

## World's Greatest Investor

**W**e investors have a built-in need to understand the world, especially that sliver that has a direct impact on our financial well-being. And when the unexpected occurs, we seek answers.

That surely was the case in 1973, when stock prices started a brutal downhill slide that only got worse the following year. By the end of 1974, the overall stock market was down an agonizing 50 percent. Investors were left shaken, wondering what happened to their portfolio, their retirement savings. And they asked themselves, What should I have done differently?

As it happens, academicians at leading universities had been thinking about the stock market for some time. Working separately, they had developed and refined several ideas about the behavior of markets, particularly the core concept of risk and return.

One idea, with its roots in psychology, starts with the acknowledgment that most people get emotional when it comes to money. Specifically, most investors abhor the thought of losing money, which these financial scholars equated with price volatility. If investors don't have the emotional fortitude to remain calm when stock market prices start bouncing wildly, they are almost certain to panic and make bad decisions. Therefore, the ideal investment strategy must reflect their specific point on the risk/reward scale, which measures their ability to tolerate price volatility.

Another concept, closely tied to risk tolerance, is the notion of diversification. The core idea is that volatility can be better managed if a stock portfolio is diversified among different companies and industries. Thus, if any one particular area of the economy is hit by some disaster, a widely diversified portfolio has the built-in protection that works to mitigate price losses.

Over the years both these general theories—risk equals price and diversification tempers price volatility—have been debated, amended, expanded, published, footnoted, and debated again. Eventually, through a kind of cloistered evolution, those separate ideas coalesced into one overall concept that came to be known as *Modern Portfolio Theory*. But it remained quietly ensconced in academia until the dramatic stock market sell-off of 1973–1974. Those crushing losses sent investors and their advisors looking for answers.

That's when Modern Portfolio Theory was “discovered” in the ivory towers and brought down into the marketplace. Suddenly, or so it seemed at the time, everyone turned to Modern Portfolio Theory as the one approach that made the most sense for investors.

There's just one problem with Modern Portfolio Theory. His name is Warren Buffett.

Buffett does not equate risk with price volatility. He does not manage a broadly diversified portfolio of common stocks but rather a concentrated, low-turnover portfolio. Nonetheless, his performance through almost seven decades has led many to call him the world's greatest investor—or, in some cases, a five-sigma event, a statistical phenomenon so rare that it practically never occurs.<sup>1</sup>

Omaha-born and -raised, Warren Buffett graduated from the University of Nebraska, then went to Columbia University to study with Benjamin Graham and David Dodd, the coauthors of *Security Analysis*, the seminal book on value investing. Graham was also the author of *The Intelligent Investor*, which Buffett has called the most important investment book ever written. He has often declared that it had forever changed his thinking on how to invest in the stock market.

After Columbia, Buffett worked for a time at his mentor's company, the Graham-Newman Corporation, before returning to

Omaha and launching his own investment company, the Buffett Limited Partnership, in 1956. He set an ambitious goal for himself: to beat the Dow Jones Industrial Average by an average 10 percentage points per year. For the next 13 years (1957–1969), the partnership generated an average annual return of 31 percent, 22 points higher than the Dow's 9 percent average annual return. Even more amazing, Buffett beat the Dow every single one of those 13 years. In all that time, he never had a down year.

In 1962, the Buffett Partnership began buying shares in a Massachusetts textile manufacturer called Berkshire Hathaway. By 1965, Buffett was in effective control of the company. When the Buffett Partnership ceased operations at the end of 1969, he told his partners he was going to move his personal investments from the partnership into Berkshire Hathaway stock. That was the start of what became the Berkshire Hathaway of today: a conglomerate that owns both private companies and public securities. In its first 10 years with Buffett at the helm (1965–1974), which included the disastrous bear market of 1973–1974, a dollar invested in Berkshire Hathaway tripled. Over the same time frame, that same dollar in the S&P 500 Index with dividends reinvested returned 13 cents. And he was just getting started.

No professional investor has managed money longer than Warren Buffett.<sup>2</sup> Adjusting for the overlap between Buffett Partnership and Berkshire Hathaway, he has managed portfolios for 66 years. Separating Berkshire Hathaway's performance (1965–2022), Berkshire's overall gain for 58 years was 3,787,464 percent compared to the S&P 500 Index, which, with dividends included, returned 24,708 percent. That's a compounded annual gain of 19.8 percent for Buffett, versus the 9.9 percent for the S&P 500 Index. Put differently, one dollar invested in the S&P 500 Index in 1965 would be worth \$248 at the end of 2022; invested in Berkshire, it was worth \$37,875.

## Understanding Patterns

The human mind craves patterns, for they suggest order that, in turn, enables us to make sense of the world.<sup>3</sup> Investors are no different.

