CHAPTER 1

A Five-Sigma Event

THE WORLD'S GREATEST INVESTOR

"Brace yourself," Buffett said, with a sly grin. He was sitting in a Manhattan living room on a spring morning with one of his dearest and oldest friends, Carol Loomis. A *New York Times* best-selling author and an award-winning journalist, Carol is senior editor-at-large at *Fortune* magazine, where she has worked since 1954, and is considered to be the magazine's resident expert on Warren Buffett. It is well known among the Buffett faithful that she has also been editing Berkshire Hathaway's annual reports since 1977.

On that spring day in 2006, Buffett told Carol that he had changed his thinking about how and when he was going to give away his fortune in Berkshire Hathaway stock. Like most people, Carol knew that Buffett, after a small allocation to his three children, was going to leave 99 percent of his wealth to charity, but it was always thought it would go to the Buffett Foundation established by his late wife, Susan. Now he was telling Carol he had changed his mind. "I know what I want to do," he said, "and it makes sense to get going."[1]

So, shortly before lunch, on June 26, 2006, Warren Buffett, who was then the second richest man in the world, stepped up to the microphone inside the New York Public Library. The audience—hundreds of the wealthiest people in the city—greeted him with a standing ovation. After a few brief words, Buffett reached inside his jacket pocket and pulled out five letters. Each one announced the disposition of his fortune, and only awaited his signature. The first three letters were easy; he just signed "Dad" and then handed them to his children: daughter Suze, eldest son Howard, and second son Peter. The fourth letter was turned over to a representative of his late wife's charitable foundation. Together, these four letters promised to give away a combined $6 billion.[2]

The fifth letter was the surprise. Buffett signed it and handed it to the wife of the only man on the planet who was richer than himself, Bill Gates. With that last letter, Buffett pledged over $30 billion in Berkshire Hathaway stock to the world's largest philanthropic organization, the Bill and Melinda Gates Foundation. It was by far the single greatest amount of money ever given away, miles bigger than the contributions by Andrew Carnegie ($7.2 billion when adjusted to current dollars), John D. Rockefeller ($7.1 billion), or John D. Rockefeller Jr. ($5.5 billion).

In the days that followed, there were countless questions. Was Buffett ill, perhaps even dying? "No, absolutely not," he said. "I feel terrific." Did his wife's passing have anything to do with his decision? "Yes, it does," confessed Buffett. It was well known that Susie would have inherited Buffett's fortune for the Buffett Foundation. "She would have enjoyed the process," he said. "She was a little afraid of it, in terms of scaling up. But she would have liked doing it, and would have been very good at it."[3]

But after his wife's death, Buffett changed his thinking. He realized that the Bill and Melinda Gates Foundation was a terrific organization, already scaled to handle the billions of dollars Buffett was going to send its way. They "wouldn't have to go through the real grind of getting to a megasize like the Buffett Foundation would—and they could productively use my money now," he said. "What can be more logical, in whatever you want done, than finding someone better equipped than you are to do it?"[4]

It was quintessential Buffett. Rationality prevailed. At Berkshire Hathaway, Buffett reminds us there are scores of managers running businesses that do a much better job of running their operations than he ever could. Likewise, the Bill and Melinda Gates

Foundation would do a better job of managing his philanthropy than he could do himself.

Bill Gates said of his friend, “Warren will be remembered not only as the greatest investor, but the world’s greatest investor for good.”[5] This will most certainly be true. But it is important to remember that the good his philanthropic generosity will do was made possible in the first place by his unparalleled investing skill. When Buffett handed the letter and check for $30 billion to Melinda Gates, I immediately thought back to another check he had written 50 years earlier—for $100, his initial investment in the Buffett Partnership, Ltd.

