BERKSHIRE HATHAWAY INC.

To the Shareholders of Berkshire Hathaway Inc.:

Our per-share book value increased 14.3% during 1993. Over the last 29 years (that is, since present management took over) book value has grown from $19 to $8,854, or at a rate of 23.3% compounded annually.

During the year, Berkshire's net worth increased by $1.5 billion, a figure affected by two negative and two positive non-operating items. For the sake of completeness, I'll explain them here. If you aren't thrilled by accounting, however, feel free to fast-forward through this discussion:

1. The first negative was produced by a change in Generally Accepted Accounting Principles (GAAP) having to do with the taxes we accrue against unrealized appreciation in the securities we carry at market value. The old rule said that the tax rate used should be the one in effect when the appreciation took place. Therefore, at the end of 1992, we were using a rate of 34% on the $6.4 billion of gains generated after 1986 and 28% on the $1.2 billion of gains generated before that. The new rule stipulates that the current tax rate should be applied to all gains. The rate in the first quarter of 1993, when this rule went into effect, was 34%. Applying that rate to our pre-1987 gains reduced net worth by $70 million.

2. The second negative, related to the first, came about because the corporate tax rate was raised in the third quarter of 1993 to 35%. This change required us to make an additional charge of 1% against all of our unrealized gains, and that charge penalized net worth by $75 million. Oddly, GAAP required both this charge and the one described above to be deducted from the earnings we report, even though the unrealized appreciation that gave rise to the charges was never included in earnings, but rather was credited directly to net worth.

3. Another 1993 change in GAAP affects the value at which we carry the securities that we own. In recent years, both the common stocks and certain common-equivalent securities held by our insurance companies have been valued at market, whereas equities held by our non- insurance subsidiaries or by the parent company were carried at their aggregate cost or market, whichever was lower. Now GAAP says that *all* common stocks should be carried at market, a rule we began

following in the fourth quarter of 1993. This change produced a gain in Berkshire's reported net worth of about $172 million.

4. Finally, we issued some stock last year. In a transaction described in last year's Annual Report, we issued 3,944 shares in early January, 1993 upon the conversion of $46 million convertible debentures that we had called for redemption. Additionally, we issued 25,203 shares when we acquired Dexter Shoe, a purchase discussed later in this report. The overall result was that our shares outstanding increased by 29,147 and our net worth by about $478 million. Per-share book value also grew, because the shares issued in these transactions carried a price above their book value.

Of course, it's per-share intrinsic value, not book value, that counts. Book value is an accounting term that measures the capital, including retained earnings, that has been put into a business. Intrinsic value is a present-value estimate of the cash that can be taken out of a business during its remaining life. At most companies, the two values are unrelated. Berkshire, however, is an exception: Our book value, though significantly below our intrinsic value, serves as a useful device for tracking that key figure. In 1993, each measure grew by roughly 14%, advances that I would call satisfactory but unexciting.

These gains, however, were outstripped by a much larger gain—39%—in Berkshire's market price. Over time, of course, market price and intrinsic value will arrive at about the same destination. But in the short run the two often diverge in a major way, a phenomenon I've discussed in the past. Two years ago, Coca-Cola and Gillette, both large holdings of ours, enjoyed market price increases that dramatically outpaced their earnings gains. In the 1991 Annual Report, I said that the stocks of these companies could not continuously overperform their businesses.

From 1991 to 1993, Coke and Gillette increased their annual operating earnings per share by 38% and 37% respectively, but their market prices moved up only 11% and 6%. In other words, the companies overperformed their stocks, a result that no doubt partly reflects Wall Street's new apprehension about brand names. Whatever the reason, what will count over time is the earnings performance of these companies. If they prosper, Berkshire will also prosper, though not in a lock-step manner.

Let me add a lesson from history: Coke went public in 1919 at $40 per share. By the end of 1920 the market, coldly reevaluating Coke's future prospects, had battered the stock down by more than 50%, to $19.50. At yearend 1993, that single share, with dividends reinvested, was worth more than $2.1 million. As Ben Graham said: "In the short-run, the market is a voting machine—reflecting a voterregistration test that requires only money, not intelligence or emotional stability—but in the long-run, the market is a weighing machine."

So how should Berkshire's over-performance in the market last year be viewed? Clearly, Berkshire was selling at a higher percentage of intrinsic value at the end of 1993 than was the case at the beginning of the year. On the other hand, in a world of 6% or 7% long-term interest rates, Berkshire's market price was not inappropriate if —and you should understand that this is a huge if—Charlie Munger, Berkshire's Vice Chairman, and I can attain our long-standing goal of increasing Berkshire's per-share intrinsic value at an average annual rate of 15%. We have not retreated from this goal. But we again emphasize, as we have for many years, that the growth in our capital base makes 15% an ever-more difficult target to hit.

What we have going for us is a growing collection of good-sized operating businesses that possess economic characteristics ranging from good to terrific, run by managers whose performance ranges from terrific to terrific. You need have no worries about this group.

The capital-allocation work that Charlie and I do at the parent company, using the funds that our managers deliver to us, has a less certain outcome: It is not easy to find new businesses and managers comparable to those we have. Despite that difficulty, Charlie and I relish the search, and we are happy to report an important success in 1993.

Dexter Shoe

What we did last year was build on our 1991 purchase of H. H. Brown, a superbly-run manufacturer of work shoes, boots and other footwear. Brown has been a real winner: Though we had high hopes to begin with, these expectations have been considerably exceeded thanks to Frank Rooney, Jim Issler and the talented managers who work with them. Because of our confidence in Frank's team, we next acquired Lowell Shoe, at the end of 1992. Lowell was a long-established manufacturer of women's and nurses' shoes, but its business needed some fixing. Again, results have surpassed our expectations. So we promptly jumped at the chance last year to acquire Dexter Shoe of Dexter, Maine, which manufactures popular-priced men's and women's shoes. Dexter, I can assure you, needs *no* fixing: It is one of the best-managed companies Charlie and I have seen in our business lifetimes.

Harold Alfond, who started working in a shoe factory at 25 cents an hour when he was 20, founded Dexter in 1956 with $10,000 of capital. He was joined in 1958 by

Peter Lunder, his nephew. The two of them have since built a business that now produces over 7.5 million pairs of shoes annually, most of them made in Maine and the balance in Puerto Rico. As you probably know, the domestic shoe industry is generally thought to be unable to compete with imports from low-wage countries. But someone forgot to tell this to the ingenious managements of Dexter and H. H. Brown and to their skilled labor forces, which together make the U.S. plants of both companies highly competitive against all comers.

Dexter’s business includes 77 retail outlets, located primarily in the Northeast. The company is also a major manufacturer of golf shoes, producing about 15% of U.S. output. Its bread and butter, though, is the manufacture of traditional shoes for traditional retailers, a job at which it excels: Last year both Nordstrom and J.C. Penney bestowed special awards upon Dexter for its performance as a supplier during 1992.

Our 1993 results include Dexter only from our date of merger, November 7th. In 1994, we expect Berkshire’s shoe operations to have more than $550 million in sales, and we would not be surprised if the combined pre-tax earnings of these businesses topped $85 million. Five years ago we had no thought of getting into shoes. Now we have 7,200 employees in that industry, and I sing “There’s No Business Like Shoe Business” as I drive to work. So much for strategic plans.

At Berkshire, we have no view of the future that dictates what businesses or industries we will enter. Indeed, we think it’s usually poison for a corporate giant’s shareholders if it embarks upon new ventures pursuant to some grand vision. We prefer instead to focus on the economic characteristics of businesses that we wish to own and the personal characteristics of managers with whom we wish to associate —and then to hope we get lucky in finding the two in combination. At Dexter, we did.

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And now we pause for a short commercial: Though they owned a business jewel, we believe that Harold and Peter (who were not interested in cash) made a sound decision in exchanging their Dexter stock for shares of Berkshire. What they did, in effect, was trade a 100% interest in a single terrific business for a smaller interest in a large group of terrific businesses. They incurred no tax on this exchange and now own a security that can be easily used for charitable or personal gifts, or that can be converted to cash in amounts, and at times, of their own choosing. Should members of their families desire to, they can pursue varying financial paths without running into the complications that often arise when assets are concentrated in a private business.

For tax and other reasons, private companies also often find it difficult to diversify outside their industries. Berkshire, in contrast, can diversify with ease. So in shifting their ownership to Berkshire, Dexter's shareholders solved a reinvestment problem. Moreover, though Harold and Peter now have non-controlling shares in Berkshire, rather than controlling shares in Dexter, they know they will be treated as partners and that we will follow owner-oriented practices. If they elect to retain their Berkshire shares, their investment result from the merger date forward will exactly parallel my own result. Since I have a huge percentage of my net worth committed for life to Berkshire shares—and since the company will issue me neither restricted shares nor stock options—my gain-loss equation will always match that of all other owners.

Additionally, Harold and Peter know that at Berkshire we can keep our promises: There will be no changes of control or culture at Berkshire for many decades to come. Finally, and of paramount importance, Harold and Peter can be sure that they will get to run their business—an activity they dearly love—exactly as they did before the merger. At Berkshire, we do not tell .400 hitters how to swing.

What made sense for Harold and Peter probably makes sense for a few other owners of large private businesses. So, if you have a business that might fit, let me hear from you. Our acquisition criteria are set forth in the appendix on page 22.

Sources of Reported Earnings

The table below shows the major sources of Berkshire's reported earnings. In this presentation, amortization of Goodwill and other major purchase-price accounting adjustments are not charged against the specific businesses to which they apply, but are instead aggregated and shown separately. This procedure lets you view the earnings of our businesses as they would have been reported had we not purchased them. I've explained in past reports why this form of presentation seems to us to be more useful to investors and managers than one utilizing GAAP, which requires purchase-price adjustments to be made on a business-by-business basis. The total net earnings we show in the table are, of course, identical to the GAAP total in our audited financial statements.

(000s omitted)

	Pre-Tax Earnings		*Berkshire's Share of Net Earnings*

			(after taxes and minority interests)	
	1993	*1992*	*1993*	*1992*
Operating Earnings:				
Insurance Group:				
Underwriting	$ 30,876	$(108,961)	$ 20,156	$(71,141)
Net Investment Income	375,946	355,067	321,321	305,763
H. H. Brown, Lowell, and Dexter	44,025 *	27,883	28,829	17,340
Buffalo News	50,962	47,863	29,696	28,163
Commercial & Consumer Finance	22,695	19,836	14,161	12,664
Fechheimer	13,442	13,698	6,931	7,267
Kirby	39,147	35,653	25,056	22,795
Nebraska Furniture Mart	21,540	17,110	10,398	8,072

Scott Fetzer Manufacturing Group	38,196	31,954	23,809	19,883
See's Candies	41,150	42,357	24,367	25,501
World Book	19,915	29,044	13,537	19,503
Purchase-Price Accounting & Goodwill Charges	(17,033)	(12,087)	(13,996)	(13,070)
Interest Expense**	(56,545)	(98,643)	(35,614)	(62,899)
Shareholder-Designated Contributions	(9,448)	(7,634)	(5,994)	(4,913)
Other	28,428	67,540	15,094	32,798
Operating Earnings	643,296	460,680	477,751	347,726
Sales of Securities	546,422	89,937	356,702	59,559
Tax Accruals Caused by New Accounting Rules	---	---	(146,332)	---

Total Earnings — All Entities	$1,189,718	$ 550,617	$688,121	$407,285

**   Includes Dexter's earnings only from the date it was acquired, November 7, 1993.*

***   Excludes interest expense of Commercial and Consumer Finance businesses. In 1992 includes $22.5 million of premiums paid on the early redemption of debt.*

A large amount of information about these businesses is given on pages 38-49, where you will also find our segment earnings reported on a GAAP basis. In addition, on pages 52-59, we have rearranged Berkshire's financial data into four segments on a non-GAAP basis, a presentation that corresponds to the way Charlie and I think about the company. Our intent is to supply you with the financial information that we would wish you to give us if our positions were reversed.

"Look-Through" Earnings

We've previously discussed look-through earnings, which we believe more accurately portray the earnings of Berkshire than does our GAAP result. As we calculate them, look-through earnings consist of: (1) the operating earnings reported in the previous section, plus; (2) the retained operating earnings of major investees that, under GAAP accounting, are not reflected in our profits, less; (3) an allowance for the tax that would be paid by Berkshire if these retained earnings of investees had instead been distributed to us. The "operating earnings" of which we speak here exclude capital gains, special accounting items and major restructuring charges.

Over time, our look-through earnings need to increase at about 15% annually if our intrinsic value is to grow at that rate. Last year, I explained that we had to increase these earnings to about $1.8 billion in the year 2000, were we to meet the 15% goal. Because we issued additional shares in 1993, the amount needed has risen to about $1.85 billion.

That is a tough goal, but one that we expect you to hold us to. In the past, we've criticized the managerial practice of shooting the arrow of performance and *then* painting the target, centering it on whatever point the arrow happened to hit. We will instead risk embarrassment by painting first and shooting later.

If we are to hit the bull's-eye, we will need markets that allow the purchase of businesses and securities on sensible terms. Right now, markets are difficult, but they can—and will—change in unexpected ways and at unexpected times. In the meantime, we'll try to resist the temptation to do something marginal simply because we are long on cash. There's no use running if you're on the wrong road.

The following table shows how we calculate look-through earnings, though I warn you that the figures are necessarily *very* rough. (The dividends paid to us by these investees have been included in the operating earnings itemized on page 8, mostly under "Insurance Group: Net Investment Income.")

Berkshire's Major Investees	Berkshire's Approximate Ownership at Yearend		Berkshire's Share of Undistributed Operating Earnings (in millions)	
	1993	1992	1993	1992
Capital Cities/ABC Inc.	13.0%	18.2%	$ 83(2)	$ 70
The Coca-Cola Company	7.2%	7.1%	94	82
Federal Home Loan Mortgage Corp.	6.8% (1)	8.2% (1)	41(2)	29(2)
GEICO Corp.	48.4%	48.1%	76(3)	34(3)
General Dynamics Corp.	13.9%	14.1%	25	11(2)
The Gillette Company	10.9%	10.9%	44	38
Guinness PLC	1.9%	2.0%	8	7

The Washington Post Company	14.8%	14.6%	15	11
Wells Fargo & Company	12.2%	11.5%	53[2]	16[2]
Berkshire's share of undistributed earnings of major investees			$439	$298
Hypothetical tax on these undistributed investee earnings[4]			(61)	(42)
Reported operating earnings of Berkshire			478	348
Total look-through earnings of Berkshire			$856	$604

(1) Does not include shares allocable to the minority interest at Wesco
(2) Calculated on average ownership for the year
(3) Excludes realized capital gains, which have been both recurring and significant
(4) The tax rate used is 14%, which is the rate Berkshire pays on the dividends it receives

We have told you that we expect the undistributed, hypothetically-taxed earnings of our investees to produce at least equivalent gains in Berkshire's intrinsic value. To date, we have far exceeded that expectation. For example, in 1986 we bought three million shares of Capital Cities/ABC for $172.50 per share and late last year sold one-third of that holding for $630 per share. After paying 35% capital gains taxes, we realized a $297 million profit from the sale. In contrast, during the eight years we held these shares, the retained earnings of Cap Cities attributable to them—hypothetically taxed at a lower 14% in accordance with our look-through method—were only $152 million. In other words, we paid a much larger tax bill than our look-through presentations to you have assumed and nonetheless realized a gain that far exceeded the undistributed earnings allocable to these shares.

We expect such pleasant outcomes to recur often in the future and therefore believe our look-through earnings to be a conservative representation of Berkshire's true economic earnings.

Taxes

As our Cap Cities sale emphasizes, Berkshire is a substantial payer of federal income taxes. In aggregate, we will pay 1993 federal income taxes of $390 million, about $200 million of that attributable to operating earnings and $190 million to realized capital gains. Furthermore, our share of the 1993 federal and foreign income taxes paid by our investees is well over $400 million, a figure you don't see on our financial statements but that is nonetheless real. Directly and indirectly, Berkshire's 1993 federal income tax payments will be about 1/2 of 1% of the total paid last year by all American corporations.

Speaking for our own shares, Charlie and I have absolutely no complaint about these taxes. We know we work in a market-based economy that rewards our efforts far more bountifully than it does the efforts of others whose output is of equal or greater benefit to society. Taxation should, and does, partially redress this inequity. But we still remain extraordinarily well-treated.

Berkshire and its shareholders, in combination, would pay a much smaller tax if Berkshire operated as a partnership or "S" corporation, two structures often used for business activities. For a variety of reasons, that's not feasible for Berkshire to do. However, the penalty our corporate form imposes is mitigated—though far from eliminated—by our strategy of investing for the long term. Charlie and I would follow a buy-and-hold policy even if we ran a tax-exempt institution. We think it the soundest way to invest, and it also goes down the grain of our personalities. A third reason to favor this policy, however, is the fact that taxes are due only when gains are realized.

Through my favorite comic strip, Li'l Abner, I got a chance during my youth to see the benefits of delayed taxes, though I missed the lesson at the time. Making his readers feel superior, Li'l Abner bungled happily, but moronically, through life in Dogpatch. At one point he became infatuated with a New York temptress, Appassionatta Van Climax, but despaired of marrying her because he had only a single silver dollar and she was interested solely in millionaires. Dejected, Abner took his problem to Old Man Mose, the font of all knowledge in Dogpatch. Said the sage: Double your money 20 times and Appassionatta will be yours (1, 2, 4, 8 . . . . 1,048,576).

My last memory of the strip is Abner entering a roadhouse, dropping his dollar into a slot machine, and hitting a jackpot that spilled money all over the floor. Meticulously following Mose's advice, Abner picked up two dollars and went off to find his next double. Whereupon I dumped Abner and began reading Ben Graham.

Mose clearly was overrated as a guru: Besides failing to anticipate Abner's slavish obedience to instructions, he also forgot about taxes. Had Abner been subject, say, to the 35% federal tax rate that Berkshire pays, and had he managed one double annually, he would after 20 years only have accumulated $22,370. Indeed, had he kept on both getting his annual doubles and paying a 35% tax on each, he would have needed 7 1/2 years more to reach the $1 million required to win Appassionatta.

But what if Abner had instead put his dollar in a single investment and held it until it doubled the same 27 1/2 times? In that case, he would have realized about $200 million pre-tax or, after paying a $70 million tax in the final year, about $130 million after-tax. For that, Appassionatta would have crawled to Dogpatch. Of course, with 27 1/2 years having passed, how Appassionatta would have looked to a fellow sitting on $130 million is another question.

What this little tale tells us is that tax-paying investors will realize a far, far greater sum from a single investment that compounds internally at a given rate than from a succession of investments compounding at the same rate. But I suspect many Berkshire shareholders figured that out long ago.

Insurance Operations

At this point in the report we've customarily provided you with a table showing the annual "combined ratio" of the insurance industry for the preceding decade. This ratio compares total insurance costs (losses incurred plus expenses) to revenue from premiums. For many years, the ratio has been above 100, a level indicating an underwriting loss. That is, the industry has taken in less money each year from its policyholders than it has had to pay for operating expenses and for loss events that occurred during the year.

Offsetting this grim equation is a happier fact: Insurers get to hold on to their policyholders' money for a time before paying it out. This happens because most policies require that premiums be prepaid and, more importantly, because it often takes time to resolve loss claims. Indeed, in the case of certain lines of insurance, such as product liability or professional malpractice, many years may elapse between the loss event and payment.

To oversimplify the matter somewhat, the total of the funds prepaid by policyholders and the funds earmarked for incurred-but-not-yet-paid claims is called "the float." In the past, the industry was able to suffer a combined ratio of 107 to 111 and still break even from its insurance writings because of the earnings derived from investing this float.

As interest rates have fallen, however, the value of float has substantially declined. Therefore, the data that we have provided in the past are no longer useful for year-to-year comparisons of industry profitability. A company writing at the same combined ratio now as in the 1980's today has a far less attractive business than it did then.

Only by making an analysis that incorporates both underwriting results and the current risk-free earnings obtainable from float can one evaluate the true economics of the business that a property-casualty insurer writes. Of course, the *actual* investment results that an insurer achieves from the use of both float and stockholders' funds is also of major importance and should be carefully examined when an investor is assessing managerial performance. But that should be a separate analysis from the one we are discussing here. The value of float funds—in effect, their transfer price as they move from the insurance operation to the investment operation—should be determined simply by the risk-free, long-term rate of interest.

On the next page we show the numbers that count in an evaluation of Berkshire's insurance business. We calculate our float—which we generate in exceptional amounts relative to our premium volume—by adding loss reserves, loss adjustment reserves and unearned premium reserves and then subtracting agent's balances, prepaid acquisition costs and deferred charges applicable to assumed reinsurance. Our cost of float is determined by our underwriting loss or profit. In those years when we have had an underwriting profit, which includes 1993, our cost of float has been negative, and we have determined our insurance earnings by adding underwriting profit to float income.

	(1) Underwriting Loss	(2) Average Float	Approximate Cost of Funds	Yearend Yield on Long-Term Govt. Bonds
	(In $ Millions)		*(Ratio of 1 to 2)*	

1967	profit	$17.3	less than zero	5.50%
1968	profit	19.9	less than zero	5.90%
1969	profit	23.4	less than zero	6.79%
1970	$ 0.37	32.4	1.14%	6.25%
1971	profit	52.5	less than zero	5.81%
1972	profit	69.5	less than zero	5.82%
1973	profit	73.3	less than zero	7.27%
1974	7.36	79.1	9.30%	8.13%
1975	11.35	87.6	12.96%	8.03%
1976	profit	102.6	less than zero	7.30%
1977	profit	139.0	less than zero	7.97%
1978	profit	190.4	less than zero	8.93%
1979	profit	227.3	less than zero	10.08%
1980	profit	237.0	less than zero	11.94%

1981	profit	228.4	less than zero	13.61%
1982	21.56	220.6	9.77%	10.64%
1983	33.87	231.3	14.64%	11.84%
1984	48.06	253.2	18.98%	11.58%
1985	44.23	390.2	11.34%	9.34%
1986	55.84	797.5	7.00%	7.60%
1987	55.43	1,266.7	4.38%	8.95%
1988	11.08	1,497.7	0.74%	9.00%
1989	24.40	1,541.3	1.58%	7.97%
1990	26.65	1,637.3	1.63%	8.24%
1991	119.59	1,895.0	6.31%	7.40%
1992	108.96	2,290.4	4.76%	7.39%
1993	profit	2,624.7	less than zero	6.35%

As you can see, in our insurance operation last year we had the use of $2.6 billion at no cost; in fact we were paid $31 million, our underwriting profit, to hold these funds. This sounds good —is good—but is far from as good as it sounds.

We temper our enthusiasm because we write a large volume of "super-cat" policies (which other insurance and reinsurance companies buy to recover part of the losses they suffer from mega-catastrophes) and because last year we had no losses of consequence from this activity. As that suggests, the truly catastrophic Midwestern floods of 1993 did not trigger super-cat losses, the reason being that very few flood policies are purchased from private insurers.

It would be fallacious, however, to conclude from this single-year result that the super-cat business is a wonderful one, or even a satisfactory one. A simple example will illustrate the fallacy: Suppose there is an event that occurs 25 times in every century. If you annually give 5-for-1 odds against its occurrence *that* year, you will have many more winning years than losers. Indeed, you may go a straight six, seven or more years without loss. You also will eventually go broke.

At Berkshire, we naturally believe we are obtaining adequate premiums and giving more like 3 1/2-for-1 odds. But there is no way for us—or anyone else—to calculate the true odds on super-cat coverages. In fact, it will take decades for us to find out whether our underwriting judgment has been sound.

What we do know is that when a loss comes, it's likely to be a lulu. There may well be years when Berkshire will suffer losses from the super-cat business equal to three or four times what we earned from it in 1993. When Hurricane Andrew blew in 1992, we paid out about $125 million. Because we've since expanded our super-cat business, a similar storm today could cost us $600 million.

So far, we have been lucky in 1994. As I write this letter, we are estimating that our losses from the Los Angeles earthquake will be nominal. But if the quake had been a 7.5 instead of a 6.8, it would have been a different story.

Berkshire is ideally positioned to write super-cat policies. In Ajit Jain, we have by far the best manager in this business. Additionally, companies writing these policies need enormous capital, and our net worth is ten to twenty times larger than that of our main competitors. In most lines of insurance, huge resources aren't that important: An insurer can diversify the risks it writes and, if necessary, can lay off risks to reduce concentration in its portfolio. That isn't possible in the super-cat business. So these competitors are forced into offering far smaller limits than those we can provide. Were they bolder, they would run the risk that a mega-catastrophe —or a confluence of smaller catastrophes—would wipe them out.

One indication of our premier strength and reputation is that each of the four largest reinsurance companies in the world buys very significant reinsurance coverage from Berkshire. Better than anyone else, these giants understand that the test of a reinsurer is its ability and willingness to pay losses under trying circumstances, not its readiness to accept premiums when things look rosy.

One caution: There has recently been a substantial increase in reinsurance capacity. Close to $5 billion of equity capital has been raised by reinsurers, almost all of them newly-formed entities. Naturally these new entrants are hungry to write business so that they can justify the projections they utilized in attracting capital. This new competition won't affect our 1994 operations; we're filled up there, primarily with business written in 1993. But we are now seeing signs of price deterioration. If this trend continues, we will resign ourselves to much-reduced volume, keeping ourselves available, though, for the large, sophisticated buyer who requires a super-cat insurer with large capacity and a sure ability to pay losses.

In other areas of our insurance business, our homestate operation, led by Rod Eldred; our workers' compensation business, headed by Brad Kinstler; our credit-card operation, managed by the Kizer family; and National Indemnity's traditional auto and general liability business, led by Don Wurster, all achieved excellent results. In combination, these four units produced a significant underwriting profit and substantial float.

All in all, we have a first-class insurance business. Though its results will be highly volatile, this operation possesses an intrinsic value that exceeds its book value by a large amount—larger, in fact, than is the case at any other Berkshire business.

Common Stock Investments

Below we list our common stockholdings having a value of over $250 million. A small portion of these investments belongs to subsidiaries of which Berkshire owns less than 100%.

		12/31/93	
Shares	*Company*	*Cost*	*Market*
		(000s omitted)	

2,000,000	Capital Cities/ABC, Inc.	$ 345,000	$1,239,000
93,400,000	The Coca-Cola Company	1,023,920	4,167,975
13,654,600	Federal Home Loan Mortgage Corp. (“Freddie Mac”)	307,505	681,023
34,250,000	GEICO Corp.	45,713	1,759,594
4,350,000	General Dynamics Corp.	94,938	401,287
24,000,000	The Gillette Company	600,000	1,431,000
38,335,000	Guinness PLC	333,019	270,822
1,727,765	The Washington Post Company	9,731	440,148
6,791,218	Wells Fargo & Company	423,680	878,614

Considering the similarity of this year’s list and the last, you may decide your management is hopelessly comatose. But we continue to think that it is usually foolish to part with an interest in a business that is both understandable and durably wonderful. Business interests of that kind are simply too hard to replace.

Interestingly, corporate managers have no trouble understanding that point when they are focusing on a business they operate: A parent company that owns a subsidiary with superb long-term economics is not likely to sell that entity regardless of price. “Why,” the CEO would ask, “should I part with my crown jewel?” Yet that same CEO, when it comes to running his personal investment portfolio, will offhandedly—and even impetuously—move from business to business when presented with no more than superficial arguments by his broker for doing so. The worst of these is perhaps, “You can’t go broke taking a profit.” Can you imagine a CEO using this line to urge his board to sell a star subsidiary? In our view, what makes sense in business also makes sense in stocks: An investor should ordinarily hold a small piece of an outstanding business with the same tenacity that an owner would exhibit if he owned all of that business.

Earlier I mentioned the financial results that could have been achieved by investing $40 in The Coca-Cola Co. in 1919. In 1938, more than 50 years after the introduction of Coke, and long after the drink was firmly established as an American icon, *Fortune* did an excellent story on the company. In the second paragraph the writer reported: “Several times every year a weighty and serious investor looks long and with profound respect at Coca-Cola’s record, but comes regretfully to the conclusion that he is looking too late. The specters of saturation and competition rise before him.”

Yes, competition there was in 1938 and in 1993 as well. But it’s worth noting that in 1938 The Coca-Cola Co. sold 207 million cases of soft drinks (if its gallonage then is converted into the 192-ounce cases used for measurement today) and in 1993 it sold about 10.7 billion cases, a 50-fold increase in physical volume from a company that in 1938 was already dominant in its very major industry. Nor was the party over in 1938 for an investor: Though the $40 invested in 1919 in one share had (with dividends reinvested) turned into $3,277 by the end of 1938, a fresh $40 then invested in Coca-Cola stock would have grown to $25,000 by yearend 1993.

I can’t resist one more quote from that 1938 *Fortune* story: “It would be hard to name any company comparable in size to Coca-Cola and selling, as Coca-Cola does, an unchanged product that can point to a ten-year record anything like Coca-Cola’s.” In the 55 years that have since passed, Coke’s product line has broadened somewhat, but it’s remarkable how well that description still fits.

Charlie and I decided long ago that in an investment lifetime it’s just too hard to make hundreds of smart decisions. That judgment became ever more compelling as Berkshire’s capital mushroomed and the universe of investments that could significantly affect our results shrank dramatically. Therefore, we adopted a strategy that required our being smart—and not too smart at that—only a very few times. Indeed, we’ll now settle for one good idea a year. (Charlie says it’s my turn.)

The strategy we’ve adopted precludes our following standard diversification dogma. Many pundits would therefore say the strategy must be riskier than that employed by more conventional investors. We disagree. We believe that a policy of portfolio concentration may well *decrease* risk if it raises, as it should, both the intensity with which an investor thinks about a business and the comfort-level he must feel with its economic characteristics before buying into it. In stating this opinion, we define risk, using dictionary terms, as “the possibility of loss or injury.”

Academics, however, like to define investment “risk” differently, averring that it is the relative volatility of a stock or portfolio of stocks—that is, their volatility as compared to that of a large universe of stocks. Employing data bases and statistical skills, these academics compute with precision the “beta” of a stock—its relative volatility in the past—and then build arcane investment and capital-allocation theories around this calculation. In their hunger for a single statistic to measure risk, however, they forget a fundamental principle: It is better to be approximately right than precisely wrong.

For owners of a business—and that’s the way we think of shareholders—the academics’ definition of risk is far off the mark, so much so that it produces absurdities. For example, under beta-based theory, a stock that has dropped very sharply compared to the market—as had Washington Post when we bought it in 1973—becomes “riskier” at the lower price than it was at the higher price. Would that description have then made any sense to someone who was offered the entire company at a vastly-reduced price?

In fact, the true investor *welcomes* volatility. Ben Graham explained why in Chapter 8 of *The Intelligent Investor.* There he introduced “Mr. Market,” an obliging fellow who shows up every day to either buy from you or sell to you, whichever you wish. The more manic-depressive this chap is, the greater the opportunities available to the investor. That’s true because a wildly fluctuating market means that irrationally low prices will periodically be attached to solid businesses. It is impossible to see how the availability of such prices can be thought of as increasing the hazards for an investor who is totally free to either ignore the market or exploit its folly.

In assessing risk, a beta purist will disdain examining what a company produces, what its competitors are doing, or how much borrowed money the business employs. He may even prefer not to know the company’s name. What he treasures is the price history of its stock. In contrast, we’ll happily forgo knowing the price history and instead will seek whatever information will further our understanding of the company’s business. After we buy a stock, consequently, we would not be disturbed if markets closed for a year or two. We don’t need a daily quote on our 100% position in See’s or H. H. Brown to validate our well-being. Why, then, should we need a quote on our 7% interest in Coke?

In our opinion, the real risk that an investor must assess is whether his aggregate after-tax receipts from an investment (including those he receives on sale) will, over his prospective holding period, give him at least as much purchasing power as he had to begin with, plus a modest rate of interest on that initial stake. Though this risk cannot be calculated with engineering precision, it can in some cases be judged with a degree of accuracy that is useful. The primary factors bearing upon this evaluation are:

1) The certainty with which the long-term economic characteristics of the business can be evaluated;
2) The certainty with which management can be evaluated, both as to its ability to realize the full potential of the business and to wisely employ its cash flows;
3) The certainty with which management can be counted on to channel the rewards from the business to the shareholders rather than to itself;
4) The purchase price of the business;
5) The levels of taxation and inflation that will be experienced and that will determine the degree by which an investor's purchasing-power return is reduced from his gross return.

These factors will probably strike many analysts as unbearably fuzzy, since they cannot be extracted from a data base of any kind. But the difficulty of precisely quantifying these matters does not negate their importance nor is it insuperable. Just as Justice Stewart found it impossible to formulate a test for obscenity but nevertheless asserted, "I know it when I see it," so also can investors—in an inexact but useful way—"see" the risks inherent in certain investments without reference to complex equations or price histories.

Is it really so difficult to conclude that Coca-Cola and Gillette possess far less business risk over the long term than, say, *any* computer company or retailer? Worldwide, Coke sells about 44% of all soft drinks, and Gillette has more than a 60% share (in value) of the blade market. Leaving aside chewing gum, in which Wrigley is dominant, I know of no other significant businesses in which the leading company has long enjoyed such global power.

Moreover, both Coke and Gillette have actually increased their worldwide shares of market in recent years. The might of their brand names, the attributes of their products, and the strength of their distribution systems give them an enormous competitive advantage, setting up a protective moat around their economic castles. The average company, in contrast, does battle daily without any such means of protection. As Peter Lynch says, stocks of companies selling commodity-like products should come with a warning label: "Competition may prove hazardous to human wealth."

The competitive strengths of a Coke or Gillette are obvious to even the casual observer of business. Yet the beta of their stocks is similar to that of a great many run-of-the-mill companies who possess little or no competitive advantage. Should we conclude from this similarity that the competitive strength of Coke and Gillette gains them nothing when business risk is being measured? Or should we conclude that the risk in owning a piece of a company—its stock—is somehow divorced from the long-term risk inherent in its business operations? We believe neither conclusion makes sense and that equating beta with investment risk also makes no sense.

The theoretician bred on beta has no mechanism for differentiating the risk inherent in, say, a single-product toy company selling pet rocks or hula hoops from that of another toy company whose sole product is Monopoly or Barbie. But it's quite possible for ordinary investors to make such distinctions if they have a reasonable understanding of consumer behavior and the factors that create long-term competitive strength or weakness. Obviously, every investor will make mistakes. But by confining himself to a relatively few, easy-to-understand cases, a reasonably intelligent, informed and diligent person can judge investment risks with a useful degree of accuracy.

In many industries, of course, Charlie and I can't determine whether we are dealing with a "pet rock" or a "Barbie." We couldn't solve this problem, moreover, even if we were to spend years intensely studying those industries. Sometimes our own intellectual shortcomings would stand in the way of understanding, and in other cases the nature of the industry would be the roadblock. For example, a business that must deal with fast-moving technology is not going to lend itself to reliable evaluations of its long-term economics. Did we foresee thirty years ago what would transpire in the television-manufacturing or computer industries? Of course not. (Nor did most of the investors and corporate managers who enthusiastically entered those industries.) Why, then, should Charlie and I now think we can predict the future of other rapidly-evolving businesses? We'll stick instead with the easy cases. Why search for a needle buried in a haystack when one is sitting in plain sight?

Of course, some investment strategies—for instance, our efforts in arbitrage over the years—require wide diversification. If significant risk exists in a single transaction, overall risk should be reduced by making that purchase one of many mutually-independent commitments. Thus, you may consciously purchase a risky investment—one that indeed has a significant possibility of causing loss or injury—if you believe that your gain, weighted for probabilities, considerably exceeds your loss, comparably weighted, and if you can commit to a number of similar, but unrelated opportunities. Most venture capitalists employ this strategy. Should you choose to pursue this course, you should adopt the outlook of the casino that owns a roulette wheel, which will want to see lots of action because it is favored by probabilities, but will refuse to accept a single, huge bet.

Another situation requiring wide diversification occurs when an investor who does not understand the economics of specific businesses nevertheless believes it in his interest to be a long-term owner of American industry. That investor should both own a large number of equities and space out his purchases. By periodically investing in an index fund, for example, the know-nothing investor can actually outperform most investment professionals. Paradoxically, when "dumb" money acknowledges its limitations, it ceases to be dumb.

On the other hand, if you are a know-*something* investor, able to understand business economics and to find five to ten sensibly-priced companies that possess important long-term competitive advantages, conventional diversification makes no sense for you. It is apt simply to hurt your results and increase your risk. I cannot understand why an investor of that sort elects to put money into a business that is his 20th favorite rather than simply adding that money to his top choices—the businesses he understands best and that present the least risk, along with the greatest profit potential. In the words of the prophet Mae West: "Too much of a good thing can be wonderful."

Corporate Governance

At our annual meetings, someone usually asks "What happens to this place if you get hit by a truck?" I'm glad they are still asking the question in this form. It won't be too long before the query becomes: "What happens to this place if you *don't* get hit by a truck?"

Such questions, in any event, raise a reason for me to discuss corporate governance, a hot topic during the past year. In general, I believe that directors have stiffened their spines recently and that shareholders are now being treated somewhat more like true owners than was the case not long ago. Commentators on corporate governance, however, seldom make any distinction among three fundamentally different manager/owner situations that exist in publicly-held companies. Though the legal responsibility of directors is identical throughout, their ability to effect change differs in each of the cases. Attention usually falls on the first case, because it prevails on the corporate scene. Since Berkshire falls into the second category, however, and will someday fall into the third, we will discuss all three variations.

The first, and by far most common, board situation is one in which a corporation has no controlling shareholder. In that case, I believe directors should behave as if there is a single absentee owner, whose long-term interest they should try to further in all proper ways. Unfortunately, "long-term" gives directors a lot of wiggle room. If they lack either integrity or the ability to think independently, directors can do great violence to shareholders while still claiming to be acting in their long-term interest. But assume the board is functioning well and must deal with a management that is mediocre or worse. Directors then have the responsibility for changing that management, just as an intelligent owner would do if he were present. And if able but greedy managers over-reach and try to dip too deeply into the shareholders' pockets, directors must slap their hands.

In this plain-vanilla case, a director who sees something he doesn't like should attempt to persuade the other directors of his views. If he is successful, the board will have the muscle to make the appropriate change. Suppose, though, that the unhappy director can't get other directors to agree with him. He should then feel free to make his views known to the absentee owners. Directors seldom do that, of course. The temperament of many directors would in fact be incompatible with critical behavior of that sort. But I see nothing improper in such actions, assuming the issues are serious. Naturally, the complaining director can expect a vigorous rebuttal from the unpersuaded directors, a prospect that should discourage the dissenter from pursuing trivial or non-rational causes.

For the boards just discussed, I believe the directors ought to be relatively few in number—say, ten or less—and ought to come mostly from the outside. The outside board members should establish standards for the CEO's performance and should also periodically meet, without his being present, to evaluate his performance against those standards.

The requisites for board membership should be business savvy, interest in the job, and owner-orientation. Too often, directors are selected simply because they are prominent or add diversity to the board. That practice is a mistake. Furthermore, mistakes in selecting directors are particularly serious because appointments are so hard to undo: The pleasant but vacuous director need never worry about job security.

The second case is that existing at Berkshire, where the controlling owner is also the manager. At some companies, this arrangement is facilitated by the existence of two classes of stock endowed with disproportionate voting power. In these situations, it's obvious that the board does not act as an agent between owners and management and that the directors cannot effect change except through persuasion.

Therefore, if the owner/manager is mediocre or worse—or is over-reaching—there is little a director can do about it except object. If the directors having no connections to the owner/manager make a unified argument, it may well have some effect. More likely it will not.

If change does not come, and the matter is sufficiently serious, the outside directors should resign. Their resignation will signal their doubts about management, and it will emphasize that no outsider is in a position to correct the owner/manager's shortcomings.

The third governance case occurs when there is a controlling owner who is not involved in management. This case, examples of which are Hershey Foods and Dow Jones, puts the outside directors in a potentially useful position. If they become unhappy with either the competence or integrity of the manager, they can go directly to the owner (who may also be on the board) and report their dissatisfaction. This situation is ideal for an outside director, since he need make his case only to a single, presumably interested owner, who can forthwith effect change if the argument is persuasive. Even so, the dissatisfied director has only that single course of action. If he remains unsatisfied about a critical matter, he has no choice but to resign.

Logically, the third case should be the most effective in insuring first-class management. In the second case the owner is not going to fire himself, and in the first case, directors often find it very difficult to deal with mediocrity or mild over-reaching. Unless the unhappy directors can win over a majority of the board—an awkward social and logistical task, particularly if management's behavior is merely odious, not egregious—their hands are effectively tied. In practice, directors trapped in situations of this kind usually convince themselves that by staying around they can do at least some good. Meanwhile, management proceeds unfettered.

In the third case, the owner is neither judging himself nor burdened with the problem of garnering a majority. He can also insure that outside directors are selected who will bring useful qualities to the board. These directors, in turn, will know that the good advice they give will reach the right ears, rather than being stifled by a recalcitrant management. If the controlling owner is intelligent and self-confident, he will make decisions in respect to management that are meritocratic and pro-shareholder. Moreover—and this is critically important—he can readily correct any mistake he makes.

At Berkshire we operate in the second mode now and will for as long as I remain functional. My health, let me add, is excellent. For better or worse, you are likely to have me as an owner/manager for some time.

After my death, all of my stock will go to my wife, Susie, should she survive me, or to a foundation if she dies before I do. In neither case will taxes and bequests require the sale of consequential amounts of stock.

When my stock is transferred to either my wife or the foundation, Berkshire will enter the third governance mode, going forward with a vitally interested, but non-management, owner and with a management that must perform for that owner. In preparation for that time, Susie was elected to the board a few years ago, and in 1993 our son, Howard, joined the board. These family members will not be managers of the company in the future, but they will represent the controlling interest should anything happen to me. Most of our other directors are also significant owners of Berkshire stock, and each has a strong owner-orientation. All in all, we're prepared for "the truck."

Shareholder-Designated Contributions

About 97% of all eligible shares participated in Berkshire's 1993 shareholder-designated contributions program. Contributions made through the program were $9.4 million and 3,110 charities were recipients.

Berkshire's practice in respect to discretionary philanthropy—as contrasted to its policies regarding contributions that are clearly related to the company's business activities—differs significantly from that of other publicly-held corporations. There, most corporate contributions are made pursuant to the wishes of the CEO (who often will be responding to social pressures), employees (through matching gifts), or directors (through matching gifts or requests they make of the CEO).

At Berkshire, we believe that the company's money is the owners' money, just as it would be in a closely-held corporation, partnership, or sole proprietorship. Therefore, if funds are to be given to causes unrelated to Berkshire's business activities, it is the charities favored by our owners that should receive them. We've yet to find a CEO who believes he should personally fund the charities favored by his shareholders. Why, then, should they foot the bill for his picks?

Let me add that our program is easy to administer. Last fall, for two months, we borrowed one person from National Indemnity to help us implement the instructions that came from our 7,500 registered shareholders. I'd guess that the average corporate program in which employee gifts are matched incurs far greater administrative costs. Indeed, our entire corporate overhead is less than half the size of our charitable contributions. *(Charlie, however, insists that I tell you that $1.4* *million of our $4.9 million overhead is attributable to our corporate jet, The Indefensible.)*

Below is a list showing the largest categories to which our shareholders have steered their contributions.

(a) 347 churches and synagogues received 569 gifts
(b) 283 colleges and universities received 670 gifts
(c) 244 K-12 schools (about two-thirds secular, one- third religious) received 525 gifts
(d) 288 institutions dedicated to art, culture or the humanities received 447 gifts
(e) 180 religious social-service organizations (split about equally between Christian and Jewish) received 411 gifts
(f) 445 secular social-service organizations (about 40% youth-related) received 759 gifts
(g) 153 hospitals received 261 gifts
(h) 186 health-related organizations (American Heart Association, American Cancer Society, etc.) received 320 gifts

Three things about this list seem particularly interesting to me. First, to some degree it indicates what people choose to give money to when they are acting of their own accord, free of pressure from solicitors or emotional appeals from charities. Second, the contributions programs of publicly-held companies almost never allow gifts to churches and synagogues, yet clearly these institutions are what many shareholders would like to support. Third, the gifts made by our shareholders display conflicting philosophies: 130 gifts were directed to organizations that believe in making abortions readily available for women and 30 gifts were directed to organizations (other than churches) that discourage or are opposed to abortion.

Last year I told you that I was thinking of raising the amount that Berkshire shareholders can give under our designated-contributions program and asked for your comments. We received a few well-written letters opposing the entire idea, on the grounds that it was our job to run the business and not our job to force shareholders into making charitable gifts. Most of the shareholders responding, however, noted the tax efficiency of the plan and urged us to increase the designated amount. Several shareholders who have given stock to their children or grandchildren told me that they consider the program a particularly good way to get youngsters thinking at an early age about the subject of giving. These people, in other words, perceive the program to be an educational, as well as philanthropic, tool. The bottom line is that we did raise the amount in 1993, from $8 per share to $10.

In addition to the shareholder-designated contributions that Berkshire distributes, our operating businesses make contributions, including merchandise, averaging about $2.5 million annually. These contributions support local charities, such as The United Way, and produce roughly commensurate benefits for our businesses.

We suggest that new shareholders read the description of our shareholder-designated contributions program that appears on pages 50-51. *To participate in future programs, you must make sure your shares are registered in the name of the actual owner, not in the nominee name of a broker, bank or depository. Shares not so registered on August 31, 1994 will be ineligible for the 1994 program.*

A Few Personal Items

Mrs. B—Rose Blumkin—had her 100th birthday on December 3, 1993. (The candles cost more than the cake.) That was a day on which the store was scheduled to be open in the evening. Mrs. B, who works seven days a week, for however many hours the store operates, found the proper decision quite obvious: She simply postponed her party until an evening when the store was closed.

Mrs. B's story is well-known but worth telling again. She came to the United States 77 years ago, unable to speak English and devoid of formal schooling. In 1937, she founded the Nebraska Furniture Mart with $500. Last year the store had sales of $200 million, a larger amount by far than that recorded by any other home furnishings store in the United States. Our part in all of this began ten years ago when Mrs. B sold control of the business to Berkshire Hathaway, a deal we completed without obtaining audited financial statements, checking real estate records, or getting any warranties. In short, her word was good enough for us.

Naturally, I was delighted to attend Mrs. B's birthday party. After all, she's promised to attend *my* 100th.

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Katharine Graham retired last year as the chairman of The Washington Post Company, having relinquished the CEO title three years ago. In 1973, we purchased our stock in her company for about $10 million. Our holding now garners $7 million a year in dividends and is worth over $400 million. At the time of our purchase, we knew that the economic prospects of the company were good. But equally important, Charlie and I concluded that Kay would prove to be an outstanding manager and would treat all shareholders honorably. That latter consideration was particularly important because The Washington Post Company has two classes of stock, a structure that we've seen some managers abuse.

All of our judgments about this investment have been validated by events. Kay's skills as a manager were underscored this past year when she was elected by *Fortune's* Board of Editors to the Business Hall of Fame. On behalf of our shareholders, Charlie and I had long ago put her in Berkshire's Hall of Fame.

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Another of last year's retirees was Don Keough of Coca-Cola, although, as he puts it, his retirement lasted "about 14 hours." Don is one of the most extraordinary human beings I've ever known—a man of enormous business talent, but, even more important, a man who brings out the absolute best in everyone lucky enough to associate with him. Coca-Cola wants its product to be present at the happy times of a person's life. Don Keough, as an individual, invariably increases the happiness of those around him. It's impossible to think about Don without feeling good.

I will edge up to how I met Don by slipping in a plug for my neighborhood in Omaha: Though Charlie has lived in California for 45 years, his home as a boy was about 200 feet away from the house where I now live; my wife, Susie, grew up 1 1/2 blocks away; and we have about 125 Berkshire shareholders in the zip code. As for Don, in 1958 he bought the house directly across the street from mine. He was then a coffee salesman with a big family and a small income.

The impressions I formed in those days about Don were a factor in my decision to have Berkshire make a record $1 billion investment in Coca-Cola in 1988-89. Roberto Goizueta had become CEO of Coke in 1981, with Don alongside as his partner. The two of them took hold of a company that had stagnated during the previous decade and moved it from $4.4 billion of market value to $58 billion in less than 13 years. What a difference a pair of managers like this makes, even when their product has been around for 100 years.

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Frank Rooney did double duty last year. In addition to leading H. H. Brown to record profits—35% above the 1992 high—he also was key to our merger with Dexter.

Frank has known Harold Alfond and Peter Lunder for decades, and shortly after our purchase of H. H. Brown, told me what a wonderful operation they managed. He encouraged us to get together and in due course we made a deal. Frank told Harold and Peter that Berkshire would provide an ideal corporate “home” for Dexter, and that assurance undoubtedly contributed to their decision to join with us.

I’ve told you in the past of Frank’s extraordinary record in building Melville Corp. during his 23 year tenure as CEO. Now, at 72, he’s setting an even faster pace at Berkshire. Frank has a low-key, relaxed style, but don’t let that fool you. When he swings, the ball disappears far over the fence.

The Annual Meeting

This year the Annual Meeting will be held at the Orpheum Theater in downtown Omaha at 9:30 a.m. on Monday, April 25, 1994. A record 2,200 people turned up for the meeting last year, but the theater can handle many more. We will have a display in the lobby featuring many of our consumer products—candy, spray guns, shoes, cutlery, encyclopedias, and the like. Among my favorites slated to be there is a See’s candy assortment that commemorates Mrs. B’s 100th birthday and that features her picture, rather than Mrs. See’s, on the package.

We recommend that you promptly get hotel reservations at one of these hotels: (1) The Radisson-Redick Tower, a small (88 rooms) but nice hotel across the street from the Orpheum; (2) the much larger Red Lion Hotel, located about a five-minute walk from the Orpheum; or (3) the Marriott, located in West Omaha about 100 yards from Borsheim’s, which is a twenty-minute drive from downtown. We will have buses at the Marriott that will leave at 8:30 and 8:45 for the meeting and return after it ends.

An attachment to our proxy material explains how you can obtain the card you will need for admission to the meeting. With the admission card, we will enclose information about parking facilities located near the Orpheum. If you are driving, come a little early. Nearby lots fill up quickly and you may have to walk a few blocks.

As usual, we will have buses to take you to Nebraska Furniture Mart and Borsheim’s after the meeting and to take you from there to downtown hotels or the airport later. Those of you arriving early can visit the Furniture Mart any day of the week; it is open from 10 a.m. to 5:30 p.m. on Saturdays and from noon to 5:30 p.m. on Sundays. Borsheim’s normally is closed on Sunday but will be open for shareholders and their guests from noon to 6 p.m. on Sunday, April 24.

In past trips to Borsheim’s, many of you have met Susan Jacques. Early in 1994, Susan was made President and CEO of the company, having risen in 11 years from a $4-an-hour job that she took at the store when she was 23. Susan will be joined at Borsheim's on Sunday by many of the managers of our other businesses, and Charlie and I will be there as well.

On the previous evening, Saturday, April 23, there will be a baseball game at Rosenblatt Stadium between the Omaha Royals and the Nashville Sounds (which could turn out to be Michael Jordan's team). As you may know, a few years ago I bought 25% of the Royals (a capital-allocation decision for which I will not become famous) and this year the league has cooperatively scheduled a home stand at Annual Meeting time.

I will throw the first pitch on the 23rd, and it's a certainty that I will improve on last year's humiliating performance. On that occasion, the catcher inexplicably called for my "sinker" and I dutifully delivered a pitch that barely missed my foot. This year, I will go with my high hard one regardless of what the catcher signals, so bring your speed-timing devices. The proxy statement will include information about obtaining tickets to the game. I regret to report that you won't have to buy them from scalpers.

March 1, 1994

Warren E. Buffett
Chairman of the Board

BERKSHIRE HATHAWAY INC.

To the Shareholders of Berkshire Hathaway Inc.:

Our gain in net worth during 1994 was $1.45 billion or 13.9%. Over the last 30 years (that is, since present management took over) our per-share book value has grown from $19 to $10,083, or at a rate of 23% compounded annually.

Charlie Munger, Berkshire's Vice Chairman and my partner, and I make few predictions. One we will confidently offer, however, is that the future performance of Berkshire won't come close to matching the performance of the past.

The problem is not that what has worked in the past will cease to work in the future. To the contrary, we believe that our formula—the purchase at sensible prices of businesses that have good underlying economics and are run by honest and able people—is certain to produce reasonable success. We expect, therefore, to keep on doing well.

A fat wallet, however, is the enemy of superior investment results. And Berkshire now has a net worth of $11.9 billion compared to about $22 million when Charlie and I began to manage the company. Though there are as many good businesses as ever, it is useless for us to make purchases that are inconsequential in relation to Berkshire's capital. (As Charlie regularly reminds me, "If something is not worth doing at all, it's not worth doing well.") We now consider a security for purchase only if we believe we can deploy at least $100 million in it. Given that minimum, Berkshire's investment universe has shrunk dramatically.

Nevertheless, we will stick with the approach that got us here and try not to relax our standards. Ted Williams, in The Story of My Life, explains why: "My argument is, to be a good hitter, you've got to get a good ball to hit. It's the first rule in the book. If I have to bite at stuff that is out of my happy zone, I'm not a .344 hitter. I might only be a .250 hitter." Charlie and I agree and will try to wait for opportunities that are well within our own "happy zone."

We will continue to ignore political and economic forecasts, which are an expensive distraction for many investors and businessmen. Thirty years ago, no one could have foreseen the huge expansion of the Vietnam War, wage and price controls, two oil shocks, the resignation of a president, the dissolution of the Soviet Union, a one-day drop in the Dow of 508 points, or treasury bill yields fluctuating between 2.8% and 17.4%.

But, surprise—none of these blockbuster events made the slightest dent in Ben Graham's investment principles. Nor did they render unsound the negotiated purchases of fine businesses at sensible prices. Imagine the cost to us, then, if we had let a fear of unknowns cause us to defer or alter the deployment of capital. Indeed, we have usually made our best purchases when apprehensions about some macro event were at a peak. Fear is the foe of the faddist, but the friend of the fundamentalist.

A different set of major shocks is sure to occur in the next 30 years. We will neither try to predict these nor to profit from them. If we can identify businesses similar to those we have purchased in the past, external surprises will have little effect on our long-term results.

What we promise you—along with more modest gains—is that during your ownership of Berkshire, you will fare just as Charlie and I do. If you suffer, we will suffer; if we prosper, so will you. And we will not break this bond by introducing compensation arrangements that give us a greater participation in the upside than the downside.

We further promise you that our personal fortunes will remain overwhelmingly concentrated in Berkshire shares: We will not ask you to invest with us and then put our own money elsewhere. In addition, Berkshire dominates both the investment portfolios of most members of our families and of a great many friends who belonged to partnerships that Charlie and I ran in the 1960's. We could not be more motivated to do our best.

Luckily, we have a good base from which to work. Ten years ago, in 1984, Berkshire's insurance companies held securities having a value of $1.7 billion, or about $1,500 per Berkshire share. Leaving aside all income and capital gains from those securities, Berkshire's pre-tax earnings that year were only about $6 million. We had earnings, yes, from our various manufacturing, retailing and service businesses, but they were almost entirely offset by the combination of underwriting losses in our insurance business, corporate overhead and interest expense.

Now we hold securities worth $18 billion, or over $15,000 per Berkshire share. If you again exclude all income from these securities, our pre-tax earnings in 1994 were about $384 million. During the decade, employment has grown from 5,000 to 22,000 (including eleven people at World Headquarters).

We achieved our gains through the efforts of a superb corps of operating managers who get extraordinary results from some ordinary-appearing businesses. Casey Stengel described managing a baseball team as "getting paid for home runs other fellows hit." That's my formula at Berkshire, also.

The businesses in which we have partial interests are equally important to Berkshire's success. A few statistics will illustrate their significance: In 1994, Coca-Cola sold about 280 billion 8-ounce servings and earned a little less than a penny on each. But pennies add up. Through Berkshire's 7.8% ownership of Coke, we have an economic interest in 21 billion of its servings, which produce "soft-drink earnings" for us of nearly $200 million. Similarly, by way of its Gillette stock, Berkshire has a 7% share of the world's razor and blade market (measured by revenues, not by units), a proportion according us about $250 million of sales in 1994. And, at Wells Fargo, a $53 billion bank, our 13% ownership translates into a $7 billion "Berkshire Bank" that earned about $100 million during 1994.

It's far better to own a significant portion of the Hope diamond than 100% of a rhinestone, and the companies just mentioned easily qualify as rare gems. Best of all, we aren't limited to simply a few of this breed, but instead possess a growing collection.

Stock prices will continue to fluctuate—sometimes sharply—and the economy will have its ups and down. Over time, however, we believe it highly probable that the sort of businesses we own will continue to increase in value at a satisfactory rate.

Book Value and Intrinsic Value

We regularly report our per-share book value, an easily calculable number, though one of limited use. Just as regularly, we tell you that what counts is intrinsic value, a number that is impossible to pinpoint but essential to estimate.

For example, in 1964, we could state with certitude that Berkshire's per-share book value was $19.46. However, that figure considerably overstated the stock's intrinsic value since all of the company's resources were tied up in a sub-profitable textile business. Our textile assets had neither going-concern nor liquidation values equal to their carrying values. In 1964, then, anyone inquiring into the soundness of Berkshire's balance sheet might well have deserved the answer once offered up by a Hollywood mogul of dubious reputation: "Don't worry, the liabilities are solid."

Today, Berkshire's situation has reversed: Many of the businesses we control are worth far more than their carrying value. (Those we don't control, such as Coca-Cola or Gillette, are carried at current market values.) We continue to give you book value figures, however, because they serve as a rough, albeit significantly understated, tracking measure for Berkshire's intrinsic value. Last year, in fact, the two measures moved in concert: Book value gained 13.9%, and that was the approximate gain in intrinsic value also.

We define intrinsic value as the discounted value of the cash that can be taken out of a business during its remaining life. Anyone calculating intrinsic value necessarily comes up with a highly subjective figure that will change both as estimates of future cash flows are revised and as interest rates move. Despite its fuzziness, however, intrinsic value is all-important and is the only logical way to evaluate the relative attractiveness of investments and businesses.

To see how historical input (book value) and future output (intrinsic value) can diverge, let's look at another form of investment, a college education. Think of the education's cost as its "book value." If it is to be accurate, the cost should include the earnings that were foregone by the student because he chose college rather than a job.

For this exercise, we will ignore the important non-economic benefits of an education and focus strictly on its economic value. First, we must estimate the earnings that the graduate will receive over his lifetime and subtract from that figure an estimate of what he would have earned had he lacked his education. That gives us an excess earnings figure, which must then be discounted, at an appropriate interest rate, back to graduation day. The dollar result equals the intrinsic economic value of the education.

Some graduates will find that the book value of their education exceeds its intrinsic value, which means that whoever paid for the education didn't get his money's worth. In other cases, the intrinsic value of an education will far exceed its book value, a result that proves capital was wisely deployed. In all cases, what is clear is that book value is meaningless as an indicator of intrinsic value.

Now let's get less academic and look at Scott Fetzer, an example from Berkshire's own experience. This account will not only illustrate how the relationship of book value and intrinsic value can change but also will provide an accounting lesson that I know you have been breathlessly awaiting. Naturally, I've chosen here to talk about an acquisition that has turned out to be a huge winner.

Berkshire purchased Scott Fetzer at the beginning of 1986. At the time, the company was a collection of 22 businesses, and today we have exactly the same line-up—no additions and no disposals. Scott Fetzer's main operations are World Book, Kirby, and Campbell Hausfeld, but many other units are important contributors to earnings as well.

We paid $315.2 million for Scott Fetzer, which at the time had $172.6 million of book value. The $142.6 million premium we handed over indicated our belief that the company's intrinsic value was close to double its book value.

In the table below we trace the book value of Scott Fetzer, as well as its earnings and dividends, since our purchase.

Year	*(1)* *Beginning Book Value*	*(2)* *Earnings*	*(3)* *Dividends*	*(4)* *Ending Book Value*
		(In $ Millions)		(1)+(2)-(3)
1986	$172.6	$ 40.3	$125.0	$ 87.9
1987	87.9	48.6	41.0	95.5
1988	95.5	58.0	35.0	118.6
1989	118.6	58.5	71.5	105.5
1990	105.5	61.3	33.5	133.3

1991	133.3	61.4	74.0	120.7
1992	120.7	70.5	80.0	111.2
1993	111.2	77.5	98.0	90.7
1994	90.7	79.3	76.0	94.0

Because it had excess cash when our deal was made, Scott Fetzer was able to pay Berkshire dividends of $125 million in 1986, though it earned only $40.3 million. I should mention that we have not introduced leverage into Scott Fetzer's balance sheet. In fact, the company has gone from very modest debt when we purchased it to virtually no debt at all (except for debt used by its finance subsidiary). Similarly, we have not sold plants and leased them back, nor sold receivables, nor the like. Throughout our years of ownership, Scott Fetzer has operated as a conservatively-financed and liquid enterprise.

As you can see, Scott Fetzer's earnings have increased steadily since we bought it, but book value has not grown commensurately. Consequently, return on equity, which was exceptional at the time of our purchase, has now become truly extraordinary. Just how extraordinary is illustrated by comparing Scott Fetzer's performance to that of the Fortune 500, a group it would qualify for if it were a stand-alone company.

Had Scott Fetzer been on the 1993 500 list—the latest available for inspection—the company's return on equity would have ranked 4th. But that is far from the whole story. The top three companies in return on equity were Insilco, LTV and Gaylord Container, each of which emerged from bankruptcy in 1993 and none of which achieved meaningful earnings that year except for those they realized when they were accorded debt forgiveness in bankruptcy proceedings. Leaving aside such non-operating windfalls, Scott Fetzer's return on equity would have ranked it first on the Fortune 500, well ahead of number two. Indeed, Scott Fetzer's return on equity was double that of the company ranking tenth.

You might expect that Scott Fetzer's success could only be explained by a cyclical peak in earnings, a monopolistic position, or leverage. But no such circumstances apply. Rather, the company's success comes from the managerial expertise of CEO Ralph Schey, of whom I'll tell you more later.

First, however, the promised accounting lesson: When we paid a $142.6 million premium over book value for Scott Fetzer, that figure had to be recorded on Berkshire's balance sheet. I'll spare you the details of how this worked (these were laid out in an appendix to our 1986 Annual Report) and get to the bottom line: After a premium is initially recorded, it must in almost all cases be written off over time through annual charges that are shown as costs in the acquiring company's earnings statement.

The following table shows, first, the annual charges Berkshire has made to gradually extinguish the Scott Fetzer acquisition premium and, second, the premium that remains on our books. These charges have no effect on cash or the taxes we pay, and are not, in our view, an economic cost (though many accountants would disagree with us). They are merely a way for us to reduce the carrying value of Scott Fetzer on our books so that the figure will eventually match the net worth that Scott Fetzer actually employs in its business.

Year	*Beginning Purchase Premium*	*Purchase-Premium Charge to Berkshire Earnings*	*Ending Purchase Premium*
		(In $ Millions)	
1986	$142.6	$ 11.6	$131.0
1987	131.0	7.1	123.9
1988	123.9	7.9	115.9
1989	115.9	7.0	108.9

1990	108.9	7.1	101.9
1991	101.9	6.9	95.0
1992	95.0	7.7	87.2
1993	87.2	28.1	59.1
1994	59.1	4.9	54.2

Note that by the end of 1994 the premium was reduced to $54.2 million. When this figure is added to Scott Fetzer's year-end book value of $94 million, the total is $148.2 million, which is the current carrying value of Scott Fetzer on Berkshire's books. That amount is less than half of our carrying value for the company when it was acquired. Yet Scott Fetzer is now earning about twice what it then did. Clearly, the intrinsic value of the business has consistently grown, even though we have just as consistently marked down its carrying value through purchase-premium charges that reduced Berkshire's earnings and net worth.

The difference between Scott Fetzer's intrinsic value and its carrying value on Berkshire's books is now huge. As I mentioned earlier—but am delighted to mention again—credit for this agreeable mismatch goes to Ralph Schey, a focused, smart and high-grade manager.

The reasons for Ralph's success are not complicated. Ben Graham taught me 45 years ago that in investing it is not necessary to do extraordinary things to get extraordinary results. In later life, I have been surprised to find that this statement holds true in business management as well. What a manager must do is handle the basics well and not get diverted. That's precisely Ralph's formula. He establishes the right goals and never forgets what he set out to do. On the personal side, Ralph is a joy to work with. He's forthright about problems and is self-confident without being self-important.

He is also experienced. Though I don't know Ralph's age, I do know that, like many of our managers, he is over 65. At Berkshire, we look to performance, not to the calendar. Charlie and I, at 71 and 64 respectively, now keep George Foreman's picture on our desks. You can make book that our scorn for a mandatory retirement age will grow stronger every year.

Intrinsic Value and Capital Allocation

Understanding intrinsic value is as important for managers as it is for investors. When managers are making capital allocation decisions—including decisions to repurchase shares—it's vital that they act in ways that increase per-share intrinsic value and avoid moves that decrease it. This principle may seem obvious but we constantly see it violated. And, when misallocations occur, shareholders are hurt.

For example, in contemplating business mergers and acquisitions, many managers tend to focus on whether the transaction is immediately dilutive or anti-dilutive to earnings per share (or, at financial institutions, to per-share book value). An emphasis of this sort carries great dangers. Going back to our college-education example, imagine that a 25-year-old first-year MBA student is considering merging his future economic interests with those of a 25-year-old day laborer. The MBA student, a non-earner, would find that a "share-for-share" merger of his equity interest in himself with that of the day laborer would enhance his near-term earnings (in a big way!). But what could be sillier for the student than a deal of this kind?

In corporate transactions, it's equally silly for the would-be purchaser to focus on current earnings when the prospective acquiree has either different prospects, different amounts of non-operating assets, or a different capital structure. At Berkshire, we have rejected many merger and purchase opportunities that would have boosted current and near-term earnings but that would have reduced per-share intrinsic value. Our approach, rather, has been to follow Wayne Gretzky's advice: "Go to where the puck is going to be, not to where it is." As a result, our shareholders are now many billions of dollars richer than they would have been if we had used the standard catechism.

The sad fact is that most major acquisitions display an egregious imbalance: They are a bonanza for the shareholders of the acquiree; they increase the income and status of the acquirer's management; and they are a honey pot for the investment bankers and other professionals on both sides. But, alas, they usually reduce the wealth of the acquirer's shareholders, often to a substantial extent. That happens because the acquirer typically gives up more intrinsic value than it receives. Do that enough, says John Medlin, the retired head of Wachovia Corp., and “you are running a chain letter in reverse.”

Over time, the skill with which a company’s managers allocate capital has an enormous impact on the enterprise’s value. Almost by definition, a really good business generates far more money (at least after its early years) than it can use internally. The company could, of course, distribute the money to shareholders by way of dividends or share repurchases. But often the CEO asks a strategic planning staff, consultants or investment bankers whether an acquisition or two might make sense. That’s like asking your interior decorator whether you need a $50,000 rug.

The acquisition problem is often compounded by a biological bias: Many CEO’s attain their positions in part because they possess an abundance of animal spirits and ego. If an executive is heavily endowed with these qualities—which, it should be acknowledged, sometimes have their advantages—they won’t disappear when he reaches the top. When such a CEO is encouraged by his advisors to make deals, he responds much as would a teenage boy who is encouraged by his father to have a normal sex life. It’s not a push he needs.

Some years back, a CEO friend of mine—in jest, it must be said—unintentionally described the pathology of many big deals. This friend, who ran a property-casualty insurer, was explaining to his directors why he wanted to acquire a certain life insurance company. After droning rather unpersuasively through the economics and strategic rationale for the acquisition, he abruptly abandoned the script. With an impish look, he simply said: “Aw, fellas, all the other kids have one.”

At Berkshire, our managers will continue to earn extraordinary returns from what appear to be ordinary businesses. As a first step, these managers will look for ways to deploy their earnings advantageously in their businesses. What’s left, they will send to Charlie and me. We then will try to use those funds in ways that build per-share intrinsic value. Our goal will be to acquire either part or all of businesses that we believe we understand, that have good, sustainable underlying economics, and that are run by managers whom we like, admire and trust.

Compensation

At Berkshire, we try to be as logical about compensation as about capital allocation. For example, we compensate Ralph Schey based upon the results of

Scott Fetzer rather than those of Berkshire. What could make more sense, since he's responsible for one operation but not the other? A cash bonus or a stock option tied to the fortunes of Berkshire would provide totally capricious rewards to Ralph. He could, for example, be hitting home runs at Scott Fetzer while Charlie and I rang up mistakes at Berkshire, thereby negating his efforts many times over. Conversely, why should option profits or bonuses be heaped upon Ralph if good things are occurring in other parts of Berkshire but Scott Fetzer is lagging?

In setting compensation, we like to hold out the promise of large carrots, but make sure their delivery is tied directly to results in the area that a manager controls. When capital invested in an operation is significant, we also both charge managers a high rate for incremental capital they employ and credit them at an equally high rate for capital they release.

The product of this money's-not-free approach is definitely visible at Scott Fetzer. If Ralph can employ incremental funds at good returns, it pays him to do so: His bonus increases when earnings on additional capital exceed a meaningful hurdle charge. But our bonus calculation is symmetrical: If incremental investment yields sub-standard returns, the shortfall is costly to Ralph as well as to Berkshire. The consequence of this two-way arrangement is that it pays Ralph—and pays him well—to send to Omaha any cash he can't advantageously use in his business.

It has become fashionable at public companies to describe almost every compensation plan as aligning the interests of management with those of shareholders. In our book, alignment means being a partner in both directions, not just on the upside. Many "alignment" plans flunk this basic test, being artful forms of "heads I win, tails you lose."

A common form of misalignment occurs in the typical stock option arrangement, which does not periodically increase the option price to compensate for the fact that retained earnings are building up the wealth of the company. Indeed, the combination of a ten-year option, a low dividend payout, and compound interest can provide lush gains to a manager who has done no more than tread water in his job. A cynic might even note that when payments to owners are held down, the profit to the option-holding manager increases. I have yet to see this vital point spelled out in a proxy statement asking shareholders to approve an option plan.

I can't resist mentioning that our compensation arrangement with Ralph Schey was worked out in about five minutes, immediately upon our purchase of Scott

Fetzer and without the “help” of lawyers or compensation consultants. This arrangement embodies a few very simple ideas—not the kind of terms favored by consultants who cannot easily send a large bill unless they have established that you have a large problem (and one, of course, that requires an annual review). Our agreement with Ralph has never been changed. It made sense to him and to me in 1986, and it makes sense now. Our compensation arrangements with the managers of all our other units are similarly simple, though the terms of each agreement vary to fit the economic characteristics of the business at issue, the existence in some cases of partial ownership of the unit by managers, etc.

In all instances, we pursue rationality. Arrangements that pay off in capricious ways, unrelated to a manager’s personal accomplishments, may well be welcomed by certain managers. Who, after all, refuses a free lottery ticket? But such arrangements are wasteful to the company and cause the manager to lose focus on what should be his real areas of concern. Additionally, irrational behavior at the parent may well encourage imitative behavior at subsidiaries.

At Berkshire, only Charlie and I have the managerial responsibility for the entire business. Therefore, we are the only parties who should logically be compensated on the basis of what the enterprise does as a whole. Even so, that is not a compensation arrangement we desire. We have carefully designed both the company and our jobs so that we do things we enjoy with people we like. Equally important, we are forced to do very few boring or unpleasant tasks. We are the beneficiaries as well of the abundant array of material and psychic perks that flow to the heads of corporations. Under such idyllic conditions, we don’t expect shareholders to ante up loads of compensation for which we have no possible need.

Indeed, if we were not paid at all, Charlie and I would be delighted with the cushy jobs we hold. At bottom, we subscribe to Ronald Reagan’s creed: “It’s probably true that hard work never killed anyone, but I figure why take the chance.”

Sources of Reported Earnings

The table on the next page shows the main sources of Berkshire’s reported earnings. In this presentation, purchase-premium charges of the type we discussed in our earlier analysis of Scott Fetzer are not assigned to the specific businesses to which they apply, but are instead aggregated and shown separately. This procedure lets you view the earnings of our businesses as they would have been reported had we not purchased them. This form of presentation seems to us to be more useful to investors and managers than one utilizing GAAP, which requires purchase premiums to be charged off, business-by-business. The total earnings we show in the table are, of course, identical to the GAAP total in our audited financial statements.

	Pre-Tax Earnings		*Berkshire's Share of Net Earnings (after taxes and minority interests)*	
	1994	*1993*	*1994*	*1993*
	(000s omitted)			
Operating Earnings:				
Insurance Group:				
Underwriting	$129,926	$ 30,876	$ 80,860	$ 20,156
Net Investment Income	419,422	375,946	350,453	321,321
Buffalo News	54,238	50,962	31,685	29,696
Fechheimer	14,260	13,442	7,107	6,931
Finance Businesses	21,568	22,695	14,293	14,161

Kirby	42,349		39,147		27,719		25,056
Nebraska Furniture Mart	17,356		21,540		8,652		10,398
Scott Fetzer Manufacturing Group	39,435		38,196		24,909		23,809
See's Candies	47,539		41,150		28,247		24,367
Shoe Group	85,503		44,025	*	55,750		28,829
World Book	24,662		19,915		17,275		13,537
Purchase-Price Premium Charges	(22,595)		(17,033)		(19,355)		(13,996)
Interest Expense**	(60,111)		(56,545)		(37,264)		(35,614)
Shareholder-Designated Contributions	(10,419)		(9,448)		(6,668)		(5,994)
Other	36,232		28,428		22,576		15,094
Operating Earnings	839,365		643,296		606,239		477,751

Sales of Securities	91,332	546,422	61,138	356,702
Decline in Value of USAir Preferred Stock	(268,500)	---	(172,579)	---
Tax Accruals Caused by New Accounting Rules	---	---	---	(146,332)
Total Earnings — All Entities	$662,197	$1,189,718	$494,798	$688,121

* *Includes Dexter's earnings only from the date it was acquired, November 7, 1993.*
** *Excludes interest expense of Finance Businesses.*

A large amount of information about these businesses is given on pages 37-48, where you will also find our segment earnings reported on a GAAP basis. In addition, on pages 53-59, we have rearranged Berkshire's financial data into four segments on a non-GAAP basis, a presentation that corresponds to the way Charlie and I think about the company. Our intent is to supply you with the financial information that we would wish you to give us if our positions were reversed.

"Look-Through" Earnings

In past reports, we've discussed look-through earnings, which we believe more accurately portray the earnings of Berkshire than does our GAAP result. As we calculate them, look-through earnings consist of: (1) the operating earnings reported in the previous section, plus; (2) the retained operating earnings of major investees that, under GAAP accounting, are not reflected in our profits, less; (3) an allowance for the tax that would be paid by Berkshire if these retained earnings of investees had instead been distributed to us. The "operating earnings" of which we speak here exclude capital gains, special accounting items and major restructuring charges.

If our intrinsic value is to grow at our target rate of 15%, our look-through earnings, over time, must also increase at about that pace. When I first explained this concept a few years back, I told you that meeting this 15% goal would require us to generate look-through earnings of about $1.8 billion by 2000. Because we’ve since issued about 3% more shares, that figure has grown to $1.85 billion.

We are now modestly ahead of schedule in meeting our goal, but to a significant degree that is because our super-cat insurance business has recently delivered earnings far above trend-line expectancy (an outcome I will discuss in the next section). Giving due weight to that abnormality, we still expect to hit our target but that, of course, is no sure thing.

The following table shows how we calculate look-through earnings, though I warn you that the figures are necessarily very rough. (The dividends paid to us by these investees have been included in the operating earnings itemized on page 12, mostly under “Insurance Group: Net Investment Income.”)

Berkshire’s Major Investees	Berkshire’s Approximate Ownership at Yearend		Berkshire’s Share of Undistributed Operating Earnings (in millions)	
	1994	1993	1994	1993
	5.5%	2.4%	$ 25[2]	$ 16
Capital Cities/ABC Inc.	13.0%	13.0%	85	83[2]
The Coca-Cola Company	7.8%	7.2%	116[2]	94

Federal Home Loan Mortgage Corp.	6.3% [1]	6.8% [1]	47[2]	41[2]
Gannett Co., Inc.	4.9%	---	4[2]	---
GEICO Corp.	50.2%	48.4%	63[2]	76[3]
The Gillette Company	10.8%	10.9%	51	44
PNC Bank Corp.	8.3%	---	10[2]	---
The Washington Post Company	15.2%	14.8%	18	15
Wells Fargo & Company	13.3%	12.2%	73	53[2]
Berkshire's share of undistributed earnings of major investees			$492	$422
Hypothetical tax on these undistributed investee earnings[4]			(68)	(59)
Reported operating earnings of Berkshire			606	478
Total look-through earnings of Berkshire			$1,030	$ 841

(1) Does not include shares allocable to the minority interest at Wesco
(2) Calculated on average ownership for the year
(3) Excludes realized capital gains, which have been both recurring and significant
(4) The tax rate used is 14%, which is the rate Berkshire pays on the dividends it receives

Insurance Operations

As we've explained in past reports, what counts in our insurance business is, first, the amount of "float" we develop and, second, its cost to us. Float is money we hold but don't own. In an insurance operation, float arises because most policies require that premiums be prepaid and, more importantly, because it usually takes time for an insurer to hear about and resolve loss claims.

Typically, the premiums that an insurer takes in do not cover the losses and expenses it must pay. That leaves it running an "underwriting loss"—and that loss is the cost of float.

An insurance business is profitable over time if its cost of float is less than the cost the company would otherwise incur to obtain funds. But the business has a negative value if the cost of its float is higher than market rates for money.

As the numbers in the following table show, Berkshire's insurance business has been an enormous winner. For the table, we have compiled our float—which we generate in exceptional amounts relative to our premium volume—by adding loss reserves, loss adjustment reserves, funds held under reinsurance assumed and unearned premium reserves and then subtracting agents' balances, prepaid acquisition costs, prepaid taxes and deferred charges applicable to assumed reinsurance. Our cost of float is determined by our underwriting loss or profit. In those years when we have had an underwriting profit, such as the last two, our cost of float has been negative, and we have determined our insurance earnings by adding underwriting profit to float income.

	(1) Underwriting Loss	(2) Average Float	Approximate Cost of Funds	Yearend Yield on Long-Term Govt. Bonds

	(In $ Millions)		(Ratio of 1 to 2)	
1967	profit	$17.3	less than zero	5.50%
1968	profit	19.9	less than zero	5.90%
1969	profit	23.4	less than zero	6.79%
1970	$ 0.37	32.4	1.14%	6.25%
1971	profit	52.5	less than zero	5.81%
1972	profit	69.5	less than zero	5.82%
1973	profit	73.3	less than zero	7.27%
1974	7.36	79.1	9.30%	8.13%
1975	11.35	87.6	12.96%	8.03%
1976	profit	102.6	less than zero	7.30%
1977	profit	139.0	less than zero	7.97%
1978	profit	190.4	less than zero	8.93%
1979	profit	227.3	less than zero	10.08%

1980	profit	237.0	less than zero	11.94%
1981	profit	228.4	less than zero	13.61%
1982	21.56	220.6	9.77%	10.64%
1983	33.87	231.3	14.64%	11.84%
1984	48.06	253.2	18.98%	11.58%
1985	44.23	390.2	11.34%	9.34%
1986	55.84	797.5	7.00%	7.60%
1987	55.43	1,266.7	4.38%	8.95%
1988	11.08	1,497.7	0.74%	9.00%
1989	24.40	1,541.3	1.58%	7.97%
1990	26.65	1,637.3	1.63%	8.24%
1991	119.59	1,895.0	6.31%	7.40%
1992	108.96	2,290.4	4.76%	7.39%
1993	profit	2,624.7	less than zero	6.35%

1994	profit	3,056.6	less than zero	7.88%

Charlie and I are delighted that our float grew in 1994 and are even more pleased that it proved to be cost-free. But our message this year echoes the one we delivered in 1993: Though we have a fine insurance business, it is not as good as it currently looks.

The reason we must repeat this caution is that our “super-cat” business (which sells policies that insurance and reinsurance companies buy to protect themselves from the effects of mega-catastrophes) was again highly profitable. Since truly major catastrophes occur infrequently, our super-cat business can be expected to show large profits in most years but occasionally to record a huge loss. In other words, the attractiveness of our super-cat business will take many years to measure. Certainly 1994 should be regarded as close to a best-case. Our only significant losses arose from the California earthquake in January. I will add that we do not expect to suffer a major loss from the early-1995 Kobe earthquake.

Super-cat policies are small in number, large in size and non-standardized. Therefore, the underwriting of this business requires far more judgment than, say, the underwriting of auto policies, for which a mass of data is available. Here Berkshire has a major advantage: Ajit Jain, our super-cat manager, whose underwriting skills are the finest. His value to us is simply enormous.

In addition, Berkshire has a special advantage in the super-cat business because of our towering financial strength, which helps us in two ways. First, a prudent insurer will want its protection against true mega-catastrophes—such as a $50 billion windstorm loss on Long Island or an earthquake of similar cost in California—to be absolutely certain. But that same insurer knows that the disaster making it dependent on a large super-cat recovery is also the disaster that could cause many reinsurers to default. There’s not much sense in paying premiums for coverage that will evaporate precisely when it is needed. So the certainty that Berkshire will be both solvent and liquid after a catastrophe of unthinkable proportions is a major competitive advantage for us.

The second benefit of our capital strength is that we can write policies for amounts that no one else can even consider. For example, during 1994, a primary insurer wished to buy a short-term policy for $400 million of California earthquake coverage and we wrote the policy immediately. We know of no one else in the world who would take a $400 million risk, or anything close to it, for their own account.

Generally, brokers attempt to place coverage for large amounts by spreading the burden over a number of small policies. But, at best, coverage of that sort takes considerable time to arrange. In the meantime, the company desiring reinsurance is left holding a risk it doesn't want and that may seriously threaten its well-being. At Berkshire, on the other hand, we will quote prices for coverage as great as $500 million on the same day that we are asked to bid. No one else in the industry will do the same.

By writing coverages in large lumps, we obviously expose Berkshire to lumpy financial results. That's totally acceptable to us: Too often, insurers (as well as other businesses) follow sub-optimum strategies in order to "smooth" their reported earnings. By accepting the prospect of volatility, we expect to earn higher long-term returns than we would by pursuing predictability.

Given the risks we accept, Ajit and I constantly focus on our "worst case," knowing, of course, that it is difficult to judge what this is, since you could conceivably have a Long Island hurricane, a California earthquake, and Super Cat X all in the same year. Additionally, insurance losses could be accompanied by non-insurance troubles. For example, were we to have super-cat losses from a large Southern California earthquake, they might well be accompanied by a major drop in the value of our holdings in See's, Wells Fargo and Freddie Mac.

All things considered, we believe our worst-case *insurance* loss from a super-cat is now about $600 million after-tax, an amount that would slightly exceed Berkshire's annual earnings from other sources. If you are not comfortable with this level of exposure, the time to sell your Berkshire stock is now, not after the inevitable mega-catastrophe.

Our super-cat volume will probably be down in 1995. Prices for garden-variety policies have fallen somewhat, and the torrent of capital that was committed to the reinsurance business a few years ago will be inclined to chase premiums, irrespective of their adequacy. Nevertheless, we have strong relations with an important group of clients who will provide us with a substantial amount of business in 1995.

Berkshire's other insurance operations had excellent results in 1994. Our homestate operation, led by Rod Eldred; our workers' compensation business, headed by Brad Kinstler; our credit card operation, managed by the Kizer family; National Indemnity's traditional auto and general liability business, led by Don Wurster—all of these generated significant underwriting profits accompanied by substantial float.

We can conclude this section as we did last year: All in all, we have a first-class insurance business. Though its results will be highly volatile, this operation possesses an intrinsic value that exceeds its book value by a large amount—larger, in fact, than is the case at any other Berkshire business.

Common Stock Investments

Below we list our common stockholdings having a value of over $300 million. A small portion of these investments belongs to subsidiaries of which Berkshire owns less than 100%.

		12/31/94	
Shares	*Company*	*Cost*	*Market*
		(000s omitted)	
27,759,941	American Express Company	$ 723,919	$ 818,918
20,000,000	Capital Cities/ABC, Inc.	345,000	1,705,000
100,000,000	The Coca-Cola Company	1,298,888	5,150,000
12,761,200	Federal Home Loan Mortgage Corp. ("Freddie Mac")	270,468	644,441

6,854,500	Gannett Co., Inc.	335,216	365,002
34,250,000	GEICO Corp.	45,713	1,678,250
24,000,000	The Gillette Company	600,000	1,797,000
19,453,300	PNC Bank Corporation	503,046	410,951
1,727,765	The Washington Post Company	9,731	418,983
6,791,218	Wells Fargo & Company	423,680	984,727

Our investments continue to be few in number and simple in concept: The truly big investment idea can usually be explained in a short paragraph. We like a business with enduring competitive advantages that is run by able and owner-oriented people. When these attributes exist, and when we can make purchases at sensible prices, it is hard to go wrong (a challenge we periodically manage to overcome).

Investors should remember that their scorecard is not computed using Olympic-diving methods: Degree-of-difficulty doesn’t count. If you are right about a business whose value is largely dependent on a single key factor that is both easy to understand and enduring, the payoff is the same as if you had correctly analyzed an investment alternative characterized by many constantly shifting and complex variables.

We try to *price*, rather than *time*, purchases. In our view, it is folly to forego buying shares in an outstanding business whose long-term future is predictable, because of short-term worries about an economy or a stock market that we know to be unpredictable. Why scrap an informed decision because of an uninformed guess?

We purchased National Indemnity in 1967, See's in 1972, Buffalo News in 1977, Nebraska Furniture Mart in 1983, and Scott Fetzer in 1986 because those are the years they became available and because we thought the prices they carried were acceptable. In each case, we pondered what the business was likely to do, not what the Dow, the Fed, or the economy might do. If we see this approach as making sense in the purchase of businesses in their entirety, why should we change tack when we are purchasing small pieces of wonderful businesses in the stock market?

Before looking at new investments, we consider adding to old ones. If a business is attractive enough to buy once, it may well pay to repeat the process. We would love to increase our economic interest in See's or Scott Fetzer, but we haven't found a way to add to a 100% holding. In the stock market, however, an investor frequently gets the chance to increase his economic interest in businesses he knows and likes. Last year we went that direction by enlarging our holdings in Coca-Cola and American Express.

Our history with American Express goes way back and, in fact, fits the pattern of my pulling current investment decisions out of past associations. In 1951, for example, GEICO shares comprised 70% of my personal portfolio and GEICO was also the first stock I sold—I was then 20—as a security salesman (the sale was 100 shares to my Aunt Alice who, bless her, would have bought anything I suggested). Twenty-five years later, Berkshire purchased a major stake in GEICO at the time it was threatened with insolvency. In another instance, that of the Washington Post, about half of my initial investment funds came from delivering the paper in the 1940's. Three decades later Berkshire purchased a large position in the company two years after it went public. As for Coca-Cola, my first business venture—this was in the 1930's—was buying a six-pack of Coke for 25 cents and selling each bottle for 5 cents. It took only fifty years before I finally got it: The real money was in the syrup.

My American Express history includes a couple of episodes: In the mid-1960's, just after the stock was battered by the company's infamous salad-oil scandal, we put about 40% of Buffett Partnership Ltd.'s capital into the stock—the largest investment the partnership had ever made. I should add that this commitment gave us over 5% ownership in Amex at a cost of $13 million. As I write this, we own just under 10%, which has cost us $1.36 billion. (Amex earned $12.5 million in 1964 and $1.4 billion in 1994.)

My history with Amex's IDS unit, which today contributes about a third of the earnings of the company, goes back even further. I first purchased stock in IDS in

1953 when it was growing rapidly and selling at a price-earnings ratio of only 3. (There was a lot of low-hanging fruit in those days.) I even produced a long report —do I ever write a short one?—on the company that I sold for $1 through an ad in the Wall Street Journal.

Obviously American Express and IDS (recently renamed American Express Financial Advisors) are far different operations today from what they were then. Nevertheless, I find that a long-term familiarity with a company and its products is often helpful in evaluating it.

Mistake Du Jour

Mistakes occur at the time of decision. We can only make our mistake-du-jour award, however, when the foolishness of the decision become obvious. By this measure, 1994 was a vintage year with keen competition for the gold medal. Here, I would like to tell you that the mistakes I will describe originated with Charlie. But whenever I try to explain things that way, my nose begins to grow.

And the nominees are . . .

Late in 1993 I sold 10 million shares of Cap Cities at $63; at year-end 1994, the price was $85.25. (The difference is $222.5 million for those of you who wish to avoid the pain of calculating the damage yourself.) When we purchased the stock at $17.25 in 1986, I told you that I had previously sold our Cap Cities holdings at $4.30 per share during 1978-80, and added that I was at a loss to explain my earlier behavior. Now I've become a repeat offender. Maybe it's time to get a guardian appointed.

Egregious as it is, the Cap Cities decision earns only a silver medal. Top honors go to a mistake I made five years ago that fully ripened in 1994: Our $358 million purchase of USAir preferred stock, on which the dividend was suspended in September. In the 1990 Annual Report I correctly described this deal as an "unforced error," meaning that I was neither pushed into the investment nor misled by anyone when making it. Rather, this was a case of sloppy analysis, a lapse that may have been caused by the fact that we were buying a senior security or by hubris. Whatever the reason, the mistake was large.

Before this purchase, I simply failed to focus on the problems that would inevitably beset a carrier whose costs were both high and extremely difficult to lower. In earlier years, these life-threatening costs posed few problems. Airlines were then protected from competition by regulation, and carriers could absorb high costs because they could pass them along by way of fares that were also high.

When deregulation came along, it did not immediately change the picture: The capacity of low-cost carriers was so small that the high-cost lines could, in large part, maintain their existing fare structures. During this period, with the longer-term problems largely invisible but slowly metastasizing, the costs that were non-sustainable became further embedded.

As the seat capacity of the low-cost operators expanded, their fares began to force the old-line, high-cost airlines to cut their own. The day of reckoning for these airlines could be delayed by infusions of capital (such as ours into USAir), but eventually a fundamental rule of economics prevailed: In an unregulated commodity business, a company must lower its costs to competitive levels or face extinction. This principle should have been obvious to your Chairman, but I missed it.

Seth Schofield, CEO of USAir, has worked diligently to correct the company's historical cost problems but, to date, has not managed to do so. In part, this is because he has had to deal with a moving target, the result of certain major carriers having obtained labor concessions and other carriers having benefitted from "fresh-start" costs that came out of bankruptcy proceedings. (As Herb Kelleher, CEO of Southwest Airlines, has said: "Bankruptcy court for airlines has become a health spa.") Additionally, it should be no surprise to anyone that those airline employees who contractually receive above-market salaries will resist any reduction in these as long as their checks continue to clear.

Despite this difficult situation, USAir may yet achieve the cost reductions it needs to maintain its viability long-term. But it is far from sure that will happen.

Accordingly, we wrote our USAir investment down to $89.5 million, 25 cents on the dollar at yearend 1994. This valuation reflects both a possibility that our preferred will have its value fully or largely restored and an opposite possibility that the stock will eventually become worthless. Whatever the outcome, we will heed a prime rule of investing: You don't have to make it back the way that you lost it.

The accounting effects of our USAir writedown are complicated. Under GAAP accounting, insurance companies are required to carry all stocks on their balance sheets at estimated market value. Therefore, at the end of last year's third quarter, we were carrying our USAir preferred at $89.5 million, or 25% of cost. In other words, our net worth was at that time reflecting a value for USAir that was far below our $358 million cost.

But in the fourth quarter, we concluded that the decline in value was, in accounting terms, “other than temporary,” and that judgment required us to send the writedown of $269 million through our income statement. The amount will have no other fourth-quarter effect. That is, it will not reduce our net worth, because the diminution of value had already been reflected.

Charlie and I will not stand for reelection to USAir’s board at the upcoming annual meeting. Should Seth wish to consult with us, however, we will be pleased to be of any help that we can.

Miscellaneous

Two CEO’s who have done great things for Berkshire shareholders retired last year: Dan Burke of Capital Cities/ABC and Carl Reichardt of Wells Fargo. Dan and Carl encountered very tough industry conditions in recent years. But their skill as managers allowed the businesses they ran to emerge from these periods with record earnings, added luster, and bright prospects. Additionally, Dan and Carl prepared well for their departure and left their companies in outstanding hands. We owe them our gratitude.

* * * * * * * * * * * *

About 95.7% of all eligible shares participated in Berkshire’s 1994 shareholder-designated contributions program. Contributions made through the program were $10.4 million and 3,300 charities were recipients.

Every year a few shareholders miss participating in the program because they either do not have their shares registered in their own names on the prescribed record date or because they fail to get the designation form back to us within the 60-day period allowed for its return. Since we don’t make exceptions when requirements aren’t met, we urge that both new shareholders and old read the description of our shareholder-designated contributions program that appears on pages 50-51.

To participate in future programs, you must make sure your shares are registered in the name of the actual owner, not in the nominee name of a broker, bank or *depository. Shares not so registered on August 31, 1995 will be ineligible for the 1995 program.*

* * * * * * * * * * * * *

We made only one minor acquisition during 1994—a small retail shoe chain—but our interest in finding good candidates remains as keen as ever. The criteria we employ for purchases or mergers is detailed in the appendix on page 21.

