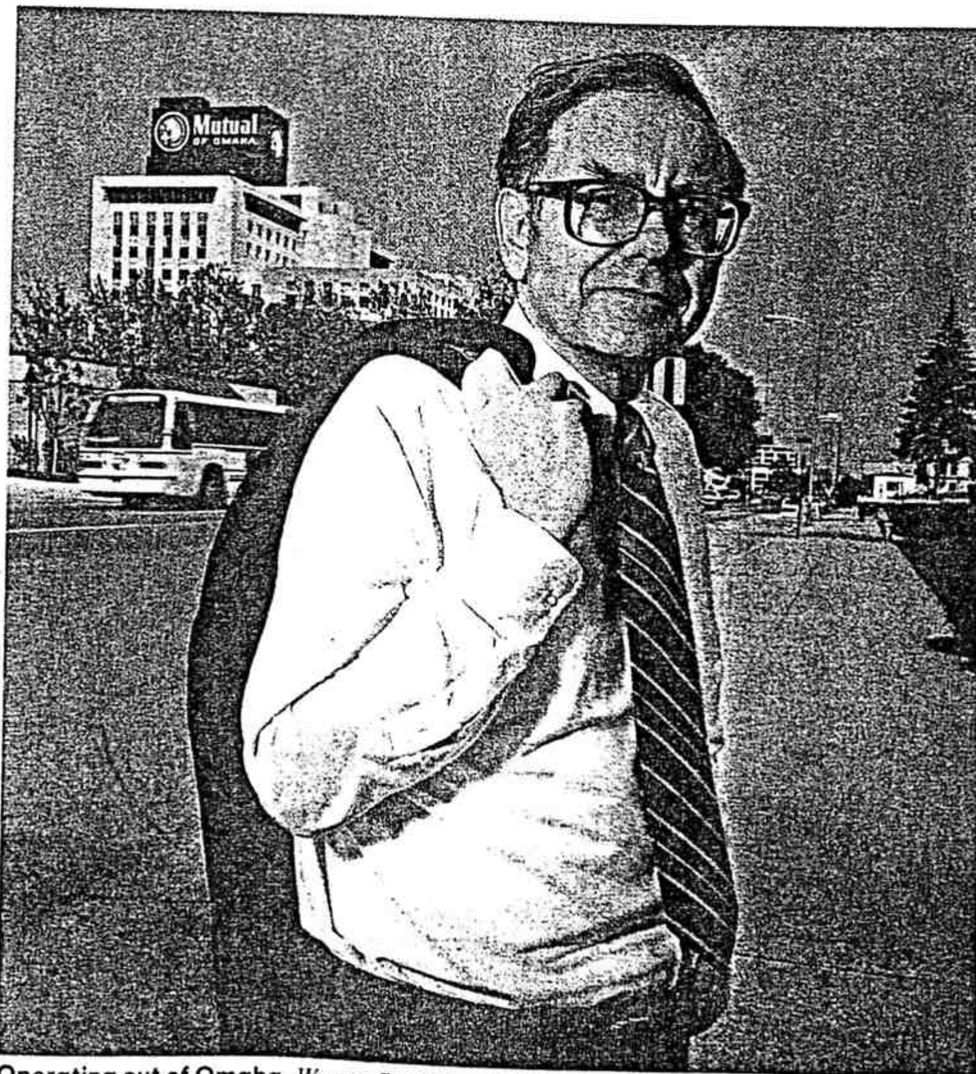
LETTERS FROM CHAIRMAN BUFFETT

Berkshire Hathaway shareholders have come to expect two things of their annual report: good news (book value has increased from $19 to $737 per share in the last 18 years) and the unorthodox letter of their chairman, Warren Buffett (who took over 18 years ago). Indeed, the chairman's letter practically *is* the Berkshire Hathaway annual report.

Shareholders get no photographs, no colored inks or foil embossing, no bar charts or graphs—not even a logo. It looks like the kind of annual you see from a company whose bubble has finally burst, only Berkshire Hathaway, an insurer with major holdings in several other industries, is no bubble; at $955 a share, up from $85 six years ago, it shows no signs of bursting.

THE CONVENTIONAL WISDOM in reading annual reports is to glance at the auditor's opinion, then check the financial results and the footnotes. The chairman's letter? Save your time. Yet such interest are Warren Buffett's letters that they have drawn a sophisticated following. Requests for reprints even! The company has assembled a compendium of the past to meet the demand.