Buffett has always claimed he won the ovarian lottery. He figures the odds of him being born in 1930 in the United States were about 30:1. He admits he couldn’t run fast and would never have been a good football player. Neither, despite his talents at plucking a ukulele, would he ever become a concert violinist. But he was “wired in a particular way” that would allow him “to thrive in a big capitalist economy with a lot of action.”[6]

“My wealth has come from a combination of living in America, some lucky genes, and compound interest,” said Buffett. “My luck was accentuated by my living in a market system that sometimes produces distorted results, though overall it serves our country well.” To keep it all in perspective, Buffett humbly reminds us that he happens to work “in an economy that rewards someone who saves lives of others on a battlefield with a medal, rewards a great teacher with thank-you notes from parents, but rewards those who can detect the mispricing of securities with sums reaching into the billions.” He called it fate’s capricious distribution of “long straws.”[7]

That may be true. But in my mind, Buffett carved his own destiny, which determined his own fate—not the other way around. This is the story of how Warren Buffett made his own long straw.

Personal History and Investment Beginnings

Warren Edward Buffett was born August 30, 1930, in Omaha, Nebraska. He was the seventh generation of Buffetts to call Omaha home. The first Nebraskan Buffett opened a grocery store in 1869.

Buffett's grandfather also ran a grocery store and once employed a young Charlie Munger, the future vice chairman of Berkshire Hathaway. Buffett's father, Howard, was a local stockbroker and banker who later became a Republican Congressman.

It was said that as soon as Warren Buffett was born he was fascinated by numbers. That may be a stretch, but it is well documented that before he entered kindergarten he was already a calculating machine. As young boys, he and his best friend Bob Russell would sit on the Russell family porch recording license-plate numbers of the cars that passed by. When darkness fell, he and Bob would go inside, spread the *Omaha World-Herald* on the floor, and count the number of times each letter appeared in the paper. They then tallied their calculations in a scrapbook, as if it was top-secret information.

One of young Buffett's most prized toys came from his Aunt Alice, who was quite fond of her peculiar but immensely likable nephew and made him an irresistible offer: If he would agree to eat his asparagus, she would give him a stopwatch. Buffett was mesmerized by this precise counting machine and used it in endless little-boy ventures, like marble races. He would summon his two sisters into the bathroom, fill the tub with water, and then direct them to drop their marble into one end. The one whose marble reached the drain stopper first was the winner (utilizing the tub's sloped shape). Buffett, stopwatch at the ready, timed and recorded each race.

But it was the second gift from Aunt Alice that sent six-year-old Buffett into a new direction—a fascination not with just numbers, but with money. On Christmas day, Buffett ripped open his present and strapped onto his belt what would become his most treasured possession—a nickel-coated money changer. He quickly found many ways to put it to good use. He set up a table outside his house and sold Chiclets to anyone who passed by. He went door-to-door selling packs of gum and soda pop. He would by a six-pack of Coke at his grandfather's grocery store for 25 cents and sell the individual bottles for a nickel: 20 percent return on investment. He also sold, door-to-door, copies of the *Saturday Evening Post* and *Liberty* magazines. Each weekend he sold popcorn and peanuts at local football games. With him through all these enterprises was his money changer, taking in dollars and making change.[8]

What now sounds like an idyllic childhood took an abrupt turn when Buffett's father returned home one night to inform the family the bank where he worked had closed. His job was gone and their savings were lost. The Great Depression had finally made its way to Omaha. Buffett's grandfather, the grocery store owner, gave Howard money to help support his family.

Fortunately, the sense of hopelessness did not last long. Howard Buffett soon pulled himself up and got back on his feet, announcing that Buffett, Sklenicka & Company had opened for business at the Union State building on Farnam Street, the same street where Buffett would someday buy a house and start his investment partnership.

The effect of the Great Depression, albeit brief, was hard on Buffett's family. It also made a deep and profound impression on young Warren. "He emerged from those first hard years with an absolute drive to become very, very, very rich," wrote Roger Lowenstein, author of *Buffett: The Making of an American Capitalist.* "He thought about it before he was five years old. And from that time on, he scarcely stopped thinking about it."[9]

When Buffett turned 10, his father took him to New York. It was a birthday gift Howard gave to each of his children. "I told my Dad I wanted to see three things," said Buffett. "I wanted to see the Scott Stamp and Coin Company. I wanted to see the Lionel Train Company. I wanted to see the New York Stock Exchange."[10] After an overnight ride on the train, Buffett and his dad made their way to Wall Street, where they met with At Mol, a member of the exchange. "After lunch, a guy came along with a tray that had all these different kinds of tobacco leaves on it," recalled Buffett. "He made up a cigar for Mr. Mol, who picked out the leaves he wanted. And I thought, this is it. It doesn't get any better than this. A custom-made cigar."[11]

