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Outstanding Investor Digest

PERSPECTIVES AND ACTIVITIES OF THE NATION'S MOST SUCCESSFUL MONEY MANAGERS.

Volume V Number 3 April 18, 1990

Investors featured in this Issue:

Other Investors in this Issue:

Companies & Investments in this Issue:

AN OPINION SAMPLER FROM OID'S MAILBAG: BRANDYWINE FUND'S FOSTER FRIESS ET AL & LEGG MASON'S ERNIE KIEHNE.

Here's a sampling of recent opinions and ideas from a couple of money managers we follow as excerpted from their most recent letters to limited partners, shareholders and other clients together with *Portfolio Reports'* estimates of their latest stock purchases:

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HRK ENTERPRISES' HAL KELLMAN "SEPARATING COMPUTER CHIPS FROM POTATO CHIPS. THE TURN IN TECHNOLOGY STOCKS HAS ONLY BEGUN."

Hal Kellman is the classic dedicated engineer down to the plastic pocket protector loaded with pens and pencils. However, unlike most engineers, Kellman has utilized his insights for the benefit of a select group of investment clients.

Over the past 21 years, those clients have earned a compound return of approximately 23.3% per year vs. 10.5% per year for the S&P 500. Here are Kellman's annual return

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BERKSHIRE HATHAWAY'S WARREN E. BUFFETT LESSONS FROM THE MASTER — MARCH 23, 1990 "IF YOU'D LIKE TO PILE UP MONEY, HERE'S THE RECIPE: FIND YOUR CIRCLE OF COMPETENCE & STAY WITHIN IT."

If any money manager has been more successful than Warren Buffett, we're not aware of it. Each $10,000 invested in Buffett Partnership, Ltd. in 1956 and reinvested in Berkshire Hathaway stock at the Partnership's termination in 1969 would today be worth well over $25 million after all fees and expenses. (The investor would have incurred only about $50,000 in income taxes during the entire 33 years.)

Amazingly, those figures substantially understate Buffett's performance. Before fees, we estimate the $10,000

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TIGER MANAGEMENT'S PAT DUFF "JUNK HAS TO BE BETTER THAN EQUITY FOR US TO BUY IT. HERE ARE SOME DEFINITELY WORTH BUYING."

Julian Robertson's Tiger Fund has compounded its equity capital at approximately 40% per year since its inception on May 5th, 1980 — earning it a spot in the top 1% of equity funds for any period you might wish to consider. After fees, limited partners have earned over 30% per year.

In 1989, Tiger did even better, earning over 62% on its equity capital — with limited partners earning 49.9% after all fees and expenses.

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BERKSHIRE HATHAWAY'S WARREN E. BUFFETT
LESSONS FROM THE MASTER
(cont'd from page 1)

would have grown to a hard-to-believe $45 million.

This issue, we're pleased to bring you excerpts from a guest lecture by Buffett to a class at Stanford Law School. The course, "What Every Lawyer Should Know About Business" is the brainchild of Buffett's longtime partner, Charlie Munger. It is believed to be the only course at any law school teaching exclusively business.

Munger conceptualized the course, funded a chair at Stanford Law School for the purpose of teaching it and assisted in the selection of Professor William Glikbarg — an ex-classmate at Harvard Law School — to teach it and serve as acting holder of the chair.

In addition, we're pleased to bring you excerpts from Buffett's latest letter to Berkshire shareholders. Regarded by many knowledgeable observers as the finest and most enjoyable business writing to be found anywhere, it's been suggested (and we would concur) that a careful reading of his letters is more valuable than two years at a leading business school.

The following excerpts were selected from Buffett's lecture at Stanford Law School on March 23, 1990:

Business & investments — interrelated parts of one whole.

"We're going to talk for a little while this morning about business and investments. People tend to think of them as belonging to two different categories."

"But there is a lot of commonality. They interact with each other. You're a better businessman if you understand investment principles and you're a better investor if you understand business principles."

"I've been fortunate to have a leg in both fields now for a good many years."

Investing is not quantum physics. Keep it simple.

"Investing seems fairly simple. And it's really true — it is quite simple. People make it a lot more complicated. You do not need to know any advanced mathematics or even intermediate mathematics to be a good investor. You do not have to have very good insights about technology."

"In the end, you have to be able to understand something about as complicated as why people drink Coca Cola and whether they're likely to keep doing it, what's happened over the last 100 years and what's likely to happen over the next 100 months. It's not very complicated."

"You don't need to go to business school to be a good

(continued in next column)

investor. You probably don't even need to go to college...."

The business makes the manager.

"...[W]hen you're in an easy business, you're going to look like a genius. If you're in a tough business, you're going to look like a dolt. Having had that insight — after only 23 or 24 years — I got out of the textile business."

Want to pile up money? Stick to shooting fish in a barrel.

"About 99% of American management thinks that if they're wonderful at doing one thing that they'll be wonderful at doing something else."

"They're like a duck on a pond when it's raining — they're going up in the world. They start thinking that they're the ones that are causing themselves to rise. So they go over to some place where it isn't raining and they just sit there on the ground. But nothing happens."

"Then they usually fire their number two in command or hire a consultant. They very seldom see that what really happens is that they have left their circle of competence."

"We had a woman who was 95 running a business for us — Mrs. Blumkin — who left us this year. She's now 96 and she went into business against us and she's plenty tough. She operates out of a golf cart. And she operates seven days a week from morning to night. She is terrific."

"She is extraordinary at one thing. She came over from Russia, landed in Seattle with a tag around her neck and couldn't speak any English. She can't speak very much English now and she's been here 77 years. But she used to run her ads and invite people to buy her bargains — and you'd almost need subtitles. But she's dynamite."

"She started Nebraska Furniture Mart with $500 about 52 years ago and it earns about $17 million pre-tax now. She could read numbers, but she couldn't read or write. She doesn't know what accruals are — she doesn't know anything about accounting."

"But if you told her what the size of this room was — even though it's not square or rectangular — she would probably be able to tell you how many square yards of carpeting were here. And she would do the extension — multiply it by $7.98 a yard, add the sales tax and knock off something for you — and she'd be right."

"She is very smart, obviously. But on top of that, she is perfect at defining her circle of competence. If you want to sell her 2,300 end tables, she will know in a minute what she can pay, how fast she can move them, the whole thing. And she'll buy them from you."

"She'll wait until just before your plane is going to leave in some blizzard when you have to get the hell out of Omaha and can't afford to miss your flight. She will be very tough in dealing with you."

"She will know exactly what she can do with it and exactly what price she needs to pay. And she won't be wrong. She won't be wrong on real estate. She won't be wrong on credit checking."

"But if you get one inch outside of her circle of competence — if you try to talk about stocks, she's not going to put 10¢ into it. She knows she doesn't know. And she knows exactly where that line is."

"She'll buy a $5 million building by eyeballing it — and pay cash. But she won't go one inch outside to do any kind of business that she doesn't know anything about."