They, too, are pattern-seeking animals. Unfortunately, most investors are looking for patterns in the wrong place. They are certain that there is some reliable pattern for predicting short-term price changes. But they are mistaken. There are no models that can consistently predict the direction of the stock market. Markets are too large, too complex, and are constantly evolving over time. The exact patterns to predicting markets do not repeat. Still, investors keep trying.

Warren Buffett also seeks patterns. But the patterns he looks for are not confined to the market but those found when analyzing businesses. Buffett has learned that inside each company there are recognizable patterns in three distinct areas: the nature of the business, financial returns, and management qualities. He firmly believes that these patterns will, at some point, reveal the future direction of the stock price. Of course, over the short run stock prices do not obligingly follow every change in a business. But if your time horizon is long enough, it is remarkable how stock prices eventually match up with the patterns revealed by the economics of the underlying businesses.

It's been said that some measure of luck is always part of a streak. There is no question Warren Buffett caught some lucky breaks over his career alongside his fair share of bad luck. But make no mistake, long streaks are imposed on great skill.<sup>4</sup> The objective of *The Warren Buffett Way* is to explore the skill set of the world's greatest investor.

## **The Making of an Entrepreneur**

We can trace the Buffett clan all the way back to John Buffett, who married Hannah Titus on the north shore of Long Island, New York, in 1696. Fast-forward to 1867, when Sidney Homan Buffett, hearing the call of the West, left New York and took a job driving a stagecoach to Omaha. Once there, he decided to stay, and in 1869 he opened the S. H. Buffett Grocery, setting in motion the Buffett dynasty that remains in Omaha today.

By 1900, Omaha was sprinkled with tall buildings and cable cars. Its population had swelled to 140,000. Sidney Buffett expanded his

grocery business, and soon his two sons joined him. The youngest, Ernest, left his father's bigger downtown location and established in the suburbs a new grocery store he grandly called Ernest Buffett, Grocer and Master Merchant. Ernest had four sons, one of whom, Howard, became the father of Warren Buffett.

Howard Buffett had little interest in the grocery business. He dreamed of becoming a journalist and at the University of Nebraska served as editor of the school newspaper, the *Daily Nebraskan*. Then, in his senior year a chance meeting with Leila Stahl, soon to be Mrs. Howard Buffett, changed his future. To win Leila's heart and her father's approval, Howard forsook a career in the news business and instead took a more dependable job selling insurance. He later parlayed that sales experience into a new job as a securities salesman, and that led to the formation of a new brokerage firm: Buffett, Skelincka & Company.

In his early years, young Warren took lessons from his grandfather, the grocery merchant. What we know is that before Warren Buffett became an investor, he became an entrepreneur: someone who starts a business to seek a profit. When Buffett was six years old, his beloved Aunt Alice sent him a present. On Christmas morning, he ripped off the wrapping paper and strapped to his belt what would become his most prized possession—a nickel-coated money changer. He quickly found many ways to put it to good use. Young Warren set up a table outside on the sidewalk and sold Chiclets to any who passed by. He went door-to-door selling packs of gum and soda pop. He bought six-packs of Coke at his grandfather's grocery store for 25 cents and sold the individual bottles for a nickel: a 20 percent return on investment.

Later, Buffett sold copies of the *Saturday Evening Post* and *Liberty* magazines. Each weekend he hawked popcorn and peanuts at local football games. In his spare time, he walked the nearby golf courses looking for lost balls, which he washed and cleaned and then resold for \$6 a dozen. He attended horse races at the Ak-sar-ben Racetrack (Nebraska spelled backwards) looking for discarded tickets mistakenly thrown away that might have been worth something.

Later he published his own racer's tip sheet called the *Stable-Boy-Selections* for 25 cents, undercutting the price of the track's official *Blue Sheet*.

In 1942, when Buffett was 12, his father was elected to the US Congress and moved the family to Washington, DC. The change was hard on the young boy. Miserable and hopelessly homesick, he was allowed to return to Omaha to live with his grandfather and Aunt Alice. The following year, Buffett gave Washington another try and restarted his entrepreneurial adventures. He was soon working two paper routes delivering the *Washington Post* and the *Washington Times-Herald*.

At Woodrow Wilson High School, he made friends with Don Daly, who quickly became infected with Buffett's enthusiasm for making money. The two pooled their savings and bought a reconditioned pinball machine for \$25. Buffett convinced a local barber to let them put a machine in this shop for half the profits. After the first day of operation, they returned to find \$4 in nickels in their machine. The Wilson Coin-Operated Machine Company expanded to seven machines, and soon Buffett was taking home \$50 a week. Next up, Buffett and Daly partnered on a 1934 Rolls Royce they purchased for \$350 and rented out for \$35 a day. At age 16, Buffett purchased a 40-acre Nebraska farm and leased it back to a farmer. By the time he graduated high school he had saved \$6,000.

