2)
1965	23.8	10.0	13.8
1966	20.3	(11.7)	32.0
1967	11.0	30.9	(19.9)
1968	19.0	11.0	8.0
1969	16.2	(8.4)	24.6
1970	12.0	3.9	8.1
1971	16.4	14.6	1.8
1972	21.7	18.9	2.8
1973	4.7	(14.8)	19.5
1974	5.5	(26.4)	31.9
1975	21.9	37.2	(15.3)
1976	59.3	23.6	35.7
1977	31.9	(7.4)	39.3
1978	24.0	6.4	17.6
1979	35.7	18.2	17.5
1980	19.3	32.3	(13.0)
1981	31.4	(5.0)	36.4

Source: Berkshire Hathaway 2003 Annual Report.

Notes: Data are for calendar years with these exceptions: 1965 and 1966, year ended 9/30; 1967, 15 months ended 12/31.

Starting in 1979, accounting rules required insurance companies to value the equity securities they hold at market rather than at the lower of cost or market, which was previously the requirement. In this table, Berkshire's results through 1978 have been restated to conform to the changed rules. In all other respects, the results are calculated using the numbers originally reported.

The S&P 500 numbers are *pre-tax* whereas the Berkshire numbers are *after-tax.* If a corporation such as Berkshire were simply to have owned the S&P 500 and accrued the appropriate taxes, its results would have lagged the S&P 500 in years when that index showed a positive return, but would have exceeded the S&P in years when the index showed a negative return. Over the years, the tax costs would have caused the aggregate lag to be substantial.

(continued)

Table 1.1 *Continued*

Year	Annual Percentage Change: In Per-Share Book Value of Berkshire (1)	In S&P 500 with Dividends Included (2)	Relative Results (1)–(2)
1982	40.0	21.4	18.6
1983	32.3	22.4	9.9
1984	13.6	6.1	7.5
1985	48.2	31.6	16.6
1986	26.1	18.6	7.5
1987	19.5	5.1	14.4
1988	20.1	16.6	3.5
1989	44.4	31.7	12.7
1990	7.4	(3.1)	10.5
1991	39.6	30.5	9.1
1992	20.3	7.6	12.7
1993	14.3	10.1	4.2
1994	13.9	1.3	12.6
1995	43.1	37.6	5.5
1996	31.8	23.0	8.8
1997	34.1	33.4	.7
1998	48.3	28.6	19.7
1999	.5	21.0	(20.5)
2000	6.5	(9.1)	15.6
2001	(6.2)	(11.9)	5.7
2002	10.0	(22.1)	32.1
2003	21.0	28.7	(7.7)
Average Annual Gain—1965–2003	22.2	10.4	11.8
Overall Gain—1964–2003	259,485	4,743	

On a year-by-year basis, Berkshire's returns have at times been volatile; changes in the stock market and thus the underlying stocks that Berkshire owns create wide swings in per share value (see Table 1.1).

To appreciate the volatility, compare the results for 1998 with 1999. In 1998, Berkshire's value increased more than 48 percent. Then, in 1999, Berkshire's increase dropped to a paltry 0.5 percent, yet the S&P 500 increased 21 percent. Two factors were involved: Berkshire's results can be traced to poor return on consumer nondurables (Coca-Cola and Gillette), while the S&P increase was fueled by the outstanding performance of technology stocks, which Berkshire does not own.

Speaking with the candor for which he is famous, Buffett admitted in the 1999 annual report that "truly large superiorities over the [S&P] index are a thing of the past."[3] He predicted, however, that over time Berkshire's performance would be "modestly" better than the S&P. And for the next three years, this turned out to be the case. Then in 2003, even though Berkshire had a terrific year—book value up 21 percent—the S&P did even better.

BUFFETT TODAY

Over the most recent years, starting in the late 1990s, Buffett has been less active in the stock market than he was in the 1980s and early 1990s. Many people have noticed this lack of activity and have wondered whether it signaled that the market had hit its top. Others have theorized that the lack of new major purchases of common stocks simply means that the type of stocks Buffett likes to purchase are no longer selling at attractive prices.