Later, Howard Buffett introduced his son to Sidney Weinberg, a senior partner at Goldman Sachs, then considered the most famous man on Wall Street. Standing in Weinberg's office, Buffett was mesmerized by the photographs and documents on the wall. He took note of the framed original letters, knowing full well they were written by famous people. While Howard and Sidney talked about financial issues of the day, Buffett was oblivious, walking around and around Weinberg's office staring at the artifacts. When it was time to go, Sidney Weinberg put his arm around Buffett and jokingly asked him what stock he liked. "He'd forgotten it all the next day," Buffett recalled, "but I remembered it forever."[12]

Even before Buffett traveled to New York, he was already intrigued with stocks and the stock market. He was a frequent visitor to his dad's brokerage office, where he would stare at stock and bond certificates that hung on the wall, just like in Sidney Weinberg's office. Often he would bounce down the two flights of stairs right into the Harris Upham brokerage firm. Many of the brokers became fond of the pesky kid who never seemed to stop asking questions. From time to time they would allow young Warren to chalk the prices of stocks on the blackboard.

On Saturday mornings, when the stock exchange was open for two hours, Buffett would hang out with his paternal great-uncle Frank Buffett and his maternal great-uncle John Barber at the brokerage office. According to Buffett, Uncle Frank was a perpetual bear and Uncle John was the ever-optimistic bull. Each competed for Buffett's attention with stories of how they thought the world would unfold. All the while, Buffett stared straight ahead at the Trans-Lux stock ticker, trying to make sense of the continually changing stock prices. Each weekend he read the "Trader" column in *Barron's*. Once he finished reading all the books on his father's bookshelf, he consumed all the investment books at the local library. Soon he began charting stock prices himself, trying to understand the numerical patterns that were flashing by his eyes.

No one was surprised when 11-year-old Buffett announced he was ready to buy his first shares of stock. However, they were shocked when he informed his family he wanted to invest $120, money he had saved from selling soda pop, peanuts, and magazines. He decided on Cities Service Preferred, one of his father's favorite stocks, and enticed his sister Doris to join him. They each bought three shares, for an investment of $114.75 each. Buffett had studied the price chart; he was confident.

That summer the stock market declined, hitting its yearly low in June. The two junior Buffetts saw their stocks decline 30 percent. Not a day went by when Doris did not pester Warren about their loss, so when Cities Service Preferred recovered to $40 per share, he sold their holdings, for a $5 profit.

To Buffett's chagrin, Cities Service Preferred soon soared to $202 a share. After commissions, Buffett calculated he had forgone a profit of over $492. Since it had taken him five years to save $120, he figured he had just given up 20 years of work. It was a painful lesson, but ultimately a valuable one. Buffett swore that, first, he would never again be sidetracked by what he paid for the stock, and, second, he would not settle for small profits. At the wise age of 11, Buffett had already learned one of the most important lessons in investing—patience. (More about this crucial quality in Chapter 7.)

In 1942, when Buffett was 12, his father was elected to the U.S. Congress and moved the family to Washington. The change was hard on the young boy. Miserable and hopelessly homesick, he was allowed to return to Omaha for a year, to live with his grandfather and Aunt Alice. The following year, 1943, Warren gave Washington another chance.

With no friendly brokerage firms to hang out in, gradually Buffett's interest moved away from the stock market and toward entrepreneurial ventures. At age 13, he was working two paper routes, delivering the *Washington Post* and the *Washington Times-Herald*. At Woodrow Wilson High School, he made friends with Don Danly, who quickly became infected with Buffett's enthusiasm for making money. The two pooled their savings and bought reconditioned pinball machines for $25. Buffett convinced a local barber to let them put a machine in his shop for half the profits. After the first day of operation, they returned to find $4 in nickels in their very first machine. The Wilson Coin-Operated Machine Company expanded to seven machines, and soon Buffett was taking home $50 per week.