Last spring, we offered to merge with a large, family-controlled business on terms that included a Berkshire convertible preferred stock. Though we failed to reach an agreement, this episode made me realize that we needed to ask our shareholders to authorize preferred shares in case we wanted in the future to move quickly if a similar acquisition opportunity were to appear. Accordingly, our proxy presents a proposal that you authorize a large amount of preferred stock, which will be issuable on terms set by the Board of Directors. You can be sure that Charlie and I will not use these shares without being completely satisfied that we are receiving as much in intrinsic value as we are giving.

* * * * * * * * * * * * *

Charlie and I hope you can come to the Annual Meeting—at a new site. Last year, we slightly overran the Orpheum Theater's seating capacity of 2,750, and therefore we will assemble at 9:30 a.m. on Monday, May 1, 1995, at the Holiday Convention Centre. The main ballroom at the Centre can handle 3,300, and if need be, we will have audio and video equipment in an adjacent room capable of handling another 1,000 people.

Last year we displayed some of Berkshire's products at the meeting, and as a result sold about 800 pounds of candy, 507 pairs of shoes, and over $12,000 of World Books and related publications. All these goods will be available again this year. Though we like to think of the meeting as a spiritual experience, we must remember that even the least secular of religions includes the ritual of the collection plate.

Of course, what you really should be purchasing is a video tape of the 1995 Orange Bowl. Your Chairman views this classic nightly, switching to slow motion for the fourth quarter. Our cover color this year is a salute to Nebraska's football coach, Tom Osborne, and his Cornhuskers, the country's top college team. I urge you to wear Husker red to the annual meeting and promise you that at least 50% of your managerial duo will be in appropriate attire.

We recommend that you promptly get hotel reservations for the meeting, as we expect a large crowd. Those of you who like to be downtown (about six miles from the Centre) may wish to stay at the Radisson Redick Tower, a small (88 rooms) but nice hotel or at the much larger Red Lion Hotel a few blocks away. In the vicinity of the Centre are the Holiday Inn (403 rooms), Homewood Suites (118 rooms) and Hampton Inn (136 rooms). Another recommended spot is the Marriott, whose west Omaha location is about 100 yards from Borsheim's and a ten-minute drive from the Centre. There will be buses at the Marriott that will leave at 8:45 and 9:00 for the meeting and return after it ends.

An attachment to our proxy material explains how you can obtain the card you will need for admission to the meeting. A good-sized parking area is available at the Centre, while those who stay at the Holiday Inn, Homewood Suites and Hampton Inn will be able to walk to the meeting.

As usual, we will have buses to take you to the Nebraska Furniture Mart and Borsheim's after the meeting and to take you from there to hotels or the airport later. I hope you make a special effort to visit the Nebraska Furniture Mart because it has opened the Mega Mart, a true retailing marvel that sells electronics, appliances, computers, CD's, cameras and audio equipment. Sales have been sensational since the opening, and you will be amazed by both the variety of products available and their display on the floor.

The Mega Mart, adjacent to NFM's main store, is on our 64-acre site about two miles north of the Centre. The stores are open from 10 a.m. to 9 p.m. on Fridays, 10 a.m. to 6 p.m. on Saturdays and noon to 6 p.m. on Sundays. When you're there be sure to say hello to Mrs. B, who, at 101, will be hard at work in our Mrs. B's Warehouse. She never misses a day at the store—or, for that matter, an hour.

Borsheim's normally is closed on Sunday but will be open for shareholders and their guests from noon to 6 p.m. on Sunday. This is always a special day, and we will try to have a few surprises. Usually this is the biggest sales day of the year, so for more reasons than one Charlie and I hope to see you there.

On Saturday evening, April 29, there will be a baseball game at Rosenblatt Stadium between the Omaha Royals and the Buffalo Bisons. The Buffalo team is owned by my friends, Mindy and Bob Rich, Jr., and I'm hoping they will attend. If so, I will try to entice Bob into a one-pitch duel on the mound. Bob is a capitalist's Randy Johnson—young, strong and athletic—and not the sort of fellow you want to face early in the season. So I will need plenty of vocal support.

The proxy statement will include information about obtaining tickets to the game. About 1,400 shareholders attended the event last year. Opening the game that night, I had my stuff and threw a strike that the scoreboard reported at eight miles per hour. What many fans missed was that I shook off the catcher's call for my fast ball and instead delivered my change-up. This year it will be all smoke.

March 7, 1995

Warren E. Buffett
Chairman of the Board

BERKSHIRE HATHAWAY INC.

To the Shareholders of Berkshire Hathaway Inc.:

Our gain in net worth during 1995 was $5.3 billion, or 45.0%. Per-share book value grew by a little less, 43.1%, because we paid stock for two acquisitions, increasing our shares outstanding by 1.3%. Over the last 31 years (that is, since present management took over) per-share book value has grown from $19 to $14,426, or at a rate of 23.6% compounded annually.

There's no reason to do handsprings over 1995's gains. This was a year in which any fool could make a bundle in the stock market. And we did. To paraphrase President Kennedy, a rising tide lifts all yachts.

Putting aside the financial results, there was plenty of good news at Berkshire last year: We negotiated three acquisitions of exactly the type we desire. Two of these, Helzberg's Diamond Shops and R.C. Willey Home Furnishings, are included in our 1995 financial statements, while our largest transaction, the purchase of GEICO, closed immediately after the end of the year. (I'll tell you more about all three acquisitions later in the report.)

These new subsidiaries roughly double our revenues. Even so, the acquisitions neither materially increased our shares outstanding nor our debt. And, though these three operations employ over 11,000 people, our headquarters staff grew only from 11 to 12. (No sense going crazy.)

Charlie Munger, Berkshire's Vice Chairman and my partner, and I want to build a collection of companies—both wholly- and partly-owned—that have excellent economic characteristics and that are run by outstanding managers. Our favorite acquisition is the negotiated transaction that allows us to purchase 100% of such a business at a fair price. But we are almost as happy when the stock market offers us the chance to buy a modest percentage of an outstanding business at a pro-rata price well below what it would take to buy 100%. This double-barrelled approach—purchases of entire businesses through negotiation or purchases of part-interests through the stock market—gives us an important advantage over capital-allocators who stick to a single course. Woody Allen once explained why eclecticism works: “The real advantage of being bisexual is that it doubles your chances for a date on Saturday night.”

Over the years, we’ve been Woody-like in our thinking, attempting to increase our marketable investments in wonderful businesses, while simultaneously trying to buy similar businesses in their entirety. The following table illustrates our progress on both fronts. In the tabulation, we show the marketable securities owned per share of Berkshire at ten-year intervals. A second column lists our per-share operating earnings (before taxes and purchase-price adjustments but after interest and corporate overhead) from all other activities. In other words, the second column shows what we earned excluding the dividends, interest and capital gains that we realized from investments. Purchase-price accounting adjustments are ignored for reasons we have explained at length in previous reports and which, as an act of mercy, we won’t repeat. (We’ll be glad to send masochists the earlier explanations, however.)

Year	Marketable Securities Per Share	Pre-tax Earnings Per Share Excluding All Income from Investments
1965	$ 4	$ 4.08
1975	159	(6.48)
1985	2,443	18.86
1995	22,088	258.20

Yearly Growth Rate: 1965-95	33.4%	14.7%

These results have not sprung from some master plan that we concocted in 1965. In a general way, we knew then what we hoped to accomplish but had no idea what specific opportunities might make it possible. Today we remain similarly unstructured: Over time, we expect to improve the figures in both columns but have no road map to tell us how that will come about.

We proceed with two advantages: First, our operating managers are outstanding and, in most cases, have an unusually strong attachment to Berkshire. Second, Charlie and I have had considerable experience in allocating capital and try to go at that job rationally and objectively. The giant disadvantage we face is size: In the early years, we needed only good ideas, but now we need good *big* ideas. Unfortunately, the difficulty of finding these grows in direct proportion to our financial success, a problem that increasingly erodes our strengths.

I will have more to say about Berkshire's prospects later in this report, when I discuss our proposed recapitalization.

Acquisitions

It may seem strange that we exult over a year in which we made three acquisitions, given that we have regularly used these pages to question the acquisition activities of most managers. Rest assured, Charlie and I haven't lost our skepticism: We believe most deals do damage to the shareholders of the acquiring company. Too often, the words from *HMS Pinafore* apply: "Things are seldom what they seem, skim milk masquerades as cream." Specifically, sellers and their representatives invariably present financial projections having more entertainment value than educational value. In the production of rosy scenarios, Wall Street can hold its own against Washington.

In any case, why potential buyers even look at projections prepared by sellers baffles me. Charlie and I never give them a glance, but instead keep in mind the story of the man with an ailing horse. Visiting the vet, he said: "Can you help me? Sometimes my horse walks just fine and sometimes he limps." The vet's reply was pointed: "No problem—when he's walking fine, sell him." In the world of mergers and acquisitions, that horse would be peddled as Secretariat.

At Berkshire, we have all the difficulties in perceiving the future that other acquisition-minded companies do. Like they also, we face the inherent problem that the seller of a business practically always knows far more about it than the buyer and also picks the time of sale—a time when the business is likely to be walking "just fine."

Even so, we do have a few advantages, perhaps the greatest being that we *don't* have a strategic plan. Thus we feel no need to proceed in an ordained direction (a course leading almost invariably to silly purchase prices) but can instead simply decide what makes sense for our owners. In doing that, we always mentally compare any move we are contemplating with dozens of other opportunities open to us, including the purchase of small pieces of the best businesses in the world via the stock market. Our practice of making this comparison—acquisitions against passive investments—is a discipline that managers focused simply on expansion seldom use.

Talking to *Time Magazine* a few years back, Peter Drucker got to the heart of things: "I will tell you a secret: Dealmaking beats working. Dealmaking is exciting and fun, and working is grubby. Running anything is primarily an enormous amount of grubby detail work . . . dealmaking is romantic, sexy. That's why you have deals that make no sense."

In making acquisitions, we have a further advantage: As payment, we can offer sellers a stock backed by an extraordinary collection of outstanding businesses. An individual or a family wishing to dispose of a single fine business, but also wishing to defer personal taxes indefinitely, is apt to find Berkshire stock a particularly comfortable holding. I believe, in fact, that this calculus played an important part in the two acquisitions for which we paid shares in 1995.

Beyond that, sellers sometimes care about placing their companies in a corporate home that will both endure and provide pleasant, productive working conditions for their managers. Here again, Berkshire offers something special. Our managers operate with extraordinary autonomy. Additionally, our ownership structure enables sellers to know that when I say we are buying to keep, the promise means something. For our part, we like dealing with owners who care what happens to their companies and people. A buyer is likely to find fewer unpleasant surprises dealing with that type of seller than with one simply auctioning off his business.

In addition to the foregoing being an explanation of our acquisition style, it is, of course, a not-so-subtle sales pitch. If you own or represent a business earning $25 million or more before tax, and it fits the criteria listed on page 23, just give me a call. Our discussion will be confidential. And if you aren't interested now, file our proposition in the back of your mind: We are never going to lose our appetite for buying companies with good economics and excellent management.

Concluding this little dissertation on acquisitions, I can't resist repeating a tale told me last year by a corporate executive. The business he grew up in was a fine one, with a long-time record of leadership in its industry. Its main product, however, was distressingly glamorless. So several decades ago, the company hired a management consultant who—naturally—advised diversification, the then-current fad. ("Focus" was not yet in style.) Before long, the company acquired a number of businesses, each after the consulting firm had gone through a long—and expensive—acquisition study. And the outcome? Said the executive sadly, "When we started, we were getting 100% of our earnings from the original business. After ten years, we were getting 150%."

Helzberg's Diamond Shops

A few years back, management consultants popularized a technique called "management by walking around" (MBWA). At Berkshire, we've instituted ABWA (acquisitions by walking around).

In May 1994, a week or so after the Annual Meeting, I was crossing the street at 58th and Fifth Avenue in New York, when a woman called out my name. I listened as she told me she'd been to, and had enjoyed, the Annual Meeting. A few seconds later, a man who'd heard the woman stop me did so as well. He turned out to be Barnett Helzberg, Jr., who owned four shares of Berkshire and had also been at our meeting.

In our few minutes of conversation, Barnett said he had a business we might be interested in. When people say that, it usually turns out they have a lemonade stand—with potential, of course, to quickly grow into the next Microsoft. So I simply asked Barnett to send me particulars. That, I thought to myself. will be the end of that.

Not long after, Barnett sent me the financial statements of Helzberg's Diamond Shops. The company had been started by his grandfather in 1915 from a single store in Kansas City and had developed by the time we met into a group with 134 stores in 23 states. Sales had grown from $10 million in 1974 to $53 million in 1984 and $282 million in 1994. We weren't talking lemonade stands.

Barnett, then 60, loved the business but also wanted to feel free of it. In 1988, as a step in that direction, he had brought in Jeff Comment, formerly President of Wanamaker's, to help him run things. The hiring of Jeff turned out to be a homerun, but Barnett still found that he couldn't shake a feeling of ultimate responsibility. Additionally, he owned a valuable asset that was subject to the vagaries of a single, very competitive industry, and he thought it prudent to diversify his family's holdings.

Berkshire was made to order for him. It took us awhile to get together on price, but there was never any question in my mind that, first, Helzberg's was the kind of business that we wanted to own and, second, Jeff was our kind of manager. In fact, we would not have bought the business if Jeff had not been there to run it. Buying a retailer without good management is like buying the Eiffel Tower without an elevator.

We completed the Helzberg purchase in 1995 by means of a tax-free exchange of stock, the only kind of transaction that interested Barnett. Though he was certainly under no obligation to do so, Barnett shared a meaningful part of his proceeds from the sale with a large number of his associates. When someone behaves that generously, you know you are going to be treated right as a buyer.

The average Helzberg's store has annual sales of about $2 million, far more than competitors operating similarly-sized stores achieve. This superior per-store productivity is the key to Helzberg's excellent profits. If the company continues its first-rate performance—and we believe it will—it could grow rather quickly to several times its present size.

Helzberg's, it should be added, is an entirely different sort of operation from Borsheim's, our Omaha jewelry business, and the two companies will operate independently of each other. Borsheim's had an excellent year in 1995, with sales up 11.7%. Susan Jacques, its 36-year-old CEO, had an even better year, giving birth to her second son at the start of the Christmas season. Susan has proved to be a terrific leader in the two years since her promotion.

R.C. Willey Home Furnishings

It was Nebraska Furniture Mart's Irv Blumkin who did the walking around in the case of R.C. Willey, long the leading home furnishings business in Utah. Over the years, Irv had told me about the strengths of that company. And he had also told Bill Child, CEO of R.C. Willey, how pleased the Blumkin family had been with its Berkshire relationship. So in early 1995, Bill mentioned to Irv that for estate tax and diversification reasons, he and the other owners of R.C. Willey might be interested in selling.

From that point forward, things could not have been simpler. Bill sent me some figures, and I wrote him a letter indicating my idea of value. We quickly agreed on a number, and found our personal chemistry to be perfect. By mid-year, the merger was completed.

R.C. Willey is an amazing story. Bill took over the business from his father-in-law in 1954 when sales were about $250,000. From this tiny base, Bill employed Mae West's philosophy: "It's not what you've got—it's what you do with what you've got." Aided by his brother, Sheldon, Bill has built the company to its 1995 sales volume of $257 million, and it now accounts for over 50% of the furniture business in Utah. Like Nebraska Furniture Mart, R.C. Willey sells appliances, electronics, computers and carpets in addition to furniture. Both companies have about the same sales volume, but NFM gets all of its business from one complex in Omaha, whereas R.C. Willey will open its sixth major store in the next few months.

Retailing is a tough business. During my investment career, I have watched a large number of retailers enjoy terrific growth and superb returns on equity for a period, and then suddenly nosedive, often all the way into bankruptcy. This shooting-star phenomenon is far more common in retailing than it is in manufacturing or service businesses. In part, this is because a retailer must stay smart, day after day. Your competitor is always copying and then topping whatever you do. Shoppers are meanwhile beckoned in every conceivable way to try a stream of new merchants. In retailing, to coast is to fail.

In contrast to this have-to-be-smart-every-day business, there is what I call the have-to-be-smart-*once* business. For example, if you were smart enough to buy a network TV station very early in the game, you could put in a shiftless and backward nephew to run things, and the business would still do well for decades. You'd do far better, of course, if you put in Tom Murphy, but you could stay comfortably in the black without him. For a retailer, hiring that nephew would be an express ticket to bankruptcy.

The two retailing businesses we purchased this year are blessed with terrific managers who love to compete and have done so successfully for decades. Like the CEOs of our other operating units, they will operate autonomously: We want them to feel that the businesses they run are *theirs*. This means no second-guessing by Charlie and me. We avoid the attitude of the alumnus whose message to the football coach is "I'm 100% with you—win or tie." Our basic goal as an owner is to behave with our managers as we like our owners to behave with us.

As we add more operations, I'm sometimes asked how many people I can handle reporting to me. My answer to that is simple: If I have one person reporting to me and he is a lemon, that's one too many, and if I have managers like those we now have, the number can be almost unlimited. We are lucky to have Bill and Sheldon associated with us, and we hope that we can acquire other businesses that bring with them managers of similar caliber.

GEICO Corporation

Right after yearend, we completed the purchase of 100% of GEICO, the seventh largest auto insurer in the United States, with about 3.7 million cars insured. I've had a 45-year association with GEICO, and though the story has been told before, it's worth a short recap here.

I attended Columbia University's business school in 1950-51, not because I cared about the degree it offered, but because I wanted to study under Ben Graham, then teaching there. The time I spent in Ben's classes was a personal high, and quickly induced me to learn all I could about my hero. I turned first to *Who's Who in America,* finding there, among other things, that Ben was Chairman of Government Employees Insurance Company, to me an unknown company in an unfamiliar industry.

A librarian next referred me to Best's Fire and Casualty insurance manual, where I learned that GEICO was based in Washington, DC. So on a Saturday in January, 1951, I took the train to Washington and headed for GEICO's downtown headquarters. To my dismay, the building was closed, but I pounded on the door until a custodian appeared. I asked this puzzled fellow if there was anyone in the office I could talk to, and he said he'd seen one man working on the sixth floor.

And thus I met Lorimer Davidson, Assistant to the President, who was later to become CEO. Though my only credentials were that I was a student of Graham's, "Davy" graciously spent four hours or so showering me with both kindness and instruction. No one has ever received a better half-day course in how the insurance industry functions nor in the factors that enable one company to excel over others. As Davy made clear, GEICO's method of selling—direct marketing—gave it an enormous cost advantage over competitors that sold through agents, a form of distribution so ingrained in the business of these insurers that it was impossible for them to give it up.

After my session with Davy, I was more excited about GEICO than I have ever been about a stock.

When I finished at Columbia some months later and returned to Omaha to sell securities, I naturally focused almost exclusively on GEICO. My first sales call—on my Aunt Alice, who always supported me 100%—was successful. But I was then a skinny, unpolished 20-year-old who looked about 17, and my pitch usually failed. Undaunted, I wrote a short report late in 1951 about GEICO for "The Security I Like Best" column in The *Commercial and Financial Chronicle,* a leading financial publication of the time. More important, I bought stock for my own account.

You may think this odd, but I have kept copies of every tax return I filed, starting with the return for 1944. Checking back, I find that I purchased GEICO shares on four occasions during 1951, the last purchase being made on September 26. This pattern of persistence suggests to me that my tendency toward self-intoxication was developed early. I probably came back on that September day from unsuccessfully trying to sell some prospect and decided—despite my already having more than 50% of my net worth in GEICO—to load up further. In any event, I accumulated 350 shares of GEICO during the year, at a cost of $10,282. At yearend, this holding was worth $13,125, more than 65% of my net worth.

You can see why GEICO was my first business love. Furthermore, just to complete this stroll down memory lane, I should add that I earned most of the funds I used to buy GEICO shares by delivering *The Washington Post,* the chief product of a company that much later made it possible for Berkshire to turn $10 million into $500 million.

Alas, I sold my entire GEICO position in 1952 for $15,259, primarily to switch into Western Insurance Securities. This act of infidelity can partially be excused by the fact that Western was selling for slightly more than one times its current earnings, a p/e ratio that for some reason caught my eye. But in the next 20 years, the GEICO stock I sold grew in value to about $1.3 million, which taught me a lesson about the inadvisability of selling a stake in an identifiably-wonderful company.

In the early 1970's, after Davy retired, the executives running GEICO made some serious errors in estimating their claims costs, a mistake that led the company to underprice its policies—and that almost caused it to go bankrupt. The company was saved only because Jack Byrne came in as CEO in 1976 and took drastic remedial measures.

Because I believed both in Jack and in GEICO's fundamental competitive strength, Berkshire purchased a large interest in the company during the second half of 1976, and also made smaller purchases later. By yearend 1980, we had put $45.7 million into GEICO and owned 33.3% of its shares. During the next 15 years, we did not make further purchases. Our interest in the company, nonetheless, grew to about 50% because it was a big repurchaser of its own shares.

Then, in 1995, we agreed to pay $2.3 billion for the half of the company we didn't own. That is a steep price. But it gives us full ownership of a growing enterprise whose business remains exceptional for precisely the same reasons that prevailed in 1951. In addition, GEICO has two extraordinary managers: Tony Nicely, who runs the insurance side of the operation, and Lou Simpson, who runs investments.

Tony, 52, has been with GEICO for 34 years. There's no one I would rather have managing GEICO's insurance operation. He has brains, energy, integrity and focus. If we're lucky, he'll stay another 34 years.

Lou runs investments just as ably. Between 1980 and 1995, the equities under Lou's management returned an average of 22.8% annually vs. 15.7% for the S&P. Lou takes the same conservative, concentrated approach to investments that we do at Berkshire, and it is an enormous plus for us to have him on board. One point that goes beyond Lou's GEICO work: His presence on the scene assures us that Berkshire would have an extraordinary professional immediately available to handle its investments if something were to happen to Charlie and me.

GEICO, of course, must continue both to attract good policyholders and keep them happy. It must also reserve and price properly. But the ultimate key to the company's success is its rock-bottom operating costs, which virtually no competitor can match. In 1995, moreover, Tony and his management team pushed underwriting and loss adjustment expenses down further to 23.6% of premiums, nearly one percentage point below 1994's ratio. In business, I look for economic castles protected by unbreachable "moats." Thanks to Tony and his management team, GEICO's moat widened in 1995.

Finally, let me bring you up to date on Davy. He's now 93 and remains my friend and teacher. He continues to pay close attention to GEICO and has always been there when the company's CEOs—Jack Byrne, Bill Snyder and Tony—have needed him. Our acquisition of 100% of GEICO caused Davy to incur a large tax. Characteristically, he still warmly supported the transaction.

Davy has been one of my heroes for the 45 years I've known him, and he's never let me down. You should understand that Berkshire would not be where it is today if Davy had not been so generous with his time on a cold Saturday in 1951. I've often thanked him privately, but it is fitting that I use this report to thank him on behalf of Berkshire's shareholders.

Insurance Operations

In addition to acquiring GEICO, we enjoyed other favorable developments in insurance during 1995.

As we've explained in past reports, what counts in our insurance business is, first, the amount of "float" we generate and, second, its cost to us. Float is money we hold but don't own. In an insurance operation, float arises because most policies require that premiums be prepaid and, more importantly, because it usually takes time for an insurer to hear about and resolve loss claims.

Typically, the premiums that an insurer takes in do not cover the losses and expenses it must pay. That leaves it running an "underwriting loss"—and that loss is the cost of float. An insurance business is profitable over time if its cost of float is less than the cost the company would otherwise incur to obtain funds. But the business has a negative value if the cost of its float is higher than market rates for money.

As the numbers in the following table show, Berkshire's insurance business has been a huge winner. For the table, we have calculated our float— which we generate in exceptional amounts relative to our premium volume—by adding loss reserves, loss adjustment reserves, funds held under reinsurance assumed and unearned premium reserves, and then subtracting agents' balances, prepaid acquisition costs, prepaid taxes and deferred charges applicable to assumed reinsurance. Our cost of float is determined by our underwriting loss or profit. In those years when we have had an underwriting profit, such as the last three, our cost of float has been negative, which means we have calculated our insurance earnings by adding underwriting profit to float income.

	(1) Underwriting Loss	(2) Average Float	Approximate Cost of Funds	Yearend Yield on Long-Term Govt. Bonds
	(In $ Millions)		*(Ratio of 1 to 2)*	
1967	profit	$17.3	less than zero	5.50%
1968	profit	19.9	less than zero	5.90%
1969	profit	23.4	less than zero	6.79%
1970	$ 0.37	32.4	1.14%	6.25%
1971	profit	52.5	less than zero	5.81%

1972	profit	69.5	less than zero	5.82%
1973	profit	73.3	less than zero	7.27%
1974	7.36	79.1	9.30%	8.13%
1975	11.35	87.6	12.96%	8.03%
1976	profit	102.6	less than zero	7.30%
1977	profit	139.0	less than zero	7.97%
1978	profit	190.4	less than zero	8.93%
1979	profit	227.3	less than zero	10.08%
1980	profit	237.0	less than zero	11.94%
1981	profit	228.4	less than zero	13.61%
1982	21.56	220.6	9.77%	10.64%
1983	33.87	231.3	14.64%	11.84%
1984	48.06	253.2	18.98%	11.58%

1985	44.23	390.2	11.34%	9.34%
1986	55.84	797.5	7.00%	7.60%
1987	55.43	1,266.7	4.38%	8.95%
1988	11.08	1,497.7	0.74%	9.00%
1989	24.40	1,541.3	1.58%	7.97%
1990	26.65	1,637.3	1.63%	8.24%
1991	119.59	1,895.0	6.31%	7.40%
1992	108.96	2,290.4	4.76%	7.39%
1993	profit	2,624.7	less than zero	6.35%
1994	profit	3,056.6	less than zero	7.88%
1995	profit	3,607.2	less than zero	5.95%

Since 1967, when we entered the insurance business, our float has grown at an annual compounded rate of 20.7%. In more years than not, our cost of funds has been less than nothing. This access to “free” money has boosted Berkshire’s performance in a major way.

Any company's level of profitability is determined by three items: (1) what its assets earn; (2) what its liabilities cost; and (3) its utilization of "leverage"—that is, the degree to which its assets are funded by liabilities rather than by equity. Over the years, we have done well on Point 1, having produced high returns on our assets. But we have also benefitted greatly—to a degree that is not generally well-understood—because our liabilities have cost us very little. An important reason for this low cost is that we have obtained float on very advantageous terms. The same cannot be said by many other property and casualty insurers, who may generate plenty of float, but at a cost that exceeds what the funds are worth to them. In those circumstances, leverage becomes a disadvantage.

Since our float has cost us virtually nothing over the years, it has in effect served as equity. Of course, it differs from true equity in that it doesn't belong to us. Nevertheless, let's assume that instead of our having $3.4 billion of float at the end of 1994, we had replaced it with $3.4 billion of equity. Under this scenario, we would have owned no more assets than we did during 1995. We would, however, have had somewhat lower earnings because the cost of float was negative last year. That is, our float threw off profits. And, of course, to obtain the replacement equity, we would have needed to sell many new shares of Berkshire. The net result—more shares, equal assets and lower earnings—would have materially reduced the value of our stock. So you can understand why float wonderfully benefits a business—*if* it is obtained at a low cost.

Our acquisition of GEICO will immediately increase our float by nearly $3 billion, with additional growth almost certain. We also expect GEICO to operate at a decent underwriting profit in most years, a fact that will increase the probability that our total float will cost us nothing. Of course, we paid a very substantial price for the GEICO float, whereas virtually all of the gains in float depicted in the table were developed internally.

Our enthusiasm over 1995's insurance results must be tempered once again because we had our third straight year of good fortune in the super-cat business. In this operation, we sell policies that insurance and reinsurance companies buy to protect themselves from the effects of mega-catastrophes. Since truly major catastrophes occur infrequently, our super-cat business can be expected to show large profits in most years but occasionally to record a huge loss. In other words, the attractiveness of our super-cat business will take many years to measure. We know that the results of years like the past three will be at least partially offset by some truly terrible year in the future. We just hope that "partially" turns out to be the proper adverb.

There were plenty of catastrophes last year, but no super-cats of the insured variety. The Southeast had a close call when Opal, sporting winds of 150 miles per hour, hovered off Florida. However, the storm abated before hitting land, and so a second Andrew was dodged. For insurers, the Kobe earthquake was another close call: The economic damage was huge—perhaps even a record—but only a tiny portion of it was insured. The insurance industry won't always be that lucky.

Ajit Jain is the guiding genius of our super-cat business and writes important non-cat business as well. In insurance, the term "catastrophe" is applied to an event, such as a hurricane or earthquake, that causes a great many insured losses. The other deals Ajit enters into usually cover only a single large loss. A simplified description of three transactions from last year will illustrate both what I mean and Ajit's versatility. We insured: (1) The life of Mike Tyson for a sum that is large initially and that, fight-by-fight, gradually declines to zero over the next few years; (2) Lloyd's against more than 225 of its "names" dying during the year; and (3) The launch, and a year of orbit, of two Chinese satellites. Happily, both satellites are orbiting, the Lloyd's folk avoided abnormal mortality, and if Mike Tyson looked any healthier, no one would get in the ring with him.

Berkshire is sought out for many kinds of insurance, both super-cat and large single-risk, because: (1) our financial strength is unmatched, and insureds know we can and will pay our losses under the most adverse of circumstances; (2) we can supply a quote faster than anyone in the business; and (3) we will issue policies with limits larger than anyone else is prepared to write. Most of our competitors have extensive reinsurance treaties and lay off much of their business. While this helps them avoid shock losses, it also hurts their flexibility and reaction time. As you know, Berkshire moves quickly to seize investment and acquisition opportunities; in insurance we respond with the same exceptional speed. In another important point, large coverages don't frighten us but, on the contrary, intensify our interest. We have offered a *policy* under which we could have lost $1 billion; the largest coverage that a client *accepted* was $400 million.

We will get hit from time to time with large losses. Charlie and I, however, are quite willing to accept relatively volatile results in exchange for better long-term earnings than we would otherwise have had. In other words, we prefer a lumpy 15% to a smooth 12%. Since most managers opt for smoothness, we are left with a competitive advantage that we try to maximize. We do, though, monitor our aggregate exposure in order to keep our "worst case" at a level that leaves us comfortable.

Indeed, our worst case from a "once-in-a-century" super-cat is far less severe—relative to net worth—than that faced by many well-known primary companies writing great numbers of property policies. These insurers don't issue single huge-limit policies as we do, but their small policies, in aggregate, can create a risk of staggering size. The "big one" would blow right through the reinsurance covers of some of these insurers, exposing them to uncapped losses that could threaten their survival. In our case, losses would be large, but capped at levels we could easily handle.

Prices are weakening in the super-cat field. That is understandable considering the influx of capital into the reinsurance business a few years ago and the natural desire of those holding the capital to employ it. No matter what others may do, we will not knowingly write business at inadequate rates. We unwittingly did this in the early 1970's and, after more than 20 years, regularly receive significant bills stemming from the mistakes of that era. My guess is that we will still be getting surprises from that business 20 years from now. A bad reinsurance contract is like hell: easy to enter and impossible to exit.

I actively participated in those early reinsurance decisions, and Berkshire paid a heavy tuition for my education in the business. Unfortunately, reinsurance students can't attend school on scholarship. GEICO, incidentally, suffered a similar, disastrous experience in the early 1980's, when it plunged enthusiastically into the writing of reinsurance and large risks. GEICO's folly was brief, but it will be cleaning things up for at least another decade. The well-publicized problems at Lloyd's further illustrate the perils of reinsurance and also underscore how vital it is that the interests of the people who write insurance business be aligned—on the downside as well as the upside—with those of the people putting up the capital. When that kind of symmetry is missing, insurers almost invariably run into trouble, though its existence may remain hidden for some time.

A small, apocryphal story about an insurance CEO who was visited by an analyst tells a lot about this industry. To the analyst's questions about his business, the CEO had nothing but gloomy answers: Rates were ridiculously low; the reserves on his balance sheet weren't adequate for ordinary claims, much less those likely to arise from asbestos and environmental problems; most of his reinsurers had long since gone broke, leaving him holding the sack. But then the CEO brightened: "Still, things could be a lot worse," he said. "It could be *my* money." At Berkshire, it's *our* money.

Berkshire's other insurance operations, though relatively small, performed magnificently in 1995. National Indemnity's traditional business had a combined ratio of 84.2 and developed, as usual, a large amount of float compared to premium volume. Over the last three years, this segment of our business, run by Don Wurster, has had an average combined ratio of 85.6. Our homestate operation, managed by Rod Eldred, grew at a good rate in 1995 and achieved a combined ratio of 81.4. Its three-year combined ratio is an amazing 82.4. Berkshire's California workers' compensation business, run by Brad Kinstler, faced fierce price-cutting in 1995 and lost a great many renewals when we refused to accept inadequate rates. Though this operation's volume dropped materially, it produced an excellent underwriting profit. Finally, John Kizer, at Central States Indemnity, continues to do an extraordinary job. His premium volume was up 23% in 1995, and underwriting profit grew by 59%. Ajit, Don, Rod, Brad and John are all under 45, an embarrassing fact demolishing my theory that managers only hit their stride after they reach 70.

To sum up, we entered 1995 with an exceptional insurance operation of moderate size. By adding GEICO, we entered 1996 with a business still better in quality, much improved in its growth prospects, and doubled in size. More than ever, insurance is our core strength.

Sources of Reported Earnings

The table below shows the main sources of Berkshire's reported earnings. In this presentation, purchase-premium charges are not assigned to the specific businesses to which they apply, but are instead aggregated and shown separately. This procedure lets you view the earnings of our businesses as they would have been reported had we not purchased them. This form of presentation seems to us to be more useful to investors and managers than one utilizing GAAP, which requires purchase-premiums to be charged off, business-by-business. The total earnings we show in the table are, of course, identical to the GAAP total in our audited financial statements.

(in millions)

	Pre-Tax Earnings		*Berkshire's Share of Net Earnings (after taxes and minority interests)*	
	1995	*1994*	*1995*	*1994*
Operating Earnings:				
Insurance Group:				
Underwriting	$ 20.5	$129.9	$ 11.3	$ 80.9
Net Investment	501.6	419.4	417.7	350.5

Income

Buffalo News	46.8		54.2		27.3		31.7	
Fechheimer	16.9		14.3		8.8		7.1	
Finance Businesses	20.8		22.1		12.6		14.6	
Home Furnishings	29.7	(1)	17.4		16.7	(1)	8.7	
Jewelry	33.9	(2)	---	(3)	19.1	(2)	---	(3)
Kirby	50.2		42.3		32.1		27.7	
Scott Fetzer Manufacturing Group	34.1		39.5		21.2		24.9	
See's Candies	50.2		47.5		29.8		28.2	
Shoe Group	58.4		85.5		37.5		55.8	
World Book	8.8		24.7		7.0		17.3	
Purchase-Price Premium	(27.0)		(22.6)		(23.4)		(19.4)	

Charges				
Interest Expense[4]	(56.0)	(60.1)	(34.9)	(37.3)
Shareholder-Designated Contributions	(11.6)	(10.4)	(7.0)	(6.7)
Other	37.4	35.7	24.4	22.3
Operating Earnings	814.7	839.4	600.2	606.2
Sales of Securities	194.1	91.3	125.0	61.1
Decline in Value of USAir Preferred Stock	---	(268.5)	---	(172.6)
Total Earnings — All Entities	$1,008.8	$662.2	$725.2	$494.8

(1) Includes R.C. Willey from June 29, 1995.
(2) Includes Helzberg's from April 30, 1995.
(3) Jewelry earnings were included in "Other" in 1994.
(4) Excludes interest expense of Finance Businesses.

A large amount of information about these businesses is given on pages 41-52, where you will also find our segment earnings reported on a GAAP basis. In addition, on pages 57-63, we have rearranged Berkshire's financial data into four segments on a non-GAAP basis, a presentation that corresponds to the way Charlie and I think about the company. Our intent is to supply you with the financial information that we would wish you to give us if our positions were reversed.

At Berkshire, we believe in Charlie's dictum—"Just tell me the bad news; the good news will take care of itself"—and that is the behavior we expect of our managers when they are reporting to us. Consequently, I also owe you—Berkshire's owners—a report on three operations that, though they continued to earn decent (or better) returns on invested capital, experienced a decline in earnings last year. Each encountered a different type of problem.

Our shoe business operated in an industry that suffered depressed earnings throughout last year, and many of our competitors made only marginal profits or worse. That means we at least maintained, and in some instances widened, our competitive superiority. So I have no doubt that our shoe operations will climb back to top-grade earnings in the future. In other words, though the turn has not yet occurred, we believe you should view last year's figures as reflecting a cyclical problem, not a secular one.

The Buffalo News, though still doing very well in comparison to other newspapers, is another story. In this case, industry trends are not good. In the 1991 Annual Report, I explained that newspapers had lost a notch in their economic attractiveness from the days when they appeared to have a bullet-proof franchise. Today, the industry retains its excellent economics, but has lost still another notch. Over time, we expect the competitive strength of newspapers to gradually erode, though the industry should nevertheless remain a fine business for many years to come.

Berkshire's most difficult problem is World Book, which operates in an industry beset by increasingly tough competition from CD-ROM and on-line offerings. True, we are still profitable, a claim that perhaps no other print encyclopedia can make. But our sales and earnings trends have gone in the wrong direction. At the end of 1995, World Book made major changes in the way it distributes its product, stepped up its efforts with electronic products and sharply reduced its overhead costs. It will take time for us to evaluate the effects of these initiatives, but we are confident they will significantly improve our viability.

All of our operations, including those whose earnings fell last year, benefit from exceptionally talented and dedicated managers. Were we to have the choice of any other executives now working in their industries, there is not one of our managers we would replace.

Many of our managers don't have to work for a living, but simply go out and perform every day for the same reason that wealthy golfers stay on the tour: They love both doing what they do and doing it well. To describe them as working may be a misnomer—they simply prefer spending much of their time on a productive activity at which they excel to spending it on leisure activities. Our job is to provide an environment that will keep them feeling this way, and so far we seem to have succeeded: Thinking back over the 1965-95 period, I can't recall that a single key manager has left Berkshire to join another employer.

Common Stock Investments

Below we present our common stock investments. Those with a market value of more than $600 million are itemized.

		12/31/95	
Shares	*Company*	*Cost*	*Market*
		(dollars in millions)	
49,456,900	American Express Company	$1,392.7	$2,046.3
20,000,000	Capital Cities/ABC, Inc.	345.0	2,467.5

100,000,000	The Coca-Cola Company	1,298.9		7,425.0
12,502,500	Federal Home Loan Mortgage Corp. (“Freddie Mac”)	260.1		1,044.0
34,250,000	GEICO Corp.	45.7		2,393.2
48,000,000	The Gillette Company	600.0		2,502.0
6,791,218	Wells Fargo & Company	423.7		1,466.9
	Others	1,379.0		2,655.4
	Total Common Stocks	$5,745.1		$22,000.3

We continue in our Rip Van Winkle mode: Five of our six top positions at yearend 1994 were left untouched during 1995. The sixth was American Express, in which we increased our ownership to about 10%.

In early 1996, two major events affected our holdings: First, our purchase of the GEICO stock we did not already own caused that company to be converted into a wholly-owned subsidiary. Second, we exchanged our Cap Cities shares for a combination of cash and Disney stock.

In the Disney merger, Cap Cities shareholders had a choice of actions. If they chose, they could exchange each of their Cap Cities shares for one share of Disney stock plus $65. Or they could ask for—though not necessarily get—all cash or all stock, with their ultimate allotment of each depending on the choices made by other shareholders and certain decisions made by Disney. For our 20 million shares, we sought stock, but do not know, as this report goes to press, how much we were allocated. We are certain, however, to receive something over 20 million Disney shares. We have also recently bought Disney stock in the market.

One more bit of history: I first became interested in Disney in 1966, when its market valuation was less than $90 million, even though the company had earned around $21 million pre-tax in 1965 and was sitting with more cash than debt. At Disneyland, the $17 million Pirates of the Caribbean ride would soon open. Imagine my excitement—a company selling at only five times rides!

Duly impressed, Buffett Partnership Ltd. bought a significant amount of Disney stock at a split-adjusted price of 31¢ per share. That decision may appear brilliant, given that the stock now sells for $66. But your Chairman was up to the task of nullifying it: In 1967 I sold out at 48¢ per share.

Oh well—we're happy to be once again a large owner of a business with both unique assets and outstanding management.

Convertible Preferred Stocks

As many of you will remember, Berkshire made five private purchases of convertible preferred stocks during the 1987-91 period and the time seems right to discuss their status. Here are the particulars:

Company	Dividend Rate	Year of Purchase	Cost	Market Value
			(dollars in millions)	
Champion International Corp.	9 1/4%	1989	$300	$388[1]

First Empire State Corp.	9%	1991	40	110
The Gillette Company	8 3/4%	1989	600	2,502(2)
Salomon Inc.	9%	1987	700	728(3)
USAir Group, Inc.	9 1/4%	1989	358	215

(1) Proceeds from sale of common we received through conversion in 1995.
(2) 12/31/95 value of common we received through conversion in 1991.
(3) Includes $140 we received in 1995 from partial redemption.

In each case we had the option of sticking with these preferreds as fixed-income securities or converting them into common stock. Initially, their value to us came primarily from their fixed-income characteristics. The option we had to convert was a kicker.

Our $300 million private purchase of American Express "Percs"—described in the 1991 Annual Report—is not included in the table because that security was a modified form of common stock whose fixed-income characteristics contributed only a minor portion of its initial value. Three years after we bought them, the Percs automatically were converted to common stock. In contrast, the five securities in the table were set to become common stocks only if we wished them to—a crucial difference.

When we purchased our convertible securities, I told you that we expected to earn after-tax returns from them that "moderately" exceeded what we could earn from the medium-term fixed-income securities they replaced. We beat this expectation—but only because of the performance of a single issue. I also told you that these securities, as a group, would "not produce the returns we can achieve when we find a business with wonderful economic prospects." Unfortunately, that prediction was fulfilled. Finally, I said that "under almost any conditions, we expect these preferreds to return us our money plus dividends." That's one I would like to have back. Winston Churchill once said that "eating my words has never given me indigestion." My assertion, however, that it was almost impossible for us to lose money on our preferreds has caused me some well-deserved heartburn.

Our best holding has been Gillette, which we told you from the start was a superior business. Ironically, though, this is also the purchase in which I made my biggest mistake—of a kind, however, never recognized on financial statements.

We paid $600 million in 1989 for Gillette preferred shares that were convertible into 48 million (split-adjusted) common shares. Taking an alternative route with the $600 million, I probably could have purchased 60 million shares of common from the company. The market on the common was then about $10.50, and given that this would have been a huge private placement carrying important restrictions, I probably could have bought the stock at a discount of at least 5%. I can't be sure about this, but it's likely that Gillette's management would have been just as happy to have Berkshire opt for common.

But I was far too clever to do that. Instead, for less than two years, we received some extra dividend income (the difference between the preferred's yield and that of the common), at which point the company—quite properly—called the issue, moving to do that as quickly as was possible. If I had negotiated for common rather than preferred, we would have been better off at yearend 1995 by $625 million, minus the "excess" dividends of about $70 million.

In the case of Champion, the ability of the company to call our preferred at 115% of cost forced a move out of us last August that we would rather have delayed. In this instance, we converted our shares just prior to the pending call and offered them to the company at a modest discount.

Charlie and I have never had a conviction about the paper industry—actually, I can't remember ever owning the common stock of a paper producer in my 54 years of investing—so our choice in August was whether to sell in the market or to the company. Champion's management had always been candid and honorable in dealing with us and wished to repurchase common shares, so we offered our stock to the company. Our Champion capital gain was moderate—about 19% after tax from a six-year investment—but the preferred delivered us a good after-tax dividend yield throughout our holding period. (That said, many press accounts have overstated the after-tax yields earned by property-casualty insurance companies on dividends paid to them. What the press has failed to take into account is a change in the tax law that took effect in 1987 and that significantly reduced the dividends received credit applicable to insurers. For details, see our 1986 Annual Report.)

Our First Empire preferred will be called on March 31, 1996, the earliest date allowable. We are comfortable owning stock in well-run banks, and we will convert and keep our First Empire common shares. Bob Wilmers, CEO of the company, is an outstanding banker, and we love being associated with him.

Our other two preferreds have been disappointing, though the Salomon preferred has modestly outperformed the fixed-income securities for which it was a substitute. However, the amount of management time Charlie and I have devoted to this holding has been vastly greater than its economic significance to Berkshire. Certainly I never dreamed I would take a new job at age 60—Salomon interim chairman, that is—because of an earlier purchase of a fixed-income security.

Soon after our purchase of the Salomon preferred in 1987, I wrote that I had "no special insights regarding the direction or future profitability of investment banking." Even the most charitable commentator would conclude that I have since proved my point.

To date, our option to convert into Salomon common has not proven of value. Furthermore, the Dow Industrials have doubled since I committed to buy the preferred, and the brokerage group has performed equally as well. That means my decision to go with Salomon because I saw value in the conversion option must be graded as very poor. Even so, the preferred has continued under some trying conditions to deliver as a fixed-income security, and the 9% dividend is currently quite attractive.

Unless the preferred is converted, its terms require redemption of 20% of the issue on October 31 of each year, 1995-99, and $140 million of our original $700 million was taken on schedule last year. (Some press reports labeled this a sale, but a senior security that matures is not "sold.") Though we did not elect to convert the preferred that matured last year, we have four more bites at the conversion apple, and I believe it quite likely that we will yet find value in our right to convert.

I discussed the USAir investment at length in last year's report. The company's results improved in 1995, but it still faces significant problems. On the plus side for us is the fact that our preferred is structurally well-designed: For example, though we have not been paid dividends since June 1994, the amounts owed us are compounding at 5% over the prime rate. On the minus side is the fact that we are dealing with a weak credit.

We feel much better about our USAir preferred than we did a year ago, but your guess is as good as mine as to its ultimate value. (Indeed, considering my record with this investment, it's fair to say that your guess may be *better* than mine.) At yearend we carried our preferred (in which there is no public market) at 60% of par, though USAir also has outstanding a junior preferred that is significantly inferior to ours in all respects except conversion price and that was then trading at 82% of par. As I write this, the junior issue has advanced to 97% of par. Let's hope the market is right.

Overall, our preferreds have performed well, but that is true only because of one huge winner, Gillette. Leaving aside Gillette, our preferreds as a group have delivered us after-tax returns no more than equal to those we could have earned from the medium-term fixed-income issues that they replaced.

A Proposed Recapitalization

At the Annual Meeting you will be asked to approve a recapitalization of Berkshire, creating two classes of stock. If the plan is adopted, our existing common stock will be designated as Class A Common Stock and a new Class B Common Stock will be authorized.

Each share of the “B” will have the rights of 1/30th of an “A” share with these exceptions: First, a B share will have 1/200th of the vote of an A share (rather than 1/30th of the vote). Second, the B will not be eligible to participate in Berkshire’s shareholder-designated charitable contributions program.

When the recapitalization is complete, each share of A will become convertible, at the holder’s option and at any time, into 30 shares of B. This conversion privilege will not extend in the opposite direction. That is, holders of B shares will not be able to convert them into A shares.

We expect to list the B shares on the New York Stock Exchange, where they will trade alongside the A stock. To create the shareholder base necessary for a listing—and to ensure a liquid market in the B stock—Berkshire expects to make a public offering for cash of at least $100 million of new B shares. The offering will be made only by means of a prospectus.

The market will ultimately determine the price of the B shares. Their price, though, should be in the neighborhood of 1/30th of the price of the A shares.

Class A shareholders who wish to give gifts may find it convenient to convert a share or two of their stock into Class B shares. Additionally, arbitrage-related conversions will occur if demand for the B is strong enough to push its price to slightly above 1/30th of the price of A.

However, because the Class A stock will entitle its holders to full voting rights and access to Berkshire’s contributions program, these shares will be superior to the Class B shares and we would expect most shareholders to remain holders of the Class A—which is precisely what the Buffett and Munger families plan to do, except in those instances when we ourselves might convert a few shares to facilitate gifts. The prospect that most shareholders will stick to the A stock suggests that it will enjoy a somewhat more liquid market than the B.

There are tradeoffs for Berkshire in this recapitalization. But they do not arise from the proceeds of the offering—we will find constructive uses for the money—nor in any degree from the price at which we will sell the B shares. As I write this—with Berkshire stock at $36,000—Charlie and I do not believe it undervalued. Therefore, the offering we propose will not diminish the per-share intrinsic value of our existing stock. Let me also put our thoughts about valuation more baldly: Berkshire is selling at a price at which Charlie and I would not consider buying it.

What Berkshire will incur by way of the B stock are certain added costs, including those involving the mechanics of handling a larger number of shareholders. On the other hand, the stock should be a convenience for people wishing to make gifts. And those of you who have hoped for a split have gained a do-it-yourself method of bringing one about.

We are making this move, though, for other reasons—having to do with the appearance of expense-laden unit trusts purporting to be low-priced "clones" of Berkshire and sure to be aggressively marketed. The idea behind these vehicles is not new: In recent years, a number of people have told me about their wish to create an "all-Berkshire" investment fund to be sold at a low dollar price. But until recently, the promoters of these investments heard out my objections and backed off.

I did not discourage these people because I prefer large investors over small. Were it possible, Charlie and I would love to turn $1,000 into $3,000 for multitudes of people who would find that gain an important answer to their immediate problems.

In order to quickly triple small stakes, however, we would have to just as quickly turn our present market capitalization of $43 billion into $129 billion (roughly the market cap of General Electric, America's most highly valued company). *We can't come close to doing that.* The very best we hope for is—on average—to double Berkshire's per-share intrinsic value every five years, and we may well fall far short of that goal.

In the end, Charlie and I do not care whether our shareholders own Berkshire in large or small amounts. What we wish for are shareholders of any size who are knowledgeable about our operations, share our objectives and long-term perspective, and are aware of our limitations, most particularly those imposed by our large capital base.

The unit trusts that have recently surfaced fly in the face of these goals. They would be sold by brokers working for big commissions, would impose other burdensome costs on their shareholders, and would be marketed *en masse* to unsophisticated buyers, apt to be seduced by our past record and beguiled by the publicity Berkshire and I have received in recent years. The sure outcome: a multitude of investors destined to be disappointed.

Through our creation of the B stock—a low-denomination product far superior to Berkshire-only trusts—we hope to make the clones unmerchandisable.

But both present and prospective Berkshire shareholders should pay special attention to one point: Though the per-share intrinsic value of our stock has grown at an excellent rate during the past five years, its market price has grown still faster. The stock, in other words, has outperformed the business.

That kind of market overperformance cannot persist indefinitely, neither for Berkshire nor any other stock. *Inevitably, there will be periods of underperformance as well.* The price volatility that results, though endemic to public markets, is not to our liking. What we would prefer instead is to have the market price of Berkshire precisely track its intrinsic value. Were the stock to do that, every shareholder would benefit during his period of ownership in exact proportion to the progress Berkshire itself made in the period.

Obviously, the market behavior of Berkshire's stock will never conform to this ideal. But we will come closer to this goal than we would otherwise if our present and prospective shareholders are informed, business-oriented and not exposed to high-commission salesmanship when making their investment decisions. To that end, we are better off if we can blunt the merchandising efforts of the unit trusts—and that is the reason we are creating the B stock.

We look forward to answering your questions about the recapitalization at the Annual Meeting.

Miscellaneous

Berkshire isn’t the only American corporation utilizing the new, exciting ABWA strategy. At about 1:15 p.m. on July 14, 1995, Michael Eisner, CEO of The Walt Disney Company, was walking up Wildflower Lane in Sun Valley. At the same time, I was leaving a lunch at Herbert Allen’s home on that street to meet Tom Murphy, CEO of Cap Cities/ABC, for a golf game.

That morning, speaking to a large group of executives and money managers assembled by Allen’s investment bank, Michael had made a brilliant presentation about Disney, and upon seeing him, I offered my congratulations. We chatted briefly—and the subject of a possible combination of Disney and Cap Cities came up. This wasn’t the first time a merger had been discussed, but progress had never before been made, in part because Disney wanted to buy with cash and Cap Cities desired stock.

Michael and I waited a few minutes for Murph to arrive, and in the short conversation that ensued, both Michael and Murph indicated they might bend on the stock/cash question. Within a few weeks, they both did, at which point a contract was put together in three very busy days.

The Disney/Cap Cities deal makes so much sense that I’m sure it would have occurred without that chance encounter in Sun Valley. But when I ran into Michael that day on Wildflower Lane, he was heading for his plane, so without that accidental meeting the deal certainly wouldn’t have happened in the time frame it did. I believe both Disney and Cap Cities will benefit from the fact that we all serendipitously met that day.

* * * * * * * * * * * * *

It’s appropriate that I say a few words here about Murph. To put it simply, he is as fine an executive as I have ever seen in my long exposure to business. Equally important, he possesses human qualities every bit the equal of his managerial qualities. He’s an extraordinary friend, parent, husband and citizen. In those rare instances in which Murph’s personal interests diverged from those of shareholders, he unfailingly favored the owners. When I say that I like to be associated with managers whom I would love to have as a sibling, in-law, or trustee of my will, Murph is the exemplar of what I mean.

If Murph should elect to run another business, don't bother to study its value—just buy the stock. And don't later be as dumb as I was two years ago when I sold one-third of our holdings in Cap Cities for $635 million (versus the $1.27 billion those shares would bring in the Disney merger).

* * * * * * * * * * * *

About 96.3% of all eligible shares participated in Berkshire's 1995 shareholder-designated contributions program. Contributions made were $11.6 million and 3,600 charities were recipients. A full description of the shareholder-designated contributions program appears on pages 54-55.

Every year a few shareholders miss out on the program because they don't have their shares registered in their own names on the prescribed record date or because they fail to get their designation form back to us within the 60-day period allowed. That second problem pained me especially this year because two good friends with substantial holdings missed the deadline. We had to deny their requests to be included because we can't make exceptions for some shareholders while refusing to make them for others.

To participate in future programs, you must own Class A shares that are registered in the name of the actual owner, not the nominee name of a broker, bank or depository. Shares not so registered on August 31, 1996, will be ineligible for the 1996 program. When you get the form, return it promptly so that it does not get put aside or forgotten.

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When it comes to our Annual Meetings, Charlie and I are managerial oddballs: We thoroughly enjoy the event. So come join us on Monday, May 6. At Berkshire, we have no investor relations department and don't use financial analysts as a channel for disseminating information, earnings "guidance," or the like. Instead, we prefer direct manager-to-owner communication and believe that the Annual Meeting is the ideal place for this interchange of ideas. Talking to you there is efficient for us and also democratic in that all present simultaneously hear what we have to say.

Last year, for the first time, we had the Annual Meeting at the Holiday Convention Centre and the logistics seemed to work. The ballroom there was filled with about 3,200 people, and we had a video feed into a second room holding another 800 people. Seating in the main room was a little tight, so this year we will probably configure it to hold 3,000. This year we will also have two rooms for the overflow.

All in all, we will be able to handle 5,000 shareholders. The meeting will start at 9:30 a.m., but be warned that last year the main ballroom was filled shortly after 8:00 a.m.

Shareholders from 49 states attended our 1995 meeting—where were you, Vermont?—and a number of foreign countries, including Australia, Sweden and Germany, were represented. As always, the meeting attracted shareholders who were interested in Berkshire's business—as contrasted to shareholders who are primarily interested in themselves—and the questions were all good. Charlie and I ate lunch on stage and answered questions for about five hours.

We feel that if owners come from all over the world, we should try to make sure they have an opportunity to ask their questions. Most shareholders leave about noon, but a thousand or so hardcore types usually stay to see whether we will drop. Charlie and I are in training to last at least five hours again this year.

We will have our usual array of Berkshire products at the meeting and this year will add a sales representative from GEICO. At the 1995 meeting, we sold 747 pounds of candy, 759 pairs of shoes, and over $17,500 of World Books and related publications. In a move that might have been dangerous had our stock been weak, we added knives last year from our Quikut subsidiary and sold 400 sets of these. (We draw the line at soft fruit, however.) All of these goods will again be available this year. We don't consider a cultural event complete unless a little business is mixed in.

Because we expect a large crowd for the meeting, we recommend that you promptly get both plane and hotel reservations. Those of you who like to be downtown (about six miles from the Centre) may wish to stay at the Radisson Redick Tower, a small (88 rooms) but nice hotel, or at the much larger Red Lion Hotel a few blocks away. In the vicinity of the Centre are the Holiday Inn (403 rooms), Homewood Suites (118 rooms) and Hampton Inn (136 rooms). Another recommended spot is the Marriott, whose west Omaha location is about 100 yards from Borsheim's and a ten-minute drive from the Centre. There will be buses at the Marriott that will leave at 7:30, 8:00 and 8:30 for the meeting and return after it ends.

An attachment to our proxy material explains how you can obtain the card you will need for admission to the meeting. A good-sized parking area is available at the Centre, while those who stay at the Holiday Inn, Homewood Suites and Hampton Inn will be able to walk to the meeting. As usual, we will have buses to take you to the Nebraska Furniture Mart and Borsheim's after the meeting and to take you from there to hotels or the airport later.

NFM's main store, on its 64-acre site about two miles north of the Centre, is open from 10 a.m. to 9 p.m. on weekdays, 10 a.m. to 6 p.m. on Saturdays, and noon to 6 p.m. on Sundays. Rose Blumkin—"Mrs. B"—is now 102, but will be hard at work in Mrs. B's Warehouse. She was honored in November at the opening of The Rose, a classic downtown theater of the 20's that has been magnificently restored, but that would have been demolished had she not saved it. Ask her to tell you the story.

Borsheim's normally is closed on Sunday but will be open for shareholders and their guests from 10 a.m. to 6 p.m. on May 5th. Additionally, we will have a special opening for shareholders on Saturday, the 4th, from 6 p.m. to 9 p.m. Last year, on Shareholders Day, we wrote 1,733 tickets in the six hours we were open—which is a sale every 13 seconds. Remember, though, that records are made to be broken.

At Borsheim's, we will also have the world's largest faceted diamond on display. Two years in the cutting, this inconspicuous bauble is 545 carats in size. Please inspect this stone and let it guide you in determining what size gem is appropriate for the one you love.

On Saturday evening, May 4, there will be a baseball game at Rosenblatt Stadium between the Omaha Royals and the Louisville Redbirds. I expect to make the opening pitch—owning a quarter of the team assures me of one start per year—but our manager, Mike Jirschele, will probably make his usual mistake and yank me immediately after. About 1,700 shareholders attended last year's game. Unfortunately, we had a rain-out, which greatly disappointed the many scouts in the stands. But the smart ones will be back this year, and I plan to show them my best stuff.

Our proxy statement will include information about obtaining tickets to the game. We will also offer an information packet this year listing restaurants that will be open on Sunday night and describing various things that you can do in Omaha on the weekend.

For years, I've unsuccessfully tried to get my grade school classmate, "Pal" Gorat, to open his steakhouse for business on the Sunday evening preceding the meeting. But this year he's relented. Gorat's is a family-owned enterprise that has thrived for 52 years, and if you like steaks, you'll love this place. I've told Pal he will get a good crowd, so call Gorat's at 402-551-3733 for a reservation. You'll spot me there—I'll be the one eating the rare T-bone with a double order of hash browns.

March 1, 1996

Warren E. Buffett
Chairman of the Board

BERKSHIRE HATHAWAY INC.

Chairman's Letter

To the Shareholders of Berkshire Hathaway Inc.:

Our gain in net worth during 1996 was $6.2 billion, or 36.1%. Per-share book value, however, grew by less, 31.8%, because the number of Berkshire shares increased: We issued stock in acquiring FlightSafety International and also sold new Class B shares.* Over the last 32 years (that is, since present management took over) per-share book value has grown from $19 to $19,011, or at a rate of 23.8% compounded annually.

> * *Each Class B share has an economic interest equal to 1/30th of that possessed by a Class A share, which is the new designation for the only stock that Berkshire had outstanding before May 1996.Throughout this report, we state all per-share figures in terms of "Class A equivalents," which are the sum of the Class A shares outstanding and 1/30th of the Class B shares outstanding.*

For technical reasons, we have restated our 1995 financial statements, a matter that requires me to present one of my less-than-thrilling explanations of accounting arcana. I'll make it brief.

The restatement was required because GEICO became a wholly-owned subsidiary of Berkshire on January 2, 1996, whereas it was previously classified as an investment. From an economic viewpoint—taking into account major tax efficiencies and other benefits we gained—the value of the 51% of GEICO we owned at year-end 1995 *increased* significantly when we acquired the remaining 49% of the company two days later. Accounting rules applicable to this type of "step acquisition," however, required us to *write down* the value of our 51% at the time we moved to 100%. That writedown—which also, of course, reduced book value—amounted to $478.4 million. As a result, we now carry our original 51% of GEICO at a value that is both lower than its market value at the time we purchased the remaining 49% of the company and lower than the value at which we carry that 49% itself.

There is an offset, however, to the reduction in book value I have just described: Twice during 1996 we issued Berkshire shares at a premium to book value, first in May when we sold the B shares for cash and again in December when we used both A and B shares as part-payment for FlightSafety. In total, the three non-operational items affecting book value contributed less than one percentage point to our 31.8% per-share gain last year.

I dwell on this rise in per-share book value because it roughly indicates our economic progress during the year. But, as Charlie Munger, Berkshire's Vice Chairman, and I have repeatedly told you, what counts at Berkshire is intrinsic value, not book value. The last time you got that message from us was in the Owner's Manual, sent to you in June after we issued the Class B shares. In that manual, we not only defined certain key terms—such as intrinsic value— but also set forth our economic principles.

For many years, we have listed these principles in the front of our annual report, but in this report, on pages 58 to 67, we reproduce the entire Owner's Manual. In this letter, we will occasionally refer to the manual so that we can avoid repeating certain definitions and explanations. For example, if you wish to brush up on "intrinsic value," see pages 64 and 65.

Last year, for the first time, we supplied you with a table that Charlie and I believe will help anyone trying to estimate Berkshire's intrinsic value. In the updated version of that table, which follows, we trace two key indices of value. The first column lists our per-share ownership of investments (including cash and equivalents) and the second column shows our per-share earnings from Berkshire's operating businesses before taxes and purchase-accounting adjustments but after all interest and corporate overhead expenses. The operating-earnings column excludes all dividends, interest and capital gains that we realized from the investments presented in the first column. In effect, the two columns show what Berkshire would have reported had it been broken into two parts.

Year	Marketable	Pre-tax Earnings Per

	Securities Per Share	Share Excluding All Income from Investments
1965	$ 4	$ 4.08
1975	159	(6.48)
1985	2,443	18.86
1995	22,088	258.20
1996	28,500	421.39
Annual Growth Rate: 1965-95	33.4%	14.7%
One-Year Growth Rate: 1965-95	29.0%	63.2%

As the table tells you, our investments per share increased in 1996 by 29.0% and our non-investment earnings grew by 63.2%. Our goal is to keep the numbers in both columns moving ahead at a reasonable (or, better yet, unreasonable) pace.

Our expectations, however, are tempered by two realities. First, our past rates of growth cannot be matched nor even approached: Berkshire's equity capital is now large—in fact, fewer than ten businesses in America have capital larger— and an abundance of funds tends to dampen returns. Second, whatever our rate of progress, it will not be smooth: Year-to-year moves in the first column of the table above will be influenced in a major way by fluctuations in securities markets; the figures in the second column will be affected by wide swings in the profitability of our catastrophe-reinsurance business.

In the table, the donations made pursuant to our shareholder-designated contributions program are charged against the second column, though we view them as a shareholder benefit rather than as an expense. All other corporate expenses are also charged against the second column. These costs may be lower than those of any other large American corporation: Our after-tax headquarters expense amounts to less than two basis points (1/50th of 1%) measured against net worth. Even so, Charlie used to think this expense percentage outrageously high, blaming it on my use of Berkshire's corporate jet, *The Indefensible*. But Charlie has recently experienced a "counter-revelation": With our purchase of FlightSafety, whose major activity is the training of corporate pilots, he now rhapsodizes at the mere mention of jets.

Seriously, costs matter. For example, equity mutual funds incur corporate expenses—largely payments to the funds' managers—that average about 100 basis points, a levy likely to cut the returns their investors earn by 10% or more over time. Charlie and I make no promises about Berkshire's results. We do promise you, however, that virtually all of the gains Berkshire makes will end up with shareholders. We are here to make money with you, not off you.

The Relationship of Intrinsic Value to Market Price

In last year's letter, with Berkshire shares selling at $36,000, I told you: (1) Berkshire's gain in market value in recent years had outstripped its gain in intrinsic value, even though the latter gain had been highly satisfactory; (2) that kind of overperformance could not continue indefinitely; (3) Charlie and I did not at that moment consider Berkshire to be undervalued.

Since I set down those cautions, Berkshire's intrinsic value has increased very significantly—aided in a major way by a stunning performance at GEICO that I will tell you more about later—while the market price of our shares has changed little. This, of course, means that in 1996 Berkshire's stock underperformed the business. Consequently, today's price/value relationship is both much different from what it was a year ago and, as Charlie and I see it, more appropriate.

Over time, the aggregate gains made by Berkshire shareholders must of necessity match the business gains of the company. When the stock temporarily overperforms or underperforms the business, a limited number of shareholders—either sellers or buyers—receive outsized benefits at the expense of those they trade with. Generally, the sophisticated have an edge over the innocents in this game.

Though our primary goal is to maximize the amount that our shareholders, in total, reap from their ownership of Berkshire, we wish also to minimize the benefits going to some shareholders at the expense of others. These are goals we would have were we managing a family partnership, and we believe they make equal sense for the manager of a public company. In a partnership, fairness requires that partnership interests be valued equitably when partners enter or exit; in a public company, fairness prevails when market price and intrinsic value are in sync. Obviously, they won't always meet that ideal, but a manager—by his policies and communications—can do much to foster equity.

Of course, the longer a shareholder holds his shares, the more bearing Berkshire's business results will have on his financial experience—and the less it will matter what premium or discount to intrinsic value prevails when he buys and sells his stock. That's one reason we hope to attract owners with long-term horizons. Overall, I think we have succeeded in that pursuit. Berkshire probably ranks number one among large American corporations in the percentage of its shares held by owners with a long-term view.

Acquisitions of 1996

We made two acquisitions in 1996, both possessing exactly the qualities we seek—excellent business economics and an outstanding manager.

The first acquisition was Kansas Bankers Surety (KBS), an insurance company whose name describes its specialty. The company, which does business in 22 states, has an extraordinary underwriting record, achieved through the efforts of Don Towle, an extraordinary manager. Don has developed first-hand relationships with hundreds of bankers and knows every detail of his operation. He thinks of himself as running a company that is "his," an attitude we treasure at Berkshire. Because of its relatively small size, we placed KBS with Wesco, our 80%-owned subsidiary, which has wanted to expand its insurance operations.

You might be interested in the carefully-crafted and sophisticated acquisition strategy that allowed Berkshire to nab this deal. Early in 1996 I was invited to the 40th birthday party of my nephew's wife, Jane Rogers. My taste for social events being low, I immediately, and in my standard, gracious way, began to invent reasons for skipping the event. The party planners then countered brilliantly by offering me a seat next to a man I always enjoy, Jane's dad, Roy Dinsdale—so I went.

The party took place on January 26. Though the music was loud—Why must bands play as if they will be paid by the decibel?—I just managed to hear Roy say he'd come from a directors meeting at Kansas Bankers Surety, a company I'd always admired. I shouted back that he should let me know if it ever became available for purchase.

On February 12, I got the following letter from Roy: "Dear Warren: Enclosed is the annual financial information on Kansas Bankers Surety. This is the company that we talked about at Janie's party. If I can be of any further help, please let me know." On February 13, I told Roy we would pay $75 million for the company—and before long we had a deal. I'm now scheming to get invited to Jane's next party.

Our other acquisition in 1996—FlightSafety International, the world's leader in the training of pilots—was far larger, at about $1.5 billion, but had an equally serendipitous origin. The heroes of this story are first, Richard Sercer, a Tucson aviation consultant, and second, his wife, Alma Murphy, an ophthalmology graduate of Harvard Medical School, who in 1990 wore down her husband's reluctance and got him to buy Berkshire stock. Since then, the two have attended all our Annual Meetings, but I didn't get to know them personally.

Fortunately, Richard had also been a long-time shareholder of FlightSafety, and it occurred to him last year that the two companies would make a good fit. He knew our acquisition criteria, and he thought that Al Ueltschi, FlightSafety's 79-year-old CEO, might want to make a deal that would both give him a home for his company and a security in payment that he would feel comfortable owning throughout his lifetime. So in July, Richard wrote Bob Denham, CEO of Salomon Inc, suggesting that he explore the possibility of a merger.

Bob took it from there, and on September 18, Al and I met in New York. I had long been familiar with FlightSafety's business, and in about 60 seconds I knew that Al was exactly our kind of manager. A month later, we had a contract. Because Charlie and I wished to minimize the issuance of Berkshire shares, the transaction we structured gave FlightSafety shareholders a choice of cash or stock but carried terms that encouraged those who were tax-indifferent to take cash. This nudge led to about 51% of FlightSafety's shares being exchanged for cash, 41% for Berkshire A and 8% for Berkshire B.

Al has had a lifelong love affair with aviation and actually piloted Charles Lindbergh. After a barnstorming career in the 1930s, he began working for Juan Trippe, Pan Am's legendary chief. In 1951, while still at Pan Am, Al founded FlightSafety, subsequently building it into a simulator manufacturer and a worldwide trainer of pilots (single-engine, helicopter, jet and marine). The company operates in 41 locations, outfitted with 175 simulators of planes ranging from the very small, such as Cessna 210s, to Boeing 747s. Simulators are not cheap—they can cost as much as $19 million —so this business, unlike many of our operations, is capital intensive. About half of the company's revenues are derived from the training of corporate pilots, with most of the balance coming from airlines and the military.

Al may be 79, but he looks and acts about 55. He will run operations just as he has in the past: We never fool with success. I have told him that though we don't believe in splitting Berkshire stock, we will split his age 2-for-1 when he hits 100.

An observer might conclude from our hiring practices that Charlie and I were traumatized early in life by an EEOC bulletin on age discrimination. The real explanation, however, is self-interest: It's difficult to teach a new dog old tricks. The many Berkshire managers who are past 70 hit home runs today at the same pace that long ago gave them reputations as young slugging sensations. Therefore, to get a job with us, just employ the tactic of the 76-

year-old who persuaded a dazzling beauty of 25 to marry him. “How did you ever get her to accept?” asked his envious contemporaries. The comeback: “I told her I was 86.”

* * * * * * * * * * * *

And now we pause for our usual commercial: If you own a large business with good economic characteristics and wish to become associated with an exceptional collection of businesses having similar characteristics, Berkshire may well be the home you seek. Our requirements are set forth on page 21. If your company meets them—and if I fail to make the next birthday party you attend—give me a call.

Insurance Operations—Overview

Our insurance business was terrific in 1996. In both primary insurance, where GEICO is our main unit, and in our “super-cat” reinsurance business, results were outstanding.

As we’ve explained in past reports, what counts in our insurance business is, first, the amount of “float” we generate and, second, its cost to us. These are matters that are important for you to understand because float is a major component of Berkshire’s intrinsic value that is not reflected in book value.

To begin with, float is money we hold but don’t own. In an insurance operation, float arises because premiums are received before losses are paid. Secondly, the premiums that an insurer takes in typically do not cover the losses and expenses it eventually must pay. That leaves it running an “underwriting loss,” which is the cost of float. An insurance business has value if its cost of float over time is less than the cost the company would otherwise incur to obtain funds. But the business is an albatross if the cost of its float is higher than market rates for money.

As the numbers in the following table show, Berkshire’s insurance business has been a huge winner. For the table, we have calculated our float— which we generate in large amounts relative to our premium volume—by adding loss reserves, loss adjustment reserves, funds held under reinsurance assumed and unearned premium reserves, and then subtracting agents’ balances, prepaid acquisition costs, prepaid taxes and deferred charges applicable to assumed reinsurance. Our cost of float is determined by our underwriting loss or profit. In those years when we have had an underwriting profit, such as the last four, our cost of float has been negative. In effect, we have been paid for holding money.

	(1) Underwriting Loss	(2) Average Float	Approximate Cost of Funds	Yearend Yield on Long-Term Govt. Bonds
	(In $ Millions)		*(Ratio of 1 to 2)*	
1967	profit	$17.3	less than zero	5.50%
1968	profit	19.9	less than zero	5.90%
1969	profit	23.4	less than zero	6.79%
1970	$ 0.37	32.4	1.14%	6.25%
1971	profit	52.5	less than zero	5.81%
1972	profit	69.5	less than zero	5.82%
1973	profit	73.3	less than zero	7.27%
1974	7.36	79.1	9.30%	8.13%

1975	11.35	87.6	12.96%	8.03%
1976	profit	102.6	less than zero	7.30%
1977	profit	139.0	less than zero	7.97%
1978	profit	190.4	less than zero	8.93%
1979	profit	227.3	less than zero	10.08%
1980	profit	237.0	less than zero	11.94%
1981	profit	228.4	less than zero	13.61%
1982	21.56	220.6	9.77%	10.64%
1983	33.87	231.3	14.64%	11.84%
1984	48.06	253.2	18.98%	11.58%
1985	44.23	390.2	11.34%	9.34%
1986	55.84	797.5	7.00%	7.60%
1987	55.43	1,266.7	4.38%	8.95%

1988	11.08	1,497.7	0.74%	9.00%
1989	24.40	1,541.3	1.58%	7.97%
1990	26.65	1,637.3	1.63%	8.24%
1991	119.59	1,895.0	6.31%	7.40%
1992	108.96	2,290.4	4.76%	7.39%
1993	profit	2,624.7	less than zero	6.35%
1994	profit	3,056.6	less than zero	7.88%
1995	profit	3,607.2	less than zero	5.95%
1996	profit	6,702.0	less than zero	6.64%

Since 1967, when we entered the insurance business, our float has grown at an annual compounded rate of 22.3%. In more years than not, our cost of funds has been less than nothing. This access to “free” money has boosted Berkshire’s performance in a major way. Moreover, our acquisition of GEICO materially increases the probability that we can continue to obtain “free” funds in increasing amounts.

Super-Cat Insurance

As in the past three years, we once again stress that the good results we are reporting for Berkshire stem in part from our super-cat business having a lucky year. In this operation, we sell policies that insurance and reinsurance companies buy to protect themselves from the effects of mega-catastrophes. Since truly major catastrophes are rare occurrences, our super-cat business can be expected to show large profits in most years—and to record a huge loss occasionally. In other words, the attractiveness of our super-cat business will take a great many years to measure. *What you must understand, however, is that a truly terrible year in the super-cat business is not a possibility—it's a certainty. The only question is when it will come.*

I emphasize this lugubrious point because I would not want you to panic and sell your Berkshire stock upon hearing that some large catastrophe had cost us a significant amount. If you would tend to react that way, you should not own Berkshire shares now, just as you should entirely avoid owning stocks if a crashing market would lead you to panic and sell. Selling fine businesses on "scary" news is usually a bad decision. (Robert Woodruff, the business genius who built Coca-Cola over many decades and who owned a huge position in the company, was once asked when it might be a good time to sell Coke stock. Woodruff had a simple answer: "I don't know. I've never sold any.")

In our super-cat operation, our customers are insurers that are exposed to major earnings volatility and that wish to reduce it. The product we sell— for what we hope is an appropriate price— is our willingness to shift that volatility to our own books. Gyrations in Berkshire's earnings don't bother us in the least: Charlie and I would much rather earn a lumpy 15% over time than a smooth 12%. (After all, our earnings swing wildly on a daily and weekly basis—why should we demand that smoothness accompany each orbit that the earth makes of the sun?) We are most comfortable with that thinking, however, when we have shareholder/partners who can also accept volatility, and that's why we regularly repeat our cautions.

We took on some major super-cat exposures during 1996. At mid-year we wrote a contract with Allstate that covers Florida hurricanes, and though there are no definitive records that would allow us to prove this point, we believe that to have *then* been the largest single catastrophe risk ever assumed by one company for its own account. Later in the year, however, we wrote a policy for the California Earthquake Authority that goes into effect on April 1, 1997, and that exposes us to a loss more than twice that possible under the Florida contract. Again we retained all the risk for our own account. Large as these coverages are, Berkshire's after-tax "worst-case" loss from a true mega-catastrophe is probably no more than $600 million, which is less than 3% of our book value and 1.5% of our market value. To gain some perspective on this exposure, look at the table on page 2 and note the much greater volatility that security markets have delivered us.

In the super-cat business, we have three major competitive advantages. First, the parties buying reinsurance from us know that we both can and will pay under the most adverse of circumstances. Were a truly cataclysmic disaster to occur, it is not impossible that a financial panic would quickly follow. If that happened, there could well be respected reinsurers that would have difficulty paying at just the moment that their clients faced extraordinary needs. Indeed, one reason we never "lay off" part of the risks we insure is that we have reservations about our ability to collect from others when disaster strikes. When it's Berkshire promising, insureds know with certainty that they can collect promptly.

Our second advantage—somewhat related—is subtle but important. After a mega-catastrophe, insurers might well find it difficult to obtain reinsurance even though their need for coverage would then be particularly great. At such a time, Berkshire would without question have very substantial capacity available—but it will naturally be our long-standing clients that have first call on it. That business reality has made major insurers and reinsurers throughout the world realize the desirability of doing business with us. Indeed, we are currently getting sizable "stand-by" fees from reinsurers that are simply nailing down their ability to get coverage from us should the market tighten.

Our final competitive advantage is that we can provide dollar coverages of a size neither matched nor approached elsewhere in the industry. Insurers looking for huge covers know that a single call to Berkshire will produce a firm and immediate offering.

A few facts about our exposure to California earthquakes—our largest risk—seem in order. The Northridge quake of 1994 laid homeowners' losses on insurers that greatly exceeded what computer models had told them to expect. Yet the intensity of that quake was mild compared to the "worst-case" possibility for California. Understandably, insurers became—ahem—shaken and started contemplating a retreat from writing earthquake coverage into their homeowners' policies.

In a thoughtful response, Chuck Quackenbush, California's insurance commissioner, designed a new residential earthquake policy to be written by a state-sponsored insurer, The California Earthquake Authority. This entity, which went into operation on December 1, 1996, needed large layers of reinsurance—and that's where we came in. Berkshire's layer of approximately $1 billion will be called upon if the Authority's aggregate losses in the period ending March 31, 2001 exceed about $5 billion. (The press originally reported larger figures, but these would have applied only if all California insurers had entered into the arrangement; instead only 72% signed up.)

So what are the true odds of our having to make a payout during the policy's term? We don't know—nor do we think computer models will help us, since we believe the precision they project is a chimera. In fact, such models can lull decision-makers into a false sense of security and thereby increase their chances of making a really huge mistake. We've already seen such debacles in both insurance and investments. Witness "portfolio insurance," whose destructive effects in the 1987 market crash led one wag to observe that it was the computers that should have been jumping out of windows.

Even if perfection in assessing risks is unattainable, insurers can underwrite sensibly. After all, you need not know a man's precise age to know that he is old enough to vote nor know his exact weight to recognize his need to diet. In insurance, it is essential to remember that virtually all surprises are unpleasant, and with that in mind we try to price our super-cat exposures so that about 90% of total premiums end up being eventually paid out in losses and expenses. Over time, we will find out how smart our pricing has been, but that will not be quickly. The super-cat business is just like the investment business in that it often takes a long time to find out whether you knew what you were doing.

What I can state with certainty, however, is that we have the best person in the world to run our super-cat business: Ajit Jain, whose value to Berkshire is simply enormous. In the reinsurance field, disastrous propositions abound. I know that because I personally embraced all too many of these in the 1970s and also because GEICO has a large runoff portfolio made up of foolish contracts written in the early-1980s, able though its then-management was. Ajit, I can assure you, won't make mistakes of this type.

I have mentioned that a mega-catastrophe might cause a catastrophe in the financial markets, a possibility that is unlikely but not far-fetched. Were the catastrophe a quake in California of sufficient magnitude to tap our coverage, we would almost certainly be damaged in other ways as well. For example, See's, Wells Fargo and Freddie Mac could be hit hard. All in all, though, we can handle this aggregation of exposures.

In this respect, as in others, we try to "reverse engineer" our future at Berkshire, bearing in mind Charlie's dictum: "All I want to know is where I'm going to die so I'll never go there." (Inverting really works: Try singing country western songs backwards and you will quickly regain your house, your car and your wife.) If we can't tolerate a possible consequence, remote though it may be, we steer clear of planting its seeds. That is why we don't borrow big amounts and why we make sure that our super-cat business losses, large though the maximums may sound, will not put a major dent in Berkshire's intrinsic value.

Insurance—GEICO and Other Primary Operations

When we moved to total ownership of GEICO early last year, our expectations were high—and they are all being exceeded. That is true from both a business and personal perspective: GEICO's operating chief, Tony Nicely, is a superb business manager and a delight to work with. Under almost any conditions, GEICO would be an exceptionally valuable asset. With Tony at the helm, it is reaching levels of performance that the organization would only a few years ago have thought impossible.

There's nothing esoteric about GEICO's success: The company's competitive strength flows directly from its position as a low-cost operator. Low costs permit low prices, and low prices attract and retain good policyholders. The final segment of a virtuous circle is drawn when policyholders recommend us to their friends. GEICO gets more than one million referrals annually and these produce more than half of our new business, an advantage that gives us enormous savings in acquisition expenses—and that makes our costs still lower.

This formula worked in spades for GEICO in 1996: Its voluntary auto policy count grew 10%. During the previous 20 years, the company's best-ever growth for a year had been 8%, a rate achieved only once. Better yet, the growth in voluntary policies accelerated during the year, led by major gains in the nonstandard market, which has been an underdeveloped area at GEICO. I focus here on voluntary policies because the involuntary business we get from assigned risk pools and the like is unprofitable. Growth in that sector is most unwelcome.

GEICO's growth would mean nothing if it did not produce reasonable underwriting profits. Here, too, the news is good: Last year we hit our underwriting targets and then some. Our goal, however, is not to widen our profit margin but rather to enlarge the price advantage we offer customers. Given that strategy, we believe that 1997's growth will easily top that of last year.

We expect new competitors to enter the direct-response market, and some of our existing competitors are likely to expand geographically. Nonetheless, the economies of scale we enjoy should allow us to maintain or even widen the protective moat surrounding our economic castle. We do best on costs in geographical areas in which we enjoy high market penetration. As our policy count grows, concurrently delivering gains in penetration, we expect to drive costs materially lower. GEICO's sustainable cost advantage is what attracted me to the company way back in 1951, when the entire business was valued at $7 million. It is also why I felt Berkshire should pay $2.3 billion last year for the 49% of the company that we didn't then own.

Maximizing the results of a wonderful business requires management and focus. Lucky for us, we have in Tony a superb manager whose business focus never wavers. Wanting also to get the entire GEICO organization concentrating as he does, we needed a compensation plan that was itself sharply focused—and immediately after our purchase, we put one in.

Today, the bonuses received by dozens of top executives, starting with Tony, are based upon only two key variables: (1) growth in voluntary auto policies and (2) underwriting profitability on "seasoned" auto business (meaning policies that have been on the books for more than one year). In addition, we use the same yardsticks to calculate the annual contribution to the company's profit-sharing plan. *Everyone* at GEICO knows what counts.

The GEICO plan exemplifies Berkshire's incentive compensation principles: Goals should be (1) tailored to the economics of the specific operating business; (2) simple in character so that the degree to which they are being realized can be easily measured; and (3) directly related to the daily activities of plan participants. As a corollary, we shun "lottery ticket" arrangements, such as options on Berkshire shares, whose ultimate value—which could range from zero to huge—is totally out of the control of the person whose behavior we would like to affect. In our view, a system that produces quixotic payoffs will not only be wasteful for owners but may actually discourage the focused behavior we value in managers.

Every quarter, all 9,000 GEICO associates can see the results that determine our profit-sharing plan contribution. In 1996, they enjoyed the experience because the plan literally went off the chart that had been constructed at the start of the year. Even I knew the answer to that problem: Enlarge the chart. Ultimately, the results called for a record contribution of 16.9% ($40 million), compared to a five-year average of less than 10% for the comparable plans previously in effect. Furthermore, at Berkshire, we never greet good work by raising the bar. If GEICO's performance continues to improve, we will happily keep on making larger charts.

Lou Simpson continues to manage GEICO's money in an outstanding manner: Last year, the equities in his portfolio outdid the S&P 500 by 6.2 percentage points. In Lou's part of GEICO's operation, we again tie compensation to performance—but to investment performance over a four-year period, not to underwriting results nor to the performance of GEICO as a whole. We think it foolish for an insurance company to pay bonuses that are tied to overall corporate results when great work on one side of the business—underwriting or investment—could conceivably be completely neutralized by bad work on the other. If you bat .350 at Berkshire, you can be sure you will get paid commensurately even if the rest of the team bats .200. In Lou and Tony, however, we are lucky to have Hall-of-Famers in both key positions.

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Though they are, of course, smaller than GEICO, our other primary insurance operations turned in equally stunning results last year. National Indemnity's traditional business had a combined ratio of 74.2 and, as usual, developed a large amount of float compared to premium volume. Over the last three years, this segment of our business, run by Don Wurster, has had an average combined ratio of 83.0. Our homestate operation, managed by Rod Eldred, recorded a combined ratio of 87.1 even though it absorbed the expenses of expanding to new states. Rod's three-year combined ratio is an amazing 83.2. Berkshire's workers' compensation business, run out of California by Brad Kinstler, has now moved into six other states and, despite the costs of that expansion, again achieved an excellent underwriting profit. Finally, John Kizer, at Central States Indemnity, set new records for premium volume while generating good earnings from underwriting. In aggregate, our smaller insurance operations (now including Kansas Bankers Surety) have an underwriting record virtually unmatched in the industry. Don, Rod, Brad and John have all created significant value for Berkshire, and we believe there is more to come.

Taxes

In 1961, President Kennedy said that we should ask not what our country can do for us, but rather ask what we can do for our country. Last year we decided to give his suggestion a try—and who says it never hurts to ask? We were told to mail $860 million in income taxes to the U.S. Treasury.

Here's a little perspective on that figure: If an equal amount had been paid by only 2,000 other taxpayers, the government would have had a balanced budget in 1996 without needing a dime of taxes—income or Social Security or what have you—from *any* other American. Berkshire shareholders can truly say, "I gave at the office."

Charlie and I believe that large tax payments by Berkshire are entirely fitting. The contribution we thus make to society's well-being is at most only proportional to its contribution to ours. Berkshire prospers in America as it would nowhere else.

Sources of Reported Earnings

The table that follows shows the main sources of Berkshire's reported earnings. In this presentation, purchase-accounting adjustments are not assigned to the specific businesses to which they apply, but are instead aggregated and shown separately. This procedure lets you view the earnings of our businesses as they would have been reported had we not purchased them. For the reasons discussed on pages 65 and 66, this form of presentation seems to us to be more useful to investors and managers than one utilizing generally-accepted accounting principles (GAAP), which require purchase-premiums to be charged off business-by-business. The total earnings we show in the table are, of course, identical to the GAAP total in our audited financial statements.

(in millions)

	Pre-Tax Earnings		*Berkshire's Share of Net Earnings (after taxes and minority interests)*	
	1996	*1995*[(1)]	*1996*	*1995*[(1)]
Operating Earnings:				
Insurance Group:				
Underwriting	$ 222.1	$ 20.5	$ 142.8	$ 11.3
Net Investment	726.2	501.6	593.1	417.7

Income

Buffalo News	50.4		46.8		29.5		27.3	
Fechheimer	17.3		16.9		9.3		8.8	
Finance Businesses	23.1		20.8		14.9		12.6	
Home Furnishings	43.8		29.7	(2)	24.8		16.7	(2)
Jewelry	27.8		33.9	(3)	16.1		19.1	(3)
Kirby	58.5		50.2		39.9		32.1	
Scott Fetzer Manufacturing Group	50.6		34.1		32.2		21.2	
See’s Candies	51.9		50.2		30.8		29.8	
Shoe Group	61.6		58.4		41.0		37.5	
World Book	12.6		8.8		9.5		7.0	
Purchase-Accounting Adjustments	(75.7)		(27.0)		(70.5)		(23.4)	

Interest Expense[4]	(94.3)	(56.0)	(56.6)	(34.9)
Shareholder-Designated Contributions	(13.3)	(11.6)	(8.5)	(7.0)
Other	58.8	37.4	34.8	24.4
Operating Earnings	1,221.4	814.7	883.1	600.2
Sales of Securities	2,484.5	194.1	1,605.5	125.0
Total Earnings — All Entities	$3,705.9	$1,008.8	$2,488.6	$ 725.2

(1) *Before the GEICO-related restatement.*
(2) *Includes R.C. Willey from June 29, 1995.*
(3) *Includes Helzberg's from April 30, 1995.*
(4) *Excludes interest expense of Finance Businesses.*

In this section last year, I discussed three businesses that reported a decline in earnings—Buffalo News, Shoe Group and World Book. All, I'm happy to say, recorded gains in 1996.

World Book, however, did not find it easy: Despite the operation's new status as the only direct-seller of encyclopedias in the country (Encyclopedia Britannica exited the field last year), its unit volume fell. Additionally, World Book spent heavily on a new CD-ROM product that began to take in revenues only in early 1997, when it was launched in association with IBM. In the face of these factors, earnings would have evaporated had World Book not revamped distribution methods and cut overhead at headquarters, thereby dramatically reducing its fixed costs. Overall, the company has gone a long way toward assuring its long-term viability in both the print and electronic marketplaces.

Our only disappointment last year was in jewelry: Borsheim's did fine, but Helzberg's suffered a material decline in earnings. Its expense levels had been geared to a sizable increase in same-store sales, consistent with the gains achieved in recent years. When sales were instead flat, profit margins fell. Jeff Comment, CEO of Helzberg's, is addressing the expense problem in a decisive manner, and the company's earnings should improve in 1997.

Overall, our operating businesses continue to perform exceptionally, far outdoing their industry norms. For this, Charlie and I thank our managers. If you should see any of them at the Annual Meeting, add your thanks as well.

More information about our various businesses is given on pages 36-46, where you will also find our segment earnings reported on a GAAP basis. In addition, on pages 51-57, we have rearranged Berkshire's financial data into four segments on a non-GAAP basis, a presentation that corresponds to the way Charlie and I think about the company. Our intent is to supply you with the financial information that we would wish you to give us if our positions were reversed.

"Look-Through" Earnings

Reported earnings are a poor measure of economic progress at Berkshire, in part because the numbers shown in the table presented earlier include only the dividends we receive from investees—though these dividends typically represent only a small fraction of the earnings attributable to our ownership. Not that we mind this division of money, since on balance we regard the undistributed earnings of investees as more valuable to us than the portion paid out. The reason is simple: Our investees often have the opportunity to reinvest earnings at high rates of return. So why should we want them paid out?

To depict something closer to economic reality at Berkshire than reported earnings, though, we employ the concept of "look-through" earnings. As we calculate these, they consist of: (1) the operating earnings reported in the previous section, plus; (2) our share of the retained operating earnings of major investees that, under GAAP accounting, are not reflected in our profits, less; (3) an allowance for the tax that would be paid by Berkshire if these retained earnings of investees had instead been distributed to us. When tabulating "operating earnings" here, we exclude purchase-accounting adjustments as well as capital gains and other major non-recurring items.

The following table sets forth our 1996 look-through earnings, though I warn you that the figures can be no more than approximate, since they are based on a number of judgment calls. (The dividends paid to us by these investees have been included in the operating earnings itemized on page 12, mostly under "Insurance Group: Net Investment Income.")

Berkshire's Major Investees	Berkshire's Approximate Ownership at Yearend[1]	Berkshire's Share of Undistributed Operating Earnings (in millions)[2]
American Express Company	10.5%	$ 132
The Coca-Cola Company	8.1%	180
The Walt Disney Company	3.6%	50
Federal Home Loan Mortgage Corp.	8.4%	77

The Gillette Company	8.6%	73
McDonald's Corporation	4.3%	38
The Washington Post Company	15.8%	27
Wells Fargo & Company	8.0%	84
Berkshire's share of undistributed earnings of major investees		661
Hypothetical tax on these undistributed investee earnings(3)		(93)
Reported operating earnings of Berkshire		954
Total look-through earnings of Berkshire		$1,522

(1) Does not include shares allocable to minority interests
(2) Calculated on average ownership for the year
(3) The tax rate used is 14%, which is the rate Berkshire pays on the dividends it receives

Common Stock Investments

Below we present our common stock investments. Those with a market value of more than $500 million are itemized.

		12/31/96	
Shares	*Company*	*Cost**	*Market*
		(dollars in millions)	
49,456,900	American Express Company	$1,392.7	$ 2,794.3
100,000,000	The Coca-Cola Company	1,298.9	10,525.0
24,614,214	The Walt Disney Company	577.0	1,716.8
64,246,000	Federal Home Loan Mortgage Corp.	333.4	1,772.8
48,000,000	The Gillette Company	600.0	3,732.0
30,156,600	McDonald's Corporation	1,265.3	1,368.4
1,727,765	The Washington Post Company	10.6	579.0
7,291,418	Wells Fargo & Company	497.8	1,966.9
	Others	1,934.5	3,295.4

Total Common Stocks	$7,910.2	$27,750.6

** Represents tax-basis cost which, in aggregate, is $1.2 billion less than GAAP cost.*

Our portfolio shows little change: We continue to make more money when snoring than when active.