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BERKSHIRE HATHAWAY'S WARREN E. BUFFETT
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"And that is a smart woman. And that is why she has killed everybody else. She started with nothing. And she's putting everybody else out of business in Omaha. They brought her in on a fair trade violation. In fact they did it four times. And she represented herself."

"She went in and told the judge, 'Look. Everybody is selling this stuff for $7 a yard. It costs me $3 a yard. I can sell it for $4 a yard for profit. Now you just tell me how much you want me to rob people. If you want me to rob them of 98¢, I'll sell it for $4.98. If you want me to rob them of $1.98, I'll sell it for $5.98.' "

"The judge ended up buying $1,400 worth of carpet."

The Peter Principle at work — with lots of zeros.

"But it's a really rare quality. If you take the CEOs of America's largest corporations, they do not know what their circle of competence is. That's one of the reasons they make so many dumb acquisitions. They rise to the top of the business because they're great salesmen, great production people or whatever."

"All of a sudden, they're running a multi-billion dollar business and their job is to allocate capital and to buy businesses. They've never bought a business in their life. They don't know what it's all about."

"So they usually do one of two things. Either they set up an internal department, hire a bunch of guys and have them tell him something to do. Of course, the guys know if they don't tell him something to do, then there will be no jobs. So you can imagine what activity takes place then. Or they go out and hire investment bankers who get paid by the transaction."

There are a lot of things I can't do. So what.

"We won't do anything that we don't think we understand ourselves. Now we may be wrong. But we will never go into something because we had Arthur D. Little or Booz Allen or McKinsey come and tell us what a wonderful business it is or analyze it for us. Because if we don't know enough to make the decision ourselves, we don't want to be involved at all. Period."

"We never get any other opinions. It's always just the two of us ourselves — Charlie and me. It's kind of dangerous that way — our minds work so similarly."

"But we're perfectly willing to pass on the 90% of the things in the world that we can't evaluate. But so what. I can't play pro football, either. There are a lot of things I can't do...."

"Our circle of competence has not widened enormously as the years have gone by. So we wait. If we wait one year, if we wait five years, that's not a problem."

"It's still restricted by the fact that Charlie and I can only understand a small percentage of all businesses. So if there are 1,700 or 1,800 companies listed on the New York Stock Exchange, we can't understand most of them."

"If I studied IBM or General Motors intensely for a year, I'd know more about them in a superficial sense but I still wouldn't know enough to make an intelligent decision."

Draw a circle of competence and stay well inside the line.

"If we don't understand a business ourselves, we don't buy it. I don't even know what a personal computer is. I don't have the faintest idea who makes the best personal computer. But even if I did, I wouldn't know who would three years from now."

"But I do know what the number one chocolate bar will be three years from now — and so do you. You may also know what the number one personal computer will be three years from now. But I won't have the same degree of confidence in that decision no matter how much you try and tell me about it."

"It's a question of drawing a circle of competence. And if there's a question, leave a margin of error. Stay well inside the line."

"Take the case of the car business. If you'd taken the heads of the five largest auto companies in 1970, 1975, 1980 and 1985 and put them under sodium pentothal and have them tell you who they thought would be number one 5 years later — or even 2 or 3 — they would have been way off. You can't know that much about certain things."

"You can't make money playing various games with those things because you'll never be sure. I'd rather wait for something I'm sure about. While you're never 100% sure about anything, ... things [will be] served up to you on a platter [from time to time]."

"Our problem is size. We aren't going to get remotely as many things served up to us on a platter as we would if we had $10 million or even $100 million. But something will come along from time to time."

"At the business school, I tell them that they would all be better off if when they got out of school somebody gave them a card with 20 punches on it. And every time they made an investment decision, they used up a punch. So they only got 20 for their lifetime. They'd make a lot of money, because every decision they make would be good."

"But you've got all these stocks listed on the stock exchanges. Every day, you can buy AT&T, General Motors or U.S. Steel or you can sell them short. You can make either decision about the business and then make that bet. Most people feel that because all those opportunities to make those decisions are there, they should make the decision. That we don't do."

"We wait for something that seems obvious. But the whole mechanism of Wall Street is saying, 'Do something. Do something.' Activity is the mother's milk of Wall Street." People have this whole different attitude just because there's a little number up there flashing around all the time. It makes them think they have to do something."

"People would be way better off if they closed the stock exchange down periodically."

We prefer to leave empire building (and work) to others.

"One advantage that we have over many managers is that we are willing to buy parts of businesses. The average manager only wants to buy all of a business or something he can manage himself. So he's restricted to what is for sale or what he can do a hostile offer for."

"We own 7% of the Coca-Cola Company. That means that our market share at Berkshire Hathaway of worldwide soft drink sales is 3%. Nobody thinks of that. But we currently have the third highest market share as a company

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BERKSHIRE HATHAWAY'S WARREN E. BUFFETT
LESSONS FROM THE MASTER
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of anyone — with 7% of Coke's 45%."

"The average manager does not want to buy Coca-Cola — even though it may be the best business in the world — because it doesn't do anything for him. He's got no more people reporting to him, his office can't be bigger, nothing can happen. It doesn't look very manly. So he's restricted from buying that business — even if he thinks it's the best."

"So he goes down the line and looks at what's for sale or what he can make a hostile offer for. If he makes a hostile offer for it, he's going to buy it in a market which is an auction market, where everybody in the world is going to be competing against him. In that kind of environment, he's going to pay the absolute top tick to buy that business. He is not going to get a good buy that way."

"And he's not going to get the best company. We can buy the best businesses in the world — we just can't buy all of them. That doesn't make any difference to me."

"I would rather have the other fellow do the work. I mean any guy who'll have a 95-year-old woman work for him seven days a week has no shame at all."

"I am perfectly willing to have Roberto Goizueta and Don Keough go out and preach Coke all over the world. They sell 600 million 8-ounce servings of soft drinks a day. If we own 7% of it, that means 42 million servings a day for us. If they were spread evenly all over the world, ... while I sleep, 14 million people are drinking our products."

"And there is no substitute, basically. In this country, Pepsi-Cola and Coke are sometimes interchangeable. In fact, there are these enormous price wars. But around the world, that is not true. This is the leading product in 155 countries and growing in market share every year. We do not have people out there going out and buying the cheapest soft drink. It just doesn't happen."

"And we can own part of that business. We can't own all of it. But I'd rather own part of a wonderful business at a reasonable price than own all of a business that I bought in a competitive auction based on what is for sale at a particular point in time. It's an enormous advantage."

Berkshire's preferred investments.

"In this country, there are very few people who actually put a lot of their own money into any business. There are a (continued in next column) lot of people putting other people's money in."

"But with Charlie and me, they're getting two people who are putting a very significant amount of money up compared to almost any individual investor you see in the United States. It's very hard to think of a company — other than where people are involved in their own businesses — where they own those kinds of stakes in other companies and sit there over a period of time without attempting to take control."

"And they get somebody who will have a lot of money up who will care about the longer term success of the business who is not wedded to the decisions of the past or the circle that they happen to be operating in."