By the time Buffett graduated from high school, his savings from various endeavors totaled $9,000. He promptly announced that he saw no reason to go to college, as it would interfere with his business ventures. His father overruled him, and by the fall

Buffett found himself enrolled at the University of Pennsylvania's Wharton School of Business and Finance. Despite Wharton's emphasis on business and finance, Buffett was unimpressed with the university. "Not exactly turned on by it," he confessed; "it didn't seem like I was learning a lot."[13] The Wharton curriculum stressed the theoretical aspects of business; what interested Buffett were the practical aspects of a business—how to make money. After two years at Wharton (1947–1949), he transferred to the University of Nebraska. He took 14 courses in one year and graduated in 1950. He was not yet 20 years old.

Back in Omaha, Buffett reconnected with the stock market. He started collecting hot tips from brokers and subscribed to publishing services. He resurrected his price charts and studied books on technical analysis. He applied the McGee point-and-figure system and every other system he could think of, trying to figure out what would work. Then one day, browsing in the local library, he came across a recently published book titled *The Intelligent Investor* by Benjamin Graham. "That," he said, "was like seeing the light."[14]

Graham's treatises on investing, including *Security Analysis* (1934), cowritten with David Dodd, so influenced Buffett that he left Omaha and traveled to New York to study with Graham at the Columbia University Graduate School of Business. Graham preached the importance of understanding a company's intrinsic value. He believed investors who accurately calculated this value and bought shares below it in price could be profitable in the market. This mathematical approach appealed to Buffett's love of numbers.

In Graham's class were 20 students. Many were older than Buffett and several were working on Wall Street. In the evening, these Wall Street professionals sat in Graham's class discussing which stocks were massively undervalued, and the next day they would be back at work buying the stocks analyzed the night before and making money.

It was soon clear to everyone that Buffett was the brightest student. He often raised his hand to answer Graham's question before Graham had finished asking it. Bill Ruane, who later cofounded the Sequoia Fund with Rick Cuniff, was in the same class. He recalls that there was an instantaneous chemistry between Graham and Buffett, and the rest of the class was primarily an audience.[15] Buffett's grade for the class was an A+—the first A+ Graham had awarded in 22 years of teaching.

After graduating from Columbia, Buffett asked Graham for a job but was turned down. At first he was stung by the rejection but later was told that the firm preferred to fill the slots at Graham-Newman with Jewish analysts who, it was perceived, were being treated unfairly on Wall Street. Undeterred, Buffett returned to Omaha, where he joined Buffett-Falk Company, his father's brokerage. He hit the ground running, eagerly recommending stocks that met Graham's value criteria. All the while Buffett stayed in touch with Graham, sending him stock ideas after stock ideas. Then, in 1954, Graham called with news: The religious barrier had been lifted and there was a seat at Graham-Newman if he was still interested. Buffett was on the next plane to New York.

During his tenure at Graham-Newman, Buffett became fully immersed in his mentor's investment approach. In addition to Buffett, Graham also hired Walter Schloss, Tom Knapp, and Bill Ruane. Schloss went on to manage money at WJS Ltd. Partners for 28 years. Knapp, a Princeton chemistry major, was a founding partner in Tweedy, Browne Partners. Ruane cofounded the Sequoia Fund.

For Buffett, Graham was much more than a tutor. "It was Graham who provided the first reliable map to that wondrous and often forbidding city, the stock market," wrote Roger Lowenstein. "He laid out a methodological basis for picking stocks, previously a pseudoscience similar to gambling."[16] Since the days when 11-year-old Buffett first purchased Cities Service Preferred, he had spent half of his life studying the mysteries of the stock market. Now he had answers. Alice Schroeder, author of *The Snowball: Warren Buffett and the Business of Life*, wrote, "Warren's reaction was that of a man emerging from the cave in which he had been living all his life, blinking in the sunlight as he perceived reality for the first time." According to Schroeder, Buffett's original "concept of a stock was derived from the patterns formed by the prices at which pieces of paper were traded. Now he saw that those pieces of paper were simply symbols of an underlying truth."[17]

In 1956, two years after Buffett arrived, Graham-Newman disbanded and Graham, then 61, decided to retire. Once again Buffett returned to Omaha. Armed with the knowledge he had acquired from Graham, and with the financial backing of family and friends, he began a limited investment partnership. He was 25 years old.