Inactivity strikes us as intelligent behavior. Neither we nor most business managers would dream of feverishly trading highly-profitable subsidiaries because a small move in the Federal Reserve's discount rate was predicted or because some Wall Street pundit had reversed his views on the market. Why, then, should we behave differently with our minority positions in wonderful businesses? The art of investing in public companies successfully is little different from the art of successfully acquiring subsidiaries. In each case you simply want to acquire, at a sensible price, a business with excellent economics and able, honest management. Thereafter, you need only monitor whether these qualities are being preserved.

When carried out capably, an investment strategy of that type will often result in its practitioner owning a few securities that will come to represent a very large portion of his portfolio. This investor would get a similar result if he followed a policy of purchasing an interest in, say, 20% of the future earnings of a number of outstanding college basketball stars. A handful of these would go on to achieve NBA stardom, and the investor's take from them would soon dominate his royalty stream. To suggest that this investor should sell off portions of his most successful investments simply because they have come to dominate his portfolio is akin to suggesting that the Bulls trade Michael Jordan because he has become so important to the team.

In studying the investments we have made in both subsidiary companies and common stocks, you will see that we favor businesses and industries unlikely to experience major change. The reason for that is simple: Making either type of purchase, we are searching for operations that we believe are virtually certain to possess enormous competitive strength ten or twenty years from now. A fast-changing industry environment may offer the chance for huge wins, but it precludes the certainty we seek.

I should emphasize that, as citizens, Charlie and I welcome change: Fresh ideas, new products, innovative processes and the like cause our country's standard of living to rise, and that's clearly good. As investors, however, our reaction to a fermenting industry is much like our attitude toward space exploration: We applaud the endeavor but prefer to skip the ride.

Obviously all businesses change to some extent. Today, See's is different in many ways from what it was in 1972 when we bought it: It offers a different assortment of candy, employs different machinery and sells through different distribution channels. But the reasons why people today buy boxed chocolates, and why they buy them from us rather than from someone else, are virtually unchanged from what they were in the 1920s when the See family was building the business. Moreover, these motivations are not likely to change over the next 20 years, or even 50.

We look for similar predictability in marketable securities. Take Coca-Cola: The zeal and imagination with which Coke products are sold has burgeoned under Roberto Goizueta, who has done an absolutely incredible job in creating value for his shareholders. Aided by Don Keough and Doug Ivester, Roberto has rethought and improved every aspect of the company. But the fundamentals of the business—the qualities that underlie Coke's competitive dominance and stunning economics—have remained constant through the years.

I was recently studying the 1896 report of Coke (and you think that *you* are behind in your reading!). At that time Coke, though it was already the leading soft drink, had been around for only a decade. But its blueprint for the next 100 years was already drawn. Reporting sales of $148,000 that year, Asa Candler, the company's president, said: "We have not lagged in our efforts to go into all the world teaching that Coca-Cola is the article, par excellence, for the health and good feeling of all people." Though "health" may have been a reach, I love the fact that Coke still relies on Candler's basic theme today—a century later. Candler went on to say, just as Roberto could now, "No article of like character has ever so firmly entrenched itself in public favor." Sales of syrup that year, incidentally, were 116,492 gallons versus about 3.2 billion in 1996.

I can't resist one more Candler quote: "Beginning this year about March 1st . . . we employed ten traveling salesmen by means of which, with systematic correspondence from the office, we covered almost the territory of the Union." That's my kind of sales force.

Companies such as Coca-Cola and Gillette might well be labeled "The Inevitables." Forecasters may differ a bit in their predictions of exactly how much soft drink or shaving-equipment business these companies will be doing in ten or twenty years. Nor is our talk of inevitability meant to play down the vital work that these companies must continue to carry out, in such areas as manufacturing, distribution, packaging and product innovation. In the end, however, no sensible observer—not even these companies' most vigorous competitors, assuming they are assessing the matter honestly—questions that Coke and Gillette will dominate their fields worldwide for an investment lifetime. Indeed, their dominance will probably strengthen. Both companies have significantly expanded their already huge shares of market during the past ten years, and all signs point to their repeating that performance in the next decade.

Obviously many companies in high-tech businesses or embryonic industries will grow much faster in percentage terms than will The Inevitables. But I would rather be certain of a good result than hopeful of a great one.

Of course, Charlie and I can identify only a few Inevitables, even after a lifetime of looking for them. Leadership alone provides no certainties: Witness the shocks some years back at General Motors, IBM and Sears, all of which had enjoyed long periods of seeming invincibility. Though some industries or lines of business exhibit characteristics that endow leaders with virtually insurmountable advantages, and that tend to establish Survival of the Fattest as almost a natural law, most do not. Thus, for every Inevitable, there are dozens of Impostors, companies now riding high but vulnerable to competitive attacks. Considering what it takes to be an Inevitable, Charlie and I recognize that we will never be able to come up with a Nifty Fifty or even a Twinkling Twenty. To the Inevitables in our portfolio, therefore, we add a few "Highly Probables."

You can, of course, pay too much for even the best of businesses. The overpayment risk surfaces periodically and, in our opinion, may now be quite high for the purchasers of virtually all stocks, The Inevitables included. Investors making purchases in an overheated market need to recognize that it may often take an extended period for the value of even an outstanding company to catch up with the price they paid.

A far more serious problem occurs when the management of a great company gets sidetracked and neglects its wonderful base business while purchasing other businesses that are so-so or worse. When that happens, the suffering of investors is often prolonged. Unfortunately, that is precisely what transpired years ago at both Coke and Gillette. (Would you believe that a few decades back they were growing shrimp at Coke and exploring for oil at Gillette?) Loss of focus is what most worries Charlie and me when we contemplate investing in businesses that in general look outstanding. All too often, we've seen value stagnate in the presence of hubris or of boredom that caused the attention of managers to wander. That's not going to happen again at Coke and Gillette, however—not given their current and prospective managements.

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Let me add a few thoughts about your own investments. Most investors, both institutional and individual, will find that the best way to own common stocks is through an index fund that charges minimal fees. Those following this path are sure to beat the net results (after fees and expenses) delivered by the great majority of investment professionals.

Should you choose, however, to construct your own portfolio, there are a few thoughts worth remembering. Intelligent investing is not complex, though that is far from saying that it is easy. What an investor needs is the ability to correctly evaluate selected businesses. Note that word "selected": You don't have to be an expert on every company, or even many. You only have to be able to evaluate companies within your circle of competence. The size of that circle is not very important; knowing its boundaries, however, is vital.

To invest successfully, you need not understand beta, efficient markets, modern portfolio theory, option pricing or emerging markets. You may, in fact, be better off knowing nothing of these. That, of course, is not the prevailing view at most business schools, whose finance curriculum tends to be dominated by such subjects. In our view, though, investment students need only two well-taught courses—How to Value a Business, and How to Think About Market Prices.

Your goal as an investor should simply be to purchase, at a rational price, a part interest in an easily-understandable business whose earnings are virtually certain to be materially higher five, ten and twenty years from now. Over time, you will find only a few companies that meet these standards—so when you see one that qualifies, you should buy a meaningful amount of stock. You must also resist the temptation to stray from your guidelines: If you aren't willing to own a stock for ten years, don't even think about owning it for ten minutes. Put together a portfolio of companies whose aggregate earnings march upward over the years, and so also will the portfolio's market value.

Though it's seldom recognized, this is the exact approach that has produced gains for Berkshire shareholders: Our look-through earnings have grown at a good clip over the years, and our stock price has risen correspondingly. Had those gains in earnings not materialized, there would have been little increase in Berkshire's value.

The greatly enlarged earnings base we now enjoy will inevitably cause our future gains to lag those of the past. We will continue, however, to push in the directions we always have. We will try to build earnings by running our present businesses well—a job made easy because of the extraordinary talents of our operating managers—and by purchasing other businesses, in whole or in part, that are not likely to be roiled by change and that possess important competitive advantages.

USAir

When Richard Branson, the wealthy owner of Virgin Atlantic Airways, was asked how to become a millionaire, he had a quick answer: "There's really nothing to it. Start as a billionaire and then buy an airline." Unwilling to accept Branson's proposition on faith, your Chairman decided in 1989 to test it by investing $358 million in a 9.25% preferred stock of USAir.

I liked and admired Ed Colodny, the company's then-CEO, and I still do. But my analysis of USAir's business was both superficial and wrong. I was so beguiled by the company's long history of profitable operations, and by the protection that ownership of a senior security seemingly offered me, that I overlooked the crucial point: USAir's revenues would increasingly feel the effects of an unregulated, fiercely-competitive market whereas its cost structure was a holdover from the days when regulation protected profits. These costs, if left unchecked, portended disaster, however reassuring the airline's past record might be. (If history supplied all of the answers, the Forbes 400 would consist of librarians.)

To rationalize its costs, however, USAir needed major improvements in its labor contracts—and that's something most airlines have found it extraordinarily difficult to get, short of credibly threatening, or actually entering, bankruptcy. USAir was to be no exception. Immediately after we purchased our preferred stock, the imbalance between the company's costs and revenues began to grow explosively. In the 1990-1994 period, USAir lost an aggregate of $2.4 billion, a performance that totally wiped out the book equity of its common stock.

For much of this period, the company paid us our preferred dividends, but in 1994 payment was suspended. A bit later, with the situation looking particularly gloomy, we wrote down our investment by 75%, to $89.5 million. Thereafter, during much of 1995, I offered to sell our shares at 50% of face value. Fortunately, I was unsuccessful.

Mixed in with my many mistakes at USAir was one thing I got right: Making our investment, we wrote into the preferred contract a somewhat unusual provision stipulating that "penalty dividends"—to run five percentage points over the prime rate—would be accrued on any arrearages. This meant that when our 9.25% dividend was omitted for two years, the unpaid amounts compounded at rates ranging between 13.25% and 14%.

Facing this penalty provision, USAir had every incentive to pay arrearages just as promptly as it could. And in the second half of 1996, when USAir turned profitable, it indeed began to pay, giving us $47.9 million. We owe Stephen Wolf, the company's CEO, a huge thank-you for extracting a performance from the airline that permitted this payment. Even so, USAir's performance has recently been helped significantly by an industry tailwind that may be cyclical in nature. The company still has basic cost problems that must be solved.

In any event, the prices of USAir's publicly-traded securities tell us that our preferred stock is now probably worth its par value of $358 million, give or take a little. In addition, we have over the years collected an aggregate of $240.5 million in dividends (including $30 million received in 1997).

Early in 1996, before any accrued dividends had been paid, I tried once more to unload our holdings—this time for about $335 million. You're lucky: I again failed in my attempt to snatch defeat from the jaws of victory.

In another context, a friend once asked me: "If you're so rich, why aren't you smart?" After reviewing my sorry performance with USAir, you may conclude he had a point.

Financings

We wrote four checks to Salomon Brothers last year and in each case were delighted with the work for which we were paying. I've already described one transaction: the FlightSafety purchase in which Salomon was the initiating investment banker. In a second deal, the firm placed a small debt offering for our finance subsidiary.

Additionally, we made two good-sized offerings through Salomon, both with interesting aspects. The first was our sale in May of 517,500 shares of Class B Common, which generated net proceeds of $565 million. As I have told you before, we made this sale in response to the threatened creation of unit trusts that would have marketed themselves as Berkshire look-alikes. In the process, they would have used our past, and definitely nonrepeatable, record to entice naive small investors and would have charged these innocents high fees and commissions.

I think it would have been quite easy for such trusts to have sold many billions of dollars worth of units, and I also believe that early marketing successes by these trusts would have led to the formation of others. (In the securities business, whatever can be sold will be sold.) The trusts would have meanwhile indiscriminately poured the proceeds of their offerings into a supply of Berkshire shares that is fixed and limited. The likely result: a speculative bubble in our stock. For at least a time, the price jump would have been self-validating, in that it would have pulled new waves of naive and impressionable investors into the trusts and set off still more buying of Berkshire shares.

Some Berkshire shareholders choosing to exit might have found that outcome ideal, since they could have profited at the expense of the buyers entering with false hopes. Continuing shareholders, however, would have suffered once reality set in, for at that point Berkshire would have been burdened with both hundreds of thousands of unhappy, indirect owners (trustholders, that is) and a stained reputation.

Our issuance of the B shares not only arrested the sale of the trusts, but provided a low-cost way for people to invest in Berkshire if they still wished to after hearing the warnings we issued. To blunt the enthusiasm that brokers normally have for pushing new issues—because that's where the money is—we arranged for our offering to carry a commission of only 1.5%, the lowest payoff that we have ever seen in a common stock underwriting. Additionally, we made the amount of the offering open-ended, thereby repelling the typical IPO buyer who looks for a short-term price spurt arising from a combination of hype and scarcity.

Overall, we tried to make sure that the B stock would be purchased only by investors with a long-term perspective. Those efforts were generally successful: Trading volume in the B shares immediately following the offering—a rough index of "flipping"—was far below the norm for a new issue. In the end we added about 40,000 shareholders, most of whom we believe both understand what they own and share our time horizons.

Salomon could not have performed better in the handling of this unusual transaction. Its investment bankers understood perfectly what we were trying to achieve and tailored every aspect of the offering to meet these objectives. The firm would have made far more money—perhaps ten times as much—if our offering had been standard in its make-up. But the investment bankers involved made no attempt to tweak the specifics in that direction. Instead they came up with ideas that were counter to Salomon's financial interest but that made it much more certain Berkshire's goals would be reached. Terry Fitzgerald captained this effort, and we thank him for the job that he did.

Given that background, it won't surprise you to learn that we again went to Terry when we decided late in the year to sell an issue of Berkshire notes that can be exchanged for a portion of the Salomon shares that we hold. In this instance, once again, Salomon did an absolutely first-class job, selling $500 million principal amount of five-year notes for $447.1 million. Each $1,000 note is exchangeable into 17.65 shares and is callable in three years at accreted value. Counting the original issue discount and a 1% coupon, the securities will provide a yield of 3% to maturity for holders who do not exchange them for Salomon stock. But it seems quite likely that the notes will be exchanged before their maturity. If that happens, our interest cost will be about 1.1% for the period prior to exchange.

In recent years, it has been written that Charlie and I are unhappy about all investment-banking fees. That's dead wrong. We have paid a great many fees over the last 30 years—beginning with the check we wrote to Charlie Heider upon our purchase of National Indemnity in 1967—and we are delighted to make payments that are commensurate with performance. In the case of the 1996 transactions at Salomon Brothers, we more than got our money's worth.

Miscellaneous

Though it was a close decision, Charlie and I have decided to enter the 20th Century. Accordingly, we are going to put future quarterly and annual reports of Berkshire on the Internet, where they can be accessed via http://www.berkshirehathaway.com. We will always "post" these reports on a Saturday so that anyone interested will have ample time to digest the information before trading begins. Our publishing schedule for the next 12 months is May 17, 1997, August 16, 1997, November 15, 1997, and March 14, 1998. We will also post any press releases that we issue.

At some point, we may stop mailing our quarterly reports and simply post these on the Internet. This move would eliminate significant costs. Also, we have a large number of "street name" holders and have found that the distribution of our quarterlies to them is highly erratic: Some holders receive their mailings weeks later than others.

The drawback to Internet-only distribution is that many of our shareholders lack computers. Most of these holders, however, could easily obtain printouts at work or through friends. Please let me know if you prefer that we continue mailing quarterlies. We want your input—starting with whether you even read these reports—and at a minimum will make no change in 1997. Also, we will definitely keep delivering the annual report in its present form in addition to publishing it on the Internet.

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About 97.2% of all eligible shares participated in Berkshire's 1996 shareholder-designated contributions program. Contributions made were $13.3 million, and 3,910 charities were recipients. A full description of the shareholder-designated contributions program appears on pages 48-49.

Every year a few shareholders miss out on the program because they don't have their shares registered in their own names on the prescribed record date or because they fail to get the designation form back to us within the 60-day period allowed. This is distressing to Charlie and me. But if replies are received late, we have to reject them because we can't make exceptions for some shareholders while refusing to make them for others.

To participate in future programs, you must own Class A shares that are registered in the name of the actual owner, not the nominee name of a broker, bank or depository. Shares not so registered on August 31, 1997, will be ineligible for the 1997 program. When you get the form, return it promptly so that it does not get put aside or forgotten.

The Annual Meeting

Our capitalist's version of Woodstock -the Berkshire Annual Meeting-will be held on Monday, May 5. Charlie and I thoroughly enjoy this event, and we hope that you come. We will start at 9:30 a.m., break for about 15 minutes at noon (food will be available—but at a price, of course), and then continue talking to hard-core attendees until at least 3:30. Last year we had representatives from all 50 states, as well as Australia, Greece, Israel, Portugal, Singapore, Sweden, Switzerland, and the United Kingdom. The annual meeting is a time for owners to get their business-related questions answered, and therefore Charlie and I will stay on stage until we start getting punchy. (When that happens, I hope you notice a change.)

Last year we had attendance of 5,000 and strained the capacity of the Holiday Convention Centre, even though we spread out over three rooms. This year, our new Class B shares have caused a doubling of our stockholder count, and we are therefore moving the meeting to the Aksarben Coliseum, which holds about 10,000 and also has a huge parking lot. The doors will open for the meeting at 7:00 a.m., and at 8:30 we will—upon popular demand—show a new Berkshire movie produced by Marc Hamburg, our CFO. (In this company, no one gets by with doing only a single job.)

Overcoming our legendary repugnance for activities even faintly commercial, we will also have an abundant array of Berkshire products *for sale* in the halls outside the meeting room. Last year we broke all records, selling 1,270 pounds of See's candy, 1,143 pairs of Dexter shoes, $29,000 of World Books and related publications, and 700 sets of knives manufactured by our Quikut subsidiary. Additionally, many shareholders made inquiries about GEICO auto policies. If you would like to investigate possible insurance savings, bring your present policy to the meeting. We estimate that about 40% of our shareholders can save money by insuring with us. (We'd like to say 100%, but the insurance business doesn't work that way: Because insurers differ in their underwriting judgments, some of our shareholders are currently paying rates that are lower than GEICO's.)

An attachment to the proxy material enclosed with this report explains how you can obtain the card you will need for admission to the meeting. We expect a large crowd, so get both plane and hotel reservations promptly. American Express (800-799-6634) will be happy to help you with arrangements. As usual, we will have buses servicing the larger hotels to take you to and from the meeting, and also to take you to Nebraska Furniture Mart, Borsheim's and the airport after it is over.

NFM's main store, located on a 75-acre site about a mile from Aksarben, is open from 10 a.m. to 9 p.m. on weekdays, 10 a.m. to 6 p.m. on Saturdays, and noon to 6 p.m. on Sundays. Come by and say hello to "Mrs. B" (Rose Blumkin). She's 103 now and sometimes operates with an oxygen mask that is attached to a tank on her cart. But if you try to keep pace with her, it will be you who needs oxygen. NFM did about $265 million of business last year—a record for a single-location home furnishings operation—and you'll see why once you check out its merchandise and prices.

Borsheim's normally is closed on Sunday but will be open for shareholders from 10 a.m. to 6 p.m. on May 4th. Last year on "Shareholder Sunday" we broke every Borsheim's record in terms of tickets, dollar volume and, no doubt, attendees per square inch. Because we expect a capacity crowd this year as well, all shareholders attending on Sunday must bring their admission cards. Shareholders who prefer a somewhat less frenzied experience will get the same special treatment on Saturday, when the store is open from 10 a.m. to 5:30 p.m., or on Monday between 10 a.m. and 8 p.m. Come by at any time this year and let Susan Jacques, Borsheim's CEO, and her skilled associates perform a painless walletectomy on you.

My favorite steakhouse, Gorat's, was sold out last year on the weekend of the annual meeting, even though it added an additional seating at 4 p.m. on Sunday. You can make reservations beginning on April 1st *(but not earlier)* by calling 402-551-3733. I will be at Gorat's on Sunday after Borsheim's, having my usual rare T-bone and double order of hashbrowns. I can also recommend—this is the standard fare when Debbie Bosanek, my invaluable assistant, and I go to lunch—the hot roast beef sandwich with mashed potatoes and gravy. Mention Debbie's name and you will be given an extra boat of gravy.

The Omaha Royals and Indianapolis Indians will play baseball on Saturday evening, May 3rd, at Rosenblatt Stadium. Pitching in my normal rotation—one throw a year—I will start.

Though Rosenblatt is normal in appearance, it is anything but: The field sits on a unique geological structure that occasionally emits short gravitational waves causing even the most smoothly-delivered pitch to sink violently. I have been the victim of this weird phenomenon several times in the past but am hoping for benign conditions this year. There will be lots of opportunities for photos at the ball game, but you will need incredibly fast reflexes to snap my fast ball en route to the plate.

Our proxy statement includes information about obtaining tickets to the game. We will also provide an information packet listing restaurants that will be open on Sunday night and describing various things that you can do in Omaha on the weekend. The entire gang at Berkshire looks forward to seeing you.

February 28, 1997

Warren E. Buffett
Chairman of the Board

BERKSHIRE HATHAWAY INC.

1997 Chairman's Letter

To the Shareholders of Berkshire Hathaway Inc.:

Our gain in net worth during 1997 was $8.0 billion, which increased the per-share book value of both our Class A and Class B stock by 34.1%. Over the last 33 years (that is, since present management took over) per-share book value has grown from $19 to $25,488, a rate of 24.1% compounded annually. *

> * All figures used in this report apply to Berkshire's A shares, the successor to the only stock that the company had outstanding before 1996. The B shares have an economic interest equal to 1/30th that of the A.

Given our gain of 34.1%, it is tempting to declare victory and move on. But last year's performance was no great triumph: *Any* investor can chalk up large returns when stocks soar, as they did in 1997. In a bull market, one must avoid the error of the preening duck that quacks boastfully after a torrential rainstorm, thinking that its paddling skills have caused it to rise in the world. A right-thinking duck would instead compare its position after the downpour to that of the other ducks on the pond.

So what's our duck rating for 1997? The table on the facing page shows that though we paddled furiously last year, passive ducks that simply invested in the S&P Index rose almost as fast as we did. Our appraisal of 1997's performance, then: Quack.

When the market booms, we tend to suffer in comparison with the S&P Index. The Index bears no tax costs, nor do mutual funds, since they pass through all tax liabilities to their owners. Last year, on the other hand, Berkshire paid or accrued $4.2 billion for federal income tax, or about 18% of our beginning net worth.

Berkshire will always have corporate taxes to pay, which means it needs to overcome their drag in order to justify its existence. Obviously, Charlie

Munger, Berkshire's Vice Chairman and my partner, and I won't be able to lick that handicap every year. But we expect over time to maintain a modest advantage over the Index, and that is the yardstick against which you should measure us. We will not ask you to adopt the philosophy of the Chicago Cubs fan who reacted to a string of lackluster seasons by saying, "Why get upset? Everyone has a bad century now and then."

Gains in book value are, of course, not the bottom line at Berkshire. What truly counts are gains in per-share intrinsic business value. Ordinarily, though, the two measures tend to move roughly in tandem, and in 1997 that was the case: Led by a blow-out performance at GEICO, Berkshire's intrinsic value (which far exceeds book value) grew at nearly the same pace as book value.

For more explanation of the term, intrinsic value, you may wish to refer to our Owner's Manual, reprinted on pages 62 to 71. This manual sets forth our owner-related business principles, information that is important to all of Berkshire's shareholders.

In our last two annual reports, we furnished you a table that Charlie and I believe is central to estimating Berkshire's intrinsic value. In the updated version of that table, which follows, we trace our two key components of value. The first column lists our per-share ownership of investments (including cash and equivalents) and the second column shows our per-share earnings from Berkshire's operating businesses before taxes and purchase-accounting adjustments (discussed on pages 69 and 70), but after all interest and corporate expenses. The second column excludes all dividends, interest and capital gains that we realized from the investments presented in the first column. In effect, the columns show what Berkshire would look like were it split into two parts, with one entity holding our investments and the other operating all of our businesses and bearing all corporate costs.

Year	Investments Per Share	Pre-tax Earnings Per Share Excluding All Income from Investments
1967	$ 41	$ 1.09

1977	372	12.44
1987	3,910	108.14
1997	38,043	717.82

Pundits who ignore what our 38,000 employees contribute to the company, and instead simply view Berkshire as a de facto investment company, should study the figures in the second column. We made our first business acquisition in 1967, and since then our pre-tax operating earnings have grown from $1 million to $888 million. Furthermore, as noted, in this exercise we have assigned all of Berkshire's corporate expenses—overhead of $6.6 million, interest of $66.9 million and shareholder contributions of $15.4 million—to our business operations, even though a portion of these could just as well have been assigned to the investment side.

Here are the growth rates of the two segments by decade:

Decade Ending	Investments Per Share	Pre-tax Earnings Per Share Excluding All Income from Investments
1977	24.6%	27.6%
1987	26.5%	24.1%
1997	25.5%	20.8%
Annual Growth Rate, 1967-1997	25.6%	24.2%

During 1997, both parts of our business grew at a satisfactory rate, with investments increasing by $9,543 per share, or 33.5%, and operating earnings growing by $296.43 per share, or 70.3%. One important caveat: Because we were lucky in our super-cat insurance business (to be discussed later) and because GEICO's underwriting gain was well above what we can expect in most years, our 1997 operating earnings were much better than we anticipated and also more than we expect for 1998.

Our rate of progress in both investments and operations is *certain* to fall in the future. For anyone deploying capital, nothing recedes like success. My own history makes the point: Back in 1951, when I was attending Ben Graham's class at Columbia, an idea giving me a $10,000 gain improved my investment performance for the year by a full 100 percentage points. Today, an idea producing a $500 million pre-tax profit for Berkshire adds *one* percentage point to our performance. It's no wonder that my annual results in the 1950s were better by nearly thirty percentage points than my annual gains in any subsequent decade. Charlie's experience was similar. We weren't smarter then, just smaller. At our present size, any performance superiority we achieve will be minor.

We will be helped, however, by the fact that the businesses to which we have already allocated capital—both operating subsidiaries and companies in which we are passive investors—have splendid long-term prospects. We are also blessed with a managerial corps that is unsurpassed in ability and focus. Most of these executives are wealthy and do not need the pay they receive from Berkshire to maintain their way of life. They are motivated by the joy of accomplishment, not by fame or fortune.

Though we are delighted with what we own, we are not pleased with our prospects for committing incoming funds. Prices are high for both businesses and stocks. That does not mean that the prices of either will fall—we have absolutely no view on that matter—but it does mean that we get relatively little in prospective earnings when we commit fresh money.

Under these circumstances, we try to exert a Ted Williams kind of discipline. In his book *The Science of Hitting*, Ted explains that he carved the strike zone into 77 cells, each the size of a baseball. Swinging only at balls in his "best" cell, he knew, would allow him to bat .400; reaching for balls in his "worst" spot, the low outside corner of the strike zone, would reduce him to .230. In other words, waiting for the fat pitch would mean a trip to the Hall of Fame; swinging indiscriminately would mean a ticket to the minors.

If they are in the strike zone at all, the business "pitches" we now see are just catching the lower outside corner. If we swing, we will be locked into low returns. But if we let all of today's balls go by, there can be no assurance that the next ones we see will be more to our liking. Perhaps the attractive prices of the past were the aberrations, not the full prices of today. Unlike Ted, we can't be called out if we resist three pitches that are barely in the strike zone; nevertheless, just standing there, day after day, with my bat on my shoulder is not my idea of fun.

Unconventional Commitments

When we can't find our favorite commitment—a well-run and sensibly-priced business with fine economics—we usually opt to put new money into very short-term instruments of the highest quality. Sometimes, however, we venture elsewhere. Obviously we believe that the alternative commitments we make are more likely to result in profit than loss. But we also realize that they do not offer the certainty of profit that exists in a wonderful business secured at an attractive price. Finding that kind of opportunity, we *know* that we are going to make money—the only question being when. With alternative investments, we *think* that we are going to make money. But we also recognize that we will sometimes realize losses, occasionally of substantial size.

We had three non-traditional positions at yearend. The first was derivative contracts for 14.0 million barrels of oil, that being what was then left of a 45.7 million barrel position we established in 1994-95. Contracts for 31.7 million barrels were settled in 1995-97, and these supplied us with a pre-tax gain of about $61.9 million. Our remaining contracts expire during 1998 and 1999. In these, we had an unrealized gain of $11.6 million at yearend. Accounting rules require that commodity positions be carried at market value. Therefore, both our annual and quarterly financial statements reflect any unrealized gain or loss in these contracts. When we established our contracts, oil for future delivery seemed modestly underpriced. Today, though, we have no opinion as to its attractiveness.

Our second non-traditional commitment is in silver. Last year, we purchased 111.2 million ounces. Marked to market, that position produced a pre-tax gain of $97.4 million for us in 1997. In a way, this is a return to the past for me: Thirty years ago, I bought silver because I anticipated its demonetization by the U.S. Government. Ever since, I have followed the metal's fundamentals but not owned it. In recent years, bullion inventories have fallen materially, and last summer Charlie and I concluded that a higher price would be needed to establish equilibrium between supply and demand. Inflation expectations, it should be noted, play no part in our calculation of silver's value.

Finally, our largest non-traditional position at yearend was $4.6 billion, at amortized cost, of long-term zero-coupon obligations of the U.S. Treasury. These securities pay no interest. Instead, they provide their holders a return by way of the discount at which they are purchased, a characteristic that makes their market prices move rapidly when interest rates change. If rates rise, you lose heavily with zeros, and if rates fall, you make outsized gains. Since rates fell in 1997, we ended the year with an unrealized pre-tax gain of $598.8 million in our zeros. Because we carry the securities at market value, that gain is reflected in yearend book value.

In purchasing zeros, rather than staying with cash-equivalents, we risk looking very foolish: A macro-based commitment such as this never has anything close to a 100% probability of being successful. However, you pay Charlie and me to use our best judgment—not to avoid embarrassment—and we will occasionally make an unconventional move when we believe the odds favor it. Try to think kindly of us when we blow one. Along with President Clinton, we will be feeling your pain: The Munger family has more than 90% of its net worth in Berkshire and the Buffetts more than 99%.

How We Think About Market Fluctuations

A short quiz: If you plan to eat hamburgers throughout your life and are not a cattle producer, should you wish for higher or lower prices for beef? Likewise, if you are going to buy a car from time to time but are not an auto manufacturer, should you prefer higher or lower car prices? These questions, of course, answer themselves.

But now for the final exam: If you expect to be a net saver during the next five years, should you hope for a higher or lower stock market during that period? Many investors get this one wrong. Even though they are going to be net buyers of stocks for many years to come, they are elated when stock prices rise and depressed when they fall. In effect, they rejoice because prices have risen for the "hamburgers" they will soon be buying. This reaction makes no sense. Only those who will be sellers of equities in the near future should be happy at seeing stocks rise. Prospective purchasers should much prefer sinking prices.

For shareholders of Berkshire who do not expect to sell, the choice is even clearer. To begin with, our owners are automatically saving even if they spend every dime they personally earn: Berkshire "saves" for them by retaining all earnings, thereafter using these savings to purchase businesses and securities. Clearly, the more cheaply we make these buys, the more profitable our owners' indirect savings program will be.

Furthermore, through Berkshire you own major positions in companies that consistently repurchase their shares. The benefits that these programs supply us grow as prices fall: When stock prices are low, the funds that an investee spends on repurchases increase our ownership of that company by a greater amount than is the case when prices are higher. For example, the repurchases that Coca-Cola, The Washington Post and Wells Fargo made in past years at very low prices benefitted Berkshire far more than do today's repurchases, made at loftier prices.

At the end of every year, about 97% of Berkshire's shares are held by the same investors who owned them at the start of the year. That makes them savers. They should therefore rejoice when markets decline and allow both us and our investees to deploy funds more advantageously.

So smile when you read a headline that says "Investors lose as market falls." Edit it in your mind to "*Dis*investors lose as market falls—but investors gain." Though writers often forget this truism, there is a buyer for every seller and what hurts one necessarily helps the other. (As they say in golf matches: "Every putt makes *someone* happy.")

We gained enormously from the low prices placed on many equities and businesses in the 1970s and 1980s. Markets that then were hostile to investment transients were friendly to those taking up permanent residence. In recent years, the actions we took in those decades have been validated, but we have found few new opportunities. In its role as a corporate "saver," Berkshire continually looks for ways to sensibly deploy capital, but it may be some time before we find opportunities that get us truly excited.

Insurance Operations—Overview

What does excite us, however, is our insurance business. GEICO is flying, and we expect that it will continue to do so. Before we expound on that, though, let's discuss "float" and how to measure its cost. Unless you understand this subject, it will be impossible for you to make an informed judgment about Berkshire's intrinsic value.

To begin with, float is money we hold but don't own. In an insurance operation, float arises because premiums are received before losses are paid, an interval that sometimes extends over many years. During that time, the insurer invests the money. Typically, this pleasant activity carries with it a downside: The premiums that an insurer takes in usually do not cover the losses and expenses it eventually must pay. That leaves it running an "underwriting loss," which is the cost of float. An insurance business has value if its cost of float over time is less than the cost the company would otherwise incur to obtain funds. But the business is a lemon if its cost of float is higher than market rates for money.

A caution is appropriate here: Because loss costs must be estimated, insurers have enormous latitude in figuring their underwriting results, and that makes it very difficult for investors to calculate a company's true cost of float. Estimating errors, usually innocent but sometimes not, can be huge. The consequences of these miscalculations flow directly into earnings. An experienced observer can usually detect large-scale errors in reserving, but the general public can typically do no more than accept what's presented, and at times I have been amazed by the numbers that big-name auditors have implicitly blessed. As for Berkshire, Charlie and I attempt to be conservative in presenting its underwriting results to you, because we have found that virtually all surprises in insurance are unpleasant ones.

As the numbers in the following table show, Berkshire's insurance business has been a huge winner. For the table, we have calculated our float—which we generate in large amounts relative to our premium volume—by adding net loss reserves, loss adjustment reserves, funds held under reinsurance assumed and unearned premium reserves, and then subtracting agents' balances, prepaid acquisition costs, prepaid taxes and deferred charges applicable to assumed reinsurance. Our cost of float is determined by our underwriting loss or profit. In those years when we have had an underwriting profit, such as the last five, our cost of float has been negative. In effect, we have been paid for holding money.

	(1) Underwriting Loss	(2) Average Float	Approximate Cost of Funds	Yearend Yield on Long-Term Govt. Bonds
	(In $ Millions)		(Ratio of 1 to 2)	
1967	profit	$17.3	less than zero	5.50%
1968	profit	19.9	less than zero	5.90%
1969	profit	23.4	less than zero	6.79%
1970	$ 0.37	32.4	1.14%	6.25%
1971	profit	52.5	less than zero	5.81%
1972	profit	69.5	less than zero	5.82%
1973	profit	73.3	less than zero	7.27%
1974	7.36	79.1	9.30%	8.13%
1975	11.35	87.6	12.96%	8.03%
1976	profit	102.6	less than zero	7.30%

1977	profit	139.0	less than zero	7.97%
1978	profit	190.4	less than zero	8.93%
1979	profit	227.3	less than zero	10.08%
1980	profit	237.0	less than zero	11.94%
1981	profit	228.4	less than zero	13.61%
1982	21.56	220.6	9.77%	10.64%
1983	33.87	231.3	14.64%	11.84%
1984	48.06	253.2	18.98%	11.58%
1985	44.23	390.2	11.34%	9.34%
1986	55.84	797.5	7.00%	7.60%
1987	55.43	1,266.7	4.38%	8.95%
1988	11.08	1,497.7	0.74%	9.00%
1989	24.40	1,541.3	1.58%	7.97%

1990	26.65	1,637.3	1.63%	8.24%
1991	119.59	1,895.0	6.31%	7.40%
1992	108.96	2,290.4	4.76%	7.39%
1993	profit	2,624.7	less than zero	6.35%
1994	profit	3,056.6	less than zero	7.88%
1995	profit	3,607.2	less than zero	5.95%
1996	profit	6,702.0	less than zero	6.64%
1997	profit	7,093.1	less than zero	5.92%

Since 1967, when we entered the insurance business, our float has grown at an annual compounded rate of 21.7%. Better yet, it has cost us nothing, and in fact has made us money. Therein lies an accounting irony: Though our float is shown on our balance sheet as a liability, it has had a value to Berkshire greater than an equal amount of net worth would have had.

The expiration of several large contracts will cause our float to decline during the first quarter of 1998, but we expect it to grow substantially over the long term. We also believe that our cost of float will continue to be highly favorable.

Super-Cat Insurance

Occasionally, however, the cost of our float will spike severely. That will occur because of our heavy involvement in the super-cat business, which by its nature is the most volatile of all insurance lines. In this operation, we sell policies that insurance and reinsurance companies purchase in order to limit their losses when mega-catastrophes strike. Berkshire is the preferred market for sophisticated buyers: When the "big one" hits, the financial strength of super-cat writers will be tested, and Berkshire has no peer in this respect.

Since truly major catastrophes are rare occurrences, our super-cat business can be expected to show large profits in most years—and to record a huge loss occasionally. In other words, the attractiveness of our super-cat business will take a great many years to measure. *What you must understand, however, is that a truly terrible year in the super-cat business is not a possibility—it's a certainty. The only question is when it will come.*

Last year, we were very lucky in our super-cat operation. The world suffered no catastrophes that caused huge amounts of insured damage, so virtually all premiums that we received dropped to the bottom line. This pleasant result has a dark side, however. Many investors who are "innocents"—meaning that they rely on representations of salespeople rather than on underwriting knowledge of their own—have come into the reinsurance business by means of purchasing pieces of paper that are called "catastrophe bonds." The second word in this term, though, is an Orwellian misnomer: A true bond obliges the issuer to pay; these bonds, in effect, are contracts that lay a provisional promise to pay on the *purchaser*.

This convoluted arrangement came into being because the promoters of the contracts wished to circumvent laws that prohibit the writing of insurance by entities that haven't been licensed by the state. A side benefit for the promoters is that calling the insurance contract a "bond" may also cause unsophisticated buyers to assume that these instruments involve far less risk than is actually the case.

Truly outsized risks will exist in these contracts if they are not properly priced. A pernicious aspect of catastrophe insurance, however, makes it likely that mispricing, even of a severe variety, will not be discovered for a very long time. Consider, for example, the odds of throwing a 12 with a pair of dice—1 out of 36. Now assume that the dice will be thrown once a year; that you, the "bond-buyer," agree to pay $50 million if a 12 appears; and that for "insuring" this risk you take in an annual "premium" of $1 million. That would mean you had significantly underpriced the risk. Nevertheless, you could go along for years thinking you were making money—indeed, easy money. There is actually a 75.4% probability that you would go for a decade without paying out a dime. Eventually, however, you would go broke.

In this dice example, the odds are easy to figure. Calculations involving monster hurricanes and earthquakes are necessarily much fuzzier, and the best we can do at Berkshire is to estimate a range of probabilities for such events. The lack of precise data, coupled with the rarity of such catastrophes, plays into the hands of promoters, who typically employ an “expert” to advise the potential bond-buyer about the probability of losses. The expert puts no money on the table. Instead, he receives an up-front payment that is forever his no matter how inaccurate his predictions. Surprise: When the stakes are high, an expert can invariably be found who will affirm—to return to our example—that the chance of rolling a 12 is not 1 in 36, but more like 1 in 100. (In fairness, we should add that the expert will probably believe that his odds are correct, a fact that makes him less reprehensible—but more dangerous.)

The influx of “investor” money into catastrophe bonds—which may well live up to their name—has caused super-cat prices to deteriorate materially. Therefore, we will write less business in 1998. We have some large multi-year contracts in force, however, that will mitigate the drop. The largest of these are two policies that we described in last year’s report—one covering hurricanes in Florida and the other, signed with the California Earthquake Authority, covering earthquakes in that state. Our “worst-case” loss remains about $600 million after-tax, the maximum we could lose under the CEA policy. Though this loss potential may sound large, it is only about 1% of Berkshire’s market value. Indeed, if we could get appropriate prices, we would be willing to significantly increase our “worst-case” exposure.

Our super-cat business was developed from scratch by Ajit Jain, who has contributed to Berkshire’s success in a variety of other ways as well. Ajit possesses both the discipline to walk away from business that is inadequately priced and the imagination to then find other opportunities. Quite simply, he is one of Berkshire’s major assets. Ajit would have been a star in whatever career he chose; fortunately for us, he enjoys insurance.

Insurance—GEICO (1-800-555-2756) and Other Primary Operations

Last year I wrote about GEICO's Tony Nicely and his terrific management skills. If I had known then what he had in store for us in 1997, I would have searched for still greater superlatives. Tony, now 54, has been with GEICO for 36 years and last year was his best. As CEO, he has transmitted vision, energy and enthusiasm to all members of the GEICO family—raising their sights from what *has* been achieved to what *can* be achieved.

We measure GEICO's performance by first, the net increase in its voluntary auto policies (that is, not including policies assigned us by the state) and, second, the profitability of "seasoned" auto business, meaning policies that have been with us for more than a year and are thus past the period in which acquisition costs cause them to be money-losers. In 1996, in-force business grew 10%, and I told you how pleased I was, since that rate was well above anything we had seen in two decades. Then, in 1997, growth jumped to 16%.

Below are the new business and in-force figures for the last five years:

Years	New Voluntary Auto Policies	Voluntary Auto Policies in Force
1993	354,882	2,011,055
1994	396,217	2,147,549
1995	461,608	2,310,037
1996	617,669	2,543,699
1997	913,176	2,949,439

Of course, any insurer can grow rapidly if it gets careless about underwriting. GEICO's underwriting profit for the year, though, was 8.1% of premiums, far above its average. Indeed, that percentage was higher than we wish it to be: Our goal is to pass on most of the benefits of our low-cost operation to our customers, holding ourselves to about 4% in underwriting profit. With that in mind, we reduced our average rates a bit during 1997 and may well cut them again this year. Our rate changes varied, of course, depending on the policyholder and where he lives; we strive to charge a rate that properly reflects the loss expectancy of each driver.

GEICO is not the only auto insurer obtaining favorable results these days. Last year, the industry recorded profits that were far better than it anticipated or can sustain. Intensified competition will soon squeeze margins very significantly. But this is a development we welcome: Long term, a tough market helps the low-cost operator, which is what we are and intend to remain.

Last year I told you about the record 16.9% profit-sharing contribution that GEICO's associates had earned and explained that two simple variables set the amount: policy growth and profitability of seasoned business. I further explained that 1996's performance was so extraordinary that we had to enlarge the chart delineating the possible payouts. The new configuration didn't make it through 1997: We enlarged the chart's boundaries again and awarded our 10,500 associates a profit-sharing contribution amounting to 26.9% of their base compensation, or $71 million. In addition, the same two variables—policy growth and profitability of seasoned business—determined the cash bonuses that we paid to dozens of top executives, starting with Tony.

At GEICO, we are paying in a way that makes sense for both our owners and our managers. We distribute merit badges, not lottery tickets: In none of Berkshire's subsidiaries do we relate compensation to our stock price, which our associates cannot affect in any meaningful way. Instead, we tie bonuses to each unit's business performance, which is the direct product of the unit's people. When that performance is terrific—as it has been at GEICO—there is nothing Charlie and I enjoy more than writing a big check.

GEICO's underwriting profitability will probably fall in 1998, but the company's growth could accelerate. We're planning to step on the gas: GEICO's marketing expenditures this year will top $100 million, up 50% from 1997. Our market share today is only 3%, a level of penetration that should increase dramatically in the next decade. The auto insurance industry is huge—it does about $115 billion of volume annually—and there are tens of millions of drivers who would save substantial money by switching to us.

* * * * * * * * * * * *

In the 1995 report, I described the enormous debt that you and I owe to Lorimer Davidson. On a Saturday early in 1951, he patiently explained the ins and outs of both GEICO and its industry to me—a 20-year-old stranger who'd arrived at GEICO's headquarters uninvited and unannounced. Davy later became the company's CEO and has remained my friend and teacher for 47 years. The huge rewards that GEICO has heaped on Berkshire would not have materialized had it not been for his generosity and wisdom. Indeed, had I not met Davy, I might never have grown to understand the whole field of insurance, which over the years has played such a key part in Berkshire's success.

Davy turned 95 last year, and it's difficult for him to travel. Nevertheless, Tony and I hope that we can persuade him to attend our annual meeting, so that our shareholders can properly thank him for his important contributions to Berkshire. Wish us luck.

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Though they are, of course, far smaller than GEICO, our other primary insurance operations turned in results last year that, in aggregate, were fully as stunning. National Indemnity's traditional business had an underwriting profit of 32.9% and, as usual, developed a large amount of float compared to premium volume. Over the last three years, this segment of our business, run by Don Wurster, has had a profit of 24.3%. Our homestate operation, managed by Rod Eldred, recorded an underwriting profit of 14.1% even though it continued to absorb the expenses of geographical expansion. Rod's three-year record is an amazing 15.1%. Berkshire's workers' compensation business, run out of California by Brad Kinstler, had a modest underwriting loss in a difficult environment; its three-year underwriting record is a positive 1.5%. John Kizer, at Central States Indemnity, set a new volume record while generating good underwriting earnings. At Kansas Bankers Surety, Don Towle more than lived up to the high expectations we had when we purchased the company in 1996.

In aggregate, these five operations recorded an underwriting profit of 15.0%. The two Dons, along with Rod, Brad and John, have created significant value for Berkshire, and we believe there is more to come.

Sources of Reported Earnings

The table that follows shows the main sources of Berkshire's reported earnings. In this presentation, purchase-accounting adjustments are not assigned to the specific businesses to which they apply, but are instead aggregated and shown separately. This procedure lets you view the earnings of our businesses as they would have been reported had we not purchased them. For the reasons discussed on pages 69 and 70, this form of presentation seems to us to be more useful to investors and managers than one utilizing generally-accepted accounting principles (GAAP), which require purchase-premiums to be charged off business-by-business. The total earnings we show in the table are, of course, identical to the GAAP total in our audited financial statements.

(in millions)

	Pre-Tax Earnings		*Berkshire's Share of Net Earnings (after taxes and minority interests)*	
	1997	*1996*	*1997*	*1996*
Operating Earnings:				
Insurance Group:				
Underwriting — Super-Cat	$ 283.0	$ 167.0	$ 182.7	$ 107.4
Underwriting — Other Reinsurance	(155.2)	(174.8)	(100.1)	(112.4)

Underwriting — GEICO	280.7		171.4		181.1		110.2	
Underwriting — Other Primary	52.9		58.5		34.1		37.6	
Net Investment Income	882.3		726.2		703.6		593.1	
Buffalo News	55.9		50.4		32.7		29.5	
Finance Businesses	28.1		23.1		18.0		14.9	
FlightSafety	139.5		3.1	(1)	84.4		1.9	(1)
Home Furnishings	56.8	(2)	43.8		32.2	(2)	24.8	
Jewelry	31.6		27.8		18.3		16.1	
Scott Fetzer(excluding finance operation)	118.9		121.7		77.3		81.6	
See’s Candies	58.6		51.9		35.0		30.8	
Shoe Group	48.8		61.6		32.2		41.0	

Purchase-Accounting Adjustments	(104.9)	(75.7)	(97.0)	(70.5)
Interest Expense(3)	(106.6)	(94.3)	(67.1)	(56.6)
Shareholder-Designated Contributions	(15.4)	(13.3)	(9.9)	(8.5)
Other	60.7	73.0	37.0	42.2
Operating Earnings	1,715.7	1,221.4	1,194.5	883.1
Capital Gains from Investments	1,111.9	2,484.5	707.1	1,605.5
Total Earnings — All Entities	$2,827.6	$3,705.9	$1,901.6	$2,488.6

(1) From date of acquisition, December 23, 1996.
(2) Includes Star Furniture from July 1, 1997.
(3) Excludes interest expense of Finance Businesses.

Overall, our operating businesses continue to perform exceptionally well, far outdoing their industry norms. We are particularly pleased that profits improved at Helzberg's after a disappointing 1996. Jeff Comment, Helzberg's CEO, took decisive steps early in 1997 that enabled the company to gain real momentum by the crucial Christmas season. In the early part of this year, as well, sales remained strong.

Casual observers may not appreciate just how extraordinary the performance of many of our businesses has been: If the earnings history of, say, Buffalo News or Scott Fetzer is compared to the records of their publicly-owned peers, their performance might seem to have been unexceptional. But most public companies retain two-thirds or more of their earnings to fund their corporate growth. In contrast, those Berkshire subsidiaries have paid 100% of their earnings to us, their parent company, to fund *our* growth.

In effect, the records of the public companies reflect the cumulative benefits of the earnings they have retained, while the records of our operating subsidiaries get no such boost. Over time, however, the earnings these subsidiaries have distributed have created truly huge amounts of earning power elsewhere in Berkshire. The News, See's and Scott Fetzer have alone paid us $1.8 billion, which we have gainfully employed elsewhere. We owe their managements our gratitude for much more than the earnings that are detailed in the table.

Additional information about our various businesses is given on pages 36—50, where you will also find our segment earnings reported on a GAAP basis. In addition, on pages 55—61, we have rearranged Berkshire's financial data into four segments on a non-GAAP basis, a presentation that corresponds to the way Charlie and I think about the company. Our intent is to supply you with the financial information that we would wish you to give us if our positions were reversed.

Look-Through Earnings

Reported earnings are a poor measure of economic progress at Berkshire, in part because the numbers shown in the table presented earlier include only the dividends we receive from investees—though these dividends typically represent only a small fraction of the earnings attributable to our ownership. Not that we mind this division of money, since on balance we regard the undistributed earnings of investees as more valuable to us than the portion paid out. The reason is simple: Our investees often have the opportunity to reinvest earnings at high rates of return. So why should we want them paid out?

To depict something closer to economic reality at Berkshire than reported earnings, though, we employ the concept of "look-through" earnings. As we calculate these, they consist of: (1) the operating earnings reported in the previous section, plus; (2) our share of the retained operating earnings of major investees that, under GAAP accounting, are not reflected in our profits, less; (3) an allowance for the tax that would be paid by Berkshire if these retained earnings of investees had instead been distributed to us. When tabulating "operating earnings" here, we exclude purchase-accounting adjustments as well as capital gains and other major non-recurring items.

The following table sets forth our 1997 look-through earnings, though I warn you that the figures can be no more than approximate, since they are based on a number of judgment calls. (The dividends paid to us by these investees have been included in the operating earnings itemized on page 11, mostly under "Insurance Group: Net Investment Income.")

Berkshire's Major Investees	Berkshire's Approximate Ownership at Yearend[1]	Berkshire's Share of Undistributed Operating Earnings (in millions)[2]
American Express Company	10.7%	$161
The Coca-Cola Company	8.1%	216
The Walt Disney Company	3.2%	65
Freddie Mac	8.6%	86
The Gillette Company	8.6%	82
The Washington	16.5%	30

Post Company		
Wells Fargo & Company	7.8%	103
Berkshire’s share of undistributed earnings of major investees		743
Hypothetical tax on these undistributed investee earnings(3)		(105)
Reported operating earnings of Berkshire		1,292
Total look-through earnings of Berkshire		$1,930

(1) Does not include shares allocable to minority interests
(2) Calculated on average ownership for the year
(3) The tax rate used is 14%, which is the rate Berkshire pays on the dividends it receives

Acquisitions of 1997

In 1997, we agreed to acquire Star Furniture and International Dairy Queen (a deal that closed early in 1998). Both businesses fully meet our criteria: They are understandable; possess excellent economics; and are run by outstanding people.

The Star transaction has an interesting history. Whenever we buy into an industry whose leading participants aren’t known to me, I always ask our new partners, “Are there any more at home like you?” Upon our purchase of Nebraska Furniture Mart in 1983, therefore, the Blumkin family told me about three outstanding furniture retailers in other parts of the country. At the time, however, none was for sale.

Many years later, Irv Blumkin learned that Bill Child, CEO of R.C. Willey—one of the recommended three—might be interested in merging, and we promptly made the deal described in the 1995 report. We have been delighted with that association—Bill is the perfect partner. Furthermore, when we asked Bill about industry standouts, he came up with the remaining two names given me by the Blumkins, one of these being Star Furniture of Houston. But time went by without there being any indication that either of the two was available.

On the Thursday before last year's annual meeting, however, Bob Denham of Salomon told me that Melvyn Wolff, the long-time controlling shareholder and CEO of Star, wanted to talk. At our invitation, Melvyn came to the meeting and spent his time in Omaha confirming his positive feelings about Berkshire. I, meanwhile, looked at Star's financials, and liked what I saw.

A few days later, Melvyn and I met in New York and made a deal in a single, two-hour session. As was the case with the Blumkins and Bill Child, I had no need to check leases, work out employment contracts, etc. I knew I was dealing with a man of integrity and that's what counted.

Though the Wolff family's association with Star dates back to 1924, the business struggled until Melvyn and his sister Shirley Toomin took over in 1962. Today Star operates 12 stores—ten in Houston and one each in Austin and Bryan—and will soon move into San Antonio as well. We won't be surprised if Star is many times its present size a decade from now.

Here's a story illustrating what Melvyn and Shirley are like: When they told their associates of the sale, they also announced that Star would make large, special payments to those who had helped them succeed—and then defined that group as everyone in the business. Under the terms of our deal, it was Melvyn and Shirley's money, not ours, that funded this distribution. Charlie and I love it when we become partners with people who behave like that.

The Star transaction closed on July 1. In the months since, we've watched Star's already-excellent sales and earnings growth accelerate further. Melvyn and Shirley will be at the annual meeting, and I hope you get a chance to meet them.

Next acquisition: International Dairy Queen. There are 5,792 Dairy Queen stores operating in 23 countries—all but a handful run by franchisees—and in addition IDQ franchises 409 Orange Julius operations and 43 Karmelkorn operations. In 190 locations, “treat centers” provide some combination of the three products.

For many years IDQ had a bumpy history. Then, in 1970, a Minneapolis group led by John Mooty and Rudy Luther took control. The new managers inherited a jumble of different franchising agreements, along with some unwise financing arrangements that had left the company in a precarious condition. In the years that followed, management rationalized the operation, extended food service to many more locations, and, in general, built a strong organization.

Last summer Mr. Luther died, which meant his estate needed to sell stock. A year earlier, Dick Kiphart of William Blair & Co., had introduced me to John Mooty and Mike Sullivan, IDQ’s CEO, and I had been impressed with both men. So, when we got the chance to merge with IDQ, we offered a proposition patterned on our FlightSafety acquisition, extending selling shareholders the option of choosing either cash or Berkshire shares having a slightly lower immediate value. By tilting the consideration as we did, we encouraged holders to opt for cash, the type of payment we by far prefer. Even then, only 45% of IDQ shares elected cash.

Charlie and I bring a modicum of product expertise to this transaction: He has been patronizing the Dairy Queens in Cass Lake and Bemidji, Minnesota, for decades, and I have been a regular in Omaha. We have put our money where our mouth is.

A Confession

I’ve mentioned that we strongly prefer to use cash rather than Berkshire stock in acquisitions. A study of the record will tell you why: If you aggregate all of our stock-only mergers (excluding those we did with two affiliated companies, Diversified Retailing and Blue Chip Stamps), you will find that our shareholders are slightly worse off than they would have been had I not done the transactions. Though it hurts me to say it, when I’ve issued stock, I’ve cost you money.

Be clear about one thing: This cost has *not* occurred because we were misled in any way by sellers or because they thereafter failed to manage with diligence and skill. On the contrary, the sellers were completely candid when we were negotiating our deals and have been energetic and effective ever since.

Instead, our problem has been that we own a truly marvelous collection of businesses, which means that trading away a portion of them for something new almost never makes sense. When we issue shares in a merger, we reduce your ownership in all of our businesses—partly-owned companies such as Coca-Cola, Gillette and American Express, and all of our terrific operating companies as well. An example from sports will illustrate the difficulty we face: For a baseball team, acquiring a player who can be expected to bat .350 is almost always a wonderful event—*except* when the team must trade a .380 hitter to make the deal.

Because our roster is filled with .380 hitters, we have tried to pay cash for acquisitions, and here our record has been far better. Starting with National Indemnity in 1967, and continuing with, among others, See's, Buffalo News, Scott Fetzer and GEICO, we have acquired—for cash—a number of large businesses that have performed incredibly well since we bought them. These acquisitions have delivered Berkshire tremendous value—indeed, far more than I anticipated when we made our purchases.

We believe that it is almost impossible for us to "trade up" from our present businesses and managements. Our situation is the opposite of Camelot's Mordred, of whom Guenevere commented, "The one thing I can say for him is that he is bound to marry well. Everybody is above him." Marrying well is extremely difficult for Berkshire.

So you can be sure that Charlie and I will be very reluctant to issue shares in the future. In those cases when we simply must do so—when certain shareholders of a desirable acquiree insist on getting stock—we will include an attractive cash option in order to tempt as many of the sellers to take cash as is possible.

Merging with public companies presents a special problem for us. If we are to offer *any* premium to the acquiree, one of two conditions must be present: Either our own stock must be overvalued relative to the acquiree's, or the two companies together must be expected to earn more than they would if operated separately. Historically, Berkshire has seldom been overvalued. In this market, moreover, undervalued acquirees are almost impossible to find. That other possibility—synergy gains—is usually unrealistic, since we expect acquirees to operate after we've bought them just as they did before. Joining with Berkshire does not normally raise their revenues nor cut their costs.

Indeed, their reported costs (but not their true ones) will *rise* after they are bought by Berkshire if the acquiree has been granting options as part of its compensation packages. In these cases, "earnings" of the acquiree have been overstated because they have followed the standard—but, in our view, dead wrong—accounting practice of ignoring the cost to a business of issuing options. When Berkshire acquires an option-issuing company, we promptly substitute a cash compensation plan having an economic value equivalent to that of the previous option plan. The acquiree's true compensation cost is thereby brought out of the closet and charged, as it should be, against earnings.

The reasoning that Berkshire applies to the merger of public companies *should* be the calculus for all buyers. Paying a takeover premium does not make sense for any acquirer unless a) its stock is overvalued relative to the acquiree's or b) the two enterprises will earn more combined than they would separately. Predictably, acquirers normally hew to the second argument because very few are willing to acknowledge that their stock is overvalued. However, voracious buyers—the ones that issue shares as fast as they can print them—are tacitly conceding that point. (Often, also, they are running Wall Street's version of a chain-letter scheme.)

In some mergers there truly are major synergies—though oftentimes the acquirer pays too much to obtain them—but at other times the cost and revenue benefits that are projected prove illusory. Of one thing, however, be certain: If a CEO is enthused about a particularly foolish acquisition, both his internal staff and his outside advisors will come up with whatever projections are needed to justify his stance. Only in fairy tales are emperors told that they are naked.

Common Stock Investments

Below we present our common stock investments. Those with a market value of more than $750 million are itemized.

			12/31/97
Shares	*Company*	*Cost**	*Market*

(dollars in millions)

49,456,900	American Express Company	$1,392.7	$ 4,414.0
200,000,000	The Coca-Cola Company	1,298.9	13,337.5
21,563,414	The Walt Disney Company	381.2	2,134.8
63,977,600	Freddie Mac	329.4	2,683.1
48,000,000	The Gillette Company	600.0	4,821.0
23,733,198	Travelers Group Inc.	604.4	1,278.6
1,727,765	The Washington Post Company	10.6	840.6
6,690,218	Wells Fargo & Company	412.6	2,270.9
	Others	2,177.1	4,467.2
	Total Common Stocks	$7,206.9	$36,247.7

***** Represents tax-basis cost which, in aggregate, is $1.8 billion less than GAAP cost.

We made net sales during the year that amounted to about 5% of our beginning portfolio. In these, we significantly reduced a few of our holdings that are below the $750 million threshold for itemization, and we also modestly trimmed a few of the larger positions that we detail. Some of the sales we made during 1997 were aimed at changing our bond-stock ratio moderately in response to the relative values that we saw in each market, a realignment we have continued in 1998.

Our reported positions, we should add, sometimes reflect the investment decisions of GEICO's Lou Simpson. Lou independently runs an equity portfolio of nearly $2 billion that may at times overlap the portfolio that I manage, and occasionally he makes moves that differ from mine.

Though we don't attempt to predict the movements of the stock market, we do try, in a very rough way, to value it. At the annual meeting last year, with the Dow at 7,071 and long-term Treasury yields at 6.89%, Charlie and I stated that we did not consider the market overvalued *if* 1) interest rates remained where they were or fell, and 2) American business continued to earn the remarkable returns on equity that it had recently recorded. So far, interest rates have fallen —that's one requisite satisfied—and returns on equity still remain exceptionally high. If they stay there—and if interest rates hold near recent levels—there is no reason to think of stocks as generally overvalued. On the other hand, returns on equity are not a sure thing to remain at, or even near, their present levels.

In the summer of 1979, when equities looked cheap to me, I wrote a *Forbes* article entitled "You pay a very high price in the stock market for a cheery consensus." At that time skepticism and disappointment prevailed, and my point was that investors should be glad of the fact, since pessimism drives down prices to truly attractive levels. Now, however, we have a very cheery consensus. That does not necessarily mean this is the wrong time to buy stocks: Corporate America is now earning far more money than it was just a few years ago, and in the presence of lower interest rates, every dollar of earnings becomes more valuable. Today's price levels, though, have materially eroded the "margin of safety" that Ben Graham identified as the cornerstone of intelligent investing.

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In last year's annual report, I discussed Coca-Cola, our largest holding. Coke continues to increase its market dominance throughout the world, but, tragically, it has lost the leader responsible for its outstanding performance. Roberto Goizueta, Coke's CEO since 1981, died in October. After his death, I read every one of the more than 100 letters and notes he had written me during the past nine years. Those messages could well serve as a guidebook for success in both business and life.

In these communications, Roberto displayed a brilliant and clear strategic vision that was always aimed at advancing the well-being of Coke shareholders. Roberto knew where he was leading the company, how he was going to get there, and why this path made the most sense for his owners—and, equally important, he had a burning sense of urgency about reaching his goals. An excerpt from one handwritten note he sent to me illustrates his mind-set: "By the way, I have told Olguita that what she refers to as an obsession, you call focus. I like your term much better." Like all who knew Roberto, I will miss him enormously.

Consistent with his concern for the company, Roberto prepared for a seamless succession long before it seemed necessary. Roberto knew that Doug Ivester was the right man to take over and worked with Doug over the years to ensure that no momentum would be lost when the time for change arrived. The Coca-Cola Company will be the same steamroller under Doug as it was under Roberto.

Convertible Preferreds

Two years ago, I gave you an update on the five convertible preferreds that we purchased through private placements in the 1987-1991 period. At the time of that earlier report, we had realized a small profit on the sale of our Champion International holding. The four remaining preferred commitments included two, Gillette and First Empire State, that we had converted into common stock in which we had large unrealized gains, and two others, USAir and Salomon, that had been trouble-prone. At times, the last two had me mouthing a line from a country song: "How can I miss you if you won't go away?"

Since I delivered that report, all four holdings have grown significantly in value. The common stocks of both Gillette and First Empire have risen substantially, in line with the companies' excellent performance. At yearend, the $600 million we put into Gillette in 1989 had appreciated to $4.8 billion, and the $40 million we committed to First Empire in 1991 had risen to $236 million.

Our two laggards, meanwhile, have come to life in a very major way. In a transaction that finally rewarded its long-suffering shareholders, Salomon recently merged into Travelers Group. All of Berkshire's shareholders—including me, very personally—owe a huge debt to Deryck Maughan and Bob Denham for, first, playing key roles in saving Salomon from extinction following its 1991 scandal and, second, restoring the vitality of the company to a level that made it an attractive acquisition for Travelers. I have often said that I wish to work with executives that I like, trust and admire. No two fit that description better than Deryck and Bob.

Berkshire's final results from its Salomon investment won't be tallied for some time, but it is safe to say that they will be far better than I anticipated two years ago. Looking back, I think of my Salomon experience as having been both fascinating and instructional, though for a time in 1991-92 I felt like the drama critic who wrote: "I would have enjoyed the play except that I had an unfortunate seat. It faced the stage."

The resuscitation of US Airways borders on the miraculous. Those who have watched my moves in this investment know that I have compiled a record that is unblemished by success. I was wrong in originally purchasing the stock, and I was wrong later, in repeatedly trying to unload our holdings at 50 cents on the dollar.

Two changes at the company coincided with its remarkable rebound: 1) Charlie and I left the board of directors and 2) Stephen Wolf became CEO. Fortunately for our egos, the second event was the key: Stephen Wolf's accomplishments at the airline have been phenomenal.

There still is much to do at US Airways, but survival is no longer an issue. Consequently, the company made up the dividend arrearages on our preferred during 1997, adding extra payments to compensate us for the delay we suffered. The company's common stock, furthermore, has risen from a low of $4 to a recent high of $73.

Our preferred has been called for redemption on March 15. But the rise in the company's stock has given our conversion rights, which we thought worthless not long ago, great value. It is now almost certain that our US Airways shares will produce a decent profit—that is, if my cost for Maalox is excluded—and the gain could even prove indecent.

Next time I make a big, dumb decision, Berkshire shareholders will know what to do: *Phone Mr. Wolf*.

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In addition to the convertible preferreds, we purchased one other private placement in 1991, $300 million of American Express Percs. This security was essentially a common stock that featured a tradeoff in its first three years: We received extra dividend payments during that period, but we were also capped in the price appreciation we could realize. Despite the cap, this holding has proved extraordinarily profitable thanks to a move by your Chairman that combined luck and skill—110% luck, the balance skill.

Our Percs were due to convert into common stock in August 1994, and in the month before I was mulling whether to sell upon conversion. One reason to hold was Amex's outstanding CEO, Harvey Golub, who seemed likely to maximize whatever potential the company had (a supposition that has since been proved—in spades). But the size of that potential was in question: Amex faced relentless competition from a multitude of card-issuers, led by Visa. Weighing the arguments, I leaned toward sale.

Here's where I got lucky. During that month of decision, I played golf at Prouts Neck, Maine with Frank Olson, CEO of Hertz. Frank is a brilliant manager, with intimate knowledge of the card business. So from the first tee on I was quizzing him about the industry. By the time we reached the second green, Frank had convinced me that Amex's corporate card was a terrific franchise, and I had decided not to sell. On the back nine I turned buyer, and in a few months Berkshire owned 10% of the company.

We now have a $3 billion gain in our Amex shares, and I naturally feel very grateful to Frank. But George Gillespie, our mutual friend, says that I am confused about where my gratitude should go. After all, he points out, it was he who arranged the game and assigned me to Frank's foursome.

Quarterly Reports to Shareholders

In last year's letter, I described the growing costs we incur in mailing quarterly reports and the problems we have encountered in delivering them to "street-name" shareholders. I asked for your opinion about the desirability of our continuing to print reports, given that we now publish our quarterly and annual communications on the Internet, at our site, www.berkshirehathaway.com. Relatively few shareholders responded, but it is clear that at least a small number who want the quarterly information have no interest in getting it off the Internet. Being a life-long sufferer from technophobia, I can empathize with this group.

The cost of publishing quarterlies, however, continues to balloon, and we have therefore decided to send printed versions only to shareholders who request them. If you wish the quarterlies, please complete the reply card that is bound into this report. In the meantime, be assured that *all* shareholders will continue to receive the *annual* report in printed form.

Those of you who enjoy the computer should check out our home page. It contains a large amount of current information about Berkshire and also all of our annual letters since 1977. In addition, our website includes links to the home pages of many Berkshire subsidiaries. On these sites you can learn more about our subsidiaries' products and—yes—even place orders for them.

We are required to file our quarterly information with the SEC no later than 45 days after the end of each quarter. One of our goals in posting communications on the Internet is to make this material information—in full detail and in a form unfiltered by the media—simultaneously available to all interested parties at a time when markets are closed. Accordingly, we plan to send our 1998 quarterly information to the SEC on three Fridays, May 15, August 14, and November 13, and on those nights to post the same information on the Internet. This procedure will put all of our shareholders, whether they be direct or "street-name," on an equal footing. Similarly, we will post our 1998 annual report on the Internet on Saturday, March 13, 1999, and mail it at about the same time.

Shareholder-Designated Contributions

About 97.7% of all eligible shares participated in Berkshire's 1997 shareholder-designated contributions program. Contributions made were $15.4 million, and 3,830 charities were recipients. A full description of the program appears on pages 52—53.

Cumulatively, over the 17 years of the program, Berkshire has made contributions of $113.1 million pursuant to the instructions of our shareholders.

The rest of Berkshire's giving is done by our subsidiaries, which stick to the philanthropic patterns that prevailed before they were acquired (except that their former owners themselves take on the responsibility for their personal charities). In aggregate, our subsidiaries made contributions of $8.1 million in 1997, including in-kind donations of $4.4 million.

Every year a few shareholders miss out on our contributions program because they don't have their shares registered in their own names on the prescribed record date or because they fail to get the designation form back to us within the 60-day period allowed. Charlie and I regret this. But if replies are received late, we have to reject them because we can't make exceptions for some shareholders while refusing to make them for others.

To participate in future programs, you must own Class A shares that are registered in the name of the actual owner, not the nominee name of a broker, bank or depository. Shares not so registered on August 31, 1998, will be ineligible for the 1998 program. When you get the contributions form from us, return it promptly so that it does not get put aside or forgotten.

The Annual Meeting

Woodstock Weekend at Berkshire will be May 2-4 this year. The finale will be the annual meeting, which will begin at 9:30 a.m. on Monday, May 4. Last year we met at Aksarben Coliseum, and both our staff and the crowd were delighted with the venue. There was only one crisis: The night before the meeting, I lost my voice, thereby fulfilling Charlie's wildest fantasy. He was crushed when I showed up the next morning with my speech restored.

Last year about 7,500 attended the meeting. They represented all 50 states, as well as 16 countries, including Australia, Brazil, Israel, Saudi Arabia, Singapore and Greece. Taking into account several overflow rooms, we believe that we can handle more than 11,000 people, and that should put us in good shape this year even though our shareholder count has risen significantly. Parking is ample at Aksarben; acoustics are excellent; and seats are comfortable.

The doors will open at 7 a.m. on Monday and at 8:30 we will again feature the world premiere of a movie epic produced by Marc Hamburg, our CFO. The meeting will last until 3:30, with a short break at noon. This interval will permit the exhausted to leave unnoticed and allow time for the hardcore to lunch at Aksarben's concession stands. Charlie and I enjoy questions from owners, so bring up whatever is on your mind.

Berkshire products will again be *for sale* in the halls outside the meeting room. Last year—not that I pay attention to this sort of thing—we again set sales records, moving 2,500 pounds of See's candy, 1,350 pairs of Dexter shoes, $75,000 of World Books and related publications, and 888 sets of Quikut knives. We also took orders for a new line of apparel, featuring our Berkshire logo, and sold about 1,000 polo, sweat, and T-shirts. At this year's meeting, we will unveil our 1998 collection.

GEICO will again be on hand with a booth staffed by star associates from its regional offices. Find out whether you can save money by shifting your auto insurance to GEICO. About 40% of those who check us out learn that savings are possible. The proportion is not 100% because insurers differ in their underwriting judgments, with some favoring drivers who live in certain geographical areas and work at certain occupations more than we do. We believe, however, that we more frequently offer the low price than does any other national carrier selling insurance to all comers. In the GEICO informational material that accompanies this report, you will see that in 38 states we now offer a special discount of as much as 8% to our shareholders. We also have applications pending that would extend this discount to drivers in other states.

An attachment to the proxy material that is enclosed with this report explains how you can obtain the card you will need for admission to the meeting. We expect a large crowd, so get plane, hotel and car reservations promptly. American Express (800-799-6634) will be happy to help you with arrangements. As usual, we will have buses at the larger hotels that will take you to and from the meeting and also deliver you to Nebraska Furniture Mart, Borsheim's and the airport after its conclusion. You are likely, however, to find a car handy.

NFM's main store, located on a 75-acre site about a mile from Aksarben, is open from 10 a.m. to 9 p.m. on weekdays, 10 a.m. to 6 p.m. on Saturdays, and noon to 6 p.m. on Sundays. During the period from May 1 to May 5, shareholders who present NFM with the coupon that will accompany their meeting ticket will be entitled to a discount that is otherwise restricted to its employees.

Borsheim's normally is closed on Sunday but will be open for shareholders from 10 a.m. to 6 p.m. on May 3rd. Last year was our second-best shareholder's day, exceeded only by 1996's. I regard this slippage as an anomaly and hope that you will prove me right this year. Charlie will be available for autographs. He smiles, however, only if the paper he signs is a Borsheim's sales ticket. Shareholders who wish to visit on Saturday (10 a.m. to 5:30 p.m.) or on Monday (10 a.m.-8 p.m.) should be sure to identify themselves as Berkshire owners so that Susan Jacques, Borsheim's CEO, can make you especially welcome. Susan, I should add, had a fabulous year in 1997. As a manager, she is everything that an owner hopes for.

On Sunday afternoon we will also have a special treat for bridge players in the mall outside of Borsheim's. There, Bob Hamman—a legend of the game for more than three decades—will take on all comers. Join in and dazzle Bob with your skill.

My favorite steakhouse, Gorat's, opens one Sunday a year—for Berkshire shareholders on the night before the annual meeting. Last year the restaurant started serving at 4 p.m. and finished about 1:30 a.m, an endurance trial that was the result of taking 1,100 reservations vs. a seating capacity of 235. If you make a reservation and then can't attend, be sure to let Gorat's know promptly, since it goes to great effort to help us and we want to reciprocate. You can make reservations beginning on April 1st (*but not before*) by calling 402-551-3733. Last year I had to leave Gorat's a little early because of my voice problem, but this year I plan to leisurely savor every bite of my rare T-bone and double order of hash browns.

After this warmup, Charlie and I will head for the Dairy Queen on 114th, just south of Dodge. There are 12 great Dairy Queens in metropolitan Omaha, but the 114th Street location is the best suited to handle the large crowd that we expect. South of the property, there are hundreds of parking spaces on both sides of the street. Also, this Dairy Queen will extend its Sunday hours to 11 p.m. in order to accommodate our shareholders.

The 114th Street operation is now run by two sisters, Coni Birge and Deb Novotny, whose grandfather put up the building in 1962 at what was then the outer edge of the city. Their mother, Jan Noble, took over in 1972, and Coni and Deb continue as third generation owner-managers. Jan, Coni and Deb will all be on hand Sunday evening, and I hope that you meet them. Enjoy one of their hamburgers if you can't get into Gorat's. And then, around eight o'clock, join me in having a Dusty Sundae for dessert. This item is a personal specialty—the Dairy Queen will furnish you a copy of my recipe—and will be offered only on Shareholder Sunday.

The Omaha Royals and Albuquerque Dukes will play baseball on Saturday evening, May 2nd, at Rosenblatt Stadium. As usual, your Chairman, shamelessly exploiting his 25% ownership of the team, will take the mound. But this year you will see something new.

In past games, much to the bafflement of the crowd, I have shaken off the catcher's first call. He has consistently asked for my sweeping curve, and I have just as regularly resisted. Instead, I have served up a pathetic fast ball, which on my best day was clocked at eight miles per hour (with a following wind).

There's a story behind my unwillingness to throw the curve ball. As some of you may know, Candy Cummings invented the curve in 1867 and used it to great effect in the National Association, where he never won less than 28 games in a season. The pitch, however, drew immediate criticism from the very highest of authorities, namely Charles Elliott, then president of Harvard University, who declared, "I have heard that this year we at Harvard won the baseball championship because we have a pitcher who has a fine curve ball. I am further instructed that the purpose of the curve ball is to deliberately deceive the batter. Harvard is not in the business of teaching deception." (I'm not making this up.)

Ever since I learned of President Elliott's moral teachings on this subject, I have scrupulously refrained from using my curve, however devastating its effect might have been on hapless batters. Now, however, it is time for my karma to run over Elliott's dogma and for me to quit holding back. Visit the park on Saturday night and marvel at the majestic arc of my breaking ball.

Our proxy statement includes information about obtaining tickets to the game. We will also provide an information packet describing the local hot spots, including, of course, those 12 Dairy Queens.

Come to Omaha—the cradle of capitalism—in May and enjoy yourself.

February 27, 1998

Warren E. Buffett
Chairman of the Board

BERKSHIRE HATHAWAY INC.

To the Shareholders of Berkshire Hathaway Inc.:

Our gain in net worth during 1998 was $25.9 billion, which increased the per-share book value of both our Class A and Class B stock by 48.3%. Over the last 34 years (that is, since present management took over) per-share book value has grown from $19 to $37,801, a rate of 24.7% compounded annually.*

* All figures used in this report apply to Berkshire's A shares, the successor to the only stock that the company had outstanding before 1996. The B shares have an economic interest equal to 1/30th that of the A.

Normally, a gain of 48.3% would call for handsprings — but not this year. Remember Wagner, whose music has been described as better than it sounds? Well, Berkshire's progress in 1998 — though more than satisfactory — was not as good as it looks. That's because most of that 48.3% gain came from our issuing shares in acquisitions.

To explain: Our stock sells at a large premium over book value, which means that any issuing of shares we do — whether for cash or as consideration in a merger — instantly increases our per-share book-value figure, even though we've earned not a dime. What happens is that we get more per-share book value in such transactions than we give up. These transactions, however, do not deliver us any immediate gain in per-share *intrinsic value*, because in this respect what we give and what we get are roughly equal. And, as Charlie Munger, Berkshire's Vice Chairman and my partner, and I can't tell you too often (though you may feel that we try), it's the per-share gain in intrinsic value that counts rather than the per-share gain in book value. Though Berkshire's intrinsic value grew very substantially in 1998, the gain fell well short of the 48.3% recorded for book value. Nevertheless, intrinsic value still *far* exceeds book value. (For a more extensive discussion of these terms, and other investment and accounting concepts, please refer to our Owner’s Manual, on pages 56-64, in which we set forth our owner-related business principles. Intrinsic value is discussed on pages 61 and 62.)

We entered 1999 with the best collection of businesses and managers in our history. The two companies we acquired in 1998, General Re and Executive Jet, are first-class in every way — more about both later — and the performance of our operating businesses last year exceeded my hopes. GEICO, once again, simply shot the lights out. On the minus side, several of the public companies in which we have major investments experienced significant operating shortfalls that neither they nor I anticipated early in the year. Consequently, our equity portfolio did not perform nearly as well as did the S&P 500. The problems of these companies are almost certainly temporary, and Charlie and I believe that their long-term prospects are excellent.

In our last three annual reports, we furnished you a table that we regard as central to estimating Berkshire's intrinsic value. In the updated version of that table, which follows, we trace our two key components of value, including General Re on a pro-forma basis as if we had owned it throughout the year. The first column lists our per-share ownership of investments (including cash and equivalents but excluding securities held in our financial products operation) and the second column shows our per-share earnings from Berkshire's operating businesses before taxes and purchase-accounting adjustments (discussed on pages 62 and 63), but after all interest and corporate expenses. The second column excludes *all* dividends, interest and capital gains that we realized from the investments presented in the first column. In effect, the columns show how Berkshire would look if it were split into two parts, with one entity holding our investments and the other operating all of our businesses and bearing all corporate costs.

Year	Investments Per Share	Pre-tax Earnings Per Share With All Income from Investments Excluded
1968	$ 53	$ 2.87
1978	465	12.85
1988	4,876	145.77
1998	47,647	474.45

Here are the growth rates of the two segments by decade:

Decade Ending	Investments Per Share	Pre-tax Earnings Per Share With All Income from Investments Excluded
1978	24.2%	16.2%
1988	26.5%	27.5%
1998	25.6%	12.5%
Annual Growth Rate, 1968-1998	25.4%	18.6%

During 1998, our investments increased by $9,604 per share, or 25.2%, but per-share operating earnings fell by 33.9%. General Re (included, as noted, on a pro-forma basis) explains both facts. This company has very large investments, and these greatly increased our per-share investment figure. But General Re also had an underwriting loss in 1998, and that hurt operating earnings. Had we not acquired General Re, per-share operating earnings would have shown a modest gain.

Though certain of our acquisitions and operating strategies may from time to time affect one column more than the other, we continually work to increase the figures in both. But one thing is certain: Our future rates of gain will fall far short of those achieved in the past. Berkshire's capital base is now simply too large to allow us to earn truly outsized returns. If you believe otherwise, you should consider a career in sales but avoid one in mathematics (bearing in mind that there are really only three kinds of people in the world: those who can count and those who can't).

Currently we are working to compound a net worth of $57.4 billion, the largest of any American corporation (though our figure will be eclipsed if the merger of Exxon and Mobil takes place). Of course, our lead in net worth does not mean that Berkshire outranks all other businesses in value: Market value is what counts for owners and General Electric and Microsoft, for example, have valuations more than three times Berkshire's. Net worth, though, measures the capital that managers must deploy, and at Berkshire that figure has indeed become huge.

Nonetheless, Charlie and I will do our best to increase intrinsic value in the future at an average rate of 15%, a result we consider to be at the very peak of possible outcomes. We may have years when we exceed 15%, but we will most certainly have other years when we fall far short of that — including years showing negative returns — and those will bring our average down. In the meantime, you should understand just what an average gain of 15% over the next five years implies: It means we will need to increase net worth by $58 billion. Earning this daunting 15% will require us to come up with big ideas: Popcorn stands just won't do. Today's markets are not friendly to our search for "elephants," but you can be sure that we will stay focused on the hunt.

Whatever the future holds, I make you one promise: I'll keep at least 99% of my net worth in Berkshire for as long as I am around. How long will that be? My model is the loyal Democrat in Fort Wayne who asked to be buried in Chicago so that he could stay active in the party. To that end, I've already selected a "power spot" at the office for my urn.

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Our financial growth has been matched by employment growth: We now have 47,566 on our payroll, with the acquisitions of 1998 bringing 7,074 employees to us and internal growth adding another 2,500. To balance this gain of 9,500 in hands-on employees, we have enlarged the staff at world headquarters from 12 to 12.8. (The .8 doesn't refer to me or Charlie: We have a new person in accounting, working four days a week.) Despite this alarming trend toward corporate bloat, our after-tax overhead last year was about $3.5 million, or well under one basis point (.01 of 1%) of the value of the assets we manage.

Taxes

One beneficiary of our increased size has been the U.S. Treasury. The federal income taxes that Berkshire and General Re have paid, or will soon pay, in respect to 1998 earnings total $2.7 billion. That means we shouldered *all* of the U.S. Government's expenses for more than a half-day.

Follow that thought a little further: If only 625 other U.S. taxpayers had paid the Treasury as much as we and General Re did last year, no one else — neither corporations nor 270 million citizens — would have had to pay federal income taxes or any other kind of federal tax (for example, social security or estate taxes). Our shareholders can truly say that they "gave at the office."

Writing checks to the IRS that include strings of zeros does not bother Charlie or me. Berkshire as a corporation, and we as individuals, have prospered in America as we would have in no other country. Indeed, if we lived in some other part of the world and completely escaped taxes, I'm sure we would be worse off financially (and in many other ways as well). Overall, we feel extraordinarily lucky to have been dealt a hand in life that enables us to write large checks to the government rather than one requiring the government to regularly write checks to us — say, because we are disabled or unemployed.

Berkshire's tax situation is sometimes misunderstood. First, capital gains have no special attraction for us: A corporation pays a 35% rate on taxable income, whether it comes from capital gains or from ordinary operations. This means that Berkshire's tax on a long-term capital gain is fully 75% higher than what an individual would pay on an identical gain.

Some people harbor another misconception, believing that we can exclude 70% of all dividends we receive from our taxable income. Indeed, the 70% rate applies to most corporations and also applies to Berkshire in cases where we hold stocks in non-insurance subsidiaries. However, almost all of our equity investments are owned by our insurance companies, and in that case the exclusion is 59.5%. That still means a dollar of dividends is considerably more valuable to us than a dollar of ordinary income, but not to the degree often assumed.

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Berkshire truly went all out for the Treasury last year. In connection with the General Re merger, we wrote a $30 million check to the government to pay an SEC fee tied to the new shares created by the deal. We understand that this payment set an SEC record. Charlie and I are enormous admirers of what the Commission has accomplished for American investors. We would rather, however, have found another way to show our admiration.

GEICO (1-800-847-7536)

Combine a great idea with a great manager and you're certain to obtain a great result. That mix is alive and well at GEICO. The idea is low-cost auto insurance, made possible by direct-to-customer marketing, and the manager is Tony Nicely. Quite simply, there is no one in the business world who could run GEICO better than Tony does. His instincts are unerring, his energy is boundless, and his execution is flawless. While maintaining underwriting discipline, Tony is building an organization that is gaining market share at an accelerating rate.

This pace has been encouraged by our compensation policies. The direct writing of insurance — that is, without there being an agent or broker between the insurer and its policyholder — involves a substantial front-end investment. First-year business is therefore unprofitable in a major way. At GEICO, we do not wish this cost to deter our associates from the aggressive pursuit of new business — which, as it renews, will deliver significant profits — so we leave it out of our compensation formulas. What's included then? We base 50% of our associates' bonuses and profit sharing on the earnings of our "seasoned" book, meaning policies that have been with us for more than a year. The other 50% is tied to growth in policyholders — and here we have stepped on the gas.

In 1995, the year prior to its acquisition by Berkshire, GEICO spent $33 million on marketing and had 652 telephone counselors. Last year the company spent $143 million, and the counselor count grew to 2,162. The effects that these efforts had at the company are shown by the new business and in-force figures below:

Years	New Auto Policies*	Auto Policies In-Force*

1993	354,882	2,011,055
1994	396,217	2,147,549
1995	461,608	2,310,037
1996	617,669	2,543,699
1997	913,176	2,949,439
1998	1,317,761	3,562,644

* "Voluntary" only; excludes assigned risks and the like.

In 1999, we will again increase our marketing budget, spending at least $190 million. In fact, there is no limit to what Berkshire is willing to invest in GEICO's new-business activity, as long as we can concurrently build the infrastructure the company needs to properly serve its policyholders.

Because of the first-year costs, companies that are concerned about quarterly or annual earnings would shy from similar investments, no matter how intelligent these might be in terms of building long-term value. Our calculus is different: We simply measure whether we are creating more than a dollar of value per dollar spent — and if that calculation is favorable, the more dollars we spend the happier I am.

There is far more to GEICO's success, of course, than low prices and a torrent of advertising. The handling of claims must also be fair, fast and friendly — and ours is. Here's an impartial scorecard on how we shape up: In New York, our largest-volume state, the Insurance Department recently reported that GEICO's complaint ratio in 1997 was not only the lowest of the five largest auto insurers but was also less than half the average of the other four.

GEICO's 1998 profit margin of 6.7% was better than we had anticipated — and, indeed, better than we wished. Our results reflect an industry-wide phenomenon: In recent years, both the frequency of auto accidents and their severity have unexpectedly declined. We responded by reducing rates 3.3% in 1998, and we will reduce them still more in 1999. These moves will soon bring profit margins down — at the least to 4%, which is our target, and perhaps considerably lower. Whatever the case, we believe that our margins will continue to be much better than those of the industry.

With GEICO's growth and profitability both outstanding in 1998, so also were its profit-sharing and bonus payments. Indeed, the profit-sharing payment of $103 million or 32.3% of salary — which went to all 9,313 associates who had been with us for more than a year — may well have been the highest percentage payment at any large company in the country. (In addition, associates benefit from a company-funded pension plan.)

The 32.3% may turn out to be a high-water mark, given that the profitability component in our profit-sharing calculation is almost certain to come down in the future. The growth component, though, may well increase. Overall, we expect the two benchmarks together to dictate very significant profit-sharing payments for decades to come. For our associates, growth pays off in other ways as well: Last year we promoted 4,612 people.

Impressive as the GEICO figures are, we have far more to do. Our market share improved significantly in 1998 — but only from 3% to 3½%. For every policyholder we now have, there are another ten who should be giving us their business.

Some of you who are reading this may be in that category. About 40% of those who check our rates find that they can save money by doing business with us. The proportion is not 100% because insurers differ in their underwriting judgements, with some giving more credit than we do to drivers who live in certain geographical areas or work at certain occupations. We believe, however, that we more frequently offer the low price than does any other national carrier selling insurance to all comers. Furthermore, in 40 states we can offer a special discount — usually 8% — to our shareholders. So give us a call and check us out.

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You may think that one commercial in this section is enough. But I have another to present, this one directed at managers of publicly-owned companies.

At Berkshire we feel that telling outstanding CEOs, such as Tony, how to run their companies would be the height of foolishness. Most of our managers wouldn't work for us if they got a lot of backseat driving.

(Generally, they don't have to work for *anyone*, since 75% or so are independently wealthy.) Besides, they are the Mark McGwires of the business world and need no advice from us as to how to hold the bat or when to swing.

Nevertheless, Berkshire's ownership may make even the best of managers more effective. First, we eliminate all of the ritualistic and nonproductive activities that normally go with the job of CEO. Our managers are totally in charge of their personal schedules. Second, we give each a simple mission: Just run your business as if: 1) you own 100% of it; 2) it is the only asset in the world that you and your family have or will ever have; and 3) you can't sell or merge it for at least a century. As a corollary, we tell them they should not let any of their decisions be affected even slightly by accounting considerations. We want our managers to think about what counts, not how it will be counted.

Very few CEOs of public companies operate under a similar mandate, mainly because they have owners who focus on short-term prospects and reported earnings. Berkshire, however, has a shareholder base — which it will have for decades to come — that has the longest investment horizon to be found in the public-company universe. Indeed, a majority of our shares are held by investors who expect to die still holding them. We can therefore ask our CEOs to manage for maximum long-term value, rather than for next quarter's earnings. We certainly don't ignore the current results of our businesses — in most cases, they are of great importance — but we *never* want them to be achieved at the expense of our building ever-greater competitive strengths.

I believe the GEICO story demonstrates the benefits of Berkshire's approach. Charlie and I haven't taught Tony a thing — and never will — but we *have* created an environment that allows him to apply all of his talents to what's important. He does not have to devote his time or energy to board meetings, press interviews, presentations by investment bankers or talks with financial analysts. Furthermore, he need never spend a moment thinking about financing, credit ratings or "Street" expectations for earnings per share. Because of our ownership structure, he also knows that this operational framework will endure for decades to come. In this environment of freedom, both Tony and his company can convert their almost limitless potential into matching achievements.

If you are running a large, profitable business that will thrive in a GEICO-like environment, check our acquisition criteria on page 21 and give me a call. I promise a fast answer and will mention your inquiry to no one except Charlie.

Executive Jet Aviation (1-800-848-6436)

To understand the huge potential at Executive Jet Aviation (EJA), you need some understanding of its business, which is selling fractional shares of jets and operating the fleet for its many owners. Rich Santulli, CEO of EJA, created the fractional ownership industry in 1986, by visualizing an important new way of using planes. Then he combined guts and talent to turn his idea into a major business.

In a fractional ownership plan, you purchase a portion — say /^{1} 8th — of any of a wide variety of jets that EJA offers. That purchase entitles you to 100 hours of flying time annually. ("Dead-head" hours don't count against your allotment, and you are also allowed to average your hours over five years.) In addition, you pay both a monthly management fee and a fee for hours actually flown.

Then, on a few hours notice, EJA makes your plane, or another at least as good, available to you at your choice of the 5500 airports in the U.S. In effect, calling up your plane is like phoning for a taxi.

I first heard about the NetJets® program, as it is called, about four years ago from Frank Rooney, our manager at

H.H. Brown. Frank had used and been delighted with the service and suggested that I meet Rich to investigate signing up for my family's use. It took Rich about 15 minutes to sell me a quarter (200 hours annually) of a Hawker 1000. Since then, my family has learned firsthand — through flying 900 hours on 300 trips — what a friendly, efficient, and safe operation EJA runs. Quite simply, they love this service. In fact, they quickly grew so enthusiastic that I did a testimonial ad for EJA long before I knew there was any possibility of our purchasing the business. I did, however, ask Rich to give me a call if he ever got interested in selling. Luckily, he phoned me last May, and we quickly made a $725 million deal, paying equal amounts of cash and stock.

EJA, which is by far the largest operator in its industry, has more than 1,000 customers and 163 aircraft (including 23 “core” aircraft that are owned or leased by EJA itself, so that it can make sure that service is first-class even during the times when demand is heaviest). Safety, of course, is the paramount issue in any flight operation, and Rich’s pilots — now numbering about 650 — receive extensive training at least twice a year from FlightSafety International, another Berkshire subsidiary and the world leader in pilot training. The bottom line on our pilots: I’ve sold the Berkshire plane and will now do all of my business flying, as well as my personal flying, with NetJets’ crews.

Being the leader in this industry is a major advantage for all concerned. Our customers gain because we have an armada of planes positioned throughout the country at all times, a blanketing that allows us to provide unmatched service. Meanwhile, we gain from the blanketing because it reduces dead-head costs. Another compelling attraction for our clients is that we offer products from Boeing, Gulfstream, Falcon, Cessna, and Raytheon, whereas our two competitors are owned by manufacturers that offer only their own planes. In effect, NetJets is like a physician who can recommend whatever medicine best fits the needs of each patient; our competitors, in contrast, are producers of a “house” brand that they must prescribe for one and all.

In many cases our clients, both corporate and individual, own fractions of several different planes and can therefore match specific planes to specific missions. For example, a client might own /1 16th of three different jets (each giving it 50 hours of flying time), which in total give it a virtual fleet, obtained for a small fraction of the cost of a single plane.

Significantly, it is not only small businesses that can benefit from fractional ownership. Already, some of America’s largest companies use NetJets as a supplement to their own fleet. This saves them big money in both meeting peak requirements and in flying missions that would require their wholly-owned planes to log a disproportionate amount of dead-head hours.

When a plane is slated for personal use, the clinching argument is that either the client signs up now or his children likely will later. That's an equation I explained to my wonderful Aunt Alice 40 years ago when she asked me whether she could afford a fur coat. My reply settled the issue: "Alice, *you* aren't buying it; your heirs are."