"This can be of some value. In a sense, if they use us right, they get what I get working with Charlie [Munger]. Charlie isn't active all the time. But Charlie is the best mind I could possibly test things out on. He's got his money in Berkshire — and it wouldn't make any difference if he did or did not — and he will tell me exactly what he thinks about any idea that comes along. Most of them he doesn't like."

"But we can be useful to companies — more useful to some than others."

Our preferred deals benefit common shareholders most.

"...Essentially, we've got preferred stock that averages about 9% pre-tax. That's a little under 8% after-tax. If Berkshire earns 8% after-tax on capital, it won't be a very good business. So there has to be some possibility that the common stock is going to go up."

"We do have the advantage of yield and we do have the advantage of a mandatory redemption in ten years or so. So there is a time when we can get out at our cost."

"But beyond that, we don't get anything like a control position. We've got a standstill on all these positions that prevents us from buying a controlling position. We don't control those companies and don't want to."

"If the common stock doesn't go up, we'll have gotten some extra yield. If the common does go up, we will not have made as much as the shareholders made on the common stock because convertibles never do. If we make money on the common stock, the common stockholders will make even more money."

"...[However,] if I owned 1% of another company and Charlie wasn't associated with us, I'd like him to have our preferred positions — because he'd have a lot of his own money up and he'd have a lot of votes...."

"If I owned the common and he owned the preferred, I'd make more money out of the common. On the upside, I would make more than he'd make. On the downside, he would be significantly more protected — by a wide margin."

How times have changed.

"I just stuck one other illustration in here. It comes from the 1957 prospectus when Capital Cities went public. I'm not 100% positive of this because I haven't checked it, but to the best of my memory this is the only public offering ever made by Cap Cities. This is when they raised their [initial] money publicly."

"They got some money from Lowell Thomas and a few people at one point and from us when they merged with ABC, but I think this was the only public offering."

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BERKSHIRE HATHAWAY'S WARREN E. BUFFETT
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"What's really entertaining is the fact that it took two underwriters to put together this $299,000 offering: Harold C. Shore — which I'm sure is a household word — and First Securities in Durham, North Carolina. It's almost unbelievable — the total underwriting commission was $6,500 for the two companies. For all you hear about Wall Street and greedy investment bankers, at least it didn't prevail in 1957 for Cap Cities' offering."

"You'll see that I've recapped the situation in 1957 when Cap Cities went public, comparing CBS and Cap Cities. And you'll see that CBS was doing almost $400 million [in sales] and Cap Cities was doing less than a million. You'll see that Cap Cities had $102,000 in the bank and CBS had $46 million."

"CBS had a network and all these stations and Cap Cities' first station in Albany used to be a home for retired nuns. They used the place where they prayed as their studio. The place was such a dump that the directors insisted one time that Murph [CEO Thomas Murphy] paint it. So he came back the following month and painted the side that faced the road. There was one news truck but it was labeled Truck #6 or something like that."

Of television, CBS and Tom Murphy.

"Television was destined to be a marvelous business. For a long time, there were only these three electronic highways [the three networks]. Anybody that wanted to talk to the American public en masse or any significant fraction thereof only had three channels. That was a great time to be in it. It's not so great now but it was terrific then."

"It was strictly a distribution channel. Distribution channels can make a fortune or nothing depending on how many channels there are. If there's one pipeline in between, you can make a fortune. And that's what you are, for example, in the case of a daily newspaper. If there are a bunch of pipelines, you won't make anything. It's a very interesting business in that way."

"But anyway, here were two companies in a wonderful business — CBS with all the resources and Cap Cities on with nothing but a guy named Tom Murphy. It was like two people embarking from London to New York — one on a leaky rowboat and one on the QE II. They both arrived in New York some years later. Basically, the guy with the rowboat got there first with considerably more cargo on board than did the guy on the QE II."

"But it's interesting. You never will find a better manager in the world than Tom Murphy. He's number one. He was in a wonderful business and he accomplished an enormous amount...."

The limits of price-based competition.

"We bought See's Candy in 1972. They were selling candy for $2 a pound. Today they're selling it for $8 a pound."

"Can you imagine coming home on Valentine's Day and saying, 'Honey, here's a box of candy. I took the low bid. I got it for $2.85 a pound in a back alley. You'd better wash it off before you eat it.' "

"There isn't a price competitor who can crack that [market] basically — particularly in terms of the gift aspect."

"Do I want to go into a drug store and buy an unmarked thing that just says 'Chocolate Bar' because it's a nickel cheaper than a Hershey Bar? Generic chocolate bars are just not going to work. If they don't have a Hershey Bar, I'll walk across the street."

"They don't have a problem with distribution. I could put out Buffett's Candy Bar and nobody would buy it. There's no way I could crack Hershey's market. Take the top candy bars today and 20 years ago and you'll see they're virtually the same."

"Yet Mars is trying to figure out how to beat Hershey and vice versa. Cadbury comes over to this country and tries to figure out how to knock 'em off. It isn't that people don't try. They just can't do anything about it."

The fewer assets required, the more the company is worth.

"*The Daily Racing Form*, *TV Guide* and *Seventeen Magazine* sold for $3 billion about a year and a half ago. They had almost no tangible assets. But they had this one small castle — *The Racing Form* — surrounded by a huge moat, and a very big castle — *TV Guide* — surrounded by a huge moat."

"And it's the size of the castle and the width and depth of the moat that determine the value. It had nothing to do with science, the Super Bowl or anything."

"The strange thing — it's a real contradiction — is that if a business is earning a given amount of money and everything else is equal, the less it has in assets, the more it's worth. You won't get that in any accounting book."

"The really desirable business is the one that doesn't take any money to operate because it's already proven that money will not enable anyone to get a position within the business. Those are the great businesses."

"You don't need any money whatsoever in a fabulous business...."

Risk arbitrage — assessing probabilities and outcomes.

"Risk arbitrage is something I've been doing for 40 years now. And my boss, Ben Graham, did it for 30 years before that. Arbitrage has been around since two markets existed anywhere. When there was a wheat market in Omaha and a wheat market in Chicago, if they got out of line, there was arbitrage. That's pure arbitrage — which is done with currencies and commodities."

"Risk arbitrage is done with announced corporate events. Before I came here this morning, I had a call or two from my office which related to two arbitrage activities that we're doing. And they both involve announced events. My job is to assess the probability of those events actually transpiring and the gain/loss ratios."

"So if I think an event has a 90% chance of occurring and there's 3 points on the upside, and there's a 10% chance that it will fall through and there's 9 points on the downside, then that's 90¢ off of $2.70 leaving $1.80 mathematical expectation. Then there's the time involved."

"Those are the mathematics involved. But the real question is assigning the probabilities and understanding the upside and downside."

"That's an investing type function. It isn't investing in the classic sense of trying to figure out what an asset is

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going to be worth over 10 or 20 years. It's appraising the value of something in a very short-term period based on corporate announcements against current prices."

"We do some of that when the deals are right and we don't do any when they aren't. At our size, there may only be 10 or 15 a year that we'll look at. Back when I was a lot younger and before we had all this money. I might look at 100 a year."