What accounted for Buffett's burning passion to make money? One dramatic, heartbreaking circumstance: the Great Depression. Although in some ways Buffett's younger years seem to reflect an idyllic childhood, all that changed when his father returned home one night and informed 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 could not afford to give his son a job but he did supply the family with food, on credit.

Warren Buffett was in every way a child of the Depression, and its effect, albeit brief, made a deep and profound impression on him. As Roger Lowenstein, author of *Buffett: The Making of an American Capitalist*, put it, "He emerged from those first hard years with an

absolute drive to become very, very, very rich. He thought about it before he was five years old. And from that time on, he scarcely stopped thinking about it.”<sup>5</sup> Buffett often visited the home of Carl Falk, then his father’s business partner, to read Falk’s investment books. One day Mrs. Falk, making lunch for young Warren, heard him declare that he “would be a millionaire before the age 30 and if not, I’m going to jump off the tallest building in Omaha.” Mrs. Falk, horrified, asked Warren to never say that again. He just laughed. She pressed him: Why would he say such a thing? “It’s not that I want money,” he replied. “It’s just the fun of making money and watching it grow.”<sup>6</sup> In later years he added, “Money could make me independent. I could do what I wanted to do with my life. And the biggest thing I wanted was to work for myself. The idea of doing what I wanted and to do it every day was important to me.”<sup>7</sup>

### ***Chasing His Dreams: Early Influences***

Many popular stories swirl around Warren Buffett that account for his success. But there is one story that is not widely known, and it is quite possibly the most significant of all.

In 1941, 11-year-old Warren, browsing in the Benson branch of the Omaha Public Library, came across a distinguished-looking book with a shiny silver cover, *One Thousand Ways to Make \$1,000: Practical Suggestions, Based on Actual Experience, for Starting a Business of Your Own and Making Money in Your Spare Time* by F. C. Minaker, published by the Darnell Corporation in 1936. In the fashion of the time, Frances Mary Cowan Minaker used initials to disguise her gender.

Think about a young boy living in Omaha, Nebraska, in the 1940s. There were no televisions, no video games, no personal computers or smartphones. Yes, there were radio programs and a rare Saturday afternoon movie at the downtown cinema. But for most people, including Warren, entertainment was reading: newspapers, magazines, and books. Now imagine young Warren running home from the library, tightly clutching his new treasure, bursting into the house, plopping down in a chair, opening the book to page one

and diving into a new world of how to make money—a world he had not yet fully understood or appreciated.

Minaker's book is long (408 pages) and comprehensive. In addition to hundreds of specific suggestions for new businesses, it offers clear, straightforward lessons on good salesmanship, advertising, merchandising, customer relations, and much more. It is filled with stories of people who turned a good idea into a good business, sometimes with stunning success.

There is the stirring story of James C. Penney, whose first job paid him a measly \$2.27 a month. Penney combined his small grubstake with two other partners and opened the first J.C. Penney on April 14, 1902. That first year, store sales amounted to \$28,891. James' share of the profits was a tad over \$1,000.

Warren flipped another page and read the story of 23-year-old John Wanamaker, who persuaded his brother-in-law, Nathan Brown, to combine their piddling savings and open a gentleman's clothing store in their home town, Philadelphia. It was 1861. Before them lay the prospects of national civil war. Behind them were the remnants of the 1857 banking depression that caused massive unemployment and the almost complete ruination of manufacturers and wholesalers. Undeterred, they opened the doors on April 27, 1861. Eight years later Wanamaker & Brown was the largest men's retailer in the United States.

With daydreams mounting, Warren read on.

When he came to page 153, Warren must have broken out with huge grin. Chapter 6 is all about starting roadside businesses, something the young entrepreneur had already been doing for more than five years. Chapter 10 is filled with scores of ideas for service businesses, one of which involved placing coin-operated pool tables in local stores and taverns. From our present-day perspective, we can see a straight line from that story to Buffett's pinball business two years later. In the same Chapter 10, "Selling Your Services," we find another story, one that had an even greater influence on Warren's thinking.

In 1933, a man named Harry Larson was shopping in his local drugstore when someone (we don't know who exactly) asked him how much he weighed. Harry turned around and spied a

coin-operated scale; he put in his penny and got his answer and then moved over to the cigar counter. During the few minutes he waited in line, seven other customers decided to try the penny scale. That caught Harry's attention, and he set out to learn more. The store owner explained that the machines were leased and that his 25 percent share of the profits was about \$20 a month, leaving 75 percent for the company that owned the scale.