EJA's growth has been explosive: In 1997, it accounted for 31% of all corporate jets ordered in the world. Nonetheless, Rich and I believe that the potential of fractional ownership has barely been scratched. If many thousands of owners find it sensible to own 100% of a plane — which must be used 350-400 hours annually if it's to make economic sense — there must be a large multiple of that number for whom fractional ownership works.

In addition to being a terrific executive, Rich is fun. Like most of our managers, he has no economic need whatsoever to work. Rich spends his time at EJA because it's his baby — and he wants to see how far he can take it. We both already know the answer, both literally and figuratively: to the ends of the earth.

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And now a small hint to Berkshire directors: Last year I spent more than nine times my salary at Borsheim's and EJA. Just think how Berkshire's business would boom if you'd only spring for a raise.

General Re

On December 21, we completed our $22 billion acquisition of General Re Corp. In addition to owning 100% of General Reinsurance Corporation, the largest U.S. property-casualty reinsurer, the company also owns (including stock it has an arrangement to buy) 82% of the oldest reinsurance company in the world, Cologne Re. The two companies together reinsure all lines of insurance and operate in 124 countries.

For many decades, General Re's name has stood for quality, integrity and professionalism in reinsurance — and under Ron Ferguson's leadership, this reputation has been burnished still more. Berkshire can add absolutely nothing to the skills of General Re's and Cologne Re's managers. On the contrary, there is a lot that they can teach us.

Nevertheless, we believe that Berkshire's ownership will benefit General Re in important ways and that its earnings a decade from now will materially exceed those that would have been attainable absent the merger. We base this optimism on the fact that we can offer General Re's management a freedom to operate in whatever manner will best allow the company to exploit its strengths.

Let's look for a moment at the reinsurance business to understand why General Re could not on its own do what it can under Berkshire. Most of the demand for reinsurance comes from primary insurers who want to escape the wide swings in earnings that result from large and unusual losses. In effect, a reinsurer gets paid for absorbing the volatility that the client insurer wants to shed.

Ironically, though, a publicly-held reinsurer gets graded by both its owners and those who evaluate its credit on the smoothness of its own results. Wide swings in earnings hurt both credit ratings and p/e ratios, even when the business that produces such swings has an expectancy of satisfactory profits over time. This market reality sometimes causes a reinsurer to make costly moves, among them laying off a significant portion of the business it writes (in transactions that are called "retrocessions") or rejecting good business simply because it threatens to bring on too much volatility.

Berkshire, in contrast, happily accepts volatility, just as long as it carries with it the expectation of increased profits over time. Furthermore, we are a Fort Knox of capital, and that means volatile earnings can't impair our premier credit ratings. Thus we have the perfect structure for writing — and *retaining* — reinsurance in virtually any amount. In fact, we've used this strength over the past decade to build a powerful super-cat business.

What General Re gives us, however, is the distribution force, technical facilities and management that will allow us to employ our structural strength in every facet of the industry. In particular, General Re and Cologne Re can now accelerate their push into international markets, where the preponderance of industry growth will almost certainly occur. As the merger proxy statement spelled out, Berkshire also brings tax and investment benefits to General Re. But the most compelling reason for the merger is simply that General Re's outstanding management can now do what it does best, unfettered by the constraints that have limited its growth.

Berkshire is assuming responsibility for General Re's investment portfolio, though not for Cologne Re's. We will not, however, be involved in General Re's underwriting. We will simply ask the company to exercise the discipline of the past while increasing the proportion of its business that is retained, expanding its product line, and widening its geographical coverage — making these moves in recognition of Berkshire's financial strength and tolerance for wide swings in earnings. As we've long said, we prefer a lumpy 15% return to a smooth 12%.

Over time, Ron and his team will maximize General Re's new potential. He and I have known each other for many years, and each of our companies has initiated significant business that it has reinsured with the other. Indeed, General Re played a key role in the resuscitation of GEICO from its near-death status in 1976.

Both Ron and Rich Santulli plan to be at the annual meeting, and I hope you get a chance to say hello to them.

The Economics of Property-Casualty Insurance

With the acquisition of General Re — and with GEICO's business mushrooming — it becomes more important than ever that you understand how to evaluate an insurance company. The key determinants are: (1) the amount of float that the business generates; (2) its cost; and (3) most important of all, the long-term outlook for both of these factors.

To begin with, float is money we hold but don't own. In an insurance operation, float arises because premiums are received before losses are paid, an interval that sometimes extends over many years. During that time, the insurer invests the money. Typically, this pleasant activity carries with it a downside: The premiums that an insurer takes in usually do not cover the losses and expenses it eventually must pay. That leaves it running an "underwriting loss," which is the cost of float. An insurance business has value if its cost of float over time is less than the cost the company would otherwise incur to obtain funds. But the business is a lemon if its cost of float is higher than market rates for money.

A caution is appropriate here: Because loss costs must be estimated, insurers have enormous latitude in figuring their underwriting results, and that makes it very difficult for investors to calculate a company's true cost of float. Errors of estimation, usually innocent but sometimes not, can be huge. The consequences of these miscalculations flow directly into earnings. An experienced observer can usually detect large-scale errors in reserving, but the general public can typically do no more than accept what's presented, and at times I have been amazed by the numbers that big-name auditors have implicitly blessed. As for Berkshire, Charlie and I attempt to be conservative in presenting its underwriting results to you, because we have found that virtually all surprises in insurance are unpleasant ones.

The table that follows shows the float generated by Berkshire's insurance operations since we entered the business 32 years ago. The data are for every fifth year and also the last, which includes General Re's huge float. For the table we have calculated our float — which we generate in large amounts relative to our premium volume — by adding net loss reserves, loss adjustment reserves, funds held under reinsurance assumed and unearned premium reserves, and then subtracting agents balances, prepaid acquisition costs, prepaid taxes and deferred charges applicable to assumed reinsurance. (Got that?)

Year	**Average Float (in $ millions)**
1967	17
1972	70
1977	139
1982	221
1987	1,267
1992	2,290
1997	7,093

1998	22,762 (yearend)

Impressive as the growth in our float has been — 25.4% compounded annually — what really counts is the cost of this item. If that becomes too high, growth in float becomes a curse rather than a blessing.

At Berkshire, the news is all good: Our average cost over the 32 years has been well under zero. In aggregate, we have posted a substantial underwriting profit, which means that we have been paid for holding a large and growing amount of money. This is the best of all worlds. Indeed, though our net float is recorded on our balance sheet as a liability, it has had more economic value to us than an equal amount of net worth would have had. As long as we can continue to achieve an underwriting profit, float will continue to outrank net worth in value.

During the next few years, Berkshire's growth in float may well be modest. The reinsurance market is soft, and in this business, relationships change slowly. Therefore, General Re's float — /2 3rds of our total — is unlikely to increase significantly in the near term. We do expect, however, that our cost of float will remain very attractive compared to that of other insurers.

Sources of Reported Earnings

The table that follows shows the main sources of Berkshire's reported earnings. In this presentation, purchase-accounting adjustments are not assigned to the specific businesses to which they apply, but are instead aggregated and shown separately. This procedure lets you view the earnings of our businesses as they would have been reported had we not purchased them. For the reasons discussed on pages 62 and 63, this form of presentation seems to us to be more useful to investors and managers than one utilizing generally-accepted accounting principles (GAAP), which require purchase-premiums to be charged off business-by-business. The total earnings we show in the table are, of course, identical to the GAAP total in our audited financial statements.

	(in millions)			
	Pre-Tax Earnings		*Berkshire's Share of Net Earnings (after taxes and minority interests)*	
	1998	*1997*	*1998*	*1997*
Operating Earnings:				
Insurance Group:				
Underwriting — Super-Cat	$154	$283	$100	$183
Underwriting — Other Reinsurance	(175)	(155)	(114)	(100)
Underwriting — GEICO	269	281	175	181
Underwriting — Other Primary	17	53	10	34
Net Investment Income	974	882	731	704
Buffalo News	53	56	32	33
Finance and Financial Products Businesses	205	28	133	18
Flight Services	181[1]	140	110[1]	84
Home Furnishings	72	57[2]	41	32[2]
International Dairy Queen	58	—	35	—
Jewelry	39	32	23	18
Scott Fetzer (excluding finance operation)	137	119	85	77
See's Candies	62	59	40	35
Shoe Group	33	49	23	32
General Re	26[3]	—	16[3]	—
Purchase-Accounting Adjustments	(123)	(101)	(118)	(94)
Interest Expense [4]	(100)	(107)	(63)	(67)
Shareholder-Designated Contributions	(17)	(15)	(11)	(10)
Other	34	60	29	37
Operating Earnings	1,899	1,721	1,277	1,197
Capital Gains from Investments	2,415	1,106	1,553	704
Total Earnings - All Entities	$4,314	$2,827	$ 2,830	$1,901

(1) Includes Executive Jet from August 7, 1998.
(2) Includes Star Furniture from July 1, 1997.
(3) From date of acquisition, December 21, 1998.
(4) Excludes interest expense of Finance Businesses.

You can be proud of our operating managers. They almost invariably deliver earnings that are at the very top of what conditions in their industries allow, meanwhile fortifying their businesses' long-term competitive strengths. In aggregate, they have created many billions of dollars of value for you.

An example: In my 1994 letter, I reported on Ralph Schey's extraordinary performance at Scott Fetzer. Little did I realize that he was just warming up. Last year Scott Fetzer, operating with no leverage (except for a conservative level of debt in its finance subsidiary), earned a record $96.5 million after-tax on its $112 million net worth.

Today, Berkshire has an unusually large number of individuals, such as Ralph, who are truly legends in their industries. Many of these joined us when we purchased their companies, but in recent years we have also identified a number of strong managers internally. We further expanded our corps of all-stars in an important way when we acquired General Re and EJA.

Charlie and I have the easy jobs at Berkshire: We do very little except allocate capital. And, even then, we are not all that energetic. We have one excuse, though: In allocating capital, activity does not correlate with achievement. Indeed, in the fields of investments and acquisitions, frenetic behavior is often counterproductive. Therefore, Charlie and I mainly just wait for the phone to ring.

Our managers, however, work very hard — and it shows. Naturally, they want to be paid fairly for their efforts, but pay alone can’t explain their extraordinary accomplishments. Instead, each is primarily motivated by a vision of just how far his or her business can go — and by a desire to be the one who gets it there. Charlie and I thank them on your behalf and ours.

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Additional information about our various businesses is given on pages 39-53, where you will also find our segment earnings reported on a GAAP basis. In addition, on pages 65-71, we have rearranged Berkshire's financial data into four segments on a non-GAAP basis, a presentation that corresponds to the way Charlie and I think about the company.

Normally, we follow this section with one on “Look-Through” Earnings. Because the General Re acquisition occurred near yearend, though, neither a historical nor a pro-forma calculation of a 1998 number seems relevant. We will resume the look-through calculation in next year’s report.

Investments

Below we present our common stock investments. Those with a market value of more than $750 million are itemized.

		12/31/98	
Shares	*Company*	*Cost**	*Market*
		(dollars in millions)	
50,536,900	American Express Company	$1,470	$ 5,180
200,000,000	The Coca-Cola Company	1,299	13,400
51,202,242	The Walt Disney Company	281	1,536
60,298,000	Freddie Mac	308	3,885
96,000,000	The Gillette Company	600	4,590
1,727,765	The Washington Post Company	11	999
63,595,180	Wells Fargo & Company	392	2,540
	Others	2,683	5,135
	Total Common Stocks	$ 7,044	$ 37,265

* Represents tax-basis cost which, in aggregate, is $1.5 billion less than GAAP cost.

During the year, we slightly increased our holdings in American Express, one of our three largest commitments, and left the other two unchanged. However, we trimmed or substantially cut many of our smaller positions. Here, I need to make a confession (ugh): The portfolio actions I took in 1998 actually *decrease*d our gain for the year. In particular, my decision to sell McDonald's was a very big mistake. Overall, you would have been better off last year if I had regularly snuck off to the movies during market hours.

At yearend, we held more than $15 billion in cash equivalents (including high-grade securities due in less than one year). Cash never makes us happy. But it's better to have the money burning a hole in Berkshire's pocket than resting comfortably in someone else's. Charlie and I will continue our search for large equity investments or, better yet, a really major business acquisition that would absorb our liquid assets. Currently, however, we see nothing on the horizon.

Once we knew that the General Re merger would definitely take place, we asked the company to dispose of the equities that it held. (As mentioned earlier, we do not manage the Cologne Re portfolio, which includes many equities.) General Re subsequently eliminated its positions in about 250 common stocks, incurring $935 million of taxes in the process. This "clean sweep" approach reflects a basic principle that Charlie and I employ in business and investing: We don't back into decisions.

Last year I deviated from my standard practice of not disclosing our investments (other than those we are legally required to report) and told you about three unconventional investments we had made. There were several reasons behind that disclosure. First, questions about our silver position that we had received from regulatory authorities led us to believe that they wished us to publicly acknowledge this investment. Second, our holdings of zero-coupon bonds were so large that we wanted our owners to know of this investment's potential impact on Berkshire's net worth. Third, we simply wanted to alert you to the fact that we sometimes *do* make unconventional commitments.

Normally, however, as discussed in the Owner's Manual on page 61, we see no advantage in talking about specific investment actions. Therefore — unless we again take a position that is particularly large — we will not post you as to what we are doing in respect to any specific holding of an unconventional sort. We can report, however, that we have eliminated certain of the positions discussed last year and added certain others.

Our never-comment-even-if-untrue policy in regard to investments may disappoint "piggybackers" but will benefit owners: Your Berkshire shares would be worth less if we discussed what we are doing. Incidentally, we should warn you that media speculation about our investment moves continues in most cases to be incorrect. People who rely on such commentary do so at their own peril.

Accounting — Part 1

Our General Re acquisition put a spotlight on an egregious flaw in accounting procedure. Sharp-eyed shareholders reading our proxy statement probably noticed an unusual item on page 60. In the pro-forma statement of income — which detailed how the combined 1997 earnings of the two entities would have been affected by the merger — there was an item stating that compensation expense would have been increased by $63 million.

This item, we hasten to add, does not signal that either Charlie or I have experienced a major personality change. (He still travels coach and quotes Ben Franklin.) Nor does it indicate any shortcoming in General Re's accounting practices, which have followed GAAP to the letter. Instead, the pro-forma adjustment came about because we are replacing General Re's longstanding stock option plan with a cash plan that ties the incentive compensation of General Re managers to their operating achievements. Formerly what counted for these managers was General Re's stock price; now their payoff will come from the business performance they deliver.

The new plan and the terminated option arrangement have matching economics, which means that the rewards they deliver to employees should, for a given level of performance, be the same. But what these people could have formerly anticipated earning from new option grants will now be paid in cash. (Options granted in past years remain outstanding.)

Though the two plans are an economic wash, the cash plan we are putting in will produce a vastly different accounting result. This Alice-in-Wonderland outcome occurs because existing accounting principles ignore the cost of stock options when earnings are being calculated, even though options are a huge and increasing expense at a great many corporations. In effect, accounting principles offer management a choice: Pay employees in one form and count the cost, or pay them in another form and ignore the cost. Small wonder then that the use of options has mushroomed. This lop-sided choice has a big downside for owners, however: Though options, if properly structured, can be an appropriate, *and even ideal*, way to compensate and motivate top managers, they are more often wildly capricious in their distribution of rewards, inefficient as motivators, and inordinately expensive for shareholders.

Whatever the merits of options may be, their accounting treatment is outrageous. Think for a moment of that $190 million we are going to spend for advertising at GEICO this year. Suppose that instead of paying cash for our ads, we paid the media in ten-year, at-the-market Berkshire options. Would anyone then care to argue that Berkshire had not borne a cost for advertising, or should not be charged this cost on its books?

Perhaps Bishop Berkeley — you may remember him as the philosopher who mused about trees falling in a forest when no one was around — would believe that an expense unseen by an accountant does not exist. Charlie and I, however, have trouble being philosophical about unrecorded costs. When we consider investing in an option-issuing company, we make an appropriate downward adjustment to reported earnings, simply subtracting an amount equal to what the company could have realized by publicly selling options of like quantity and structure. Similarly, if we contemplate an acquisition, we include in our evaluation the cost of replacing any option plan. Then, if we make a deal, we promptly take that cost out of hiding.

Readers who disagree with me about options will by this time be mentally quarreling with my equating the cost of options issued to employees with those that might theoretically be sold and traded publicly. It is true, to state one of these arguments, that employee options are sometimes forfeited — that lessens the damage done to shareholders — whereas publicly-offered options would not be. It is true, also, that companies receive a tax deduction when employee options are exercised; publicly-traded options deliver no such benefit. But there's an offset to these points: Options issued to employees are often repriced, a transformation that makes them much more costly than the public variety.

It's sometimes argued that a non-transferable option given to an employee is less valuable to him than would be a publicly-traded option that he could freely sell. That fact, however, does not reduce the *cost* of the nontransferable option: Giving an employee a company car that can only be used for certain purposes diminishes its value to the employee, but does not in the least diminish its cost to the employer.

The earning revisions that Charlie and I have made for options in recent years have frequently cut the reported per-share figures by 5%, with 10% not all that uncommon. On occasion, the downward adjustment has been so great that it has affected our portfolio decisions, causing us either to make a sale or to pass on a stock purchase we might otherwise have made.

A few years ago we asked three questions in these pages to which we have not yet received an answer: “If options aren't a form of compensation, what are they? If compensation isn't an expense, what is it? And, if expenses shouldn't go into the calculation of earnings, where in the world should they go?”

Accounting — Part 2

The role that managements have played in stock-option accounting has hardly been benign: A distressing number of both CEOs and auditors have in recent years bitterly fought FASB's attempts to replace option fiction with truth and virtually none have spoken out in support of FASB. Its opponents even enlisted Congress in the fight, pushing the case that inflated figures were in the national interest.

Still, I believe that the behavior of managements has been even worse when it comes to restructurings and merger accounting. Here, many managements purposefully work at manipulating numbers and deceiving investors. And, as Michael Kinsley has said about Washington: "The scandal isn't in what's done that's *illegal* but rather in what's *legal*."

It was once relatively easy to tell the good guys in accounting from the bad: The late 1960's, for example, brought on an orgy of what one charlatan dubbed "bold, imaginative accounting" (the practice of which, incidentally, made him loved for a time by Wall Street because he never missed expectations). But most investors of that period knew who was playing games. And, to their credit, virtually all of America's most-admired companies then shunned deception.

In recent years, probity has eroded. Many major corporations still play things straight, but a significant and growing number of otherwise high-grade managers — CEOs you would be happy to have as spouses for your children or as trustees under your will — have come to the view that it's okay to manipulate earnings to satisfy what they believe are Wall Street's desires. Indeed, many CEOs think this kind of manipulation is not only okay, but actually their *duty*.

These managers start with the assumption, all too common, that their job at all times is to encourage the highest stock price possible (a premise with which we adamantly disagree). To pump the price, they strive, admirably, for operational excellence. But when operations don't produce the result hoped for, these CEOs resort to unadmirable accounting stratagems. These either manufacture the desired "earnings" or set the stage for them in the future.

Rationalizing this behavior, these managers often say that their shareholders will be hurt if their currency for doing deals — that is, their stock — is not fully-priced, and they also argue that in using accounting shenanigans to get the figures they want, they are only doing what everybody else does. Once such an everybody's-doing-it attitude takes hold, ethical misgivings vanish. Call this behavior Son of Gresham: Bad accounting drives out good.

The distortion *du jour* is the "restructuring charge," an accounting entry that can, of course, be legitimate but that too often is a device for manipulating earnings. In this bit of legerdemain, a large chunk of costs that should properly be attributed to a number of years is dumped into a single quarter, typically one already fated to disappoint investors. In some cases, the purpose of the charge is to clean up earnings misrepresentations of the past, and in others it is to prepare the ground for future misrepresentations. In either case, the size and timing of these charges is dictated by the cynical proposition that Wall Street will not mind if earnings fall short by $5 per share in a given quarter, just as long as this deficiency ensures that quarterly earnings in the future will consistently exceed expectations by five cents per share.

This dump-everything-into-one-quarter behavior suggests a corresponding "bold, imaginative" approach to — golf scores. In his first round of the season, a golfer should ignore his actual performance and simply fill his card with atrocious numbers — double, triple, quadruple bogeys — and then turn in a score of, say, 140. Having established this "reserve," he should go to the golf shop and tell his pro that he wishes to "restructure" his imperfect swing. Next, as he takes his new swing onto the course, he should count his good holes, but not the bad ones. These remnants from his old swing should be charged instead to the reserve established earlier. At the end of five rounds, then, his record will be 140, 80, 80, 80, 80 rather than 91, 94, 89, 94, 92. On Wall Street, they will ignore the 140 — which, after all, came from a "discontinued" swing — and will classify our hero as an 80 shooter (and one who *never* disappoints).

For those who prefer to cheat up front, there would be a variant of this strategy. The golfer, playing alone with a cooperative caddy-auditor, should defer the recording of bad holes, take four 80s, accept the plaudits he gets for such athleticism and consistency, and then turn in a fifth card carrying a 140 score. After rectifying his earlier scorekeeping sins with this "big bath," he may mumble a few apologies but will refrain from returning the sums he has previously collected from comparing scorecards in the clubhouse. (The caddy, need we add, will have acquired a loyal patron.)

Unfortunately, CEOs who use variations of these scoring schemes in real life tend to become addicted to the games they're playing — after all, it's easier to fiddle with the scorecard than to spend hours on the practice tee — and never muster the will to give them up. Their behavior brings to mind Voltaire's comment on sexual experimentation: "Once a philosopher, twice a pervert."

In the acquisition arena, restructuring has been raised to an art form: Managements now frequently use mergers to dishonestly rearrange the value of assets and liabilities in ways that will allow them to both smooth and swell future earnings. Indeed, at deal time, major auditing firms sometimes point out the possibilities for a little accounting magic (or for a lot). Getting this push from the pulpit, first-class people will frequently stoop to third-class tactics. CEOs understandably do not find it easy to reject auditor-blessed strategies that lead to increased future "earnings."

An example from the property-casualty insurance industry will illuminate the possibilities. When a p-c company is acquired, the buyer sometimes simultaneously increases its loss reserves, often substantially. This boost may merely reflect the previous inadequacy of reserves — though it is uncanny how often an actuarial "revelation" of this kind coincides with the inking of a deal. In any case, the move sets up the possibility of 'earnings" flowing into income at some later date, as reserves are released.

Berkshire has kept entirely clear of these practices: If we are to disappoint you, we would rather it be with our earnings than with our accounting. In all of our acquisitions, we have left the loss reserve figures exactly as we found them. After all, we have consistently joined with insurance managers knowledgeable about their business and honest in their financial reporting. When deals occur in which liabilities are increased immediately and substantially, simple logic says that at least one of those virtues must have been lacking — or, alternatively, that the acquirer is laying the groundwork for future infusions of "earnings."

Here's a true story that illustrates an all-too-common view in corporate America. The CEOs of two large banks, one of them a man who'd made many acquisitions, were involved not long ago in a friendly merger discussion (which in the end didn't produce a deal). The veteran acquirer was expounding on the merits of the possible combination, only to be skeptically interrupted by the other CEO: "But won't that mean a huge charge," he asked, "perhaps as much as $1 billion?" The "sophisticate" wasted no words: "We'll make it bigger than that — that's why we're doing the deal."

A preliminary tally by R. G. Associates, of Baltimore, of special charges taken or announced during 1998 — that is, charges for restructuring, in-process R&D, merger-related items, and write-downs — identified no less than 1,369 of these, totaling $72.1 billion. That is a staggering amount as evidenced by this bit of perspective: The 1997 earnings of the 500 companies in Fortune's famous list totaled $324 billion.

Clearly the attitude of disrespect that many executives have today for accurate reporting is a business disgrace. And auditors, as we have already suggested, have done little on the positive side. Though auditors *should* regard the investing public as their client, they tend to kowtow instead to the managers who choose them and dole out their pay. ("Whose bread I eat, his song I sing.")

A big piece of news, however, is that the SEC, led by its chairman, Arthur Levitt, seems determined to get corporate America to clean up its act. In a landmark speech last September, Levitt called for an end to "earnings management." He correctly observed, "Too many corporate managers, auditors and analysts are participants in a game of nods and winks." And then he laid on a real indictment: "Managing may be giving way to manipulating; integrity may be losing out to illusion."

I urge you to read the Chairman's speech (you can find it on the Internet at www.sec.gov) and to support him in his efforts to get corporate America to deliver a straight story to its owners. Levitt's job will be Herculean, but it is hard to think of another more important for him to take on.

Reports to Shareholders

Berkshire's Internet site, www.berkshirehathaway.com, has become a prime source for information about the company. While we continue to send an annual report to all shareholders, we now send quarterlies only to those who request them, letting others read these at our site. In this report, we again enclose a card that can be returned by those wanting to get printed quarterlies in 1999.

Charlie and I have two simple goals in reporting: 1) We want to give you the information that we would wish you to give us if our positions were reversed; and 2) We want to make Berkshire's information accessible to all of you simultaneously. Our ability to reach that second goal is greatly helped by the Internet.

In another portion of his September speech, Arthur Levitt deplored what he called "selective disclosure." His remarks were timely: Today, many companies matter-of-factly favor Wall Street analysts and institutional investors in a variety of ways that often skirt or cross the line of unfairness. These practices leave the great bulk of shareholders at a distinct disadvantage to a favored class.

At Berkshire, we regard the holder of one share of B stock as the equal of our large institutional investors. We, of course, warmly welcome institutions as owners and have gained a number of them through the General Re merger. We hope also that these new holders find that our owner's manual and annual reports offer them more insights and information about Berkshire than they garner about other companies from the investor relations departments that these corporations typically maintain. But if it is "earnings guidance" or the like that shareholders or analysts seek, we will simply guide them to our public documents.

This year we plan to post our quarterly reports on the Internet after the close of the market on May 14, August 13, and November 12. We also expect to put the 1999 annual report on our website on Saturday, March 11, 2000, and to mail the print version at roughly the same time.

We promptly post press releases on our website. This means that you do not need to rely on the versions of these reported by the media but can instead read the full text on your computer.

Despite the pathetic technical skills of your Chairman, I'm delighted to report that GEICO, Borsheim's, See's, and The Buffalo News are now doing substantial business via the Internet. We've also recently begun to offer annuity products on our website. This business was developed by Ajit Jain, who over the last decade has personally accounted for a significant portion of Berkshire's operating earnings. While Charlie and I sleep, Ajit keeps thinking of new ways to add value to Berkshire.

Shareholder-Designated Contributions

About 97.5% of all eligible shares participated in Berkshire's 1998 shareholder-designated contributions program, with contributions totaling $16.9 million. A full description of the program appears on pages 54-55.

Cumulatively, over the 18 years of the program, Berkshire has made contributions of $130 million pursuant to the instructions of our shareholders. The rest of Berkshire's giving is done by our subsidiaries, which stick to the philanthropic patterns that prevailed before they were acquired (except that their former owners themselves take on the responsibility for their personal charities). In aggregate, our subsidiaries made contributions of $12.5 million in 1998, including in-kind donations of $2.0 million.

To participate in future programs, you must own Class A shares that are registered in the name of the actual owner, not the nominee name of a broker, bank or depository. Shares not so registered on August 31, 1999, will be ineligible for the 1999 program. When you get the contributions form from us, return it promptly so that it does not get put aside or forgotten. Designations received after the due date will not be honored.

The Annual Meeting

This year's Woodstock for Capitalists will be held May 1-3, and we may face a problem. Last year more than 10,000 people attended our annual meeting, and our shareholders list has since doubled. So we don't quite know what attendance to expect this year. To be safe, we have booked both Aksarben Coliseum, which holds about 14,000 and the Holiday Convention

Centre, which can seat an additional 5,000. Because we know that our Omaha shareholders will want to be good hosts to the out-of-towners (many of them come from outside the U.S), we plan to give those visitors first crack at the Aksarben tickets and to subsequently allocate these to greater Omaha residents on a first-come, first-served basis. If we exhaust the Aksarben tickets, we will begin distributing Holiday tickets to Omaha shareholders.

If we end up using both locations, Charlie and I will split our pre-meeting time between the two. Additionally, we will have exhibits and also the Berkshire movie, large television screens and microphones at both sites. When we break for lunch, many attendees will leave Aksarben, which means that those at Holiday can, if they wish, make the five-minute trip to Aksarben and finish out the day there. Buses will be available to transport people who don't have cars.

The doors will open at both locations at 7 a.m. on Monday, and at 8:30 we will premier the 1999 Berkshire movie epic, produced by Marc Hamburg, our CFO. The meeting will last from 9:30 until 3:30, interrupted only by the short lunch break.

An attachment to the proxy material that is enclosed with this report explains how you can obtain the badge you will need for admission to the meeting and other events. As for plane, hotel and car reservations, we have again signed up American Express (800-799-6634) to give you special help. In our normal fashion, we will run buses from the larger hotels to the meeting. After the meeting, these will make trips back to the hotels and to Nebraska Furniture Mart, Borsheim's and the airport. Even so, you are likely to find a car useful.

The full line of Berkshire products will be available at Aksarben, and the more popular items will also be at Holiday. Last year we set sales records across-the-board, moving 3,700 pounds of See's candy, 1,635 pairs of Dexter shoes, 1,150 sets of Quikut knives and 3,104 Berkshire shirts and hats. Additionally, $26,944 of World Book products were purchased as well as more than 2,000 golf balls with the Berkshire Hathaway logo. Charlie and I are pleased but not satisfied with these numbers and confidently predict new records in all categories this year. Our 1999 apparel line will be unveiled at the meeting, so please defer your designer purchases until you view our collection.

Dairy Queen will also be on hand and will again donate all proceeds to the Children's Miracle Network. Last year we sold about 4,000 Dilly® bars, fudge bars and vanilla/orange bars. Additionally, GEICO will have a booth that will be manned by a number of our top counselors from around the country, all of them ready to supply you with auto insurance quotes. In almost all cases, GEICO will be able to offer you a special shareholder's discount. Check out whether we can save you some money.

The *piece de resistance* of our one-company trade show will be a 79-foot-long, nearly 12-foot-wide, fully-outfitted cabin of a 737 Boeing Business Jet ("BBJ"), which is NetJets' newest product. This plane has a 14-hour range; is designed to carry 19 passengers; and offers a bedroom, an office, and two showers. Deliveries to fractional owners will begin in the first quarter of 2000.

The BBJ will be available for your inspection on May 1-3 near the entrance to the Aksarben hall. You should be able to minimize your wait by making your visit on Saturday or Sunday. Bring along your checkbook in case you decide to make an impulse purchase.

NFM's multi-stored complex, located on a 75-acre site about a mile from Aksarben, is open from 10 a.m. to 9 p.m. on weekdays, and 10 a.m. to 6 p.m. on Saturdays and Sundays. This operation did $300 million in business during 1998 and offers an unrivaled breadth of merchandise — furniture, electronics, appliances, carpets and computers — all at can't-be-beat prices. During the April 30th to May 4th period, shareholders presenting their meeting badge will receive a discount that is customarily given only to its employees.

Borsheim's normally is closed on Sunday but will be open for shareholders from 10 a.m. to 6 p.m. on May 2nd. On annual meeting weekend last year, the store did an incredible amount of business. Sales were double those of the previous year, and the store's volume on Sunday greatly exceeded volume for any day in Borsheim's history. Charlie attributes this record to the fact that he autographed sales tickets that day and, while I have my doubts about this proposition, we are not about to mess with a winning formula. Please give him writer's cramp. On last year's Sunday, Borsheim's wrote 2,501 tickets during the eight hours it was open. For those of you who are mathematically challenged, that is one ticket every 11½ seconds.

Shareholders who wish to avoid Sunday's crowd can visit Borsheim's on Saturday (10 a.m.-5:30 p.m.) or on Monday (10 a.m.-8 p.m.). Be sure to identify yourself as a Berkshire owner so that Susan Jacques, Borsheim's CEO, can quote you a "shareholder-weekend" price. Susan joined us in 1983 as a $4-per-hour salesperson and was made CEO in 1994. This move ranks as one of my best managerial decisions.

Bridge players can look forward to a thrill on Sunday, when Bob Hamman — the best the game has ever seen — will turn up to play with our shareholders in the mall outside of Borsheim's. Bob plays without sorting his cards — hey, maybe that's what's wrong with my game. We will also have a couple of other tables at which another expert or two will be playing.

Gorat's — my favorite steakhouse — will again be open especially for Berkshire shareholders on the Sunday night before the meeting. Though Gorat's served from 4 p.m. until about 1 a.m. last year, its crew was swamped, and some of our shareholders had an uncomfortable wait. This year fewer reservations will be accepted, and we ask that you don't come on Sunday without a reservation. In other years, many of our shareholders have chosen to visit Gorat's on Friday, Saturday or Monday. You can make reservations beginning on April 1 *(but not before)* by calling 402-551-3733. The cognoscenti will continue to order rare T-bones with double orders of hash browns.

The Omaha Golden Spikes (neé the Omaha Royals) will meet the Iowa Cubs on Saturday evening, May 1st, at Rosenblatt Stadium. Your Chairman, whose breaking ball had the crowd buzzing last year, will again take the mound. This year I plan to introduce my "flutterball." It's a real source of irritation to me that many view our annual meeting as a financial event rather than the sports classic I consider it to be. Once the world sees my flutterball, that misperception will be erased.

Our proxy statement includes instructions about obtaining tickets to the game and also a large quantity of other information that should help you to enjoy your visit. I particularly urge the 60,000 shareholders that we gained through the Gen Re merger to join us. Come and meet your fellow capitalists.

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It wouldn't be right to close without a word about the 11.8 people who work with me in Berkshire's corporate office. In addition to handling the myriad of tax, regulatory and administrative matters that come with owning dozens of businesses, this group efficiently and cheerfully manages various special projects, some of which generate hundreds of inquiries. Here's a sample of what went on in 1998:

- 6,106 shareholders designated 3,880 charities to receive contributions.
- Kelly Muchemore processed about 17,500 admission tickets for the annual meeting, along with orders and checks for 3,200 baseball tickets.
- Kelly and Marc Hamburg produced and directed the Aksarben extravaganza, a job that required them to arrange the presentations made by our subsidiaries, prepare our movie, and sometimes lend people a hand with travel and lodging.
- Debbie Bosanek satisfied the varying needs of the 46 media organizations (13 of them non-U.S.) that covered the meeting, and meanwhile, as always, skillfully assisted me in every aspect of my job.
- Debbie and Marc assembled the data for our annual report and oversaw the production and distribution of 165,000 copies. (This year the number will be 325,000.)
- Marc handled 95% of the details — and much of the substance — connected with our completing two major mergers.
- Kelly, Debbie and Deb Ray dealt efficiently with tens of thousands of requests for annual reports and financial information that came through the office.

You and I are paying for only 11.8 people, but we are getting what would at most places be the output of 100. To all of the 11.8, my thanks.

March 1, 1999

Warren E. Buffett
Chairman of the Board

BERKSHIRE HATHAWAY INC.

To the Shareholders of Berkshire Hathaway Inc.:

Our gain in net worth during 1999 was $358 million, which increased the per-share book value of both our Class A and Class B stock by 0.5%. Over the last 35 years (that is, since present management took over) per-share book value has grown from $19 to $37,987, a rate of 24.0% compounded annually.*

> * All figures used in this report apply to Berkshire's A shares, the successor to the only stock that the company had outstanding before 1996. The B shares have an economic interest equal to 1/30th that of the A.

The numbers on the facing page show just how poor our 1999 record was. We had the worst absolute performance of my tenure and, compared to the S&P, the worst relative performance as well. Relative results are what concern us: Over time, bad relative numbers will produce unsatisfactory absolute results.

Even Inspector Clouseau could find last year's guilty party: your Chairman. My performance reminds me of the quarterback whose report card showed four Fs and a D but who nonetheless had an understanding coach. "Son," he drawled, "I think you're spending too much time on that one subject."

My "one subject" is capital allocation, and my grade for 1999 most assuredly is a D. What most hurt us during the year was the inferior performance of Berkshire's equity portfolio — and responsibility for that portfolio, leaving aside the small piece of it run by Lou Simpson of GEICO, is entirely mine. Several of our largest investees badly lagged the market in 1999 because they've had disappointing operating results. We still like these businesses and are content to have major investments in them. But their stumbles damaged our performance last year, and it’s no sure thing that they will quickly regain their stride.

The fallout from our weak results in 1999 was a more-than-commensurate drop in our stock price. In 1998, to go back a bit, the stock outperformed the business. Last year the business did much better than the stock, a divergence that has continued to the date of this letter. Over time, of course, the performance of the stock *must* roughly match the performance of the business.

Despite our poor showing last year, Charlie Munger, Berkshire’s Vice Chairman and my partner, and I expect that the gain in Berkshire’s intrinsic value over the next decade will modestly exceed the gain from owning the S&P. We can’t guarantee that, of course. But we are willing to back our conviction with our own money. To repeat a fact you’ve heard before, well over 99% of my net worth resides in Berkshire. Neither my wife nor I have ever sold a share of Berkshire and — unless our checks stop clearing — we have no intention of doing so.

Please note that I spoke of hoping to beat the S&P “modestly.” For Berkshire, truly large superiorities over that index are a thing of the past. They existed then because we could buy both businesses and stocks at far more attractive prices than we can now, and also because we then had a much smaller capital base, a situation that allowed us to consider a much wider range of investment opportunities than are available to us today.

Our optimism about Berkshire’s performance is also tempered by the expectation — indeed, in our minds, the virtual certainty — that the S&P will do far less well in the next decade or two than it has done since 1982. A recent article in Fortune expressed my views as to why this is inevitable, and I’m enclosing a copy with this report.

Our goal is to run our present businesses well — a task made easy because of the outstanding managers we have in place — and to acquire additional businesses having economic characteristics and managers comparable to those we already own. We made important progress in this respect during 1999 by acquiring Jordan’s Furniture and contracting to buy a major portion of MidAmerican Energy. We will talk more about these companies later in the report but let me emphasize one point here: We bought both for cash, issuing no Berkshire shares. Deals of that kind aren't always possible, but that is the method of acquisition that Charlie and I vastly prefer.

Guides to Intrinsic Value

I often talk in these pages about intrinsic value, a key, though far from precise, measurement we utilize in our acquisitions of businesses and common stocks. (For an extensive discussion of this, and other investment and accounting terms and concepts, please refer to our Owner's Manual on pages 55 - 62. Intrinsic value is discussed on page 60.)

In our last four reports, we have furnished you a table that we regard as useful in estimating Berkshire's intrinsic value. In the updated version of that table, which follows, we trace two key components of value. The first column lists our per-share ownership of investments (including cash and equivalents but excluding assets held in our financial products operation) and the second column shows our per-share earnings from Berkshire's operating businesses before taxes and purchase-accounting adjustments (discussed on page 61), but after all interest and corporate expenses. The second column excludes *all* dividends, interest and capital gains that we realized from the investments presented in the first column. In effect, the columns show how Berkshire would look if it were split into two parts, with one entity holding our investments and the other operating all of our businesses and bearing all corporate costs.

Year	Investments Per Share	Pre-tax Earnings (Loss) Per Share With All Income from Investments Excluded
1969	$ 45	$ 4.39
1979	577	13.07
1989	7,200	108.86
1999	47,339	(458.55)

Here are the growth rates of the two segments by decade:

Decade Ending	Investments Per Share	Pre-tax Earnings Per Shar With All Income from Investments Excluded
1979	29.0%	11.5%
1989	28.7%	23.6%
1999	20.7%	N.A.
Annual Growth Rate, 1969-1999	25.4%	N.A.

In 1999, our per-share investments changed very little, but our operating earnings, affected by negatives that overwhelmed some strong positives, fell apart. Most of our operating managers deserve a grade of A for delivering fine results and for having widened the difference between the intrinsic value of their businesses and the value at which these are carried on our balance sheet. But, offsetting this, we had a huge — and, I believe, aberrational — underwriting loss at General Re. Additionally, GEICO's underwriting profit fell, as we had predicted it would. GEICO's overall performance, though, was terrific, outstripping my ambitious goals.

We do not expect our underwriting earnings to improve in any dramatic way this year. Though GEICO's intrinsic value should grow by a highly satisfying amount, its underwriting performance is almost certain to weaken. That's because auto insurers, as a group, will do worse in 2000, and because we will materially increase our marketing expenditures. At General Re, we are raising rates and, if there is no mega-catastrophe in 2000, the company's underwriting loss should fall considerably. It takes some time, however, for the full effect of rate increases to kick in, and General Re is therefore likely to have another unsatisfactory underwriting year.

You should be aware that one item regularly working to widen the amount by which intrinsic value exceeds book value is the annual charge against income we take for amortization of goodwill — an amount now running about $500 million. This charge reduces the amount of goodwill we show as an asset and likewise the amount that is included in our book value. This is an accounting matter having nothing to do with true economic goodwill, which increases in most years. But even if economic goodwill were to remain constant, the annual amortization charge would persistently widen the gap between intrinsic value and book value.

Though we can't give you a precise figure for Berkshire's intrinsic value, or even an approximation, Charlie and I can assure you that it far exceeds our $57.8 billion book value. Businesses such as See's and Buffalo News are now worth fifteen to twenty times the value at which they are carried on our books. Our goal is to continually widen this spread at all subsidiaries.

A Managerial Story You Will Never Read Elsewhere

Berkshire's collection of managers is unusual in several important ways. As one example, a very high percentage of these men and women are independently wealthy, having made fortunes in the businesses that they run. They work neither because they need the money nor because they are contractually obligated to — we have no contracts at Berkshire. Rather, they work long and hard because they love their businesses. And I use the word "their" advisedly, since these managers are truly in charge — there are no show-and-tell presentations in Omaha, no budgets to be approved by headquarters, no dictums issued about capital expenditures. We simply ask our managers to run their companies as if these are the sole asset of their families and will remain so for the next century.

Charlie and I try to behave with our managers just as we attempt to behave with Berkshire's shareholders, treating both groups as we would wish to be treated if our positions were reversed. Though "working" means nothing to me financially, I love doing it at Berkshire for some simple reasons: It gives me a sense of achievement, a freedom to act as I see fit and an opportunity to interact daily with people I like and trust. Why should our managers — accomplished artists at what they do — see things differently?

In their relations with Berkshire, our managers often appear to be hewing to President Kennedy's charge, "Ask not what your country can do for you; ask what you can do for your country." Here's a remarkable story from last year: It's about R. C. Willey, Utah's dominant home furnishing business, which Berkshire purchased from Bill Child and his family in 1995. Bill and most of his managers are Mormons, and for this reason R. C. Willey's stores have never operated on Sunday. This is a difficult way to do business: Sunday is the favorite shopping day for many customers. Bill, nonetheless, stuck to his principles -- and while doing so built his business from $250,000 of annual sales in 1954, when he took over, to $342 million in 1999.

Bill felt that R. C. Willey could operate successfully in markets outside of Utah and in 1997 suggested that we open a store in Boise. I was highly skeptical about taking a no-Sunday policy into a new territory where we would be up against entrenched rivals open seven days a week. Nevertheless, this was Bill's business to run. So, despite my reservations, I told him to follow both his business judgment and his religious convictions.

Bill then insisted on a truly extraordinary proposition: He would personally buy the land and build the store — for about $9 million as it turned out — and would sell it to us at his cost if it proved to be successful. On the other hand, if sales fell short of his expectations, we could exit the business without paying Bill a cent. This outcome, of course, would leave him with a huge investment in an empty building. I told him that I appreciated his offer but felt that if Berkshire was going to get the upside it should also take the downside. Bill said nothing doing: If there was to be failure because of his religious beliefs, he wanted to take the blow personally.

The store opened last August and immediately became a huge success. Bill thereupon turned the property over to us — including some extra land that had appreciated significantly — and we wrote him a check for his cost. And get this: *Bill refused to take a dime of interest on the capital he had tied up over the two years*.

If a manager has behaved similarly at some other public corporation, I haven't heard about it. You can understand why the opportunity to partner with people like Bill Child causes me to tap dance to work every morning.

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A footnote: After our “soft” opening in August, we had a grand opening of the Boise store about a month later. Naturally, I went there to cut the ribbon (your Chairman, I wish to emphasize, is good for *something*). In my talk I told the crowd how sales had far exceeded expectations, making us, by a considerable margin, the largest home furnishings store in Idaho. Then, as the speech progressed, my memory miraculously began to improve. By the end of my talk, it all had come back to me: Opening a store in Boise had been *my* idea.

The Economics of Property/Casualty Insurance

Our main business — though we have others of great importance — is insurance. To understand Berkshire, therefore, it is necessary that you understand how to evaluate an insurance company. The key determinants are: (1) the amount of float that the business generates; (2) its cost; and (3) most critical of all, the long-term outlook for both of these factors.

To begin with, float is money we hold but don't own. In an insurance operation, float arises because premiums are received before losses are paid, an interval that sometimes extends over many years. During that time, the insurer invests the money. This pleasant activity typically carries with it a downside: The premiums that an insurer takes in usually do not cover the losses and expenses it eventually must pay. That leaves it running an "underwriting loss," which is the cost of float. An insurance business has value if its cost of float over time is less than the cost the company would otherwise incur to obtain funds. But the business is a lemon if its cost of float is higher than market rates for money.

A caution is appropriate here: Because loss costs must be estimated, insurers have enormous latitude in figuring their underwriting results, and that makes it very difficult for investors to calculate a company's true cost of float. Errors of estimation, usually innocent but sometimes not, can be huge. The consequences of these miscalculations flow directly into earnings. An experienced observer can usually detect large-scale errors in reserving, but the general public can typically do no more than accept what's presented, and at times I have been amazed by the numbers that big-name auditors have implicitly blessed. In 1999 a number of insurers announced reserve adjustments that made a mockery of the “earnings” that investors had relied on earlier when making their buy and sell decisions. At Berkshire, we strive to be conservative and consistent in our reserving. Even so, we warn you that an unpleasant surprise is always possible.

The table that follows shows (at intervals) the float generated by the various segments of Berkshire’s insurance operations since we entered the business 33 years ago upon acquiring National Indemnity Company (whose traditional lines are included in the segment “Other Primary”). For the table we have calculated our float — which we generate in large amounts relative to our premium volume — by adding net loss reserves, loss adjustment reserves, funds held under reinsurance assumed and unearned premium reserves, and then subtracting agents balances, prepaid acquisition costs, prepaid taxes and deferred charges applicable to assumed reinsurance. (Got that?)

Yearend Float (in $ millions)

Year	GEICO	General Re	Other Reinsurance	Other Primary	Total
1967				20	20
1977			40	131	171
1987			701	807	1,508
1997	2,917		4,014	455	7,386
1998	3,125	14,909	4,305	415	22,754
1999	3,444	15,166	6,285	403	25,298

Growth of float is important — but its cost is what’s vital. Over the years we have usually recorded only a small underwriting loss — which means our cost of float was correspondingly low — or actually had an underwriting profit, which means we were being *paid* for holding other people’s money. Indeed, our cumulative result through 1998 was an underwriting profit. In 1999, however, we incurred a $1.4 billion underwriting loss that left us with float cost of 5.8%. One mildly mitigating factor: We enthusiastically welcomed $400 million of the loss because it stems from business that will deliver us exceptional float over the next decade. The balance of the loss, however, was decidedly unwelcome, and our overall result must be judged extremely poor. Absent a mega-catastrophe, we expect float cost to fall in 2000, but any decline will be tempered by our aggressive plans for GEICO, which we will discuss later.

There are a number of people who deserve credit for manufacturing so much "no-cost" float over the years. Foremost is Ajit Jain. It's simply impossible to overstate Ajit's value to Berkshire: He has from scratch built an outstanding reinsurance business, which during his tenure has earned an underwriting profit and now holds $6.3 billion of float.

In Ajit, we have an underwriter equipped with the intelligence to properly rate most risks; the realism to forget about those he can't evaluate; the courage to write huge policies when the premium is appropriate; and the discipline to reject even the smallest risk when the premium is inadequate. It is rare to find a person possessing any one of these talents. For one person to have them all is remarkable.

Since Ajit specializes in super-cat reinsurance, a line in which losses are infrequent but extremely large when they occur, his business is sure to be far more volatile than most insurance operations. To date, we have benefitted from good luck on this volatile book. Even so, Ajit's achievements are truly extraordinary.

In a smaller but nevertheless important way, our "other primary" insurance operation has also added to Berkshire's intrinsic value. This collection of insurers has delivered a $192 million underwriting profit over the past five years while supplying us with the float shown in the table. In the insurance world, results like this are uncommon, and for their feat we thank Rod Eldred, Brad Kinstler, John Kizer, Don Towle and Don Wurster.

As I mentioned earlier, the General Re operation had an exceptionally poor underwriting year in 1999 (though investment income left the company well in the black). Our business was extremely underpriced, both domestically and internationally, a condition that is improving but not yet corrected. Over time, however, the company should develop a growing amount of low-cost float. At both General Re and its Cologne subsidiary, incentive compensation plans are now directly tied to the variables of float growth and cost of float, the same variables that determine value for owners.

Even though a reinsurer may have a tightly focused and rational compensation system, it cannot count on every year coming up roses. Reinsurance is a highly volatile business, and neither General Re nor Ajit's operation is immune to bad pricing behavior in the industry. But General Re has the distribution , the underwriting skills, the culture, and — with Berkshire's backing — the financial clout to become the world's most profitable reinsurance company. Getting there will take time, energy and discipline, but we have no doubt that Ron Ferguson and his crew can make it happen.

GEICO (1-800-847-7536 or GEICO.com)

GEICO made exceptional progress in 1999. The reasons are simple: We have a terrific business idea being implemented by an extraordinary manager, Tony Nicely. When Berkshire purchased GEICO at the beginning of 1996, we handed the keys to Tony and asked him to run the operation exactly as if he owned 100% of it. He has done the rest. Take a look at his scorecard:

Years	New Auto Policies(1)(2)	Auto Policies In-Force(1)
1993	346,882	2,011,055
1994	384,217	2,147,549
1995	443,539	2,310,037
1996	592,300	2,543,699
1997	868,430	2,949,439
1998	1,249,875	3,562,644
1999	1,648,095	4,328,900

(1) "Voluntary" only; excludes assigned risks and the like.
(2) Revised to exclude policies moved from one GEICO company to another.

In 1995, GEICO spent $33 million on marketing and had 652 telephone counselors. Last year the company spent $242 million, and the counselor count grew to 2,631. And we are just starting: The pace will step up materially in 2000. Indeed, we would happily commit $1 billion annually to marketing if we knew we could handle the business smoothly and if we expected the last dollar spent to produce new business at an attractive cost.

Currently two trends are affecting acquisition costs. The bad news is that it has become more expensive to develop inquiries. Media rates have risen, and we are also seeing diminishing returns — that is, as both we and our competitors step up advertising, inquiries per ad fall for all of us. These negatives are partly offset, however, by the fact that our closure ratio — the percentage of inquiries converted to sales — has steadily improved. Overall, we believe that our cost of new business, though definitely rising, is well below that of the industry. Of even greater importance, our operating costs for renewal business are the lowest among broad-based national auto insurers. Both of these major competitive advantages are sustainable. Others may copy our model, but they will be unable to replicate our economics.

The table above makes it appear that GEICO's retention of policyholders is falling, but for two reasons appearances are in this case deceiving. First, in the last few years our business mix has moved away from "preferred" policyholders, for whom industrywide retention rates are high, toward "standard" and "non-standard" policyholders for whom retention rates are much lower. (Despite the nomenclature, the three classes have similar profit prospects.) Second, retention rates for relatively new policyholders are always lower than those for long-time customers — and because of our accelerated growth, our policyholder ranks now include an increased proportion of new customers. Adjusted for these two factors, our retention rate has changed hardly at all.

We told you last year that underwriting margins for both GEICO and the industry would fall in 1999, and they did. We make a similar prediction for 2000. A few years ago margins got too wide, having enjoyed the effects of an unusual and unexpected decrease in the frequency and severity of accidents. The industry responded by reducing rates — but now is having to contend with an increase in loss costs. We would not be surprised to see the margins of auto insurers deteriorate by around three percentage points in 2000.

Two negatives besides worsening frequency and severity will hurt the industry this year. First, rate increases go into effect only slowly, both because of regulatory delay and because insurance contracts must run their course before new rates can be put in. Second, reported earnings of many auto insurers have benefitted in the last few years from reserve releases, made possible because the companies overestimated their loss costs in still-earlier years. This reservoir of redundant reserves has now largely dried up, and future boosts to earnings from this source will be minor at best.

In compensating its associates — from Tony on down — GEICO continues to use two variables, and only two, in determining what bonuses and profit-sharing contributions will be: 1) its percentage growth in policyholders and 2) the earnings of its "seasoned" business, meaning policies that have been with us for more than a year. We did outstandingly well on both fronts during 1999 and therefore made a profit-sharing payment of 28.4% of salary (in total, $113.3 million) to the great majority of our associates. Tony and I love writing those checks.

At Berkshire, we want to have compensation policies that are both easy to understand and in sync with what we wish our associates to accomplish. Writing new business is expensive (and, as mentioned, getting more expensive). If we were to include those costs in our calculation of bonuses — as managements did before our arrival at GEICO — we would be penalizing our associates for garnering new policies, even though these are very much in Berkshire's interest. So, in effect, we say to our associates that we will foot the bill for new business. Indeed, because percentage growth in policyholders is part of our compensation scheme, we *reward* our associates for producing this initially-unprofitable business. And then we reward them additionally for holding down costs on our seasoned business.

Despite the extensive advertising we do, our best source of new business is word-of-mouth recommendations from existing policyholders, who on the whole are pleased with our prices and service. An article published last year by *Kiplinger's Personal Finance Magazine* gives a good picture of where we stand in customer satisfaction: The magazine's survey of 20 state insurance departments showed that GEICO's complaint ratio was well below the ratio for most of its major competitors.

Our strong referral business means that we probably could maintain our policy count by spending as little as $50 million annually on advertising. That's a guess, of course, and we will never know whether it is accurate because Tony's foot is going to stay on the advertising pedal (and my foot will be on his). Nevertheless, I want to emphasize that a major percentage of the $300-$350 million we will spend in 2000 on advertising, as well as large additional costs we will incur for sales counselors, communications and facilities, are optional outlays we choose to make so that we can both achieve significant growth and extend and solidify the promise of the GEICO brand in the minds of Americans.

Personally, I think these expenditures are the best investment Berkshire can make. Through its advertising, GEICO is acquiring a direct relationship with a huge number of households that, on average, will send us $1,100 year after year. That makes us — among all companies, selling whatever kind of product — one of the country's leading direct merchandisers. Also, as we build our long-term relationships with more and more families, cash is pouring in rather than going out (no Internet economics here). Last year, as GEICO increased its customer base by 766,256, it gained $590 million of cash from operating earnings and the increase in float.

In the past three years, we have increased our market share in personal auto insurance from 2.7% to 4.1%. But we rightfully belong in many more households — maybe even yours. Give us a call and find out. About 40% of those people checking our rates find that they can save money by doing business with us. The proportion is not 100% because insurers differ in their underwriting judgments, with some giving more credit than we do to drivers who live in certain geographic areas or work at certain occupations. Our closure rate indicates, however, that we more frequently offer the low price than does any other national carrier selling insurance to all comers. Furthermore, in 40 states we can offer a special discount — usually 8% — to our shareholders. Just be sure to identify yourself as a Berkshire owner so that our sales counselor can make the appropriate adjustment.

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It’s with sadness that I report to you that Lorimer Davidson, GEICO’s former Chairman, died last November, a few days after his 97th birthday. For GEICO, Davy was a business giant who moved the company up to the big leagues. For me, he was a friend, teacher and hero. I have told you of his lifelong kindnesses to me in past reports. Clearly, my life would have developed far differently had he not been a part of it. Tony, Lou Simpson and I visited Davy in August and marveled at his mental alertness — particularly in all matters regarding GEICO. He was the company’s number one supporter right up to the end, and we will forever miss him.

Aviation Services

Our two aviation services companies — FlightSafety International (“FSI”) and Executive Jet Aviation (“EJA”) — are both runaway leaders in their field. EJA, which sells and manages the fractional ownership of jet aircraft, through its NetJets® program, is larger than its next two competitors combined. FSI trains pilots (as well as other transportation professionals) and is five times or so the size of its nearest competitor.

Another common characteristic of the companies is that they are still managed by their founding entrepreneurs. Al Ueltschi started FSI in 1951 with $10,000, and Rich Santulli invented the fractional-ownership industry in 1986. These men are both remarkable managers who have no financial need to work but thrive on helping their companies grow and excel.

Though these two businesses have leadership positions that are similar, they differ in their economic characteristics. FSI must lay out huge amounts of capital. A single flight simulator can cost as much as $15 million and we have 222. Only one person at a time, furthermore, can be trained in a simulator, which means that the capital investment per dollar of revenue at FSI is exceptionally high. Operating margins must therefore also be high, if we are to earn a reasonable return on capital. Last year we made capital expenditures of $215 million at FSI and FlightSafety Boeing, its 50%-owned affiliate.

At EJA, in contrast, the customer owns the equipment, though we, of course, must invest in a core fleet of our own planes to ensure outstanding service. For example, the Sunday after Thanksgiving, EJA’s busiest day of the year, strains our resources since fractions of 169 planes are owned by 1,412 customers, many of whom are bent on flying home between 3 and 6 p.m. On that day, and certain others, we need a supply of company-owned aircraft to make sure all parties get where they want, when they want.

Still, most of the planes we fly are owned by customers, which means that modest pre-tax margins in this business can produce good returns on equity. Currently, our customers own planes worth over $2 billion, and in addition we have $4.2 billion of planes on order. Indeed, the limiting factor in our business right now is the availability of planes. We now are taking delivery of about 8% of all business jets manufactured in the world, and we wish we could get a bigger share than that. Though EJA was supply-constrained in 1999, its recurring revenues — monthly management fees plus hourly flight fees — increased 46%.

The fractional-ownership industry is still in its infancy. EJA is now building critical mass in Europe, and over time we will expand around the world. Doing that will be expensive — very expensive — but we will spend what it takes. Scale is vital to both us and our customers: The company with the most planes in the air worldwide will be able to offer its customers the best service. "Buy a fraction, get a fleet" has real meaning at EJA.

EJA enjoys another important advantage in that its two largest competitors are both subsidiaries of aircraft manufacturers and sell only the aircraft their parents make. Though these are fine planes, these competitors are severely limited in the cabin styles and mission capabilities they can offer. EJA, in contrast, offers a wide array of planes from five suppliers. Consequently, we can give the customer whatever *he* needs to buy — rather than his getting what the competitor's parent needs to sell.

Last year in this report, I described my family's delight with the one-quarter (200 flight hours annually) of a Hawker 1000 that we had owned since 1995. I got so pumped up by my own prose that shortly thereafter I signed up for one-sixteenth of a Cessna V Ultra as well. Now my annual outlays at EJA and Borsheim's, combined, total ten times my salary. Think of this as a rough guideline for your own expenditures with us.

During the past year, two of Berkshire's outside directors have also signed on with EJA. (Maybe we're paying them too much.) You should be aware that they and I are charged exactly the same price for planes and service as is any other customer: EJA follows a "most favored nations" policy, with no one getting a special deal.

And now, brace yourself. Last year, EJA passed the ultimate test: *Charlie signed up.* No other endorsement could speak more eloquently to the value of the EJA service. Give us a call at 1-800-848-6436 and ask for our "white paper" on fractional ownership.

Acquisitions of 1999

At both GEICO and Executive Jet, our best source of new customers is the happy ones we already have. Indeed, about 65% of our new owners of aircraft come as referrals from current owners who have fallen in love with the service.

Our acquisitions usually develop in the same way. At other companies, executives may devote themselves to pursuing acquisition possibilities with investment bankers, utilizing an auction process that has become standardized. In this exercise the bankers prepare a "book" that makes me think of the Superman comics of my youth. In the Wall Street version, a formerly mild-mannered company emerges from the investment banker's phone booth able to leap over competitors in a single bound and with earnings moving faster than a speeding bullet. Titillated by the book's description of the acquiree's powers, acquisition-hungry CEOs — Lois Lanes all, beneath their cool exteriors — promptly swoon.

What's particularly entertaining in these books is the precision with which earnings are projected for many years ahead. If you ask the author-banker, however, what his own firm will earn *next month*, he will go into a protective crouch and tell you that business and markets are far too uncertain for him to venture a forecast.

Here's one story I can't resist relating: In 1985, a major investment banking house undertook to sell Scott Fetzer, offering it widely — but with no success. Upon reading of this strikeout, I wrote Ralph Schey, then and now

Scott Fetzer's CEO, expressing an interest in buying the business. I had never met Ralph, but within a week we had a deal. Unfortunately, Scott Fetzer's letter of engagement with the banking firm provided it a $2.5 million fee upon sale, even if it had nothing to do with finding the buyer. I guess the lead banker felt he should do something for his payment, so he graciously offered us a copy of the book on Scott Fetzer that his firm had prepared. With his customary tact, Charlie responded: "I'll pay $2.5 million *not* to read it."

At Berkshire, our carefully-crafted acquisition strategy is simply to wait for the phone to ring. Happily, it sometimes does so, usually because a manager who sold to us earlier has recommended to a friend that he think about following suit.

Which brings us to the furniture business. Two years ago I recounted how the acquisition of Nebraska Furniture Mart in 1983 and my subsequent association with the Blumkin family led to follow-on transactions with R. C. Willey (1995) and Star Furniture (1997). For me, these relationships have all been terrific. Not only did Berkshire acquire three outstanding retailers; these deals also allowed me to become friends with some of the finest people you will ever meet.

Naturally, I have persistently asked the Blumkins, Bill Child and Melvyn Wolff whether there are any more out there like you. Their invariable answer was the Tatelman brothers of New England and their remarkable furniture business, Jordan's.

I met Barry and Eliot Tatelman last year and we soon signed an agreement for Berkshire to acquire the company. Like our three previous furniture acquisitions, this business had long been in the family — in this case since 1927, when Barry and Eliot's grandfather began operations in a Boston suburb. Under the brothers' management, Jordan's has grown ever more dominant in its region, becoming the largest furniture retailer in New Hampshire as well as Massachusetts.

The Tatelmans don't just sell furniture or manage stores. They also present customers with a dazzling entertainment experience called "shoppertainment." A family visiting a store can have a terrific time, while concurrently viewing an extraordinary selection of merchandise. The business results are also extraordinary: Jordan's has the highest sales per square foot of any major furniture operation in the country. I urge you to visit one of their stores if you are in the Boston area — particularly the one at Natick, which is Jordan's newest. Bring money.

Barry and Eliot are classy people — just like their counterparts at Berkshire's three other furniture operations. When they sold to us, they elected to give each of their employees at least 50¢ for every hour that he or she had worked for Jordan's. This payment added up to $9 million, which came from the Tatelmans' own pockets, not from Berkshire's. And Barry and Eliot were thrilled to write the checks.

Each of our furniture operations is number one in its territory. We now sell more furniture than anyone else in Massachusetts, New Hampshire, Texas, Nebraska, Utah and Idaho. Last year Star's Melvyn Wolff and his sister, Shirley Toomim, scored two major successes: a move into San Antonio and a significant enlargement of Star's store in Austin.

There's no operation in the furniture retailing business remotely like the one assembled by Berkshire. It's fun for me and profitable for you. W. C. Fields once said, "It was a woman who drove me to drink, but unfortunately I never had the chance to thank her." I don't want to make that mistake. My thanks go to Louie, Ron and Irv Blumkin for getting me started in the furniture business and for unerringly guiding me as we have assembled the group we now have.

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Now, for our second acquisition deal: It came to us through my good friend, Walter Scott, Jr., chairman of Level 3 Communications and a director of Berkshire. Walter has many other business connections as well, and one of them is with MidAmerican Energy, a utility company in which he has substantial holdings and on whose board he sits. At a conference in California that we both attended last September, Walter casually asked me whether Berkshire might be interested in making a large investment in MidAmerican, and from the start the idea of being in partnership with Walter struck me as a good one. Upon returning to Omaha, I read some of

MidAmerican's public reports and had two short meetings with Walter and David Sokol, MidAmerican's talented and entrepreneurial CEO. I then said that, at an appropriate price, we would indeed like to make a deal.

Acquisitions in the electric utility industry are complicated by a variety of regulations including the Public Utility Holding Company Act of 1935. Therefore, we had to structure a transaction that would avoid Berkshire gaining voting control. Instead we are purchasing an 11% fixed-income security, along with a combination of common stock and exchangeable preferred that will give Berkshire just under 10% of the voting power of MidAmerican but about 76% of the equity interest. All told, our investment will be about $2 billion.

Walter characteristically backed up his convictions with real money: He and his family will buy more MidAmerican stock for cash when the transaction closes, bringing their total investment to about $280 million. Walter will also be the controlling shareholder of the company, and I can't think of a better person to hold that post.

Though there are many regulatory constraints in the utility industry, it's possible that we will make additional commitments in the field. If we do, the amounts involved could be large.

Acquisition Accounting

Once again, I would like to make some comments about accounting, in this case about its application to acquisitions. This is currently a very contentious topic and, before the dust settles, Congress may even intervene (a truly terrible idea).

When a company is acquired, generally accepted accounting principles ("GAAP") currently condone two very different ways of recording the transaction: "purchase" and "pooling." In a pooling, stock must be the currency; in a purchase, payment can be made in either cash or stock. Whatever the currency, managements usually detest purchase accounting because it almost always requires that a "goodwill" account be established and subsequently written off — a process that saddles earnings with a large annual charge that normally persists for decades. In contrast, pooling avoids a goodwill account, which is why managements love it.

Now, the Financial Accounting Standards Board ("FASB") has proposed an end to pooling, and many CEOs are girding for battle. It will be an important fight, so we'll venture some opinions. To begin with, we agree with the many managers who argue that goodwill amortization charges are usually spurious. You'll find my thinking about this in the appendix to our 1983 annual report, which is available on our website, and in the Owner's Manual on pages 55 - 62.

For accounting rules to mandate amortization that will, in the usual case, conflict with reality is deeply troublesome: Most accounting charges *relate* to what's going on, even if they don't precisely measure it. As an example, depreciation charges can't with precision calibrate the decline in value that physical assets suffer, but these charges do at least describe something that is truly occurring: Physical assets invariably deteriorate. Correspondingly, obsolescence charges for inventories, bad debt charges for receivables and accruals for warranties are among the charges that reflect true costs. The annual charges for these expenses can't be exactly measured, but the necessity for estimating them is obvious.

In contrast, economic goodwill does not, in many cases, diminish. Indeed, in a great many instances — perhaps most — it actually grows in value over time. In character, economic goodwill is much like land: The value of both assets is sure to fluctuate, but the direction in which value is going to go is in no way ordained. At See's, for example, economic goodwill has grown, in an irregular but very substantial manner, for 78 years. And, if we run the business right, growth of that kind will probably continue for at least another 78 years.

To escape from the fiction of goodwill charges, managers embrace the fiction of pooling. This accounting convention is grounded in the poetic notion that when two rivers merge their streams become indistinguishable. Under this concept, a company that has been merged into a larger enterprise has not been "purchased" (even though it will often have received a large "sell-out" premium). Consequently, no goodwill is created, and those pesky subsequent charges to earnings are eliminated. Instead, the accounting for the ongoing entity is handled as if the businesses had forever been one unit.

So much for poetry. The reality of merging is usually far different: There is indisputably an acquirer and an acquiree, and the latter has been “purchased,” no matter how the deal has been structured. If you think otherwise, just ask employees severed from their jobs which company was the conqueror and which was the conquered. You will find no confusion. So on this point the FASB is correct: In most mergers, a purchase has been made. Yes, there are some true “mergers of equals,” but they are few and far between.

Charlie and I believe there’s a reality-based approach that should both satisfy the FASB, which correctly wishes to record a purchase, and meet the objections of managements to nonsensical charges for diminution of goodwill. We would first have the acquiring company record its purchase price — whether paid in stock or cash — at fair value. In most cases, this procedure would create a large asset representing economic goodwill. We would then leave this asset on the books, not requiring its amortization. Later, if the economic goodwill became impaired, as it sometimes would, it would be written down just as would any other asset judged to be impaired.

If our proposed rule were to be adopted, it should be applied retroactively so that acquisition accounting would be consistent throughout America — a far cry from what exists today. One prediction: If this plan were to take effect, managements would structure acquisitions more sensibly, deciding whether to use cash or stock based on the real consequences for their shareholders rather than on the unreal consequences for their reported earnings.

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In our purchase of Jordan’s, we followed a procedure that will maximize the cash produced for our shareholders but minimize the earnings we report to you. Berkshire purchased assets for cash, an approach that on our tax returns permits us to amortize the resulting goodwill over a 15-year period. Obviously, this tax deduction materially increases the amount of cash delivered by the business. In contrast, when stock, rather than assets, is purchased for cash, the resulting writeoffs of goodwill are not taxdeductible. The economic difference between these two approaches is substantial.

From the economic standpoint of the acquiring company, the worst deal of all is a stock-for-stock acquisition. Here, a huge price is often paid without there being any step-up in the tax basis of either the stock of the acquiree or its assets. If the acquired entity is subsequently sold, its owner may owe a large capital gains tax (at a 35% or greater rate), even though the sale may truly be producing a major economic loss.

We have made some deals at Berkshire that used far-from-optimal tax structures. These deals occurred because the sellers insisted on a given structure and because, overall, we still felt the acquisition made sense. We have never done an inefficiently-structured deal, however, in order to make our figures look better.

Sources of Reported Earnings

The table that follows shows the main sources of Berkshire's reported earnings. In this presentation, purchase-accounting adjustments are not assigned to the specific businesses to which they apply, but are instead aggregated and shown separately. This procedure lets you view the earnings of our businesses as they would have been reported had we not purchased them. For the reasons discussed on page 61, this form of presentation seems to us to be more useful to investors and managers than one utilizing generally accepted accounting principles (GAAP), which require purchase-premiums to be charged off business-by-business. The total earnings we show in the table are, of course, identical to the GAAP total in our audited financial statements.

	(in millions)			
	Pre-Tax Earnings		Berkshire's Share of Net Earnings (after taxes and minority interests)	
	1999	1998	1999	1998
Operating Earnings:				
Insurance Group:				
Underwriting — Reinsurance	$(1,440)	$(21)	$(927)	$(14)
Underwriting — GEICO	24	269	16	175
Underwriting — Other Primary	22	17	14	10
Net Investment Income	2,482	974	1,764	731
Buffalo News	55	53	34	32
Finance and Financial Products Businesses	125	205	86	133
Flight Services	225	181 (1)	132	110 (1)
Home Furnishings	79 (2)	72	46 (2)	41
International Dairy Queen	56	58	35	35
Jewelry	51	39	31	23
Scott Fetzer (excluding finance operation)	147	137	92	85
See's Candies	74	62	46	40
Shoe Group	17	33	11	23
Purchase-Accounting Adjustments	(739)	(123)	(648)	(118)
Interest Expense (3)	(109)	(100)	(70)	(63)
Shareholder-Designated Contributions	(17)	(17)	(11)	(11)
Other	33	60 (4)	20	45 (4)
Operating Earnings	1,085	1,899	671	1,277
Capital Gains from Investments	1,365	2,415	886	1,553
Total Earnings - All Entities	$2,450	$4,314	$1,557	$ 2,830

(1) Includes Executive Jet from August 7, 1998.
(2) Includes Jordan's Furniture from November 13, 1999.
(3) Excludes interest expense of Finance Businesses.
(4) Includes General Re operations for ten days in 1998.

Almost all of our manufacturing, retailing and service businesses had excellent results in 1999. The exception was Dexter Shoe, and there the shortfall did not occur because of managerial problems: In skills, energy and devotion to their work, the Dexter executives are every bit the equal of our other managers. But we manufacture shoes primarily in the U.S., and it has become extremely difficult for domestic producers to compete effectively. In 1999, approximately 93% of the 1.3 billion pairs of shoes purchased in this country came from abroad, where extremely low-cost labor is the rule.

Counting both Dexter and H. H. Brown, we are currently the leading domestic manufacturer of shoes, and we are likely to continue to be. We have loyal, highly-skilled workers in our U.S. plants, and we want to retain every job here that we can. Nevertheless, in order to remain viable, we are sourcing more of our output internationally. In doing that, we have incurred significant severance and relocation costs that are included in the earnings we show in the table.

A few years back, Helzberg's, our 200-store jewelry operation, needed to make operating adjustments to restore margins to appropriate levels. Under Jeff Comment's leadership, the job was done and profits have dramatically rebounded. In the shoe business, where we have Harold Alfond, Peter Lunder, Frank Rooney and Jim Issler in charge, I believe we will see a similar improvement over the next few years.

See's Candies deserves a special comment, given that it achieved a record operating margin of 24% last year. Since we bought See's for $25 million in 1972, it has earned $857 million pre-tax. And, despite its growth, the business has required very little additional capital. Give the credit for this performance to Chuck Huggins. Charlie and I put him in charge the day of our purchase, and his fanatical insistence on both product quality and friendly service has rewarded customers, employees and owners.

Chuck gets better every year. When he took charge of See's at age 46, the company's pre-tax profit, expressed in millions, was about 10% of his age. Today he's 74, and the ratio has increased to 100%. Having discovered this mathematical relationship — let's call it Huggins' Law — Charlie and I now become giddy at the mere thought of Chuck's birthday.

* * * * * * * * * * * *

Additional information about our various businesses is given on pages 39 - 54, where you will also find our segment earnings reported on a GAAP basis. In addition, on pages 63 - 69, we have rearranged Berkshire's financial data into four segments on a non-GAAP basis, a presentation that corresponds to the way Charlie and I think about the company.

Look-Through Earnings

Reported earnings are an inadequate measure of economic progress at Berkshire, in part because the numbers shown in the table presented earlier include only the dividends we receive from investees — though these dividends typically represent only a small fraction of the earnings attributable to our ownership. Not that we mind this division of money, since on balance we regard the undistributed earnings of investees as more valuable to us than the portion paid out. The reason for our thinking is simple: Our investees often have the opportunity to reinvest earnings at high rates of return. So why should we want them paid out?

To depict something closer to economic reality at Berkshire than reported earnings, though, we employ the concept of "look-through" earnings. As we calculate these, they consist of: (1) the operating earnings reported in the previous section, plus; (2) our share of the retained operating earnings of major investees that, under GAAP accounting, are not reflected in our profits, less; (3) an allowance for the tax that would be paid by Berkshire if these retained earnings of investees had instead been distributed to us. When tabulating "operating earnings" here, we exclude purchase-accounting adjustments as well as capital gains and other major non-recurring items.

The following table sets forth our 1999 look-through earnings, though I warn you that the figures can be no more than approximate, since they are based on a number of judgment calls. (The dividends paid to us by these investees have been included in the operating earnings itemized on page 13, mostly under "Insurance Group: Net Investment Income.")

Berkshire's Major Investees	Berkshire's Approximate Ownership at Yearend[(1)]	Berkshire's Share of Undistributed Operating Earnings (in millions)[(2)]
American Express Company	11.3%	$228
The Coca-Cola Company	8.1%	144
Freddie Mac	8.6%	127
The Gillette Company	9.0%	53
M&T Bank	6.5%	17
The Washington Post Company	18.3%	30
Wells Fargo & Company	3.6%	108
Berkshire's share of undistributed earnings of major investees		707
Hypothetical tax on these undistributed investee earnings[(3)]		(99)
Reported operating earnings of Berkshire		1,318
Total look-through earnings of Berkshire		$ 1,926

(1) Does not include shares allocable to minority interests
(2) Calculated on average ownership for the year

(3) The tax rate used is 14%, which is the rate Berkshire pays on the dividends it receives

Investments

Below we present our common stock investments. Those that had a market value of more than $750 million at the end of 1999 are itemized.

		12/31/99	
Shares	*Company*	*Cost**	*Market*
		(dollars in millions)	
50,536,900	American Express Company	$1,470	$ 8,402
200,000,000	The Coca-Cola Company	1,299	11,650
59,559,300	Freddie Mac	294	2,803
96,000,000	The Gillette Company	600	3,954
1,727,765	The Washington Post Company	11	960
59,136,680	Wells Fargo & Company	349	2,391
	Others	4,180	6,848
	Total Common Stocks	$8,203	$37,008

* Represents tax-basis cost which, in aggregate, is $691 million less than GAAP cost.

We made few portfolio changes in 1999. As I mentioned earlier, several of the companies in which we have large investments had disappointing business results last year. Nevertheless, we believe these companies have important competitive advantages that will endure over time. This attribute, which makes for good long-term investment results, is one Charlie and I occasionally believe we can identify. More often, however, we can’t — not at least with a high degree of conviction. This explains, by the way, why we don’t own stocks of tech companies, even though we share the general view that our society will be transformed by their products and services. Our problem — which we can’t solve by studying up — is that we have no insights into which participants in the tech field possess a truly *durable* competitive advantage.

Our lack of tech insights, we should add, does not distress us. After all, there are a great many business areas in which Charlie and I have no special capital-allocation expertise. For instance, we bring nothing to the table when it comes to evaluating patents, manufacturing processes or geological prospects. So we simply don’t get into judgments in those fields.

If we have a strength, it is in recognizing when we are operating well within our circle of competence and when we are approaching the perimeter. Predicting the long-term economics of companies that operate in fast-changing industries is simply far beyond our perimeter. If others claim predictive skill in those industries — and seem to have their claims validated by the behavior of the stock market — we neither envy nor emulate them. Instead, we just stick with what we understand. If we stray, we will have done so inadvertently, not because we got restless and substituted hope for rationality. Fortunately, it's almost certain there will be opportunities from time to time for Berkshire to do well within the circle we've staked out.

Right now, the prices of the fine businesses we already own are just not that attractive. In other words, we feel much better about the businesses than their stocks. That's why we haven't added to our present holdings. Nevertheless, we haven't yet scaled back our portfolio in a major way: If the choice is between a questionable business at a comfortable price or a comfortable business at a questionable price, we much prefer the latter. What really gets our attention, however, is a comfortable business at a comfortable price.

Our reservations about the prices of securities we own apply also to the general level of equity prices. We have never attempted to forecast what the stock market is going to do in the next month or the next year, and we are not trying to do that now. But, as I point out in the enclosed article, equity investors currently seem wildly optimistic in their expectations about future returns.

We see the growth in corporate profits as being largely tied to the business done in the country (GDP), and we see GDP growing at a real rate of about 3%. In addition, we have hypothesized 2% inflation. Charlie and I have no particular conviction about the accuracy of 2%. However, it's the market's view: Treasury Inflation-Protected Securities (TIPS) yield about two percentage points less than the standard treasury bond, and if you believe inflation rates are going to be higher than that, you can profit by simply buying TIPS and shorting Governments.

If profits do indeed grow along with GDP, at about a 5% rate, the valuation placed on American business is unlikely to climb by much more than that.

Add in something for dividends, and you emerge with returns from equities that are dramatically less than most investors have either experienced in the past or expect in the future. If investor expectations become more realistic — and they almost certainly will — the market adjustment is apt to be severe, particularly in sectors in which speculation has been concentrated.

Berkshire will someday have opportunities to deploy major amounts of cash in equity markets — we are confident of that. But, as the song goes, "Who knows where or when?" Meanwhile, if anyone starts explaining to you what is going on in the truly-manic portions of this "enchanted" market, you might remember still another line of song: "Fools give you reasons, wise men never try."

Share Repurchases

Recently, a number of shareholders have suggested to us that Berkshire repurchase its shares. Usually the requests were rationally based, but a few leaned on spurious logic.

There is only one combination of facts that makes it advisable for a company to repurchase its shares: First, the company has available funds — cash plus sensible borrowing capacity — beyond the near-term needs of the business and, second, finds its stock selling in the market below its intrinsic value, conservatively-calculated. To this we add a caveat: Shareholders should have been supplied all the information they need for estimating that value. Otherwise, insiders could take advantage of their uninformed partners and buy out their interests at a fraction of true worth. We have, on rare occasions, seen that happen. Usually, of course, chicanery is employed to drive stock prices up, not down.

The business "needs" that I speak of are of two kinds: First, expenditures that a company must make to maintain its competitive position (e.g., the remodeling of stores at Helzberg's) and, second, optional outlays, aimed at business growth, that management expects will produce more than a dollar of value for each dollar spent (R. C. Willey's expansion into Idaho).

When available funds exceed needs of those kinds, a company with a growth-oriented shareholder population can buy new businesses or repurchase shares. If a company's stock is selling well below intrinsic value, repurchases usually make the most sense. In the mid-1970s, the wisdom of making these was virtually screaming at managements, but few responded. In most cases, those that did made their owners much wealthier than if alternative courses of action had been pursued. Indeed, during the 1970s (and, spasmodically, for some years thereafter) we searched for companies that were large repurchasers of their shares. This often was a tipoff that the company was both undervalued and run by a shareholder-oriented management.

That day is past. Now, repurchases are all the rage, but are all too often made for an unstated and, in our view, ignoble reason: to pump or support the stock price. The shareholder who chooses to sell today, of course, is benefitted by any buyer, whatever his origin or motives. But the *continuing* shareholder is penalized by repurchases above intrinsic value. Buying dollar bills for $1.10 is not good business for those who stick around.

Charlie and I admit that we feel confident in estimating intrinsic value for only a portion of traded equities and then only when we employ a range of values, rather than some pseudo-precise figure. Nevertheless, it appears to us that many companies now making repurchases are overpaying departing shareholders at the expense of those who stay. In defense of those companies, I would say that it is natural for CEOs to be optimistic about their own businesses. They also know a whole lot more about them than I do. However, I can't help but feel that too often today's repurchases are dictated by management's desire to "show confidence" or be in fashion rather than by a desire to enhance per-share value.

Sometimes, too, companies say they are repurchasing shares to offset the shares issued when stock options granted at much lower prices are exercised. This "buy high, sell low" strategy is one many unfortunate investors have employed — but never intentionally! Managements, however, seem to follow this perverse activity very cheerfully.

Of course, both option grants and repurchases may make sense — but if that's the case, it's not because the two activities are logically related. Rationally, a company's decision to repurchase shares or to issue them should stand on its own feet. Just because stock has been issued to satisfy options — or for any other reason — does not mean that stock should be repurchased at a price above intrinsic value. Correspondingly, a stock that sells well below intrinsic value should be repurchased whether or not stock has previously been issued (or may be because of outstanding options).

You should be aware that, at certain times in the past, I have erred in *not* making repurchases. My appraisal of Berkshire's value was then too conservative or I was too enthused about some alternative use of funds. We have therefore missed some opportunities — though Berkshire's trading volume at these points was too light for us to have done much buying, which means that the gain in our per-share value would have been minimal. (A repurchase of, say, 2% of a company's shares at a 25% discount from per-share intrinsic value produces only a ½% gain in that value at most — and even less if the funds could alternatively have been deployed in value-building moves.)

Some of the letters we've received clearly imply that the writer is unconcerned about intrinsic value considerations but instead wants us to trumpet an intention to repurchase so that the stock will rise (or quit going down). If the writer wants to sell tomorrow, his thinking makes sense — for him! — but if he intends to hold, he should instead hope the stock falls and trades in enough volume for us to buy a lot of it. That's the only way a repurchase program can have any real benefit for a continuing shareholder.

We will not repurchase shares unless we believe Berkshire stock is selling well below intrinsic value, conservatively calculated. Nor will we attempt to talk the stock up or down. (Neither publicly or privately have I ever told anyone to buy or sell Berkshire shares.) Instead we will give all shareholders — and potential shareholders — the same valuation-related information we would wish to have if our positions were reversed.

Recently, when the A shares fell below $45,000, we considered making repurchases. We decided, however, to delay buying, if indeed we elect to do *any*, until shareholders have had the chance to review this report. If we do find that repurchases make sense, we will only rarely place bids on the New York Stock Exchange ("NYSE"). Instead, we will respond to offers made directly to us at or below the NYSE bid. If you wish to offer stock, have your broker call Mark Millard at 402-346-1400. When a trade occurs, the broker can either record it in the “third market” or on the NYSE. We will favor purchase of the B shares if they are selling at more than a 2% discount to the A. We will not engage in transactions involving fewer than 10 shares of A or 50 shares of B.

Please be clear about one point: We will *never* make purchases with the intention of stemming a decline in Berkshire’s price. Rather we will make them if and when we believe that they represent an attractive use of the Company’s money. At best, repurchases are likely to have only a very minor effect on the future rate of gain in our stock’s intrinsic value.

Shareholder-Designated Contributions

About 97.3% of all eligible shares participated in Berkshire's 1999 shareholder-designated contributions program, with contributions totaling $17.2 million. A full description of the program appears on pages 70 - 71.

Cumulatively, over the 19 years of the program, Berkshire has made contributions of $147 million pursuant to the instructions of our shareholders. The rest of Berkshire's giving is done by our subsidiaries, which stick to the philanthropic patterns that prevailed before they were acquired (except that their former owners themselves take on the responsibility for their personal charities). In aggregate, our subsidiaries made contributions of $13.8 million in 1999, including in-kind donations of $2.5 million.

To participate in future programs, you must own Class A shares that are registered in the name of the actual owner, not the nominee name of a broker, bank or depository. Shares not so registered on August 31, 2000, will be ineligible for the 2000 program. When you get the contributions form from us, return it promptly so that it does not get put aside or forgotten. Designations received after the due date will not be honored.

The Annual Meeting

This year’s Woodstock Weekend for Capitalists will follow a format slightly different from that of recent years. We need to make a change because the

Aksarben Coliseum, which served us well the past three years, is gradually being closed down. Therefore, we are relocating to the Civic Auditorium (which is on Capitol Avenue between 18th and 19th, behind the Doubletree Hotel), the only other facility in Omaha offering the space we require.

The Civic, however, is located in downtown Omaha, and we would create a parking and traffic nightmare if we were to meet there on a weekday. We will, therefore, convene on Saturday, April 29, with the doors opening at 7 a.m., the movie beginning at 8:30 and the meeting itself commencing at 9:30. As in the past, we will run until 3:30 with a short break at noon for food, which will be available at the Civic's concession stands.

An attachment to the proxy material that is enclosed with this report explains how you can obtain the credential you will need for admission to the meeting and other events. As for plane, hotel and car reservations, we have again signed up American Express (800-799-6634) to give you special help. In our normal fashion, we will run buses from the larger hotels to the meeting. After the meeting, the buses will make trips back to the hotels and to Nebraska Furniture Mart, Borsheim's and the airport. Even so, you are likely to find a car useful.

We have scheduled the meeting in 2002 and 2003 on the customary first Saturday in May. In 2001, however, the Civic is already booked on that Saturday, so we will meet on April 28. The Civic should fit our needs well on any weekend, since there will then be more than ample parking in nearby lots and garages as well as on streets. We will also be able to greatly enlarge the space we give exhibitors. So, overcoming my normal commercial reticence, I will see that you have a wide display of Berkshire products at the Civic that you can *purchase*. As a benchmark, in 1999 shareholders bought 3,059 pounds of See's candy, $16,155 of World Book Products, 1,928 pairs of Dexter shoes, 895 sets of Quikut knives, 1,752 golf balls with the Berkshire Hathaway logo and 3,446 items of Berkshire apparel. I know you can do better.

Last year, we also initiated the sale of at least eight fractions of Executive Jet aircraft. We will again have an array of models at the Omaha airport for your inspection on Saturday and Sunday. Ask an EJA representative at the Civic about viewing any of these planes.

Dairy Queen will also be on hand at the Civic and again will donate all proceeds to the Children's Miracle Network. Last year we sold 4,586 Dilly® bars, fudge bars and vanilla/orange bars. Additionally, GEICO will have a booth that will be staffed by a number of our top counselors from around the country, all of them ready to supply you with auto insurance quotes. In most cases, GEICO will be able to offer you a special shareholder's discount. Bring the details of your existing insurance, and check out whether we can save you some money.

Finally, Ajit Jain and his associates will be on hand to offer both no-commission annuities and a liability policy with jumbo limits of a size rarely available elsewhere. Talk to Ajit and learn how to protect yourself and your family against a $10 million judgment.

NFM's newly remodeled complex, located on a 75-acre site on 72nd Street between Dodge and Pacific, is open from 10 a.m. to 9 p.m. on weekdays and 10 a.m. to 6 p.m. on Saturdays and Sundays. This operation offers an unrivaled breadth of merchandise — furniture, electronics, appliances, carpets and computers — all at can't-be-beat prices. In 1999 NFM did more than $300 million of business at its 72nd Street location, which in a metropolitan area of 675,000 is an absolute miracle. During the Thursday, April 27 to Monday, May 1 period, any shareholder presenting his or her meeting credential will receive a discount that is customarily given only to employees. We have offered this break to shareholders the last couple of years, and sales have been amazing. In last year's five-day "Berkshire Weekend," NFM's volume was $7.98 million, an increase of 26% from 1998 and 51% from 1997.

Borsheim's — the largest jewelry store in the country except for Tiffany's Manhattan store — will have two shareholder-only events. The first will be a champagne and dessert party from 6 p.m.-10 p.m. on Friday, April 28. The second, the main gala, will be from 9 a.m. to 6 p.m. on Sunday, April 30. On that day, Charlie and I will be on hand to sign *sales tickets*. Shareholder prices will be available Thursday through Monday, so if you wish to avoid the largest crowds, which will form on Friday evening and Sunday, come at other times and identify yourself as a shareholder. On Saturday, we will be open until 7 p.m. Borsheim's operates on a gross margin that is fully twenty percentage points below that of its major rivals, so be prepared to be blown away by both our prices and selection.

In the mall outside of Borsheim's, we will again have Bob Hamman — the best bridge player the game has ever seen — available to play with our shareholders on Sunday. We will also have a few other experts playing at additional tables. In 1999, we had more demand than tables, but we will cure that problem this year.

Patrick Wolff, twice US chess champion, will again be in the mall playing blindfolded against all comers. He tells me that he has never tried to play more than four games simultaneously while handicapped this way but might try to bump that limit to five or six this year. If you're a chess fan, take Patrick on — but be sure to check his blindfold before your first move.

Gorat's — my favorite steakhouse — will again be open exclusively for Berkshire shareholders on Sunday, April 30, and will be serving from 4 p.m. until about midnight. Please remember that you can't come to Gorat's on Sunday without a reservation. To make one, call 402-551-3733 on April 3 (*but not before*). If Sunday is sold out, try Gorat's on one of the other evenings you will be in town. I make a "quality check" of Gorat's about once a week and can report that their rare T-bone (with a double order of hash browns) is still unequaled throughout the country.

The usual baseball game will be held at Rosenblatt Stadium at 7 p.m. on Saturday night. This year the Omaha Golden Spikes will play the Iowa Cubs. Come early, because that's when the real action takes place. Those who attended last year saw your Chairman pitch to Ernie Banks.

This encounter proved to be the titanic duel that the sports world had long awaited. After the first few pitches — which were not my best, but when have I ever thrown my best? — I fired a brushback at Ernie just to let him know who was in command. Ernie charged the mound, and I charged the plate. But a clash was avoided because we became exhausted before reaching each other.

Ernie was dissatisfied with his performance last year and has been studying the game films all winter. As you may know, Ernie had 512 home runs in his career as a Cub. Now that he has spotted telltale weaknesses in my delivery, he expects to get #513 on April 29. I, however, have learned new ways to disguise my "flutterball." Come and watch this matchup.

I should add that I have extracted a promise from Ernie that he will not hit a "come-backer" at me since I would never be able to duck in time to avoid it. My reflexes are like Woody Allen's, who said his were so slow that he was once hit by a car being pushed by two guys.

Our proxy statement contains instructions about obtaining tickets to the game and also a large quantity of other information that should help you enjoy your visit in Omaha. Join us at the Capitalist Caper on Capitol Avenue.

March 1, 2000

Warren E. Buffett
Chairman of the Board

BERKSHIRE HATHAWAY INC.

To the Shareholders of Berkshire Hathaway Inc.:

Our gain in net worth during 2000 was $3.96 billion, which increased the per-share book value of both our Class A and Class B stock by 6.5%. Over the last 36 years (that is, since present management took over) per-share book value has grown from $19 to $40,442, a gain of 23.6% compounded annually.*

> * All figures used in this report apply to Berkshire's A shares, the successor to the only stock that the company had outstanding before 1996. The B shares have an economic interest equal to 1/30th that of the A.

Overall, we had a decent year, our book-value gain having outpaced the performance of the S&P 500. And, though this judgment is necessarily subjective, we believe Berkshire's gain in per-share intrinsic value moderately exceeded its gain in book value. (Intrinsic value, as well as other key investment and accounting terms and concepts, are explained in our Owner's Manual on pages 59-66. Intrinsic value is discussed on page 64.)

Furthermore, we completed two significant acquisitions that we negotiated in 1999 and initiated six more. All told, these purchases have cost us about $8 billion, with 97% of that amount paid in cash and 3% in stock. The eight businesses we've acquired have aggregate sales of about $13 billion and employ 58,000 people. Still, we incurred no debt in making these purchases, and our shares outstanding have increased only $^1/_3$ of 1%. Better yet, we remain awash in liquid assets and are both eager and ready for even larger acquisitions.

I will detail our purchases in the next section of the report. But I will tell you now that we have embraced the 21st century by entering such cutting-edge industries as brick, carpet, insulation and paint. Try to control your excitement.

On the minus side, policyholder growth at GEICO slowed to a halt as the year progressed. It has become much more expensive to obtain new business. I told you last year that we would get our money's worth from stepped-up advertising at GEICO in 2000, but I was wrong. We'll examine the reasons later in the report.