[Editor's note: Berkshire subsequently filed a 13-D on Rorer Group — generally agreed to be an arbitrage position.]

Borsheim's is like the Nebraska football team.

"My wife, Susie, can explain the Borsheim's investment to you. She thinks it's the best thing we've got."

[Editor's note: Borsheim's, of course, sells jewelry.]

"Borsheim's doesn't take any time. I spend some time on it because I enjoy it. But it needs me the same way the Nebraska football team needs me on Saturday afternoon."

"But it does not distract me from doing anything else. It does not take money or time away from Coca-Cola."

Size and attention are negatives in investing.

"The limiting factor in Coca-Cola was how much money we could get into it during the period while the price was still attractive to us.... We try to time it in a way, generally, so we can get as much bought before we have to make public disclosures."

"We got close to what we wanted to buy. I would have bought more if we could have bought it at the prices we were paying, but not tons more."

"We started buying in June and we finished in March. It took us 8 or 9 months to buy 7% of an extraordinary company. And the company itself was repurchasing shares at the same time. So between the company and us — and we were obviously working at odds with each other — we bought 12% of the business in that period. It's extraordinary."

"Size and attention are negatives in investing. But it really doesn't make that much difference. It doesn't mess up my personal life at all. It does mean that there's more likely to be piggy backing."

"But the game gets a little more difficult all the time. Size is the bigger problem. It has to be."

Some advice from Buffett that we hope everyone will take.

"We've got a fellow here — who I won't embarrass by pointing out — who will write up any companies I mention and sell that information to other people. And he's here by invitation."

"If you're interested in investments, I'd advise you to subscribe to his publication."

[Editor's note: We're very pleased to report that Buffett was speaking of *OID*. Of course, we hope all non-subscribers will feel free to piggy back this one idea.]

It's hard to be smarter than your dumbest competitor.

"The 100% [annualized increase on Berkshire's expenditure on their corporate jet] is due to a change in my taste, not due to the appreciation of the aircraft itself. The one we paid $850,000 for, we sold for a million. That reflects the aircraft market. The other is simply an index of my ability to indulge myself."

"The airline business is a terrible business. If 25 years ago, you'd asked what would grow more — the airline transportation business or a bunch of newspapers in Council Bluffs, Iowa and other small cities, you'd say the airline business. The airline business has grown faster — way faster — in terms of unit sales. But it's been about as bad a business as you can think of."

"TWA is one of the oldest carriers in the United States. And it has earned net no money in 40 years. Pan Am and Eastern have earned no money. It isn't because they have paid it out. They just haven't earned it and they carry more passengers every year."

"The airline business is a very tough business. It's capital intensive, it's labor intensive and it's a commodity product. You can't have a worse description than that. All you do is spend money. You never get a chance to breathe. That's the nature of that business, unfortunately...."

"It's going to be price competitive. If someone starts giving frequent flyer coupons, ten more will give them the next day. And if someone starts giving double coupons, ten more will do the same. In a competitive business, you've got to keep matching your competitor — no matter how dumb he is."

"It's like a corner with four gas stations in the old days. If one guy drops his price, the others have to drop theirs five minutes later. [In a commodity business,] it's very hard to be smarter than your dumbest competitor."

"I learned that in business school a long time ago. That's one of the things they taught right."

We don't believe in fooling around.

"When I really want to buy something, my normal feeling is that I'd like to have my entire net worth in it. That's the way we usually feel. When that happens you make a lot of money. Those ideas have crossed a lot of different filters."

"If you take our big ideas versus our small ideas over a 40 year period, just measuring the size of the portfolio and our experience with it, it's been night and day. [Our big ideas have done far better.] That's why you should only have 20 punches on your card...."

"I have people ask me all the time whether or not they should take a flyer on this situation or that one. I've never answered one of those questions yet. The answer is you don't do that."

"Only do things that you want to put a lot of money in. If you don't want to put a lot of money in it, it isn't a good idea. Then you don't want it — period."

"I don't want to buy anything — with the exception of certain arbitrage situations — where I wouldn't want to put 10% of my net worth into it. If I don't want to put that into it, then it just isn't much of an idea."

Why not buy dollar bills for 80¢? Here's why.

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"If you say you want to buy dollar bills for 50¢, you may ask why don't you do more at 80¢. The answer is that you know you get chances to buy more of something at 50¢ — either that dollar bill or something else."

"So you set very wide margins of safety. And those margins of safety do not apply to when you have to sell something out, but they really do apply when you're committing new cash. We do it for additional reasons beyond that but those are the economic reasons."

"You can't be that sure that if you can buy something worth $1.00 for 50¢ that you should sell it at 51¢ and buy something else for 50¢. It isn't that fine-tuned a game unless you're comparing different government bonds or something of the sort. There are wide price areas you get into where you are still comfortable because you know you own something for less than it's worth and you think that the value is going up. But it doesn't have the compelling discount to it that would cause you to reach in your pocket and put fresh money into it."

Cheaper is riskier? Nonsense.

"Charlie and I just don't think modern portfolio theory makes any sense at all. We think it's a lot of nonsense. We don't think we're taking risks. Modern portfolio theory basically involves risk as measured by the volatility of the price action of the stock."

"We bought Washington Post Company at a valuation of $80 million back in 1974. The whole company could have been sold that night for $400 million. It could have been sold to five different people immediately for cash. If you'd asked any one of 100 analysts how much the company was worth when we were buying it, no one would have argued about the fact that it was worth $400 million."

"But they just said it isn't going to go up next week or next month — so they sold the stock. We bought close to 10% of the company in a period of a month or two for a valuation of $80 million."

"Now under the whole theory of beta and modern portfolio theory, we would have been doing something riskier buying the stock for $40 million than we were buying it for $80 million, even though it's worth $400 million — because it would have had more volatility. With that, they've lost me."

"There are situations where risk can be equated with reward. But basically, when you're buying things that are cheap, the fact that they get cheaper — I don't care how fast they do it or anything else — that makes them less risky. There's less risk buying Washington Post at $80 million than $120 million and less risk still at $40 million."

"But it presumes you know what you're doing. The whole theory of modern portfolio theory is that you don't know what you're doing, essentially. It says you don't know anything so here's what you do."

"I've often wondered how they teach a whole course on it. They assume it's an efficient market and they say everything is priced right. How do they hold a class for the rest of the semester? But somehow they do it."

The worst kind of competition — foreign.

"Generally speaking, I don't like to get into businesses that have a lot of worldwide competition for the same reason I told you earlier — because I don't like to get into ones that have domestic competition."

"But it's tougher if they're in worldwide competition. There's a reason why some manufacturing is located over in Taiwan or elsewhere. There may be certain long-term structural advantages. For example, they may have fewer lawyers per capita. Our litigation costs increase the cost of producing widgets. There are all kinds of relative cost differentials that may work against me over the long run."

A grim reminder of what can happen in other countries.

"I prefer businesses domiciled in the U.S. Susie and I each have one share of a stock I bought in 1955. It looked very safe at the time. It was a marvelous stock."