The Buffett Partnership Ltd.

The Buffett Partnership began with seven limited partners who together contributed $105,000. Buffett, the general partner, started with $100. The limited partners received 6 percent annually on their investments and 75 percent of the profits above this bogey; Buffett earned the other 25 percent. But the goal of partnership was relative, not absolute. Buffett's intention, he told his partners, was to beat the Dow Jones Industrial Average by 10 percentage points.

Buffett promised his partners that "our investments will be chosen on the basis of value not popularity" and that the partnership "will attempt to reduce permanently capital loss (not short-term quotational loss) to a minimum."[18] Initially, the partnership bought undervalued common stocks based on Graham's strict criteria. In addition, Buffett also engaged in merger arbitrage—a strategy in which the stocks of two merging companies are simultaneously bought and sold to create a riskless profit.

Out of the gate, the Buffett partnership posted incredible numbers. In its first five years (1957–1961), a period in which the Dow was up 75 percent, the partnership gained 251 percent (181 percent for limited partners). Buffett was beating the Dow not by the promised 10 percentage points but by an average of 35.

As Buffett's reputation became more widely known, more people asked him to manage their money. As more investors came in, more partnerships were formed, until Buffett decided in 1962 to reorganize everything into a single partnership. That year Buffett moved the partnership office from his home to Kiewit Plaza in

Omaha, where his office remains today. The following year, Buffett made one of his most famous investments, one that served to boost his already growing reputation.

One of the worst corporate scandals in the 1960s occurred when the Allied Crude Vegetable Oil Company, led by Tino De Angelis, discovered it could obtain loans based on the inventory of its salad oil. Using one simple fact—that oil floats on top of water—De Angelis rigged the game. He built a refinery in New Jersey, put in 139 five-story storage tanks to hold soybean oil, then filled the tanks with water topped with just a few feet of salad oil. When inspectors arrived to confirm inventory, Allied employees would clamber up to the top of the tanks, dip in a measuring stick, and call out a false number to the inspectors on the ground. When the scandal broke, it was learned that Bank of America, Bank Leumi, American Express, and other international trading companies had backed over $150 million in fraudulent loans.

American Express was one of the biggest casualties of what became known as the salad oil scandal. The company lost $58 million and its share price dropped by over 50 percent. If Buffett had learned anything from Ben Graham, it was this: When a stock of a strong company sells below its intrinsic value, act decisively.

Buffett was aware of the $58 million loss, but what he did not know was how customers viewed the scandal. So he hung out at the cash registers of Omaha restaurants and discovered there was no drop-off in the use of the famous American Express Green Card. He also visited several banks in the area and learned that the financial scandal was having no impact on the sale of American Express Travelers Cheques.

Returning to his office, Buffett promptly invested $13 million—a whopping 25 percent of the partnership assets—in shares of American Express. Over the next two years, the shares tripled and the partners netted a cool $20 million in profit. It was pure Graham, and pure Buffett.

In the beginning, Buffett confined the partnership to buying undervalued securities and certain merger arbitrage announcements. But in the fifth year, he purchased his first controlling interest in a business—the Dempster Mill Manufacturing Company, a maker of farm equipment. Next he began buying shares in an ailing New England textile company called Berkshire Hathaway, and by 1965 he had control of the business.