Another negative — which has persisted for several years — is that we see our equity portfolio as only mildly attractive. We own stocks of some excellent businesses, but most of our holdings are fully priced and are unlikely to deliver more than moderate returns in the future. We're not alone in facing this problem: The long-term prospect for equities in general is far from exciting.

Finally, there is the negative that recurs annually: Charlie Munger, Berkshire's Vice Chairman and my partner, and I are a year older than when we last reported to you. Mitigating this adverse development is the indisputable fact that the age of your top managers is increasing at a considerably lower rate — *percentage-wise* — than is the case at almost all other major corporations. Better yet, this differential will widen in the future.

Charlie and I continue to aim at increasing Berkshire's per-share value at a rate that, over time, will modestly exceed the gain from owning the S&P 500. As the table on the facing page shows, a small annual advantage in our favor can, if sustained, produce an anything-but-small long-term advantage. To reach our goal we will need to add a few good businesses to Berkshire's stable each year, have the businesses we own generally gain in value, and avoid any material increase in our outstanding shares. We are confident about meeting the last two objectives; the first will require some luck.

It's appropriate here to thank two groups that made my job both easy and fun last year — just as they do every year. First, our operating managers continue to run their businesses in splendid fashion, which allows me to spend my time allocating capital rather than supervising them. (I wouldn't be good at that anyway.)

Our managers are a very special breed. At most large companies, the truly talented divisional managers seldom have the job they really want. Instead they yearn to become CEOs, either at their present employer or elsewhere. Indeed, if they stay put, they and their colleagues are likely to feel they have failed.

At Berkshire, our all-stars have *exactly* the jobs they want, ones that they hope and expect to keep throughout their business lifetimes. They therefore concentrate solely on maximizing the long-term value of the businesses that they "own" and love. If the businesses succeed, they have succeeded. And they stick with us: In our last 36 years, Berkshire has never had a manager of a significant subsidiary voluntarily leave to join another business.

The other group to which I owe enormous thanks is the home-office staff. After the eight acquisitions more than doubled our worldwide workforce to about 112,000, Charlie and I went soft last year and added one more person at headquarters. (Charlie, bless him, never lets me forget Ben Franklin's advice: "A small leak can sink a great ship.") Now we have 13.8 people.

This tiny band works miracles. In 2000 it handled all of the details connected with our eight acquisitions, processed extensive regulatory and tax filings (our tax return covers 4,896 pages), smoothly produced an annual meeting to which 25,000 tickets were issued, and accurately dispensed checks to 3,660 charities designated by our shareholders. In addition, the group dealt with all the routine tasks served up by a company with a revenue run-rate of $40 billion and more than 300,000 owners. And, to add to all of this, the other 12.8 are a delight to be around.

I should pay to have my job.

Acquisitions of 2000

Our acquisition technique at Berkshire is simplicity itself: We answer the phone. I'm also glad to report that it rings a bit more often now, because owners and/or managers increasingly wish to join their companies with Berkshire. Our acquisition criteria are set forth on page 23, and the number to call is 402-346-1400.

Let me tell you a bit about the businesses we have purchased during the past 14 months, starting with the two transactions that were initiated in 1999, but closed in 2000. (This list excludes some smaller purchases that were made by the managers of our subsidiaries and that, in most cases, will be integrated into their operations.)

• I described the first purchase — 76% of **MidAmerican Energy** — in last year's report. Because of regulatory constraints on our voting privileges, we perform only a "one-line" consolidation of MidAmerican's earnings and equity in our financial statements. If we instead fully consolidated the company's figures, our revenues in 2000 would have been $5 billion greater than we reported, though net income would remain the same.

• On November 23, 1999, I received a one-page fax from Bruce Cort that appended a *Washington Post* article describing an aborted buyout of **CORT Business Services**. Despite his name, Bruce has no connection with CORT. Rather, he is an airplane broker who had sold Berkshire a jet in 1986 and who, before the fax, had not been in touch with me for about ten years.

I knew nothing about CORT, but I immediately printed out its SEC filings and liked what I saw. That same day I told Bruce I had a possible interest and asked him to arrange a meeting with Paul Arnold, CORT's CEO. Paul and I got together on November 29, and I knew at once that we had the right ingredients for a purchase: a fine though unglamorous business, an outstanding manager, and a price (going by that on the failed deal) that made sense.

Operating out of 117 showrooms, CORT is the national leader in "rent-to-rent" furniture, primarily used in offices but also by temporary occupants of apartments. This business, it should be noted, has no similarity to "rent-to-own" operations, which usually involve the sale of home furnishings and electronics to people having limited income and poor credit.

We quickly purchased CORT for Wesco, our 80%-owned subsidiary, paying about $386 million in cash. You will find more details about CORT's operations in Wesco's 1999 and 2000 annual reports. Both Charlie and I enjoy working with Paul, and CORT looks like a good bet to beat our original expectations.

• Early last year, Ron Ferguson of General Re put me in contact with Bob Berry, whose family had owned **U.S. Liability** for 49 years. This insurer, along with two sister companies, is a medium-sized, highly-respected writer of unusual risks — "excess and surplus lines" in insurance jargon. After Bob and I got in touch, we agreed by phone on a half-stock, half-cash deal.

In recent years, Tom Nerney has managed the operation for the Berry family and has achieved a rare combination of excellent growth and unusual profitability. Tom is a powerhouse in other ways as well. In addition to having four adopted children (two from Russia), he has an extended family: the Philadelphia Belles, a young-teen girls basketball team that Tom coaches. The team had a 62-4 record last year and finished second in the AAU national tournament.

Few property-casualty companies are outstanding businesses. We have far more than our share, and U.S. Liability adds luster to the collection.

• **Ben Bridge Jeweler** was another purchase we made by phone, prior to any face-to-face meeting between me and the management. Ed Bridge, who with his cousin, Jon, manages this 65-store West Coast retailer, is a friend of Barnett Helzberg, from whom we bought Helzberg Diamonds in 1995. Upon learning that the Bridge family proposed to sell its company, Barnett gave Berkshire a strong recommendation. Ed then called and explained his business to me, also sending some figures, and we made a deal, again half for cash and half for stock.

Ed and Jon are fourth generation owner-managers of a business started 89 years ago in Seattle. Both the business and the family— including Herb and Bob, the fathers of Jon and Ed — enjoy extraordinary reputations. Same-store sales have increased by 9%, 11%, 13%, 10%, 12%, 21% and 7% over the past seven years, a truly remarkable record.

It was vital to the family that the company operate in the future as in the past. No one wanted another jewelry chain to come in and decimate the organization with ideas about synergy and cost saving (which, though they would never work, were certain to be tried). I told Ed and Jon that they would be in charge, and they knew I could be believed: After all, it's obvious that your Chairman would be a disaster at actually running a store or selling jewelry (though there are members of his family who have earned black belts as purchasers).

In their typically classy way, the Bridges allocated a substantial portion of the proceeds from their sale to the hundreds of co-workers who had helped the company achieve its success. We're proud to be associated with both the family and the company.

- In July we acquired **Justin Industries**, the leading maker of Western boots — including the Justin, Tony Lama, Nocona, and Chippewa brands — and the premier producer of brick in Texas and five neighboring states.

Here again, our acquisition involved serendipity. On May 4th, I received a fax from Mark Jones, a stranger to me, proposing that Berkshire join a group to acquire an unnamed company. I faxed him back, explaining that with rare exceptions we don't invest with others, but would happily pay him a commission if he sent details and we later made a purchase. He replied that the "mystery company" was Justin. I then went to Fort Worth to meet John Roach, chairman of the company and John Justin, who had built the business and was its major shareholder. Soon after, we bought Justin for $570 million in cash.

John Justin loved Justin Industries but had been forced to retire because of severe health problems (which sadly led to his death in late February). John was a class act — as a citizen, businessman and human being. Fortunately, he had groomed two outstanding managers, Harrold Melton at Acme and Randy Watson at Justin Boot, each of whom runs his company autonomously.

Acme, the larger of the two operations, produces more than one billion bricks per year at its 22 plants, about 11.7% of the industry's national output. The brick business, however, is necessarily regional, and in its territory Acme enjoys unquestioned leadership. When Texans are asked to name a brand of brick, 75% respond Acme, compared to 16% for the runner-up. (Before our purchase, I couldn't have named a brand of brick. Could you have?) This brand recognition is not only due to Acme's product quality, but also reflects many decades of extraordinary community service by both the company and John Justin.

I can't resist pointing out that Berkshire — whose top management has long been mired in the 19th century — is now one of the very few authentic "clicks-and-bricks" businesses around. We went into 2000 with GEICO doing significant business on the Internet, and then we added Acme. You can bet this move by Berkshire is making them *sweat* in Silicon Valley.

• In June, Bob Shaw, CEO of **Shaw Industries**, the world's largest carpet manufacturer, came to see me with his partner, Julian Saul, and the CEO of a second company with which Shaw was mulling a merger. The potential partner, however, faced huge asbestos liabilities from past activities, and any deal depended on these being eliminated through insurance.

The executives visiting me wanted Berkshire to provide a policy that would pay *all* future asbestos costs. I explained that though we could write an exceptionally large policy — far larger than any other insurer would ever think of offering — we would never issue a policy that lacked a cap.

Bob and Julian decided that if we didn't want to bet the ranch on the extent of the acquiree's liability, neither did they. So their deal died. But my interest in Shaw was sparked, and a few months later Charlie and I met with Bob to work out a purchase by Berkshire. A key feature of the deal was that both Bob and Julian were to continue owning at least 5% of Shaw. This leaves us associated with the best in the business as shown by Bob and Julian's record: Each built a large, successful carpet business before joining forces in 1998.

Shaw has annual sales of about $4 billion, and we own 87.3% of the company. Leaving aside our insurance operation, Shaw is by far our largest business. Now, if people walk all over us, we won't mind.

• In July, Bob Mundheim, a director of **Benjamin Moore Paint**, called to ask if Berkshire might be interested in acquiring it. I knew Bob from Salomon, where he was general counsel during some difficult times, and held him in very high regard. So my answer was "Tell me more."

In late August, Charlie and I met with Richard Roob and Yvan Dupuy, past and present CEOs of Benjamin Moore. We liked them; we liked the business; and we made a $1 billion cash offer on the spot. In October, their board approved the transaction, and we completed it in December. Benjamin

Moore has been making paint for 117 years and has thousands of independent dealers that are a vital asset to its business. Make sure you specify our product for your next paint job.

• Finally, in late December, we agreed to buy **Johns Manville Corp.** for about $1.8 billion. This company's incredible odyssey over the last few decades — too multifaceted to be chronicled here — was shaped by its long history as a manufacturer of asbestos products. The much-publicized health problems that affected many people exposed to asbestos led to JM's declaring bankruptcy in 1982.

Subsequently, the bankruptcy court established a trust for victims, the major asset of which was a controlling interest in JM. The trust, which sensibly wanted to diversify its assets, agreed last June to sell the business to an LBO buyer. In the end, though, the LBO group was unable to obtain financing.

Consequently, the deal was called off on Friday, December 8th. The following Monday, Charlie and I called Bob Felise, chairman of the trust, and made an all-cash offer with no financing contingencies. The next day the trustees voted tentatively to accept our offer, and a week later we signed a contract.

JM is the nation's leading producer of commercial and industrial insulation and also has major positions in roofing systems and a variety of engineered products. The company's sales exceed $2 billion and the business has earned good, if cyclical, returns. Jerry Henry, JM's CEO, had announced his retirement plans a year ago, but I'm happy to report that Charlie and I have convinced him to stick around.

* * * * * * * * * * * *

Two economic factors probably contributed to the rush of acquisition activity we experienced last year. First, many managers and owners foresaw near-term slowdowns in their businesses — and, in fact, we purchased several companies whose earnings will almost certainly decline this year from peaks they reached in 1999 or 2000. The declines make no difference to us, given that we expect all of our businesses to now and then have ups and downs. (Only in the sales presentations of investment banks do earnings move forever upward.) We don't care about the bumps; what matters are the overall results. But the decisions of other people are sometimes affected by the near-term outlook, which can both spur sellers and temper the enthusiasm of purchasers who might otherwise compete with us.

A second factor that helped us in 2000 was that the market for junk bonds dried up as the year progressed. In the two preceding years, junk bond purchasers had relaxed their standards, buying the obligations of ever-weaker issuers at inappropriate prices. The effects of this laxity were felt last year in a ballooning of defaults. In this environment, "financial" buyers of businesses — those who wish to buy using only a sliver of equity — became unable to borrow all they thought they needed. What they could still borrow, moreover, came at a high price. Consequently, LBO operators became less aggressive in their bidding when businesses came up for sale last year. Because we analyze purchases on an all-equity basis, our evaluations did not change, which means we became considerably more competitive.

Aside from the economic factors that benefited us, we now enjoy a major and growing advantage in making acquisitions in that we are often the buyer of choice for the seller. That fact, of course, doesn't assure a deal — sellers have to like our price, and we have to like their business and management — but it does help.

We find it meaningful when an owner *cares* about whom he sells to. We like to do business with someone who loves his company, not just the money that a sale will bring him (though we certainly understand why he likes that as well). When this emotional attachment exists, it signals that important qualities will likely be found within the business: honest accounting, pride of product, respect for customers, and a loyal group of associates having a strong sense of direction. The reverse is apt to be true, also. When an owner auctions off his business, exhibiting a total lack of interest in what follows, you will frequently find that it has been dressed up for sale, particularly when the seller is a "financial owner." And if owners behave with little regard for their business and its people, their conduct will often contaminate attitudes and practices throughout the company.

When a business masterpiece has been created by a lifetime — or several lifetimes — of unstinting care and exceptional talent, it should be important to the owner what corporation is entrusted to carry on its history. Charlie and I believe Berkshire provides an almost unique home. We take our obligations to the people who created a business very seriously, and Berkshire’s ownership structure ensures that we can fulfill our promises. When we tell John Justin that his business will remain headquartered in Fort Worth, or assure the Bridge family that its operation will not be merged with another jeweler, these sellers can take those promises to the bank.

How much better it is for the “painter” of a business Rembrandt to personally select its permanent home than to have a trust officer or uninterested heirs auction it off. Throughout the years we have had great experiences with those who recognize that truth and apply it to their business creations. We’ll leave the auctions to others.

The Economics of Property/Casualty Insurance

Our main business — though we have others of great importance — is insurance. To understand Berkshire, therefore, it is necessary that you understand how to evaluate an insurance company. The key determinants are: (1) the amount of float that the business generates; (2) its cost; and (3) most critical of all, the long-term outlook for both of these factors.

To begin with, float is money we hold but don't own. In an insurance operation, float arises because premiums are received before losses are paid, an interval that sometimes extends over many years. During that time, the insurer invests the money. This pleasant activity typically carries with it a downside: The premiums that an insurer takes in usually do not cover the losses and expenses it eventually must pay. That leaves it running an "underwriting loss," which is the cost of float. An insurance business has value if its cost of float over time is less than the cost the company would otherwise incur to obtain funds. But the business is a lemon if its cost of float is higher than market rates for money.

A caution is appropriate here: Because loss costs must be estimated, insurers have enormous latitude in figuring their underwriting results, and that makes it very difficult for investors to calculate a company's true cost of float. Errors of estimation, usually innocent but sometimes not, can be huge. The consequences of these miscalculations flow directly into earnings. An experienced observer can usually detect large-scale errors in reserving, but the general public can typically do no more than accept what's presented, and at times I have been amazed by the numbers that big-name auditors have implicitly blessed. Both the income statements and balance sheets of insurers can be minefields.

At Berkshire, we strive to be both consistent and conservative in our reserving. But we will make mistakes. And we warn you that there is nothing symmetrical about surprises in the insurance business: They almost always are unpleasant.

The table that follows shows (at intervals) the float generated by the various segments of Berkshire's insurance operations since we entered the business 34 years ago upon acquiring National Indemnity Company (whose traditional lines are included in the segment "Other Primary"). For the table we have calculated our float — which we generate in large amounts relative to our premium volume — by adding net loss reserves, loss adjustment reserves, funds held under reinsurance assumed and unearned premium reserves, and then subtracting insurance-related receivables, prepaid acquisition costs, prepaid taxes and deferred charges applicable to assumed reinsurance. (Don't panic, there won't be a quiz.)

Yearend Float (in $ millions)

Year	GEICO	General Re	Other Reinsurance	Other Primary	Total
1967				20	20
1977			40	131	171
1987			701	807	1,508
1997	2,917		4,014	455	7,386
1998	3,125	14,909	4,305	415	22,754
1999	3,444	15,166	6,285	403	25,298
2000	3,943	15,525	7,805	598	27,871

We're pleased by the growth in our float during 2000 but not happy with its cost. Over the years, our cost of float has been very close to zero, with the underwriting profits realized in most years offsetting the occasional terrible year such as 1984, when our cost was a staggering 19%. In 2000, however, we had an underwriting loss of $1.6 billion, which gave us a float cost of 6%. Absent a mega-catastrophe, we expect our float cost to fall in 2001 — perhaps substantially — in large part because of corrections in pricing at General Re that should increasingly be felt as the year progresses. On a smaller scale, GEICO may experience the same improving trend.

There are two factors affecting our cost of float that are very rare at other insurers but that now loom large at Berkshire. First, a few insurers that are currently experiencing large losses have offloaded a significant portion of these on us in a manner that penalizes our current earnings but gives us float we can use for many years to come. After the loss that we incur in the first year of the policy, there are *no* further costs attached to this business.

When these policies are properly priced, we welcome the pain-today, gain-tomorrow effects they have. In 1999, $400 million of our underwriting loss (about 27.8% of the total) came from business of this kind and in 2000 the figure was $482 million (34.4% of our loss). We have no way of predicting how much similar business we will write in the future, but what we do get will typically be in large chunks. Because these transactions can materially distort our figures, we will tell you about them as they occur.

Other reinsurers have little taste for this insurance. They simply can't stomach what huge underwriting losses do to their reported results, even though these losses are produced by policies whose overall economics are certain to be favorable. You should be careful, therefore, in comparing our underwriting results with those of other insurers.

An even more significant item in our numbers — which, again, you won't find much of elsewhere — arises from transactions in which we assume *past* losses of a company that wants to put its troubles behind it. To illustrate, the XYZ insurance company might have last year bought a policy obligating us to pay the first $1 billion of losses and loss adjustment expenses from events that happened in, say, 1995 and earlier years. These contracts can be very large, though we always require a cap on our exposure. We entered into a number of such transactions in 2000 and expect to close several more in 2001.

Under GAAP accounting, this “retroactive” insurance neither benefits nor penalizes our current earnings. Instead, we set up an asset called “deferred charges applicable to assumed reinsurance,” in an amount reflecting the difference between the premium we receive and the (higher) losses we expect to pay (for which reserves are immediately established). We then amortize this asset by making annual charges to earnings that create equivalent underwriting losses. You will find the amount of the loss that we incur from these transactions in both our quarterly and annual management discussion. By their nature, these losses will continue for many years, often stretching into decades. As an offset, though, we have the use of float — lots of it.

Clearly, float carrying an annual cost of this kind is not as desirable as float we generate from policies that are expected to produce an underwriting profit (of which we have plenty). Nevertheless, this retroactive insurance should be decent business for us.

The net of all this is that a) I expect our cost of float to be very attractive in the future but b) rarely to return to a “no-cost” mode because of the annual charge that retroactive reinsurance will lay on us. Also — obviously — the ultimate benefits that we derive from float will depend not only on its cost but, fully as important, how effectively we deploy it.

Our retroactive business is almost single-handedly the work of Ajit Jain, whose praises I sing annually. It is impossible to overstate how valuable Ajit is to Berkshire. Don’t worry about my health; worry about his.

Last year, Ajit brought home a $2.4 billion reinsurance premium, perhaps the largest in history, from a policy that retroactively covers a major U.K. company. Subsequently, he wrote a large policy protecting the Texas Rangers from the possibility that Alex Rodriguez will become permanently disabled. As sports fans know, “A-Rod” was signed for $252 million, a record, and we think that our policy probably also set a record for disability insurance. We cover many other sports figures as well.

In another example of his versatility, Ajit last fall negotiated a very interesting deal with Grab.com, an Internet company whose goal was to attract millions of people to its site and there to extract information from them that would be useful to marketers. To lure these people, Grab.com held out the possibility of a $1 billion prize (having a $170 million present value) and we insured its payment. A message on the site explained that the chance of anyone winning the prize was low, and indeed no one won. But the possibility of a win was far from nil.

Writing such a policy, we receive a modest premium, face the possibility of a huge loss, and get good odds. Very few insurers like that equation. And they're unable to cure their unhappiness by reinsurance. Because each policy has unusual — and sometimes unique — characteristics, insurers can't lay off the occasional shock loss through their standard reinsurance arrangements. Therefore, any insurance CEO doing a piece of business like this must run the small, but real, risk of a horrible quarterly earnings number, one that he would not enjoy explaining to his board or shareholders. Charlie and I, however, like any proposition that makes compelling mathematical sense, regardless of its effect on reported earnings.

At General Re, the news has turned considerably better: Ron Ferguson, along with Joe Brandon, Tad Montross, and a talented supporting cast took many actions during 2000 to bring that company's profitability back to past standards. Though our pricing is not fully corrected, we have significantly repriced business that was severely unprofitable or dropped it altogether. If there's no mega-catastrophe in 2001, General Re's float cost should fall materially.

The last couple of years haven't been any fun for Ron and his crew. But they have stepped up to tough decisions, and Charlie and I applaud them for these. General Re has several important and enduring business advantages. Better yet, it has managers who will make the most of them.

In aggregate, our smaller insurance operations produced an excellent underwriting profit in 2000 while generating significant float — just as they have done for more than a decade. If these companies were a single and separate operation, people would consider it an outstanding insurer. Because the companies instead reside in an enterprise as large as Berkshire, the world may not appreciate their accomplishments — but I sure do. Last year I thanked Rod Eldred, John Kizer, Don Towle and Don Wurster, and I again do so. In addition, we now also owe thanks to Tom Nerney at U.S. Liability and Michael Stearns, the new head of Cypress.

You may notice that Brad Kinstler, who *was* CEO of Cypress and whose praises I've sung in the past, is no longer in the list above. That's because we needed a new manager at Fechheimer Bros., our Cincinnati-based uniform company, and called on Brad. We seldom move Berkshire managers from one enterprise to another, but maybe we should try it more often: Brad is hitting home runs in his new job, just as he always did at Cypress.

GEICO (1-800-847-7536 or GEICO.com)

We show below the usual table detailing GEICO's growth. Last year I enthusiastically told you that we would step up our expenditures on advertising in 2000 and that the added dollars were the best investment that GEICO could make. I was wrong: The extra money we spent did not produce a commensurate increase in inquiries. Additionally, the percentage of inquiries that we converted into sales fell for the first time in many years. These negative developments combined to produce a sharp increase in our per-policy acquisition cost.

Years	New Auto Policies(1)	Auto Policies In-Force(1)
1993	346,882	2,011,055
1994	384,217	2,147,549
1995	443,539	2,310,037
1996	592,300	2,543,699
1997	868,430	2,949,439
1998	1,249,875	3,562,644
1999	1,648,095	4,328,900
2000	1,472,853	4,696,842

(1) "Voluntary" only; excludes assigned risks and the like.

Agonizing over errors is a mistake. But acknowledging and analyzing them can be useful, though that practice is rare in corporate boardrooms. There, Charlie and I have almost never witnessed a candid post-mortem of a failed decision, *particularly one involving an acquisition*. A notable exception to this never-look-back approach is that of The Washington Post Company, which unfailingly and objectively reviews its acquisitions three years after they are made. Elsewhere, triumphs are trumpeted, but dumb decisions either get no follow-up or are rationalized.

The financial consequences of these boners are regularly dumped into massive restructuring charges or write-offs that are casually waved off as “nonrecurring.” Managements just love these. Indeed, in recent years it has seemed that no earnings statement is complete without them. The origins of these charges, though, are never explored. When it comes to corporate blunders, CEOs invoke the concept of the Virgin Birth.

To get back to our examination of GEICO: There are at least four factors that could account for the increased costs we experienced in obtaining new business last year, and all probably contributed in some manner.

First, in our advertising we have pushed “frequency” very hard, and we probably overstepped in certain media. We’ve always known that increasing the number of messages through any medium would eventually produce diminishing returns. The third ad in an hour on a given cable channel is simply not going to be as effective as the first.

Second, we may have already picked much of the low-hanging fruit. Clearly, the willingness to do business with a direct marketer of insurance varies widely among individuals: Indeed, some percentage of Americans — particularly older ones — are reluctant to make direct purchases of any kind. Over the years, however, this reluctance will ebb. A new generation with new habits will find the savings from direct purchase of their auto insurance too compelling to ignore.

Another factor that surely decreased the conversion of inquiries into sales was stricter underwriting by GEICO. Both the frequency and severity of losses increased during the year, and rates in certain areas became inadequate, in some cases substantially so. In these instances, we necessarily tightened our underwriting standards. This tightening, as well as the many rate increases we put in during the year, made our offerings less attractive to some prospects.

A high percentage of callers, it should be emphasized, can still save money by insuring with us. Understandably, however, some prospects will switch to save $200 per year but will not switch to save $50. Therefore, rate increases that bring our prices closer to those of our competitors will hurt our acceptance rate, even when we continue to offer the best deal.

Finally, the competitive picture changed in at least one important respect: State Farm — by far the largest personal auto insurer, with about 19% of the market — has been very slow to raise prices. Its costs, however, are clearly increasing right along with those of the rest of the industry. Consequently, State Farm had an underwriting loss last year from auto insurance (including rebates to policyholders) of 18% of premiums, compared to 4% at GEICO. Our loss produced a float cost for us of 6.1%, an unsatisfactory result. (Indeed, at GEICO we expect float, over time, to be free.) But we estimate that State Farm's float cost in 2000 was about 23%. The willingness of the largest player in the industry to tolerate such a cost makes the economics difficult for other participants.

That does not take away from the fact that State Farm is one of America's greatest business stories. I've urged that the company be studied at business schools because it has achieved fabulous success while following a path that in many ways defies the dogma of those institutions. Studying counter-evidence is a highly useful activity, though not one always greeted with enthusiasm at citadels of learning.

State Farm was launched in 1922, by a 45-year-old, semi-retired Illinois farmer, to compete with long-established insurers — haughty institutions in New York, Philadelphia and Hartford — that possessed overwhelming advantages in capital, reputation, and distribution. Because State Farm is a mutual company, its board members and managers could not be owners, and it had no access to capital markets during its years of fast growth. Similarly, the business never had the stock options or lavish salaries that many people think vital if an American enterprise is to attract able managers and thrive.

In the end, however, State Farm eclipsed all its competitors. In fact, by 1999 the company had amassed a tangible net worth exceeding that of all but four American businesses. If you want to read how this happened, get a copy of *The Farmer from Merna*.

Despite State Farm's strengths, however, GEICO has much the better business model, one that embodies significantly lower operating costs. And, when a company is selling a product with commodity-like economic characteristics, being the low-cost producer is all-important. This enduring competitive advantage of GEICO — one it possessed in 1951 when, as a 20-year-old student, I first became enamored with its stock — is the reason that over time it will inevitably increase its market share significantly while simultaneously achieving excellent profits. Our growth will be slow, however, if State Farm elects to continue bearing the underwriting losses that it is now suffering.

Tony Nicely, GEICO's CEO, remains an owner's dream. Everything he does makes sense. He never engages in wishful thinking or otherwise distorts reality, as so many managers do when the unexpected happens. As 2000 unfolded, Tony cut back on advertising that was not cost-effective, and he will continue to do that in 2001 if cutbacks are called for (though we will always maintain a *massive* media presence). Tony has also aggressively filed for price increases where we need them. He looks at the loss reports every day and is never behind the curve. To steal a line from a competitor, we are in good hands with Tony.

I've told you about our profit-sharing arrangement at GEICO that targets only two variables — growth in policies and the underwriting results of seasoned business. Despite the headwinds of 2000, we still had a performance that produced an 8.8% profit-sharing payment, amounting to $40.7 million.

GEICO will be a huge part of Berkshire's future. Because of its rock-bottom operating costs, it offers a great many Americans the cheapest way to purchase a high-ticket product that they *must* buy. The company then couples this bargain with service that consistently ranks high in independent surveys. That's a combination inevitably producing growth and profitability.

In just the last few years, *far* more drivers have learned to associate the GEICO brand with saving money on their insurance. We will pound that theme relentlessly until all Americans are aware of the value that we offer.

Investments

Below we present our common stock investments. Those that had a market value of more than $1 billion at the end of 2000 are itemized.

		12/31/00	
Shares	*Company*	*Cost*	*Market*
		(dollars in millions)	
151,610,700	American Express Company	$1,470	$ 8,329
200,000,000	The Coca-Cola Company	1,299	12,188
96,000,000	The Gillette Company	600	3,468
1,727,765	The Washington Post Company	11	1,066
55,071,380	Wells Fargo & Company	319	3,067
	Others	6,703	9,501
	Total Common Stocks	$10,402	$ 37,619

In 2000, we sold nearly all of our Freddie Mac and Fannie Mae shares, established 15% positions in several mid-sized companies, bought the high-yield bonds of a few issuers (very few — the category is not labeled junk without reason) and added to our holdings of high-grade, mortgage-backed securities. There are no “bargains” among our current holdings: We’re content with what we own but far from excited by it.

Many people assume that marketable securities are Berkshire’s first choice when allocating capital, but that’s not true: Ever since we first published our economic principles in 1983, we have consistently stated that we would rather purchase businesses than stocks. (See number 4 on page 60.) One reason for that preference is personal, in that I love working with our managers. They are high-grade, talented and loyal. And, frankly, I find their business behavior to be more rational and owner-oriented than that prevailing at many public companies.

But there’s also a powerful financial reason behind the preference, and that has to do with taxes. The tax code makes Berkshire’s owning 80% or more of a business far more profitable for us, proportionately, than our owning a smaller share. When a company we own all of earns $1 million after tax, the entire amount inures to our benefit. If the $1 million is upstreamed to Berkshire, we owe no tax on the dividend. And, if the earnings are retained and we were to sell the subsidiary — not likely at Berkshire! — for $1million more than we paid for it, we would owe no capital gains tax. That’s because our “tax cost” upon sale would include both what we paid for the business and all earnings it subsequently retained.

Contrast that situation to what happens when we own an investment in a marketable security. There, if we own a 10% stake in a business earning $10 million after tax, our $1 million share of the earnings is subject to *additional* state and federal taxes of (1) about $140,000 if it is distributed to us (our tax rate on most dividends is 14%); or (2) no less than $350,000 if the $1 million is retained and subsequently captured by us in the form of a capital gain (on which our tax rate is usually about 35%, though it sometimes approaches 40%). We may defer paying the $350,000 by not immediately realizing our gain, but eventually we must pay the tax. In effect, the government is our “partner” twice when we own part of a business through a stock investment, but only once when we own at least 80%.

Leaving aside tax factors, the formula we use for evaluating stocks and businesses is identical. Indeed, the formula for valuing *all* assets that are purchased for financial gain has been unchanged since it was first laid out by a very smart man in about 600 B.C. (though he wasn’t smart enough to know it was 600 B.C.).

The oracle was Aesop and his enduring, though somewhat incomplete, investment insight was “a bird in the hand is worth two in the bush.” To flesh out this principle, you must answer only three questions. How certain are you that there are indeed birds in the bush? When will they emerge and how many will there be? What is the risk-free interest rate (which we consider to be the yield on long-term U.S. bonds)? If you can answer these three questions, you will know the maximum value of the bush — and the maximum number of the birds you now possess that should be offered for it. And, of course, don’t literally think birds. Think dollars.

Aesop’s investment axiom, thus expanded and converted into dollars, is immutable. It applies to outlays for farms, oil royalties, bonds, stocks, lottery tickets, and manufacturing plants. And neither the advent of the steam engine, the harnessing of electricity nor the creation of the automobile changed the formula one iota — nor will the Internet. Just insert the correct numbers, and you can rank the attractiveness of all possible uses of capital throughout the universe.

Common yardsticks such as dividend yield, the ratio of price to earnings or to book value, and even growth rates have *nothing* to do with valuation except to the extent they provide clues to the amount and timing of cash flows into and from the business. Indeed, growth can destroy value if it requires cash inputs in the early years of a project or enterprise that exceed the discounted value of the cash that those assets will generate in later years. Market commentators and investment managers who glibly refer to "growth" and "value" styles as contrasting approaches to investment are displaying their ignorance, not their sophistication. Growth is simply a component — usually a plus, sometimes a minus — in the value equation.

Alas, though Aesop's proposition and the third variable — that is, interest rates — are simple, plugging in numbers for the other two variables is a difficult task. Using precise numbers is, in fact, foolish; working with a range of possibilities is the better approach.

Usually, the range must be so wide that no useful conclusion can be reached. Occasionally, though, even very conservative estimates about the future emergence of birds reveal that the price quoted is startlingly low in relation to value. (Let's call this phenomenon the IBT — Inefficient Bush Theory.) To be sure, an investor needs some general understanding of business economics as well as the ability to think independently to reach a well-founded positive conclusion. But the investor does not need brilliance nor blinding insights.

At the other extreme, there are many times when the *most* brilliant of investors can't muster a conviction about the birds to emerge, not even when a very broad range of estimates is employed. This kind of uncertainty frequently occurs when new businesses and rapidly changing industries are under examination. In cases of this sort, *any* capital commitment must be labeled speculative.

Now, speculation — in which the focus is not on what an asset will produce but rather on what the next fellow will pay for it — is neither illegal, immoral nor un-American. But it is not a game in which Charlie and I wish to play. We bring nothing to the party, so why should we expect to take anything home?

The line separating investment and speculation, which is never bright and clear, becomes blurred still further when most market participants have recently enjoyed triumphs. Nothing sedates rationality like large doses of effortless money. After a heady experience of that kind, normally sensible people drift into behavior akin to that of Cinderella at the ball. They know that overstaying the festivities — that is, continuing to speculate in companies that have gigantic valuations relative to the cash they are likely to generate in the future — will eventually bring on pumpkins and mice. But they nevertheless hate to miss a single minute of what is one helluva party. Therefore, the giddy participants all plan to leave just seconds before midnight. There's a problem, though: They are dancing in a room in which the clocks have no hands.

Last year, we commented on the exuberance — and, yes, it was irrational — that prevailed, noting that investor expectations had grown to be several multiples of probable returns. One piece of evidence came from a Paine Webber-Gallup survey of investors conducted in December 1999, in which the participants were asked their opinion about the annual returns investors could expect to realize over the decade ahead. Their answers averaged 19%. That, for sure, was an irrational expectation: For American business as a whole, there couldn't possibly be enough birds in the 2009 bush to deliver such a return.

Far more irrational still were the huge valuations that market participants were then putting on businesses almost certain to end up being of modest or no value. Yet investors, mesmerized by soaring stock prices and ignoring all else, piled into these enterprises. It was as if some virus, racing wildly among investment professionals as well as amateurs, induced hallucinations in which the values of stocks in certain sectors became decoupled from the values of the businesses that underlay them.

This surreal scene was accompanied by much loose talk about "value creation." We readily acknowledge that there has been a huge amount of true value created in the past decade by new or young businesses, and that there is much more to come. But value is destroyed, not created, by any business that loses money over its lifetime, no matter how high its interim valuation may get.

What actually occurs in these cases is wealth *transfer*, often on a massive scale. By shamelessly merchandising birdless bushes, promoters have in recent years moved billions of dollars from the pockets of the public to their own purses (and to those of their friends and associates). The fact is that a bubble market has allowed the creation of bubble companies, entities designed more with an eye to making money *off* investors rather than *for* them. Too often, an IPO, not profits, was the primary goal of a company's promoters. At bottom, the "business model" for these companies has been the old-fashioned chain letter, for which many fee-hungry investment bankers acted as eager postmen.

But a pin lies in wait for every bubble. And when the two eventually meet, a new wave of investors learns some very old lessons: First, many in Wall Street — a community in which quality control is not prized — will sell investors anything they will buy. Second, speculation is most dangerous when it looks easiest.

At Berkshire, we make *no* attempt to pick the few winners that will emerge from an ocean of unproven enterprises. We're not smart enough to do that, and we know it. Instead, we try to apply Aesop's 2,600-year-old equation to opportunities in which we have reasonable confidence as to how many birds are in the bush and when they will emerge (a formulation that my grandsons would probably update to "A girl in a convertible is worth five in the phonebook."). Obviously, we can never precisely predict the timing of cash flows in and out of a business or their exact amount. We try, therefore, to keep our estimates conservative and to focus on industries where business surprises are unlikely to wreak havoc on owners. Even so, we make many mistakes: I'm the fellow, remember, who thought he understood the future economics of trading stamps, textiles, shoes and second-tier department stores.

Lately, the most promising "bushes" have been negotiated transactions for entire businesses, and that pleases us. You should clearly understand, however, that these acquisitions will at best provide us only reasonable returns. Really juicy results from negotiated deals can be anticipated only when capital markets are severely constrained and the whole business world is pessimistic. We are 180 degrees from that point.

Sources of Reported Earnings

The table that follows shows the main sources of Berkshire's reported earnings. In this presentation, purchase-accounting adjustments are not assigned to the specific businesses to which they apply, but are instead aggregated and shown separately. This procedure lets you view the earnings of our businesses as they would have been reported had we not purchased them. For the reasons discussed on page 65, this form of presentation seems to us to be more useful to investors and managers than one utilizing generally accepted accounting principles (GAAP), which require purchase-premiums to be charged off business-by-business. The total net earnings we show in the table are, of course, identical to the GAAP total in our audited financial statements.

	(in millions)			
	Pre-Tax Earnings		*Berkshire's Share of Net Earnings (after taxes and minority interests)*	
	2000	*1999*	*2000*	*1999*
Operating Earnings:				
Insurance Group:				
Underwriting – Reinsurance	$(1,399)	$(1,440)	$(899)	$(927)
Underwriting – GEICO	(224)	24	(146)	16
Underwriting – Other Primary	38	22	24	14
Net Investment Income	2,747	2,482	1,929	1,764
Finance and Financial Products Business	556	125	360	86
Flight Services	213	225	126	132
MidAmerican Energy (76% owned)	197	--	109	--
Retail Operations	175	130	104	77
Scott Fetzer (excluding finance operation)	122	147	80	92
Other Businesses	225	210	134	131
Purchase-Accounting Adjustments	(881)	(739)	(843)	(648)
Corporate Interest Expense	(92)	(109)	(61)	(70)
Shareholder-Designated Contributions	(17)	(17)	(11)	(11)
Other	39	25	30	15
Operating Earnings	1,699	1,085	936	671
Capital Gains from Investments	3,955	1,365	2,392	886
Total Earnings – All Entities	$5,654	$2,450	$3,328	$1,557

Most of our manufacturing, retailing and service businesses did at least reasonably well last year.

The exception was shoes, particularly at Dexter. In our shoe businesses generally, our attempt to keep the bulk of our production in domestic factories has cost us dearly. We face another very tough year in 2001 also, as we make significant changes in how we do business.

I clearly made a mistake in paying what I did for Dexter in 1993. Furthermore, I compounded that mistake in a huge way by using Berkshire shares in payment. Last year, to recognize my error, we charged off all the remaining accounting goodwill that was attributable to the Dexter transaction. We may regain some economic goodwill at Dexter in the future, but we clearly have none at present.

The managers of our shoe businesses are first-class from both a business and human perspective. They are working very hard at a tough — and often terribly painful — job, even though their personal financial circumstances don't require them to do so. They have my admiration and thanks.

On a more pleasant note, we continue to be the undisputed leader in two branches of Aircraft Services — pilot training at FlightSafety (FSI) and fractional ownership of business jets at Executive Jet (EJA). Both companies are run by their remarkable founders.

Al Ueltschi at FSI is now 83 and continues to operate at full throttle. Though I am not a fan of stock splits, I am planning to split Al's age 2-for-1 when he hits 100. (If it works, guess who's next.)

We spent $272 million on flight simulators in 2000, and we'll spend a similar amount this year. Anyone who thinks that the annual charges for depreciation don't reflect a real cost — every bit as real as payroll or raw materials — should get an internship at a simulator company. Every year we spend amounts equal to our depreciation charge simply to stay in the same economic place — and then spend additional sums to grow. And growth is in prospect for FSI as far as the eye can see.

Even faster growth awaits EJA (whose fractional-ownership program is called NetJets—). Rich Santulli is the dynamo behind this business.

Last year I told you that EJA's recurring revenue from monthly management fees and hourly usage grew by 46% in 1999. In 2000 the growth was 49%. I also told you that this was a low-margin business, in which survivors will be few. Margins were indeed slim at EJA last year, in part because of the major costs we are incurring in developing our business in Europe.

Regardless of the cost, you can be sure that EJA’s spending on safety will be whatever is needed. Obviously, we would follow this policy under any circumstances, but there’s some self-interest here as well: I, my wife, my children, my sisters, my 94-year-old aunt, all but one of our directors, and at least nine Berkshire managers regularly fly in the NetJets program. Given that cargo, I applaud Rich’s insistence on unusually high amounts of pilot training (an average of 23 days a year). In addition, our pilots cement their skills by flying 800 or so hours a year. Finally, each flies only one model of aircraft, which means our crews do no switching around among planes with different cockpit and flight characteristics.

EJA’s business continues to be constrained by the availability of new aircraft. Still, our customers will take delivery of more than 50 new jets in 2001, 7% of world output. We are confident we will remain the world leader in fractional ownership, in respect to number of planes flying, quality of service, and standards of safety.

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Additional information about our various businesses is given on pages 42-58, where you will also find our segment earnings reported on a GAAP basis. In addition, on pages 67-73, we have rearranged Berkshire’s financial data into four segments on a non-GAAP basis, a presentation that corresponds to the way Charlie and I think about the company.

Look-Through Earnings

Reported earnings are an inadequate measure of economic progress at Berkshire, in part because the numbers shown in the table on page 15 include only the dividends we receive from investees — though these dividends typically represent only a small fraction of the earnings attributable to our ownership. To depict something closer to economic reality at Berkshire than reported earnings, though, we employ the concept of "lookthrough" earnings. As we calculate these, they consist of: (1) the operating earnings reported on page 15; plus; (2) our share of the retained operating earnings of major investees that, under GAAP accounting, are not reflected in our profits, less; (3) an allowance for the tax that would be paid by Berkshire if these retained earnings of investees had instead been distributed to us. When tabulating "operating earnings" here, we exclude purchase-accounting adjustments as well as capital gains and other major non-recurring items.

The following table sets forth our 2000 look-through earnings, though I warn you that the figures can be no more than approximate, since they are based on a number of judgment calls. (The dividends paid to us by these investees have been included in the operating earnings itemized on page 15, mostly under "Insurance Group: Net Investment Income.")

Berkshire's Major Investees	Berkshire's Approximate Ownership at Yearend(1)	Berkshire's Share of Undistributed Operating Earnings (in millions)(2)
American Express Company	11.4%	$265
The Coca-Cola Company	8.1%	160
Freddie Mac	0.3%	106
The Gillette Company	9.1%	51
M&T Bank	7.2%	23
The Washington Post Company	18.3%	18
Wells Fargo & Company	3.2%	117
Berkshire's share of undistributed earnings of major investees		740
Hypothetical tax on these undistributed investee earnings(3)		(104)
Reported operating earnings of Berkshire		1,779
Total look-through earnings of Berkshire		$ 2,415

(1) Does not include shares allocable to minority interests
(2) Calculated on average ownership for the year
(3) The tax rate used is 14%, which is the rate Berkshire pays on most dividends it receives

Full and Fair Reporting

At Berkshire, full reporting means giving you the information that we would wish you to give to us if our positions were reversed. What Charlie and I would want under that circumstance would be all the important facts about current operations as well as the CEO’s frank view of the long-term economic characteristics of the business. We would expect both a lot of financial details and a discussion of any significant data we would need to interpret what was presented.

When Charlie and I read reports, we have no interest in pictures of personnel, plants or products. References to EBITDA make us shudder — does management think the tooth fairy pays for capital expenditures? We're very suspicious of accounting methodology that is vague or unclear, since too often that means management wishes to hide something. And we don't want to read messages that a public relations department or consultant has turned out. Instead, we expect a company's CEO to explain in his or her own words what's happening.

For us, fair reporting means getting information to our 300,000 "partners" simultaneously, or as close to that mark as possible. We therefore put our annual and quarterly financials on the Internet between the close of the market on a Friday and the following morning. By our doing that, shareholders and other interested investors have timely access to these important releases and also have a reasonable amount of time to digest the information they include before the markets open on Monday. This year our quarterly information will be available on the Saturdays of May 12, August 11, and November 10. The 2001 annual report will be posted on March 9.

We applaud the work that Arthur Levitt, Jr., until recently Chairman of the SEC, has done in cracking down on the corporate practice of "selective disclosure" that had spread like cancer in recent years. Indeed, it had become virtually standard practice for major corporations to "guide" analysts or large holders to earnings expectations that were intended either to be on the nose or a tiny bit below what the company truly expected to earn. Through the selectively dispersed hints, winks and nods that companies engaged in, speculatively-minded institutions and advisors were given an information edge over investment-oriented individuals. This was corrupt behavior, unfortunately embraced by both Wall Street and corporate America.

Thanks to Chairman Levitt, whose general efforts on behalf of investors were both tireless and effective, corporations are now required to treat all of their owners equally. The fact that this reform came about because of coercion rather than conscience should be a matter of shame for CEOs and their investor relations departments.

One further thought while I'm on my soapbox: Charlie and I think it is both deceptive and dangerous for CEOs to predict growth rates for their companies. They are, of course, frequently egged on to do so by both analysts and their own investor relations departments. They should resist, however, because too often these predictions lead to trouble.

It's fine for a CEO to have his own internal goals and, in our view, it's even appropriate for the CEO to publicly express some hopes about the future, if these expectations are accompanied by sensible caveats. But for a major corporation to predict that its per-share earnings will grow over the long term at, say, 15% annually is to court trouble.

That's true because a growth rate of that magnitude can only be maintained by a very small percentage of large businesses. Here's a test: Examine the record of, say, the 200 highest earning companies from 1970 or 1980 and tabulate how many have increased per-share earnings by 15% annually since those dates. You will find that only a handful have. I would wager you a very significant sum that fewer than 10 of the 200 most profitable companies in 2000 will attain 15% annual growth in earnings-per-share over the next 20 years.

The problem arising from lofty predictions is not just that they spread unwarranted optimism. Even more troublesome is the fact that they corrode CEO behavior. Over the years, Charlie and I have observed many instances in which CEOs engaged in uneconomic operating maneuvers so that they could meet earnings targets they had announced. Worse still, after exhausting all that operating acrobatics would do, they sometimes played a wide variety of accounting games to "make the numbers." These accounting shenanigans have a way of snowballing: Once a company moves earnings from one period to another, operating shortfalls that occur thereafter require it to engage in further accounting maneuvers that must be even more "heroic." These can turn fudging into fraud. (More money, it has been noted, has been stolen with the point of a pen than at the point of a gun.)

Charlie and I tend to be leery of companies run by CEOs who woo investors with fancy predictions. A few of these managers will prove prophetic — but others will turn out to be congenital optimists, or even charlatans. Unfortunately, it's not easy for investors to know in advance which species they are dealing with.

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I've warned you in the past that you should not believe everything you read or hear about Berkshire — even when it is published or broadcast by a prestigious news organization. Indeed, erroneous reports are particularly dangerous when they are circulated by highly-respected members of the media, simply because most readers and listeners know these outlets to be generally credible and therefore believe what they say.

An example is a glaring error about Berkshire's activities that appeared in the December 29 issue of *The Wall Street Journal*, a generally excellent paper that I have for all of my life found useful. On the front page (and above the fold, as they say) *The Journal* published a news brief that said, in unequivocal terms, that we were buying bonds of Conseco and Finova. This item directed the reader to the lead story of the Money and Investing section. There, in the second paragraph of the story, *The Journal* reported, *again without any qualification*, that Berkshire was buying Conseco and Finova bonds, adding that Berkshire had invested "several hundred million dollars" in each. Only in the 18th paragraph of the story (which by that point had jumped to an inside page) did the paper hedge a bit, saying that our Conseco purchases had been disclosed by "people familiar with the matter."

Well, not *that* familiar. True, we had purchased bonds and bank debt of Finova — though the report was wildly inaccurate as to the amount. But to this day neither Berkshire nor I have *ever* bought a share of stock or a bond of Conseco.

Berkshire is normally covered by a *Journal* reporter in Chicago who is both accurate and conscientious. In this case, however, the "scoop" was the product of a New York reporter for the paper. Indeed, the 29th was a busy day for him: By early afternoon, he had repeated the story on CNBC. Immediately, in lemming-like manner, other respected news organizations, relying solely on the *Journal*, began relating the same "facts." The result: Conseco stock advanced sharply during the day on exceptional volume that placed it ninth on the NYSE most-active list.

During all of the story's iterations, I never heard or read the word "rumor." Apparently reporters and editors, who generally pride themselves on their careful use of language, just can't bring themselves to attach this word to their accounts. But what description would fit more precisely? Certainly not the usual "sources say" or "it has been reported."

A column entitled "Today's Rumors," however, would not equate with the self-image of the many news organizations that think themselves above such stuff. These members of the media would feel that publishing such acknowledged fluff would be akin to *L'Osservatore Romano* initiating a gossip column. But rumors are what these organizations often publish and broadcast, whatever euphemism they duck behind. At a minimum, readers deserve honest terminology — a warning label that will protect their financial health in the same way that smokers whose physical health is at risk are given a warning.

The Constitution's First Amendment allows the media to print or say almost anything. Journalism's First Principle should require that the media be scrupulous in deciding what that will be.

Miscellaneous

In last year's report we examined the battle then raging over the use of "pooling" in accounting for mergers. It seemed to us that both sides were voicing arguments that were strong in certain respects and seriously flawed in others. We are pleased that the Financial Accounting Standards Board has since gone to an alternative approach that strikes us as very sound.

If the proposed rule becomes final, we will no longer incur a large annual charge for amortization of intangibles. Consequently, our reported earnings will more closely reflect economic reality. (See page 65.) None of this will have an effect on Berkshire's intrinsic value. Your Chairman, however, will personally benefit in that there will be one less item to explain in these letters.

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I'm enclosing a report — generously supplied by *Outstanding Investor Digest* — of Charlie's remarks at last May's Wesco annual meeting. Charlie thinks about business economics and investment matters better than anyone I know, and I’ve learned a lot over the years by listening to him. Reading his comments will improve your understanding of Berkshire.

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In 1985, we purchased Scott Fetzer, acquiring not only a fine business but the services of Ralph Schey, a truly outstanding CEO, as well. Ralph was then 61. Most companies, focused on the calendar rather than ability, would have benefited from Ralph’s talents for only a few years.

At Berkshire, in contrast, Ralph ran Scott Fetzer for 15 years until his retirement at the end of 2000. Under his leadership, the company distributed $1.03 billion to Berkshire against our net purchase price of $230 million. We used these funds, in turn, to purchase other businesses. All told, Ralph’s contributions to Berkshire’s present value extend well into the billions of dollars.

As a manager, Ralph belongs in Berkshire’s Hall of Fame, and Charlie and I welcome him to it.

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A bit of nostalgia: It was exactly 50 years ago that I entered Ben Graham’s class at Columbia. During the decade before, I had enjoyed — make that *loved* — analyzing, buying and selling stocks. But my results were no better than average.

Beginning in 1951 my performance improved. No, I hadn’t changed my diet or taken up exercise. The only new ingredient was Ben’s ideas. Quite simply, a few hours spent at the feet of the master proved far more valuable to me than had ten years of supposedly original thinking.

In addition to being a great teacher, Ben was a wonderful friend. My debt to him is incalculable.

Shareholder-Designated Contributions

About 97% of all eligible shares participated in Berkshire's 2000 shareholder-designated contributions program, with contributions totaling $16.9 million. A full description of the program appears on pages 74-75.

Cumulatively, over the 20 years of the program, Berkshire has made contributions of $164 million pursuant to the instructions of our shareholders. The rest of Berkshire's giving is done by our subsidiaries, which stick to the philanthropic patterns that prevailed before they were acquired (except that their former owners themselves take on the responsibility for their personal charities). In aggregate, our subsidiaries made contributions of $18.3 million in 2000, including in-kind donations of $3 million.

To participate in future programs, you must own Class A shares that are registered in the name of the actual owner, not the nominee name of a broker, bank or depository. Shares not so registered on August 31, 2001 will be ineligible for the 2001 program. When you get the contributions form from us, return it promptly so that it does not get put aside or forgotten. Designations received after the due date will not be honored.

The Annual Meeting

Last year we moved the annual meeting to the Civic Auditorium, and it worked very well for us. We will meet there again on Saturday, April 28. The doors will open at 7 a.m., the movie will begin at 8:30, and the meeting itself will commence at 9:30. There will be a short break at noon for food, with sandwiches available at the Civic’s concession stands. Except for that interlude, Charlie and I will answer questions until 3:30.

For the next couple of years, the Civic is our only choice. We must therefore hold the meeting on either Saturday or Sunday to avoid the traffic and parking nightmare that would occur on a weekday. Shortly, however, Omaha will have a new Convention Center with ample parking. Assuming that the Center is then available to us, I will poll shareholders to see whether you wish to return to a Monday meeting. We will decide that vote based on the wishes of a majority of shareholders, not shares.

An attachment to the proxy material that is enclosed with this report explains how you can obtain the credential you will need for admission to this year's meeting and other events. As for plane, hotel and car reservations, we have again signed up American Express (800-799-6634) to give you special help. In our normal fashion, we will run buses from the larger hotels to the meeting. After the meeting, the buses will make trips back to the hotels and to Nebraska Furniture Mart, Borsheim's and the airport. Even so, you are likely to find a car useful.

We have added so many new companies to Berkshire this year that I'm not going to detail all of the products that we will be *selling* at the meeting. But come prepared to carry home everything from bricks to candy. One new product, however, deserves special note: Bob Shaw has designed a 3 x 5 rug featuring an excellent likeness of Charlie. Obviously, it would be embarrassing for Charlie — make that humiliating — if slow sales forced us to slash the rug's price, so step up and do your part.

GEICO will have a booth staffed by a number of its top counselors from around the country, all of them ready to supply you with auto insurance quotes. In most cases, GEICO will be able to offer you a special shareholder's discount (usually 8%). Bring the details of your existing insurance and check out whether we can save you some money.

At the Omaha airport on Saturday, we will have the usual array of aircraft from Executive Jet available for your inspection. Just ask an EJA representative at the Civic about viewing any of these planes. If you buy what we consider an appropriate number of items during the weekend, you may well need your own plane to take them home.

At Nebraska Furniture Mart, located on a 75-acre site on 72nd Street between Dodge and Pacific, we will again be having "Berkshire Weekend" pricing, which means we will be offering our shareholders a discount that is customarily given only to employees. We initiated this special pricing at NFM four years ago and sales during the "Weekend" grew from \$5.3 million in 1997 to \$9.1 million in 2000.

To get the discount, you must make your purchases between Wednesday, April 25 and Monday, April 30 and also present your meeting credential.

The period's special pricing will even apply to the products of several prestige manufacturers that normally have ironclad rules against discounting but that, in the spirit of our shareholder weekend, have made an exception for you. We appreciate their cooperation. NFM is open from 10 a.m. to 9 p.m. on weekdays and 10 a.m. to 6 p.m. on Saturdays and Sundays.

Borsheim's — the largest jewelry store in the country except for Tiffany's Manhattan store — will have two shareholder-only events. The first will be a cocktail reception from 6 p.m. to 10 p.m. on Friday, April 27. The second, the main gala, will be from 9 a.m. to 5 p.m. on Sunday, April 29. Shareholder prices will be available Thursday through Monday, so if you wish to avoid the large crowds that will assemble on Friday evening and Sunday, come at other times and identify yourself as a shareholder. On Saturday, we will be open until 6 p.m. Borsheim's operates on a gross margin that is fully twenty percentage points below that of its major rivals, so the more you buy, the more you save (or at least that's what my family always tells me).

In the mall outside of Borsheim's, we will have local bridge experts available to play with our shareholders on Sunday. Bob Hamman, who normally is with us, will be in Africa this year. He has promised, however, to be on hand in 2002. Patrick Wolff, twice U.S. chess champion, will also be in the mall, taking on all comers — blindfolded! Last year, Patrick played as many as six games simultaneously — with his blindfold securely in place — and demolished his opponents.

As if all this isn't enough to test your skills, our Borsheim's Olympiad this year will also include Bill Robertie, one of only two players to twice win the backgammon world championship. Backgammon can be a big money game, so bring along your stock certificates.

Gorat's — my favorite steakhouse — will again be open exclusively for Berkshire shareholders on Sunday, April 29, and will be serving from 4 p.m. until 10 p.m. Please remember that you can't come to Gorat's on Sunday without a reservation. To make one, call 402-551-3733 on April 2 (*but not before*). If Sunday is sold out, try Gorat's on one of the other evenings you will be in town. If you order a rare T-bone with a double order of hash browns, you will establish your credentials as an epicure.

The usual baseball game will be held at Rosenblatt Stadium at 7 p.m. on Saturday night. This year the Omaha Golden Spikes will play the New Orleans Zephyrs. Ernie Banks is again going to be on hand to — bravely — face my fastball (once clocked at 95 mpm — miles per month).

My performance last year was not my best: It took me five pitches to throw anything resembling a strike. And, believe me, it gets lonely on the mound when you can't find the plate. Finally, I got one over, and Ernie lashed a line drive to left field. After I was yanked from the game, the many sports writers present asked what I had served up to Ernie. I quoted what Warren Spahn said after Willie Mays hit one of his pitches for a home run (Willie's first in the majors): "It was a helluva pitch for the first sixty feet."

It will be a different story this year. I don't want to tip my hand, so let's just say Ernie will have to deal with a pitch he has never seen before.

Our proxy statement contains instructions about obtaining tickets to the game and also a large quantity of other information that should help you enjoy your visit in Omaha. There will be plenty of action in town. So come for Woodstock Weekend and join our Celebration of Capitalism at the Civic.

February 28, 2001

Warren E. Buffett
Chairman of the Board

BERKSHIRE HATHAWAY INC.

To the Shareholders of Berkshire Hathaway Inc.:

Berkshire's *loss* in net worth during 2001 was $3.77 billion, which decreased the per-share book value of both our Class A and Class B stock by 6.2%. Over the last 37 years (that is, since present management took over) per-share book value has grown from $19 to $37,920, a rate of 22.6% compounded annually.*

*All figures used in this report apply to Berkshire's A shares, the successor to the only stock that the company had outstanding before 1996. The B shares have an ec onomic interest equal to 1/30th that of the A.

Per-share intrinsic grew somewhat faster than book value during these 37 years, and in 2001 it probably decreased a bit less. We explain intrinsic value in our Owner's Manual, which begins on page 62. I urge new shareholders to read this manual to become familiar with Berkshire's key economic principles.

Two years ago, reporting on 1999, I said that we had experienced both the worst absolute and relative performance in our history. I added that "relative results are what concern us," a viewpoint I've had since forming my first investment partnership on May 5, 1956. Meeting with my seven founding limited partners that evening, I gave them a short paper titled "The Ground Rules" that included this sentence: "Whether we do a good job or a poor job is to be measured against the general experience in securities." We initially used the Dow Jones Industrials as our benchmark, but shifted to the S&P 500 when that index became widely used. Our comparative record since 1965 is chronicled on the facing page; last year Berkshire's advantage was 5.7 percentage points.

Some people disagree with our focus on relative figures, arguing that "you can't eat relative performance." But if you expect — as Charlie Munger, Berkshire's Vice Chairman, and I do — that owning the S&P 500 will produce reasonably satisfactory results over time, it follows that, for long-term investors, gaining small advantages annually over that index *must* prove rewarding. Just as you can eat well throughout the year if you own a profitable, but highly seasonal, business such as See's (which loses considerable money during the summer months) so, too, can you regularly feast on investment returns that beat the averages, however variable the absolute numbers may be.

Though our corporate performance last year was satisfactory, *my* performance was anything but. I manage most of Berkshire's equity portfolio, and my results were poor, just as they have been for several years. Of even more importance, I allowed General Re to take on business without a safeguard I knew was important, and on September 11th, this error caught up with us. I'll tell you more about my mistake later and what we are doing to correct it.

Another of my 1956 Ground Rules remains applicable: "I cannot promise results to partners." But Charlie and I *can* promise that your economic result from Berkshire will parallel ours during the period of your ownership: We will not take cash compensation, restricted stock or option grants that would make our results superior to yours.

Additionally, I will keep well over 99% of my net worth in Berkshire. My wife and I have never sold a share nor do we intend to. Charlie and I are disgusted by the situation, so common in the last few years, in which shareholders have suffered billions in losses while the CEOs, promoters, and other higher-ups who fathered these disasters have walked away with extraordinary wealth. Indeed, many of these people were urging investors to buy shares while concurrently dumping their own, sometimes using methods that hid their actions. To their shame, these business leaders view shareholders as patsies, not partners.

Though Enron has become the symbol for shareholder abuse, there is no shortage of egregious conduct elsewhere in corporate America. One story I've heard illustrates the all-too-common attitude of managers toward

owners: A gorgeous woman slinks up to a CEO at a party and through moist lips purrs, "I'll do anything — *anything* — you want. Just tell me what you would like.” With no hesitation, he replies, “Reprice my options.”

One final thought about Berkshire: In the future we won’t come close to replicating our past record. To be sure, Charlie and I will strive for above-average performance and will not be satisfied with less. But two conditions at Berkshire are far different from what they once were: Then, we could often buy businesses and securities at much lower valuations than now prevail; and more important, we were then working with far less money than we now have. Some years back, a good $10 million idea could do wonders for us (witness our investment in Washington Post in 1973 or GEICO in 1976). Today, the combination of *ten* such ideas and a triple in the value of *each* would increase the net worth of Berkshire by only ¼ of 1%. We need “elephants” to make significant gains now — and they are hard to find.

On the positive side, we have as fine an array of operating managers as exists at any company. (You can read about many of them in a new book by Robert P. Miles: *The Warren Buffett CEO*.) In large part, moreover, they are running businesses with economic characteristics ranging from good to superb. The ability, energy and loyalty of these managers is simply extraordinary. We now have completed 37 Berkshire years without having a CEO of an operating business elect to leave us to work elsewhere.

Our star-studded group grew in 2001. First, we completed the purchases of two businesses that we had agreed to buy in 2000 — Shaw and Johns Manville. Then we acquired two others, MiTek and XTRA, and contracted to buy two more: Larson-Juhl, an acquisition that has just closed, and Fruit of the Loom, which will close shortly if creditors approve our offer. All of these businesses are led by smart, seasoned and trustworthy CEOs.

Additionally, all of our purchases last year were for cash, which means our shareholders became owners of these additional businesses without relinquishing any interest in the fine companies they already owned. We will continue to follow our familiar formula, striving to increase the value of the excellent businesses we have, adding new businesses of similar quality, and issuing shares only grudgingly.

Acquisitions of 2001

A few days before last year's annual meeting, I received a heavy package from St. Louis, containing an unprepossessing chunk of metal whose function I couldn't imagine. There was a letter in the package, though, from Gene Toombs, CEO of a company called MiTek. He explained that MiTek is the world's leading producer of this thing I'd received, a "connector plate," which is used in making roofing trusses. Gene also said that the U.K. parent of MiTek wished to sell the company and that Berkshire seemed to him the ideal buyer. Liking the sound of his letter, I gave Gene a call. It took me only a minute to realize that he was our kind of manager and MiTek our kind of business. We made a cash offer to the U.K. owner and before long had a deal.

Gene's managerial crew is exceptionally enthusiastic about the company and wanted to participate in the purchase. Therefore, we arranged for 55 members of the MiTek team to buy 10% of the company, with each putting up a minimum of $100,000 in cash. Many borrowed money so they could participate.

As they would *not* be if they had options, all of these managers are true *owners*. They face the downside of decisions as well as the upside. They incur a cost of capital. And they can't "reprice" their stakes: What they paid is what they live with.

Charlie and I love the high-grade, truly entrepreneurial attitude that exists at MiTek, and we predict it will be a winner for all involved.

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In early 2000, my friend, Julian Robertson, announced that he would terminate his investment partnership, Tiger Fund, and that he would liquidate it entirely except for four large holdings. One of these was XTRA, a leading lessor of truck trailers. I then called Julian, asking whether he might consider selling his XTRA block or whether, for that matter, the company's management might entertain an offer for the entire company. Julian referred me to Lew Rubin, XTRA's CEO. He and I had a nice conversation, but it was apparent that no deal was to be done.

Then in June 2001, Julian called to say that he had decided to sell his XTRA shares, and I resumed conversations with Lew. The XTRA board accepted a proposal we made, which was to be effectuated through a tender offer expiring on September 11th. The tender conditions included the usual “out,” allowing us to withdraw if the stock market were to close before the offer’s expiration. Throughout much of the 11th, Lew went through a particularly wrenching experience: First, he had a son-in-law working in the World Trade Center who couldn’t be located; and second, he knew we had the option of backing away from our purchase. The story ended happily: Lew’s son-in-law escaped serious harm, and Berkshire completed the transaction.

Trailer leasing is a cyclical business but one in which we should earn decent returns over time. Lew brings a new talent to Berkshire, and we hope to expand in leasing.

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On December 3rd, I received a call from Craig Ponzio, owner of Larson-Juhl, the U.S. leader in custom-made picture frames. Craig had bought the company in 1981 (after first working at its manufacturing plant while attending college) and thereafter increased its sales from $3 million to $300 million. Though I had never heard of Larson-Juhl before Craig’s call, a few minutes talk with him made me think we would strike a deal. He was straightforward in describing the business, cared about who bought it, and was realistic as to price. Two days later, Craig and Steve McKenzie, his CEO, came to Omaha and in ninety minutes we reached an agreement. In ten days we had signed a contract.

Larson-Juhl serves about 18,000 framing shops in the U.S. and is also the industry leader in Canada and much of Europe. We expect to see opportunities for making complementary acquisitions in the future.

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As I write this letter, creditors are considering an offer we have made for Fruit of the Loom. The company entered bankruptcy a few years back, a victim both of too much debt and poor management. And, a good many years before that, I had some Fruit of the Loom experience of my own.

In August 1955, I was one of five employees, including two secretaries, working for the three managers of Graham-Newman Corporation, a New York investment company. Graham-Newman controlled Philadelphia and Reading Coal and Iron ("P&R"), an anthracite producer that had excess cash, a tax loss carryforward, and a declining business. At the time, I had a significant portion of my limited net worth invested in P&R shares, reflecting my faith in the business talents of my bosses, Ben Graham, Jerry Newman and Howard (Micky) Newman.

This faith was rewarded when P&R purchased the Union Underwear Company from Jack Goldfarb for $15 million. Union (though it was then only a licensee of the name) produced Fruit of the Loom underwear. The company possessed $5 million in cash — $2.5 million of which P&R used for the purchase — and was earning about $3 million pre-tax, earnings that could be sheltered by the tax position of P&R. And, oh yes: Fully $9 million of the remaining $12.5 million due was satisfied by non-interest-bearing notes, payable from 50% of any earnings Union had in excess of $1 million. (*Those* were the days; I get goosebumps just thinking about such deals.)

Subsequently, Union bought the licensor of the Fruit of the Loom name and, along with P&R, was merged into Northwest Industries. Fruit went on to achieve annual pre-tax earnings exceeding $200 million.

John Holland was responsible for Fruit's operations in its most bountiful years. In 1996, however, John retired, and management loaded the company with debt, in part to make a series of acquisitions that proved disappointing. Bankruptcy followed. John was then rehired, and he undertook a major reworking of operations. Before John's return, deliveries were chaotic, costs soared and relations with key customers deteriorated. While correcting these problems, John also reduced employment from a bloated 40,000 to 23,000. In short, he's been restoring the old Fruit of the Loom, albeit in a much more competitive environment.

Stepping into Fruit's bankruptcy proceedings, we made a proposal to creditors to which we attached no financing conditions, even though our offer had to remain outstanding for many months. We did, however, insist on a very unusual proviso: John had to be available to continue serving as CEO after we took over. To us, John and the brand are Fruit's key assets.

I was helped in this transaction by my friend and former boss, Micky Newman, now 81. What goes around truly does come around.

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Our operating companies made several “bolt-on” acquisitions during the year, and I can’t resist telling you about one. In December, Frank Rooney called to tell me H.H. Brown was buying the inventory and trademarks of Acme Boot for $700,000.

That sounds like small potatoes. But — would you believe it? — Acme was the second purchase of P&R, an acquisition that took place just before I left Graham-Newman in the spring of 1956. The price was $3.2 million, part of it again paid with non-interest bearing notes, for a business with sales of $7 million.

After P&R merged with Northwest, Acme grew to be the world’s largest bootmaker, delivering annual profits many multiples of what the company had cost P&R. But the business eventually hit the skids and never recovered, and that resulted in our purchasing Acme’s remnants.

In the frontispiece to *Security Analysis*, Ben Graham and Dave Dodd quoted Horace: “Many shall be restored that now are fallen and many shall fall that are now in honor.” Fifty-two years after I first read those lines, my appreciation for what they say about business and investments continues to grow.

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In addition to bolt-on acquisitions, our managers continually look for ways to grow internally. In that regard, here’s a postscript to a story I told you two years ago about R.C. Willey’s move to Boise. As you may remember, Bill Child, R.C. Willey’s chairman, wanted to extend his home-furnishings operation beyond Utah, a state in which his company does more than $300 million of business (up, it should be noted, from $250,000 when Bill took over 48 years ago). The company achieved this dominant position, moreover, with a “closed on Sunday” policy that defied conventional retailing wisdom. I was skeptical that this policy could succeed in Boise or, for that matter, anyplace outside of Utah. After all, Sunday is the day many consumers most like to shop.

Bill then insisted on something extraordinary: He would invest $11 million of his own money to build the Boise store and would sell it to Berkshire at cost (without interest!) if the venture succeeded. If it failed, Bill would keep the store and eat the loss on its disposal. As I told you in the 1999 annual report, the store immediately became a huge success — and it has since grown.

Shortly after the Boise opening, Bill suggested we try Las Vegas, and this time I was even more skeptical. How could we do business in a metropolis of that size and be closed on Sundays, a day that all of our competitors would be exploiting? Buoyed by the Boise experience, however, we proceeded to locate in Henderson, a mushrooming city adjacent to Las Vegas.

The result: This store outsells all others in the R.C. Willey chain, doing a volume of business that far exceeds the volume of any competitor and that is twice what I had anticipated. I cut the ribbon at the grand opening in October — this was after a “soft” opening and a few weeks of exceptional sales — and, just as I did at Boise, I suggested to the crowd that the new store was my idea.

It didn’t work. Today, when I pontificate about retailing, Berkshire people just say, “What does Bill think?” (I’m going to draw the line, however, if he suggests that we also close on Saturdays.)

The Economics of Property/Casualty Insurance

Our main business – though we have others of great importance – is insurance. To understand Berkshire, therefore, it is necessary that you understand how to evaluate an insurance company. The key determinants are: (1) the amount of float that the business generates; (2) its cost; and (3) most critical of all, the long-term outlook for both of these factors.

To begin with, float is money we hold but don't own. In an insurance operation, float arises because premiums are received before losses are paid, an interval that sometimes extends over many years. During that time, the insurer invests the money. This pleasant activity typically carries with it a downside: The premiums that an insurer takes in usually do not cover the losses and expenses it eventually must pay. That leaves it running an“underwriting loss,”which is the cost of float. An insurance business has value if its cost of float over time is less than the cost the company would otherwise incur to obtain funds. But the business is a lemon if its cost of float is higher than market rates for money.

Historically, Berkshire has obtained its float at a very low cost. Indeed, our cost has been less than zero in about half of the years in which we’ve operated; that is, we’ve actually been paid for holding other people’s money. Over the last few years, however, our cost has been too high, and in 2001 it was terrible.

The table that follows shows (at intervals) the float generated by the various segments of Berkshire’s insurance operations since we entered the business 35 years ago upon acquiring National Indemnity Company (whose traditional lines are included in the segment “Other Primary”). For the table we have calculated our float – which we generate in large amounts relative to our premium volume – by adding net loss reserves, loss adjustment reserves, funds held under reinsurance assumed and unearned premium reserves, and then subtracting insurance-related receivables, prepaid acquisition costs, prepaid taxes and deferred charges applicable to assumed reinsurance. (Got that?)

Yearend Float (in $ millions)

Year	GEICO	General Re	Other Reinsurance	Other Primary	Total
1967				20	20
1977			40	131	171
1987			701	807	1,508
1997	2,917		4,014	455	7,386
1998	3,125	14,909	4,305	415	22,754
1999	3,444	15,166	6,285	403	25,298
2000	3,943	15,525	7,805	598	27,871
2001	4,251	19,310	11,262	685	35,508

Last year I told you that, barring a mega-catastrophe, our cost of float would probably drop from its 2000 level of 6%. I had in mind natural catastrophes when I said that, but instead we were hit by a man-made catastrophe on September 11th — an event that delivered the insurance industry its largest loss in history. Our float cost therefore came in at a staggering 12.8%. It was our worst year in float cost since 1984, and a result that to a significant degree, as I will explain in the next section, we brought upon ourselves.

If no mega-catastrophe occurs, I — once again — expect the cost of our float to be low in the coming year. We will indeed need a low cost, as will *all* insurers. Some years back, float costing, say, 4% was tolerable because government bonds yielded twice as much, and stocks prospectively offered still loftier returns. Today, fat returns are nowhere to be found (at least *we* can't find them) and short-term funds earn less than 2%. Under these conditions, each of our insurance operations, save one, must deliver an underwriting profit if it is to be judged a good business. The exception is our retroactive reinsurance operation (a business we explained in last year's annual report), which has desirable economics even though it currently hits us with an annual underwriting loss of about $425 million.

Principles of Insurance Underwriting

When property/casualty companies are judged by their cost of float, very few stack up as satisfactory businesses. And interestingly — unlike the situation prevailing in many other industries — neither size nor brand name determines an insurer's profitability. Indeed, many of the biggest and best-known companies regularly deliver mediocre results. What counts in this business is underwriting discipline. The winners are those that unfailingly stick to three key principles:

1. *They accept only those risks that they are able to properly evaluate (staying within their circle of competence) and that, after they have evaluated all relevant factors including remote loss scenarios, carry the expectancy of profit. These insurers ignore market-share considerations and are sanguine about losing business to competitors that are offering foolish prices or policy conditions.*

2. *They limit the business they accept in a manner that guarantees they will suffer no aggregation of losses from a single event or from related events that will threaten their solvency. They ceaselessly search for possible correlation among seemingly-unrelated risks.*
3. *They avoid business involving moral risk: No matter what the rate, trying to write good contracts with bad people doesn't work. While most policyholders and clients are honorable and ethical, doing business with the few exceptions is usually expensive, sometimes extraordinarily so.*

The events of September 11th made it clear that our implementation of rules 1 and 2 at General Re had been dangerously weak. In setting prices and also in evaluating aggregation risk, we had either overlooked or dismissed the possibility of large-scale terrorism losses. That was a relevant underwriting factor, and we ignored it.

In pricing property coverages, for example, we had looked to the past and taken into account only costs we might expect to incur from windstorm, fire, explosion and earthquake. But what will be the largest insured property loss in history (after adding related business-interruption claims) originated from none of these forces. In short, all of us in the industry made a fundamental underwriting mistake by focusing on experience, rather than exposure, thereby assuming a huge terrorism risk for which we received no premium.

Experience, of course, is a highly useful starting point in underwriting most coverages. For example, it's important for insurers writing California earthquake policies to know how many quakes in the state during the past century have registered 6.0 or greater on the Richter scale. This information will not tell you the exact probability of a big quake next year, or where in the state it might happen. But the statistic has utility, particularly if you are writing a huge statewide policy, as National Indemnity has done in recent years.

At certain times, however, using experience as a guide to pricing is not only useless, but actually dangerous. Late in a bull market, for example, large losses from directors and officers liability insurance ("D&O") are likely to be relatively rare. When stocks are rising, there are a scarcity of targets to sue, and both questionable accounting and management chicanery often go undetected. At that juncture, experience on high-limit D&O may look great.

But that's just when *exposure* is likely to be exploding, by way of ridiculous public offerings, earnings manipulation, chain-letter-like stock promotions and a potpourri of other unsavory activities. When stocks fall, these sins surface, hammering investors with losses that can run into the hundreds of billions. Juries deciding whether those losses should be borne by small investors or big insurance companies can be expected to hit insurers with verdicts that bear little relation to those delivered in bull-market days. Even one jumbo judgment, moreover, can cause settlement costs in later cases to mushroom. Consequently, the correct rate for D&O "excess" (meaning the insurer or reinsurer will pay losses above a high threshold) might well, if based on *exposure*, be five or more times the premium dictated by *experience*.

Insurers have always found it costly to ignore new exposures. Doing that in the case of terrorism, however, could literally bankrupt the industry. No one knows the probability of a nuclear detonation in a major metropolis this year (or even multiple detonations, given that a terrorist organization able to construct one bomb might not stop there). Nor can anyone, with assurance, assess the probability in this year, or another, of deadly biological or chemical agents being introduced simultaneously (say, through ventilation systems) into multiple office buildings and manufacturing plants. An attack like that would produce astronomical workers' compensation claims.

Here's what we *do* know:

(a) The probability of such mind-boggling disasters, though likely very low at present, is not zero.

(b) The probabilities are increasing, in an irregular and immeasurable manner, as knowledge and materials become available to those who wish us ill. Fear may recede with time, but the danger won't — the war against terrorism can never be won. The best the nation can achieve is a long succession of stalemates. There can be no checkmate against hydra-headed foes.

(c) Until now, insurers and reinsurers have blithely assumed the financial consequences from the incalculable risks I have described.

(d) Under a "close-to-worst-case" scenario, which could conceivably involve $1 trillion of damage, the insurance industry would be destroyed unless it manages in some manner to dramatically limit its assumption of terrorism risks. Only the U.S. Government has the resources to absorb such a blow. If it is unwilling to do so on a prospective basis, the general citizenry must bear its own risks and count on the Government to come to its rescue after a disaster occurs.

Why, you might ask, didn't I recognize the above facts *before* September 11th? The answer, sadly, is that I did — but I didn't convert thought into action. I violated the Noah rule: Predicting rain doesn't count; building arks does. I consequently let Berkshire operate with a dangerous level of risk — at General Re in particular. I'm sorry to say that much risk for which we haven't been compensated remains on our books, but it is running off by the day.

At Berkshire, it should be noted, we have for some years been willing to assume more risk than any other insurer has *knowingly* taken on. That's still the case. We are perfectly willing to lose $2 billion to $2½ billion in a single event (as we did on September 11th) if we have been paid properly for assuming the risk that caused the loss (which on that occasion we weren't).

Indeed, we have a major competitive advantage because of our tolerance for huge losses. Berkshire has massive liquid resources, substantial non-insurance earnings, a favorable tax position and a knowledgeable shareholder constituency willing to accept volatility in earnings. This unique combination enables us to assume risks that far exceed the appetite of even our largest competitors. Over time, insuring these jumbo risks should be profitable, though periodically they will bring on a terrible year.

The bottom-line today is that we will write some coverage for terrorist-related losses, including a few non-correlated policies with very large limits. But we will not knowingly expose Berkshire to losses beyond what we can comfortably handle. We will control our total exposure, no matter what the competition does.

Insurance Operations in 2001

Over the years, our insurance business has provided ever-growing, low-cost funds that have fueled much of Berkshire's growth. Charlie and I believe this will continue to be the case. But we stumbled in a big way in 2001, largely because of underwriting losses at General Re.

In the past I have assured you that General Re was underwriting with discipline — and I have been proven wrong. Though its managers' intentions were good, the company broke each of the three underwriting rules I set forth in the last section and has paid a huge price for doing so. One obvious cause for its failure is that it did not reserve correctly — more about this in the next section — and therefore severely miscalculated the cost of the product it was selling. Not knowing your costs will cause problems in any business. In long-tail reinsurance, where years of unawareness will promote and prolong severe underpricing, ignorance of true costs is dynamite.

Additionally, General Re was overly-competitive in going after, and retaining, business. While all concerned may intend to underwrite with care, it is nonetheless difficult for able, hard-driving professionals to curb their urge to prevail over competitors. If "winning," however, is equated with market share rather than profits, trouble awaits. "No" must be an important part of any underwriter's vocabulary.

At the risk of sounding Pollyannaish, I now assure you that underwriting discipline is being restored at General Re (and its Cologne Re subsidiary) with appropriate urgency. Joe Brandon was appointed General Re's CEO in September and, along with Tad Montross, its new president, is committed to producing underwriting profits. Last fall, Charlie and I read Jack Welch's terrific book, *Jack, Straight from the Gut* (get a copy!). In discussing it, we agreed that Joe has many of Jack's characteristics: He is smart, energetic, hands-on, and expects much of both himself and his organization.

When it was an independent company, General Re often shone, and now it also has the considerable strengths Berkshire brings to the table. With that added advantage and with underwriting discipline restored, General Re should be a huge asset for Berkshire. I predict that Joe and Tad will make it so.

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At the National Indemnity reinsurance operation, Ajit Jain continues to add enormous value to Berkshire. Working with only 18 associates, Ajit manages one of the world's largest reinsurance operations measured by assets, and *the* largest, based upon the size of individual risks assumed.

I have known the details of almost every policy that Ajit has written since he came with us in 1986, and never on even a single occasion have I seen him break any of our three underwriting rules. His extraordinary discipline, of course, does not eliminate losses; it does, however, prevent foolish losses. And that's the key: Just as is the case in investing, insurers produce outstanding long-term results primarily by avoiding dumb decisions, rather than by making brilliant ones.

Since September 11th, Ajit has been particularly busy. Among the policies we have written and retained entirely for our own account are (1) $578 million of property coverage for a South American refinery once a loss there exceeds $1 billion; (2) $1 billion of non-cancelable third-party liability coverage for losses arising from acts of terrorism at several large international airlines; (3) £500 million of property coverage on a large North Sea oil platform, covering losses from terrorism and sabotage, above £600 million that the insured retained or reinsured elsewhere; and (4) significant coverage on the Sears Tower, including losses caused by terrorism, above a $500 million threshold. We have written many other jumbo risks as well, such as protection for the World Cup Soccer Tournament and the 2002 Winter Olympics. In all cases, however, we have attempted to avoid writing groups of policies from which losses might seriously aggregate. We will not, for example, write coverages on a large number of office and apartment towers in a single metropolis without excluding losses from both a nuclear explosion and the fires that would follow it.

No one can match the speed with which Ajit can offer huge policies. After September 11th, his quickness to respond, always important, has become a major competitive advantage. So, too, has our unsurpassed financial strength. Some reinsurers — particularly those who, in turn, are accustomed to laying off much of their business on a second layer of reinsurers known as retrocessionaires — are in a weakened condition and would have difficulty surviving a second mega-cat. When a daisy chain of retrocessionaires exists, a single weak link can pose trouble for all. In assessing the soundness of their reinsurance protection, insurers must therefore apply a stress test to all participants in the chain, and must contemplate a catastrophe loss occurring during a very unfavorable economic environment. After all, you only find out who is swimming naked when the tide goes out. At Berkshire, we retain our risks and depend on no one. And whatever the world's problems, our checks will clear.

Ajit's business will ebb and flow — but his underwriting principles won't waver. It's impossible to overstate his value to Berkshire.

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GEICO, by far our largest primary insurer, made major progress in 2001, thanks to Tony Nicely, its CEO, and his associates. Quite simply, Tony is an owner's dream.

GEICO's premium volume grew 6.6% last year, its float grew $308 million, and it achieved an underwriting profit of $221 million. This means we were actually paid that amount last year to hold the $4.25 billion in float, which of course doesn't belong to Berkshire but can be used by us for investment.

The only disappointment at GEICO in 2001 — and it's an important one — was our inability to add policyholders. Our preferred customers (81% of our total) grew by 1.6% but our standard and non-standard policies fell by 10.1%. Overall, policies in force fell .8%.

New business has improved in recent months. Our closure rate from telephone inquiries has climbed, and our Internet business continues its steady growth. We, therefore, expect at least a modest gain in policy count during 2002. Tony and I are eager to commit much more to marketing than the $219 million we spent last year, but at the moment we cannot see how to do so effectively. In the meantime, our operating costs are low and far below those of our major competitors; our prices are attractive; and our float is cost-free and growing.

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Our other primary insurers delivered their usual fine results last year. These operations, run by Rod Eldred, John Kizer, Tom Nerney, Michael Stearns, Don Towle and Don Wurster had combined premium volume of $579 million, up 40% over 2000. Their float increased 14.5% to $685 million, and they recorded an underwriting profit of $30 million. In aggregate, these companies are one of the finest insurance operations in the country, and their 2002 prospects look excellent.

“Loss Development” and Insurance Accounting

Bad terminology is the enemy of good thinking. When companies or investment professionals use terms such as “EBITDA” and “pro forma,” they want you to unthinkingly accept concepts that are dangerously flawed. (In golf, my score is frequently below par on a *pro forma* basis: I have firm plans to “restructure” my putting stroke and therefore only count the swings I take before reaching the green.)

In insurance reporting, “loss development” is a widely used term — and one that is seriously misleading. First, a definition: Loss reserves at an insurer are not funds tucked away for a rainy day, but rather a liability account. If properly calculated, the liability states the amount that an insurer will have to pay for *all* losses (including associated costs) that have occurred prior to the reporting date but have not yet been paid. When calculating the reserve, the insurer will have been notified of many of the losses it is destined to pay, but others will not yet have been reported to it. These losses are called IBNR, for incurred but not reported. Indeed, in some cases (involving, say, product liability or embezzlement) the insured itself will not yet be aware that a loss has occurred.

It’s clearly difficult for an insurer to put a figure on the ultimate cost of all such reported and unreported events. But the ability to do so with reasonable accuracy is vital. Otherwise the insurer’s managers won’t know what its actual loss costs are and how these compare to the premiums being charged.

GEICO got into huge trouble in the early 1970s because for several years it severely underreserved, and therefore believed its product (insurance protection) was costing considerably less than was truly the case. Consequently, the company sailed blissfully along, underpricing its product and selling more and more policies at ever-larger losses.

When it becomes evident that reserves at past reporting dates understated the liability that truly existed at the time, companies speak of “loss development.” In the year discovered, these shortfalls penalize reported earnings because the “catch-up” costs from prior years must be added to current-year costs when results are calculated. This is what happened at General Re in 2001: a staggering $800 million of loss costs that actually occurred in earlier years, but that were not then recorded, were belatedly recognized last year and charged against current earnings. The mistake was an honest one, I can assure you of that. Nevertheless, for several years, this underreserving caused us to believe that our costs were much lower than they truly were, an error that contributed to woefully inadequate pricing. Additionally, the overstated profit figures led us to pay substantial incentive compensation that we should not have and to incur income taxes far earlier than was necessary.

We recommend scrapping the term “loss development” and its equally ugly twin, “reserve strengthening.” (Can you imagine an insurer, upon finding its reserves excessive, describing the reduction that follows as “reserve weakening”?) “Loss development” suggests to investors that some natural, uncontrollable event has occurred in the current year, and “reserve strengthening” implies that adequate amounts have been further buttressed. The truth, however, is that management made an error in estimation that in turn produced an error in the earnings previously reported. The losses didn’t “develop” — they were there all along. What developed was management’s understanding of the losses (or, in the instances of chicanery, management’s willingness to finally fess up).

A more forthright label for the phenomenon at issue would be “loss costs we failed to recognize when they occurred” (or maybe just “oops”). Underreserving, it should be noted, is a common — and serious — problem throughout the property/casualty insurance industry. At Berkshire we told you of our own problems with underestimation in 1984 and 1986. Generally, however, our reserving has been conservative.

Major underreserving is common in cases of companies struggling for survival. In effect, insurance accounting is a self-graded exam, in that the insurer gives some figures to its auditing firm and generally doesn't get an argument. (What the *auditor* gets, however, is a letter from management that is designed to take his firm off the hook if the numbers later look silly.) A company experiencing financial difficulties — of a kind that, if truly faced, could put it out of business — seldom proves to be a tough grader. Who, after all, wants to prepare his own execution papers?

Even when companies have the best of intentions, it's not easy to reserve properly. I've told the story in the past about the fellow traveling abroad whose sister called to tell him that their dad had died. The brother replied that it was impossible for him to get home for the funeral; he volunteered, however, to shoulder its cost. Upon returning, the brother received a bill from the mortuary for $4,500, which he promptly paid. A month later, and a month after that also, he paid $10 pursuant to an add-on invoice. When a third $10 invoice came, he called his sister for an explanation. "Oh," she replied, "I forgot to tell you. We buried dad in a rented suit."

There are a lot of "rented suits" buried in the past operations of insurance companies. Sometimes the problems they signify lie dormant for decades, as was the case with asbestos liability, before virulently manifesting themselves. Difficult as the job may be, it's management's responsibility to adequately account for *all* possibilities. Conservatism is essential. When a claims manager walks into the CEO's office and says "Guess what just happened," his boss, if a veteran, does not expect to hear it's good news. Surprises in the insurance world have been far from symmetrical in their effect on earnings.

Because of this one-sided experience, it is folly to suggest, as some are doing, that all property/casualty insurance reserves be *discounted*, an approach reflecting the fact that they will be paid in the future and that therefore their present value is less than the stated liability for them. Discounting might be acceptable *if* reserves could be precisely established. They can't, however, because a myriad of forces — judicial broadening of policy language and medical inflation, to name just two chronic problems — are constantly working to make reserves inadequate. Discounting would exacerbate this already-serious situation and, additionally, would provide a new tool for the companies that are inclined to fudge.

I'd say that the effects from telling a profit-challenged insurance CEO to lower reserves through discounting would be comparable to those that would ensue if a father told his 16-year-old son to have a normal sex life. Neither party needs that kind of push.

Sources of Reported Earnings

The table that follows shows the main sources of Berkshire's reported earnings. In this presentation, purchase-accounting adjustments (primarily relating to "goodwill") are not assigned to the specific businesses to which they apply, but are instead aggregated and shown separately. This procedure lets you view the earnings of our businesses as they would have been reported had we not purchased them. In recent years, our "expense" for goodwill amortization has been large. Going forward, generally accepted accounting principles ("GAAP") will no longer require amortization of goodwill. This change will increase our reported earnings (though not our true economic earnings) and simplify this section of the report.

	(in millions)			
	Pre-Tax Earnings		Berkshire's Share of Net Earnings (after taxes and Minority interests)	
	2001	2000	2001	2000
Operating Earnings:				
Insurance Group:				
Underwriting – Reinsurance	$(4,318)	$(1,416)	$(2,824)	$(911)
Underwriting – GEICO	221	(224)	144	(146)
Underwriting – Other Primary	30	25	18	16
Net Investment Income	2,824	2,773	1,968	1,946
Building Products[1]	461	34	287	21
Finance and Financial Products Business	519	530	336	343
Flight Services	186	213	105	126
MidAmerican Energy (76% owned)	600	197	230	109
Retail Operations	175	175	101	104
Scott Fetzer (excluding finance operation)	129	122	83	80
Shaw Industries[2]	292	--	156	--
Other Businesses	179	221	103	133
Purchase-Accounting Adjustments	(726)	(881)	(699)	(843)
Corporate Interest Expense	(92)	(92)	(60)	(61)
Shareholder-Designated Contributions	(17)	(17)	(11)	(11)
Other	25	39	16	30
Operating Earnings	488	1,699	(47)	936
Capital Gains from Investments	1,320	3,955	842	2,392
Total Earnings – All Entities	$1,808	$5,654	$ 795	$3,328

(1) *Includes Acme Brick from August 1, 2000; Benjamin Moore from December 18, 2000; Johns Manville from February 27, 2001; and MiTek from July 31, 2001.*

(2) *From date of acquisition, January 8, 2001.*

Here are some highlights (and lowlights) from 2001 relating to our non-insurance activities:

• Our shoe operations (included in "other businesses") lost $46.2 million pre-tax, with profits at H.H. Brown and Justin swamped by losses at Dexter.

I've made three decisions relating to Dexter that have hurt you in a major way: (1) buying it in the first place;

(2) paying for it with stock and (3) procrastinating when the need for changes in its operations was obvious. I would like to lay these mistakes on Charlie (or anyone else, for that matter) but they were mine. Dexter, prior to our purchase — and indeed for a few years after — prospered despite low-cost foreign competition that was brutal. I concluded that Dexter could continue to cope with that problem, and I was wrong.

We have now placed the Dexter operation — which is still substantial in size — under the management of Frank Rooney and Jim Issler at H.H. Brown. These men have performed outstandingly for Berkshire, skillfully contending with the extraordinary changes that have bedeviled the footwear industry. During part of 2002, Dexter will be hurt by unprofitable sales commitments it made last year. After that, we believe our shoe business will be reasonably profitable.

• MidAmerican Energy, of which we own 76% on a fully-diluted basis, had a good year in 2001. Its reported earnings should also increase considerably in 2002 given that the company has been shouldering a large charge for the amortization of goodwill and that this "cost" will disappear under the new GAAP rules.

Last year MidAmerican swapped some properties in England, adding Yorkshire Electric, with its 2.1 million customers. We are now serving 3.6 million customers in the U.K. and are its 2nd largest electric utility. We have an equally important operation in Iowa as well as major generating facilities in California and the Philippines.

At MidAmerican — this may surprise you — we also own the second-largest residential real estate brokerage business in the country. We are market-share leaders in a number of large cities, primarily in the Midwest, and have recently acquired important firms in Atlanta and Southern California. Last year, operating under various names that are locally familiar, we handled about 106,000 transactions involving properties worth nearly $20 billion. Ron Peltier has built this business for us, and it's likely he will make more acquisitions in 2002 and the years to come.