"There's just one problem. Its property is located in Havana and Castro seized it. We can't get title to it. It just sits there. We've got huge claims with the government. And it's never going to be worth anything."

"I keep it around to remind me of what can happen. The rules in other countries can just change overnight."

No hostile takeovers here.

"We only go where we're wanted. I have a number of times told companies when we're buying their stock that I want to buy as much as they're comfortable with. In the case of The Washington Post, for example, Kay Graham got uncomfortable when we got up to 9%. I said, 'OK, we'll never buy another share.' It's that simple."

"I want management to be comfortable, because if they're uncomfortable they may do a lot of dumb things — like issues shares too cheap. I want them to do smart things. Therefore, we will never buy an amount that makes them uncomfortable."

"We usually like to buy all we can up to that point. And I discuss that with them."

Negotiation — Berkshire Hathaway style.

"We handle negotiations way different than anybody. When we bought See's Candy, I spent an hour there. Every business we've bought on one call. On the Borsheim's deal, I dropped over to Ike Friedman's house for half an hour. He showed me some figures that weren't audited penciled on a piece of paper."

"If I need a team of lawyers and accountants, it isn't going to be a good deal.... We've never had an extended negotiation with anybody about anything. That's just not our style. If it's going to be that way, I don't want to deal with them — because it's going to ruin my life sooner or later. So we just walk away."

The following excerpts were selected from Buffett's latest letter to Berkshire Hathaway shareholders dated March 2, 1990:

All good things must end — or at least slow down.

"We face another obstacle: In a finite world, high growth rates must self-destruct. If the base from which the

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growth is taking place is tiny, this law may not operate for a time. But when the base balloons, the party ends: A high growth rate eventually forges its own anchor."

"Carl Sagan has entertainingly described this phenomenon, musing about the destiny of bacteria that reproduce by dividing into two every 15 minutes. Says Sagan: 'That means four doublings an hour, and 96 doublings a day. Although a bacterium weighs only about a trillionth of a gram, its descendants, after a day of wild asexual abandon, will collectively weigh as much as a mountain... in two days, more than the sun — and before very long, everything in the universe will be made of bacteria.' "

"Not to worry, says Sagan: Some obstacle always impedes this kind of exponential growth. 'The bugs run out of food, or they poison each other, or they are shy about reproducing in public.' "

As we get bigger, the fireworks are harder to come by.

"Even on bad days, Charlie Munger (Berkshire's Vice Chairman and my partner) and I do not think of Berkshire as a bacterium. Nor, to our unending sorrow, have we found a way to double its net worth every 15 minutes. Furthermore, we are not the least bit shy about reproducing — financially — in public."

"Nevertheless, Sagan's observations apply. From Berkshire's present base of $4.9 billion in net worth, we will find it much more difficult to average 15% annual growth in book value than we did to average 23.8% from the $22 million we began with."

[Editor's note: While it's no doubt true, Buffett has said this for years. In the meantime, Berkshire Hathaway's net worth and equity valuation continue to grow much like well-fed bacteria.]

Less frenzied approach offers a staggering tax advantage.

"Because of the way the tax law works, the Rip Van Winkle style of investing that we favor — if successful — has an important mathematical edge over a more frenzied approach. Let's look at an extreme comparison."

"Imagine that Berkshire had only $1, which we put in a security that doubled by yearend and was then sold. Imagine further that we used the after-tax proceeds to repeat this process in each of the next 19 years, scoring a double each time. At the end of the 20 years, the 34% capital gains tax that we would have paid on the profits from each sale would have delivered about $13,000 to the government and we'd be left with about $25,250. Not bad."

"If, however, we made a single fantastic investment that itself doubled 20 times during the 20 years, our dollar would grow to $1,048,576. Were we then to cash out, we would pay a 34% tax of roughly $356,500 and be left with about $692,000."

"The sole reason for this staggering difference ... would be the timing of tax payments. Interestingly, the government would gain from Scenario 2 in exactly the same 27:1 ratio as we — taking in taxes of $356,500 vs. $13,000 — though, admittedly, it would have to wait for its money."

Marrying for money — a mistake for most, insane for us.

"We have not, we should stress, adopted our strategy favoring long-term investment commitments because of these mathematics. Indeed, it is possible we could earn greater after-tax returns by moving rather frequently from one investment to another. Many years ago, that's exactly what Charlie and I did."

"Now we would rather stay put, even if that means slightly lower returns. Our reason is simple: We have found splendid business relationships to be so rare and so enjoyable that we want to retain all we develop. This decision is particularly easy for us because we feel that these relationships will produce good — though perhaps not optimal — financial results."

"Considering that, we think it makes little sense for us to give up time with people we know to be interesting and admirable for time with others we do not know and who are likely to have human qualities far closer to average. That would be akin to marrying for money — a mistake under most circumstances, insanity if one is already rich."

A familiar formula for success:

"NFM and Borsheim's follow precisely the same formula for success:

(1) unparalleled depth and breadth of merchandise at one location;

(2) the lowest operating costs in the business;

(3) the shrewdest of buying, made possible in part by the huge volumes purchased;

(4) gross margins, and therefore prices, far below competitors'; and

(5) friendly personalized service with family members on hand at all times...."

A simple objective: To maximize eventual net worth.

"In selecting marketable securities for our insurance companies, we generally choose among five major categories: (1) long-term common stock investments, (2) medium-term fixed-income securities, (3) long-term fixed-income securities, (4) short-term cash equivalents, and (5) short-term arbitrage commitments."

"We have no particular bias when it comes to choosing from these categories; we just continuously search among them for the highest after-tax returns as measured by 'mathematical expectation,' limiting ourselves always to investment alternatives we think we understand."

"Our criteria have nothing to do with maximizing immediately reportable earnings; our goal, rather, is to maximize eventual net worth.

Our investment in Coke — better late than never.

"Our holdings of Coca-Cola increased from 14,172,500 shares at the end of 1988 to 23,350,000. This Coca-Cola investment provides yet another example of the incredible speed with which your Chairman responds to investment opportunities, no matter how obscure or well-disguised they may be."

"I believe I had my first Coca-Cola in either 1935 or 1936. Of a certainty, it was in 1936 that I started buying Cokes at the rate of six for 25¢ from Buffett & Son, the

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family grocery store, to sell around the neighborhood for 5¢ each. In this excursion into high-margin retailing, I duly observed the extraordinary consumer attractiveness and commercial possibilities of the product."

"I continued to note these qualities for the next 52 years as Coke blanketed the world. During this period, however, I carefully avoided buying even a single share, instead allocating major portions of my net worth to street railway companies, windmill manufacturers, anthracite producers, textile businesses, trading-stamp issuers, and the like. (If you think I'm making this up, I can supply the names.)"

"Only in the summer of 1988 did my brain finally establish contact with my eyes. What I then perceived was both clear and fascinating."

"After drifting somewhat in the 1970's, Coca-Cola had in 1981 become a new company with the move of Roberto Goizueta to CEO. ...What was already the world's most ubiquitous product gained new momentum, with sales overseas virtually exploding."