■ ■ ■

In differential calculus, an inflection point is a point on a curve at which the curvature changes from being plus to minus or minus to plus. Inflection points can also occur in companies, industries, economies, geopolitical situations, and individuals as well. I believe the 1960s proved to be Buffett's inflection point—where Buffett the investor evolved into Buffett the businessperson. It was also a period when the market itself reached an inflection point. Since 1956, the valuation strategy outlined by Graham and used by Buffett had dominated the stock market. But by the mid-1960s a new era was unfolding. It was called the "Go-Go" years—the "Go-Go" referred to growth stocks. It was a time when greed begin driving the market and where fast money was made and lost in the pursuit of high-flying performance stocks.[19]

Despite the underlying shift in market psychology, the Buffett Partnership continued to post outstanding results. By the end of 1966, the partnership had gained 1,156 percent (704 percent for limited partners), blitzing the Dow, which was up 123 percent over the same period. Even so, Buffett was becoming increasingly uneasy. Whereas the market had been dancing to the principles outlined by Graham, the new music being played in the stock market made little sense to Buffett.

In 1969, Buffett decided to end the investment partnership. He found the market highly speculative and worthwhile values increasingly scarce. By the late 1960s, the stock market was dominated by highly priced growth stocks. The Nifty Fifty were on the tip of every investor's tongue. Stocks like Avon, Polaroid, and Xerox were trading at fifty to one hundred times earnings. Buffett mailed a letter to his partners confessing that he was out of step with the current market environment. "On one point, however, I am clear," he said.

"I will not abandon a previous approach whose logic I understand, although I find it difficult to apply, even though it may mean forgoing large and apparently easy profits, to embrace an approach which I don't fully understand, have not practiced successfully and which possibly could lead to substantial permanent loss of capital."[20]

At the beginning of the partnership, Buffett had set a goal of outperforming the Dow by an average of 10 percentage points each year. Between 1957 and 1969, he did beat the Dow—not by 10 percentage points a year but by 22! When the partnership disbanded, investors received their portions. Some were given an education in municipal bonds and others were directed to a money manager. The only individual whom Buffett recommended was Bill Ruane, his old classmate at Columbia. Ruane agreed to manage some of the partners' money, and thus was born the Sequoia Fund. Other members of the partnership, including Buffett, took their portions in Berkshire Hathaway stock. Buffett's share of the partnership had grown to $25 million, and that was enough to give him control of Berkshire Hathaway.

When Buffett disbanded the partnership, many thought the "money changer's" best days were behind him. In reality, he was just getting started.

Berkshire Hathaway

The original company, Berkshire Cotton Manufacturing, was incorporated in 1889. Forty years later, Berkshire combined operations with several other textile mills, resulting in one of New England's largest industrial companies. During this period, Berkshire produced approximately 25 percent of the country's cotton needs and absorbed 1 percent of New England's electrical capacity. In 1955, Berkshire merged with Hathaway Manufacturing, and the name was subsequently changed to Berkshire Hathaway.

Unfortunately, the years following the merger were dismal. In less than 10 years, stockholders' equity dropped by half and losses from operations exceeded $10 million. During the next 20 years, Buffett, along with Ken Chace, who managed the textile group, labored intensely to turn around the New England textile mills. Results were disappointing. Returns on equity struggled to reach double digits.

By the 1970s, shareholders of Berkshire Hathaway began to question the wisdom of retaining an investment in textiles. Buffett made no attempt to hide the difficulties and on several occasions explained his thinking: The textile mills were the largest employer in the area; the workforce was an older age group that possessed relatively nontransferable skills; management had shown a high degree of enthusiasm; the unions were being reasonable; and, very importantly, Buffett believed that some profits could be realized from the textile business.

However, he made it clear that he expected the textile group to earn positive returns on modest capital expenditures. "I won't close down a business of subnormal profitability merely to add a fraction of a point to our corporate returns," said Buffett. "I also feel it is inappropriate for even an exceptionally profitable company to fund an operation once it appears to have unending losses in prospect. Adam Smith would disagree with my first proposition and Karl Marx would disagree with my second; the middle ground," he explained, "is the only position that leaves me comfortable."[21]

As Berkshire Hathaway entered the 1980s, Buffett was coming to grips with certain realities. First, the very nature of the textile business made high returns on equity improbable. Textiles are commodities, and commodities by definition have a difficult time distinguishing their products from those of competitors. Foreign competition, employing a cheap labor force, was squeezing profit margins. Second, in order to stay competitive the textile mills would require significant capital improvements, a prospect that is frightening in an inflationary environment and disastrous if the business returns are anemic.