That, Harry told Minaker, was the start of everything. He took \$175 from savings and bought three machines, and was soon earning a monthly profit of \$98. But it was what Harry did next that intrigued Buffett. "I bought 70 machines altogether. . . . The other 67 were paid out of the pennies taken from the first three. . . . I've earned enough to pay for the scales, and make a good living besides."<sup>8</sup>

And that—one penny at a time—is the essence of compounding. We often think of compounding only as it applies to interest. You probably know Albert Einstein's famous quote, "Compound interest is the eighth wonder of the world. He who understands it, earns it. He who doesn't, pays it." But at its core the concept is broader and more powerful: Use profits to make further profits. Harry Larson instinctively understood it; so did a young Warren Buffett.

Many years later, Buffett used the penny-weight machines to describe his thinking. "The weighing machine was easy to understand. I'd buy a weighing machine and use the profits to buy more weighing machines. Pretty soon I'd have 20 weighing machines, and everybody would be weighing themselves 50 times a day. I thought—that is where the money is. The compounding of it—what could be better than that?"<sup>9</sup> It was the exact mental model that formed the outline, the architecture, of what became Berkshire Hathaway.

"The first step in starting a business of your own," Minaker writes, "is to know something about it. . . . So read everything published about the businesses you intend to start, to get the combined experience of others, and begin your plans where they left off." That means, she insists, learning all you can from both sides of the question: how to succeed *and* how not to fail. Reading about a business, she says, is like sitting down with a businessman in his parlor and talking about your problem. "Only those who think they

know all there is to be known—and more besides—consider such an exchange of ideas foolish,” she writes. What’s really foolish is spending hundreds of dollars (in today’s dollars probably hundreds of thousands, even millions) to discover that your idea won’t work, when someone else who has already tried it and wrote about it can tell you “exactly *why* it is not a good idea.”<sup>10</sup>

The lesson was not lost on Warren Buffett. At Berkshire Hathaway’s headquarters, the largest room is not Buffet’s office but the reference library down the hall. It is lined with row on row of filing cabinets, all filled with the stories of businesses. The cabinets contain every annual report, past and present, of all the major traded companies. Buffett has read them all. From them he has learned not only what worked and was profitable but, more important, what businesses failed and lost money.

The second lesson Buffett took from Minaker can be encapsulated in two words: Take action. Or, as Minaker so compellingly puts it, “The way to begin to make money, is to begin.”<sup>11</sup> Hundreds of thousands have dreamed about starting their own business, she notes, but never did because they were stuck—waiting for business forecasts to improve, or perhaps waiting for their own prospects to get better, or just simply waiting for the right moment. They often delay getting started “because they cannot see clearly ahead.” The caution here is, be aware that the perfect moment is never beforehand, and waiting for it is simply a way to hide in the safety of doing nothing.

Another manifestation of this phenomenon, Minaker points out, is that people become frozen because they spend too much time seeking counsel from others. “If you ask the advice of enough people, you are sure to almost end up doing nothing.”<sup>12</sup> Those who have studied Warren Buffett easily recognize Minaker’s counsel. Yes, Buffett discussed big ideas with his longtime business partner, Charlie Munger. But it is also true that if Buffett believes Berkshire is in line to make a good purchase he won’t spend all day talking on the phone. He never holds off making a final decision because the stock market is up or down, or the economy is growing or

contracting, or the forecast for interest rates is rising or falling. If it is a good business at a good price, Buffett takes action.

Along with her advice, Minaker also delivers compelling inspiration. “Leaving the harbor [with your new business] is like the captain of a ship at sea; you rely on your own judgment and ability.” She calls it “the most satisfying part of a business life.”<sup>13</sup>

It’s easy to imagine the young Warren recognizing the truth to that. From the time he started selling candy and soda pop at age six, Buffett was his own boss. He was steadfastly confident and loved his independence. By the time he graduated from high school he was already the richest 16-year-old in Omaha. He may very well have been the world’s richest self-made teenager. But he was not yet the millionaire he had once bragged about becoming. That required him to stay in school.

### ***Getting an Education***

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 11 he marked the board at the brokerage house where his father worked. That same year he bought his first shares of stock, Cities Services Preferred. As we have seen, his early years were enlivened with money-making entrepreneurial ventures and lessons about the stock market. Despite his father urging him toward higher education, young Warren believed he was already successful. He told his father he would rather skip college and go directly into business. Anyway, he argued, he had already read hundreds of books on business and investing, so what could college teach him? He was overruled.

Buffett was right. Although he enrolled at the Wharton School of Finance and Commerce at the University of Pennsylvania in 1947, after two unrewarding years there it was clear he knew more about accounting and business than his professors. He was spending more time at Philadelphia brokerages studying the stock market than

studying for class. When the fall semester began in 1949, Buffett was nowhere to be found.

Back in Omaha, Buffett enrolled at the University of Nebraska and earned a bachelor's degree in one year, taking 14 courses over two semesters. All that year, and even after graduating, most days Buffett could be found in the library absorbing every book he could find on business and investing. Sometime in that summer of 1950 he found a copy of a new book by Benjamin Graham, *The Intelligent Investor*. The book that changed his life.