"Through a truly rare blend of marketing and financial skills, Roberto has maximized both the growth of his product and the rewards that this growth brings to shareholders. Normally, the CEO of a consumer products company, drawing on his natural inclinations or experience, will cause either marketing or finance to dominate the business at the expense of the other discipline. With Roberto, the mesh of marketing and finance is perfect and the result is a shareholder's dream...."

Our holdings are vulnerable (& even likely) to decline.

"As I mentioned earlier, the yearend prices of our major investees were much higher relative to their intrinsic values than theretofore. While those prices may not yet cause nosebleeds, they are clearly vulnerable to a general market decline."

"A drop in their prices would not disturb us at all — it might in fact work to our eventual benefit — but it *would* cause at least a one-year reduction in Berkshire's net worth. We think such a reduction is almost certain in at least one of the next three years. Indeed, it would take only about a 10% year-to-year decline in the aggregate value of our portfolio investments to send Berkshire's net worth down."

Corporate transactions in 1989 made no sense to us

"We told you last year that we expected to do little in arbitrage during 1989, and that's the way it turned out."

"Arbitrage positions are a substitute for short-term cash equivalents, and during part of the year we held relatively low levels of cash. In the rest of the year, we had a fairly good-sized cash position and even so chose not to engage in arbitrage."

"The main reason was corporate transactions that made no economic sense to us; arbitraging such deals comes too close to playing the greater-fool game. (As Wall Streeter Ray DeVoe says: 'Fools rush in where angels fear to trade.')"

"We will engage in arbitrage from time to time — sometimes on a large scale — but only when we like the odds."

Our zero coupon bonds harken back to a simpler time.

"Neither our bonds nor those of certain other companies that issued similar bonds last year (notably Loews and Motorola) resemble the great bulk of zero-coupon bonds that have been issued in recent years."

"Of these, Charlie and I have been, and will continue to be, outspoken critics. As I will later explain, such bonds have often been used in the most deceptive of ways and with deadly consequences to investors."

"But before we tackle that subject, let's travel back to Eden, to a time when the apple had not yet been bitten. If you're my age you bought your first zero-coupon bonds during World War II, by purchasing the famous Series E U.S. Savings Bond, the most widely-sold bond issue in history. (After the war, these bonds were held by one out of two U.S. households.) Nobody, of course, called the Series E a zero-coupon bond, a term in fact that I doubt had been invented. But that's precisely what the Series E was."

"These bonds came in denominations as small as $18.75. That amount purchased a $25 obligation of the United States government due in 10 years, terms that gave the buyer a compounded annual return of 2.9%. At the time, this was an attractive offer: the 2.9% rate was higher than that generally available on Government bonds and the holder faced no market-fluctuation risk, since he could at any time cash in his bonds with only a minor reduction in interest."

A benign evolution — bond "stripping".

"A second form of zero-coupon U.S. Treasury issue, also benign and useful, surfaced in the last decade. One problem with a normal bond is that even though it pays a given interest rate — say 10% — the holder cannot be assured that a compounded 10% return will be realized. For that rate to materialize, each semi-annual coupon must be reinvested at 10% as it is received. If current interest rates are, say, only 6% or 7% when these coupons come due, the holder will be unable to compound his money over the life of the bond at the advertised rate. For pension funds or other investors with long-term liabilities, 'reinvestment risk' of this type can be a serious problem. Savings Bonds might have solved it, except that they are issued only to individuals and are unavailable in large denominations. What big buyers needed was huge quantities of 'Savings Bond Equivalents.' "

"Enter some ingenious and, in this case, highly useful investment bankers (led, I'm happy to say, by Salomon Brothers). They created the instrument desired by 'stripping' the semi-annual coupons from standard Government issues. Each coupon, once detached, takes on the essential character of a Savings Bond since it represents a single sum due sometime in the future."

"For example, if you strip the 40 semi-annual coupons from a U.S. Government Bond due in the year 2010, you will have 40 zero-coupon bonds, with maturities from six months to 20 years, each of which can then be bundled with other coupons of like maturity and marketed. If

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current interest rates are, say, 10% for all maturities, the six-month issue will sell for 95.24% of maturity value and the 20-year issue will sell for 14.20%."

"The purchaser of any given maturity is thus guaranteed a compounded rate of 10% for his entire holding period. Stripping of government bonds has occurred on a large scale in recent years, as long-term investors, ranging from pension funds to individual IRA accounts, recognized these high-grade, zero-coupon issues to be well suited to their needs."

One way to avoid default — promise to pay nothing.

"But as happens in Wall Street all too often, what the wise do in the beginning, fools do in the end. In the last few years zero-coupon bonds (and their functional equivalent, pay-in-kind bonds, which distribute additional PIK bonds semi-annually as interest instead of paying cash) have been issued in enormous quantities by ever-junkier credits."

"To these issuers, zero (or PIK) bonds offer one overwhelming advantage: It is impossible to default on a promise to pay nothing. Indeed, if LDC governments had issued no debt in the 1970s other than long-term zero-coupon obligations, they would now have a spotless record as debtors."

Debt becomes something to be refinanced, not repaid.

"This principle at work — that you need not default for a long time if you solemnly promise to pay nothing for a long time — has not been lost on promoters and investment bankers seeking to finance ever-shakier deals. But its acceptance by lenders took a while: When the leveraged buy-out craze began some years back, purchasers could borrow only on a reasonably sound basis, in which conservatively-estimated *free* cash flow — that is, operating earnings plus depreciation and amortization less normalized capital expenditures — was adequate to cover both interest and modest reductions in debt."

"Later, as the adrenaline of deal-makers surged, businesses began to be purchased at prices so high that all free cash flow necessarily had to be allocated to the payment of interest. That left nothing for the paydown of

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debt. In effect, a Scarlett O'Hara 'I'll think about it tomorrow' position in respect to principal payments was taken by borrowers and accepted by a new breed of lender, the buyer of original-issue junk bonds."

"Debt now became something to be refinanced rather than repaid. The change brings to mind a *New Yorker* cartoon in which the grateful borrower rises to shake the hand of the bank's lending officer and gushes: 'I don't know how I'll ever repay you.' "

Ignoring depreciation — a dangerous delusion.

"Soon borrowers found even the new, lax standards intolerably binding. To induce lenders to finance even sillier transactions, they introduced an abomination, EBDIT — Earnings Before Depreciation, Interest and Taxes — as the test of a company's ability to pay interest. Using this sawed-off yardstick, the borrower ignored depreciation as an expense on the theory that it did not require a current cash outlay."

"Such an attitude is clearly delusional. At 95% of American businesses, capital expenditures that over time roughly approximate depreciation are a necessity and are every bit as real an expense as labor or utility costs. Even a high school dropout knows that to finance a car he must have income that covers not only interest and operating expenses, but also realistically-calculated depreciation. He would be laughed out of the bank if he started talking about EBDIT."

"Capital outlays at a business can be skipped, of course, in any given month, just as a human can skip a day or even a week of eating. But if the skipping becomes routine and is not made up, the body weakens and eventually dies. Furthermore, a start-and-stop feeding policy will over time produce a less healthy organism, human or corporate, than that produced by a steady diet."