• Considering the recessionary environment plaguing them, our retailing operations did well in 2001. In jewelry, same-store sales fell 7.6% and pre-tax margins were 8.9% versus 10.7% in 2000. Return on invested capital remains high.

Same-store sales at our home-furnishings retailers were unchanged and so was the margin — 9.1% pre-tax — these operations earned. Here, too, return on invested capital is excellent.

We continue to expand in both jewelry and home-furnishings. Of particular note, Nebraska Furniture Mart is constructing a mammoth 450,000 square foot store that will serve the greater Kansas City area beginning in the fall of 2003. Despite Bill Child's counter-successes, we will keep this store open on Sundays.

• The large acquisitions we initiated in late 2000 — Shaw, Johns Manville and Benjamin Moore — all came through their first year with us in great fashion. Charlie and I knew at the time of our purchases that we were in good hands with Bob Shaw, Jerry Henry and Yvan Dupuy, respectively — and we admire their work even more now. Together these businesses earned about $659 million pre-tax.

Shortly after yearend we exchanged 4,740 Berkshire A shares (or their equivalent in B shares) for the 12.7% minority interest in Shaw, which means we now own 100% of the company. Shaw is our largest non-insurance operation and will play a big part in Berkshire's future.

• All of the income shown for Flight Services in 2001 — and a bit more — came from FlightSafety, our pilot-training subsidiary. Its earnings increased 2.5%, though return on invested capital fell slightly because of the $258 million investment we made last year in simulators and other fixed assets. My 84-year-old friend, Al Ueltschi, continues to run FlightSafety with the same enthusiasm and competitive spirit that he has exhibited since 1951, when he invested $10,000 to start the company. If I line Al up with a bunch of 60-year-olds at the annual meeting, you will not be able to pick him out.

After September 11th, training for commercial airlines fell, and today it remains depressed. However, training for business and general aviation, our main activity, is at near-normal levels and should continue to grow. In 2002, we expect to spend $162 million for 27 simulators, a sum far in excess of our annual depreciation charge of $95 million. Those who believe that EBITDA is in any way equivalent to true earnings are welcome to pick up the tab.

Our NetJets® fractional ownership program sold a record number of planes last year and also showed a gain of 21.9% in service income from management fees and hourly charges. Nevertheless, it operated at a small loss, versus a small profit in 2000. We made a little money in the U.S., but these earnings were more than offset by European losses. Measured by the value of our customers' planes, NetJets accounts for about half of the industry. We believe the other participants, in aggregate, lost significant money.

Maintaining a premier level of safety, security and service was always expensive, and the cost of sticking to those standards was exacerbated by September 11th. No matter how much the cost, we will continue to be the industry leader in all three respects. An uncompromising insistence on delivering only the best to his customers is embedded in the DNA of Rich Santulli, CEO of the company and the inventor of fractional ownership. I'm delighted with his fanaticism on these matters for both the company's sake and my family's: I believe the Buffetts fly more fractional-ownership hours — we log in excess of 800 annually — than does any other family. In case you're wondering, we use exactly the same planes and crews that serve NetJet's other customers.

NetJets experienced a spurt in new orders shortly after September 11th, but its sales pace has since returned to normal. Per-customer usage declined somewhat during the year, probably because of the recession.

Both we and our customers derive significant operational benefits from our being the runaway leader in the fractional ownership business. We have more than 300 planes constantly on the go in the U.S. and can therefore be wherever a customer needs us on very short notice. The ubiquity of our fleet also reduces our "positioning" costs below those incurred by operators with smaller fleets.

These advantages of scale, and others we have, give NetJets a significant economic edge over competition. Under the competitive conditions likely to prevail for a few years, however, our advantage will at best produce modest profits.

• Our finance and financial products line of business now includes XTRA, General Re Securities (which is in a run-off mode that will continue for an extended period) and a few other relatively small operations. The bulk of the assets and liabilities in this segment, however, arise from a few fixed-income strategies, involving highly-liquid AAA securities, that I manage. This activity, which only makes sense when certain market relationships exist, has produced good returns in the past and has reasonable prospects for continuing to do so over the next year or two.

Investments

Below we present our common stock investments. Those that had a market value of more than $500 million at the end of 2001 are itemized.

		12/31/01	
Shares	*Company*	*Cost*	*Market*
		(dollars in millions)	
151,610,700	American Express Company	$ 1,470	$ 5,410
200,000,000	The Coca-Cola Company	1,299	9,430
96,000,000	The Gillette Company	600	3,206
15,999,200	H&R Block, Inc.	255	715
24,000,000	Moody's Corporation	499	957
1,727,765	The Washington Post Company	11	916
53,265,080	Wells Fargo & Company	306	2,315
	Others	4,103	5,726
	Total Common Stocks	$8,543	$28,675

We made few changes in our portfolio during 2001. As a group, our larger holdings have performed poorly in the last few years, some because of disappointing operating results. Charlie and I still like the basic businesses of all the companies we own. But we do not believe Berkshire's equity holdings as a group are undervalued.

Our restrained enthusiasm for these securities is matched by decidedly lukewarm feelings about the prospects for stocks in general over the next decade or so. I expressed my views about equity returns in a speech I gave at an Allen and Company meeting in July (which was a follow-up to a similar presentation I had made two years earlier) and an edited version of my comments appeared in a December 10th *Fortune* article. I'm enclosing a copy of that article. You can also view the *Fortune* version of my 1999 talk at our website www.berkshirehathaway.com.

Charlie and I believe that American business will do fine over time but think that today's equity prices presage only moderate returns for investors. The market outperformed business for a very long period, and that phenomenon had to end. A market that no more than parallels business progress, however, is likely to leave many investors disappointed, particularly those relatively new to the game.

Here's one for those who enjoy an odd coincidence: The Great Bubble ended on March 10, 2000 (though we didn't realize that fact until some months later). On that day, the NASDAQ (recently 1,731) hit its all-time high of 5,132. That same day, Berkshire shares traded at $40,800, their lowest price since mid-1997.

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During 2001, we were somewhat more active than usual in "junk" bonds. These are not, we should emphasize, suitable investments for the general public, because too often these securities live up to their name. We have *never* purchased a newly-issued junk bond, which is the only kind most investors are urged to buy. When losses occur in this field, furthermore, they are often disastrous: Many issues end up at a small fraction of their original offering price and some become entirely worthless.

Despite these dangers, we periodically find a few — a *very* few — junk securities that are interesting to us. And, so far, our 50-year experience in distressed debt has proven rewarding. In our 1984 annual report, we described our purchases of Washington Public Power System bonds when that issuer fell into disrepute. We've also, over the years, stepped into other apparent calamities such as Chrysler Financial, Texaco and RJR Nabisco — all of which returned to grace. Still, if we stay active in junk bonds, you can expect us to have losses from time to time.

Occasionally, a purchase of distressed bonds leads us into something bigger. Early in the Fruit of the Loom bankruptcy, we purchased the company's public and bank debt at about 50% of face value. This was an unusual bankruptcy in that interest payments on senior debt were continued without interruption, which meant we earned about a 15% current return. Our holdings grew to 10% of Fruit's senior debt, which will probably end up returning us about 70% of face value. Through this investment, we indirectly reduced our purchase price for the whole company by a small amount.

In late 2000, we began purchasing the obligations of FINOVA Group, a troubled finance company, and that, too, led to our making a major transaction. FINOVA then had about $11 billion of debt outstanding, of which we purchased 13% at about two-thirds of face value. We expected the company to go into bankruptcy, but believed that liquidation of its assets would produce a payoff for creditors that would be well above our cost. As default loomed in early 2001, we joined forces with Leucadia National Corporation to present the company with a prepackaged plan for bankruptcy.

The plan as subsequently modified (and I'm simplifying here) provided that creditors would be paid 70% of face value (along with full interest) and that they would receive a newly-issued 7½% note for the 30% of their claims not satisfied by cash. To fund FINOVA's 70% distribution, Leucadia and Berkshire formed a jointly-owned entity — mellifluently christened Berkadia — that borrowed $5.6 billion through FleetBoston and, in turn, re-lent this sum to FINOVA, concurrently obtaining a priority claim on its assets. Berkshire guaranteed 90% of the Berkadia borrowing and also has a secondary guarantee on the 10% for which Leucadia has primary responsibility. (Did I mention that I am simplifying?).

There is a spread of about two percentage points between what Berkadia pays on its borrowing and what it receives from FINOVA, with this spread flowing 90% to Berkshire and 10% to Leucadia. As I write this, each loan has been paid down to $3.9 billion.

As part of the bankruptcy plan, which was approved on August 10, 2001, Berkshire also agreed to offer 70% of face value for up to $500 million principal amount of the $3.25 billion of new 7½% bonds that were issued by FINOVA. (Of these, we had already received $426.8 million in principal amount because of our 13% ownership of the original debt.) Our offer, which was to run until September 26, 2001, could be withdrawn under a variety of conditions, one of which became operative if the New York Stock Exchange closed during the offering period. When that indeed occurred in the week of September 11th, we promptly terminated the offer.

Many of FINOVA's loans involve aircraft assets whose values were significantly diminished by the events of September 11th. Other receivables held by the company also were imperiled by the economic consequences of the attack that day. FINOVA's prospects, therefore, are not as good as when we made our proposal to the bankruptcy court. Nevertheless we feel that overall the transaction will prove satisfactory for Berkshire. Leucadia has day-to-day operating responsibility for FINOVA, and we have long been impressed with the business acumen and managerial talent of its key executives.

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It's déjà vu time again: In early 1965, when the investment partnership I ran took control of Berkshire, that company had its main banking relationships with First National Bank of Boston and a large New York City bank. Previously, I had done no business with either.

Fast forward to 1969, when I wanted Berkshire to buy the Illinois National Bank and Trust of Rockford. We needed $10 million, and I contacted both banks. There was no response from New York. However, two representatives of the Boston bank immediately came to Omaha. They told me they would supply the money for our purchase and that we would work out the details later.

For the next three decades, we borrowed almost nothing from banks. (Debt is a four-letter word around Berkshire.) Then, in February, when we were structuring the FINOVA transaction, I again called Boston, where First National had morphed into FleetBoston. Chad Gifford, the company's president, responded just as Bill Brown and Ira Stepanian had back in 1969 — "you've got the money and we'll work out the details later."

And that's just what happened. FleetBoston syndicated a loan for $6 billion (as it turned out, we didn't need $400 million of it), and it was quickly oversubscribed by 17 banks throughout the world. Sooooo . . . if you ever need $6 billion, just give Chad a call — assuming, that is, your credit is AAA.

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One more point about our investments: The media often report that "Buffett is buying" this or that security, having picked up the "fact" from reports that

Berkshire files. These accounts are sometimes correct, but at other times the transactions Berkshire reports are actually being made by Lou Simpson, who runs a $2 billion portfolio for GEICO that is quite independent of me. Normally, Lou does not tell me what he is buying or selling, and I learn of his activities only when I look at a GEICO portfolio summary that I receive a few days after the end of each month. Lou's thinking, of course, is quite similar to mine, but we usually end up in different securities. That's largely because he's working with less money and can therefore invest in smaller companies than I. Oh, yes, there's also another minor difference between us: In recent years, Lou's performance has been far better than mine.

Charitable Contributions

Berkshire follows a highly unusual policy in respect to charitable contributions — but it's one that Charlie and I believe is both rational and fair to owners.

First, we let our operating subsidiaries make their own charitable decisions, requesting only that the owners/managers who once ran these as independent companies make all donations to their *persona*l charities from their own funds, instead of using company money. When our managers are using company funds, we trust them to make gifts in a manner that delivers commensurate tangible or intangible benefits to the operations they manage. Last year contributions from Berkshire subsidiaries totaled $19.2 million.

At the parent company level, we make no contributions except those designated by shareholders. We do not match contributions made by directors or employees, nor do we give to the favorite charities of the Buffetts or the Mungers. However, prior to our purchasing them, a few of our subsidiaries had employee-match programs and we feel fine about their continuing them: It's not our style to tamper with successful business cultures.

To implement our *owners'* charitable desires, each year we notify registered holders of A shares (A's represent 86.6% of our equity capital) of a per-share amount that they can instruct us to contribute to as many as three charities. Shareholders name the charity; Berkshire writes the check. Any organization that qualifies under the Internal Revenue Code can be designated by shareholders. Last year Berkshire made contributions of $16.7 million at the direction of 5,700 shareholders, who named 3,550 charities as recipients. Since we started this program, our shareholders' gifts have totaled $181 million.

Most public corporations eschew gifts to religious institutions. These, however, are favorite charities of our shareholders, who last year named 437 churches and synagogues to receive gifts. Additionally, 790 schools were recipients. A few of our larger shareholders, including Charlie and me, designate their personal foundations to get gifts, so that those entities can, in turn, disburse their funds widely.

I get a few letters every week criticizing Berkshire for contributing to Planned Parenthood. These letters are usually prompted by an organization that wishes to see boycotts of Berkshire products. The letters are invariably polite and sincere, but their writers are unaware of a key point: It's not Berkshire, but rather its owners who are making charitable decisions — and these owners are about as diverse in their opinions as you can imagine. For example, they are probably on both sides of the abortion issue in roughly the same proportion as the American population. We'll follow their instructions, whether they designate Planned Parenthood or Metro Right to Life, just as long as the charity possesses 501(c)(3) status. It's as if we paid a dividend, which the shareholder then donated. Our form of disbursement, however, is more tax-efficient.

In neither the purchase of goods nor the hiring of personnel, do we ever consider the religious views, the gender, the race or the sexual orientation of the persons we are dealing with. It would not only be wrong to do so, it would be idiotic. We need all of the talent we can find, and we have learned that able and trustworthy managers, employees and suppliers come from a very wide spectrum of humanity.

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To participate in our future charitable contribution programs, you must own Class A shares that are registered in the name of the actual owner, not the nominee name of a broker, bank or depository. Shares not so registered on August 31, 2002 will be ineligible for the 2002 program. When you get the *contributions form from us, return it promptly. Designations received after the due date will not be honored.*

The Annual Meeting

This year's annual meeting will be on Saturday, May 4, and we will again be at the Civic Auditorium. The doors will open at 7 a.m., the movie will begin at 8:30, and the meeting itself will commence at 9:30. There will be a short break at noon for food. (Sandwiches can be bought at the Civic's concession stands.) Except for that interlude, Charlie and I will answer questions until 3:30. Give us your best shot.

For at least the next year, the Civic, located downtown, is the only site available to us. We must therefore hold the meeting on either Saturday or Sunday to avoid the traffic and parking nightmare sure to occur on a weekday. Shortly, however, Omaha will have a new Convention Center with plenty of parking facilities. Assuming that we then head for the Center, I will poll shareholders to see whether you wish to return to the Monday meeting that was standard until 2000. We will decide that vote based on a count of shareholders, not shares. (This is *not* a system, however, we will ever institute to decide who should be CEO.)

An attachment to the proxy material that is enclosed with this report explains how you can obtain the credential you will need for admission to the meeting and other events. As for plane, hotel and car reservations, we have again signed up American Express (800-799-6634) to give you special help. They do a terrific job for us each year, and I thank them for it.

In our usual fashion, we will run buses from the larger hotels to the meeting. Afterwards, the buses will make trips back to the hotels and to Nebraska Furniture Mart, Borsheim's and the airport. Even so, you are likely to find a car useful.

We have added so many new companies to Berkshire this year that I'm not going to detail all of the products that we will be *selling* at the meeting. But come prepared to carry home everything from bricks to candy. And underwear, of course. Assuming our Fruit of the Loom purchase has closed by May 4, we will be selling Fruit’s latest styles, which will make you your neighborhood’s fashion leader. Buy a lifetime supply.

GEICO will have a booth staffed by a number of its top counselors from around the country, all of them ready to supply you with auto insurance quotes. In most cases, GEICO will be able to give you a special shareholder discount (usually 8%). This special offer is permitted by 41 of the 49 jurisdictions in which we operate. Bring the details of your existing insurance and check out whether we can save you money.

At the Omaha airport on Saturday, we will have the usual array of aircraft from NetJets® available for your inspection. Just ask a representative at the Civic about viewing any of these planes. If you buy what we consider an appropriate number of items during the weekend, you may well need your own plane to take them home. And, if you buy a fraction of a plane, we might even throw in a three-pack of briefs or boxers.

At Nebraska Furniture Mart, located on a 75-acre site on 72nd Street between Dodge and Pacific, we will again be having ”Berkshire Weekend” pricing, which means we will be offering our shareholders a discount that is customarily given only to employees. We initiated this special pricing at NFM five years ago, and sales during the ”Weekend” grew from $5.3 million in 1997 to $11.5 million in 2001.

To get the discount, you must make your purchases on Thursday, May 2 through Monday, May 6 and also present your meeting credential. The period’s special pricing will even apply to the products of several prestigious manufacturers that normally have ironclad rules against discounting but that, in the spirit of our shareholder weekend, have made an exception for you. We appreciate their cooperation. NFM is open from 10 a.m. to 9 p.m. on weekdays and 10 a.m. to 6 p.m. on Saturdays and Sundays.

Borsheim’s — the largest jewelry store in the country except for Tiffany’s Manhattan store — will have two shareholder-only events. The first will be a cocktail reception from 6 p.m. to 10 p.m. on Friday, May 3. The second, the main gala, will be from 9 a.m. to 5 p.m. on Sunday, May 5. Shareholder prices will be available Thursday through Monday, so if you wish to avoid the large crowds that will assemble on Friday evening and Sunday, come at other times and identify yourself as a shareholder. On Saturday, we will be open until 6 p.m. Borsheim's operates on a gross margin that is fully twenty percentage points below that of its major rivals, so the more you buy, the more you save (or at least that's what my wife and daughter tell me). Come by and let us perform a walletectomy on you.

In the mall outside of Borsheim's, we will have some of the world's top bridge experts available to play with our shareholders on Sunday afternoon. We expect Bob and Petra Hamman along with Sharon Osberg to host tables. Patrick Wolff, twice U.S. chess champion, will also be in the mall, taking on all comers — blindfolded!

Last year, Patrick played as many as six games simultaneously — with his blindfold securely in place — and this year will try for seven. Finally, Bill Robertie, one of only two players who have twice won the backgammon world championship, will be on hand to test your skill at that game. Come to the mall on Sunday for the Mensa Olympics.

Gorat's — my favorite steakhouse — will again be open exclusively for Berkshire shareholders on Sunday, May 5, and will be serving from 4 p.m. until 10 p.m. Please remember that to come to Gorat's on Sunday, you must have a reservation. To make one, call 402-551-3733 on April 1 (*but not before*). If Sunday is sold out, try Gorat's on one of the other evenings you will be in town. Show your sophistication by ordering a rare T-bone with a double order of hash browns.

The usual baseball game will be held at Rosenblatt Stadium at 7 p.m. on Saturday night. This year the Omaha Royals will play the Oklahoma RedHawks. Last year, in an attempt to emulate the career switch of Babe Ruth, I gave up pitching and tried batting. Bob Gibson, an Omaha native, was on the mound and I was terrified, fearing Bob's famous brush-back pitch. Instead, he delivered a fast ball in the strike zone, and with a Mark McGwire-like swing, I managed to connect for a hard grounder, which inexplicably died in the infield. I didn't run it out: At my age, I get winded playing a hand of bridge.

I'm not sure what will take place at the ballpark this year, but come out and be surprised. Our proxy statement contains instructions for obtaining tickets to the game. Those people ordering tickets to the annual meeting will receive a booklet containing all manner of information that should help you enjoy your visit in Omaha. There will be plenty of action in town. So come for Woodstock Weekend and join our Celebration of Capitalism at the Civic.

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Finally, I would like to thank the wonderful and incredibly productive crew at World Headquarters (all 5,246.5 square feet of it) who make my job so easy. Berkshire added about 40,000 employees last year, bringing our workforce to 110,000. At headquarters we added one employee and now have 14.8. (I've tried in vain to get JoEllen Rieck to change her workweek from four days to five; I think she likes the national recognition she gains by being .8.)

The smooth handling of the array of duties that come with our current size and scope – as well as some additional activities almost unique to Berkshire, such as our shareholder gala and designated-gifts program – takes a very special group of people. And that we most definitely have.

February 28, 2002

Warren E. Buffett
Chairman of the Board

BERKSHIRE HATHAWAY INC.

To the Shareholders of Berkshire Hathaway Inc.:

Our gain in net worth during 2002 was $6.1 billion, which increased the per-share book value of both our Class A and Class B stock by 10.0%. Over the last 38 years (that is, since present management took over) per-share book value has grown from $19 to $41,727, a rate of 22.2% compounded annually.*

*All figures used in this report apply to Berkshire's A shares, the successor to the only stock that the company had outstanding before 1996. The B shares have an economic interest equal to 1/30th that of the A.

In all respects 2002 was a banner year. I'll provide details later, but here's a summary:

- Our various non-insurance operations performed exceptionally well, despite a sluggish economy. A decade ago Berkshire's annual pre-tax earnings from our non-insurance businesses was $272 million. Now, from our ever-expanding collection of manufacturing, retailing, service and finance businesses, we earn that sum *monthly*.
- Our insurance group increased its float to $41.2 billion, a hefty gain of $5.7 billion. Better yet, the use of these funds in 2002 cost us only 1%. Getting back to low-cost float feels good, particularly after our poor results during the three previous years. Berkshire's reinsurance division and GEICO shot the lights out in 2002, and underwriting discipline was restored at General Re.
- Berkshire acquired some important new businesses — with economic characteristics ranging from good to great, run by managers ranging from great to great. Those attributes are two legs of our "entrance" strategy, the third being a sensible purchase price. Unlike LBO operators and private equity firms, we have no "exit" strategy — we buy to keep. That's one reason why Berkshire is usually the first — and sometimes the only — choice for sellers and their managers.

- Our marketable securities outperformed most indices. For Lou Simpson, who manages equities at GEICO, this was old stuff. But, for me, it was a welcome change from the last few years, during which my investment record was dismal.

The confluence of these favorable factors in 2002 caused our book-value gain to outstrip the performance of the S&P 500 by 32.1 percentage points. This result is aberrational: Charlie Munger, Berkshire's vice chairman and my partner, and I hope to achieve — *at most* — an average annual advantage of a few points. In the future, there will be years in which the S&P soundly trounces us. That will in fact almost certainly happen during a strong bull market, because the portion of our assets committed to common stocks has significantly declined. This change, of course, helps our relative performance in down markets such as we had in 2002.

I have another caveat to mention about last year's results. If you've been a reader of financial reports in recent years, you've seen a flood of "pro-forma" earnings statements — tabulations in which managers invariably show "earnings" far in excess of those allowed by their auditors. In these presentations, the CEO tells his owners "don't count this, don't count that — just count what makes earnings fat." Often, a forget-all-this-bad-stuff message is delivered year after year without management so much as blushing.

We've yet to see a pro-forma presentation disclosing that audited earnings were somewhat high. So let's make a little history: Last year, on a pro-forma basis, Berkshire had *lower* earnings than those we actually reported.

That is true because two favorable factors aided our reported figures. First, in 2002 there was no megacatastrophe, which means that Berkshire (and other insurers as well) earned more from insurance than if losses had been normal. In years when the reverse is true — because of a blockbuster hurricane, earthquake or man-made disaster — many insurers like to report that they would have earned X "except for" the unusual event. The implication is that since such megacats are infrequent, they shouldn't be counted when "true" earnings are calculated. That is deceptive nonsense. "Except for" losses will forever be part of the insurance business, and they will forever be paid with shareholders' money.

Nonetheless, for the purposes of this exercise, we'll take a page from the industry's book. For last year, when we didn't have any truly major disasters, a downward adjustment is appropriate if you wish to "normalize" our underwriting result.

Secondly, the bond market in 2002 favored certain strategies we employed in our finance and financial products business. Gains from those strategies will certainly diminish within a year or two — and may well disappear.

Soooo . . . "except for" a couple of favorable breaks, our pre-tax earnings last year would have been about $500 million less than we actually reported. We're happy, nevertheless, to bank the excess. As Jack Benny once said upon receiving an award: "I don't deserve this honor — but, then, I have arthritis, and I don't deserve that either."

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We continue to be blessed with an extraordinary group of managers, many of whom haven't the slightest financial need to work. They stick around, though: In 38 years, we've never had a single CEO of a subsidiary elect to leave Berkshire to work elsewhere. Counting Charlie, we now have six managers over 75, and I hope that in four years that number increases by at least two (Bob Shaw and I are both 72). Our rationale: "It's hard to teach a new dog old tricks."

Berkshire's operating CEOs are masters of their crafts and run their businesses as if they were their own. My job is to stay out of their way and allocate whatever excess capital their businesses generate. It's easy work.

My managerial model is Eddie Bennett, who was a batboy. In 1919, at age 19, Eddie began his work with the Chicago White Sox, who that year went to the World Series. The next year, Eddie switched to the Brooklyn Dodgers, and they, too, won their league title. Our hero, however, smelled trouble. Changing boroughs, he joined the Yankees in 1921, and they promptly won their first pennant in history. Now Eddie settled in, shrewdly seeing what was coming. In the next seven years, the Yankees won five American League titles.

What does this have to do with management? It's simple — to be a winner, work with winners. In 1927, for example, Eddie received $700 for the 1/8th World Series share voted him by the legendary Yankee team of Ruth and Gehrig. This sum, which Eddie earned by working only four days (because New York swept the Series) was roughly equal to the full-year pay then earned by batboys who worked with ordinary associates.

Eddie understood that how he lugged bats was unimportant; what counted instead was hooking up with the cream of those on the playing field. I've learned from Eddie. At Berkshire, I regularly hand bats to many of the heaviest hitters in American business.

Acquisitions

We added some sluggers to our lineup last year. Two acquisitions pending at yearend 2001 were completed: Albecca (which operates under the name Larson-Juhl), the U.S. leader in custom-made picture frames; and Fruit of the Loom, the producer of about 33.3% of the men's and boy's underwear sold in the U.S. and of other apparel as well.

Both companies came with outstanding CEOs: Steve McKenzie at Albecca and John Holland at Fruit. John, who had retired from Fruit in 1996, rejoined it three years ago and rescued the company from the disastrous path it had gone down after he'd left. He's now 70, and I am trying to convince him to make his next retirement coincident with mine (presently scheduled for five years after my death — a date subject, however, to extension).

We initiated and completed two other acquisitions last year that were somewhat below our normal size threshold. In aggregate, however, these businesses earn more than $60 million pre-tax annually. Both operate in industries characterized by tough economics, but both also have important competitive strengths that enable them to earn decent returns on capital.

The newcomers are:

1. CTB, a worldwide leader in equipment for the poultry, hog, egg production and grain industries; and

2. Garan, a manufacturer of children's apparel, whose largest and best-known line is Garanimals®.

These two companies came with the managers responsible for their impressive records: Vic Mancinelli at CTB and Seymour Lichtenstein at Garan.

The largest acquisition we initiated in 2002 was The Pampered Chef, a company with a fascinating history dating back to 1980. Doris Christopher was then a 34-year-old suburban Chicago home economics teacher with a husband, two little girls, and absolutely no business background. Wanting, however, to supplement her family's modest income, she turned to thinking about what she knew best — food preparation. Why not, she wondered, make a business out of marketing kitchenware, focusing on the items she herself had found most useful?

To get started, Doris borrowed $3,000 against her life insurance policy — all the money *ever* injected into the company — and went to the Merchandise Mart on a buying expedition. There, she picked up a dozen each of this and that, and then went home to set up operations in her basement.

Her plan was to conduct in-home presentations to small groups of women, gathered at the homes of their friends. While driving to her first presentation, though, Doris almost talked herself into returning home, convinced she was doomed to fail.

But the women she faced that evening loved her and her products, purchased $175 of goods, and TPC was underway. Working with her husband, Jay, Doris did $50,000 of business in the first year. Today — only 22 years later — TPC does more than $700 million of business annually, working through 67,000 kitchen consultants.

I've been to a TPC party, and it's easy to see why the business is a success. The company's products, in large part proprietary, are well-styled and highly useful, and the consultants are knowledgeable and enthusiastic. Everyone has a good time. Hurry to pamperedchef.com on the Internet to find where to attend a party near you.

Two years ago, Doris brought in Sheila O’Connell Cooper, now CEO, to share the management load, and in August they met with me in Omaha. It took me about ten seconds to decide that these were two managers with whom I wished to partner, and we promptly made a deal. Berkshire shareholders couldn’t be luckier than to be associated with Doris and Sheila.

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Berkshire also made some important acquisitions last year through MidAmerican Energy Holdings (MEHC), a company in which our equity interest is 80.2%. Because the Public Utility Holding Company Act (PUHCA) limits us to 9.9% voting control, however, we are unable to fully consolidate MEHC’s financial statements.

Despite the voting-control limitation — and the somewhat strange capital structure at MEHC it has engendered — the company is a key part of Berkshire. Already it has $18 billion of assets and delivers our largest stream of non-insurance earnings. It could well grow to be huge.

Last year MEHC acquired two important gas pipelines. The first, Kern River, extends from Southwest Wyoming to Southern California. This line moves about 900 million cubic feet of gas a day and is undergoing a $1.2 billion expansion that will double throughput by this fall. At that point, the line will carry enough gas to generate electricity for ten million homes.

The second acquisition, Northern Natural Gas, is a 16,600 mile line extending from the Southwest to a wide range of Midwestern locations. This purchase completes a corporate odyssey of particular interest to Omahans.

From its beginnings in the 1930s, Northern Natural was one of Omaha’s premier businesses, run by CEOs who regularly distinguished themselves as community leaders. Then, in July, 1985, the company — which in 1980 had been renamed InterNorth — merged with Houston Natural Gas, a business less than half its size. The companies announced that the enlarged operation would be headquartered in Omaha, with InterNorth’s CEO continuing in that job.

Within a year, those promises were broken. By then, the former CEO of Houston Natural had taken over the top job at InterNorth, the company had been renamed, and the headquarters had been moved to Houston. These switches were orchestrated by the new CEO — Ken Lay — and the name he chose was Enron.

Fast forward 15 years to late 2001. Enron ran into the troubles we've heard so much about and borrowed money from Dynegy, putting up the Northern Natural pipeline operation as collateral. The two companies quickly had a falling out, and the pipeline's ownership moved to Dynegy. That company, in turn, soon encountered severe financial problems of its own.

MEHC received a call on Friday, July 26, from Dynegy, which was looking for a quick and certain cash sale of the pipeline. Dynegy phoned the right party: On July 29, we signed a contract, and shortly thereafter Northern Natural returned home.

When 2001 began, Charlie and I had no idea that Berkshire would be moving into the pipeline business. But upon completion of the Kern River expansion, MEHC will transport about 8% of all gas used in the U.S. We continue to look for large energy-related assets, though in the electric utility field PUHCA constrains what we can do.

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A few years ago, and somewhat by accident, MEHC found itself in the residential real estate brokerage business. It is no accident, however, that we have dramatically expanded the operation. Moreover, we are likely to keep on expanding in the future.

We call this business HomeServices of America. In the various communities it serves, though, it operates under the names of the businesses it has acquired, such as CBS in Omaha, Edina Realty in Minneapolis and Iowa Realty in Des Moines. In most metropolitan areas in which we operate, we are the clear market leader.

HomeServices is now the second largest residential brokerage business in the country. On one side or the other (or both), we participated in $37 billion of transactions last year, up 100% from 2001.

Most of our growth came from three acquisitions we made during 2002, the largest of which was Prudential California Realty. Last year, this company, the leading realtor in a territory consisting of Los Angeles, Orange and San Diego Counties, participated in $16 billion of closings.

In a very short period, Ron Peltier, the company's CEO, has increased HomeServices' revenues — and profits — dramatically. Though this business will always be cyclical, it's one we like and in which we continue to have an appetite for sensible acquisitions.

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Dave Sokol, MEHC's CEO, and Greg Abel, his key associate, are huge assets for Berkshire. They are dealmakers, and they are managers. Berkshire stands ready to inject massive amounts of money into MEHC — and it will be fun to watch how far Dave and Greg can take the business.

The Economics of Property/Casualty Insurance

Our core business — though we have others of great importance — is insurance. To understand Berkshire, therefore, it is necessary that you understand how to evaluate an insurance company. The key determinants are: (1) the amount of float that the business generates; (2) its cost; and (3) most critical of all, the long-term outlook for both of these factors.

To begin with, float is money we hold but don't own. In an insurance operation, float arises because premiums are received before losses are paid, an interval that sometimes extends over many years. During that time, the insurer invests the money. This pleasant activity typically carries with it a downside: The premiums that an insurer takes in usually do not cover the losses and expenses it eventually must pay. That leaves it running an "underwriting loss," which is the cost of float. An insurance business has value if its cost of float over time is less than the cost the company would otherwise incur to obtain funds. But the business is a lemon if its cost of float is higher than market rates for money. Moreover, the downward trend of interest rates in recent years has transformed underwriting losses that formerly were tolerable into burdens that move insurance businesses deeply into the lemon category.

Historically, Berkshire has obtained its float at a very low cost. Indeed, our cost has been less than zero in many years; that is, we've actually been paid for holding other people's money. In 2001, however, our cost was terrible, coming in at 12.8%, about half of which was attributable to World Trade Center losses. Back in 1983-84, we had years that were even worse. There's nothing automatic about cheap float.

The table that follows shows (at intervals) the float generated by the various segments of Berkshire's insurance operations since we entered the business 36 years ago upon acquiring National Indemnity Company (whose traditional lines are included in the segment "Other Primary"). For the table we have calculated our float — which we generate in large amounts relative to our premium volume — by adding net loss reserves, loss adjustment reserves, funds held under reinsurance assumed and unearned premium reserves, and then subtracting insurance-related receivables, prepaid acquisition costs, prepaid taxes and deferred charges applicable to assumed reinsurance. (Got that?)

Yearend Float (in $ millions)

Year	**GEICO**	**General Re**	**Other Reinsurance**	**Other Primary**	**Total**
1967				20	20
1977			40	131	171
1987			701	807	1,508
1997	2,917		4,014	455	7,386
1998	3,125	14,909	4,305	415	22,754
1999	3,444	15,166	6,285	403	25,298
2000	3,943	15,525	7,805	598	27,871
2001	4,251	19,310	11,262	685	35,508
2002	4,678	22,207	13,396	943	41,224

Last year our cost of float was 1%. As I mentioned earlier, you should temper your enthusiasm about this favorable result given that no megacatastrophe occurred in 2002. We're certain to get one of these disasters periodically, and when we do our float-cost will spike.

Our 2002 results were hurt by 1) a painful charge at General Re for losses that should have been recorded as costs in earlier years, and 2) a "desirable" charge we incur annually for retroactive insurance (see the next section for more about these items). These costs totaled $1.75 billion, or about 4.6% of float. Fortunately, our overall underwriting experience on 2002 business was excellent, which allowed us, even after the charges noted, to approach a no-cost result.

Absent a megacatastrophe, I expect our cost of float in 2003 to again be very low — perhaps even less than zero. In the rundown of our insurance operations that follows, you will see why I'm optimistic that, over time, our underwriting results will both surpass those achieved by the industry and deliver us investable funds at minimal cost.

Insurance Operations

If our insurance operations are to generate low-cost float over time, they must: (a) underwrite with unwavering discipline; (b) reserve conservatively; and (c) avoid an aggregation of exposures that would allow a supposedly "impossible" incident to threaten their solvency. All of our major insurance businesses, with one exception, have regularly met those tests.

The exception is General Re, and there was much to do at that company last year to get it up to snuff. I'm delighted to report that under Joe Brandon's leadership, and with yeoman assistance by Tad Montross, enormous progress has been made on each of the fronts described.

When I agreed in 1998 to merge Berkshire with Gen Re, I thought that company stuck to the three rules I've enumerated. I had studied the operation for decades and had observed underwriting discipline that was consistent and reserving that was conservative. At merger time, I detected no slippage in Gen Re's standards.

I was dead wrong. Gen Re's culture and practices had substantially changed and unbeknownst to management — and to me — the company was grossly mispricing its current business. In addition, Gen Re had accumulated an aggregation of risks that would have been fatal had, say, terrorists detonated several large-scale nuclear bombs in an attack on the U.S. A disaster of that scope was highly improbable, of course, but it is up to insurers to limit their risks in a manner that leaves their finances rock-solid if the “impossible” happens. Indeed, had Gen Re remained independent, the World Trade Center attack alone would have threatened the company’s existence.

When the WTC disaster occurred, it exposed weaknesses in Gen Re’s operations that I should have detected earlier. But I was lucky: Joe and Tad were on hand, freshly endowed with increased authority and eager to rapidly correct the errors of the past. They knew what to do — and they did it.

It takes time for insurance policies to run off, however, and 2002 was well along before we managed to reduce our aggregation of nuclear, chemical and biological risk (NCB) to a tolerable level. That problem is now behind us.

On another front, Gen Re’s underwriting attitude has been dramatically altered: The entire organization now understands that we wish to write only properly-priced business, whatever the effect on volume. Joe and Tad judge themselves *only* by Gen Re’s underwriting profitability. Size simply doesn’t count.

Finally, we are making every effort to get our reserving right. If we fail at that, we can’t know our true costs. And any insurer that has no idea what its costs are is heading for big trouble.

At yearend 2001, General Re attempted to reserve adequately for all losses that had occurred prior to that date and were not yet paid — but we failed badly. Therefore the company’s 2002 underwriting results were penalized by an additional $1.31 billion that we recorded to correct the estimation mistakes of earlier years. When I review the reserving errors that have been uncovered at General Re, a line from a country song seems apt: “I wish I didn’t know now what I didn’t know then.”

I can promise you that our top priority going forward is to avoid inadequate reserving. But I can’t guarantee success. The natural tendency of most casualty-insurance managers is to underreserve, and they must have a particular mindset — which, it may surprise you, has nothing to do with actuarial expertise — if they are to overcome this devastating bias. Additionally, a reinsurer faces far more difficulties in reserving properly than does a primary insurer. Nevertheless, at Berkshire, we have generally been successful in our reserving, and we are determined to be at General Re as well.

In summary, I believe General Re is now well positioned to deliver huge amounts of no-cost float to Berkshire and that its sink-the-ship catastrophe risk has been eliminated. The company still possesses the important competitive strengths that I've outlined in the past. And it gained another highly significant advantage last year when each of its three largest worldwide competitors, previously rated AAA, was demoted by at least one rating agency. Among the giants, General Re, rated AAA across-the-board, is now in a class by itself in respect to financial strength.

No attribute is more important. Recently, in contrast, one of the world's largest reinsurers — a company regularly recommended to primary insurers by leading brokers — has all but ceased paying claims, including those both valid and due. This company owes many billions of dollars to hundreds of primary insurers who now face massive write-offs. "Cheap" reinsurance is a fool's bargain: When an insurer lays out money today in exchange for a reinsurer's promise to pay a decade or two later, it's dangerous — and possibly life-threatening — for the insurer to deal with any but the strongest reinsurer around. /P >

Berkshire shareholders owe Joe and Tad a huge thank you for their accomplishments in 2002. They worked harder during the year than I would wish for anyone — and it is paying off.

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At GEICO, everything went so well in 2002 that we should pinch ourselves. Growth was substantial, profits were outstanding, policyholder retention was up and sales productivity jumped significantly. These trends continue in early 2003.

Thank Tony Nicely for all of this. As anyone who knows him will attest, Tony has been in love with GEICO for 41 years — ever since he went to work for the company at 18 — and his results reflect this passion. He is proud of the money we save policyholders — about $1 billion annually versus what other insurers, on average, would have charged them. He is proud of the service we provide these policyholders: In a key industry survey, GEICO was recently ranked above all major competitors. He is proud of his 19,162 associates, who last year were awarded profit-sharing payments equal to 19% of their base salary because of the splendid results they achieved. And he is proud of the growing profits he delivers to Berkshire shareholders.

GEICO took in $2.9 billion in premiums when Berkshire acquired full ownership in 1996. Last year, its volume was $6.9 billion, with plenty of growth to come. Particularly promising is the company's Internet operation, whose new business grew by 75% last year. Check us out at GEICO.com (or call 800-847-7536). In most states, shareholders get a special 8% discount.

Here's one footnote to GEICO's 2002 earnings that underscores the need for insurers to do business with only the strongest of reinsurers. In 1981-1983, the managers then running GEICO decided to try their hand at writing commercial umbrella and product liability insurance. The risks seemed modest: the company took in only $3,051,000 from this line and used almost all of it — $2,979,000 — to buy reinsurance in order to limit its losses. GEICO was left with a paltry $72,000 as compensation for the minor portion of the risk that it retained. But this small bite of the apple was more than enough to make the experience memorable. GEICO's losses from this venture now total a breathtaking $94.1 *million* or about 130,000% of the net premium it received. Of the total loss, uncollectable receivables from deadbeat reinsurers account for no less than $90.3 million (including $19 million charged in 2002). So much for "cheap" reinsurance.

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Ajit Jain's reinsurance division was the major reason our float cost us so little last year. If we ever put a photo in a Berkshire annual report, it will be of Ajit. In color!

Ajit's operation has amassed $13.4 billion of float, more than all but a handful of insurers have ever built up. He accomplished this from a standing start in 1986, and even now has a workforce numbering only 20. And, most important, he has produced underwriting profits.

His profits are particularly remarkable if you factor in some accounting arcana that I am about to lay on you. So prepare to eat your spinach (or, alternatively, if debits and credits aren't your thing, skip the next two paragraphs).

Ajit's 2002 underwriting profit of $534 million came *after* his operation recognized a charge of $428 million attributable to "retroactive" insurance he has written over the years. In this line of business, we assume from another insurer the obligation to pay up to a specified amount for losses they have already incurred — often for events that took place decades earlier — but that are yet to be paid (for example, because a worker hurt in 1980 will receive monthly payments for life). In these arrangements, an insurer pays us a large upfront premium, but one that is less than the losses we expect to pay. We willingly accept this differential because a) our payments are capped, and b) we get to use the money until loss payments are actually made, with these often stretching out over a decade or more. About 80% of the $6.6 billion in asbestos and environmental loss reserves that we carry arises from capped contracts, whose costs consequently can't skyrocket.

When we write a retroactive policy, we immediately record both the premium and a reserve for the expected losses. The difference between the two is entered as an asset entitled "deferred charges — reinsurance assumed." This is no small item: at yearend, for all retroactive policies, it was $3.4 billion. We then amortize this asset downward by charges to income over the expected life of each policy. These charges — $440 million in 2002, including charges at Gen Re — create an underwriting loss, but one that is intentional and desirable. And even after this drag on reported results, Ajit achieved a large underwriting gain last year.

We want to emphasize, however, that we assume risks in Ajit's operation that are huge — *far* larger than those retained by any other insurer in the world. Therefore, a single event could cause a major swing in Ajit's results in any given quarter or year. That bothers us not at all: As long as we are paid appropriately, we love taking on short-term volatility that others wish to shed. At Berkshire, we would rather earn a lumpy 15% over time than a smooth 12%.

If you see Ajit at our annual meeting, bow deeply.

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Berkshire's smaller insurers had an outstanding year. Their aggregate float grew by 38%, and they realized an underwriting profit of $32 million, or 4.5% of premiums. Collectively, these operations would make one of the finest insurance companies in the country.

Included in these figures, however, were terrible results in our California workers' compensation operation. There, we have work to do. There, too, our reserving severely missed the mark. Until we figure out how to get this business right, we will keep it small.

For the fabulous year they had in 2002, we thank Rod Eldred, John Kizer, Tom Nerney, Don Towle and Don Wurster. They added a lot of value to your Berkshire investment.

Sources of Reported Earnings

The table that follows shows the main sources of Berkshire's reported earnings. You will notice that "Purchase-Accounting Adjustments" dropped sharply in 2002, the reason being that GAAP rules changed then, no longer requiring the amortization of goodwill. This change increases our reported earnings, but has no effect on our economic earnings.

	(in millions)			
	Pre-Tax Earnings		Berkshire's Share of Net Earnings (after taxes and Minority interests)	
	2002	2001	2002	2001
Operating Earnings:				
Insurance Group:				
Underwriting – General Re	$(1,393)	$(3,671)	$(930)	$(2,391)
Underwriting – Berkshire Group	534	(647)	347	(433)
Underwriting – GEICO	416	221	271	144
Underwriting – Other Primary	32	30	20	18
Net Investment Income	3,050	2,824	2,096	1,968
Apparel[1]	229	(33)	156	(28)
Building Products[2]	516	461	313	287
Finance and Financial Products Business	1,016	519	659	336
Flight Services	225	186	133	105
MidAmerican Energy (80% owned)	613	565	359	230
Retail Operations	166	175	97	101
Scott Fetzer (excluding finance operation)	129	129	83	83
Shaw Industries[3]	424	292	258	156
Other Businesses	256	212	160	131
Purchase-Accounting Adjustments	(119)	(726)	(65)	(699)
Corporate Interest Expense	(86)	(92)	(55)	(60)
Shareholder-Designated Contributions	(17)	(17)	(11)	(11)
Other	19	25	12	16
Operating Earnings	6,010	453	3,903	(47)
Capital Gains from Investments	603	1,320	383	842
Total Earnings – All Entities	$6,613	$1,773	$4,286	$ 795

[1] *Includes Fruit of the Loom from April 30, 2002 and Garan from September 4, 2002.*

[2] *Includes Johns Manville from February 27, 2001 and MiTek from July 31, 2001.*

[3] *From date of acquisition, January 8, 2001.*

Here's a summary of major developments at our non-insurance businesses:

• MidAmerican Energy's earnings grew in 2002 and will likely do so again this year. Most of the increase, both present and expected, results from the acquisitions described earlier. To fund these, Berkshire purchased $1,273 million of MidAmerican junior debt (bringing our total holdings of these 11% obligations to $1,728 million) and also invested $402 million in a "common-equivalent" stock. We now own (on a fully-diluted basis) 80.2% of MidAmerican's equity. MidAmerican's financial statements are presented in detail on page 37.

• Last year I told you of the problems at Dexter that led to a huge loss in our shoe business. Thanks to Frank Rooney and Jim Issler of H.H. Brown, the Dexter operation has been turned around. Despite the cost of unwinding our problems there, we earned $24 million in shoes last year, an upward swing of $70 million from 2001.

Randy Watson at Justin also contributed to this improvement, increasing margins significantly while trimming invested capital. Shoes are a tough business, but we have terrific managers and believe that in the future we will earn reasonable returns on the capital we employ in this operation.

• In a so-so year for home-furnishing and jewelry retailers, our operations did well. Among our eight retailing operations, the best performer was Homemaker's in Des Moines. There, the talented Merschman family achieved outstanding gains in both sales and profits.

Nebraska Furniture Mart will open a new blockbuster store in metropolitan Kansas City in August. With 450,000 square feet of retail space, it could well produce the second largest volume of any furniture store in the country — the Omaha operation being the national champion. I hope Berkshire shareholders in the Kansas City area will come out for the opening (and keep coming).

Our home and construction-related businesses — Acme Brick, Benjamin Moore Paint, Johns-Manville, MiTek and Shaw — delivered $941 million of pre-tax earnings last year. Of particular significance was Shaw's gain from $292 million in 2001 to $424 million. Bob Shaw and Julian Saul are terrific operators. Carpet prices increased only 1% last year, but Shaw's productivity gains and excellent expense control delivered significantly improved margins.

We cherish cost-consciousness at Berkshire. Our model is the widow who went to the local newspaper to place an obituary notice. Told there was a 25-cents-a-word charge, she requested "Fred Brown died." She was then informed there was a seven-word minimum. "Okay" the bereaved woman replied, "make it 'Fred Brown died, golf clubs for sale'."

• Earnings from flight services increased last year — but only because we realized a special pre-tax gain of $60 million from the sale of our 50% interest in FlightSafety Boeing. Without this gain, earnings from our training business would have fallen slightly in concert with the slowdown in business-aviation activity. FlightSafety training continues to be the gold standard for the industry, and we expect growth in the years to come.

At NetJets, our fractional-ownership operation, we are the runaway leader of the four-company field. FAA records indicate that our industry share in 2002 was 75%, meaning that clients purchased or leased planes from us that were valued at triple those recorded by our three competitors *combined*. Last year, our fleet flew 132.7 million nautical miles, taking clients to 130 countries.

Our preeminence is directly attributable to Rich Santulli, NetJets' CEO. He invented the business in 1986 and ever since has exhibited an unbending devotion to the highest levels of service, safety and security. Rich, Charlie and I insist on planes (and personnel) worthy of carrying our own families — because they regularly do.

Though NetJets revenues set a record in 2002, the company again lost money. A small profit in the

U.S. was more than offset by losses in Europe. Overall, the fractional-ownership industry lost significant sums last year, and that is almost certain to be the outcome in 2003 as well. The bald fact is that airplanes are costly to operate.

Over time, this economic reality should work to our advantage, given that for a great many companies, private aircraft are an essential business tool. And for most of these companies, NetJets makes compelling sense as either a primary or supplementary supplier of the aircraft they need.

Many businesses could save millions of dollars annually by flying with us. Indeed, the yearly savings at some large companies could exceed $10 million. Equally important, these companies would actually increase their operational capabilities by using us. A fractional ownership of a single NetJets plane allows a client to have several planes in the air simultaneously. Additionally, through the interchange arrangement we make available, an owner of an interest in one plane can fly any of 12 other models, using whatever plane makes most sense for a mission. (One of my sisters owns a fraction of a Falcon 2000, which she uses for trips to Hawaii, but —

exhibiting the Buffett gene — she interchanges to a more economical Citation Excel for short trips in the U.S.)

The roster of NetJets users confirms the advantages we offer major businesses. Take General Electric, for example. It has a large fleet of its own but also has an unsurpassed knowledge of how to utilize aircraft effectively and economically. And it is our largest customer.

• Our finance and financial products line covers a variety of operations, among them certain activities in high-grade fixed-income securities that proved highly profitable in 2002. Earnings in this arena will probably continue for a while, but are certain to decrease — and perhaps disappear — in time.

This category also includes a highly satisfactory — but rapidly diminishing — income stream from our Berkadia investment in Finova (described in last year's report). Our partner, Leucadia National Corp., has managed this operation with great skill, willingly doing far more than its share of the heavy lifting. I like this division of labor and hope to join with Leucadia in future transactions.

On the minus side, the Finance line also includes the operations of General Re Securities, a derivatives and trading business. This entity lost $173 million pre-tax last year, a result that, in part, is a belated acknowledgment of faulty, albeit standard, accounting it used in earlier periods. Derivatives, in fact, deserve an extensive look, both in respect to the accounting their users employ and to the problems they may pose for both individual companies and our economy.

Derivatives

Charlie and I are of one mind in how we feel about derivatives and the trading activities that go with them: We view them as time bombs, both for the parties that deal in them and the economic system.

Having delivered that thought, which I'll get back to, let me retreat to explaining derivatives, though the explanation must be general because the word covers an extraordinarily wide range of financial contracts. Essentially, these instruments call for money to change hands at some future date, with the amount to be determined by one or more reference items, such as interest rates, stock prices or currency values. If, for example, you are either long or short an S&P 500 futures contract, you are a party to a very simple derivatives transaction — with your gain or loss *derived* from movements in the index. Derivatives contracts are of varying duration (running sometimes to 20 or more years) and their value is often tied to several variables.

Unless derivatives contracts are collateralized or guaranteed, their ultimate value also depends on the creditworthiness of the counterparties to them. In the meantime, though, before a contract is settled, the counterparties record profits and losses — often huge in amount — in their current earnings statements without so much as a penny changing hands.

The range of derivatives contracts is limited only by the imagination of man (or sometimes, so it seems, madmen). At Enron, for example, newsprint and broadband derivatives, due to be settled many years in the future, were put on the books. Or say you want to write a contract speculating on the number of twins to be born in Nebraska in 2020. No problem — at a price, you will easily find an obliging counterparty.

When we purchased Gen Re, it came with General Re Securities, a derivatives dealer that Charlie and I didn't want, judging it to be dangerous. We failed in our attempts to sell the operation, however, and are now terminating it.

But closing down a derivatives business is easier said than done. It will be a great many years before we are totally out of this operation (though we reduce our exposure daily). In fact, the reinsurance and derivatives businesses are similar: Like Hell, both are easy to enter and almost impossible to exit. In either industry, once you write a contract — which may require a large payment decades later — you are usually stuck with it. True, there are methods by which the risk can be laid off with others. But most strategies of that kind leave you with residual liability.

Another commonality of reinsurance and derivatives is that both generate reported earnings that are often wildly overstated. That's true because today’s earnings are in a significant way based on estimates whose inaccuracy may not be exposed for many years.

Errors will usually be honest, reflecting only the human tendency to take an optimistic view of one’s commitments. But the parties to derivatives also have enormous incentives to cheat in accounting for them. Those who trade derivatives are usually paid (in whole or part) on “earnings” calculated by mark-to-market accounting. But often there is no real market (think about our contract involving twins) and “mark-to-model” is utilized. This substitution can bring on large-scale mischief. As a general rule, contracts involving multiple reference items and distant settlement dates increase the opportunities for counterparties to use fanciful assumptions. In the twins scenario, for example, the two parties to the contract might well use differing models allowing *both* to show substantial profits for many years. In extreme cases, mark-to-model degenerates into what I would call mark-to-myth.

Of course, both internal and outside auditors review the numbers, but that’s no easy job. For example, General Re Securities at yearend (after ten months of winding down its operation) had 14,384 contracts outstanding, involving 672 counterparties around the world. Each contract had a plus or minus value derived from one or more reference items, including some of mind-boggling complexity. Valuing a portfolio like that, expert auditors could easily and honestly have widely varying opinions.

The valuation problem is far from academic: In recent years, some huge-scale frauds and near-frauds have been facilitated by derivatives trades. In the energy and electric utility sectors, for example, companies used derivatives and trading activities to report great “earnings” — until the roof fell in when they actually tried to convert the derivatives-related receivables on their balance sheets into cash. “Mark-to-market” then turned out to be truly “mark-to-myth.”

I can assure you that the marking errors in the derivatives business have not been symmetrical. Almost invariably, they have favored either the trader who was eyeing a multi-million dollar bonus or the CEO who wanted to report impressive “earnings” (or both). The bonuses were paid, and the CEO profited from his options. Only much later did shareholders learn that the reported earnings were a sham.

Another problem about derivatives is that they can exacerbate trouble that a corporation has run into for completely unrelated reasons. This pile-on effect occurs because many derivatives contracts require that a company suffering a credit downgrade immediately supply collateral to counterparties. Imagine, then, that a company is downgraded because of general adversity and that its derivatives instantly kick in with *their* requirement, imposing an unexpected and enormous demand for cash collateral on the company. The need to meet this demand can then throw the company into a liquidity crisis that may, in some cases, trigger still more downgrades. It all becomes a spiral that can lead to a corporate meltdown.

Derivatives also create a daisy-chain risk that is akin to the risk run by insurers or reinsurers that lay off much of their business with others. In both cases, huge receivables from many counterparties tend to build up over time. (At Gen Re Securities, we still have $6.5 billion of receivables, though we've been in a liquidation mode for nearly a year.) A participant may see himself as prudent, believing his large credit exposures to be diversified and therefore not dangerous. Under certain circumstances, though, an exogenous event that causes the receivable from Company A to go bad will also affect those from Companies B through Z. History teaches us that a crisis often causes problems to correlate in a manner undreamed of in more tranquil times.

In banking, the recognition of a "linkage" problem was one of the reasons for the formation of the Federal Reserve System. Before the Fed was established, the failure of weak banks would sometimes put sudden and unanticipated liquidity demands on previously-strong banks, causing them to fail in turn. The Fed now insulates the strong from the troubles of the weak. But there is no central bank assigned to the job of preventing the dominoes toppling in insurance or derivatives. In these industries, firms that are fundamentally solid can become troubled simply because of the travails of other firms further down the chain. When a "chain reaction" threat exists within an industry, it pays to minimize links of any kind. That's how we conduct our reinsurance business, and it's one reason we are exiting derivatives.

Many people argue that derivatives reduce systemic problems, in that participants who can't bear certain risks are able to transfer them to stronger hands. These people believe that derivatives act to stabilize the economy, facilitate trade, and eliminate bumps for individual participants. And, on a micro level, what they say is often true. Indeed, at Berkshire, I sometimes engage in large-scale derivatives transactions in order to facilitate certain investment strategies.

Charlie and I believe, however, that the macro picture is dangerous and getting more so. Large amounts of risk, particularly credit risk, have become concentrated in the hands of relatively few derivatives dealers, who in addition trade extensively with one other. The troubles of one could quickly infect the others. On top of that, these dealers are owed huge amounts by non-dealer counterparties. Some of these counterparties, as I've mentioned, are linked in ways that could cause them to contemporaneously run into a problem because of a single event (such as the implosion of the telecom industry or the precipitous decline in the value of merchant power projects). Linkage, when it suddenly surfaces, can trigger serious systemic problems.

Indeed, in 1998, the leveraged and derivatives-heavy activities of a single hedge fund, Long-Term Capital Management, caused the Federal Reserve anxieties so severe that it hastily orchestrated a rescue effort. In later Congressional testimony, Fed officials acknowledged that, had they not intervened, the outstanding trades of LTCM — a firm unknown to the general public and employing only a few hundred people — could well have posed a serious threat to the stability of American markets. In other words, the Fed acted because its leaders were fearful of what might have happened to other financial institutions had the LTCM domino toppled. And this affair, though it paralyzed many parts of the fixed-income market for weeks, was far from a worst-case scenario.

One of the derivatives instruments that LTCM used was total-return swaps, contracts that facilitate 100% leverage in various markets, including stocks. For example, Party A to a contract, usually a bank, puts up all of the money for the purchase of a stock while Party B, without putting up any capital, agrees that at a future date it will receive any gain or pay any loss that the bank realizes.

Total-return swaps of this type make a joke of margin requirements. Beyond that, other types of derivatives severely curtail the ability of regulators to curb leverage and generally get their arms around the risk profiles of banks, insurers and other financial institutions. Similarly, even experienced investors and analysts encounter major problems in analyzing the financial condition of firms that are heavily involved with derivatives contracts. When Charlie and I finish reading the long footnotes detailing the derivatives activities of major banks, the only thing we understand is that we *don't* understand how much risk the institution is running.

The derivatives genie is now well out of the bottle, and these instruments will almost certainly multiply in variety and number until some event makes their toxicity clear. Knowledge of how dangerous they are has already permeated the electricity and gas businesses, in which the eruption of major troubles caused the use of derivatives to diminish dramatically. Elsewhere, however, the derivatives business continues to expand unchecked. Central banks and governments have so far found no effective way to control, or even monitor, the risks posed by these contracts.

Charlie and I believe Berkshire should be a fortress of financial strength — for the sake of our owners, creditors, policyholders and employees. We try to be alert to any sort of megacatastrophe risk, and that posture may make us unduly apprehensive about the burgeoning quantities of long-term derivatives contracts and the massive amount of uncollateralized receivables that are growing alongside. In our view, however, derivatives are financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal.

Investments

Below we show our common stock investments. Those that had a market value of more than $500 million at the end of 2002 are itemized.

Shares	Company	12/31/02 Cost	Market
		(dollars in millions)	
151,610,700	American Express Company	$ 1,470	$ 5,359
200,000,000	The Coca-Cola Company	1,299	8,768
96,000,000	The Gillette Company	600	2,915
15,999,200	H&R Block, Inc.	255	643
6,708,760	M&T Bank	103	532
24,000,000	Moody's Corporation	499	991
1,727,765	The Washington Post Company	11	1,275
53,265,080	Wells Fargo & Company	306	2,497
	Others	4,621	5,383
	Total Common Stocks	$9,164	$28,363

We continue to do little in equities. Charlie and I are increasingly comfortable with our holdings in Berkshire's major investees because most of them have increased their earnings while their valuations have decreased. But we are not inclined to add to them. Though these enterprises have good prospects, we don't yet believe their shares are undervalued.

In our view, the same conclusion fits stocks generally. Despite three years of falling prices, which have significantly improved the attractiveness of common stocks, we still find *very* few that even mildly interest us. That dismal fact is testimony to the insanity of valuations reached during The Great Bubble. Unfortunately, the hangover may prove to be proportional to the binge.

The aversion to equities that Charlie and I exhibit today is far from congenital. We love owning common stocks — if they can be purchased at attractive prices. In my 61 years of investing, 50 or so years have offered that kind of opportunity. There will be years like that again. Unless, however, we see a very high probability of at least 10% pre-tax returns (which translate to 6½-7% after corporate tax), we will sit on the sidelines. With short-term money returning less than 1% after-tax, sitting it out is no fun. But occasionally successful investing requires inactivity.

Last year we were, however, able to make sensible investments in a few "junk" bonds and loans. Overall, our commitments in this sector sextupled, reaching $8.3 billion by yearend.

Investing in junk bonds and investing in stocks are alike in certain ways: Both activities require us to make a price-value calculation and also to scan hundreds of securities to find the very few that have attractive reward/risk ratios. But there are important differences between the two disciplines as well. In stocks, we expect every commitment to work out well because we concentrate on conservatively financed businesses with strong competitive strengths, run by able and honest people. If we buy into these companies at sensible prices, losses should be rare. Indeed, during the 38 years we have run the company's affairs, gains from the equities we manage at Berkshire (that is, excluding those managed at General Re and GEICO) have exceeded losses by a ratio of about 100 to one.

Purchasing junk bonds, we are dealing with enterprises that are far more marginal. These businesses are usually overloaded with debt and often operate in industries characterized by low returns on capital. Additionally, the quality of management is sometimes questionable. Management may even have interests that are directly counter to those of debtholders. Therefore, we expect that we will have occasional large losses in junk issues. So far, however, we have done reasonably well in this field.

Corporate Governance

Both the ability and fidelity of managers have long needed monitoring. Indeed, nearly 2,000 years ago, Jesus Christ addressed this subject, speaking (Luke 16:2) approvingly of "a certain rich man" who told his manager, "Give an account of thy stewardship; for thou mayest no longer be steward."

Accountability and stewardship withered in the last decade, becoming qualities deemed of little importance by those caught up in the Great Bubble. As stock prices went up, the behavioral norms of managers went down. By the late '90s, as a result, CEOs who traveled the high road did not encounter heavy traffic.

Most CEOs, it should be noted, are men and women you would be happy to have as trustees for your children's assets or as next-door neighbors. Too many of these people, however, have in recent years behaved badly at the office, fudging numbers and drawing obscene pay for mediocre business achievements. These otherwise decent people simply followed the career path of Mae West: “I was Snow White but I drifted.”

In theory, corporate boards should have prevented this deterioration of conduct. I last wrote about the responsibilities of directors in the 1993 annual report. (We will send you a copy of this discussion on request, or you may read it on the Internet in the Corporate Governance section of the 1993 letter.) There, I said that directors “should behave as if there was a single absentee owner, whose long-term interest they should try to further in all proper ways.” This means that directors must get rid of a manager who is mediocre or worse, no matter how likable he may be. Directors must react as did the chorus-girl bride of an 85-yearold multimillionaire when he asked whether she would love him if he lost his money. “Of course,” the young beauty replied, “I would miss you, but I would still love you.”

In the 1993 annual report, I also said directors had another job: “If able but greedy managers overreach and try to dip too deeply into the shareholders’ pockets, directors must slap their hands.” Since I wrote that, over-reaching has become common but few hands have been slapped.

Why have intelligent and decent directors failed so miserably? The answer lies not in inadequate laws — it’s always been clear that directors are obligated to represent the interests of shareholders — but rather in what I’d call “boardroom atmosphere.”

It’s almost impossible, for example, in a boardroom populated by well-mannered people, to raise the question of whether the CEO should be replaced. It’s equally awkward to question a proposed acquisition that has been endorsed by the CEO, particularly when his inside staff and outside advisors are present and unanimously support his decision. (They wouldn’t be in the room if they didn’t.) Finally, when the compensation committee — armed, as always, with support from a high-paid consultant — reports on a megagrant of options to the CEO, it would be like belching at the dinner table for a director to suggest that the committee reconsider.

These “social” difficulties argue for outside directors regularly meeting without the CEO — a reform that is being instituted and that I enthusiastically endorse. I doubt, however, that most of the other new governance rules and recommendations will provide benefits commensurate with the monetary and other costs they impose.

The current cry is for "independent" directors. It is certainly true that it is desirable to have directors who think and speak independently — but they must also be business-savvy, interested and shareholder-oriented. In my 1993 commentary, those are the three qualities I described as essential.

Over a span of 40 years, I have been on 19 public-company boards (excluding Berkshire's) and have interacted with perhaps 250 directors. Most of them were "independent" as defined by today's rules. But the great majority of these directors lacked at least one of the three qualities I value. As a result, their contribution to shareholder well-being was minimal at best and, too often, negative. These people, decent and intelligent though they were, simply did not know enough about business and/or care enough about shareholders to question foolish acquisitions or egregious compensation. My own behavior, I must ruefully add, frequently fell short as well: Too often I was silent when management made proposals that I judged to be counter to the interests of shareholders. In those cases, collegiality trumped independence.

So that we may further see the failings of "independence," let's look at a 62-year case study covering thousands of companies. Since 1940, federal law has mandated that a large proportion of the directors of investment companies (most of these mutual funds) be independent. The requirement was originally 40% and now it is 50%. In any case, the typical fund has long operated with a majority of directors who qualify as independent.

These directors and the entire board have many perfunctory duties, but in actuality have only two important responsibilities: obtaining the best possible investment manager and negotiating with that manager for the lowest possible fee. When you are seeking investment help yourself, those two goals are the only ones that count, and directors acting for other investors should have exactly the same priorities. Yet when it comes to independent directors pursuing either goal, their record has been absolutely pathetic.

Many thousands of investment-company boards meet annually to carry out the vital job of selecting who will manage the savings of the millions of owners they represent. Year after year the directors of Fund A select manager A, Fund B directors select manager B, etc. … in a zombie-like process that makes a mockery of stewardship. Very occasionally, a board will revolt. But for the most part, a monkey will type out a Shakespeare play before an “independent” mutual-fund director will suggest that his fund look at other managers, even if the incumbent manager has persistently delivered substandard performance. When they are handling their own money, of course, directors will look to alternative advisors — but it never enters their minds to do so when they are acting as fiduciaries for others.

The hypocrisy permeating the system is vividly exposed when a fund management company — call it “A” — is sold for a huge sum to Manager “B”. Now the “independent” directors experience a “counterrevelation” and decide that Manager B is the best that can be found — even though B was available (and ignored) in previous years. Not so incidentally, B also could formerly have been hired at a far lower rate than is possible now that it has bought Manager A. That’s because B has laid out a fortune to acquire A, and B must now recoup that cost through fees paid by the A shareholders who were “delivered” as part of the deal. (For a terrific discussion of the mutual fund business, read John Bogle’s *Common Sense on Mutual Funds*.)

A few years ago, my daughter was asked to become a director of a family of funds managed by a major institution. The fees she would have received as a director were very substantial, enough to have increased her annual income by about 50% (a boost, she will tell you, she could use!). Legally, she would have been an independent director. But did the fund manager who approached her think there was *any* chance that she would think independently as to what advisor the fund should employ? Of course not. I am proud to say that she showed *real* independence by turning down the offer. The fund, however, had no trouble filling the slot (and — surprise — the fund has not changed managers).

Investment company directors have failed as well in negotiating management fees (just as compensation committees of many American companies have failed to hold the compensation of their CEOs to sensible levels). If you or I were empowered, I can assure you that we could easily negotiate materially lower management fees with the incumbent managers of most mutual funds. And, believe me, if directors were promised a portion of any fee savings they realized, the skies would be filled with falling fees. Under the current system, though, reductions mean nothing to “independent” directors while meaning everything to managers. So guess who wins?

Having the right money manager, of course, is far more important to a fund than reducing the manager’s fee. Both tasks are nonetheless the job of directors. And in stepping up to these all-important responsibilities, tens of thousands of “independent” directors, over more than six decades, have failed miserably. (They’ve succeeded, however, in taking care of themselves; their fees from serving on multiple boards of a single “family” of funds often run well into six figures.)

When the manager cares deeply and the directors don’t, what’s needed is a powerful countervailing force — and that’s the missing element in today’s corporate governance. Getting rid of mediocre CEOs and eliminating overreaching by the able ones requires action by owners — big owners. The logistics aren’t that tough: The ownership of stock has grown increasingly concentrated in recent decades, and today it would be easy for institutional managers to exert their will on problem situations. Twenty, or even fewer, of the largest institutions, acting together, could effectively reform corporate governance at a given company, simply by withholding their votes for directors who were tolerating odious behavior. In my view, this kind of concerted action is the only way that corporate stewardship can be meaningfully improved.

Unfortunately, certain major investing institutions have “glass house” problems in arguing for better governance elsewhere; they would shudder, for example, at the thought of their own performance and fees being closely inspected by their own boards. But Jack Bogle of Vanguard fame, Chris Davis of Davis Advisors, and Bill Miller of Legg Mason are now offering leadership in getting CEOs to treat their owners properly. Pension funds, as well as other fiduciaries, will reap better investment returns in the future if they support these men.

The acid test for reform will be CEO compensation. Managers will cheerfully agree to board “diversity,” attest to SEC filings and adopt meaningless proposals relating to process. What many will fight, however, is a hard look at their own pay and perks.

In recent years compensation committees too often have been tail-wagging puppy dogs meekly following recommendations by consultants, a breed not known for allegiance to the faceless shareholders who pay their fees. (If you can't tell whose side someone is on, they are *not* on yours.) True, each committee is required by the SEC to state its reasoning about pay in the proxy. But the words are usually boilerplate written by the company's lawyers or its human-relations department.

This costly charade should cease. Directors should not serve on compensation committees unless they are *themselves* capable of negotiating on behalf of owners. They should explain both how they think about pay and how they measure performance. Dealing with shareholders' money, moreover, they should behave as they would were it their own.

In the 1890s, Samuel Gompers described the goal of organized labor as "More!" In the 1990s, America's CEOs adopted his battle cry. The upshot is that CEOs have often amassed riches while their shareholders have experienced financial disasters.

Directors should stop such piracy. There's nothing wrong with paying well for truly exceptional business performance. But, for anything short of that, it's time for directors to shout "Less!" It would be a travesty if the bloated pay of recent years became a baseline for future compensation. Compensation committees should go back to the drawing boards.

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Rules that have been proposed and that are almost certain to go into effect will require changes in Berkshire's board, obliging us to add directors who meet the codified requirements for "independence."

Doing so, we will add a test that we believe is important, but far from determinative, in fostering independence: We will select directors who have huge and true ownership interests (that is, stock that they or their family have *purchased*, not been given by Berkshire or received via options), expecting those interests to influence their actions to a degree that dwarfs other considerations such as prestige and board fees.

That gets to an often-overlooked point about directors' compensation, which at public companies averages perhaps $50,000 annually. It baffles me how the many directors who look to these dollars for perhaps 20% or more of their annual income can be considered independent when Ron Olson, for example, who is on our board, may be deemed not independent because he receives a tiny percentage of his very large income from Berkshire legal fees. As the investment company saga suggests, a director whose moderate income is heavily dependent on directors' fees — and who hopes mightily to be invited to join other boards in order to earn more fees — is highly unlikely to offend a CEO or fellow directors, who in a major way will determine his reputation in corporate circles. If regulators believe that "significant" money taints independence (and it certainly can), they have overlooked a massive class of possible offenders.

At Berkshire, wanting our fees to be meaningless to our directors, we pay them only a pittance. Additionally, not wanting to insulate our directors from any corporate disaster we might have, we don't provide them with officers' and directors' liability insurance (an unorthodoxy that, not so incidentally, has saved our shareholders many millions of dollars over the years). Basically, we want the behavior of our directors to be driven by the effect their decisions will have on their family's net worth, not by their compensation. That's the equation for Charlie and me as managers, and we think it's the right one for Berkshire directors as well.

To find new directors, we will look through our shareholders list for people who directly, or in their family, have had large Berkshire holdings — in the millions of dollars — for a long time. Individuals making that cut should automatically meet two of our tests, namely that they be interested in Berkshire and shareholder-oriented. In our third test, we will look for business savvy, a competence that is far from commonplace.

Finally, we will continue to have members of the Buffett family on the board. They are not there to run the business after I die, nor will they then receive compensation of any kind. Their purpose is to ensure, for both our shareholders and managers, that Berkshire's special culture will be nurtured when I'm succeeded by other CEOs.

Any change we make in the composition of our board will not alter the way Charlie and I run Berkshire. We will continue to emphasize substance over form in our work and waste as little time as possible during board meetings in show-and-tell and perfunctory activities. The most important job of our board is likely to be the selection of successors to Charlie and me, and that is a matter upon which it will focus.

The board we have had up to now has overseen a shareholder-oriented business, consistently run in accord with the economic principles set forth on pages 68-74 (which I urge all new shareholders to read). Our goal is to obtain new directors who are equally devoted to those principles.

The Audit Committee

Audit committees can't audit. Only a company's outside auditor can determine whether the earnings that a management purports to have made are suspect. Reforms that ignore this reality and that instead focus on the structure and charter of the audit committee will accomplish little.

As we've discussed, far too many managers have fudged their company's numbers in recent years, using both accounting and operational techniques that are typically legal but that nevertheless materially mislead investors. Frequently, auditors knew about these deceptions. Too often, however, they remained silent. The key job of the audit committee is simply to get the auditors to divulge what they know.

To do this job, the committee must make sure that the auditors worry more about misleading its members than about offending management. In recent years auditors have not felt that way. They have instead generally viewed the CEO, rather than the shareholders or directors, as their client. That has been a natural result of day-to-day working relationships and also of the auditors' understanding that, no matter what the book says, the CEO and CFO pay their fees and determine whether they are retained for both auditing and other work. The rules that have been recently instituted won't materially change this reality. What *will* break this cozy relationship is audit committees unequivocally putting auditors on the spot, making them understand they will become liable for major monetary penalties if they don't come forth with what they know or suspect.

In my opinion, audit committees can accomplish this goal by asking four questions of auditors, the answers to which should be recorded and reported to shareholders. These questions are:

1. If the auditor were solely responsible for preparation of the company's financial statements, would they have in any way been prepared differently from the manner selected by management? This question should cover both material and nonmaterial differences. If the auditor would have done something differently, both management's argument and the auditor's response should be disclosed. The audit committee should then evaluate the facts.
2. If the auditor were an investor, would he have received — in plain English — the information essential to his understanding the company's financial performance during the reporting period?
3. Is the company following the same internal audit procedure that would be followed if the auditor himself were CEO? If not, what are the differences and why?
4. Is the auditor aware of any actions — either accounting or operational — that have had the purpose and effect of moving revenues or expenses from one reporting period to another?

If the audit committee asks these questions, its composition — the focus of most reforms — is of minor importance. In addition, the procedure will save time and expense. When auditors are put on the spot, they will do their duty. If they are not put on the spot . . . well, we have seen the results of that.

The questions we have enumerated should be asked at least a week before an earnings report is released to the public. That timing will allow differences between the auditors and management to be aired with the committee and resolved. If the timing is tighter — if an earnings release is imminent when the auditors and committee interact — the committee will feel pressure to rubberstamp the prepared figures. Haste is the enemy of accuracy. My thinking, in fact, is that the SEC's recent shortening of reporting deadlines will hurt the quality of information that shareholders receive. Charlie and I believe that rule is a mistake and should be rescinded.

The primary advantage of our four questions is that they will act as a prophylactic. Once the auditors know that the audit committee will require them to affirmatively endorse, rather than merely acquiesce to, management's actions, they will resist misdoings early in the process, well before specious figures become embedded in the company's books. Fear of the plaintiff's bar will see to that.

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The Chicago Tribune ran a four-part series on Arthur Andersen last September that did a great job of illuminating how accounting standards and audit quality have eroded in recent years. A few decades ago, an Arthur Andersen audit opinion was the gold standard of the profession. Within the firm, an elite Professional Standards Group (PSG) insisted on honest reporting, no matter what pressures were applied by the client. Sticking to these principles, the PSG took a stand in 1992 that the cost of stock options should be recorded as the expense it clearly was. The PSG's position was reversed, however, by the "rainmaking" partners of Andersen who knew what their clients wanted — higher reported earnings no matter what the reality. Many CEOs also fought expensing because they knew that the obscene megagrants of options they craved would be slashed if the true costs of these had to be recorded.

Soon after the Andersen reversal, the independent accounting standards board (FASB) voted 7-0 for expensing options. Predictably, the major auditing firms and an army of CEOs stormed Washington to pressure the Senate — what better institution to decide accounting questions? — into castrating the FASB. The voices of the protesters were amplified by their large political contributions, usually made with corporate money belonging to the very owners about to be bamboozled. It was not a sight for a civics class.

To its shame, the Senate voted 88-9 against expensing. Several prominent Senators even called for the demise of the FASB if it didn't abandon its position. (So much for independence.) Arthur Levitt, Jr., then Chairman of the SEC — and generally a vigilant champion of shareholders — has since described his reluctant bowing to Congressional and corporate pressures as the act of his chairmanship that he most regrets. (The details of this sordid affair are related in Levitt's excellent book, *Take on the Street*.)

With the Senate in its pocket and the SEC outgunned, corporate America knew that it was now boss when it came to accounting. With that, a new era of anything-goes earnings reports — blessed and, in some cases, encouraged by big-name auditors — was launched. The licentious behavior that followed quickly became an air pump for The Great Bubble.

After being threatened by the Senate, FASB backed off its original position and adopted an "honor system" approach, declaring expensing to be preferable but also allowing companies to ignore the cost if they wished. The disheartening result: Of the 500 companies in the S&P, 498 adopted the method deemed less desirable, which of course let them report higher "earnings." Compensation-hungry CEOs loved this outcome: Let FASB have the honor; *they* had the system.

In our 1992 annual report, discussing the unseemly and self-serving behavior of so many CEOs, I said "the business elite risks losing its credibility on issues of significance to society — about which it may have much of value to say — when it advocates the incredible on issues of significance to itself."

That loss of credibility has occurred. The job of CEOs is now to regain America's trust — and for the country's sake it's important that they do so. They will not succeed in this endeavor, however, by way of fatuous ads, meaningless policy statements, or structural changes of boards and committees. Instead, CEOs must embrace stewardship as a way of life and treat their owners as partners, not patsies. It's time for CEOs to walk the walk.

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Three suggestions for investors: First, beware of companies displaying weak accounting. If a company still does not expense options, or if its pension assumptions are fanciful, watch out. When managements take the low road in aspects that are visible, it is likely they are following a similar path behind the scenes. There is seldom just one cockroach in the kitchen.

Trumpeting EBITDA (earnings before interest, taxes, depreciation and amortization) is a particularly pernicious practice. Doing so implies that depreciation is not truly an expense, given that it is a “non-cash” charge. That’s nonsense. In truth, depreciation is a particularly unattractive expense because the cash outlay it represents is paid up front, before the asset acquired has delivered any benefits to the business. Imagine, if you will, that at the beginning of this year a company paid all of its employees for the next ten years of their service (in the way they would lay out cash for a fixed asset to be useful for ten years). In the following nine years, compensation would be a “non-cash” expense — a reduction of a prepaid compensation asset established this year. Would anyone care to argue that the recording of the expense in years two through ten would be simply a bookkeeping formality?

Second, unintelligible footnotes usually indicate untrustworthy management. If you can’t understand a footnote or other managerial explanation, it’s usually because the CEO doesn’t want you to. Enron’s descriptions of certain transactions *still* baffle me.

Finally, be suspicious of companies that trumpet earnings projections and growth expectations. Businesses seldom operate in a tranquil, no-surprise environment, and earnings simply don’t advance smoothly (except, of course, in the offering books of investment bankers).

Charlie and I not only don’t know today what our businesses will earn *next year* — we don’t even know what they will earn *next quarter*. We are suspicious of those CEOs who regularly claim they do know the future — and we become downright incredulous if they consistently reach their declared targets. Managers that always promise to “make the numbers” will at some point be tempted to *make up* the numbers.

Shareholder-Designated Contributions

About 97.3% of all eligible shares participated in Berkshire's 2002 shareholder-designated contributions program, with contributions totaling

$16.5 million.

Cumulatively, over the 22 years of the program, Berkshire has made contributions of $197 million pursuant to the instructions of our shareholders. The rest of Berkshire's giving is done by our subsidiaries, which stick to the philanthropic patterns that prevailed before they were acquired (except that their former owners themselves take on the responsibility for their personal charities). In aggregate, our subsidiaries made contributions of $24 million in 2002, including in-kind donations of $4 million.

To participate in future programs, you must own Class A shares that are registered in the name of the actual owner, not the nominee name of a broker, bank or depository. Shares not so registered on August 31, 2003 will be ineligible for the 2003 program. When you get the contributions form from us, return it promptly so that it does not get put aside or forgotten. Designations received after the due date will not be honored.

The Annual Meeting

This year’s annual meeting will be held on Saturday, May 3, and once again we will be at the Civic Auditorium. The doors will open at 7 a.m., the movie will begin at 8:30, and the meeting itself will commence at 9:30. There will be a short break at noon for food. (Sandwiches will be available at the Civic’s concession stands.) That interlude aside, Charlie and I will answer questions until 3:30. Give us your best shot.

An attachment to the proxy material that is enclosed with this report explains how you can obtain the credential you will need for admission to the meeting and other events. As for plane, hotel and car reservations, we have again signed up American Express (800-799-6634) to give you special help. They do a terrific job for us each year, and I thank them for it.

In our usual fashion, we will run vans from the larger hotels to the meeting. Afterwards, the vans will make trips back to the hotels and to Nebraska Furniture Mart, Borsheim’s and the airport. Even so, you are likely to find a car useful.

Our exhibit area for Berkshire goods and services will be bigger and better than ever this year. So be prepared to *spend*. I think you will particularly enjoy visiting The Pampered Chef display, where you may run into Doris and Sheila.

GEICO will have a booth staffed by a number of its top counselors from around the country, all of them ready to supply you with auto insurance quotes. In most cases, GEICO will be able to give you a special shareholder discount (usually 8%). This special offer is permitted by 41 of the 49 jurisdictions in which we operate. Bring the details of your existing insurance and check out whether we can save you money.

On Saturday, at the Omaha airport, we will have the usual array of aircraft from NetJets® available for your inspection. Just ask a representative at the Civic about viewing any of these planes. If you buy what we consider an appropriate number of items during the weekend, you may well need your own plane to take them home. Furthermore, if you buy a fraction of a plane, I'll personally see that you get a three-pack of briefs from Fruit of the Loom.

At Nebraska Furniture Mart, located on a 77-acre site on 72nd Street between Dodge and Pacific, we will again be having "Berkshire Weekend" pricing, which means we will be offering our shareholders a discount that is customarily given only to employees. We initiated this special pricing at NFM six years ago, and sales during the "Weekend" grew from $5.3 million in 1997 to $14.2 million in 2002.

To get the discount, you must make your purchases during the Thursday, May 1 through Monday, May 5 period and also present your meeting credential. The period's special pricing will even apply to the products of several prestigious manufacturers that normally have ironclad rules against discounting but that, in the spirit of our shareholder weekend, have made an exception for you. We appreciate their cooperation. NFM is open from 10 a.m. to 9 p.m. on weekdays and 10 a.m. to 6 p.m. on Sundays. On Saturday this year, from 6 p.m. to 10 p.m., we are having a special affair for shareholders only. I'll be there, eating hot dogs and drinking Coke.

Borsheim's — the largest jewelry store in the country except for Tiffany's Manhattan store — will have two shareholder-only events. The first will be a cocktail reception from 6 p.m. to 10 p.m. on Friday, May 2. The second, the main gala, will be from 9 a.m. to 5 p.m. on Sunday, May 4. Ask Charlie to autograph your *sales ticket*.

Shareholder prices will be available Thursday through Monday, so if you wish to avoid the large crowds that will assemble on Friday evening and Sunday, come at other times and identify yourself as a shareholder. On Saturday, we will be open until 6 p.m. Borsheim's operates on a gross margin that is fully twenty percentage points below that of its major rivals, so the more you buy, the more you save (or at least that's what my wife and daughter tell me).

In the mall outside of Borsheim's, we will have some of the world's top bridge experts available to play with our shareholders on Sunday afternoon. We expect Bob Hamman, Sharon Osberg, Fred Gitelman and Sheri Winestock to host tables. Patrick Wolff, twice U.S. chess champion, will also be in the mall, taking on all comers — blindfolded! Last year, Patrick played six games *simultaneously* — with his blindfold securely in place — and for the first time suffered a loss. (He won the other five games, however.) He's been training overtime ever since and is planning to start a new streak this year.

Additionally, Bill Robertie, one of only two players who have twice won the backgammon world championship, will be on hand to test your skill at that game. Finally, we will have a newcomer: Peter Morris, the winner of the World Scrabble Championship in 1991. Peter will play on five boards simultaneously (no blindfold for him, however) and will also allow his challengers to consult a Scrabble dictionary.

We are also going to test your vocal chords at the mall. My friend, Al Oehrle of Philadelphia, will be at the piano to play any song in any key. Susie and I will lead the singing. *She* is good.

Gorat's — my favorite steakhouse — will again be open exclusively for Berkshire shareholders on Sunday, May 4, and will be serving from 4 p.m. until 10 p.m. Please remember that to come to Gorat's on Sunday, you must have a reservation. To make one, call 402-551-3733 on April 1 (*but not before*). If Sunday is sold out, try Gorat's on one of the other evenings you will be in town. Show your sophistication by ordering a rare T-bone with a double order of hash browns.

There won't be a ball game this year. After my fastball was clocked at 5 mph last year, I decided to hang up my spikes. So I'll see you on Saturday night at NFM instead.

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Next year our meeting will be held at Omaha's new convention center. This switch in locations will allow us to hold the event on either Saturday or Monday, whichever the majority of you prefer. Using the enclosed special ballot, please vote for your preference — *but only if you are likely to attend in the future*.

We will make the Saturday/Monday decision based upon a count of shareholders, not shares. That is, a Class B shareholder owning one share will have a vote equal to that of a Class A shareholder owning many shares. If the vote is close, we will go with the preference of out-of-towners.

Again, please vote only if there is a reasonable chance that you will be attending some meetings in the future.

February 21, 2003

Warren E. Buffett
Chairman of the Board

BERKSHIRE HATHAWAY INC.

To the Shareholders of Berkshire Hathaway Inc.:

Our gain in net worth during 2003 was $13.6 billion, which increased the per-share book value of both our Class A and Class B stock by 21%. Over the last 39 years (that is, since present management took over) per-share book value has grown from $19 to $50,498, a rate of 22.2% compounded annually.*

* All figures used in this report apply to Berkshire's A shares, the successor to the only stock that the company had outstanding before 1996. The B shares have an economic interest equal to 1/30th that of the A.

It's per-share intrinsic value that counts, however, not book value. Here, the news is good: Between 1964 and 2003, Berkshire morphed from a struggling northern textile business whose intrinsic value was less than book into a widely diversified enterprise worth far more than book. Our 39-year gain in intrinsic value has therefore somewhat exceeded our 22.2% gain in book. (For a better understanding of intrinsic value and the economic principles that guide Charlie Munger, my partner and Berkshire's vice-chairman, and me in running Berkshire, please read our Owner's Manual, beginning on page 69.)

Despite their shortcomings, book value calculations are useful at Berkshire as a slightly understated gauge for measuring the *long-term* rate of increase in our intrinsic value. The calculation is less relevant, however, than it once was in rating any single year's performance versus the S&P 500 index (a comparison we display on the facing page). Our equity holdings, including convertible preferreds, have fallen considerably as a percentage of our net worth, from an average of 114% in the 1980s, for example, to an average of 50% in 2000-03. Therefore, yearly movements in the stock market now affect a much smaller portion of our net worth than was once the case.

Nonetheless, Berkshire's long-term performance versus the S&P remains all-important. Our shareholders can buy the S&P through an index fund at very low cost. Unless we achieve gains in per-share intrinsic value in the future that outdo the S&P's performance, Charlie and I will be adding nothing to what you can accomplish on your own.

If we fail, we will have no excuses. Charlie and I operate in an ideal environment. To begin with, we are supported by an incredible group of men and women who run our operating units. If there were a Corporate Cooperstown, its roster would surely include many of our CEOs. Any shortfall in Berkshire's results will not be caused by our managers.

Additionally, we enjoy a rare sort of managerial freedom. Most companies are saddled with institutional constraints. A company's history, for example, may commit it to an industry that now offers limited opportunity. A more common problem is a shareholder constituency that pressures its manager to dance to Wall Street's tune. Many CEOs resist, but others give in and adopt operating and capital-allocation policies far different from those they would choose if left to themselves.

At Berkshire, neither history nor the demands of owners impede intelligent decision-making. When Charlie and I make mistakes, they are — in tennis parlance — unforced errors.

Operating Earnings

When valuations are similar, we strongly prefer owning businesses to owning stocks. During most of our years of operation, however, stocks were much the cheaper choice. We therefore sharply tilted our asset allocation in those years toward equities, as illustrated by the percentages cited earlier.

In recent years, however, we've found it hard to find significantly undervalued stocks, a difficulty greatly accentuated by the mushrooming of the funds we must deploy. Today, the number of stocks that can be purchased in large enough quantities to move the performance needle at Berkshire is a small fraction of the number that existed a decade ago. (Investment managers often profit far more from piling up assets than from handling those assets well. So when one tells you that increased funds won't hurt his investment performance, step back: His nose is about to grow.)

The shortage of attractively-priced stocks in which we can put large sums doesn't bother us, *providing* we can find companies to purchase that (1) have favorable and enduring economic characteristics; (2) are run by talented and honest managers and (3) are available at a sensible price. We have purchased a number of such businesses in recent years, though not enough to fully employ the gusher of cash that has come our way. In buying businesses, I've made some terrible mistakes, both of commission and omission. Overall, however, our acquisitions have led to decent gains in per-share earnings.

Below is a table that quantifies that point. But first we need to warn you that growth-rate presentations can be significantly distorted by a calculated selection of either initial or terminal dates. For example, if earnings are tiny in a beginning year, a long-term performance that was only mediocre can be made to appear sensational. That kind of distortion can come about because the company at issue was minuscule in the base year — which means that only a handful of insiders actually benefited from the touted performance — or because a larger company was then operating at just above breakeven. Picking a terminal year that is particularly buoyant will also favorably bias a calculation of growth.

The Berkshire Hathaway that present management assumed control of in 1965 had long been sizable. But in 1964, it earned only $175,586 or 15 cents per share, so close to breakeven that any calculation of earnings growth from that base would be meaningless. At the time, however, even those meager earnings looked good: Over the decade following the 1955 merger of Berkshire Fine Spinning Associates and Hathaway Manufacturing, the combined operation had lost $10.1 million and many thousands of employees had been let go. It was not a marriage made in heaven.

Against this background, we give you a picture of Berkshire's earnings growth that begins in 1968, but also includes subsequent base years spaced five years apart. A series of calculations is presented so that you can decide for yourself which period is most meaningful. I've started with 1968 because it was the first full year we operated National Indemnity, the initial acquisition we made as we began to expand Berkshire's business.

I don't believe that using 2003 as the terminal year distorts our calculations. It was a terrific year for our insurance business, but the big boost that gave to earnings was largely offset by the pathetically low interest rates we earned on our large holdings of cash equivalents (a condition that will not last). All figures shown below, it should be noted, *exclude* capital gains.

Year	*Operating Earnings in $ millions*	*Operating Earnings Per Share in $*	*Subsequent Compounded Growth Rate of Per-Share Earnings*
1964	.2	.15	Not meaningful (1964-2003)
1968	2.7	2.69	22.8% (1968-2003)
1973	11.9	12.18	20.8% (1973-2003)
1978	30.0	29.15	21.1% (1978-2003)
1983	48.6	45.60	24.3% (1983-2003)
1988	313.4	273.37	18.6% (1988-2003)
1993	477.8	413.19	23.9% (1993-2003)
1998	1,277.0	1,020.49	28.2% (1998-2003)
2003	5,422.0	3,531.32	

We will continue the capital allocation practices we have used in the past. If stocks become significantly cheaper than entire businesses, we will buy them aggressively. If selected bonds become attractive, as they did in 2002, we will again load up on these securities. Under *any* market or economic conditions, we will be happy to buy businesses that meet our standards. And, for those that do, the bigger the better. Our capital is underutilized now, but that will happen periodically. It's a painful condition to be in — but not as painful as doing something stupid. (I speak from experience.)

Overall, we are certain Berkshire's performance in the future will fall *far* short of what it has been in the past. Nonetheless, Charlie and I remain hopeful that we can deliver results that are modestly above average. That's what we're being paid for.

Acquisitions

As regular readers know, our acquisitions have often come about in strange ways. None, however, had a more unusual genesis than our purchase last year of Clayton Homes.

The unlikely source was a group of finance students from the University of Tennessee, and their teacher, Dr. Al Auxier. For the past five years, Al has brought his class to Omaha, where the group tours Nebraska Furniture Mart and Borsheim's, eats at Gorat's and then comes to Kiewit Plaza for a session with me. Usually about 40 students participate.

After two hours of give-and-take, the group traditionally presents me with a thank-you gift. (The doors stay locked until they do.) In past years it's been items such as a football signed by Phil Fulmer and a basketball from Tennessee's famous women's team.

This past February, the group opted for a book — which, luckily for me, was the recently-published autobiography of Jim Clayton, founder of Clayton Homes. I already knew the company to be the class act of the manufactured housing industry, knowledge I acquired after earlier making the mistake of buying some distressed junk debt of Oakwood Homes, one of the industry's largest companies. At the time of that purchase, I did not understand how atrocious consumer-financing practices had become throughout most of the manufactured housing industry. But I learned: Oakwood rather promptly went bankrupt.