It led Buffett to start researching business school, and later that summer he discovered that Benjamin Graham and David Dodd, coauthors of the textbook *Security Analysis*, were listed as professors at Columbia University. "I figured they were long since dead," he said.<sup>14</sup> As it turns out, Graham and Dodd were not dead but actually teaching classes at Columbia. So he quickly submitted an application and was accepted. By September 1950, Buffett was 1,200 miles away from Omaha walking onto the New York City campus.

Buffett's first class was Finance 111–112, "Investment Management and Security Analysis," taught by David Dodd.<sup>15</sup> Before heading to New York, Buffett had grabbed a copy of *Security Analysis*. By the time he got to Columbia he had practically memorized it. "The truth was I knew the book. At the time, literally, almost in those seven or eight hundred pages, I knew every example. I just sopped it up."<sup>16</sup>

When the spring semester began Buffett could hardly contain himself. His next class, taught by Benjamin Graham, was a seminar of 20 students that combined the teachings in *Security Analysis* and the lessons from *The Intelligent Investor* linked to actual stocks that were trading in the market.

Graham's message was simple to understand but revolutionary in practice. Before *Security Analysis*, the common Wall Street approach to picking stocks was to begin with some overall opinion about a stock. Do you like it or not? Then try to figure out what other people might do with the stock: buy or sell it? The financial facts were largely overlooked. Ben Graham backed up the train.

Before you throw money at a stock based on nothing more than prevailing opinions, he argued, why not first figure out what it might be worth.

Graham's method was simple. First, add up the company's current assets (account receivables, cash, and current assets), then subtract all its liabilities. That gives you the company's net worth. Then, and only then, look at the stock price. If the price was below the net assets, it was a worthwhile and potentially profitable purchase. But if the stock price was higher than the company's net worth, it wasn't worth investing. The approach fit comfortably into Buffett's sense of numbers. Ben Graham had given him what he had been seeking for years—a systematic approach for investing: Buy a dollar's worth of securities for 50 cents.

Warren relished every moment of the Columbia experience. When not in class, he could be found in the university library reading old newspapers about the stock market going back 20 years. He never stopped, seven days a week from early in the morning to late in the evening. Most wondered if he ever slept.

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, a classmate, recalled there was an instantaneous chemistry between Graham and Buffett, and the rest of the class was primarily an audience.<sup>17</sup> At the end of the semester, Buffett received an A+, the first time Graham had ever awarded that grade in his 22 years at Columbia University.

When school was over, Buffett asked Graham about working at Graham-Newman, the investment partnership Graham managed while teaching at Columbia. Graham turned him down. At first Buffett 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. Buffett offered to work for free. Again, a polite no thank you. So Buffett returned to Omaha, determined to see what he could do on his own.

He was just turning 21 years old.

***Investing Becomes the Focus***

When Buffett arrived in Omaha in the summer of 1951, his mind and energy were singularly focused on investing. He was no longer interested in part-time jobs to make extra money. First Graham then Buffett's father—the two men Buffett respected over all others—cautioned him that now was not the time to invest in the stock market. Both men warned a correction was long overdue. Warren heard only Minaker. “The way to begin making money is to begin.”

Buffett was offered a job at the Omaha National Bank but he turned it down, preferring the familiarity of his father's firm, Buffett-Falk & Company. The name of the firm had changed to reflect the contribution of its partner, Carl Falk. A friend of Howard Buffett asked if the name would soon be changed to Buffett & Son. Warren replied, “Maybe Buffett & Father.”<sup>18</sup>

Buffett threw his heart and soul into Buffett-Falk & Company. He enrolled in the Dale Carnegie course for public speaking and began teaching “Investment Principles” at the University of Omaha; his lectures were based on Graham's book *The Intelligent Investor*. He wrote a column for *The Commercial and Financial Chronicle* under the headline “The Security I Like Best.” In one of the columns Buffett touted Graham's favorite investment, a little-known insurance company called Government Employees Insurance Company (GEICO). Throughout this period, Warren maintained his relationship with Ben Graham and sent him stock ideas from time to time.

Then one day in 1954, Graham called his former student with a job offer. 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. He was not alone. In addition to Buffett, Graham also hired Walter Schloss, Tom Knapp, and Buffett's classmate, Bill Ruane. Schloss went on to manage money at WSJ Limited Partners for 28 years. Knapp, a Princeton chemistry major, was a founding partner in Tweedy, Browne Partners. Ruane along with Rick Cuniff cofounded the famous Sequoia Fund. Each day the four analysts spent their time

pouring over the Standard & Poor's *Stock Guide* and pitching ideas for the Graham-Newman mutual fund.