"As businessmen, Charlie and I relish having competitors who are unable to fund capital expenditures."

Waterfront-style schemes become the norm on Wall Street.

"You might think that waving away a major expense such as depreciation in an attempt to make a terrible deal look like a good one hits the limits of Wall Street's ingenuity. If so, you haven't been paying attention during the past few years. Promoters needed to find a way to justify even pricier acquisitions. Otherwise, they risked — heaven forbid! — losing deals to other promoters with more 'imagination.' "

"So, stepping through the Looking Glass, promoters and their investment bankers proclaimed that EBDIT should now be measured against cash interest only, which meant that interest accruing on zero-coupon or PIK bonds could be ignored when the financial feasibility of a transaction was being assessed. This approach not only relegated depreciation expense to the let's-ignore-it corner, but gave similar treatment to what was usually a significant portion of interest expense."

"To their shame, many professional investment managers went along with this nonsense, though they usually were careful to do so only with clients' money, not their own. (Calling these managers 'professionals' is actually too kind; they should be designated 'promotees.')"

"Under this new standard, a business earning, say,

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$100 million pre-tax and having debt on which $90 million of interest must be paid currently, might use a zero-coupon or PIK issue to incur another $60 million of annual interest that would accrue and compound but not come due for some years. The rate on these issues would typically be very high, which means that the situation in year 2 might be $90 million cash interest plus $69 million accrued interest, and so on as the compounding proceeds."

"Such high-rate reborrowing schemes, which a few years ago were appropriately confined to the waterfront, soon became models of modern finance at virtually all major investment banking houses."

Wall Street displays its humorous side. Join in the fun.

"When they make these offerings, investment bankers display their humorous side: They dispense income and balance sheet projections extending five or more years into the future for companies they barely had heard of a few months earlier."

"If you are shown such schedules, I suggest that you join in the fun: Ask the investment banker for the *one-year* budgets that his own firm prepared as the last few years began and then compare these with what actually happened."

Zero-coupon bonds free Wall Street from bounds of reality.

"Some time ago Ken Galbraith, in his witty and insightful *The Great Crash*, coined a new economic term: 'the bezzle,' defined as the current amount of undiscovered embezzlement. This financial creature has a magical quality: The embezzlers are richer by the amount of the bezzle, while the embezzlees do not yet feel poorer."

"Professor Galbraith astutely pointed out that this sum should be added to the National Wealth so that we might know the Psychic National Wealth. Logically, a society that wanted to *feel* enormously prosperous would both encourage its citizens to embezzle and try not to detect the crime. By this means, 'wealth' would balloon though not an erg of productive work had been done."

"The satirical nonsense of the bezzle is dwarfed by the real-world nonsense of the zero-coupon bond. With zeros, one party to a contract can experience 'income' without his opposite experiencing the pain of expenditure. In our illustration, a company capable of earning only $100 million dollars annually — and therefore capable of paying only that much in interest — magically creates 'earnings' for bondholders of $150 million. As long as major investors willingly don their Peter Pan wings and repeatedly say 'I believe' there is no limit to how much 'income' can be created by the zero-coupon bond."

"Wall Street welcomed this invention with the enthusiasm less-enlightened folk might reserve for the wheel or the plow. Here, finally was an instrument that would let the Street make deals at prices no longer limited by actual earning power. The result, obviously, would be more transactions: Silly prices will always attract sellers. And, as Jesse Unruh might have put it, transactions are the mother's milk of finance."

Zeros & PIKs give promoters time to do their worst & depart.

"The zero-coupon or PIK bond possesses one additional attraction for the promoter and investment banker, which is that the time elapsing between folly and failure can be stretched out. This is no small benefit. IF the period before all costs must be faced is long, promoters can create a string of foolish deals — and take in lots of fees — before any chickens come home to roost from their earlier ventures."

"But in the end, alchemy, whether it is metallurgical or financial, fails. A base business cannot be transformed into a golden business by tricks of accounting or capital structure. The man claiming to be a financial alchemist may become rich. But gullible investors rather than business achievements will usually be the source of his wealth."

An idea whose time has come — Zero-coupon fees.

"Whatever their weaknesses, ... many zero-coupon and PIK bonds will not default. We have in fact owned some and may buy more if ... [they] become sufficiently distressed. (We've not, however, even considered buying a new issue from a weak credit.) No financial instrument is evil per se; it's just that some variations have far more potential for mischief than others."

"The blue ribbon for mischief-making should go to the zero-coupon issuer unable to make its interest payments on a current basis. Our advice: Whenever an investment banker starts talking about EBDIT — or whenever someone creates a capital structure that doesn't allow all interest, both payable and accrued, to be comfortably met out of current cash flow *net of ample capital expenditures* — zip up your wallet."

"Turn the tables by suggesting that the promoter and his high-priced entourage accept zero-coupon fees, deferring their take until the zero-coupon bonds have been paid in full. See then how much enthusiasm for the deal endures."

Wall Streeters traveling the high road have little company.

"Our comments about investment bankers may seem harsh. But Charlie and I — in our hopelessly old-fashioned way — believe that they should perform a gatekeeping role, guarding investors against the promoter's propensity to indulge in excess."

"Promoters, after all, have throughout time exercised the same judgment and restraint in accepting money that alcoholics have exercised in accepting liquor. At a minimum, therefore, the banker's conduct should rise to that of a responsible bartender who, when necessary, refuses the profit from the next drink to avoid sending a drunk out on the highway."

"In recent years, unfortunately, many leading investment firms have found bartender morality to be an intolerably restrictive standard. Lately, those who have traveled the high road in Wall Street have not encountered heavy traffic."

The managers should have worn the ski masks.

"One distressing footnote: The cost of the zero-coupon folly will not be borne solely by the direct participants. Certain savings and loan associations were heavy buyers of

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such bonds, using cash that came from FSLIC-insured deposits. Straining to show splendid earnings, these buyers recorded — but did not receive — ultra-high interest income on these issues. Many of these associations are now in major trouble."

"Had their loans to shaky credits worked, the owners of the associations would have pocketed the profits. In the many cases in which the loans will fail, the taxpayer will pick up the bill."

"To paraphrase Jackie Mason, at these associations it was the managers who should have been wearing the ski masks."

Lesson #1: Don't pay too much attention to price alone.

"If you buy a stock at a sufficiently low price, there will usually be some hiccup in the fortunes of the business that gives you a chance to unload at a decent profit, even though the long-term performance of the business may be terrible."

"I call this the "cigar butt" approach to investing. A cigar butt found on the street ... with only one puff left in it may not offer much of a smoke, but the 'bargain purchase' will make that puff all profit."

"Unless you are a liquidator, that kind of approach to buying businesses is foolish. First, the original 'bargain' price probably will not turn out to be such a steal after all."

Don't waste your time with lousy businesses.

"In a difficult business, no sooner is one problem solved than another surfaces — never is there just one cockroach in the kitchen. Second, any initial advantage you secure will be quickly eroded by the low return that the business earns."