Manufactured housing, it should be emphasized, can deliver very good value to home purchasers. Indeed, for decades, the industry has accounted for more than 15% of the homes built in the U.S. During those years, moreover, both the quality and variety of manufactured houses consistently improved.

Progress in design and construction was not matched, however, by progress in distribution and financing. Instead, as the years went by, the industry's business model increasingly centered on the ability of both the retailer and manufacturer to unload terrible loans on naive lenders. When "securitization" then became popular in the 1990s, further distancing the supplier of funds from the lending transaction, the industry's conduct went from bad to worse. Much of its volume a few years back came from buyers who shouldn't have bought, financed by lenders who shouldn't have lent. The consequence has been huge numbers of repossessions and pitifully low recoveries on the units repossessed.

Oakwood participated fully in the insanity. But Clayton, though it could not isolate itself from industry practices, behaved considerably better than its major competitors.

Upon receiving Jim Clayton's book, I told the students how much I admired his record and they took that message back to Knoxville, home of both the University of Tennessee and Clayton Homes. Al then suggested that I call Kevin Clayton, Jim's son and the CEO, to express my views directly. As I talked with Kevin, it became clear that he was both able and a straight-shooter.

Soon thereafter, I made an offer for the business based solely on Jim's book, my evaluation of Kevin, the public financials of Clayton and what I had learned from the Oakwood experience. Clayton's board was receptive, since it understood that the large-scale financing Clayton would need in the future might be hard to get. Lenders had fled the industry and securitizations, when possible at all, carried far more expensive and restrictive terms than was previously the case. This tightening was particularly serious for Clayton, whose earnings significantly depended on securitizations.

Today, the manufactured housing industry remains awash in problems. Delinquencies continue high, repossessed units still abound and the number of retailers has been halved. A different business model is required, one that eliminates the ability of the retailer and salesman to pocket substantial money up front by making sales financed by loans that are destined to default. Such transactions cause hardship to both buyer and lender and lead to a flood of repossessions that then undercut the sale of new units. Under a proper model — one requiring significant down payments and shorter-term loans — the industry will likely remain much smaller than it was in the 90s. But it will deliver to home buyers an asset in which they will have equity, rather than disappointment, upon resale.

In the "full circle" department, Clayton has agreed to buy the assets of Oakwood. When the transaction closes, Clayton's manufacturing capacity, geographical reach and sales outlets will be substantially increased. As a byproduct, the debt of Oakwood that we own, which we bought at a deep discount, will probably return a small profit to us.

And the students? In October, we had a surprise "graduation" ceremony in Knoxville for the 40 who sparked my interest in Clayton. I donned a mortarboard and presented each student with both a PhD (for phenomenal, hard-working dealmaker) from Berkshire and a B share. Al got an A share.

If you meet some of the new Tennessee shareholders at our annual meeting, give them your thanks. And ask them if they've read any good books lately.

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In early spring, Byron Trott, a Managing Director of Goldman Sachs, told me that Wal-Mart wished to sell its McLane subsidiary. McLane distributes groceries and nonfood items to convenience stores, drug stores, wholesale clubs, mass merchandisers, quick service restaurants, theaters and others. It's a good business, but one not in the mainstream of Wal-Mart's future. It's made to order, however, for us.

McLane has sales of about $23 billion, but operates on paper-thin margins — about 1% pre-tax — and will swell Berkshire's sales figures far more than our income. In the past, some retailers had shunned McLane because it was owned by their major competitor. Grady Rosier, McLane's superb CEO, has already landed some of these accounts — he was in full stride the day the deal closed — and more will come.

For several years, I have given my vote to Wal-Mart in the balloting for Fortune Magazine's "Most Admired" list. Our McLane transaction reinforced my opinion. To make the McLane deal, I had a single meeting of about two hours with Tom Schoewe, Wal-Mart's CFO, and we then shook hands. (He did, however, first call Bentonville). Twenty-nine days later Wal-Mart had its money. We did no "due diligence." We knew everything would be exactly as Wal-Mart said it would be — and it was.

I should add that Byron has now been instrumental in three Berkshire acquisitions. He understands Berkshire far better than any investment banker with whom we have talked and — it hurts me to say this — earns his fee. I'm looking forward to deal number four (as, I am sure, is he).

Taxes

On May 20, 2003, The Washington Post ran an op-ed piece by me that was critical of the Bush tax proposals. Thirteen days later, Pamela Olson, Assistant Secretary for Tax Policy at the U.S. Treasury, delivered a speech about the new tax legislation saying, "That means a certain midwestern oracle, who, it must be noted, has played the tax code like a fiddle, is still safe retaining all his earnings." I think she was talking about me.

Alas, my "fiddle playing" will not get me to Carnegie Hall — or even to a high school recital. Berkshire, on your behalf and mine, will send the Treasury $3.3 billion for tax on its 2003 income, a sum equaling 2½% of the total income tax paid by *all* U.S. corporations in fiscal 2003. (In contrast, Berkshire's market valuation is about 1% of the value of all American corporations.) Our payment will almost certainly place us among our country's top ten taxpayers. Indeed, if only 540 taxpayers paid the amount Berkshire will pay, no other individual or corporation would have to pay *anything* to Uncle Sam. That's right: 290 million Americans and all other businesses would not have to pay a dime in income, social security, excise or estate taxes to the federal government. (Here's the math: Federal tax receipts, including social security receipts, in fiscal 2003 totaled $1.782 trillion and 540 "Berkshires," each paying $3.3 billion, would deliver the same $1.782 trillion.)

Our federal tax return for 2002 (2003 is not finalized), when we paid $1.75 billion, covered a mere 8,905 pages. As is required, we dutifully filed two copies of this return, creating a pile of paper seven feet tall. At World Headquarters, our small band of 15.8, though exhausted, momentarily flushed with pride: Berkshire, we felt, was surely pulling its share of our country's fiscal load.

But Ms. Olson sees things otherwise. And if that means Charlie and I need to try harder, we are ready to do so.

I do wish, however, that Ms. Olson would give me *some* credit for the progress I've already made. In 1944, I filed my first 1040, reporting my income as a thirteen-year-old newspaper carrier. The return covered three pages. After I claimed the appropriate business deductions, such as $35 for a bicycle, my tax bill was $7. I sent my check to the Treasury and it — without comment — promptly cashed it. We lived in peace.

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I can understand why the Treasury is now frustrated with Corporate America and prone to outbursts. But it should look to Congress and the Administration for redress, not to Berkshire.

Corporate income taxes in fiscal 2003 accounted for 7.4% of all federal tax receipts, down from a post-war peak of 32% in 1952. With one exception (1983), last year's percentage is the lowest recorded since data was first published in 1934.

Even so, tax breaks for corporations (and their investors, particularly large ones) were a major part of the Administration's 2002 and 2003 initiatives. If class warfare is being waged in America, my class is clearly winning. Today, many large corporations — run by CEOs whose fiddle-playing talents make your Chairman look like he is all thumbs — pay nothing close to the stated federal tax rate of 35%.

In 1985, Berkshire paid $132 million in federal income taxes, and all corporations paid $61 billion. The comparable amounts in 1995 were $286 million and $157 billion respectively. And, as mentioned, we will pay about $3.3 billion for 2003, a year when all corporations paid $132 billion. We hope our taxes continue to rise in the future — it will mean we are prospering — but we also hope that the rest of Corporate America antes up along with us. This might be a project for Ms. Olson to work on.

Corporate Governance

In judging whether Corporate America is serious about reforming itself, CEO pay remains the acid test. To date, the results aren't encouraging. A few CEOs, such as Jeff Immelt of General Electric, have led the way in initiating programs that are fair to managers and shareholders alike. Generally, however, his example has been more admired than followed.

It's understandable how pay got out of hand. When management hires employees, or when companies bargain with a vendor, the intensity of interest is equal on both sides of the table. One party's gain is the other party's loss, and the money involved has real meaning to both. The result is an honest-to-God negotiation.

But when CEOs (or their representatives) have met with compensation committees, too often one side — the CEO's — has cared far more than the other about what bargain is struck. A CEO, for example, will always regard the difference between receiving options for 100,000 shares or for 500,000 as monumental. To a comp committee, however, the difference may seem unimportant — particularly if, as has been the case at most companies, neither grant will have any effect on reported earnings. Under these conditions, the negotiation often has a "play-money" quality.

Overreaching by CEOs greatly accelerated in the 1990s as compensation packages gained by the most avaricious— a title for which there was vigorous competition — were promptly replicated elsewhere. The couriers for this epidemic of greed were usually consultants and human relations departments, which had no trouble perceiving who buttered their bread. As one compensation consultant commented: "There are two classes of clients you don't want to offend — actual and potential."

In proposals for reforming this malfunctioning system, the cry has been for "independent" directors. But the question of what truly motivates independence has largely been neglected.

In last year's report, I took a look at how "independent" directors — as defined by statute — had performed in the mutual fund field. The Investment Company Act of 1940 mandated such directors, and that means we've had an extended test of what statutory standards produce. In our examination last year, we looked at the record of fund directors in respect to the two key tasks board members should perform — whether at a mutual fund business or any other. These two all-important functions are, first, to obtain (or retain) an able and honest manager and then to compensate that manager fairly.

Our survey was not encouraging. Year after year, at literally thousands of funds, directors had routinely rehired the incumbent management company, however pathetic its performance had been. Just as routinely, the directors had mindlessly approved fees that in many cases far exceeded those that could have been negotiated. Then, when a management company was sold — invariably at a huge price relative to tangible assets — the directors experienced a "counter-revelation" and immediately signed on with the new manager and accepted its fee schedule. In effect, the directors decided that whoever would pay the most for the old management company was the party that should manage the shareholders' money in the future.

Despite the lapdog behavior of independent fund directors, we did not conclude that they are bad people. They're not. But sadly, "boardroom atmosphere" almost invariably sedates their fiduciary genes.

On May 22, 2003, not long after Berkshire's report appeared, the Chairman of the Investment Company Institute addressed its membership about "The State of our Industry." Responding to those who have "weighed in about our perceived failings," he mused, "It makes me wonder what life would be like if we'd actually done something wrong."

Be careful what you wish for.

Within a few months, the world began to learn that many fund-management companies had followed policies that hurt the owners of the funds they managed, while simultaneously boosting the fees of the managers. Prior to their transgressions, it should be noted, these management companies were earning profit margins and returns on tangible equity that were the envy of Corporate America. Yet to swell profits further, they trampled on the interests of fund shareholders in an appalling manner.

So what are the directors of these looted funds doing? As I write this, I have seen none that have terminated the contract of the offending management company (though naturally that entity has often fired some of its employees). Can you imagine directors who had been personally defrauded taking such a boys-will-be-boys attitude?

To top it all off, at least one miscreant management company has put itself up for sale, undoubtedly hoping to receive a huge sum for "delivering" the mutual funds it has managed to the highest bidder among other managers. This is a travesty. Why in the world don't the directors of those funds simply select whomever they think is best among the bidding organizations and sign up with that party directly? The winner would consequently be spared a huge "payoff" to the former manager who, having flouted the principles of stewardship, deserves not a dime. Not having to bear that acquisition cost, the winner could surely manage the funds in question for a far lower ongoing fee than would otherwise have been the case. Any truly independent director should insist on this approach to obtaining a new manager.

The reality is that neither the decades-old rules regulating investment company directors nor the new rules bearing down on Corporate America foster the election of truly independent directors. In both instances, an individual who is receiving 100% of his income from director fees — and who may wish to enhance his income through election to other boards — is deemed independent. That is nonsense. The same rules say that Berkshire director and lawyer Ron Olson, who receives from us perhaps 3% of his very large income, does not qualify as independent because that 3% comes from legal fees Berkshire pays his firm rather than from fees he earns as a Berkshire director. Rest assured, 3% from any source would not torpedo Ron's independence. But getting 20%, 30% or 50% of their income from director fees might well temper the independence of many individuals, particularly if their overall income is not large. Indeed, I think it's clear that at mutual funds, it has.

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Let me make a small suggestion to "independent" mutual fund directors. Why not simply affirm in each annual report that "(1) We have looked at other management companies and believe the one we have retained for the upcoming year is among the better operations in the field; and (2) we have negotiated a fee with our managers comparable to what other clients with equivalent funds would negotiate."

It does not seem unreasonable for shareholders to expect fund directors — who are often receiving fees that exceed $100,000 annually — to declare themselves on these points. Certainly these directors would satisfy themselves on both matters were they handing over a large chunk of their own money to the manager. If directors are unwilling to make these two declarations, shareholders should heed the maxim "If you don't know whose side someone is on, he's probably not on yours."

Finally, a disclaimer. A great many funds have been run well and conscientiously despite the opportunities for malfeasance that exist. The shareholders of these funds have benefited, and their managers have earned their pay. Indeed, if I were a director of certain funds, including some that charge above-average fees, I would enthusiastically make the two declarations I have suggested. Additionally, those index funds that are very low-cost (such as Vanguard's) are investor-friendly by definition and are the best selection for most of those who wish to own equities.

I am on my soapbox now only because the blatant wrongdoing that has occurred has betrayed the trust of so many millions of shareholders. Hundreds of industry insiders had to know what was going on, yet none publicly said a word. It took Eliot Spitzer, and the whistleblowers who aided him, to initiate a housecleaning. We urge fund directors to continue the job. Like directors throughout Corporate America, these fiduciaries must now decide whether their job is to work for owners or for managers.

Berkshire Governance

True independence — meaning the willingness to challenge a forceful CEO when something is wrong or foolish — is an enormously valuable trait in a director. It is also rare. The place to look for it is among high-grade people whose interests are in line with those of rank-and-file shareholders — *and are in line in a very big way*.

We've made that search at Berkshire. We now have eleven directors and *each* of them, combined with members of their families, owns more than $4 million of Berkshire stock. Moreover, all have held major stakes in Berkshire for many years. In the case of six of the eleven, family ownership amounts to at least hundreds of millions and dates back at least three decades. All eleven directors purchased their holdings in the market just as you did; we've never passed out options or restricted shares. Charlie and I love such honest-to-God ownership. After all, who ever washes a rental car?

In addition, director fees at Berkshire are nominal (as my son, Howard, periodically reminds me). Thus, the upside from Berkshire for all eleven is proportionately the same as the upside for any Berkshire shareholder. And it always will be.

The downside for Berkshire directors is actually worse than yours because we carry *no* directors and officers liability insurance. Therefore, if something really catastrophic happens on our directors' watch, they are exposed to losses that will far exceed yours.

The bottom line for our directors: You win, they win big; you lose, they lose big. Our approach might be called owner-capitalism. We know of no better way to engender true independence. (This structure does not guarantee perfect behavior, however: I've sat on boards of companies in which Berkshire had huge stakes and remained silent as questionable proposals were rubber-stamped.)

In addition to being independent, directors should have business savvy, a shareholder orientation and a genuine interest in the company. The rarest of these qualities is business savvy — and if it is lacking, the other two are of little help. Many people who are smart, articulate and admired have no real understanding of business. That's no sin; they may shine elsewhere. But they don't belong on corporate boards. Similarly, I would be useless on a medical or scientific board (though I would likely be welcomed by a chairman who wanted to run things his way). My name would dress up the list of directors, but I wouldn't know enough to critically evaluate proposals. Moreover, to cloak my ignorance, I would keep my mouth shut (if you can imagine that). In effect, I could be replaced, without loss, by a potted plant.

Last year, as we moved to change our board, I asked for self-nominations from shareholders who believed they had the requisite qualities to be a Berkshire director. Despite the lack of either liability insurance or meaningful compensation, we received more than twenty applications. Most were good, coming from owner-oriented individuals having family holdings of Berkshire worth well over $1 million. After considering them, Charlie and I — with the concurrence of our incumbent directors — asked four shareholders who did not nominate themselves to join the board: David Gottesman, Charlotte Guyman, Don Keough and Tom Murphy. These four people are all friends of mine, and I know their strengths well. They bring an extraordinary amount of business talent to Berkshire's board.

The primary job of our directors is to select my successor, either upon my death or disability, or when I begin to lose my marbles. (David Ogilvy had it right when he said: “Develop your eccentricities when young. That way, when you get older, people won’t think you are going gaga.” Charlie’s family and mine feel that we overreacted to David’s advice.)

At our directors’ meetings we cover the usual run of housekeeping matters. But the real discussion — both with me in the room and absent — centers on the strengths and weaknesses of the four internal candidates to replace me.

Our board knows that the ultimate scorecard on its performance will be determined by the record of my successor. He or she will need to maintain Berkshire’s culture, allocate capital and keep a group of America’s best managers happy in their jobs. This isn’t the toughest task in the world — the train is already moving at a good clip down the track — and I’m totally comfortable about it being done well by any of the four candidates we have identified. I have more than 99% of my net worth in Berkshire and will be happy to have my wife or foundation (depending on the order in which she and I die) continue this concentration.

Sector Results

As managers, Charlie and I want to give our owners the financial information and commentary we would wish to receive if our roles were reversed. To do this with both clarity and reasonable brevity becomes more difficult as Berkshire’s scope widens. Some of our businesses have vastly different economic characteristics from others, which means that our consolidated statements, with their jumble of figures, make useful analysis almost impossible.

On the following pages, therefore, we will present some balance sheet and earnings figures from our four major categories of businesses along with commentary about each. We particularly want you to understand the limited circumstances under which we will use debt, since typically we shun it. We will not, however, inundate you with data that has no real value in calculating Berkshire’s intrinsic value. Doing so would likely obfuscate the most important facts. One warning: When analyzing Berkshire, be sure to remember that the company should be viewed as an unfolding movie, not as a still photograph. Those who focused in the past on only the snapshot of the day sometimes reached erroneous conclusions.

Insurance

Let's start with insurance — since that's where the money is.

The fountain of funds we enjoy in our insurance operations comes from "float," which is money that doesn't belong to us but that we temporarily hold. Most of our float arises because (1) premiums are paid upfront though the service we provide — insurance protection — is delivered over a period that usually covers a year and; (2) loss events that occur today do not always result in our immediately paying claims, since it sometimes takes years for losses to be reported (think asbestos), negotiated and settled.

Float is wonderful — *if* it doesn't come at a high price. The cost of float is determined by underwriting results, meaning how losses and expenses paid compare with premiums received. The property-casualty industry as a whole regularly operates at a substantial underwriting loss, and therefore often has a cost of float that is unattractive.

Overall, our results have been good. True, we've had five terrible years in which float cost us more than 10%. But in 18 of the 37 years Berkshire has been in the insurance business, we have operated at an underwriting profit, meaning we were actually *paid* for holding money. And the quantity of this cheap money has grown far beyond what I dreamed it could when we entered the business in 1967.

Yearend Float (in $ millions)

Year	*GEICO*	*General Re*	*Other Reinsurance*	*Other Primary*	*Total*
1967				20	20
1977			40	131	171
1987			701	807	1,508
1997	2,917		4,014	455	7,386
1998	3,125	14,909	4,305	415	22,754
1999	3,444	15,166	6,285	403	25,298
2000	3,943	15,525	7,805	598	27,871
2001	4,251	19,310	11,262	685	35,508

2002	4,678	22,207	13,396	943	41,224
2003	5,287	23,654	13,948	1,331	44,220

Last year was a standout. Float reached record levels and it came without cost as all major segments contributed to Berkshire's $1.7 billion pre-tax underwriting profit.

Our results have been exceptional for one reason: We have truly exceptional managers. Insurers sell a non-proprietary piece of paper containing a non-proprietary promise. Anyone can copy anyone else's product. No installed base, key patents, critical real estate or natural resource position protects an insurer's competitive position. Typically, brands do not mean much either.

The critical variables, therefore, are managerial brains, discipline and integrity. Our managers have all of these attributes — in spades. Let's take a look at these all-stars and their operations.

• General Re had been Berkshire's problem child in the years following our acquisition of it in 1998. Unfortunately, it was a 400-pound child, and its negative impact on our overall performance was large.

That's behind us: Gen Re is fixed. Thank Joe Brandon, its CEO, and his partner, Tad Montross, for that. When I wrote you last year, I thought that discipline had been restored to both underwriting and reserving, and events during 2003 solidified my view.

That does not mean we will never have setbacks. Reinsurance is a business that is certain to deliver blows from time to time. But, under Joe and Tad, this operation will be a powerful engine driving Berkshire's future profitability.

Gen Re's financial strength, unmatched among reinsurers even as we started 2003, further improved during the year. Many of the company's competitors suffered credit downgrades last year, leaving Gen Re, and its sister operation at National Indemnity, as the only AAA-rated companies among the world's major reinsurers.

When insurers purchase reinsurance, they buy only a promise — one whose validity may not be tested for decades — and there are no promises in the reinsurance world equaling those offered by Gen Re and National Indemnity. Furthermore, unlike most reinsurers, we retain virtually all of the risks we assume. Therefore, our ability to pay is not dependent on the ability or willingness of others to reimburse us. This *independent* financial strength could be enormously important when the industry experiences the mega-catastrophe it surely will.

• Regular readers of our annual reports know of Ajit Jain's incredible contributions to Berkshire's prosperity over the past 18 years. He continued to pour it on in 2003. With a staff of only 23, Ajit runs one of the world's largest reinsurance operations, specializing in mammoth and unusual risks.

Often, these involve assuming catastrophe risks — say, the threat of a large California earthquake — of a size far greater than any other reinsurer will accept. This means Ajit's results (and Berkshire's) will be lumpy. You should, therefore, expect his operation to have an occasional horrible year. Over time, however, you can be confident of a terrific result from this one-of-a-kind manager.

Ajit writes some very unusual policies. Last year, for example, PepsiCo promoted a drawing that offered participants a chance to win a $1 billion prize. Understandably, Pepsi wished to lay off this risk, and we were the logical party to assume it. So we wrote a $1 billion policy, retaining the risk entirely for our own account. Because the prize, if won, was payable over time, our exposure in present-value terms was $250 million. (I helpfully suggested that any winner be paid $1 a year for a billion years, but that proposal didn't fly.) The drawing was held on September 14. Ajit and I held our breath, as did the finalist in the contest, and we left happier than he. PepsiCo has renewed for a repeat contest in 2004.

• GEICO was a fine insurance company when Tony Nicely took over as CEO in 1992. Now it is a great one. During his tenure, premium volume has increased from $2.2 billion to $8.1 billion, and our share of the personal-auto market has grown from 2.1% to 5.0%. More important, GEICO has paired these gains with outstanding underwriting performance.

(We now pause for a commercial)

It's been 67 years since Leo Goodwin created a great business idea at GEICO, one designed to save policyholders significant money. Go to Geico.com or call 1-800-847-7536 to see what we can do for you.

(End of commercial)

In 2003, both the number of inquiries coming into GEICO and its closure rate on these increased significantly. As a result our preferred policyholder count grew 8.2%, and our standard and non-standard policies grew 21.4%.

GEICO's business growth creates a never-ending need for more employees and facilities. Our most recent expansion, announced in December, is a customer service center in — I'm delighted to say — Buffalo. Stan Lipsey, the publisher of our Buffalo News, was instrumental in bringing the city and GEICO together.

The key figure in this matter, however, was Governor George Pataki. His leadership and tenacity are why Buffalo will have 2,500 new jobs when our expansion is fully rolled out. Stan, Tony, and I — along with Buffalo — thank him for his help.

• Berkshire's smaller insurers had another terrific year. This group, run by Rod Eldred, John Kizer, Tom Nerney, Don Towle and Don Wurster, increased its float by 41%, while delivering an excellent underwriting profit. These men, though operating in unexciting ways, produce truly exciting results.

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We should point out again that in any given year a company writing long-tail insurance (coverages giving rise to claims that are often settled many years after the loss-causing event takes place) can report almost any earnings that the CEO desires. Too often the industry has reported wildly inaccurate figures by misstating liabilities. Most of the mistakes have been innocent. Sometimes, however, they have been intentional, their object being to fool investors and regulators. Auditors and actuaries have usually failed to prevent both varieties of misstatement.

I have failed on occasion too, particularly in not spotting Gen Re's unwitting underreserving a few years back. Not only did that mean we reported inaccurate figures to you, but the error also resulted in our paying very substantial taxes earlier than was necessary. Aaarrrggghh. I told you last year, however, that I thought our current reserving was at appropriate levels. So far, that judgment is holding up.

Here are Berkshire's pre-tax underwriting results by segment:

	Gain (Loss) in $ millions	
	2003	*2002*
Gen Re	$ 145	$(1,393)
Ajit's business excluding retroactive contracts	1,434	980
Ajit's retroactive contracts*	(387)	(433)
GEICO	452	416
Other Primary	74	32
Total	$1,718	$ (398)

* These contracts were explained on page 10 of the 2002 annual report, available on the Internet at www.berkshirehathaway.com. In brief, this segment consists of a few jumbo policies that are likely to produce underwriting losses (which are capped) but also provide unusually large amounts of float.

Regulated Utility Businesses

Through MidAmerican Energy Holdings, we own an 80.5% (fully diluted) interest in a wide variety of utility operations. The largest are (1) Yorkshire Electricity and Northern Electric, whose 3.7 million electric customers make it the third largest distributor of electricity in the U.K.; (2) MidAmerican Energy, which serves 689,000 electric customers in Iowa and; (3) Kern River and Northern Natural pipelines, which carry 7.8% of the natural gas transported in the United States.

Berkshire has three partners, who own the remaining 19.5%: Dave Sokol and Greg Abel, the brilliant managers of the business, and Walter Scott, a long-time friend of mine who introduced me to the company. Because MidAmerican is subject to the Public Utility Holding Company Act

(“PUHCA”), Berkshire’s voting interest is limited to 9.9%. Walter has the controlling vote.

Our limited voting interest forces us to account for MidAmerican in our financial statements in an abbreviated manner. Instead of our fully including its assets, liabilities, revenues and expenses in our statements, we record only a one-line entry in both our balance sheet and income account. It’s likely that some day, perhaps soon, either PUHCA will be repealed or accounting rules will change. Berkshire’s consolidated figures would then take in all of MidAmerican, including the substantial debt it utilizes.

The size of this debt (which is not now, nor will it be, an obligation of Berkshire) is entirely appropriate. MidAmerican’s diverse and stable utility operations assure that, even under harsh economic conditions, aggregate earnings will be ample to very comfortably service all debt.

At yearend, $1.578 billion of MidAmerican’s most junior debt was payable to Berkshire. This debt has allowed acquisitions to be financed without our three partners needing to increase their already substantial investments in MidAmerican. By charging 11% interest, Berkshire is compensated fairly for putting up the funds needed for purchases, while our partners are spared dilution of their equity interests.

MidAmerican also owns a significant non-utility business, Home Services of America, the second largest real estate broker in the country. Unlike our utility operations, this business is highly cyclical, but nevertheless one we view enthusiastically. We have an exceptional manager, Ron Peltier, who, through both his acquisition and operational skills, is building a brokerage powerhouse.

Last year, Home Services participated in $48.6 billion of transactions, a gain of $11.7 billion from 2002. About 23% of the increase came from four acquisitions made during the year. Through our 16 brokerage firms — all of which retain their local identities — we employ 16,343 brokers in 16 states. Home Services is almost certain to grow substantially in the next decade as we continue to acquire leading localized operations.

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Here’s a tidbit for fans of free enterprise. On March 31, 1990, the day electric utilities in the U.K. were denationalized, Northern and Yorkshire had 6,800 employees in functions these companies continue today to perform. Now they employ 2,539. Yet the companies are serving about the same number of customers as when they were government owned and are distributing more electricity.

This is not, it should be noted, a triumph of deregulation. Prices and earnings continue to be regulated in a fair manner by the government, just as they should be. It is a victory, however, for those who believe that profit-motivated managers, even though they recognize that the benefits will largely flow to customers, will find efficiencies that government never will.

Here are some key figures on MidAmerican’s operations:

	Earnings (in $ millions)	
	2003	*2002*
U.K. Utilities	$ 289	$ 267
Iowa	269	241
Pipelines	261	104
Home Services	113	70
Other (Net)	144	108
Earnings before corporate interest and tax	1,076	790
Corporate Interest, other than to Berkshire	(225)	(192)
Interest Payments to Berkshire	(184)	(118)
Tax	(251)	(100)
Net Earnings	$ 416	$ 380
Earnings Applicable to Berkshire*	$ 429	$ 359
Debt Owed to Others	10,296	10,286
Debt Owed to Berkshire	1,578	1,728

* Includes interest paid to Berkshire (net of related income taxes) of $118 in 2003 and $75 in 2002.

Finance and Financial Products

This sector includes a wide-ranging group of activities. Here’s some commentary on the most important.

• I manage a few opportunistic strategies in AAA fixed-income securities that have been quite profitable in the last few years. These opportunities come and go — and at present, they are going. We sped their departure somewhat last year, thereby realizing 24% of the capital gains we show in the table that follows.

Though far from foolproof, these transactions involve no credit risk and are conducted in exceptionally liquid securities. We therefore finance the positions almost entirely with borrowed money. As the assets are reduced, so also are the borrowings. The smaller portfolio we now have means that in the near future our earnings in this category will decline significantly. It was fun while it lasted, and at some point we'll get another turn at bat.

• A far less pleasant unwinding operation is taking place at Gen Re Securities, the trading and derivatives operation we inherited when we purchased General Reinsurance.

When we began to liquidate Gen Re Securities in early 2002, it had 23,218 outstanding tickets with 884 counterparties (some having names I couldn't pronounce, much less creditworthiness I could evaluate). Since then, the unit's managers have been skillful and diligent in unwinding positions. Yet, at yearend — nearly two years later — we still had 7,580 tickets outstanding with 453 counterparties. (As the country song laments, "How can I miss you if you won't go away?")

The shrinking of this business has been costly. We've had pre-tax losses of $173 million in 2002 and $99 million in 2003. These losses, it should be noted, came from a portfolio of contracts that — in full compliance with GAAP — had been regularly marked-to-market with standard allowances for future credit-loss and administrative costs. Moreover, our liquidation has taken place both in a benign market — we've had no credit losses of significance — and in an orderly manner. This is just the opposite of what might be expected if a financial crisis forced a number of derivatives dealers to cease operations simultaneously.

If our derivatives experience — and the Freddie Mac shenanigans of mind-blowing size and audacity that were revealed last year — makes you suspicious of accounting in this arena, consider yourself wised up. No matter how financially sophisticated you are, you can't possibly learn from reading the disclosure documents of a derivatives-intensive company what risks lurk in its positions. Indeed, the more you know about derivatives, the less you will feel you can learn from the disclosures normally proffered you. In Darwin's words, "Ignorance more frequently begets confidence than does knowledge."

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And now it's confession time: I'm sure I could have saved you $100 million or so, pre-tax, if I had acted more promptly to shut down Gen Re Securities. Both Charlie and I knew at the time of the General Reinsurance merger that its derivatives business was unattractive. Reported profits struck us as illusory, and we felt that the business carried sizable risks that could not effectively be measured or limited. Moreover, we knew that any major problems the operation might experience would likely correlate with troubles in the financial or insurance world that would affect Berkshire elsewhere. In other words, if the derivatives business were ever to need shoring up, it would commandeer the capital and credit of Berkshire at just the time we could otherwise deploy those resources to huge advantage. (A historical note: We had just such an experience in 1974 when we were the victim of a major insurance fraud. We could not determine for some time how much the fraud would ultimately cost us and therefore kept more funds in cash-equivalents than we normally would have.

Absent this precaution, we would have made larger purchases of stocks that were then extraordinarily cheap.)

Charlie would have moved swiftly to close down Gen Re Securities — no question about that. I, however, dithered. As a consequence, our shareholders are paying a far higher price than was necessary to exit this business.

• Though we include Gen Re's sizable life and health reinsurance business in the "insurance" sector, we show the results for Ajit Jain's life and annuity business in this section. That's because this business, in large part, involves arbitraging money. Our annuities range from a retail product sold directly on the Internet to structured settlements that require us to make payments for 70 years or more to people severely injured in accidents.

We've realized some extra income in this business because of accelerated principal payments we received from certain fixed-income securities we had purchased at discounts. This phenomenon has ended, and earnings are therefore likely to be lower in this segment during the next few years.

• We have a $604 million investment in Value Capital, a partnership run by Mark Byrne, a member of a family that has helped Berkshire over the years in many ways. Berkshire is a limited partner in, and has no say in the management of, Mark's enterprise, which specializes in highly-hedged fixed-income opportunities. Mark is smart and honest and, along with his family, has a significant investment in Value.

Because of accounting abuses at Enron and elsewhere, rules will soon be instituted that are likely to require that Value's assets and liabilities be consolidated on Berkshire's balance sheet. We regard this requirement as inappropriate, given that Value's liabilities — which usually are above $20 billion — are in no way ours. Over time, other investors will join us as partners in Value. When enough do, the need for us to consolidate Value will disappear.

• We have told you in the past about Berkadia, the partnership we formed three years ago with Leucadia to finance and manage the wind-down of Finova, a bankrupt lending operation. The plan was that we would supply most of the capital and Leucadia would supply most of the brains. And that's the way it has worked. Indeed, Joe Steinberg and Ian Cumming, who together run Leucadia, have done such a fine job in liquidating Finova's portfolio that the $5.6 billion guarantee we took on in connection with the transaction has been extinguished. The unfortunate byproduct of this fast payoff is that our future income will be much reduced. Overall, Berkadia has made excellent money for us, and Joe and Ian have been terrific partners.

• Our leasing businesses are XTRA (transportation equipment) and CORT (office furniture). Both operations have had poor earnings during the past two years as the recession caused demand to drop considerably more than was anticipated. They remain leaders in their fields, and I expect at least a modest improvement in their earnings this year.

- Through our Clayton purchase, we acquired a significant manufactured-housing finance operation. Clayton, like others in this business, had traditionally securitized the loans it originated. The practice relieved stress on Clayton's balance sheet, but a by-product was the "front-ending" of income (a result dictated by GAAP).

We are in no hurry to record income, have enormous balance-sheet strength, and believe that over the long-term the economics of holding our consumer paper are superior to what we can now realize through securitization. So Clayton has begun to retain its loans.

We believe it's appropriate to finance a soundly-selected book of interest-bearing receivables almost entirely with debt (just as a bank would). Therefore, Berkshire will borrow money to finance Clayton's portfolio and re-lend these funds to Clayton at our cost plus one percentage point. This markup fairly compensates Berkshire for putting its exceptional creditworthiness to work, but it still delivers money to Clayton at an attractive price.

In 2003, Berkshire did $2 billion of such borrowing and re-lending, with Clayton using much of this money to fund several large purchases of portfolios from lenders exiting the business. A portion of our loans to Clayton also provided "catch-up" funding for paper it had generated earlier in the year from its own operation and had found difficult to securitize.

You may wonder why we borrow money while sitting on a mountain of cash. It's because of our "every tub on its own bottom" philosophy. We believe that any subsidiary lending money should pay an appropriate rate for the funds needed to carry its receivables and should not be subsidized by its parent. Otherwise, having a rich daddy can lead to sloppy decisions. Meanwhile, the cash we accumulate at Berkshire is destined for business acquisitions or for the purchase of securities that offer opportunities for significant profit. Clayton's loan portfolio will likely grow to at least $5 billion in not too many years and, with sensible credit standards in place, should deliver significant earnings.

For simplicity's sake, we include all of Clayton's earnings in this sector, though a sizable portion is derived from areas other than consumer finance.

	(in $ millions)			
	Pre-Tax Earnings		*Interest-bearing Liabilities*	
	2003	*2002*	*2003*	*2002*
Trading – Ordinary Income	$ 379	$ 553	$7,826	$13,762
Gen Re Securities	(99)	(173)	8,041*	10,631*
Life and annuity operation	99	83	2,331	1,568
Value Capital	31	61	18,238*	20,359*
Berkadia	101	115	525	2,175
Leasing operations	34	34	482	503
Manufactured housing finance (Clayton)	37**	—	2,032	—
Other	84	102	618	630
Income before capital gains	666	775		
Trading – Capital Gains	1,215	578	N.A.	N.A.
Total	$1,881	$1,353		

* Includes all liabilities
** From date of acquisition, August 7, 2003

Manufacturing, Service and Retailing Operations

Our activities in this category cover the waterfront. But let's look at a simplified balance sheet and earnings statement consolidating the entire group.

Balance Sheet 12/31/03 (in $ millions)

Assets		*Liabilities and Equity*	
Cash and equivalents	$ 1,250	Notes payable	$ 1,593
Accounts and notes receivable	2,796	Other current liabilities	4,300
Inventory	3,656	Total current liabilities	5,893
Other current assets	262		
Total current assets	7,964		
Goodwill and other intangibles	8,351	Deferred taxes	105
Fixed assets	5,898	Term debt and other liabilities	1,890
Other assets	1,054	Equity	15,379
	$23,267		$23,267

Earnings Statement (in $ millions)

	2003	*2002*
Revenues	$32,106	$16,970
Operating expenses (including depreciation of $605 in 2003 and $477 in 2002)	29,885	14,921
Interest expense (net)	64	108
Pre-tax income	2,157	1,941
Income taxes	813	743
Net income	$ 1,344	$ 1,198

This eclectic group, which sells products ranging from Dilly Bars to B-737s, earned a hefty 20.7% on average tangible net worth last year. However, we purchased these businesses at substantial premiums to net worth — that fact is reflected in the goodwill item shown on the balance sheet — and that reduces the earnings on our average *carrying* value to 9.2%.

Here are the pre-tax earnings for the larger categories or units.

	Pre-Tax Earnings (in $ millions)	
	2003	*2002*
Building Products	$ 559	$ 516
Shaw Industries	436	424
Apparel	289	229
Retail Operations	224	219
Flight Services	72	225
McLane *	150	—
Other businesses	427	328
	$2,157	$1,941

* From date of acquisition, May 23, 2003.

• Three of our building-materials businesses — Acme Brick, Benjamin Moore and MiTek — had record operating earnings last year. And earnings at Johns Manville, the fourth, were trending upward at yearend. Collectively, these companies earned 21.0% on tangible net worth.

• Shaw Industries, the world's largest manufacturer of broadloom carpet, also had a record year. Led by Bob Shaw, who built this huge enterprise from a standing start, the company will likely set another earnings record in 2004. In November, Shaw acquired various carpet operations from Dixie Group, which should add about $240 million to sales this year, boosting Shaw's volume to nearly $5 billion.

• Within the apparel group, Fruit of the Loom is our largest operation. Fruit has three major assets: a 148-year-old universally-recognized brand, a low-cost manufacturing operation, and John Holland, its CEO. In 2003, Fruit accounted for 42.3% of the men's and boys' underwear that was sold by mass marketers (Wal-Mart, Target, K-Mart, etc.) and increased its share of the women's and girls' business in that channel to 13.9%, up from 11.3% in 2002.

• In retailing, our furniture group earned $106 million pre-tax, our jewelers $59 million and See's, which is both a manufacturer and retailer, $59 million.

Both R.C. Willey and Nebraska Furniture Mart ("NFM") opened hugely successful stores last year, Willey in Las Vegas and NFM in Kansas City, Kansas. Indeed, we believe the Kansas City store is the country's largest-volume home-furnishings store. (Our Omaha operation, while located on a single plot of land, consists of three units.)

NFM was founded by Rose Blumkin ("Mrs. B") in 1937 with $500. She worked until she was 103 (hmmm . . . not a bad idea). One piece of wisdom she imparted to the generations following her was, "If you have the lowest price, customers will find you at the bottom of a river." Our store serving greater Kansas City, which is located in one of the area's more sparsely populated parts, has proved Mrs. B's point. Though we have more than 25 acres of parking, the lot has at times overflowed.

"Victory," President Kennedy told us after the Bay of Pigs disaster, "has a thousand fathers, but defeat is an orphan." At NFM, we knew we had a winner a month after the boffo opening in Kansas City, when our new store attracted an unexpected paternity claim. A speaker there, referring to the Blumkin family, asserted, "They had enough confidence and the policies of the Administration were working such that they were able to provide work for 1,000 of our fellow citizens." The proud papa at the podium? President George W. Bush.

• In flight services, FlightSafety, our training operation, experienced a drop in "normal" operating earnings from $183 million to $150 million. (The abnormals: In 2002 we had a $60 million pre-tax gain from the sale of a partnership interest to Boeing, and in 2003 we recognized a $37 million loss stemming from the premature obsolescence of simulators.) The corporate aviation business has slowed significantly in the past few years, and this fact has hurt FlightSafety's results. The company continues, however, to be far and away the leader in its field. Its simulators have an original cost of $1.2 billion, which is more than triple the cost of those operated by our closest competitor.

NetJets, our fractional-ownership operation lost $41 million pre-tax in 2003. The company had a modest operating profit in the U.S., but this was more than offset by a $32 million loss on aircraft inventory and by continued losses in Europe.

NetJets continues to dominate the fractional-ownership field, and its lead is increasing: Prospects overwhelmingly turn to us rather than to our three major competitors. Last year, among the four of us, we accounted for 70% of net sales (measured by value).

An example of what sets NetJets apart from competitors is our Mayo Clinic Executive Travel Response program, a free benefit enjoyed by all of our owners. On land or in the air, anywhere in the world and at any hour of any day, our owners and their families have an immediate link to Mayo. Should an emergency occur while they are traveling here or abroad, Mayo will instantly direct them to an appropriate doctor or hospital. Any baseline data about the patient that Mayo possesses is simultaneously made available to the treating physician. Many owners have already found this service invaluable, including one who needed emergency brain surgery in Eastern Europe.

The $32 million inventory write-down we took in 2003 occurred because of falling prices for used aircraft early in the year. Specifically, we bought back fractions from withdrawing owners at prevailing prices, and these fell in value before we were able to remarket them. Prices are now stable.

The European loss is painful. But any company that forsakes Europe, as all of our competitors have done, is destined for second-tier status. Many of our U.S. owners fly extensively in Europe and want the safety and security assured by a NetJets plane and pilots. Despite a slow start, furthermore, we are now adding European customers at a good pace. During the years 2001 through 2003, we had gains of 88%, 61% and 77% in European management-and-flying revenues. We have not, however, yet succeeded in stemming the flow of red ink.

Rich Santulli, NetJets' extraordinary CEO, and I expect our European loss to diminish in 2004 and also anticipate that it will be more than offset by U.S. profits. Overwhelmingly, our owners love the NetJets experience. Once a customer has tried us, going back to commercial aviation is like going back to holding hands. NetJets will become a very big business over time and will be one in which we are preeminent in both customer satisfaction and profits. Rich will see to that.

Investments

The table that follows shows our common stock investments. Those that had a market value of more than $500 million at the end of 2003 are itemized.

			12/31/03	
Shares	*Company*	*Percentage of Company Owned*	*Cost*	*Market*
			(in $ millions)	
151,610,700	American Express Company	11.8	$ 1,470	$ 7,312
200,000,000	The Coca-Cola Company	8.2	1,299	10,150
96,000,000	The Gillette Company	9.5	600	3,526
14,610,900	H&R Block, Inc....................................	8.2	227	809
15,476,500	HCA Inc.	3.1	492	665
6,708,760	M&T Bank Corporation	5.6	103	659
24,000,000	Moody's Corporation	16.1	499	1,453
2,338,961,000	PetroChina Company Limited.............	1.3	488	1,340
1,727,765	The Washington Post Company	18.1	11	1,367
56,448,380	Wells Fargo & Company......................	3.3	463	3,324
	Others		2,863	4,682
	Total Common Stocks		$ 8,515	$35,287

We bought some Wells Fargo shares last year. Otherwise, among our six largest holdings, we last changed our position in Coca-Cola in 1994, American Express in 1998, Gillette in 1989, Washington Post in 1973, and Moody's in 2000. Brokers don't love us.

We are neither enthusiastic nor negative about the portfolio we hold. We own pieces of excellent businesses — all of which had good gains in intrinsic value last year — but their current prices reflect their excellence. The unpleasant corollary to this conclusion is that I made a big mistake in not selling several of our larger holdings during The Great Bubble. If these stocks are fully priced now, you may wonder what I was thinking four years ago when their intrinsic value was lower and their prices far higher. So do I.

In 2002, junk bonds became very cheap, and we purchased about $8 billion of these. The pendulum swung quickly though, and this sector now looks decidedly unattractive to us. Yesterday's weeds are today being priced as flowers.

We've repeatedly emphasized that realized gains at Berkshire are meaningless for analytical purposes. We have a huge amount of unrealized gains on our books, and our thinking about when, and if, to cash them depends not at all on a desire to report earnings at one specific time or another. Nevertheless, to see the diversity of our investment activities, you may be interested in the following table, categorizing the gains we reported during 2003:

Category	*Pre-Tax Gain (in $ million)*
Common Stocks	$ 448
U.S. Government Bonds	1,485
Junk Bonds	1,138
Foreign Exchange Contracts	825
Other	233
	$4,129

The common stock profits occurred around the edges of our portfolio — not, as we already mentioned, from our selling down our major positions. The profits in governments arose from our liquidation of long-term strips (the most volatile of government securities) and from certain strategies I follow within our finance and financial products division. We retained most of our junk portfolio, selling only a few issues. Calls and maturing bonds accounted for the rest of the gains in the junk category.

During 2002 we entered the foreign currency market for the first time in my life, and in 2003 we enlarged our position, as I became increasingly bearish on the dollar. I should note that the cemetery for seers has a huge section set aside for macro forecasters. We have in fact made few macro forecasts at Berkshire, and we have seldom seen others make them with sustained success.

We have — and will continue to have — the bulk of Berkshire's net worth in U.S. assets. But in recent years our country's trade deficit has been force-feeding huge amounts of claims on, and ownership in, America to the rest of the world. For a time, foreign appetite for these assets readily absorbed the supply. Late in 2002, however, the world started choking on this diet, and the dollar's value began to slide against major currencies. Even so, prevailing exchange rates will not lead to a material letup in our trade deficit. So whether foreign investors like it or not, they will continue to be flooded with dollars. The consequences of this are anybody's guess. They could, however, be troublesome — and reach, in fact, well beyond currency markets.

As an American, I hope there is a benign ending to this problem. I myself suggested one possible solution — which, incidentally, leaves Charlie cold — in a November 10, 2003 article in Fortune Magazine. Then again, perhaps the alarms I have raised will prove needless: Our country's dynamism and resiliency have repeatedly made fools of naysayers. But Berkshire holds many billions of cash-equivalents denominated in dollars. So I feel more comfortable owning foreign-exchange contracts that are at least a partial offset to that position.

These contracts are subject to accounting rules that require changes in their value to be contemporaneously included in capital gains or losses, even though the contracts have not been closed. We show these changes each quarter in the Finance and Financial Products segment of our earnings statement. At yearend, our open foreign exchange contracts totaled about $12 billion at market values and were spread among five currencies. Also, when we were purchasing junk bonds in 2002, we tried when possible to buy issues denominated in Euros. Today, we own about $1 billion of these.

When we can't find anything exciting in which to invest, our "default" position is U.S. Treasuries, both bills and repos. No matter how low the yields on these instruments go, we never "reach" for a little more income by dropping our credit standards or by extending maturities. Charlie and I detest taking even small risks unless we feel we are being adequately compensated for doing so. About as far as we will go down that path is to occasionally eat cottage cheese a day after the expiration date on the carton.

* * * * * * * * * * * *

A 2003 book that investors can learn much from is *Bull!* by Maggie Mahar. Two other books I'd recommend are *The Smartest Guys in the Room* by Bethany McLean and Peter Elkind, and *In an Uncertain World* by Bob Rubin. All three are well-reported and well-written. Additionally, Jason Zweig last year did a first-class job in revising *The Intelligent Investor*, my favorite book on investing.

Designated Gifts Program

From 1981 through 2002, Berkshire administered a program whereby shareholders could direct Berkshire to make gifts to their favorite charitable organizations. Over the years we disbursed $197 million pursuant to this program. Churches were the most frequently named designees, and many thousands of other organizations benefited as well. We were the only major public company that offered such a program to shareholders, and Charlie and I were proud of it.

We reluctantly terminated the program in 2003 because of controversy over the abortion issue. Over the years numerous organizations on both sides of this issue had been designated by our shareholders to receive contributions. As a result, we regularly received some objections to the gifts designated for pro-choice operations. A few of these came from people and organizations that proceeded to boycott products of our subsidiaries. That did not concern us. We refused all requests to limit the right of our owners to make whatever gifts they chose (as long as the recipients had 501(c)(3) status).

In 2003, however, many *independent* associates of The Pampered Chef began to feel the boycotts. This development meant that people who trusted us — but who were neither employees of ours nor had a voice in Berkshire decision-making — suffered serious losses of income.

For our shareholders, there was some modest tax efficiency in Berkshire doing the giving rather than their making their gifts directly. Additionally, the program was consistent with our "partnership" approach, the first principle set forth in our Owner's Manual. But these advantages paled when they were measured against damage done loyal associates who had with great personal effort built businesses of their own. Indeed, Charlie and I see nothing charitable in harming decent, hard-working people just so we and other shareholders can gain some minor tax efficiencies.

Berkshire now makes no contributions at the parent company level. Our various subsidiaries follow philanthropic policies consistent with their practices prior to their acquisition by Berkshire, except that any personal contributions that former owners had earlier made from their corporate pocketbook are now funded by them personally.

The Annual Meeting

Last year, I asked you to vote as to whether you wished our annual meeting to be held on Saturday or Monday. I was hoping for Monday. Saturday won by 2 to 1. It will be a while before shareholder democracy resurfaces at Berkshire.

But you have spoken, and we will hold this year's annual meeting on Saturday, May 1 at the new Qwest Center in downtown Omaha. The Qwest offers us 194,000 square feet for exhibition by our subsidiaries (up from 65,000 square feet last year) and much more seating capacity as well. The Qwest's doors will open at 7 a.m., the movie will begin at 8:30, and the meeting itself will commence at 9:30. There will be a short break at noon for food. (Sandwiches will be available at the Qwest's concession stands.) That interlude aside, Charlie and I will answer questions until 3:30. We will tell you everything we know . . . and, at least in my case, more.

An attachment to the proxy material that is enclosed with this report explains how you can obtain the credential you will need for admission to the meeting and other events. As for plane, hotel and car reservations, we have again signed up American Express (800-799-6634) to give you special help. They do a terrific job for us each year, and I thank them for it.

In our usual fashion, we will run vans from the larger hotels to the meeting. Afterwards, the vans will make trips back to the hotels and to Nebraska Furniture Mart, Borsheim's and the airport. Even so, you are likely to find a car useful.

Our exhibition of Berkshire goods and services will blow you away this year. On the floor, for example, will be a 1,600 square foot Clayton home (featuring Acme brick, Shaw carpet, Johns-Manville insulation, MiTek fasteners, Carefree awnings, and outfitted with NFM furniture). You'll find it a far cry from the mobile-home stereotype of a few decades ago.

GEICO will have a booth staffed by a number of its top counselors from around the country, all of them ready to supply you with auto insurance quotes. In most cases, GEICO will be able to give you a special shareholder discount (usually 8%). This special offer is permitted by 41 of the 49 jurisdictions in which we operate. Bring the details of your existing insurance and check out whether we can save you money.

On Saturday, at the Omaha airport, we will have the usual array of aircraft from NetJets® available for your inspection. Stop by the NetJets booth at the Qwest to learn about viewing these planes. If you buy what we consider an appropriate number of items during the weekend, you may well need your own plane to take them home.

At Nebraska Furniture Mart, located on a 77-acre site on 72nd Street between Dodge and Pacific, we will again be having "Berkshire Weekend" pricing, which means we will be offering our shareholders a discount that is customarily given only to employees. We initiated this special pricing at NFM seven years ago, and sales during the "Weekend" grew from $5.3 million in 1997 to $17.3 million in 2003. Every year has set a new record.

To get the discount, you must make your purchases between Thursday, April 29 and Monday, May 3 inclusive, and also present your meeting credential. The period's special pricing will even apply to the products of several prestigious manufacturers that normally have ironclad rules against discounting but that, in the spirit of our shareholder weekend, have made an exception for you. We appreciate their cooperation. NFM is open from 10 a.m. to 9 p.m. Monday through Saturday, and 10 a.m. to 6 p.m. on Sunday. On Saturday this year, from 5:30 p.m. to 8 p.m., we are having a special affair for shareholders only. I'll be there, eating barbeque and drinking Coke.

Borsheim's — the largest jewelry store in the country except for Tiffany's Manhattan store — will have two shareholder-only events. The first will be a cocktail reception from 6 p.m. to 10 p.m. on Friday, April 30. The second, the main gala, will be from 9 a.m. to 4 p.m. on Sunday, May 2. Ask Charlie to autograph your *sales ticket*.

Shareholder prices will be available Thursday through Monday, so if you wish to avoid the large crowds that will assemble on Friday evening and Sunday, come at other times and identify yourself as a shareholder. On Saturday, we will be open until 6 p.m. Borsheim's operates on a gross margin that is fully twenty percentage points below that of its major rivals, so the more you buy, the more you save — at least that's what my wife and daughter tell me. (Both were impressed early in life by the story of the boy who, after missing a street car, walked home and proudly announced that he had saved 5¢ by doing so. His father was irate: "Why didn't you miss a cab and save 85¢?")

In the mall outside of Borsheim's, we will have Bob Hamman and Sharon Osberg, two of the world's top bridge experts, available to play with our shareholders on Sunday afternoon. Additionally, Patrick Wolff, twice U.S. chess champion, will be in the mall, taking on all comers — blindfolded! I've watched, and he doesn't peek.

Gorat's — my favorite steakhouse — will again be open exclusively for Berkshire shareholders on Sunday, May 2, and will be serving from 4 p.m. until 10 p.m. Please remember that to come to Gorat's on Sunday, you must have a reservation. To make one, call 402-551-3733 on April 1 (*but not before*). If Sunday is sold out, try Gorat's on one of the other evenings you will be in town. Flaunt your mastery of fine dining by ordering, as I do, a rare T-bone with a double order of hash browns.

We will have a special reception on Saturday afternoon from 4:00 to 5:00 for shareholders who come from outside of North America. Every year our meeting draws many people from around the globe, and Charlie and I want to be sure we personally meet those who have come so far. Any shareholder who comes from other than the U.S. or Canada will be given special credentials and instructions for attending this function.

Charlie and I have a great time at the annual meeting. And you will, too. So join us at the Qwest for our annual Woodstock for Capitalists.

February 27, 2004

Warren E. Buffett
Chairman of the Board

BERKSHIRE HATHAWAY INC.

To the Shareholders of Berkshire Hathaway Inc.:

Our gain in net worth during 2004 was $8.3 billion, which increased the per-share book value of both our Class A and Class B stock by 10.5%. Over the last 40 years (that is, since present management took over) book value has grown from $19 to $55,824, a rate of 21.9% compounded annually.*

*All figures used in this report apply to Berkshire's A shares, the successor to the only stock that the company had outstanding before 1996. The B shares have an economic interest equal to 1/30th that of the A.

It's per-share intrinsic value that counts, however, not book value. Here, the news is good: Between 1964 and 2004, Berkshire morphed from a struggling northern textile business whose intrinsic value was less than book into a diversified enterprise worth far more than book. Our 40-year gain in intrinsic value has therefore somewhat exceeded our 21.9% gain in book. (For an explanation of intrinsic value and the economic principles that guide Charlie Munger, my partner and Berkshire's vice-chairman, and me in running Berkshire, please read our Owner's Manual, beginning on page 73.)

Despite their shortcomings, yearly calculations of book value are useful at Berkshire as a slightly understated gauge for measuring the *long-term* rate of increase in our intrinsic value. The calculations are less relevant, however, than they once were in rating any single year's performance versus the S&P 500 index (a comparison we display on the facing page). Our equity holdings (including convertible preferreds) have fallen considerably as a percentage of our net worth, from an average of 114% in the 1980s, for example, to less than 50% in recent years. Therefore, yearly movements in the stock market now affect a much smaller portion of our net worth than was once the case, a fact that will normally cause us to underperform in years when stocks rise substantially and overperform in years when they fall.

However the yearly comparisons work out, Berkshire's long-term performance versus the S&P remains all-important. Our shareholders can buy the S&P through an index fund at very low cost. Unless we achieve gains in per-share intrinsic value in the future that outdo the S&P, Charlie and I will be adding nothing to what you can accomplish on your own.

Last year, Berkshire's book-value gain of 10.5% fell short of the index's 10.9% return. Our lackluster performance was not due to any stumbles by the CEOs of our operating businesses: As always, they pulled more than their share of the load. My message to them is simple: Run your business as if it were the only asset your family will own over the next hundred years. Almost invariably they do just that and, after taking care of the needs of their business, send excess cash to Omaha for me to deploy.

I didn't do that job very well last year. My hope was to make several multi-billion dollar acquisitions that would add new and significant streams of earnings to the many we already have. But I struck out. Additionally, I found very few attractive securities to buy. Berkshire therefore ended the year with $43 billion of cash equivalents, not a happy position. Charlie and I will work to translate some of this hoard into more interesting assets during 2005, though we can't promise success.

In one respect, 2004 was a remarkable year for the stock market, a fact buried in the maze of numbers on page 2. If you examine the 35 years since the 1960s ended, you will find that an investor's return, including dividends, from owning the S&P has averaged 11.2% annually (well above what we expect future returns to be). But if you look for years with returns anywhere close to that 11.2% — say, between 8% and 14% — you will find only *one* before 2004. In other words, last year's "normal" return is anything but.

Over the 35 years, American business has delivered terrific results. It should therefore have been easy for investors to earn juicy returns: All they had to do was piggyback Corporate America in a diversified, low-expense way. An index fund that they never touched would have done the job. Instead many investors have had experiences ranging from mediocre to disastrous.

There have been three primary causes: first, high costs, usually because investors traded excessively or spent far too much on investment management; second, portfolio decisions based on tips and fads rather than on thoughtful, quantified evaluation of businesses; and third, a start-and-stop approach to the market marked by untimely entries (after an advance has been long underway) and exits (after periods of stagnation or decline). Investors should remember that excitement and expenses are their enemies. And if they insist on trying to time their participation in equities, they should try to be fearful when others are greedy and greedy only when others are fearful.

Sector Results

As managers, Charlie and I want to give our owners the financial information and commentary we would wish to receive if our roles were reversed. To do this with both clarity and reasonable brevity becomes more difficult as Berkshire's scope widens. Some of our businesses have vastly different economic characteristics from others, which means that our consolidated statements, with their jumble of figures, make useful analysis almost impossible.

On the following pages, therefore, we will present some balance sheet and earnings figures from our four major categories of businesses along with commentary about each. We particularly want you to understand the limited circumstances under which we will use debt, given that we typically shun it. We will not, however, inundate you with data that has no real value in estimating Berkshire's intrinsic value. Doing so would tend to obfuscate the facts that count.

Regulated Utility Businesses

We have an 80.5% (fully diluted) interest in MidAmerican Energy Holdings, which owns a wide variety of utility operations. The largest of these are (1) Yorkshire Electricity and Northern Electric, whose 3.7 million electric customers make it the third largest distributor of electricity in the U.K.; (2) MidAmerican Energy, which serves 698,000 electric customers, primarily in Iowa; and (3) Kern River and Northern Natural pipelines, which carry 7.9% of the natural gas consumed in the U.S.

The remaining 19.5% of MidAmerican is owned by three partners of ours: Dave Sokol and Greg Abel, the brilliant managers of these businesses, and Walter Scott, a long-time friend of mine who introduced me to the company. Because MidAmerican is subject to the Public Utility Holding Company Act ("PUHCA"), Berkshire's voting interest is limited to 9.9%. Voting control rests with Walter.

Our limited voting interest forces us to account for MidAmerican in an abbreviated manner. Instead of our fully incorporating the company's assets, liabilities, revenues and expenses into Berkshire's statements, we make one-line entries only in both our balance sheet and income account. It's likely, though, that PUHCA will someday — perhaps soon — be repealed or that accounting rules will change. Berkshire's consolidated figures would then incorporate all of MidAmerican, including the substantial debt it utilizes (though this debt is not now, nor will it ever be, an obligation of Berkshire).

At yearend, $1.478 billion of MidAmerican's junior debt was payable to Berkshire. This debt has allowed acquisitions to be financed without our partners needing to increase their already substantial investments in MidAmerican. By charging 11% interest, Berkshire is compensated fairly for putting up the funds needed for purchases, while our partners are spared dilution of their equity interests. Because MidAmerican made no large acquisitions last year, it paid down $100 million of what it owes us.

	Earnings (in $ millions)	
	2004	*2003*
U.K. utilities	$ 326	$ 289
Iowa utility	268	269
Pipelines	288	261
HomeServices	130	113
Other (net)	172	190
Loss from zinc project	(579)	(46)
Earnings before corporate interest and taxes	605	1,076
Interest, other than to Berkshire	(212)	(225)
Interest on Berkshire junior debt	(170)	(184)
Income tax	(53)	(251)
Net earnings	$ 170	$ 416
Earnings applicable to Berkshire*	$ 237	$ 429
Debt owed to others	10,528	10,296
Debt owed to Berkshire	1,478	1,578

*Includes interest earned by Berkshire (net of related income taxes) of $110 in 2004 and $118 in 2003.

Insurance

Since Berkshire purchased National Indemnity ("NICO") in 1967, property-casualty insurance has been our core business and the propellant of our growth. Insurance has provided a fountain of funds with which we've acquired the securities and businesses that now give us an ever-widening variety of earnings streams. So in this section, I will be spending a little time telling you how we got where we are.

The source of our insurance funds is "float," which is money that doesn't belong to us but that we temporarily hold. Most of our float arises because (1) premiums are paid upfront though the service we provide — insurance protection — is delivered over a period that usually covers a year and; (2) loss events that occur today do not always result in our immediately paying claims, because it sometimes takes many years for losses to be reported (asbestos losses would be an example), negotiated and settled. The $20 million of float that came with our 1967 purchase has now increased — both by way of internal growth and acquisitions — to $46.1 billion.

Float is wonderful — *if* it doesn't come at a high price. Its cost is determined by underwriting results, meaning how the expenses and losses we will ultimately pay compare with the premiums we have received. When an underwriting profit is achieved — as has been the case at Berkshire in about half of the 38 years we have been in the insurance business — float is better than free. In such years, we are actually paid for holding other people's money. For most insurers, however, life has been far more difficult: In aggregate, the property-casualty industry almost invariably operates at an underwriting loss. When that loss is large, float becomes expensive, sometimes devastatingly so.

Insurers have generally earned poor returns for a simple reason: They sell a commodity-like product. Policy forms are standard, and the product is available from many suppliers, some of whom are mutual companies ("owned" by policyholders rather than stockholders) with profit goals that are limited. Moreover, most insureds don't care from whom they buy. Customers by the millions say "I need some Gillette blades" or "I'll have a Coke" but we wait in vain for "I'd like a National Indemnity policy, please."

Consequently, price competition in insurance is usually fierce. Think airline seats.

So, you may ask, how do Berkshire's insurance operations overcome the dismal economics of the industry and achieve some measure of enduring competitive advantage? We've attacked that problem in several ways. Let's look first at NICO's strategy.

When we purchased the company — a specialist in commercial auto and general liability insurance — it did not appear to have any attributes that would overcome the industry's chronic troubles. It was not well-known, had no informational advantage (the company has never had an actuary), was not a low-cost operator, and sold through general agents, a method many people thought outdated. Nevertheless, for almost all of the past 38 years, NICO has been a star performer. Indeed, had we not made this acquisition, Berkshire would be lucky to be worth half of what it is today.

What we've had going for us is a managerial mindset that most insurers find impossible to replicate. Take a look at the facing page. Can you imagine *any* public company embracing a business model that would lead to the decline in revenue that we experienced from 1986 through 1999? That colossal slide, it should be emphasized, did not occur because business was unobtainable. Many billions of premium dollars were readily available to NICO had we only been willing to cut prices. But we instead consistently priced to make a profit, not to match our most optimistic competitor. We never left customers — but they left us.

Most American businesses harbor an "institutional imperative" that rejects extended decreases in volume. What CEO wants to report to his shareholders that not only did business contract last year but that it will continue to drop? In insurance, the urge to keep writing business is also intensified because the consequences of foolishly-priced policies may not become apparent for some time. If an insurer is optimistic in its reserving, reported earnings will be overstated, and years may pass before true loss costs are revealed (a form of self-deception that nearly destroyed GEICO in the early 1970s).

Portrait of a Disciplined Underwriter

National Indemnity Company

Year		*Written Premium (In $ millions)*	*No. of Employees at Year-End*	*Ratio of Operating Expenses to Written Premium*	*Underwriting Profit (Loss) as a Percentage of Premiums (Calculated as of year end 2004)**
1980	....	$79.6	372	32.3%	8.2%
1981	....	59.9	353	36.1%	(.8%)
1982	....	52.5	323	36.7%	(15.3%)
1983	....	58.2	308	35.6%	(18.7%)
1984	....	62.2	342	35.5%	(17.0%)
1985	....	160.7	380	28.0%	1.9%
1986	....	366.2	403	25.9%	30.7%
1987	....	232.3	368	29.5%	27.3%
1988	....	139.9	347	31.7%	24.8%
1989	....	98.4	320	35.9%	14.8%
1990	....	87.8	289	37.4%	7.0%
1991	....	88.3	284	35.7%	13.0%
1992	....	82.7	277	37.9%	5.2%
1993	....	86.8	279	36.1%	11.3%
1994	....	85.9	263	34.6%	4.6%
1995	....	78.0	258	36.6%	9.2%
1996	....	74.0	243	36.5%	6.8%
1997	....	65.3	240	40.4%	6.2%
1998	....	56.8	231	40.4%	9.4%
1999	....	54.5	222	41.2%	4.5%
2000	....	68.1	230	38.4%	2.9%
2001	....	161.3	254	28.8%	(11.6%)
2002	....	343.5	313	24.0%	16.8%
2003	....	594.5	337	22.2%	18.1%
2004	....	605.6	340	22.5%	5.1%

* It takes a long time to learn the true profitability of any given year. First, many claims are received after the end of the year, and we must estimate how many of these there will be and what they will cost. (In insurance jargon, these claims are termed IBNR — incurred but not reported.) Second, claims often take years, or even decades, to settle, which means there can be many surprises along the way.

For these reasons, the results in this column simply represent our best estimate at the end of 2004 as to how we have done in prior years. Profit margins for the years through 1999 are probably close to correct because these years are "mature," in the sense that they have few claims still outstanding. The more recent the year, the more guesswork is involved. In particular, the results shown for 2003 and 2004 are apt to change significantly.

Finally, there is a fear factor at work, in that a shrinking business usually leads to layoffs. To avoid pink slips, employees will rationalize inadequate pricing, telling themselves that poorly-priced business must be tolerated in order to keep the organization intact and the distribution system happy. If this course isn't followed, these employees will argue, the company will not participate in the recovery that they invariably feel is just around the corner.

To combat employees' natural tendency to save their own skins, we have always promised NICO's workforce that *no one* will be fired because of declining volume, however severe the contraction. (This is not Donald Trump's sort of place.) NICO is not labor-intensive, and, as the table suggests, can live with excess overhead. It can't live, however, with underpriced business and the breakdown in underwriting discipline that accompanies it. An insurance organization that doesn't care deeply about underwriting at a profit *this* year is unlikely to care *next* year either.

Naturally, a business that follows a no-layoff policy must be especially careful to avoid overstaffing when times are good. Thirty years ago Tom Murphy, then CEO of Cap Cities, drove this point home to me with a hypothetical tale about an employee who asked his boss for permission to hire an assistant. The employee assumed that adding $20,000 to the annual payroll would be inconsequential. But his boss told him the proposal should be evaluated as a $3 million decision, given that an additional person would probably cost at least that amount over his lifetime, factoring in raises, benefits and other expenses (more people, more toilet paper). And unless the company fell on very hard times, the employee added would be unlikely to be dismissed, however marginal his contribution to the business.

It takes real fortitude — embedded deep within a company's culture — to operate as NICO does. Anyone examining the table can scan the years from 1986 to 1999 quickly. But living day after day with dwindling volume — while competitors are boasting of growth and reaping Wall Street's applause — is an experience few managers can tolerate. NICO, however, has had four CEOs since its formation in 1940 and *none* have bent. (It should be noted that only one of the four graduated from college. Our experience tells us that extraordinary business ability is largely innate.)

The current managerial star — make that superstar — at NICO is Don Wurster (yes, he's "the graduate"), who has been running things since 1989. His slugging percentage is right up there with Barry Bonds' because, like Barry, Don will accept a walk rather than swing at a bad pitch. Don has now amassed $950 million of float at NICO that over time is almost certain to be proved the negative-cost kind. Because insurance prices are falling, Don's volume will soon decline very significantly and, as it does, Charlie and I will applaud him ever more loudly.

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Another way to prosper in a commodity-type business is to be the low-cost operator. Among auto insurers operating on a broad scale, GEICO holds that cherished title. For NICO, as we have seen, an ebb-and-flow business model makes sense. But a company holding a low-cost advantage must pursue an unrelenting foot-to-the-floor strategy. And that's just what we do at GEICO.

A century ago, when autos first appeared, the property-casualty industry operated as a cartel. The major companies, most of which were based in the Northeast, established "bureau" rates and that was it. No one cut prices to attract business. Instead, insurers competed for strong, well-regarded agents, a focus that produced high commissions for agents and high prices for consumers.

In 1922, State Farm was formed by George Mecherle, a farmer from Merna, Illinois, who aimed to take advantage of the pricing umbrella maintained by the high-cost giants of the industry. State Farm employed a "captive" agency force, a system keeping its acquisition costs lower than those incurred by the bureau insurers (whose "independent" agents successfully played off one company against another). With its low-cost structure, State Farm eventually captured about 25% of the personal lines (auto and homeowners) business, far outdistancing its once-mighty competitors. Allstate, formed in 1931, put a similar distribution system into place and soon became the runner-up in personal lines to State Farm. Capitalism had worked its magic, and these low-cost operations looked unstoppable.

But a man named Leo Goodwin had an idea for an even more efficient auto insurer and, with a skimpy $200,000, started GEICO in 1936. Goodwin's plan was to eliminate the agent entirely and to deal instead directly with the auto owner. Why, he asked himself, should there be any unnecessary and expensive links in the distribution mechanism when the product, auto insurance, was both mandatory and costly. Purchasers of business insurance, he reasoned, might well require professional advice, but most consumers knew what they needed in an auto policy. That was a powerful insight.

Originally, GEICO mailed its low-cost message to a limited audience of government employees. Later, it widened its horizons and shifted its marketing emphasis to the phone, working inquiries that came from broadcast and print advertising. And today the Internet is coming on strong.

Between 1936 and 1975, GEICO grew from a standing start to a 4% market share, becoming the country's fourth largest auto insurer. During most of this period, the company was superbly managed, achieving both excellent volume gains and high profits. It looked unstoppable. But after my friend and hero Lorimer Davidson retired as CEO in 1970, his successors soon made a huge mistake by under-reserving for losses. This produced faulty cost information, which in turn produced inadequate pricing. By 1976, GEICO was on the brink of failure.

Jack Byrne then joined GEICO as CEO and, almost single-handedly, saved the company by heroic efforts that included major price increases. Though GEICO's survival required these, policyholders fled the company, and by 1980 its market share had fallen to 1.8%. Subsequently, the company embarked on some unwise diversification moves. This shift of emphasis away from its extraordinary core business stunted GEICO's growth, and by 1993 its market share had grown only fractionally, to 1.9%. Then Tony Nicely took charge.

And what a difference that's made: In 2005 GEICO will probably secure a 6% market share. Better yet, Tony has matched growth with profitability. Indeed, GEICO delivers all of its constituents major benefits: In 2004 its customers saved $1 billion or so compared to what they would otherwise have paid for coverage, its associates earned a $191 million profit-sharing bonus that averaged 24.3% of salary, and its owner — that's us — enjoyed excellent financial returns.

There’s more good news. When Jack Byrne was rescuing the company in 1976, New Jersey refused to grant him the rates he needed to operate profitably. He therefore promptly — and properly — withdrew from the state. Subsequently, GEICO avoided both New Jersey and Massachusetts, recognizing them as two jurisdictions in which insurers were destined to struggle.

In 2003, however, New Jersey took a new look at its chronic auto-insurance problems and enacted legislation that would curb fraud and allow insurers a fair playing field. Even so, one might have expected the state’s bureaucracy to make change slow and difficult.

But just the opposite occurred. Holly Bakke, the New Jersey insurance commissioner, who would be a success in *any* line of work, was determined to turn the law’s intent into reality. With her staff’s cooperation, GEICO ironed out the details for re-entering the state and was licensed last August. Since then, we’ve received a response from New Jersey drivers that is multiples of my expectations.

We are now serving 140,000 policyholders — about 4% of the New Jersey market — and saving them substantial sums (as we do drivers everywhere). Word-of-mouth recommendations within the state are causing inquiries to pour in. And once we hear from a New Jersey prospect, our closure rate — the percentage of policies issued to inquiries received — is far higher in the state than it is nationally.

We make no claim, of course, that we can save *everyone* money. Some companies, using rating systems that are different from ours, will offer certain classes of drivers a lower rate than we do. But we believe GEICO offers the lowest price more often than any other national company that serves all segments of the public. In addition, in most states, including New Jersey, Berkshire shareholders receive an 8% discount. So gamble fifteen minutes of your time and go to GEICO.com — or call 800-847-7536 — to see whether you can save big money (which you might want to use, of course, to buy other Berkshire products).

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Reinsurance — insurance sold to other insurers who wish to lay off part of the risks they have assumed — should *not* be a commodity product. At bottom, any insurance policy is simply a promise, and as everyone knows, promises vary enormously in their quality.

At the primary insurance level, nevertheless, just who makes the promise is often of minor importance. In personal-lines insurance, for example, states levy assessments on solvent companies to pay the policyholders of companies that go broke. In the business-insurance field, the same arrangement applies to workers' compensation policies. "Protected" policies of these types account for about 60% of the property-casualty industry's volume. Prudently-run insurers are irritated by the need to subsidize poor or reckless management elsewhere, but that's the way it is.

Other forms of business insurance at the primary level involve promises that carry greater risks for the insured. When Reliance Insurance and Home Insurance were run into the ground, for example, their promises proved to be worthless. Consequently, many holders of their business policies (other than those covering workers' compensation) suffered painful losses.

The solvency risk in primary policies, however, pales in comparison to that lurking in reinsurance policies. When a reinsurer goes broke, staggering losses almost always strike the primary companies it has dealt with. This risk is far from minor: GEICO has suffered tens of millions in losses from its careless selection of reinsurers in the early 1980s.

Were a true mega-catastrophe to occur in the next decade or two — and that's a real possibility — some reinsurers would not survive. The largest insured loss to date is the World Trade Center disaster, which cost the insurance industry an estimated $35 billion. Hurricane Andrew cost insurers about $15.5 billion in 1992 (though that loss would be far higher in today's dollars). Both events rocked the insurance and reinsurance world. But a $100 billion event, or even a larger catastrophe, remains a possibility if either a particularly severe earthquake or hurricane hits just the wrong place. Four significant hurricanes struck Florida during 2004, causing an aggregate of $25 billion or so in insured losses. Two of these — Charley and Ivan — could have done at least three times the damage they did had they entered the U.S. not far from their actual landing points.

Many insurers regard a $100 billion industry loss as “unthinkable” and won’t even plan for it. But at Berkshire, we are fully prepared. Our share of the loss would probably be 3% to 5%, and earnings from our investments and other businesses would comfortably exceed that cost. When “the day after” arrives, Berkshire’s checks will clear.

Though the hurricanes hit us with a $1.25 billion loss, our reinsurance operations did well last year. At General Re, Joe Brandon has restored a long-admired culture of underwriting discipline that, for a time, had lost its way. The excellent results he realized in 2004 on current business, however, were offset by adverse developments from the years before he took the helm. At NICO’s reinsurance operation, Ajit Jain continues to successfully underwrite huge risks that no other reinsurer is willing or able to accept. Ajit’s value to Berkshire is enormous.

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Our insurance managers, maximizing the competitive strengths I’ve mentioned in this section, again delivered first-class underwriting results last year. As a consequence, our float was better than costless. Here’s the scorecard:

		(in $ millions)	
	Underwriting Profit	*Yearend Float*	
Insurance Operations	*2004*	*2004*	*2003*
General Re	$ 3	$23,120	$23,654
B-H Reinsurance	417	15,278	13,948
GEICO	970	5,960	5,287
Other Primary*	161	1,736	1,331
Total	$1,551	$46,094	$44,220

*Includes, in addition to National Indemnity, a variety of other exceptional insurance businesses, run by Rod Eldred, John Kizer, Tom Nerney and Don Towle.

Berkshire’s float increased $1.9 billion in 2004, even though a few insureds opted to commute (that is, unwind) certain reinsurance contracts. We agree to such commutations only when we believe the economics are favorable to us (after giving due weight to what we might earn in the future on the money we are returning).

To summarize, last year we were paid more than $1.5 billion to hold an average of about $45.2 billion. In 2005 pricing will be less attractive than it has been. Nevertheless, absent a mega-catastrophe, we have a decent chance of achieving no-cost float again this year.

Finance and Finance Products

Last year in this section we discussed a potpourri of activities. In this report, we'll skip over several that are now of lesser importance: Berkadia is down to tag ends; Value Capital has added other investors, negating our expectation that we would need to consolidate its financials into ours; and the trading operation that I run continues to shrink.

• Both of Berkshire's leasing operations rebounded last year. At CORT (office furniture), earnings remain inadequate, but are trending upward. XTRA disposed of its container and intermodal businesses in order to concentrate on trailer leasing, long its strong suit. Overhead has been reduced, asset utilization is up and decent profits are now being achieved under Bill Franz, the company's new CEO.

• The wind-down of Gen Re Securities continues. We decided to exit this derivative operation three years ago, but getting out is easier said than done. Though derivative instruments are purported to be highly liquid — and though we have had the benefit of a benign market while liquidating ours — we still had 2,890 contracts outstanding at yearend, down from 23,218 at the peak. Like Hell, derivative trading is easy to enter but difficult to leave. (Other similarities come to mind as well.)

Gen Re's derivative contracts have always been required to be marked to market, and I believe the company's management conscientiously tried to make realistic "marks." The market prices of derivatives, however, can be very fuzzy in a world in which settlement of a transaction is sometimes decades away and often involves multiple variables as well. In the interim the marks influence the managerial and trading bonuses that are paid annually. It's small wonder that phantom profits are often recorded.

Investors should understand that in all types of financial institutions, rapid growth sometimes masks major underlying problems (and occasionally fraud). The real test of the earning power of a derivatives operation is what it achieves after operating for an extended period in a no-growth mode. You only learn who has been swimming naked when the tide goes out.

• After 40 years, we've finally generated a little synergy at Berkshire: Clayton Homes is doing well and that's in part due to its association with Berkshire. The manufactured home industry continues to reside in the intensive care unit of Corporate America, having sold less than 135,000 new homes last year, about the same as in 2003. Volume in these years was the lowest since 1962, and it was also only about 40% of annual sales during the years 1995-99. That era, characterized by irresponsible financing and naïve funders, was a fool's paradise for the industry.

Because one major lender after another has fled the field, financing continues to bedevil manufacturers, retailers and purchasers of manufactured homes. Here Berkshire's support has proven valuable to Clayton. We stand ready to fund whatever makes sense, and last year Clayton's management found much that qualified.

As we explained in our 2003 report, we believe in using borrowed money to support profitable, interest-bearing receivables. At the beginning of last year, we had borrowed $2 billion to relend to Clayton (at a one percentage-point markup) and by January 2005 the total was $7.35 billion. Most of the dollars added were borrowed by us on January 4, 2005, to finance a seasoned portfolio that Clayton purchased on December 30, 2004 from a bank exiting the business.

We now have two additional portfolio purchases in the works, totaling about $1.6 billion, but it's quite unlikely that we will secure others of any significance. Therefore, Clayton's receivables (in which originations will roughly offset payoffs) will probably hover around $9 billion for some time and should deliver steady earnings. This pattern will be far different from that of the past, in which Clayton, like all major players in its industry, "securitized" its receivables, causing earnings to be front-ended. In the last two years, the securitization market has dried up. The limited funds available today come only at higher cost and with harsh terms. Had Clayton remained independent in this period, it would have had mediocre earnings as it struggled with financing.

In April, Clayton completed the acquisition of Oakwood Homes and is now the industry's largest producer and retailer of manufactured homes. We love putting more assets in the hands of Kevin Clayton, the company's CEO. He is a prototype Berkshire manager. Today, Clayton has 11,837 employees, up from 7,136 when we purchased it, and Charlie and I are pleased that Berkshire has been useful in facilitating this growth.

For simplicity's sake, we include all of Clayton's earnings in this sector, though a sizable portion of these are derived from areas other than consumer finance.

	(in $ millions)			
	Pre-Tax Earnings		*Interest-Bearing Liabilities*	
	2004	*2003*	*2004*	*2003*
Trading – ordinary income	$ 264	$ 355	$5,751	$7,826
Gen Re Securities	(44)	(99)	5,437*	8,041*
Life and annuity operation	(57)	85	2,467	2,331
Value Capital	30	31	N/A	N/A
Berkadia	1	101	—	525
Leasing operations	92	34	391	482
Manufactured housing finance (Clayton)	220	37**	3,636	2,032
Other	78	75	N/A	N/A
Income before capital gains	584	619		
Trading – capital gains	1,750	1,215		
Total	$2,334	$1,834		

* Includes all liabilities

** From date of acquisition, August 7, 2003

Manufacturing, Service and Retailing Operations

Our activities in this category cover the waterfront. But let's look at a summary balance sheet and earnings statement consolidating the entire group.

Balance Sheet 12/31/04 (in $ millions)

Assets		*Liabilities and Equity*	
Cash and equivalents	$ 899	Notes payable	$ 1,143
Accounts and notes receivable	3,074	Other current liabilities	4,685
Inventory	3,842	Total current liabilities	5,828
Other current assets	254		
Total current assets	8,069		
Goodwill and other intangibles	8,362	Deferred taxes	248
Fixed assets	6,161	Term debt and other liabilities	1,965
Other assets	1,044	Equity	15,595
	$23,636		$23,636

Earnings Statement (in $ millions)

	2004	*2003*
Revenues	$44,142	$32,106
Operating expenses (including depreciation of $676 in 2004 and $605 in 2003)	41,604	29,885
Interest expense (net)	57	64
Pre-tax earnings	2,481	2,157
Income taxes	941	813
Net income	$ 1,540	$ 1,344

This eclectic group, which sells products ranging from Dilly Bars to fractional interests in Boeing 737s, earned a very respectable 21.7% on average tangible net worth last year, compared to 20.7% in 2003. It’s noteworthy that these operations used only minor financial leverage in achieving these returns. Clearly, we own some very good businesses. We purchased many of them, however, at substantial premiums to net worth — a matter that is reflected in the goodwill item shown on the balance sheet — and that fact reduces the earnings on our average *carrying* value to 9.9%.

Here are the pre-tax earnings for the larger categories or units.

	Pre-Tax Earnings (in $ millions)	
	2004	2003
Building Products	$ 643	$ 559
Shaw Industries	466	436
Apparel & Footwear	325	289
Retailing of Jewelry, Home Furnishings and Candy	215	224
Flight Services	191	72
McLane	228	150*
Other businesses	413	427
	$2,481	$2,157

* From date of acquisition, May 23, 2003.

• In the building-products sector and at Shaw, we've experienced staggering cost increases for both raw-materials and energy. By December, for example, steel costs at MiTek (whose primary business is connectors for roof trusses) were running 100% over a year earlier. And MiTek uses 665 million pounds of steel every year. Nevertheless, the company continues to be an outstanding performer. Since we purchased MiTek in 2001, Gene Toombs, its CEO, has made some brilliant "bolt-on" acquisitions and is on his way to creating a mini-Berkshire.

Shaw fielded a barrage of price increases in its main fiber materials during the year, a hit that added more than $300 million to its costs. (When you walk on carpet you are, in effect, stepping on processed oil.) Though we followed these hikes in costs with price increases of our own, there was an inevitable lag. Therefore, margins narrowed as the year progressed and remain under pressure today. Despite these roadblocks, Shaw, led by Bob Shaw and Julian Saul, earned an outstanding 25.6% on tangible equity in 2004. The company is a powerhouse and has a bright future.

• In apparel, Fruit of the Loom increased unit sales by 10 million dozen, or 14%, with shipments of intimate apparel for women and girls growing by 31%. Charlie, who is far more knowledgeable than I am on this subject, assures me that women are *not* wearing more underwear. With this expert input, I can only conclude that our market share in the women's category must be growing rapidly. Thanks to John Holland, Fruit is on the move.

A smaller operation, Garan, also had an excellent year. Led by Seymour Lichtenstein and Jerry Kamiel, this company manufactures the popular

Garanimals line for children. Next time you are in a Wal-Mart, check out this imaginative product.

- Among our retailers, Ben Bridge (jewelry) and R. C. Willey (home furnishings) were particular standouts last year.

At Ben Bridge same-store sales grew 11.4%, the best gain among the publicly-held jewelers whose reports I have seen. Additionally, the company's profit margin widened. Last year was not a fluke: During the past decade, the same-store sales gains of the company have averaged 8.8%.

Ed and Jon Bridge are fourth-generation managers and run the business exactly as if it were their own — which it is in every respect except for Berkshire's name on the stock certificates. The Bridges have expanded successfully by securing the right locations and, more importantly, by staffing these stores with enthusiastic and knowledgeable associates. We will move into Minneapolis-St. Paul this year.

At Utah-based R. C. Willey, the gains from expansion have been even more dramatic, with 41.9% of 2004 sales coming from out-of-state stores that didn't exist before 1999. The company also improved its profit margin in 2004, propelled by its two new stores in Las Vegas.

I would like to tell you that these stores were my idea. In truth, I thought they were mistakes. I knew, of course, how brilliantly Bill Child had run the R. C. Willey operation in Utah, where its market share had long been huge. But I felt our closed-on-Sunday policy would prove disastrous away from home. Even our first out-of-state store in Boise, which was highly successful, left me unconvinced. I kept asking whether Las Vegas residents, conditioned to seven-day-a-week retailers, would adjust to us. Our first Las Vegas store, opened in 2001, answered this question in a resounding manner, immediately becoming our number one unit.

Bill and Scott Hymas, his successor as CEO, then proposed a second Las Vegas store, only about 20 minutes away. I felt this expansion would cannibalize the first unit, adding significant costs but only modest sales. The result? Each store is now doing about 26% more volume than any other store in the chain and is consistently showing large year-over-year gains.

R. C. Willey will soon open in Reno. Before making this commitment, Bill and Scott again asked for my advice. Initially, I was pretty puffed up about the fact that they were consulting me. But then it dawned on me that the opinion of someone who is *always* wrong has its own special utility to decision-makers.

• Earnings improved in flight services. At FlightSafety, the world's leader in pilot training, profits rose as corporate aviation rebounded and our business with regional airlines increased. We now operate 283 simulators with an original cost of $1.2 billion. Pilots are trained one at a time on this expensive equipment. This means that as much as $3.50 of capital investment is required to produce $1 of annual revenue. With this level of capital intensity, FlightSafety requires very high operating margins in order to obtain reasonable returns on capital, which means that utilization rates are all-important. Last year, FlightSafety's return on tangible equity improved to 15.1% from 8.4% in 2003.

In another 2004 event, Al Ueltschi, who founded FlightSafety in 1951 with $10,000, turned over the CEO position to Bruce Whitman, a 43-year veteran at the company. (But Al's not going anywhere; I won't let him.) Bruce shares Al's conviction that flying an aircraft is a privilege to be extended only to people who regularly receive the highest quality of training and are undeniably competent. A few years ago, Charlie was asked to intervene with Al on behalf of a tycoon friend whom FlightSafety had flunked. Al's reply to Charlie: "Tell your pal he belongs in the back of the plane, not the cockpit."

FlightSafety's number one customer is NetJets, our aircraft fractional-ownership subsidiary. Its 2,100 pilots spend an average of 18 days a year in training. Additionally, these pilots fly only one aircraft type whereas many flight operations juggle pilots among several types. NetJets' high standards on both fronts are two of the reasons I signed up with the company years before Berkshire bought it.

Fully as important in my decisions to both use and buy NetJets, however, was the fact that the company was managed by Rich Santulli, the creator of the fractional-ownership industry and a fanatic about safety and service. I viewed the selection of a flight provider as akin to picking a brain surgeon:

you simply want the best. (Let someone else experiment with the low bidder.)

Last year NetJets again gained about 70% of the net new business (measured by dollar value) going to the four companies that dominate the industry. A portion of our growth came from the 25-hour card offered by Marquis Jet Partners. Marquis is not owned by NetJets, but is instead a customer that repackages the purchases it makes from us into smaller packages that it sells through its card. Marquis deals exclusively with NetJets, utilizing the power of our reputation in its marketing.

Our U.S. contracts, including Marquis customers, grew from 3,877 to 4,967 in 2004 (versus approximately 1,200 contracts when Berkshire bought NetJets in 1998). Some clients (including me) enter into multiple contracts because they wish to use more than one type of aircraft, selecting for any given trip whichever type best fits the mission at hand.

NetJets earned a modest amount in the U.S. last year. But what we earned domestically was largely offset by losses in Europe. We are now, however, generating real momentum abroad. Contracts (including 25-hour cards that we ourselves market in Europe) increased from 364 to 693 during the year. We will again have a very significant European loss in 2005, but domestic earnings will likely put us in the black overall.

Europe has been expensive for NetJets — far more expensive than I anticipated — but it is essential to building a flight operation that will forever be in a class by itself. Our U.S. owners already want a quality service wherever they travel and their wish for flight hours abroad is certain to grow dramatically in the decades ahead. Last year, U.S. owners made 2,003 flights in Europe, up 22% from the previous year and 137% from 2000. Just as important, our European owners made 1,067 flights in the U.S., up 65% from 2003 and 239% from 2000.

Investments

We show below our common stock investments. Those that had a market value of more than $600 million at the end of 2004 are itemized.

			12/31/04	
Shares	*Company*	*Percentage of Company Owned*	*Cost**	*Market*
			(in $ millions)	
151,610,700	American Express Company	12.1	$1,470	$ 8,546
200,000,000	The Coca-Cola Company	8.3	1,299	8,328
96,000,000	The Gillette Company	9.7	600	4,299
14,350,600	H&R Block, Inc.......................................	8.7	223	703
6,708,760	M&T Bank Corporation	5.8	103	723
24,000,000	Moody's Corporation	16.2	499	2,084
2,338,961,000	PetroChina "H" shares (or equivalents)...	1.3	488	1,249
1,727,765	The Washington Post Company	18.1	11	1,698
56,448,380	Wells Fargo & Company.........................	3.3	463	3,508
1,724,200	White Mountains Insurance.....................	16.0	369	1,114
	Others		3,531	5,465
	Total Common Stocks		$9,056	$37,717

*This is our actual purchase price and also our tax basis; GAAP "cost" differs in a few cases because of write-ups or write-downs that have been required.

Some people may look at this table and view it as a list of stocks to be bought and sold based upon chart patterns, brokers' opinions, or estimates of near-term earnings. Charlie and I ignore such distractions and instead view our holdings as fractional ownerships in businesses. This is an important distinction. Indeed, this thinking has been the cornerstone of my investment behavior since I was 19. At that time I read Ben Graham's *The Intelligent Investor*, and the scales fell from my eyes. (Previously, I had been entranced by the stock market, but didn't have a clue about how to invest.)

Let's look at how the *businesses* of our "Big Four" — American Express, Coca-Cola, Gillette and Wells Fargo — have fared since we bought into these companies. As the table shows, we invested $3.83 billion in the four, by way of multiple transactions between May 1988 and October 2003. On a composite basis, our dollar-weighted purchase date is July 1992. By yearend 2004, therefore, we had held these "business interests," on a weighted basis, about 12½ years.

In 2004, Berkshire's share of the group's earnings amounted to $1.2 billion. These earnings might legitimately be considered "normal." True, they were swelled because Gillette and Wells Fargo omitted option costs in their presentation of earnings; but on the other hand they were reduced because Coke had a non-recurring write-off.

Our share of the earnings of these four companies has grown almost every year, and now amounts to about 31.3% of our cost. Their cash distributions to us have also grown consistently, totaling $434 million in 2004, or about 11.3% of cost. All in all, the Big Four have delivered us a satisfactory, though far from spectacular, business result.

That's true as well of our experience in the market with the group. Since our original purchases, valuation gains have somewhat exceeded earnings growth because price/earnings ratios have increased. On a year-to-year basis, however, the business and market performances have often diverged, sometimes to an extraordinary degree. During The Great Bubble, market-value gains far outstripped the performance of the businesses. In the aftermath of the Bubble, the reverse was true.

Clearly, Berkshire's results would have been far better if I had caught this swing of the pendulum. That may seem easy to do when one looks through an always-clean, rear-view mirror. Unfortunately, however, it's the windshield through which investors must peer, and that glass is invariably fogged. Our huge positions add to the difficulty of our nimbly dancing in and out of holdings as valuations swing.

Nevertheless, I can properly be criticized for merely clucking about nose-bleed valuations during the Bubble rather than acting on my views. Though I said at the time that certain of the stocks we held were priced ahead of themselves, I underestimated just how severe the overvaluation was. I talked when I should have walked.

What Charlie and I would like is a little action now. We don't enjoy sitting on $43 billion of cash equivalents that are earning paltry returns. Instead, we yearn to buy more fractional interests similar to those we now own or — better still — more large businesses outright. We will do either, however, only when purchases can be made at prices that offer us the prospect of a reasonable return on our investment.