"They're wonderful," says Leon Levy of Odyssey Partners, no minor Wall Street legend himself, whereupon he recounts the passage in the last letter that most amused him—the one in which Buffett says he wouldn't have wanted any part of the acquisitions most others were making in 1982. "For many of these acquisitions," Buffett writes, "managerial intellect wilted in competition with managerial adrenaline. The thrill of the chase blinded pursuers to the consequences of the catch. Pascal's observation seems apt: 'It has struck me that all men's misfortunes spring from the single cause that they are unable to stay quietly in one room.' (Your chairman left the room too often last year and almost starred in



Operating out of Omaha, *Warren Buffett has hit Wall Street for half a billion.*

PHOTOGRAPH BY DAN BUDNIK—WOODFIN CAMP

the Acquisition Follies of 1982. In retrospect our major accomplishment of the year was that a very large purchase to which we had firmly committed [fell through] for reasons totally beyond our control. Had it come off, this transaction would have consumed extraordinary amounts of time and energy, all for a most uncertain payoff. If we were to introduce graphics to this report, illustrating favorable business developments of the past year, two blank pages depicting this blown deal would be the appropriate centerfold.)"

"I love that," beams Levy.

Buffett himself says he tries to talk to shareholders as if they were his partners. "I assume I've got a very intelligent partner who has been away for a year and needs to be filled in on all that's happened." He also assumes little turnover among his 2,000 shareholders. "Rather than repeat the same things each year," he says, "I take up topics that further their education." It is an exercise he seems clearly to enjoy—the letters, currently running around 12 printed pages, get longer every year. (The other extreme may have been reached last year by Wisconsin banker Jack Puelicher, another iconoclastic C.E.O., whose letter to Marshall & Ilsley shareholders read, in its entirety: "Your company had a very good year in 1982. Some of it was due to luck; some of it was due to good planning and management. We hope you enjoy the numbers and the pictures.")

BUFFETT'S ATTENTION to his letters was sharpened by his service on an SEC panel formed in 1976 to study disclosure practices. (The committee issued a 1,200-page document that concluded the disclosure system was basically sound.) Former SEC Commissioner A. A. Sommer Jr., who chaired the committee—himself a Berkshire Hathaway shareholder—says the group felt such letters were very important. Even so, he adds, "Warren's letters are unique. Damn few C.E.O.s are as smart in as many ways as Warren. It would be awfully hard to require that kind of discussion from all C.E.O.s."

Does Buffett ever take on unorthodox subjects in his letters? Yes, he responds, he discusses his mistakes.

"The textile business again had a very poor year," he reported in 1977. (When Buffett first took over Berkshire Hathaway in 1965, that's *all* it was—a New Bedford, Massachusetts, textile manufacturer.) "We have mistakenly predicted better results in each of the last two years. Many difficulties experienced [have been] due primarily to industry conditions, but some of the problems have been of our own making."

ANDREW TOBIAS's books include *Fire and Ice, The Only Investment Guide You'll Ever Need, Getting By on $100,000 a Year,* and *The Invisible Bankers.*

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"We continue to look for ways to expand our insurance operation," he wrote his shareholders in 1979, "but your reaction to this intent should not be unrestrained joy. Some of our expansion efforts—largely initiated by your chairman—have been lackluster, others have been expensive failures."

Buffett downplays the excellence of his own efforts but, like a proud coach, highlights it in his players. Berkshire Hathaway owns a big chunk of Geico, the auto insurer, and of that company's brass he writes: "Jack Byrne and Bill Snyder are achieving the most elusive of human goals—keeping things simple and remembering what you set out to do."

And of an 81-year-old subsidiary chief, since deceased: "Our experience has been that the manager of an already high-cost operation frequently is uncommonly resourceful in finding new ways to add overhead, while the manager of a tightly run operation usually continues to find additional methods to curtail costs, even when his costs are already well below those of his competitors. No one has demonstrated this latter ability better than Gene Abegg."

Here and there notes of sentimentality pop up, but if Buffett wants to say something a little silly about the Washington Post Co., for which he delivered papers at the age of 13, or Geico, which first caught his eye at 20, it should be remembered that Berkshire's holdings in the one have risen in value from $11 million to $103 million and in the other from $47 million to $310 million, both in under a decade. So he can say what he likes.