"For example, if you buy a business for $8 million that can be sold or liquidated for $10 million and promptly take either course, you can realize a high return. But the investment will disappoint if the business is sold for $10 million in ten years and in the interim has annually earned and distributed only a few percent on cost. Time is the friend of the wonderful business, the enemy of the mediocre.

You might think this principle is obvious, but I had to learn it the hard way — in fact, I had to learn it several times over. Shortly after purchasing Berkshire, I acquired a Baltimore department store, Hochschild, Kohn, buying through a company called Diversified Retailing that later merged with Berkshire. I bought at a substantial discount from book value, the people were first-class, and the deal included some extras — unrecorded real estate values and a significant LIFO inventory cushion. How could I miss?"

"So-o-o — three years later I was lucky to sell the business for about what I had paid. After ending our corporate marriage to Hochschild, Kohn, I had memories like those of the husband in the country song, 'My Wife Ran Away With My Best Friend and I Still Miss Him a Lot.' "

"I could give you other personal examples of 'bargain-purchase' folly but I'm sure you get the picture: It's far better to buy a wonderful company at a fair price than a fair company at a wonderful price."

"Charlie understood this early; I was a slow learner. But now, when buying companies or common stocks, we look for first-class businesses accompanied by first-class managements."

We've done better avoiding dragons than slaying them.

"To the extent we have been successful, it is because we concentrated on identifying one-foot hurdles that we could step over rather than because we acquired any ability to clear seven-footers."

"The finding may seem unfair, but in both business and investments it is usually far more profitable to simply stick with the easy and obvious than it is to resolve the difficult."

"On occasion, tough problems *must* be tackled as was the case when we started our Sunday paper in Buffalo. In other instances, a great investment opportunity occurs when a marvelous business encounters a one-time huge, but solvable, problem as was the case many years back at both American Express and GEICO."

"Overall, however, we've done better by avoiding dragons than by slaying them."

Beware the institutional imperative.

"My most surprising discovery: the overwhelming importance in business of an unseen force that we might call 'the institutional imperative.' In business school, I was given no hint of the imperative's existence and I did not intuitively understand it when I entered the business world. I thought then that decent, intelligent, and experienced managers would automatically make rational business decisions."

"But I learned over time that isn't so. Instead, rationality frequently wilts when the institutional imperative comes into play."

"For example:

(1) As if governed by Newton's First Law of Motion, an institution will resist any change in its current direction;

(2) Just as work expands to fill available time, corporate projects or acquisitions will materialize to soak up available funds;

(3) Any business craving of the leader, however foolish, will be quickly supported by detailed rate-of-return and strategic studies prepared by his troops; and

(4) The behavior of peer companies, whether they are expanding, acquiring, setting executive compensation or whatever, will be mindlessly imitated."

"Institutional dynamics, not venality or stupidity, set businesses on these courses, which are too often misguided. After making some expensive mistakes because I ignored the power of the imperative, I have tried to organize and manage Berkshire in ways that minimize its influence. Furthermore, Charlie and I have attempted to concentrate our investments in companies that appear alert to the problem."

We've never made a good deal with a bad person.

"After some other mistakes, I learned to go into business only with people whom I like, trust, and admire.

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As I noted before, this policy of itself will not ensure success: A second-class textile or department-store company won't prosper simply because its managers are men that you would be pleased to see your daughter marry. However, an owner — or investor — can accomplish wonders if he manages to associate himself with such people in businesses that possess decent economic characteristics."

"Conversely, we do not wish to join with managers who lack admirable qualities, no matter how attractive the prospects of their business. We've never succeeded in making a good deal with a bad person."

Some of my worst mistakes were not swinging at fat pitches.

"Some of my worst mistakes were not publicly visible. These were stock and business purchases whose virtues I understood and yet didn't make."

"It's no sin to miss a great opportunity outside one's area of competence. But I have passed on a couple of really big purchases that were served up to me on a platter and that I was fully capable of understanding. For Berkshire's shareholders, myself included, the cost of this thumb-sucking has been huge."

What's the hurry? Getting rich slow is just fine.

"If your actions are sensible, you are certain to get good results; in most such cases, leverage just moves things along faster. Charlie and I have never been in a big hurry: We enjoy the process far more than the proceeds — though we have learned to live with those also."

The corporate jet — an insult to bacteria.

"Last summer we sold the corporate jet we purchased for $850,000 three years ago and bought another used jet for $6.7 million. Those of you who recall the mathematics of the multiplying bacteria ... will understandably panic: If our net worth continues to increase at current rates, and the cost of replacing planes also continues to rise at the now-established rate of 100% compounded annually, it will not be long before Berkshire's entire net worth is consumed by its jet."

"Charlie doesn't like it when I equate the jet with bacteria; he feels it's degrading to the bacteria...."

"Naming the plane has not been easy. I initially suggested 'The Charles T. Munger.' Charlie countered with 'The Aberration.' We finally settled on 'The Indefensible.'

Berkshire's investment criteria

Here's what we're looking for:

"We hope to buy more businesses that are similar to the ones we have, and we can use some help. If you have a business that fits the following criteria, call me or, preferably, write."

"Here's what we're looking for:

(1) Large purchases (at least $10 million of after-tax earnings),
(2) demonstrated consistent earning power (future projections are of little interest to us, nor are "turnaround" situations),
(3) businesses earning good returns on equity while employing little or no debt,
(4) management in place (we can't supply it),
(5) simple businesses (if there's lots of technology, we won't understand it),
(6) an offering price (we don't want to waste our time or that of the seller by talking, even preliminarily, about a transaction when price is unknown)."

"We will not engage in unfriendly takeovers. We can promise complete confidentiality and a very fast answer — customarily within five minutes — as to whether we're interested. We prefer to buy for cash, but will consider issuing stock when we receive as much in intrinsic business value as we give."

A particularly good home for owner-managers.

"Our favorite form of purchase is one fitting the Blumkin-Friedman-Heldman mold. In cases like these, the company's owner-managers wish to generate significant amounts of cash, sometimes for themselves, but often for their families or inactive shareholders. At the same time, these managers wish to remain significant owners who continue to run their companies just as they have in the past."

"We think we offer a particularly good fit for owners with such objectives. We invite potential sellers to check us out by contacting people with whom we have done business in the past."

No cocker spaniels, please.

"Charlie and I frequently get approached about acquisitions that don't come close to meeting our tests: We've found that if you advertise an interest in buying collies, a lot of people will call hoping to sell you their cocker spaniels. Our interest in new ventures, turnarounds, or auction-like sales can best be expressed by a Goldwynism: 'Please include me out.' "

We're still in the market for preferred-style investments.

"Besides being interested in the purchase of businesses as described above, we are also interested in the negotiated purchase of large, but not controlling, blocks of stock comparable to those we hold in Capital Cities, Salomon, Gillette, USAir and Champion."

"Last year we said we had a special interest in large purchases of convertible preferreds. We still have an appetite of that kind, but it is limited since we are now close to the maximum position we feel appropriate for this category of investment."

—OID

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