The two years that Buffett spent at Graham-Newman were exhilarating but also frustrating. Graham and his partner, Jerry Newman, batted down most of his recommendations. When the Dow Jones Industrial Average hit a record high 420 in 1955, the Graham-Newman mutual fund was sitting on \$4 million in cash. No matter how compelling were Buffett's stock picks, the door at Graham-Newman was closed. Buffett concluded that the only place for his ideas was his own portfolio. The following year, Graham himself had enough. He retired and moved to Beverly Hills, California, where he continued to write and teach, this time at UCLA, until his death at age 82.

For Buffett, Graham was much more than a tutor. Roger Lowenstein describes it well: "It was Graham who provided the first reliable map to that wondrous and often forbidding city, the stock market. He laid out a methodological basis for picking stocks, previously a pseudoscience similar to gambling."<sup>19</sup> Since the days when 11-year-old Buffett first purchased Cities Service Preferred, he had spent half his life studying the mysteries of the stock market, including vast amounts of time deciphering technical analysis and chart reading. Now he had answers. Alice Schroeder, author of *The Snowball: Warren Buffett and the Business of Life*, adds a compelling analogy: "Warren's reaction was that of a man emerging from a cave in which he had been living all his life, blinking in the sunlight as he perceived reality for the first time. Buffett's original concept of a stock was derived from the patterns formed by prices at which pieces of paper were traded. Now he saw that those pieces of paper were simply symbols of an underlying truth."<sup>20</sup>

So Buffett returned to Omaha for the second time, far different from the young graduate five years earlier. He was now older, more experienced, certainly wiser about investing, and definitely a lot richer. Armed with the knowledge he acquired from Graham, and with the financial backing of family and friends, he began a limited investment partnership. Buffett was 25 years old, and he knew

one thing for sure: He would never work for someone else again. He was ready to be his own captain.

## **Buffett Limited Partnership**

Chapter 10 of Minaker's book, titled "Selling Your Services," begins by asking the reader to take a personal inventory. Figure out what you're good at, what you do better than anyone else. Then figure out who needs help and how best to reach them.

Through his teaching at the University of Omaha and his popular column on investing, Buffett had already begun to build his reputation in Omaha. The time spent at Graham-Newman only added to his credibility. So no sooner did he arrive back in Omaha than family and friends pounced, asking him to manage their money. His sister Doris and her husband, his loving Aunt Alice, his father-in-law, his ex-roommate Chuck Person, and a local Omaha attorney named Dan Monen all wanted in. Collectively, in the spring of 1956 they gave Buffett \$105,000 to invest. Thus was born the Buffett Limited Partnership with 25-year-old Warren as general partner.

When everyone gathered for the kickoff meeting at a local Omaha dinner club, Buffett set the tone. He handed each person the formal partnership agreement, assuring them there was nothing nefarious about the legalistic look of the document. Then with complete disclosure he set the ground rules for the partnership.<sup>21</sup>

First, the financial terms. Limited partners would receive the first 6 percent return of the investment partnership. Thereafter, they would receive 75 percent of the profits, with the balance going to Buffett. Any annual deficiency in performance goals would be made up the next year. So if the limited partners didn't get their full 6 percent return in any one year, the following year the shortage would be added to that year's 6 percent. Buffett would not receive his performance bonus until his partners were made whole.

Buffett told his partners he could not promise results, but he did promise that the investments he made for the partnership would be based on the value principles he learned from Ben

Graham. He went on to describe how they should think about the yearly gains and losses. First, they should ignore the daily, weekly, and monthly gyrations of the stock market, which, in any event, were beyond his control. Furthermore, they should not put much emphasis on how well or poorly the investments performed in any one year. Better to judge results over at least three years, five years was even better.

Buffett promised his partners that our “investment results will be chosen on the basis of value not popularity” and that the partnership “will attempt to reduce permanent capital loss (not short-term quotational loss) to a minimum.”<sup>22</sup> Last, Warren told his partners he was not in the business of forecasting the stock market or economic cycles. That meant he would not discuss or disclose what the partnership was buying, selling, or holding.

At dinner that night, everyone signed up for the partnership. Over the years, as more partners were added, they were given the same ground rules. Lest anyone forget, Buffett included the rules with performance results sent every year to each partner.

### ***Growing the Partnership***

Out of the gate, the Buffett partnership posted incredible numbers. In the first five years (1957–1961), a period when the Dow Jones Industrial Average was up 75 percent, the partnership gained 251 percent (181 percent for limited partners). Buffett was not beating the Dow by his original goal of 10 percentage points a year but by an average 35 percent.

As Buffett’s reputation became more widely known, more people asked him to manage their money. At the end of 1961, the Buffett partnership had \$7.2 million in capital, more than Graham-Newman managed at its peak. And \$1 million of that belonged to Buffett. He had just turned 31.