Buffett was faced with a difficult choice. If he made large capital contributions to the textile division in order to remain competitive, Berkshire would be left with poor returns on what was becoming an expanding capital base. If he did not reinvest, Berkshire's textile mills would become less competitive with other domestic textile manufacturers. Whether Berkshire reinvested or not, foreign competition continued to have an advantage by employing a cheaper labor force.

By 1980, the annual report revealed ominous clues for the future of the textile group. That year, the group lost its prestigious lead-off position in the Chairman's Letter. By the next year, the textile group was not discussed in the letter at all. Then, the inevitable: In July 1985, Buffett closed the books on the textile group, thus ending a business that had begun some 100 years earlier.

Despite the misfortunes of the textile group, the experience was not a complete failure. First, Buffett learned a valuable lesson about corporate turnarounds: They seldom succeed. Second, the textile group did generate enough capital in the early years to buy an insurance company, and that is a much brighter story.

Insurance Operations

In March 1967, Berkshire Hathaway purchased, for $8.6 million, the outstanding stock of two insurance companies headquartered in Omaha: National Indemnity Company and National Fire & Marine Insurance Company. It was the beginning of Berkshire Hathaway's phenomenal success story.

To appreciate the phenomenon, it is important to recognize the true value of owning an insurance company. Insurance companies are sometimes good investments, sometimes not. They are, however, always terrific investment *vehicles*. Policyholders, in paying premiums, provide a constant stream of cash; insurance companies invest this cash until claims are filed. Because of the uncertainty of when claims will occur, insurance companies opt to invest in liquid securities—primarily short-term fixed income securities, longer-dated bonds, and stocks. Thus Warren Buffett acquired not only two modestly healthy companies, but also a cast-iron vehicle for managing investments.

In 1967, the two insurance companies had a bond portfolio worth more than $24.7 million and a stock portfolio worth $7.2 million. In two years, the combined portfolio approached $42 million. This was a handsome portfolio for a seasoned stock picker like Buffett. He had already experienced some limited success managing the textile company's securities portfolio. When Buffett took control of Berkshire in 1965, the company had $2.9 million in marketable securities. By the end of the first year Buffett had enlarged the securities account to $5.4 million. In 1967, the dollar return from investing was three times the return of the entire textile division, which had 10 times the equity base of the common stock portfolio.

It has been argued that when Buffett entered the insurance business and exited the textile business, he merely exchanged one commodity for another. Insurance companies, like textiles, are selling a product that is indistinguishable. Insurance policies are standardized and can be copied by anyone. There are no trademarks, patents, advantages in location, or raw materials that distinguish one from another. It is easy to get licensed, and insurance rates are an open book. Often the most distinguishable attribute of an insurance company is its personnel. The efforts of individual managers have enormous impact on an insurance company's performance. Over the years, Buffett has added several insurance companies to the Berkshire insurance group. One prominent addition, now well known thanks to a clever advertising campaign, is GEICO. By 1991, Berkshire Hathaway owned nearly half of GEICO's outstanding common shares. For the next three years, the company's impressive performance continued to climb; so did Buffett's interest. In 1994, Berkshire announced it owned 51 percent of the company, and serious discussion began on GEICO joining the Berkshire family. Two years later, Buffett wrote a check for $2.3 billion and GEICO became a wholly owned business.

Buffett was not done. In 1998, he paid seven times the amount he had spent to buy the remaining outstanding shares of GEICO—about $16 billion in Berkshire Hathaway stock—to acquire a reinsurance company called General Re. It was his biggest acquisition up to that date.

Over the years, Buffett has continued to buy insurance companies, but without question his smartest acquisition was a person—Ajit Jain, whom he hired to run the Berkshire Hathaway Reinsurance

Group. Ajit, born in 1951, earned an engineering degree at the prestigious Indian Institutes of Technology. He worked for IBM for three years, then enrolled at Harvard to gain a business degree.