Happily, he says it with a sense of humor. "In a characteristically rash move," he writes, "we have expanded World Head[illegible] ters by 252 square feet (17%), coincic[illegible] with the signing of a new five-year le[illegible] World Headquarters—in Omaha—hous[illegible] addition to Buffett, five other people[illegible] compact organization lets all of us spen[illegible] time managing the business rather than [illegible] aging each other.")

Most chairmen's letters describe hov[illegible] everything went, under the circumsta[illegible] hoping the shareholders will buy it. Bu[illegible] stress the negative, knowing that they v[illegible]

In the most recent report, immediate[illegible] ter observing that Berkshire Hathaway[illegible] year rise in book value represents a [illegible] compound annual rate of growth, he [illegible] "You can be certain that this percentag[illegible] diminish in the future. Geometric pro[illegible] sions eventually forge their own anch[illegible] (He's right, of course. Maintaining tha[illegible] for another 18 years would mean grow[illegible] book value to $22 billion and, after 18 [illegible] more, to nearly $1 million per share.) [illegible] when stating the paper gains in the [illegible] shire Hathaway portfolio—up 40% in 1[illegible] he is careful first to subtract the taxes[illegible] would be paid if those gains were take[illegible]

To be sure, it's easy to be candid and[illegible] deprecatory when any fool can see [illegible] you're terrific. What may be a tad galli[illegible] some of his peers is that Buffett's lette[illegible] view not only his own performance and[illegible] takes but those of the rest of the na[illegible] managers as well. "There are indicati[illegible] he writes, "that several large insurers [illegible] in 1982 for obscure accounting and rese[illegible] maneuvers that masked significant de[illegible] ration in their underlying businesses. [illegible] surance, as elsewhere, the reaction of [illegible] managements to weak operations is [illegible] weak accounting." His recurring them[illegible] rights of shareholders, as trampled on [illegible] many other managers.

WELL KNOWN are the corp[illegible] managers who fight herc[illegible] to fend off generous tend[illegible] fers. Less sharply perceive[illegible] the managers who pay too much to gr[illegible] acquisition. "Managers who want to e[illegible] their domain at the expense of owners,'[illegible] fett chides wryly, "might better cons[illegible] career in government."

It's even worse, in his view, when t[illegible] quisition is made with stock, because t[illegible] quirer's stock so often sells in the mark[illegible] a discount to its true value. "The ac[illegible] who nevertheless barges ahead is usi[illegible] undervalued currency [his stock] to pa[illegible] fully valued property ... Friendly i[illegible] ment bankers will reassure him as t[illegible] soundness of his actions. (Don't ask th[illegible] ber whether you need a haircut.)"

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In light of the enormous premium required to buy *all* of a company, Buffett's strategy has been one of partial acquisition. Where another company will bid $48 a share for all of a company whose shares were yesterday selling at $25, Buffett is content to buy quietly at $25. "What really makes us dance," he admits, is to buy 100% of a business at a good price, but that is awfully hard to do. And so it is that at year's end Berkshire Hathaway owned, among other holdings, chunks of Blue Chip Stamps (60%), Geico (35%), General Foods (4%), precious metals fabricator Handy & Harman (17%), R.J. Reynolds (2.7%), Interpublic (15%), Ogilvy & Mather (9%), Time Inc., publisher of FORTUNE (2.7%), and the Washington Post Co. (13%).

Berkshire Hathaway's reported earnings include its share of the earnings at Blue Chip Stamps—which it is merging with—but only the dividend income from the other companies in its investment portfolio. So Buffett must each year remind shareholders that reported profits exclude a large portion of true earning power. "This is not a criticism of accounting procedures," he hastens to add. "We would not like to have the job of designing a better system. It's simply to say that managers and investors alike must understand that accounting numbers are the beginning, not the end, of business valuation."

LAMENTING the complexities of accounting, he reveals that "the Yãnomamö Indians employ only three numbers: one, two, and more than two. Maybe their time will come."