Still more investors came in, more partnerships were formed, until by 1962 Buffett decided to reorganize everything into a single partnership. That year, he moved the partnership office from his home to Kiewit Plaza in Omaha, where his office remains today.

The following year, 1963, 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 Tino De Angelis, CEO of the Allied Crude Vegetable Oil Company, discovered he could obtain loans based on the inventory of the company's salad oil. Using one simple fact, that oil floats on top of water, he rigged the game. He built a refinery in New Jersey, put in 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 Lemumi, 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 more than 50 percent. Buffett was certainly aware of the financial loss, but he did not know how customers of American Express viewed the scandal. So he hung out at the 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. Back in the 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 \$20 million in profit.

### ***Beating the Dow***

Buffett continued to soundly beat the Dow Jones Industrial Average. After 10 years, the Buffett Partnership's assets had grown to more than \$53 million. Buffett's share was near \$10 million. But even as the partnership was adding heroic returns, difficulties were mounting. Scouring the market, Buffett was having great

difficulty finding stocks that met his definition of value. Since the first days of the partnership in 1956, the valuation strategy Buffett had learned from Ben Graham dominated the stock market. But by the mid-1960s, a new era was unfolding. It was called the “go-go” years (*go-go* meaning growth stocks). Greed began driving the market. Fast money was made and lost in the pursuit of high-flying performance stocks.<sup>23</sup>

Still, 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 partners), blitzing the Dow’s gain of 123 percent over the same period. In 1968, the Buffett Partnership returned 59 percent compared to the Dow’s 8 percent. It was the single best performance year of the partnership. Ever the realist, Buffett wrote to his partners that the results “should be treated as a freak—like picking up thirteen spades in a bridge game.”<sup>24</sup>

Nevertheless, Buffett was becoming increasingly uneasy. The new drumbeat being played in the stock market made little sense to him. He found the market highly speculative and worthwhile values increasingly scarce. Finally, in 1969, at the height of his investment success, Buffett decided to end the investment partnership. He mailed a letter to his partners confessing that he was out of step with 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 capital loss.”<sup>25</sup>

In shutting down the Buffett Partnership, Buffett took extra care to ensure all the partners clearly understood the next steps. He outlined three different options. For those who wished to remain in the stock market, Buffett recommended Bill Ruane, his former classmate and colleague from Graham-Newman. Twenty million dollars in the Buffett Partnership were transferred to Ruane, Cuniff, & Stires and thus was born the Sequoia Fund.

A second option for partners was to invest in municipal bonds. To Buffett's mind, the 10-year outlook for stocks was approximately the same as for municipal bonds, which by their nature are tax-free and less risky. The consummate educator, Buffett sent each partner a 100-page manifesto on the mechanics of buying tax-free bonds.<sup>26</sup> As a third option, partners could allocate their assets to one of the partnership's major holdings, the common shares of Berkshire Hathaway.

When Buffett disbanded the partnership, more than a few thought his best days were behind him. In reality, they were just beginning. Buffett was always upfront and plainspoken. He told his partners he was going to move his personal investment in the Buffett Partnership to Berkshire Hathaway. From its initial asset base of \$105,000, the Buffett Partnership had grown to \$104 million in assets under management; from this, Buffett earned \$25 million. Now he was telling his partners he was moving this money to Berkshire Hathaway, giving him full control of the company. As Doc Angel, one of the early Buffett Partnership loyalists, said, "That's all anybody had to hear if they had any brains."<sup>27</sup>

## **Berkshire Hathaway: Compounding Conglomerate**

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 changed to Berkshire Hathaway.

Early in the Buffett Partnership time line, Buffett began acquiring shares in Berkshire Hathaway. The stock was selling for \$7.50 per share with working capital of \$10.25 and a book value of \$20.20. It was a classic Ben Graham stock.

Unfortunately the years following the merger between Berkshire and Hathaway were dismal. In less than 10 years, stockholder's

equity dropped by half and losses from operations exceeded \$10 million. Buffett was well aware of the difficulties US textile manufacturers faced in competing against much cheaper foreign imports. Even so, he couldn't resist the attractiveness of "picking up a discarded cigar butt that had one puff remaining in it."<sup>28</sup> The cigar butt theory is the name given to Graham's emphasis on buying hard assets on the cheap even though those assets had little economic vitality. With the cash and securities on the balance sheet along with even a limited potential for business profits going forward, Buffett figured there was not much downside to Berkshire Hathaway and a reasonable likelihood of making money.

By 1965, the Buffett Partnership owned 39 percent of the Berkshire Hathaway common shares outstanding. Buffett was then locked in a proxy battle with the board of directors to take over the company, fire the inept management, and replace them with people better at allocating capital. When the dust settled, Warren won the fight but in doing so found he had allocated 25 percent of the Buffett Partnership's assets to an economically sinking ship with no exit strategy. "I became the dog who caught the car."<sup>29</sup>

The journey from managing one of the greatest investment partnerships in history to then parlaying his net worth into owning a dying manufacturing business had all the markings of Greek tragedy. What was Buffett thinking?