Although Ajit had no insurance background, Buffett quickly recognized his brilliance. From a starting point in 1985, Ajit built the Reinsurance Group's float (premiums earned but losses not paid) to $34 billion in a little over 20 years. According to Buffett, Ajit "insures risks that no one else has the desire or the capital to take on. His operation combines capacity, speed, decisiveness, and most importantly, brains in a manner that is unique in the insurance business."[22] Not a day goes by without Buffett and Ajit having a conversation. To give you an idea of Ajit's value, in the 2009 Berkshire annual report, Buffett wrote, "If Charlie, I and Ajit are ever in a sinking boat—and you can only save one of us—swim to Ajit."

The Man and His Company

Warren Buffett is not easy to describe. Physically he is unremarkable, with looks that are more grandfatherly than corporate titan. 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 those things logical and a foul distaste for imbecility. He embraces the simple and avoids the complicated.

Reading his annual reports, one is struck by how comfortable Buffett is quoting the Bible, John Maynard Keynes, or Mae West. Of course the operable word is *reading*. Each report is 60 to 70 pages of dense information: no pictures, no color graphics, no charts. Those disciplined enough to start on page 1 and to continue uninterrupted are rewarded with a healthy dose of financial acumen, folksy humor, and unabashed honesty. Buffett is very 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.

The company that Buffett directs is the embodiment of his personality, his business philosophy (which is identically tied to his investment philosophy), and his own unique style. Berkshire Hathaway, Inc. is complex but not complicated. There are just two major parts; the operating businesses and the stock portfolio, made possible by the earnings of the noninsurance businesses and the insurance companies' float. Running through it all is Warren Buffett's down-to-earth way of looking at businesses he's considering buying outright, a business he's evaluating for common stock purchase, or the management of his own company.

Today, Berkshire Hathaway is divided into three major groups: its Insurance Operations; its Regulated Capital-Intensive Businesses, which includes MidAmerican Energy and the railroad Burlington Northern Santa Fe; and Manufacturing, Services and Retailing Operations, with products ranging from lollipops to jet airplanes. Collectively, these businesses generated, in 2012, $10.8 billion in earnings for Berkshire Hathaway compared to the $399 million Buffett the businessperson earned in 1988. At year-end 2012, Berkshire Hathaway's portfolio of investments had a market value of $87.6 billion against a cost basis of $49.8 billion. Twenty-five years ago, in 1988, Buffett the investor had a portfolio valued at $3 billion against a cost basis of $1.3 billion.

Over the past 48 years, starting in 1965, the year Buffett took control of Berkshire Hathaway, the book value of the company has grown from $19 to $114,214 per share, a compounded annual gain of 19.7 percent; during that period, the Standard & Poor's (S&P) 500 index gained 9.4 percent, dividends included. That is a 10.3 percent relative outperformance earned for almost five decades. As I said earlier, when the "money changer" shut down the Buffett Partnership, he was just getting started.

Five-Sigma Event

For years academicians and investment professionals have debated the validity of what has come to be known as the efficient market theory. This controversial theory suggests that analyzing stocks is a waste of time because all available information is already reflected in current prices. Those who adhere to this theory claim, only partly in jest, that investment professionals could throw darts at a page of stock quotes and pick winners just as successfully as a seasoned financial analyst who spends hours poring over the latest annual report or quarterly statement.

Yet the success of some individuals who continually beat the indexes—most notably Warren Buffett—suggests that the efficient market theory is flawed. Efficient market theoreticians counter that it is not the theory that is flawed. Rather, they say, individuals like Buffett are a five-sigma event, a statistical phenomenon so rare it practically never occurs.[23] It would be easy to side with those who claim Buffett is a statistical rarity. No one has ever come close to repeating his investment performance, whether it was the 13-year results from the Buffett Partnership or the almost five-decade performance record at Berkshire Hathaway. When we tabulate the results of almost every investment professional, noting their inability to beat the major indexes over time, it prompts the question: Is the stock market indeed unassailable, or is it a question of the methods used by most investors?

Last, we have Buffett's own words to consider. "What we do is not beyond anyone else's competence. I feel the same way about managing that I do about investing: it is just not necessary to do extraordinary things to get extraordinary results."[24] Most would dismiss Buffett's explanation as nothing more than his special brand of Midwestern humility. But I have taken his word on the matter, and it is the subject of this book.