Because of the growing importance of the company's nonconsolidated holdings, Buffett argues, it's no longer appropriate for shareholders to gauge Berkshire's performance by the ratio of reported earnings to equity, as until recently he had been advising they should. But then he adds: "You should be suspicious of such an assertion. Yardsticks seldom are discarded while yielding favorable readings. But when results deteriorate, most managers favor disposition of the yardstick rather than disposition of the manager. To managers faced with such deterioration, a more flexible measurement system often suggests itself: just shoot the arrow of business performance into a blank canvas and then carefully draw the bull's-eye around the implanted arrow. We generally believe in pre-set, long-lived, and small bull's-eyes."

One of the bull's-eyes he considers notably unimpressive is the widely trum achievement of "record earnings." ' all," he explains, "even a totally do savings account will produce steadily interest earnings each year becau compounding."

It's no surprise that Buffett would ch on shareholders' rights; at 52, he has been a professional shareholder himsel and his wife own shares in Berkshire H way recently worth $460 million, and I shire Hathaway is itself largely in the ness of owning shares.

Author Jerry Goodman, in *Supermon* bels Buffett "easily the outstanding m manager of the generation," noting tl partnership he began in 1956—and ha consummate foresight to close dow 1969—achieved a compound annual gr of 31%. "What was more remarka writes Goodman, "was that he did it wit philosophy of another generation ... pure Benjamin Graham, applied with a lute consistency." The late Benjamin ham, of course, authored *The Intelligen vestor,* in print almost continuously s 1949. Buffett chose Graham as a me (and, years later, Graham chose Buffet help revise his book).

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Although Graham and Buffett did not ree in all things, their common perception is to buy assets so cheaply that, over time, ey could hardly fail to profit. This approach lls for a level head and hard work. "The arket, like the Lord," Buffett writes, elps those who help themselves. But, une the Lord, the market does not forgive ose who know not what they do."

Buffett's strategy of partial acquisition akes sense when companies are selling in e marketplace at a substantial discount to eir true value as ongoing businesses, but ot when the market, as it periodically does, mps over the moon. In 1972, with Avon d the rest selling at 60 times earnings, erkshire had only 15% of its portfolio in eqties, vs. 80% at the end of 1982. "There ere as many good businesses around in 72 as in 1982," he writes, "but the prices e stock market placed upon those busiesses in 1972 looked absurd." Should the ock market keep climbing, he warns, Berkire's "ability to utilize capital effectively in rtial-ownership positions will be reduced eliminated. We currently are seeing early aces of this problem." (Damn—another ll market.)

One problem all Buffett's letters address is the state of the property/casualty insurance industry—his core business. "For much of this century," he writes, "a large portion of the industry worked, in effect, within a legal quasi-administered pricing system fostered by insurance regulators. While price competition existed, it was not pervasive among the larger companies." That gentlemanly day, says Buffett, is gone. "Although parts of the old structure remain ... the new capacity is not reluctant to use price as a prime competitive weapon. Indeed, it relishes that use. In the process, customers have learned that insurance is no longer a one-price business. They won't forget."

It is Buffett's plan to live with low volume while he waits for the shakeout that will cause prices to firm.

HE IS LESS CONFIDENT, letter after letter, of the prospects for the textile industry—a capital-intensive commodity business in which periods of tight supply, and hence decent prices, come around only rarely (and then last only "the better part of a morning"). Out of loyalty to his employees, however, and perhaps out of a certain nostalgia for Berkshire's roots, Buffett steadfastly refuses to abandon this business. Such behavior might seem to flout the interests of Berkshire shareholders—only, with 47% of the company stock, Buffett is able to summon a majority vote for this policy, or any other, practically all by himself. Even so, he assures his shareholders, it's not the kind of business he is eager to enter in the future.

Among the final notes in Buffett's letters is a virtual BUSINESSES WANTED classified. It tells a lot about how Warren Buffett operates. Berkshire Hathaway, Buffett writes, is looking for large, simple businesses ("if there's lots of technology, we won't understand it") with consistent earning power, little debt, management in place ("we can't supply it"), and an offering price ("we don't want to waste our time or that of the seller by talking, even preliminarily, when price is unknown.") "We will not engage in unfriendly transactions. We can promise complete confidentiality and a very fast answer as to possible interest—customarily within five minutes."

■ To write an interesting chairman's letter, it helps if you are a chairman with interesting ideas. Buffett's is a refreshing style in business as in prose. ■