It's clear what he was *not* thinking. Buffett had no clear plan to engineer a complete turnaround. And even though he had Graham whispering in his ear, he never intended to sell the company to a greater fool. Who would have wanted to buy a 75-year-old, low-margin, capital-intensive, labor-dependent, 19th-century New England maker of fabric liners for men's suits? No, Buffett was guided by a stronger principle, a principle that in fact lies at the heart of his investing philosophy—long-term compounding.

From an early age, Buffett was taught the benefits of compound interest. More important, he experienced the benefits of a compounding machine firsthand when he took the earnings from his various jobs and plowed them back into his young enterprise. If one paper route was a good job for making money, then

having two paper routes meant more money. If owning one pinball machine added to his savings, then owning three was better. Even as a kid, Warren was not geared to spend the money he earned.

In many ways, Buffett's childhood enterprises were like a conglomerate, enabling him to transfer money unimpaired from one business to another or, better yet, to plow money back into the best business. And 20 years later, a conglomerate is what he had with Berkshire Hathaway, although few recognized it.

Most thought that Warren Buffett had rolled the dice on a beaten-down textile business, but what they missed is that in one bold step he now owned a corporate entity called Berkshire Hathaway that in turn owned a textile company. Buffett figured all he had to do was to wring out whatever cash was left from Berkshire Hathaway manufacturing and reallocate it to a better business. Fortunately, the textile group of manufacturers under the Berkshire name did hold enough cash and short-term securities on their balance sheet to allow Buffett to buy other businesses, which, as we will see, is a much brighter story. It wasn't long before the metamorphosis of Berkshire Hathaway was complete, from a single-line textile manufacturer to a conglomerate that owned a portfolio of diversified business interests.

In the 2014 Berkshire Hathaway Annual Report, Buffett gave shareholders a short tutorial on the advantages of owning a conglomerate. "If the conglomerate form is used judiciously, it is an ideal structure for maximizing long-term capital." A conglomerate is perfectly positioned to allocate capital rationally and at a minimal cost, he explained. Furthermore, a conglomerate that owns different businesses is in an ideal position: "Without incurring taxes or much in the way of other costs [it can] move huge sums from businesses that have limited opportunities for incremental investment to other sectors with greater promise."<sup>30</sup>

You have probably noticed that with his decision about Berkshire Hathaway, Buffett had pulled away from the stock-picking methods taught by Ben Graham. Maximizing long-term capital gain was not a Ben Graham strategy. His approach to buying stocks was to keenly focus on cheap stocks based on hard assets with limited downside price risk. Once the stock price reset back to fair value,

Graham would quickly sell and move on to the next investment. The idea of compounding an existing position over several years was not part of his calculation. In fact, the word *compound* appears nowhere in *Security Analysis* or *The Intelligent Investor*.

By contrast, even in the earliest years of his partnership Buffett was writing about the “Joys of Compounding.”<sup>31</sup> In the 1963 Buffett Partnership letter to his partners, he relayed the story of Queen Isabella underwriting the voyage of Christopher Columbus for \$30,000. He pointed out that if that investment compounded at 4 percent, it would have been worth \$2 trillion 500 years later. Year after year, Buffett would school his partners on the wonders of compound interest, a mathematical concept discovered almost 300 years earlier (1683) by the Swiss mathematician Jacob Bernoulli. Buffett pointed out that a \$100,000 investment compounded at 4 percent becomes \$224,000 in 30 years but \$8,484,940 when compounded at 16 percent. His advice: live a long life and compound money at a high rate.

However, we should not forget that the partnership years, and Graham’s influence thereon, are critical to the story of Warren Buffett. He grew the Buffett Partnership assets by perfectly executing Graham’s stock-picking methodology. Its success helped to build Buffett’s net worth, and the yearly performance bonus added to his financial security. That enabled him to provide a solid financial foundation for his family. But once their financial future was secured, the question became, what next?

One option was to continue the partnership. Keep on buying and selling stocks each year, paying commissions and taxes along the way, always having to navigate the rocky shores of overpriced markets. The other was to change vessels and chart a new course.

In 2023 Berkshire Hathaway, once a modest New England textile manufacturer, had a market value of \$744 billion. It was the ninth-largest company in the world. The original A shares, which Buffett purchased in 1962 at \$7.50, trade for \$517,917. What is spectacular about this achievement is that Berkshire Hathaway reached this milestone not by discovering a blockbuster drug or inventing a new technology but rather perfecting an older miracle—the 17th-century idea of financial compounding.