We know it is Buffett's preference to "buy certainties at a discount." "Certainties" are defined by the predictability of a company's economics. The more predicable a company's economics, the more certainty we might have about its valuation. When we look down the list of stocks that Buffett owns as well as the wholly owned companies inside Berkshire, we are struck by the high degree of predictability reflected there. The "discount" part of the statement obviously refers to the stock price.

Knowing that Buffett likes to buy highly predictable economics at prices below the intrinsic value of the business, we can conclude that his buyer's strike reflects the lack of choices in this arena. I am pretty sure that if Coca-Cola, Gillette, or other similar businesses were today selling at fifty cents on the dollar, Buffett would add more shares to Berkshire's portfolio.

We also know Buffett's discipline of operating only within his "circle of competence." Think of this circle of competence as the cumulative history of your experience. If someone had successfully operated a certain business within a certain industry for a decade or more, we would say that person had achieved a high level of competence for the task at hand. However, if someone else had only a few years' experience operating a new business, we could reasonably question that person's level of competence. Perhaps in Buffett's rational mind, the sum total of his business experience in studying and operating the businesses in Berkshire's portfolio sets the bar of competence so high that it would be difficult to achieve a similar level of insight into a new industry.

So perhaps Buffett faces a dilemma. Within his circle of competence, the types of stocks he likes to purchase are not currently selling at discounted prices. At the same time, outside his circle of competence, faster-growing businesses are being born in new industries that have yet to achieve the high level of economic certainty Buffett requires. If this analysis is correct, it explains why there have been no new large buys of common stocks in the past few years.

We would be foolish indeed to assume that because the menu of stocks available for purchase has been reduced, Warren Buffett is left without investment options. Certainly he has been active in the fixed-income market, including taking a significant position in high-yield bonds in 2002. He is alert for the periodic arbitrage opportunity as well, but considering the amount of capital Buffett needs to deploy to make meaningful returns, the arbitrage markets are perhaps not as fruitful as they once were.

But Berkshire Hathaway shareholders should not feel they are being deprived of opportunities. Too often, shareholders forget one of the most important owner-related business principles Buffett outlines each year in the annual report. The fourth principle states, "Our preference would be able to reach our goal [of maximizing Berkshire's average annual rate of gain in intrinsic value] by directly owning a diversified group of businesses that generate cash and consistently earn above-average returns on capital. Our second choice is to own parts of similar businesses attained primarily through the purchases of marketable common stocks."

In Berkshire's early years, owning common stocks made the most sense economically. Now, as common stock prices have risen dramatically and the purchasing power of Berkshire's retained earnings has mushroomed, the strategy of buying whole businesses, which is Buffett's stated preference, has come to the forefront.

There is a personal factor as well. We know that Buffett greatly enjoys his relationships with his operating managers and takes a great deal of pride in Berkshire's collection of operating businesses. Conversely, the angst he has endured by being a shareholder of publicly traded companies, with the issues of executive compensation and questionable capital reinvestment strategies that accompany ownership, may make being a shareholder less appealing for Buffett today than it used to be. If the economics are not compelling, why would Buffett choose to endure the corporate governance fiascos associated with being a major shareholder?

The only activity Buffett involves himself in with Berkshire's operating businesses is setting executive compensation and allocating the profits. Inside Berkshire's world, these decisions are highly rational. Outside in the stock market, management decisions on executive compensation and capital reallocation do not always reflect rationality.

What does this mean for individual investors? Because Buffett is not actively involved in the stock market, should they automatically pull back as well? Buffett's alternative strategy is to buy businesses outright, an option that is out of reach for most investors. So how should they proceed?

There appear to be two obvious choices. One is to make an investment in Berkshire Hathaway and so participate in the economics of these outstanding businesses. The second choice is to take the Buffett approach to investing, expand your circle of competence by studying intently the business models of the companies participating in the New Economy landscape, and march ahead.

I believe that the fundamental principles that have so long guided Buffett's decisions are uncompromised, and they still carry opportunities for careful investors to outperform the S&P 500. The purpose of this book is to present those principles in a way that thoughtful investors can understand and use.