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We've repeatedly emphasized that the "realized" gains that we report quarterly or annually are meaningless for analytical purposes. We have a huge amount of unrealized gains on our books, and our thinking about when, and if, to cash them depends not at all on a desire to report earnings at one specific time or another. A further complication in our reported gains occurs because GAAP requires that foreign exchange contracts be marked to market, a stipulation that causes unrealized gains or losses in these holdings to flow through our published earnings as if we had sold our positions.

Despite the problems enumerated, you may be interested in a breakdown of the gains we reported in 2003 and 2004. The data reflect actual sales except in the case of currency gains, which are a combination of sales and marks to market.

Category	*Pre-Tax Gain (in $ millions)*	
	2004	*2003*
Common Stocks	$ 870	$ 448
U.S. Government Bonds	104	1,485
Junk Bonds	730	1,138
Foreign Exchange Contracts	1,839	825
Other	(47)	233
Total	$3,496	$4,129

The junk bond profits include a foreign exchange component. When we bought these bonds in 2001 and 2002, we focused first, of course, on the credit quality of the issuers, all of which were American corporations. Some of these companies, however, had issued bonds denominated in foreign currencies. Because of our views on the dollar, we favored these for purchase when they were available.

As an example, we bought €254 million of Level 3 bonds (10 ¾% of 2008) in 2001 at 51.7% of par, and sold these at 85% of par in December 2004. This issue was traded in Euros that cost us 88¢ at the time of purchase but that brought $1.29 when we sold. Thus, of our $163 million overall gain, about $85 million came from the market's revised opinion about Level 3's credit quality, with the remaining $78 million resulting from the appreciation of the Euro. (In addition, we received cash interest during our holding period that amounted to about 25% annually on our dollar cost.)

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The media continue to report that “Buffett buys” this or that stock. Statements like these are almost always based on filings Berkshire makes with the SEC and are therefore wrong. As I’ve said before, the stories should say “*Berkshire* buys.”

Portrait of A Disciplined Investor

Lou Simpson

Year		*Return from GEICO Equities*	*S&P Return*	*Relative Results*
1980	....	23.7%	32.3%	(8.6%)
1981	....	5.4%	(5.0%)	10.4%
1982	....	45.8%	21.4%	24.4%
1983	....	36.0%	22.4%	13.6%
1984	....	21.8%	6.1%	15.7%
1985	....	45.8%	31.6%	14.2%
1986	....	38.7%	18.6%	20.1%
1987	....	(10.0%)	5.1%	(15.1%)
1988	....	30.0%	16.6%	13.4%
1989	....	36.1%	31.7%	4.4%
1990	....	(9.9%)	(3.1%)	(6.8%)
1991	....	56.5%	30.5%	26.0%
1992	....	10.8%	7.6%	3.2%
1993	....	4.6%	10.1%	(5.5%)
1994	....	13.4%	1.3%	12.1%
1995	....	39.8%	37.6%	2.2%
1996	....	29.2%	23.0%	6.2%
1997	....	24.6%	33.4%	(8.8%)
1998	....	18.6%	28.6%	(10.0%)
1999	....	7.2%	21.0%	(13.8%)
2000	....	20.9%	(9.1%)	30.0%
2001	....	5.2%	(11.9%)	17.1%
2002	....	(8.1%)	(22.1%)	14.0%
2003	....	38.3%	28.7%	9.6%
2004	....	16.9%	10.9%	6.0%
Average Annual Gain 1980-2004		20.3%	13.5%	6.8%

Even then, it is typically not I who make the buying decisions. Lou Simpson manages about $2½ billion of equities that are held by GEICO, and it is his transactions that Berkshire is usually reporting. Customarily his purchases are in the $200-$300 million range and are in companies that are smaller than the ones I focus on. Take a look at the facing page to see why Lou is a cinch to be inducted into the investment Hall of Fame.

You may be surprised to learn that Lou does not necessarily inform me about what he is doing. When Charlie and I assign responsibility, we truly hand over the baton — and we give it to Lou just as we do to our operating managers. Therefore, I typically learn of Lou's transactions about ten days after the end of each month. Sometimes, it should be added, I silently disagree with his decisions. But he's usually right.

Foreign Currencies

Berkshire owned about $21.4 billion of foreign exchange contracts at yearend, spread among 12 currencies. As I mentioned last year, holdings of this kind are a decided change for us. Before March 2002, neither Berkshire nor I had *ever* traded in currencies. But the evidence grows that our trade policies will put unremitting pressure on the dollar for many years to come — so since 2002 we've heeded that warning in setting our investment course. (As W.C. Fields once said when asked for a handout: "Sorry, son, all my money's tied up in currency.")

Be clear on one point: In no way does our thinking about currencies rest on doubts about America. We live in an extraordinarily rich country, the product of a system that values market economics, the rule of law and equality of opportunity. Our economy is far and away the strongest in the world and will continue to be. We are lucky to live here.

But as I argued in a November 10, 2003 article in *Fortune*, (available at berkshirehathaway.com), our country's trade practices are weighing down the dollar. The decline in its value has already been substantial, but is nevertheless likely to continue. Without policy changes, currency markets could even become disorderly and generate spillover effects, both political and financial. No one knows whether these problems will materialize. But such a scenario is a far-from-remote possibility that policymakers should be considering *now*. Their bent, however, is to lean toward not-so-benign neglect: A 318-page Congressional study of the consequences of unremitting trade deficits was published in November 2000 and has been gathering dust ever since. The study was ordered after the deficit hit a then-alarming $263 billion in 1999; by last year it had risen to $618 billion.

Charlie and I, it should be emphasized, believe that true trade — that is, the exchange of goods and services with other countries — is enormously beneficial for both us and them. Last year we had $1.15 trillion of such honest-to-God trade and the more of this, the better. But, as noted, our country also purchased an additional $618 billion in goods and services from the rest of the world that was unreciprocated. That is a staggering figure and one that has important consequences.

The balancing item to this one-way pseudo-trade — in economics there is always an offset — is a transfer of wealth from the U.S. to the rest of the world. The transfer may materialize in the form of IOUs our private or governmental institutions give to foreigners, or by way of their assuming ownership of our assets, such as stocks and real estate. In either case, Americans end up owning a reduced portion of our country while non-Americans own a greater part. This force-feeding of American wealth to the rest of the world is now proceeding at the rate of $1.8 billion daily, an increase of 20% since I wrote you last year. Consequently, other countries and their citizens now own a net of about $3 trillion of the U.S. A decade ago their net ownership was negligible.

The mention of trillions numbs most brains. A further source of confusion is that the current account deficit (the sum of three items, the most important by far being the trade deficit) and our national budget deficit are often lumped as “twins.” They are anything but. They have different causes and different consequences.

A budget deficit in no way reduces the portion of the national pie that goes to Americans. As long as other countries and their citizens have no net ownership of the U.S., 100% of our country’s output belongs to our citizens under *any* budget scenario, even one involving a huge deficit.

As a rich “family” awash in goods, Americans will argue through their legislators as to how government should redistribute the national output — that is who pays taxes and who receives governmental benefits. If “entitlement” promises from an earlier day have to be reexamined, “family members" will angrily debate among themselves as to who feels the pain. Maybe taxes will go up; maybe promises will be modified; maybe more internal debt will be issued. But when the fight is finished, *all* of the family's huge pie remains available for its members, however it is divided. No slice must be sent abroad.

Large and persisting current account deficits produce an entirely different result. As time passes, and as claims against us grow, we own less and less of what we produce. In effect, the rest of the world enjoys an ever-growing royalty on American output. Here, we are like a family that consistently overspends its income. As time passes, the family finds that it is working more and more for the "finance company" and less for itself.

Should we continue to run current account deficits comparable to those now prevailing, the net ownership of the U.S. by other countries and their citizens a decade from now will amount to roughly $11 trillion. And, if foreign investors were to earn only 5% on that net holding, we would need to send a net of $.55 trillion of goods and services abroad *every year* merely to service the U.S. investments then held by foreigners. At that date, a decade out, our GDP would probably total about $18 trillion (assuming low inflation, which is far from a sure thing). Therefore, our U.S. "family" would then be delivering 3% of its annual output to the rest of the world simply as tribute for the overindulgences of the past. In this case, unlike that involving budget deficits, the sons would truly pay for the sins of their fathers.

This annual royalty paid the world — which would not disappear unless the U.S. massively underconsumed and began to run consistent and large trade surpluses — would undoubtedly produce significant political unrest in the U.S. Americans would still be living very well, indeed better than now because of the growth in our economy. But they would chafe at the idea of perpetually paying tribute to their creditors and owners abroad. A country that is now aspiring to an "Ownership Society" will not find happiness in — and I'll use hyperbole here for emphasis — a "Sharecropper's Society." But that's precisely where our trade policies, supported by Republicans and Democrats alike, are taking us.

Many prominent U.S. financial figures, both in and out of government, have stated that our current-account deficits cannot persist. For instance, the minutes of the Federal Reserve Open Market Committee of June 29-30, 2004 say: “The staff noted that outsized external deficits could not be sustained indefinitely.” But, despite the constant handwringing by luminaries, they offer no substantive suggestions to tame the burgeoning imbalance.

In the article I wrote for *Fortune* 16 months ago, I warned that “a gently declining dollar would not provide the answer.” And so far it hasn’t. Yet policymakers continue to hope for a “soft landing,” meanwhile counseling other countries to stimulate (read “inflate”) their economies and Americans to save more. In my view these admonitions miss the mark: There are deep-rooted structural problems that will cause America to continue to run a huge current-account deficit unless trade policies either change materially or the dollar declines by a degree that could prove unsettling to financial markets.

Proponents of the trade status quo are fond of quoting Adam Smith: “What is prudence in the conduct of every family can scarce be folly in that of a great kingdom. If a foreign country can supply us with a commodity cheaper than we ourselves can make it, better buy it of them with some part of the produce of our own industry, employed in a way in which we have some advantage.”

I agree. Note, however, that Mr. Smith’s statement refers to trade of *product* for product, not of *wealth* for product as our country is doing to the tune of $.6 trillion annually. Moreover, I am sure that he would never have suggested that “prudence” consisted of his “family” selling off part of its farm every day in order to finance its overconsumption. Yet that is just what the “great kingdom” called the United States is doing.

If the U.S. was running a $.6 trillion current-account *surplus*, commentators worldwide would violently condemn our policy, viewing it as an extreme form of “mercantilism” — a long-discredited economic strategy under which countries fostered exports, discouraged imports, and piled up treasure. would condemn such a policy as well. But, in effect if not in intent, the rest of the world is practicing mercantilism in respect to the U.S., an act made possible by our vast store of assets and our pristine credit history. Indeed, the world would never let any other country use a credit card denominated in its own currency to the insatiable extent we are employing ours. Presently, most foreign investors are sanguine: they may view us as spending junkies, but they know we are *rich* junkies as well.

Our spendthrift behavior won't, however, be tolerated indefinitely. And though it's impossible to forecast just when and how the trade problem will be resolved, it's improbable that the resolution will foster an *increase* in the value of our currency relative to that of our trading partners.

We hope the U.S. adopts policies that will quickly and substantially reduce the current-account deficit. True, a prompt solution would likely cause Berkshire to record losses on its foreign-exchange contracts. But Berkshire's resources remain heavily concentrated in dollar-based assets, and both a strong dollar and a low-inflation environment are very much in our interest.

If you wish to keep abreast of trade and currency matters, read *The Financial Times*.This London-based paper has long been the leading source for daily international financial news and now has an excellent American edition. Both its reporting and commentary on trade are first-class.

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And, again, our usual caveat: macro-economics is a tough game in which few people, Charlie and I included, have demonstrated skill. We may well turn out to be wrong in our currency judgments. (Indeed, the fact that so many pundits now predict weakness for the dollar makes us uneasy.) If so, our mistake will be very public. The irony is that if we chose the opposite course, leaving all of Berkshire's assets in dollars even as they declined significantly in value, no one would notice our mistake.

John Maynard Keynes said in his masterful *The General Theory*: "Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally." (Or, to put it in less elegant terms, lemmings as a class may be derided but never does an *individual* lemming get criticized.) From a reputational standpoint, Charlie and I run a clear risk with our foreign-exchange commitment. But we believe in managing Berkshire as if we owned 100% of it ourselves. And, were that the case, we would not be following a dollar-only policy.

Miscellaneous

- Last year I told you about a group of University of Tennessee finance students who played a key role in our $1.7 billion acquisition of Clayton Homes. Earlier, they had been brought to Omaha by their professor, Al Auxier — he brings a class every year — to tour Nebraska Furniture Mart and Borsheim's, eat at Gorat's and have a Q&A session with me at Kiewit Plaza. These visitors, like those who come for our annual meeting, leave impressed by both the city and its friendly residents.

Other colleges and universities have now come calling. This school year we will have visiting classes, ranging in size from 30 to 100 students, from Chicago, Dartmouth (Tuck), Delaware State, Florida State, Indiana, Iowa, Iowa State, Maryland, Nebraska, Northwest Nazarene, Pennsylvania (Wharton), Stanford, Tennessee, Texas, Texas A&M, Toronto (Rotman), Union and Utah. Most of the students are MBA candidates, and I've been impressed by their quality. They are keenly interested in business and investments, but their questions indicate that they also have more on their minds than simply making money. I always feel good after meeting them.

At our sessions, I tell the newcomers the story of the Tennessee group and its spotting of Clayton Homes. I do this in the spirit of the farmer who enters his hen house with an ostrich egg and admonishes the flock: "I don't like to complain, girls, but this is just a small sample of what the competition is doing." To date, our new scouts have not brought us deals. But their mission in life has been made clear to them.

- You should be aware of an accounting rule that mildly distorts our financial statements in a pain-today, gain-tomorrow manner. Berkshire purchases life insurance policies from individuals and corporations who would otherwise surrender them for cash. As the new holder of the policies, we pay any premiums that become due and ultimately — when the original holder dies — collect the face value of the policies.

The original policyholder is usually in good health when we purchase the policy. Still, the price we pay for it is always well above its cash surrender value ("CSV"). Sometimes the original policyholder has borrowed against the CSV to make premium payments. In that case, the remaining CSV will be tiny and our purchase price will be a large multiple of what the original policyholder would have received, had he cashed out by surrendering it.

Under accounting rules, we must immediately charge as a realized capital loss the excess over CSV that we pay upon purchasing the policy. We also must make additional charges each year for the amount by which the premium we pay to keep the policy in force exceeds the increase in CSV. But obviously, we don't think these bookkeeping charges represent economic losses. If we did, we wouldn't buy the policies.

During 2004, we recorded net "losses" from the purchase of policies (and from the premium payments required to maintain them) totaling $207 million, which was charged against realized investment gains in our earnings statement (included in "other" in the table on page 17). When the proceeds from these policies are received in the future, we will record as realized investment gain the excess over the then-CSV.

• Two post-bubble governance reforms have been particularly useful at Berkshire, and I fault myself for not putting them in place many years ago. The first involves regular meetings of directors without the CEO present. I've sat on 19 boards, and on many occasions this process would have led to dubious plans being examined more thoroughly. In a few cases, CEO changes that were needed would also have been made more promptly. There is no downside to this process, and there are many possible benefits.

The second reform concerns the "whistleblower line," an arrangement through which employees can send information to me and the board's audit committee without fear of reprisal. Berkshire's extreme decentralization makes this system particularly valuable both to me and the committee. (In a sprawling "city" of 180,000 — Berkshire's current employee count — not every sparrow that falls will be noticed at headquarters.) Most of the complaints we have received are of "the guy next to me has bad breath" variety, but on occasion I have learned of important problems at our subsidiaries that I otherwise would have missed. The issues raised are usually not of a type discoverable by audit, but relate instead to personnel and business practices. Berkshire would be more valuable today if I had put in a whistleblower line decades ago.

- Charlie and I love the idea of shareholders thinking and behaving like owners. Sometimes that requires them to be pro-active. And in this arena large institutional owners should lead the way.

So far, however, the moves made by institutions have been less than awe-inspiring. Usually, they've focused on minutiae and ignored the three questions that truly count. First, does the company have the right CEO? Second, is he/she overreaching in terms of compensation? Third, are proposed acquisitions more likely to create or destroy per-share value?

On such questions, the interests of the CEO may well differ from those of the shareholders. Directors, moreover, sometimes lack the knowledge or gumption to overrule the CEO. Therefore, it's vital that large owners focus on these three questions and speak up when necessary.

Instead many simply follow a "checklist" approach to the issue *du jour*. Last year I was on the receiving end of a judgment reached in that manner. Several institutional shareholders and their advisors decided I lacked "independence" in my role as a director of Coca-Cola. One group wanted me removed from the board and another simply wanted me booted from the audit committee.

My first impulse was to secretly fund the group behind the second idea. Why anyone would wish to be on an audit committee is beyond me. But since directors must be assigned to one committee or another, and since no CEO wants me on his compensation committee, it's often been my lot to get an audit committee assignment. As it turned out, the institutions that opposed me failed and I was re-elected to the audit job. (I fought off the urge to ask for a recount.)

Some institutions questioned my "independence" because, among other things, McLane and Dairy Queen buy lots of Coke products. (Do they want us to favor Pepsi?) But independence is defined in Webster's as "not subject to control by others." I'm puzzled how anyone could conclude that our Coke purchases would "control" my decision-making when the counterweight is the wellbeing of $8 billion of Coke stock held by Berkshire. Assuming I'm even marginally rational, elementary arithmetic should make it clear that my heart and mind belong to the owners of Coke, not to its management.

I can't resist mentioning that Jesus understood the calibration of independence far more clearly than do the protesting institutions. In Matthew 6:21 He observed: "For where your treasure is, there will your heart be also." Even to an institutional investor, $8 billion should qualify as "treasure" that dwarfs any profits Berkshire might earn on its routine transactions with Coke.

Measured by the biblical standard, the Berkshire board is a model: (a) *every* director is a member of a family owning at least $4 million of stock; (b) *none* of these shares were acquired from Berkshire via options or grants; (c) *no* directors receive committee, consulting or board fees from the company that are more than a tiny portion of their annual income; and (d) although we have a standard corporate indemnity arrangement, we carry no liability insurance for directors.

At Berkshire, board members travel the same road as shareholders.

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Charlie and I have seen much behavior confirming the Bible's "treasure" point. In our view, based on our considerable boardroom experience, the *least* independent directors are likely to be those who receive an important fraction of their annual income from the fees they receive for board service (and who hope as well to be recommended for election to other boards and thereby to boost their income further). Yet these are the very board members most often classed as "independent."

Most directors of this type are decent people and do a first-class job. But they wouldn't be human if they weren't tempted to thwart actions that would threaten their livelihood. Some may go on to succumb to such temptations.

Let's look at an example based upon circumstantial evidence. I have first-hand knowledge of a recent acquisition proposal (not from Berkshire) that was favored by management, blessed by the company's investment banker and slated to go forward at a price above the level at which the stock had sold for some years (or now sells for). In addition, a number of directors favored the transaction and wanted it proposed to shareholders.

Several of their brethren, however, each of whom received board and committee fees totaling about $100,000 annually, scuttled the proposal, which meant that shareholders never learned of this multi-billion offer. Non-management directors owned little stock except for shares they had received from the company. Their open-market purchases in recent years had meanwhile been nominal, even though the stock had sold far below the acquisition price proposed. In other words, these directors didn't want the shareholders to be offered X even though they had consistently declined the opportunity to buy stock for their own account at a fraction of X.

I don't know which directors opposed letting shareholders see the offer. But I do know that $100,000 is an important portion of the annual income of some of those deemed "independent," clearly meeting the Matthew 6:21 definition of "treasure." If the deal had gone through, these fees would have ended.

Neither the shareholders nor I will ever know what motivated the dissenters. Indeed they themselves will not likely know, given that self-interest inevitably blurs introspection. We do know one thing, though: At the same meeting at which the deal was rejected, the board voted itself a significant increase in directors' fees.

• While we are on the subject of self-interest, let's turn again to the most important accounting mechanism still available to CEOs who wish to overstate earnings: the non-expensing of stock options. The accomplices in perpetuating this absurdity have been many members of Congress who have defied the arguments put forth by all Big Four auditors, all members of the Financial Accounting Standards Board and virtually all investment professionals.

I'm enclosing an op-ed piece I wrote for *The Washington Post* describing a truly breathtaking bill that was passed 312-111 by the House last summer. Thanks to Senator Richard Shelby, the Senate didn't ratify the House's foolishness. And, to his great credit, Bill Donaldson, the investor-minded Chairman of the SEC, has stood firm against massive political pressure, generated by the check-waving CEOs who first muscled Congress in 1993 about the issue of option accounting and then repeated the tactic last year.

Because the attempts to obfuscate the stock-option issue continue, it's worth pointing out that no one — neither the FASB, nor investors generally, nor I — are talking about restricting the use of options in any way. Indeed, my successor at Berkshire may well receive much of his pay via options, albeit logically-structured ones in respect to 1) an appropriate strike price, 2) an escalation in price that reflects the retention of earnings, and 3) a ban on his quickly disposing of any shares purchased through options. We cheer arrangements that motivate managers, whether these be cash bonuses or options. And if a company is truly receiving value for the options it issues, we see no reason why recording their cost should cut down on their use.

The simple fact is that certain CEOs know their own compensation would be far more rationally determined if options were expensed. They also suspect that their stock would sell at a lower price if realistic accounting were employed, meaning that they would reap less in the market when they unloaded their personal holdings. To these CEOs such unpleasant prospects are a fate to be fought with all the resources they have at hand — even though the funds they use in that fight normally don't belong to them, but are instead put up by their shareholders.

Option-expensing is scheduled to become mandatory on June 15th. You can therefore expect intensified efforts to stall or emasculate this rule between now and then. Let your Congressman and Senators know what you think on this issue.

The Annual Meeting

There are two changes this year concerning the annual meeting. First, we have scheduled the meeting for the last Saturday in April (the 30th), rather than the usual first Saturday in May. This year Mother's Day falls on May 8, and it would be unfair to ask the employees of Borsheim's and Gorat's to take care of us at that special time — so we've moved everything up a week. Next year we'll return to our regular timing, holding the meeting on May 6, 2006.

Additionally, we are changing the sequence of events on meeting day, April 30. Just as always, the doors will open at the Qwest Center at 7 a.m. and the movie will be shown at 8:30. At 9:30, however, we will go directly to the question and answer period, which (allowing for lunch at the Qwest's stands) will last until 3:00. Then, after a short recess, Charlie and I will convene the annual meeting at 3:15.

We have made this change because a number of shareholders complained last year about the time consumed by two speakers who advocated proposals of limited interest to the majority of the audience — and who were no doubt relishing their chance to talk to a captive group of about 19,500. With our new procedure, those shareholders who wish to hear it all can stick around for the formal meeting and those who don't can leave — or better yet shop.

There will be plenty of opportunity for that pastime in the vast exhibition hall that adjoins the meeting area. Kelly Muchemore, the Flo Ziegfeld of Berkshire, put on a magnificent shopping extravaganza last year, and she says that was just a warm-up for this year. (Kelly, I am delighted to report, is getting married in October. I'm giving her away and suggested that she make a little history by holding the wedding at the annual meeting. She balked, however, when Charlie insisted that he be the ringbearer.)

Again we will showcase a 2,100 square foot Clayton home (featuring Acme brick, Shaw carpet, Johns Manville insulation, MiTek fasteners, Carefree awnings and NFM furniture). Take a tour through the home. Better yet, buy it.

GEICO will have a booth staffed by a number of its top counselors from around the country, all of them ready to supply you with auto insurance quotes. In most cases, GEICO will be able to give you a special shareholder discount (usually 8%). This special offer is permitted by 45 of the 50 jurisdictions in which we operate. Bring the details of your existing insurance and check out whether we can save you money.

On Saturday, at the Omaha airport, we will have the usual array of aircraft from NetJets® available for your inspection. Stop by the NetJets booth at the Qwest to learn about viewing these planes. Come to Omaha by bus; leave in your new plane.

The Bookworm shop did a terrific business last year selling Berkshire-related books. Displaying 18 titles, they sold 2,920 copies for $61,000. Since we charge the shop no rent (I must be getting soft), it gives shareholders a 20% discount. This year I've asked The Bookworm to add Graham Allison's *Nuclear Terrorism: The Ultimate Preventable Catastrophe*, a must-read for those concerned with the safety of our country. In addition, the shop will premiere *Poor Charlie's Almanack*, a book compiled by Peter Kaufman. Scholars have for too long debated whether Charlie is the reincarnation of Ben Franklin. This book should settle the question.

An attachment to the proxy material that is enclosed with this report explains how you can obtain the credential you will need for admission to the meeting and other events. As for plane, hotel and car reservations, we have again signed up American Express (800-799-6634) to give you special help. They do a terrific job for us each year, and I thank them for it.

At Nebraska Furniture Mart, located on a 77-acre site on 72nd Street between Dodge and Pacific, we will again be having "Berkshire Weekend" pricing. We initiated this special event at NFM eight years ago, and sales during the "Weekend" grew from $5.3 million in 1997 to $25.1 million in 2004 (up 45% from a year earlier). Every year has set a new record, and on Saturday of last year, we had the largest single-day sales in NFM's history — $6.1 million.

To get the discount, you must make your purchases between Thursday, April 28 and Monday, May 2 inclusive, and also present your meeting credential. The period's special pricing will even apply to the products of several prestigious manufacturers that normally have ironclad rules against discounting but that, in the spirit of our shareholder weekend, have made an exception for you. We appreciate their cooperation. NFM is open from 10 a.m. to 9 p.m. Monday through Saturday, and 10 a.m. to 6 p.m. on Sunday. On Saturday this year, from 5:30 p.m. to 8 p.m. we are having a special affair for shareholders only. I'll be there, eating barbeque and drinking Coke.

Borsheim's — the largest jewelry store in the country except for Tiffany's Manhattan store — will have two shareholder-only events. The first will be a cocktail reception from 6 p.m. to 10 p.m. on Friday, April 29. The second, the main gala, will be from 9 a.m. to 4 p.m. on Sunday, May 1. On Saturday, we will be open until 6 p.m.

We will have huge crowds at Borsheim's throughout the weekend. For your convenience, therefore, shareholder prices will be available from Monday, April 25 through Saturday, May 7. During that period, just identify yourself as a shareholder through your meeting credentials or a brokerage statement.

Borsheim's operates on a gross margin that is fully twenty percentage points below that of its major rivals, even before the shareholders' discount. Last year, business over the weekend increased 73% from 2003, setting a record that will be tough to beat. Show me it can be done.

In a tent outside of Borsheim's, Patrick Wolff, twice U.S. chess champion, will take on all comers in groups of six — blindfolded. Additionally, we will have Bob Hamman and Sharon Osberg, two of the world's top bridge experts, available to play with our shareholders on Sunday afternoon. They plan to keep their eyes *open* — but Bob never sorts his cards, even when playing for a national championship.

Gorat's — my favorite steakhouse — will again be open exclusively for Berkshire shareholders on Sunday, May 1, and will be serving from 4 p.m. until 10 p.m. Please remember that to come to Gorat's on that day, you must have a reservation. To make one, call 402-551-3733 on April 1 (*but not before*). If Sunday is sold out, try Gorat's on one of the other evenings you will be in town. Enhance your reputation as an epicure by ordering, as I do, a rare T-bone with a double helping of hash browns.

We will again have a special reception from 4:00 to 5:30 on Saturday afternoon for shareholders who have come from outside of North America. Every year our meeting draws many people from around the globe, and Charlie and I want to be sure we personally greet those who have come so far. Last year we enjoyed meeting more than 400 of you including at least 100 from Australia. Any shareholder who comes from other than the U.S. or Canada will be given a special credential and instructions for attending this function.

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Charlie and I are lucky. We have jobs that we love and are helped every day in a myriad of ways by talented and cheerful associates. No wonder we tap-dance to work. But nothing is more fun for us than getting together with our shareholder-partners at Berkshire's annual meeting. So join us on April 30th at the Qwest for our annual Woodstock for Capitalists.

February 28, 2005

Warren E. Buffett
Chairman of the Board

BERKSHIRE HATHAWAY INC.

To the Shareholders of Berkshire Hathaway Inc.:

Our gain in net worth during 2005 was $5.6 billion, which increased the per-share book value of both our Class A and Class B stock by 6.4%. Over the last 41 years (that is, since present management took over) book value has grown from $19 to $59,377, a rate of 21.5% compounded annually.*

> * All figures used in this report apply to Berkshire's A shares, the successor to the only stock that the company had outstanding before 1996. The B shares have an economic interest equal to 1/30th that of the A.

Berkshire had a decent year in 2005. We initiated five acquisitions (two of which have yet to close) and most of our operating subsidiaries prospered. Even our insurance business in its entirety did well, though Hurricane Katrina inflicted record losses on both Berkshire and the industry. We estimate our loss from Katrina at $2.5 billion — and her ugly sisters, Rita and Wilma, cost us an additional $.9 billion.

Credit GEICO — and its brilliant CEO, Tony Nicely — for our stellar insurance results in a disaster-ridden year. One statistic stands out: In just two years, GEICO improved its productivity by *32%*. Remarkably, employment fell by 4% even as policy count grew by 26% — and more gains are in store. When we drive unit costs down in such a dramatic manner, we can offer ever-greater value to our customers. The payoff: Last year, GEICO gained market-share, earned commendable profits and strengthened its brand. If you have a new son or grandson in 2006, name him Tony.

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My goal in writing this report is to give you the information you need to estimate Berkshire's intrinsic value. I say "estimate" because calculations of intrinsic value, though all-important, are necessarily imprecise and often seriously wrong. The more uncertain the future of a business, the more possibility there is that the calculation will be wildly off-base. (For an explanation of intrinsic value, see pages 77 — 78.) Here Berkshire has some advantages: a wide variety of relatively-stable earnings streams, combined with great liquidity and minimum debt. These factors mean that Berkshire's intrinsic value can be more precisely calculated than can the intrinsic value of most companies.

Yet if precision is aided by Berkshire's financial characteristics, the job of calculating intrinsic value has been made more complex by the mere presence of so many earnings streams. Back in 1965, when we owned only a small textile operation, the task of calculating intrinsic value was a snap. Now we own 68 distinct businesses with widely disparate operating and financial characteristics. This array of unrelated enterprises, coupled with our massive investment holdings, makes it impossible for you to simply examine our consolidated financial statements and arrive at an informed estimate of intrinsic value.

We have attempted to ease this problem by clustering our businesses into four logical groups, each of which we discuss later in this report. In these discussions, we will provide the key figures for both the group and its important components. Of course, the value of Berkshire may be either greater or less than the sum of these four parts. The outcome depends on whether our many units function better or worse by being part of a larger enterprise and whether capital allocation improves or deteriorates when it is under the direction of a holding company. In other words, does Berkshire ownership bring anything to the party, or would our shareholders be better off if they directly owned shares in each of our 68 businesses? These are important questions but ones that you will have to answer for yourself.

Before we look at our individual businesses, however, let's review two sets of figures that show where we've come from and where we are now. The first set is the amount of investments (including cash and cash-equivalents) we own on a per-share basis. In making this calculation, we exclude investments held in our finance operation because these are largely offset by borrowings:

Year	Per-Share Investments*
1965	$ 4
1975	159
1985	2,407
1995	21,817
2005	$74,129
Compound Growth Rate 1965-2005	28.0%
Compound Growth Rate 1995-2005	13.0%

*Net of minority interests

In addition to these marketable securities, which with minor exceptions are held in our insurance companies, we own a wide variety of non-insurance businesses. Below, we show the pre-tax earnings (excluding goodwill amortization) of these businesses, again on a per-share basis:

Year	Per-Share Earnings*
1965	$ 4
1975	4
1985	52
1995	175
2005	$2,441
Compound Growth Rate 1965-2005	17.2%
Compound Growth Rate 1995-2005	30.2%

*Pre-tax and net of minority interests

When growth rates are under discussion, it will pay you to be suspicious as to why the beginning and terminal years have been selected. If either year was aberrational, any calculation of growth will be distorted. In particular, a base year in which earnings were poor can produce a breathtaking, but meaningless, growth rate. In the table above, however, the base year of 1965 was abnormally *good*; Berkshire earned more money in that year than it did in all but one of the previous ten.

As you can see from the two tables, the comparative growth rates of Berkshire's two elements of value have changed in the last decade, a result reflecting our ever-increasing emphasis on business acquisitions. Nevertheless, Charlie Munger, Berkshire's Vice Chairman and my partner, and I want to increase the figures in *both* tables. In this ambition, we hope — metaphorically — to avoid the fate of the elderly couple who had been romantically challenged for some time. As they finished dinner on their 50th anniversary, however, the wife — stimulated by soft music, wine and candlelight — felt a long-absent tickle and demurely suggested to her husband that they go upstairs and make love. He agonized for a moment and then replied, "I can do one or the other, but not both."

Acquisitions

Over the years, our current businesses, in aggregate, should deliver modest growth in operating earnings. But they will not in themselves produce truly satisfactory gains. We will need major acquisitions to get that job done.

In this quest, 2005 was encouraging. We agreed to five purchases: two that were completed last year, one that closed after yearend and two others that we expect to close soon. None of the deals involve the issuance of Berkshire shares. That's a crucial, but often ignored, point: When a management proudly acquires another company for stock, the shareholders of the acquirer are concurrently selling part of their interest in everything they own. I've made this kind of deal a few times myself — and, on balance, my actions have cost you money.

Here are last year's purchases:

• On June 30 we bought Medical Protective Company ("MedPro"), a 106-year-old medical malpractice insurer based in Fort Wayne. Malpractice insurance is tough to underwrite and has proved to be a graveyard for many insurers. MedPro nevertheless should do well. It will have the attitudinal advantage that all Berkshire insurers share, wherein underwriting discipline trumps all other goals. Additionally, as part of Berkshire, MedPro has financial strength far exceeding that of its competitors, a quality assuring doctors that long-to-settle claims will not end up back on their doorstep because their insurer failed. Finally, the company has a smart and energetic CEO, Tim Kenesey, who instinctively thinks like a Berkshire manager.

• Forest River, our second acquisition, closed on August 31. A couple of months earlier, on June 21, I received a two-page fax telling me — point by point — why Forest River met the acquisition criteria we set forth on page 25 of this report. I had not before heard of the company, a recreational vehicle manufacturer with $1.6 billion of sales, nor of Pete Liegl, its owner and manager. But the fax made sense, and I immediately asked for more figures. These came the next morning, and that afternoon I made Pete an offer. On June 28, we shook hands on a deal.

Pete is a remarkable entrepreneur. Some years back, he sold his business, then far smaller than today, to an LBO operator who promptly began telling him how to run the place. Before long, Pete left, and the business soon sunk into bankruptcy. Pete then repurchased it. You can be sure that *I* won't be telling Pete how to manage his operation.

Forest River has 60 plants, 5,400 employees and has consistently gained share in the RV business, while also expanding into other areas such as boats. Pete is 61 — and definitely in an acceleration mode. Read the piece from *RV Business* that accompanies this report, and you'll see why Pete and Berkshire are made for each other.

• On November 12, 2005, an article ran in The Wall Street Journal dealing with Berkshire's unusual acquisition and managerial practices. In it Pete declared, "It was easier to sell my business than to renew my driver's license."

In New York, Cathy Baron Tamraz read the article, and it struck a chord. On November 21, she sent me a letter that began, "As president of Business Wire, I'd like to introduce you to my company, as I believe it fits the profile of Berkshire Hathaway subsidiary companies as detailed in a recent Wall Street Journal article."

By the time I finished Cathy's two-page letter, I felt Business Wire and Berkshire were a fit. I particularly liked her penultimate paragraph: "We run a tight ship and keep unnecessary spending under wraps. No secretaries or management layers here. Yet we'll invest big dollars to gain a technological advantage and move the business forward."

I promptly gave Cathy a call, and before long Berkshire had reached agreement with Business Wire's controlling shareholder, Lorry Lokey, who founded the company in 1961 (and who had just made Cathy CEO). I love success stories like Lorry's. Today 78, he has built a company that disseminates information in 150 countries for 25,000 clients. His story, like those of many entrepreneurs who have selected Berkshire as a home for their life's work, is an example of what can happen when a good idea, a talented individual and hard work converge.

• In December we agreed to buy 81% of Applied Underwriters, a company that offers a combination of payroll services and workers' compensation insurance to small businesses. A majority of Applied's customers are located in California.

In 1998, though, when the company had 12 employees, it acquired an Omaha-based operation with 24 employees that offered a somewhat-similar service. Sid Ferenc and Steve Menzies, who have built Applied's remarkable business, concluded that Omaha had many advantages as an operational base — a brilliant insight, I might add — and today 400 of the company's 479 employees are located here.

Less than a year ago, Applied entered into a large reinsurance contract with Ajit Jain, the extraordinary manager of National Indemnity's reinsurance division. Ajit was impressed by Sid and Steve, and they liked Berkshire's method of operation. So we decided to join forces. We are pleased that Sid and Steve retain 19% of Applied. They started on a shoestring only 12 years ago, and it will be fun to see what they can accomplish with Berkshire's backing.

• Last spring, MidAmerican Energy, our 80.5% owned subsidiary, agreed to buy PacifiCorp, a major electric utility serving six Western states. An acquisition of this sort requires many regulatory approvals, but we've now obtained these and expect to close this transaction soon. Berkshire will then buy $3.4 billion of MidAmerican's common stock, which MidAmerican will supplement with $1.7 billion of borrowing to complete the purchase. You can't expect to earn outsized profits in regulated utilities, but the industry offers owners the opportunity to deploy large sums at fair returns — and therefore, it makes good sense for Berkshire. A few years back, I said that we hoped to make some very large purchases in the utility field. Note the plural — we'll be looking for more.

In addition to buying these new operations, we continue to make "bolt-on" acquisitions. Some aren't so small: Shaw, our carpet operation, spent about $550 million last year on two purchases that furthered its vertical integration and should improve its profit margin in the future. XTRA and Clayton Homes also made value-enhancing acquisitions.

Unlike many business buyers, Berkshire has no "exit strategy." We buy to keep. We do, though, have an entrance strategy, looking for businesses in this country or abroad that meet our six criteria and are available at a price that will produce a reasonable return. If you have a business that fits, give me a call. Like a hopeful teenage girl, I'll be waiting by the phone.

Insurance

Let's now talk about our four sectors and start with insurance, our core business. What counts here is the amount of "float" and its cost over time.

For new readers, let me explain. "Float" is money that doesn't belong to us but that we temporarily hold. Most of our float arises because (1) premiums are paid upfront though the service we provide — insurance protection — is delivered over a period that usually covers a year and; (2) loss events that occur today do not always result in our immediately paying claims, because it sometimes takes many years for losses to be reported (asbestos losses would be an example), negotiated and settled. The $20 million of float that came with our 1967 entry into insurance has now increased — both by way of internal growth and acquisitions — to $49 billion.

Float is wonderful — *if* it doesn't come at a high price. Its cost is determined by underwriting results, meaning how the expenses and losses we will ultimately pay compare with the premiums we have received. When an insurer earns an underwriting profit — as has been the case at Berkshire in about half of the 39 years we have been in the insurance business — float is better than free. In such years, we are actually paid for holding other people's money. For most insurers, however, life has been far more difficult: In aggregate, the property-casualty industry almost invariably operates at an underwriting loss. When that loss is large, float becomes expensive, sometimes devastatingly so.

In 2004 our float cost us less than nothing, and I told you that we had a chance — absent a mega-catastrophe — of no-cost float in 2005. But we *had* the mega-cat, and as a specialist in that coverage, Berkshire suffered hurricane losses of $3.4 billion. Nevertheless, our float was costless in 2005 because of the superb results we had in our other insurance activities, particularly at GEICO.

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Auto policies in force grew by 12.1% at GEICO, a gain increasing its market share of U.S. private passenger auto business from about 5.6% to about 6.1%. Auto insurance is a big business: Each share-point equates to $1.6 billion in sales.

While our brand strength is not quantifiable, I believe it also grew significantly. When Berkshire acquired control of GEICO in 1996, its annual advertising expenditures were $31 million. Last year we were up to $502 million. And I can't wait to spend more.

Our advertising works because we have a great story to tell: More people can save money by insuring with us than is the case with any other national carrier offering policies to all comers. (Some specialized auto insurers do particularly well for applicants fitting into their niches; also, because our national competitors use rating systems that differ from ours, they will sometimes beat our price.) Last year, we achieved by far the highest conversion rate — the percentage of internet and phone quotes turned into sales — in our history. This is powerful evidence that our prices are more attractive relative to the competition than ever before. Test us by going to

GEICO.com or by calling 800-847-7536. Be sure to indicate you are a shareholder because that fact will often qualify you for a discount.

I told you last year about GEICO's entry into New Jersey in August, 2004. Drivers in that state love us. Our retention rate there for new policyholders is running higher than in any other state, and by sometime in 2007, GEICO is likely to become the third largest auto insurer in New Jersey. There, as elsewhere, our low costs allow low prices that lead to steady gains in profitable business.

That simple formula immediately impressed me 55 years ago when I first discovered GEICO. Indeed, at age 21, I wrote an article about the company — it's reproduced on page 24 — when its market value was $7 million. As you can see, I called GEICO "The Security I Like Best." And that's what I still call it.

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We have major reinsurance operations at General Re and National Indemnity. The former is run by Joe Brandon and Tad Montross, the latter by Ajit Jain. Both units performed well in 2005 considering the extraordinary hurricane losses that battered the industry.

It's an open question whether atmospheric, oceanic or other causal factors have dramatically changed the frequency or intensity of hurricanes. Recent experience is worrisome. We know, for instance, that in the 100 years before 2004, about 59 hurricanes of Category 3 strength, or greater, hit the Southeastern and Gulf Coast states, and that only three of these were Category 5s. We further know that in 2004 there were three Category 3 storms that hammered those areas and that these were followed by four more in 2005, one of them, Katrina, the most destructive hurricane in industry history. Moreover, there were three Category 5s near the coast last year that fortunately weakened before landfall.

Was this onslaught of more frequent and more intense storms merely an anomaly? Or was it caused by changes in climate, water temperature or other variables we don't fully understand? And could these factors be developing in a manner that will soon produce disasters dwarfing Katrina?

Joe, Ajit and I don't know the answer to these all-important questions. What we do know is that our ignorance means we must follow the course prescribed by Pascal in his famous wager about the existence of God. As you may recall, he concluded that since he didn't know the answer, his personal gain/loss ratio dictated an affirmative conclusion.

So guided, we've concluded that we should now write mega-cat policies only at prices far higher than prevailed last year — and then only with an aggregate exposure that would not cause us distress if shifts in some important variable produce far more costly storms in the near future. To a lesser degree, we felt this way after 2004 — and cut back our writings when prices didn't move. Now our caution has intensified. If prices seem appropriate, however, we continue to have both the ability and the appetite to be the largest writer of mega-cat coverage in the world.

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Our smaller insurers, with MedPro added to the fold, delivered truly outstanding results last year. However, what you see in the table below does not do full justice to their performance. That's because we increased the loss reserves of MedPro by about $125 million immediately after our purchase.

No one knows with any precision what amount will be required to pay the claims we inherited. Medical malpractice insurance is a "long-tail" line, meaning that claims often take many years to settle. In addition, there are other losses that have occurred, but that we won't even hear about for some time. One thing, though, we have learned — the hard way — after many years in the business: Surprises in insurance are far from symmetrical. You are lucky if you get one that is pleasant for every ten that go the other way. Too often, however, insurers react to looming loss problems with optimism. They behave like the fellow in a switchblade fight who, after his opponent has taken a mighty swipe at his throat, exclaimed, "You never touched me." His adversary's reply: "Just wait until you try to shake your head."

Excluding the reserves we added for prior periods, MedPro wrote at an underwriting profit. And our other primary companies, in aggregate, had an underwriting profit of $324 million on $1,270 million of volume. This is an extraordinary result, and our thanks go to Rod Eldred of Berkshire Hathaway

Homestate Companies, John Kizer of Central States Indemnity, Tom Nerney of U. S. Liability, Don Towle of Kansas Bankers Surety and Don Wurster of National Indemnity.

Here's the overall tally on our underwriting and float for each major sector of insurance:

	(in $ millions)			
	Underwriting Profit (Loss)		*Yearend Float*	
Insurance Operations	*2005*	*2004*	*2005*	*2004*
General Re	$(334)	$ 3	$22,920	$23,120
B-H Reinsurance	(1,069)	417	16,233	15,278
GEICO	1,221	970	6,692	5,960
Other Primary	235*	161	3,442	1,736
Total	$ 53	$1,551	$49,287	$46,094

*Includes MedPro from June 30, 2005.

Regulated Utility Business

We have an 80.5% (fully diluted) interest in MidAmerican Energy Holdings, which owns a wide variety of utility operations. The largest of these are (1) Yorkshire Electricity and Northern Electric, whose

3.7 million electric customers make it the third largest distributor of electricity in the U.K.; (2) MidAmerican Energy, which serves 706,000 electric customers, primarily in Iowa; and (3) Kern River and Northern Natural pipelines, which carry 7.8% of the natural gas consumed in the U.S. When our PacifiCorp acquisition closes, we will add 1.6 million electric customers in six Western states, with Oregon and Utah providing us the most business. This transaction will increase MidAmerican's revenues by $3.3 billion and its assets by $14.1 billion.

The Public Utility Holding Company Act ("PUHCA") was repealed on August 8, 2005, a milestone that allowed Berkshire to convert its MidAmerican preferred stock into voting common shares on February 9, 2006. This conversion ended a convoluted corporate arrangement that PUHCA had forced upon us. Now we have 83.4% of both the common stock and the votes at MidAmerican, which allows us to consolidate the company's income for financial accounting and tax purposes. Our true economic interest, however, is the aforementioned 80.5%, since there are options outstanding that are sure to be exercised within a few years and that upon exercise will dilute our ownership.

Though our voting power has increased dramatically, the dynamics of our four-party ownership have not changed at all. We view MidAmerican as a partnership among Berkshire, Walter Scott, and two terrific managers, Dave Sokol and Greg Abel. It's unimportant how many votes each party has; we will make major moves only when we are unanimous in thinking them wise. Five years of working with Dave, Greg and Walter have underscored my original belief: Berkshire couldn't have better partners.

You will notice that this year we have provided you with two balance sheets, one representing our actual figures per GAAP on December 31, 2005 (which does *not* consolidate MidAmerican) and one that reflects the subsequent conversion of our preferred. All future financial reports of Berkshire will include MidAmerican's figures.

Somewhat incongruously, MidAmerican owns the second largest real estate brokerage firm in the U.S. And it's a gem. The parent company's name is HomeServices of America, but our 19,200 agents operate through 18 locally-branded firms. Aided by three small acquisitions, we participated in $64 billion of transactions last year, up 6.5% from 2004.

Currently, the white-hot market in residential real estate of recent years is cooling down, and that should lead to additional acquisition possibilities for us. Both we and Ron Peltier, the company's CEO, expect HomeServices to be far larger a decade from now.

Here are some key figures on MidAmerican's operations:

	Earnings (in $ millions)	
	2005	2004
U.K. utilities	$ 308	$ 326
Iowa utility	288	268
Pipelines	309	288
HomeServices	148	130
Other (net)	107	172
Income (loss) from discontinued zinc project	8	(579)
Earnings before corporate interest and taxes	1,168	605
Interest, other than to Berkshire	(200)	(212)
Interest on Berkshire junior debt	(157)	(170)
Income tax	(248)	(53)
Net earnings	$ 563	$ 170
Earnings applicable to Berkshire*	$ 523	$ 237
Debt owed to others	10,296	10,528
Debt owed to Berkshire	1,289	1,478

*Includes interest earned by Berkshire (net of related income taxes) of $102 in 2005 and $110 in 2004.

Finance and Financial Products

The star of our finance sector is Clayton Homes, masterfully run by Kevin Clayton. He does not owe his brilliant record to a rising tide: The manufactured-housing business has been disappointing since Berkshire purchased Clayton in 2003. Industry sales have stagnated at 40-year lows, and the recent uptick from Katrina-related demand will almost certainly be short-lived. In recent years, many industry participants have suffered losses, and only Clayton has earned significant money.

In this brutal environment Clayton has bought a large amount of manufactured-housing loans from major banks that found them unprofitable and difficult to service. Clayton’s operating expertise and Berkshire’s financial resources have made this an excellent business for us and one in which we are preeminent. We presently service $17 billion of loans, compared to $5.4 billon at the time of our purchase. Moreover, Clayton now owns $9.6 billion of its servicing portfolio, a position built up almost entirely since Berkshire entered the picture.

To finance this portfolio, Clayton borrows money from Berkshire, which in turn borrows the same amount publicly. For the use of its credit, Berkshire charges Clayton a one percentage-point markup on its borrowing cost. In 2005, the cost to Clayton for this arrangement was $83 million. That amount is included in “Other” income in the table on the facing page, and Clayton’s earnings of $416 million are after deducting this payment.

On the manufacturing side, Clayton has also been active. To its original base of twenty plants, it first added twelve more in 2004 by way of the bankruptcy purchase of Oakwood, which just a few years earlier was one of the largest companies in the business. Then in 2005 Clayton purchased Karsten, a four-plant operation that greatly strengthens Clayton’s position on the West Coast.

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Long ago, Mark Twain said: “A man who tries to carry a cat home by its tail will learn a lesson that can be learned in no other way.” If Twain were around now, he might try winding up a derivatives business. After a few days, he would opt for cats.

We lost $104 million pre-tax last year in our continuing attempt to exit Gen Re’s derivative operation. Our aggregate losses since we began this endeavor total $404 million.

Originally we had 23,218 contracts outstanding. By the start of 2005 we were down to 2,890. You might expect that our losses would have been stemmed by this point, but the blood has kept flowing. Reducing our inventory to 741 contracts last year cost us the $104 million mentioned above.

Remember that the rationale for establishing this unit in 1990 was Gen Re’s wish to meet the needs of insurance clients. Yet one of the contracts we liquidated in 2005 had a term of 100 years! It’s difficult to imagine what “need” such a contract could fulfill except, perhaps, the need of a compensation-conscious trader to have a long-dated contract on his books. Long contracts, or alternatively those with multiple variables, are the most difficult to mark to market (the standard procedure used in accounting for derivatives) and provide the most opportunity for “imagination” when traders are estimating their value. Small wonder that traders promote them.

A business in which huge amounts of compensation flow from assumed numbers is obviously fraught with danger. When two traders execute a transaction that has several, sometimes esoteric, variables and a far-off settlement date, their respective firms must subsequently value these contracts whenever they calculate their earnings. A given contract may be valued at one price by Firm A and at another by Firm B. You can bet that the valuation differences — and I'm personally familiar with several that were *huge* — tend to be tilted in a direction favoring higher earnings at each firm. It's a strange world in which two parties can carry out a paper transaction that each can promptly report as profitable.

I dwell on our experience in derivatives each year for two reasons. One is personal and unpleasant. The hard fact is that I have cost you a lot of money by not moving immediately to close down Gen Re's trading operation. Both Charlie and I knew at the time of the Gen Re purchase that it was a problem and told its management that we wanted to exit the business. It was my responsibility to make sure that happened. Rather than address the situation head on, however, I wasted several years while we attempted to sell the operation. That was a doomed endeavor because no realistic solution could have extricated us from the maze of liabilities that was going to exist for decades. Our obligations were particularly worrisome because their potential to explode could not be measured. Moreover, if severe trouble occurred, we knew it was likely to correlate with problems elsewhere in financial markets.

So I failed in my attempt to exit painlessly, and in the meantime more trades were put on the books. Fault me for dithering. (Charlie calls it thumb-sucking.) When a problem exists, whether in personnel or in business operations, the time to act is *now*.

The second reason I regularly describe our problems in this area lies in the hope that our experiences may prove instructive for managers, auditors and regulators. In a sense, we are a canary in this business coal mine and should sing a song of warning as we expire. The number and value of derivative contracts outstanding in the world continues to mushroom and is now a multiple of what existed in 1998, the last time that financial chaos erupted.

Our experience should be particularly sobering because we were a better-than-average candidate to exit gracefully. Gen Re was a relatively minor operator in the derivatives field. It has had the good fortune to unwind its supposedly liquid positions in a benign market, all the while free of financial or other pressures that might have forced it to conduct the liquidation in a less-than-efficient manner. Our accounting in the past was conventional and actually thought to be conservative. Additionally, we know of no bad behavior by anyone involved.

It could be a different story for others in the future. Imagine, if you will, one or more firms (troubles often spread) with positions that are many multiples of ours attempting to liquidate in chaotic markets and under extreme, and well-publicized, pressures. This is a scenario to which much attention should be given now rather than after the fact. The time to have considered — and improved — the reliability of New Orleans' levees was *before* Katrina.

When we finally wind up Gen Re Securities, my feelings about its departure will be akin to those expressed in a country song, "My wife ran away with my best friend, and I sure miss him a lot."

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Below are the results of our various finance and financial products activities:

	(in $ millions)			
	Pre-Tax Earnings		*Interest-Bearing Liabilities*	
	2005	*2004*	*2005*	*2004*
Trading – ordinary income	$ 200	$ 264	$1,061	$5,751
Gen Re Securities (loss)	(104)	(44)	2,617*	5,437*
Life and annuity operation	11	(57)	2,461	2,467
Value Capital (loss)	(33)	30	N/A	N/A
Leasing operations	173	92	370	391
Manufactured-housing finance (Clayton)	416	192	9,299	3,636
Other	159	107	N/A	N/A
Income before capital gains	822	584		
Trading – capital gains (losses)	(234)	1,750		
Total	$ 588	$2,334		

*Includes all liabilities

Manufacturing, Service and Retailing Operations

Our activities in this part of Berkshire cover the waterfront. Let's look, though, at a summary balance sheet and earnings statement for the entire group.

Balance Sheet 12/31/05 (in $ millions)

Assets		*Liabilities and Equity*	
Cash and equivalents	$ 1,004	Notes payable	$ 1,469
Accounts and notes receivable	3,287	Other current liabilities	5,371
Inventory	4,143	Total current liabilities	6,840
Other current assets	342		
Total current assets	8,776		
Goodwill and other intangibles	9,260	Deferred taxes	338
Fixed assets	7,148	Term debt and other liabilities	2,188
Other assets	1,021	Equity	16,839
	$26,205		$26,205

Earnings Statement (in $ millions)

	2005	*2004*	*2003*
Revenues	$46,896	$44,142	$32,106
Operating expenses (including depreciation of $699 in 2005, $676 in 2004 and $605 in 2003)	44,190	41,604	29,885
Interest expense (net)	83	57	64
Pre-tax earnings	2,623	2,481	2,157
Income taxes	977	941	813
Net income	$ 1,646	$ 1,540	$ 1,344

This eclectic collection, which sells products ranging from Dilly Bars to fractional interests in Boeing 737s, earned a very respectable 22.2% on average tangible net worth last year. It’s noteworthy also that these operations used only minor financial leverage in achieving that return. Clearly, we own some terrific businesses. We purchased many of them, however, at substantial premiums to net worth — a point reflected in the goodwill item shown on the balance sheet — and that fact reduces the earnings on our average *carrying* value to 10.1%.

Here are the pre-tax earnings for the larger categories or units.

	Pre-Tax Earnings (in $ millions) 2005	2004
Building Products	$ 751	$ 643
Shaw Industries	485	466
Apparel & Footwear	348	325
Retailing of Jewelry, Home Furnishings and Candy	257	215
Flight Services	120	191
McLane	217	228
Other businesses	445	413
	$2,623	$2,481

• In both our building-products companies and at Shaw, we continue to be hit by rising costs for raw materials and energy. Most of these operations are significant users of oil (or more specifically, petrochemicals) and natural gas. And prices for these commodities have soared.

We, likewise, have raised prices on many products, but there are often lags before increases become effective. Nevertheless, both our building-products operations and Shaw delivered respectable results in 2005, a fact attributable to their strong business franchises and able managements.

• In apparel, our largest unit, Fruit of the Loom, again increased earnings and market-share. You know, of course, of our leadership position in men's and boys' underwear, in which we account for about 48.7% of the sales recorded by mass-marketers (Wal-Mart, Target, etc.). That's up from 44.2% in 2002, when we acquired the company. Operating from a smaller base, we have made still greater gains in intimate apparel for women and girls that is sold by the mass-marketers, climbing from 13.7% of their sales in 2002 to 24.7% in 2005. A gain like that in a major category doesn't come easy. Thank John Holland, Fruit's extraordinary CEO, for making this happen.

• I told you last year that Ben Bridge (jewelry) and R. C. Willey (home furnishings) had same-store sales gains far above the average of their industries. You might think that blow-out figures in one year would make comparisons difficult in the following year. But Ed and Jon Bridge at their operation and Scott Hymas at R. C. Willey were more than up to this challenge. Ben Bridge had a 6.6% same-store gain in 2005, and R. C. Willey came in at 9.9%.

Our never-on-Sunday approach at R. C. Willey continues to overwhelm seven-day competitors as we roll out stores in new markets. The Boise store, about which I was such a skeptic a few years back, had a 21% gain in 2005, coming off a 10% gain in 2004. Our new Reno store, opened in November, broke out of the gate fast with sales that exceeded Boise's early pace, and we will begin business in Sacramento in June. If this store succeeds as I expect it to, Californians will see many more R. C. Willey stores in the years to come.

• In flight services, earnings improved at FlightSafety as corporate aviation continued its rebound. To support growth, we invest heavily in new simulators. Our most recent expansion, bringing us to 42 training centers, is a major facility at Farnborough, England that opened in September. When it is fully built out in 2007, we will have invested more than $100 million in the building and its 15 simulators. Bruce Whitman, FlightSafety's able CEO, makes sure that no competitor comes close to offering the breadth and depth of services that we do.

Operating results at NetJets were a different story. I said last year that this business would earn money in 2005 — and I was dead wrong.

Our European operation, it should be noted, showed both excellent growth and a reduced loss. Customer contracts there increased by 37%. We are the only fractional-ownership operation of any size in Europe, and our now-pervasive presence there is a key factor in making NetJets the worldwide leader in this industry.

Despite a large increase in customers, however, our U.S. operation dipped far into the red. Its efficiency fell, and costs soared. We believe that our three largest competitors suffered similar problems, but each is owned by aircraft manufacturers that may think differently than we do about the necessity of making adequate profits. The *combined* value of the fleets managed by these three competitors, in any case, continues to be less valuable than the fleet that we operate.

Rich Santulli, one of the most dynamic managers I've ever met, will solve our revenue/expense problem. He won't do it, however, in a manner that impairs the quality of the NetJets experience. Both he and I are committed to a level of service, security and safety that can't be matched by others.

- Our retailing category includes See's Candies, a company we bought early in 1972 (a date making it our oldest non-insurance business). At that time, Charlie and I immediately decided to put Chuck Huggins, then 46, in charge. Though we were new at the game of selecting managers, Charlie and I hit a home run with this appointment. Chuck's love for the customer and the brand permeated the organization, which in his 34-year tenure produced a more-than-tenfold increase in profits. This gain was achieved in an industry growing at best slowly and perhaps not at all. (Volume figures in this industry are hard to pin down.)

At yearend, Chuck turned the reins at See's over to Brad Kinstler, who previously had served Berkshire well while running Cypress Insurance and Fechheimer's. It's unusual for us to move managers around, but Brad's record made him an obvious choice for the See's job. I hope Chuck and his wife, Donna, are at the annual meeting. If they are, shareholders can join Charlie and me in giving America's number one candy maker a richly-deserved round of applause.

* * * * * * * * * * * *

Every day, in countless ways, the competitive position of each of our businesses grows either weaker or stronger. If we are delighting customers, eliminating unnecessary costs and improving our products and services, we gain strength. But if we treat customers with indifference or tolerate bloat, our businesses will wither. On a daily basis, the effects of our actions are imperceptible; cumulatively, though, their consequences are enormous.

When our long-term competitive position improves as a result of these almost unnoticeable actions, we describe the phenomenon as "widening the moat." And doing that is essential if we are to have the kind of business we want a decade or two from now. We always, of course, hope to earn more money in the short-term. But when short-term and long-term conflict, widening the moat *must* take precedence. If a management makes bad decisions in order to hit short-term earnings targets, and consequently gets behind the eight-ball in terms of costs, customer satisfaction or brand strength, no amount of subsequent brilliance will overcome the damage that has been inflicted. Take a look at the dilemmas of managers in the auto and airline industries today as they struggle with the huge problems handed them by their predecessors. Charlie is fond of quoting Ben Franklin's "An ounce of prevention is worth a pound of cure." But sometimes no amount of cure will overcome the mistakes of the past.

Our managers focus on moat-widening — and are brilliant at it. Quite simply, they are passionate about their businesses. Usually, they were running those long before we came along; our only function since has been to stay out of the way. If you see these heroes — and our four heroines as well — at the annual meeting, thank them for the job they do for you.

* * * * * * * * * * * *

The attitude of our managers vividly contrasts with that of the young man who married a tycoon's only child, a decidedly homely and dull lass. Relieved, the father called in his new son-in-law after the wedding and began to discuss the future:

> "Son, you're the boy I always wanted and never had. Here's a stock certificate for 50% of the company. You're my equal partner from now on."
>
> "Thanks, dad."
>
> "Now, what would you like to run? How about sales?"
>
> "I'm afraid I couldn't sell water to a man crawling in the Sahara."
>
> "Well then, how about heading human relations?"
>
> "I really don't care for people."
>
> "No problem, we have lots of other spots in the business. What would you like to do?"
>
> "Actually, nothing appeals to me. Why don't you just buy me out?"

Investments

We show below our common stock investments. Those that had a market value of more than $700 million at the end of 2005 are itemized.

			12/31/05	
Shares	*Company*	*Percentage of Company Owned*	*Cost**	*Market*
			(in $ millions)	
151,610,700	American Express Company	12.2	$1,287	$ 7,802
30,322,137	Ameriprise Financial, Inc.....................	12.1	183	1,243
43,854,200	Anheuser-Busch Cos., Inc....................	5.6	2,133	1,884
200,000,000	The Coca-Cola Company	8.4	1,299	8,062
6,708,760	M&T Bank Corporation	6.0	103	732
48,000,000	Moody's Corporation	16.2	499	2,948
2,338,961,000	PetroChina "H" shares (or equivalents)...	1.3	488	1,915
100,000,000	The Procter & Gamble Company	3.0	940	5,788
19,944,300	Wal-Mart Stores, Inc.	0.5	944	933
1,727,765	The Washington Post Company	18.0	11	1,322
95,092,200	Wells Fargo & Company.........................	5.7	2,754	5,975
1,724,200	White Mountains Insurance.....................	16.0	369	963
	Others		4,937	7,154
	Total Common Stocks		$15,947	$46,721

*This is our actual purchase price and also our tax basis; GAAP "cost" differs in a few cases because of write-ups or write-downs that have been required.

A couple of last year's changes in our portfolio occurred because of corporate events: Gillette was merged into Procter & Gamble, and American Express spun off Ameriprise. In addition, we substantially increased our holdings in Wells Fargo, a company that Dick Kovacevich runs brilliantly, and established positions in Anheuser-Busch and Wal-Mart.

Expect no miracles from our equity portfolio. Though we own major interests in a number of strong, highly-profitable businesses, they are not selling at anything like bargain prices. As a group, they may double in value in ten years. The likelihood is that their per-share earnings, in aggregate, will grow 68% per year over the decade and that their stock prices will more or less match that growth. (Their managers, of course, think my expectations are too modest — and I hope they're right.)

* * * * * * * * * * * *

The P&G-Gillette merger, closing in the fourth quarter of 2005, required Berkshire to record a $5.0 billion pre-tax capital gain. This bookkeeping entry, dictated by GAAP, is meaningless from an economic standpoint, and you should ignore it when you are evaluating Berkshire's 2005 earnings. We didn't intend to sell our Gillette shares before the merger; we don't intend to sell our P&G shares now; and we incurred no tax when the merger took place.

It's hard to overemphasize the importance of who is CEO of a company. Before Jim Kilts arrived at Gillette in 2001, the company was struggling, having particularly suffered from capital-allocation blunders. In the major example, Gillette's acquisition of Duracell cost Gillette shareholders billions of dollars, a loss never made visible by conventional accounting. Quite simply, what Gillette received in business value in this acquisition was not equivalent to what it gave up. (Amazingly, this most fundamental of yardsticks is almost always ignored by both managements and their investment bankers when acquisitions are under discussion.)

Upon taking office at Gillette, Jim quickly instilled fiscal discipline, tightened operations and energized marketing, moves that dramatically increased the intrinsic value of the company. Gillette's merger with P&G then expanded the potential of both companies. For his accomplishments, Jim was paid very well — but he earned every penny. (This is no academic evaluation: As a 9.7% owner of Gillette, Berkshire in effect paid that proportion of his compensation.) Indeed, it's difficult to overpay the *truly* extraordinary CEO of a giant enterprise. But this species is rare.

Too often, executive compensation in the U.S. is ridiculously out of line with performance. That won't change, moreover, because the deck is stacked against investors when it comes to the CEO's pay. The upshot is that a mediocre-or-worse CEO — aided by his handpicked VP of human relations and a consultant from the ever-accommodating firm of Ratchet, Ratchet and Bingo — all too often receives gobs of money from an ill-designed compensation arrangement.

Take, for instance, ten year, fixed-price options (and who wouldn't?). If Fred Futile, CEO of Stagnant, Inc., receives a bundle of these — let's say enough to give him an option on 1% of the company — his self-interest is clear: He should skip dividends entirely and instead use all of the company’s earnings to repurchase stock.

Let’s assume that under Fred’s leadership Stagnant lives up to its name. In each of the ten years after the option grant, it earns $1 billion on $10 billion of net worth, which initially comes to $10 per share on the 100 million shares then outstanding. Fred eschews dividends and regularly uses all earnings to repurchase shares. If the stock constantly sells at ten times earnings per share, it will have appreciated 158% by the end of the option period. That’s because repurchases would reduce the number of shares to 38.7 million by that time, and earnings per share would thereby increase to $25.80. Simply by withholding earnings from owners, Fred gets very rich, making a cool $158 million, despite the business itself improving not at all. Astonishingly, Fred could have made more than $100 million if Stagnant’s earnings had *declined* by 20% during the ten-year period.

Fred can also get a splendid result for himself by paying no dividends and deploying the earnings he withholds from shareholders into a variety of disappointing projects and acquisitions. Even if these initiatives deliver a paltry 5% return, Fred will still make a bundle. Specifically — with Stagnant’s p/e ratio remaining unchanged at ten — Fred’s option will deliver him $63 million. Meanwhile, his shareholders will wonder what happened to the “alignment of interests” that was supposed to occur when Fred was issued options.

A “normal” dividend policy, of course — one-third of earnings paid out, for example — produces less extreme results but still can provide lush rewards for managers who achieve nothing.

CEOs understand this math and know that every dime paid out in dividends reduces the value of all outstanding options. I’ve never, however, seen this manager-owner conflict referenced in proxy materials that request approval of a fixed-priced option plan. Though CEOs invariably preach *internally* that capital comes at a cost, they somehow forget to tell shareholders that fixed-price options give them capital that is free.

It doesn't have to be this way: It's child's play for a board to design options that give effect to the automatic build-up in value that occurs when earnings are retained. But — surprise, surprise — options of that kind are almost never issued. Indeed, the very thought of options with strike prices that are adjusted for retained earnings seems foreign to compensation "experts," who are nevertheless encyclopedic about every management-friendly plan that exists. ("Whose bread I eat, his song I sing.")

Getting fired can produce a particularly bountiful payday for a CEO. Indeed, he can "earn" more in that single day, while cleaning out his desk, than an American worker earns in a lifetime of cleaning toilets. Forget the old maxim about nothing succeeding like success: Today, in the executive suite, the alltoo-prevalent rule is that nothing succeeds like *failure*.

Huge severance payments, lavish perks and outsized payments for ho-hum performance often occur because comp committees have become slaves to comparative data. The drill is simple: Three or so directors — *not chosen by chance* — are bombarded for a few hours before a board meeting with pay statistics that perpetually ratchet upwards. Additionally, the committee is told about new perks that other managers are receiving. In this manner, outlandish "goodies" are showered upon CEOs simply because of a corporate version of the argument we all used when children: "But, Mom, all the other kids have one." When comp committees follow this "logic," yesterday's most egregious excess becomes today's baseline.

Comp committees should adopt the attitude of Hank Greenberg, the Detroit slugger and a boyhood hero of mine. Hank's son, Steve, at one time was a player's agent. Representing an outfielder in negotiations with a major league club, Steve sounded out his dad about the size of the signing bonus he should ask for. Hank, a true pay-for-performance guy, got straight to the point, "What did he hit last year?" When Steve answered ".246," Hank's comeback was immediate: "Ask for a uniform."

(Let me pause for a brief confession: In criticizing comp committee behavior, I don't speak as a true insider. Though I have served as a director of twenty public companies, only one CEO has put me on his comp committee. Hmmmm . . .)

* * * * * * * * * * * *

My views on America’s long-term problem in respect to trade imbalances, which I have laid out in previous reports, remain unchanged. My conviction, however, cost Berkshire $955 million pre-tax in 2005. That amount is included in our earnings statement, a fact that illustrates the differing ways in which GAAP treats gains and losses. When we have a long-term position in stocks or bonds, year-to-year changes in value are reflected in our balance sheet but, as long as the asset is not sold, are rarely reflected in earnings. For example, our Coca-Cola holdings went from $1 billion in value early on to $13.4 billion at yearend 1998 and have since declined to $8.1 billion — with none of these moves affecting our earnings statement. Long-term currency positions, however, are daily marked to market and therefore have an effect on earnings in every reporting period. From the date we first entered into currency contracts, we are $2.0 billion in the black.

We reduced our direct position in currencies somewhat during 2005. We partially offset this change, however, by purchasing equities whose prices are denominated in a variety of foreign currencies and that earn a large part of their profits internationally. Charlie and I prefer this method of acquiring nondollar exposure. That’s largely because of changes in interest rates: As U.S. rates have risen relative to those of the rest of the world, holding most foreign currencies now involves a significant negative “carry.” The carry aspect of our direct currency position indeed cost us money in 2005 and is likely to do so again in 2006. In contrast, the ownership of foreign equities is likely, over time, to create a positive carry — perhaps a substantial one.

The underlying factors affecting the U.S. current account deficit continue to worsen, and no letup is in sight. Not only did our trade deficit — the largest and most familiar item in the current account — hit an all-time high in 2005, but we also can expect a second item — the balance of investment income — to soon turn negative. As foreigners increase their ownership of U.S. assets (or of claims against us) relative to

U.S. investments abroad, these investors will begin earning more on their holdings than we do on ours. Finally, the third component of the current account, unilateral transfers, is always negative.

The U.S., it should be emphasized, is extraordinarily rich and will get richer. As a result, the huge imbalances in its current account may continue for a long time without their having noticeable deleterious effects on the U.S. economy or on markets. I doubt, however, that the situation will forever remain benign. Either Americans address the problem soon in a way we select, or at some point the problem will likely address us in an unpleasant way of its own.

How to Minimize Investment Returns

It's been an easy matter for Berkshire and other owners of American equities to prosper over the years. Between December 31, 1899 and December 31, 1999, to give a really long-term example, the Dow rose from 66 to 11,497. (Guess what annual growth rate is required to produce this result; the surprising answer is at the end of this section.) This huge rise came about for a simple reason: Over the century American businesses did extraordinarily well and investors rode the wave of their prosperity. Businesses continue to do well. But now shareholders, through a series of self-inflicted wounds, are in a major way cutting the returns they will realize from their investments.

The explanation of how this is happening begins with a fundamental truth: With unimportant exceptions, such as bankruptcies in which some of a company's losses are borne by creditors, *the most that owners in aggregate can earn between now and Judgment Day is what their businesses in aggregate earn.* True, by buying and selling that is clever or lucky, investor A may take more than his share of the pie at the expense of investor B. And, yes, all investors *feel* richer when stocks soar. But an owner can exit only by having someone take his place. If one investor sells high, another must buy high. For owners as a whole, there is simply no magic — no shower of money from outer space — that will enable them to extract wealth from their companies beyond that created by the companies themselves.

Indeed, owners must earn less than their businesses earn because of "frictional" costs. And that's my point: These costs are now being incurred in amounts that will cause shareholders to earn *far* less than they historically have.

To understand how this toll has ballooned, imagine for a moment that all American corporations are, and always will be, owned by a single family. We'll call them the Gotrocks. After paying taxes on dividends, this family — generation after generation — becomes richer by the aggregate amount earned by its companies. Today that amount is about $700 billion annually. Naturally, the family spends some of these dollars. But the portion it saves steadily compounds for its benefit. In the Gotrocks household everyone grows wealthier at the same pace, and all is harmonious.

But let's now assume that a few fast-talking Helpers approach the family and persuade each of its members to try to outsmart his relatives by buying certain of their holdings and selling them certain others. The Helpers — for a fee, of course — obligingly agree to handle these transactions. The Gotrocks still own all of corporate America; the trades just rearrange who owns what. So the family's annual gain in wealth diminishes, equaling the earnings of American business *minus* commissions paid. The more that family members trade, the smaller their share of the pie and the larger the slice received by the Helpers. This fact is not lost upon these broker-Helpers: Activity is their friend and, in a wide variety of ways, they urge it on.

After a while, most of the family members realize that they are not doing so well at this new "beatmy-brother" game. Enter another set of Helpers. These newcomers explain to each member of the Gotrocks clan that by himself he'll never outsmart the rest of the family. The suggested cure: "Hire a manager — yes, us — and get the job done professionally." These manager-Helpers continue to use the broker-Helpers to execute trades; the managers may even increase their activity so as to permit the brokers to prosper still more. Overall, a bigger slice of the pie now goes to the two classes of Helpers.

The family's disappointment grows. Each of its members is now employing professionals. Yet overall, the group's finances have taken a turn for the worse. The solution? More help, of course.

It arrives in the form of financial planners and institutional consultants, who weigh in to advise the Gotrocks on selecting manager-Helpers. The befuddled family welcomes this assistance. By now its members know they can pick neither the right stocks nor the right stock-pickers. Why, one might ask, should they expect success in picking the right consultant? But this question does not occur to the Gotrocks, and the consultant-Helpers certainly don't suggest it to them.

The Gotrocks, now supporting three classes of expensive Helpers, find that their results get worse, and they sink into despair. But just as hope seems lost, a fourth group — we'll call them the hyper-Helpers

— appears. These friendly folk explain to the Gotrocks that their unsatisfactory results are occurring because the existing Helpers — brokers, managers, consultants — are not sufficiently motivated and are simply going through the motions. "What," the new Helpers ask, "can you expect from such a bunch of zombies?"

The new arrivals offer a breathtakingly simple solution: *Pay more money*. Brimming with self-confidence, the hyper-Helpers assert that huge contingent payments — in addition to stiff fixed fees — are what each family member must fork over in order to *really* outmaneuver his relatives.

The more observant members of the family see that some of the hyper-Helpers are really just manager-Helpers wearing new uniforms, bearing sewn-on sexy names like HEDGE FUND or PRIVATE EQUITY. The new Helpers, however, assure the Gotrocks that this change of clothing is all-important, bestowing on its wearers magical powers similar to those acquired by mild-mannered Clark Kent when he changed into his Superman costume. Calmed by this explanation, the family decides to pay up.

And that's where we are today: A record portion of the earnings that would go in their entirety to owners — if they all just stayed in their rocking chairs — is now going to a swelling army of Helpers. Particularly expensive is the recent pandemic of profit arrangements under which Helpers receive large portions of the winnings when they are smart or lucky, and leave family members with all of the losses — and large fixed fees to boot — when the Helpers are dumb or unlucky (or occasionally crooked).

A sufficient number of arrangements like this — heads, the Helper takes much of the winnings; tails, the Gotrocks lose and pay dearly for the privilege of doing so — may make it more accurate to call the family the

Hadrocks. Today, in fact, the family's frictional costs of all sorts may well amount to 20% of the earnings of American business. In other words, the burden of paying Helpers may cause American equity investors, overall, to earn only 80% or so of what they would earn if they just sat still and listened to no one.

Long ago, Sir Isaac Newton gave us three laws of motion, which were the work of genius. But Sir Isaac's talents didn't extend to investing: He lost a bundle in the South Sea Bubble, explaining later, "I can calculate the movement of the stars, but not the madness of men." If he had not been traumatized by this loss, Sir Isaac might well have gone on to discover the Fourth Law of Motion*: For investors as a whole, returns decrease as motion increases.*

* * * * * * * * * * * * Here's the answer to the question posed at the beginning of this section: To get very specific, the Dow increased from 65.73 to 11,497.12 in the 20th century, and that amounts to a gain of 5.3% compounded annually. (Investors would also have received dividends, of course.) To achieve an equal rate of gain in the 21st century, the Dow will have to rise by December 31, 2099 to — brace yourself — precisely 2,011,011.23. But I'm willing to settle for 2,000,000; six years into this century, the Dow has gained not at all.

Debt and Risk

As we consolidate MidAmerican, our new balance sheet may suggest that Berkshire has expanded its tolerance for borrowing. But that's not so. Except for token amounts, we shun debt, turning to it for only three purposes:

1. We occasionally use repos as a part of certain short-term investing strategies that incorporate ownership of U.S. government (or agency) securities. Purchases of this kind are highly opportunistic and involve only the most liquid of securities. A few years ago, we entered into several interesting transactions that have since been unwound or are running off. The offsetting debt has likewise been cut substantially and before long may be gone.

2. We borrow money against portfolios of interest-bearing receivables whose risk characteristics we understand. We did this in 2001 when we guaranteed $5.6 billion of bank debt to take over, in partnership with Leucadia, a bankrupt Finova (which held a broad range of receivables). All of that debt has been repaid. More recently, we have borrowed to finance a widely-diversified, predictably-performing portfolio of manufactured-home receivables managed by Clayton. Alternatively, we could "securitize" — that is, sell — these receivables, but retain the servicing of them. If we followed this procedure, which is common in the industry, we would not show the debt that we do on our balance sheet, and we would also accelerate the earnings we report. In the end, however, we would earn less money. Were market variables to change so as to favor securitization (an unlikely event), we could sell part of our portfolio and eliminate the related debt. Until then, we prefer better profits to better cosmetics.

3. At MidAmerican, we have substantial debt, but it is that company's obligation only. Though it will appear on our consolidated balance sheet, Berkshire does *not* guarantee it.

   Even so, this debt is unquestionably secure because it is serviced by MidAmerican's diversified stream of highly-stable utility earnings. If there were to be some bolt from the blue that hurt one of MidAmerican's utility properties, earnings from the others would still be more than ample to cover all debt requirements. Moreover, MidAmerican retains all of its earnings, an equity-building practice that is rare in the utility field.

   From a risk standpoint, it is far safer to have earnings from ten diverse and uncorrelated utility operations that cover interest charges by, say, a 2:1 ratio than it is to have far greater coverage provided by a single utility. A catastrophic event can render a single utility insolvent — witness what Katrina did to the local electric utility in New Orleans — no matter how conservative its debt policy. A geographical disaster — say, an earthquake in a Western state — can't have the same effect on MidAmerican. And even a worrier like Charlie can't think of an event that would systemically decrease utility earnings in any major way.

> Because of MidAmerican's ever-widening diversity of regulated earnings, it will always utilize major amounts of debt.

And that's about it. We are not interested in incurring any significant debt at Berkshire for acquisitions or operating purposes. Conventional business wisdom, of course, would argue that we are being too conservative and that there are added profits that could be safely earned if we injected moderate leverage into our balance sheet.

Maybe so. But many of Berkshire's hundreds of thousands of investors have a large portion of their net worth in our stock (among them, it should be emphasized, a large number of our board and key managers) and a disaster for the company would be a disaster for them. Moreover, there are people who have been permanently injured to whom we owe insurance payments that stretch out for fifty years or more. To these and other constituencies we have promised total security, whatever comes: financial panics, stock-exchange closures (an extended one occurred in 1914) or even domestic nuclear, chemical or biological attacks.

We are quite willing to accept huge risks. Indeed, more than any other insurer, we write high-limit policies that are tied to single catastrophic events. We also own a large investment portfolio whose market value could fall dramatically and quickly under certain conditions (as happened on October 19, 1987). Whatever occurs, though, Berkshire will have the net worth, the earnings streams and the liquidity to handle the problem with ease.

Any other approach is dangerous. Over the years, a number of very smart people have learned the hard way that a long string of impressive numbers multiplied by a single zero always equals zero. That is not an equation whose effects I would like to experience personally, and I would like even less to be responsible for imposing its penalties upon others.

Management Succession

As owners, you are naturally concerned about whether I will insist on continuing as CEO after I begin to fade and, if so, how the board will handle that problem. You also want to know what happens if I should die tonight.

That second question is easy to answer. Most of our many businesses have strong market positions, significant momentum, and terrific managers. The special Berkshire culture is deeply ingrained throughout our subsidiaries, and these operations won't miss a beat when I die.

Moreover, we have three managers at Berkshire who are reasonably young and fully capable of being CEO. Any of the three would be much better at certain management aspects of my job than I. On the minus side, none has my crossover experience that allows me to be comfortable making decisions in either the business arena or in investments. That problem will be solved by having another person in the organization handle marketable securities. That's an interesting job at Berkshire, and the new CEO will have no problem in hiring a talented individual to do it. Indeed, that's what we have done at GEICO for 26 years, and our results have been terrific.

Berkshire's board has fully discussed each of the three CEO candidates and has unanimously agreed on the person who should succeed me if a replacement were needed today. The directors stay updated on this subject and could alter their view as circumstances change — new managerial stars may emerge and present ones will age. The important point is that the directors know now — and will always know in the future — exactly what they will do when the need arises.

The other question that must be addressed is whether the Board will be prepared to make a change if that need should arise not from my death but rather from my decay, particularly if this decay is accompanied by my delusionally thinking that I am reaching new peaks of managerial brilliance. That problem would not be unique to me. Charlie and I have faced this situation from time to time at Berkshire's subsidiaries. Humans age at greatly varying rates — but sooner or later their talents and vigor decline. Some managers remain effective well into their 80s — Charlie is a wonder at 82 — and others noticeably fade in their 60s. When their abilities ebb, so usually do their powers of self-assessment. Someone else often needs to blow the whistle.

When that time comes for me, our board will have to step up to the job. From a financial standpoint, its members are unusually motivated to do so. I know of no other board in the country in which the financial interests of directors are so completely aligned with those of shareholders. Few boards even come close. On a personal level, however, it is extraordinarily difficult for most people to tell someone, particularly a friend, that he or she is no longer capable.

If I become a candidate for that message, however, our board will be doing me a favor by delivering it. *Every* share of Berkshire that I own is destined to go to philanthropies, and I want society to reap the maximum good from these gifts and bequests. It would be a tragedy if the philanthropic potential of my holdings was diminished because my associates shirked their responsibility to (tenderly, I hope) show me the door. But don't worry about this. We have an outstanding group of directors, and they will always do what's right for shareholders.

And while we are on the subject, I feel terrific.

The Annual Meeting

Our meeting this year will be on Saturday, May 6. As always, the doors will open at the Qwest Center at 7 a.m., and the latest Berkshire movie will be shown at 8:30. At 9:30 we will go directly to the question-and-answer period, which (with a break for lunch at the Qwest's stands) will last until 3:00. Then, after a short recess, Charlie and I will convene the annual meeting at 3:15. This schedule worked well last

year, because it let those who wanted to attend the formal session to do so, while freeing others to *shop*.

You certainly did your share in this respect last year. The 194,300 square foot hall adjoining the meeting area was filled with the products of Berkshire subsidiaries, and the 21,000 people who came to the meeting allowed every location to rack up sales records. Kelly Broz (neé Muchemore), the Flo Ziegfeld of Berkshire, orchestrates both this magnificent shopping extravaganza and the meeting itself. The exhibitors love her, and so do I. Kelly got married in October, and I gave her away. She asked me how I wanted to be listed in the wedding program. I replied "envious of the groom," and that's the way it went to press.

This year we will showcase two Clayton homes (featuring Acme brick, Shaw carpet, Johns Manville insulation, MiTek fasteners, Carefree awnings and NFM furniture). You will find that these homes, priced at $79,000 and $89,000, deliver excellent value. In fact, three shareholders came so firmly to that conclusion last year that they bought the $119,000 model we then showcased. Flanking the Clayton homes on the exhibition floor will be RVs from Forest River.

GEICO will have a booth staffed by a number of its top counselors from around the country, all of them ready to supply you with auto insurance quotes. In most cases, GEICO will be able to give you a special shareholder discount (usually 8%). This special offer is permitted by 45 of the 50 jurisdictions in which we operate. (One supplemental point: The discount is not additive if you qualify for another, such as that given certain groups.) Bring the details of your existing insurance and check out whether we can save you money. For at least 50% of you, I believe we can. And while you're at it, sign up for the new GEICO credit card. It's the one I now use.

On Saturday, at the Omaha airport, we will have the usual array of aircraft from NetJets® available for your inspection. Stop by the NetJets booth at the Qwest to learn about viewing these planes. Come to Omaha by bus; leave in your new plane.

The Bookworm boutique at the Qwest broke all records last year selling Berkshire-related books. An amazing 3,500 of these were *Poor Charlie's Almanack*, the collected wisdom of my partner. This means that a copy was sold every 9 seconds. And for good reason: You will never find a book with more useful ideas. Word-of-mouth recommendations have caused Charlie's first printing of 20,500 copies to sell out, and we will therefore have a revised and expanded edition on sale at our meeting. Among the other 22 titles and DVDs available last year at the Bookworm, 4,597 copies were sold for $84,746. Our shareholders are a bookseller's dream.

An attachment to the proxy material that is enclosed with this report explains how you can obtain the credential you will need for admission to the meeting and other events. As for plane, hotel and car reservations, we have again signed up American Express (800-799-6634) to give you special help.

Carol Pedersen, who handles these matters, does a terrific job for us each year, and I thank her for it.

At Nebraska Furniture Mart, located on a 77-acre site on 72nd Street between Dodge and Pacific, we will again be having “Berkshire Weekend” pricing. We initiated this special event at NFM nine years ago, and sales during the “Weekend” grew from $5.3 million in 1997 to $27.4 million in 2005 (up 9% from a year earlier). I get goose bumps just thinking about this volume.

To obtain the discount, you must make your purchases between Thursday, May 4 and Monday, May 8 inclusive, and also present your meeting credential. The period’s special pricing will even apply to the products of several prestigious manufacturers that normally have ironclad rules against discounting but that, in the spirit of our shareholder weekend, have made an exception for you. We appreciate their cooperation. NFM is open from 10 a.m. to 9 p.m. Monday through Saturday, and 10 a.m. to 6 p.m. on Sunday. On Saturday this year, from 5:30 p.m. to 8 p.m., we are having a special affair for shareholders only. I’ll be there, eating barbeque, drinking Coke, and counting sales.

Borsheim’s again will have two shareholder-only events. The first will be a cocktail reception from 6 p.m. to 10 p.m. on Friday, May 5. The second, the main gala, will be from 9 a.m. to 4 p.m. on Sunday, May 7. On Saturday, we will be open until 6 p.m.

We will have huge crowds at Borsheim’s throughout the weekend. For your convenience, therefore, shareholder prices will be available from Monday, May 1 through Saturday, May 13. During that period, just identify yourself as a shareholder through your meeting credentials or a brokerage statement.

Borsheim’s operates on a gross margin that, even before the shareholders’ discount, is fully twenty percentage points below that of its major rivals. Last year, our shareholder-period business increased 9% from 2004, which came on top of a 73% gain the year before. The store sold 5,000 Berkshire Monopoly games — and then ran out. We’ve learned: Plenty will be in stock this year.

In a tent outside of Borsheim's, Patrick Wolff, twice U.S. chess champion, will take on all comers in groups of six — blindfolded. Additionally, we will have Bob Hamman and Sharon Osberg, two of the world's top bridge experts, available to play with our shareholders on Sunday afternoon. They plan to keep their eyes *open* — but Bob never sorts his cards, even when playing for a national championship.

Gorat's — my favorite steakhouse — will again be open exclusively for Berkshire shareholders on Sunday, May 7, and will be serving from 4 p.m. until 10 p.m. Please remember that to come to Gorat's on that day, you must have a reservation. To make one, call 402-551-3733 on April 1 (*but not before*).

In this school year, about 35 university classes will come to Omaha for sessions with me. I take almost all — in aggregate, perhaps 2,000 students — to lunch at Gorat's. And they love it. To learn why, come join us on Sunday.

We will again have a special reception from 4:00 to 5:30 on Saturday afternoon for shareholders who have come from outside of North America. Every year our meeting draws many people from around the globe, and Charlie and I want to be sure we personally greet those who have come so far. Last year we enjoyed meeting more than 400 of you from many dozens of countries. Any shareholder who comes from other than the U.S. or Canada will be given a special credential and instructions for attending this function.

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Charlie and I are extraordinarily lucky. We were born in America; had terrific parents who saw that we got good educations; have enjoyed wonderful families and great health; and came equipped with a "business" gene that allows us to prosper in a manner hugely disproportionate to other people who contribute as much or more to our society's well-being. Moreover, we have long had jobs that we love, in which we are helped every day in countless ways by talented and cheerful associates. No wonder we tap-dance to work. But nothing is more fun for us than getting together with our shareholder-partners at Berkshire's annual meeting. So join us on May

6th at the Qwest for our annual Woodstock for Capitalists. We'll see you there.

February 28, 2006

Warren E. Buffett
Chairman of the Board

BERKSHIRE HATHAWAY INC.

To the Shareholders of Berkshire Hathaway Inc.:

Our gain in net worth during 2006 was $16.9 billion, which increased the per-share book value of both our Class A and Class B stock by 18.4%. Over the last 42 years (that is, since present management took over) book value has grown from $19 to $70,281, a rate of 21.4% compounded annually.*

* All per-share figures used in this report apply to Berkshire's A shares. Figures for the B shares are 1/30th of those shown for the A.

We believe that $16.9 billion is a record for a one-year gain in net worth — more than has ever been booked by *any* American business, leaving aside boosts that have occurred because of mergers (e.g., AOL's purchase of Time Warner). Of course, Exxon Mobil and other companies earn far more than Berkshire, but their earnings largely go to dividends and/or repurchases, rather than to building net worth.

All that said, a confession about our 2006 gain is in order. Our most important business, insurance, benefited from a large dose of luck: Mother Nature, bless her heart, went on vacation. After hammering us with hurricanes in 2004 and 2005 — storms that caused us to lose a bundle on super-cat insurance — she just vanished. Last year, the red ink from this activity turned black — *very* black.

In addition, the great majority of our 73 businesses did outstandingly well in 2006. Let me focus for a moment on one of our largest operations, GEICO. What management accomplished there was simply extraordinary.

As I've told you before, Tony Nicely, GEICO's CEO, went to work at the company 45 years ago, two months after turning 18. He became CEO in 1992, and from then on the company's growth exploded. In addition, Tony has delivered staggering productivity gains in recent years. Between yearend 2003 and yearend 2006, the number of GEICO policies increased from 5.7 million to 8.1 million, a jump of 42%. Yet during that same period, the company’s employees (measured on a fulltime-equivalent basis) *fell* 3.5%. So productivity grew 47%. And GEICO didn’t start fat.

That remarkable gain has allowed GEICO to maintain its all-important position as a low-cost producer, even though it has dramatically increased advertising expenditures. Last year GEICO spent $631 million on ads, up from $238 million in 2003 (and up from $31 million in 1995, when Berkshire took control). Today, GEICO spends far more on ads than any of its competitors, even those much larger. We will continue to raise the bar.

Last year I told you that if you had a new son or grandson to be sure to name him Tony. But Don Keough, a Berkshire director, recently had a better idea. After reviewing GEICO’s performance in 2006, he wrote me, “Forget births. Tell the shareholders to immediately change the names of their *present* children to Tony or Antoinette.” Don signed his letter “Tony.”

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Charlie Munger — my partner and Berkshire’s vice chairman — and I run what has turned out to be a big business, one with 217,000 employees and annual revenues approaching $100 billion. We certainly didn’t plan it that way. Charlie began as a lawyer, and I thought of myself as a security analyst. Sitting in those seats, we both grew skeptical about the ability of big entities of any type to function well. Size seems to make many organizations slow-thinking, resistant to change and smug. In Churchill’s words: “We shape our buildings, and afterwards our buildings shape us.” Here’s a telling fact: Of the ten non-oil companies having the largest market capitalization in 1965 — titans such as General Motors, Sears, DuPont and Eastman Kodak — only one made the 2006 list.

In fairness, we’ve seen plenty of successes as well, some truly outstanding. There are many giant-company managers whom I greatly admire; Ken Chenault of American Express, Jeff Immelt of G.E. and Dick Kovacevich of Wells Fargo come quickly to mind. But I don’t think I could do the management job they do. And I know I wouldn’t enjoy many of the duties that come with their positions — meetings, speeches, foreign travel, the charity circuit and governmental relations. For me, Ronald Reagan had it right: “It’s probably true that hard work never killed anyone — but why take the chance?”

So I’ve taken the easy route, just sitting back and working through great managers who run their own shows. My only tasks are to cheer them on, sculpt and harden our corporate culture, and make major capital-allocation decisions. Our managers have returned this trust by working hard and effectively.

For their performance over the last 42 years — and particularly for 2006 — Charlie and I thank them.

Yardsticks

Charlie and I measure Berkshire’s progress and evaluate its intrinsic value in a number of ways. No single criterion is effective in doing these jobs, and even an avalanche of statistics will not capture some factors that are important. For example, it’s essential that we have managers much younger than I available to succeed me. Berkshire has never been in better shape in this regard — but I can’t prove it to you with numbers.

There are two statistics, however, that are of real importance. The first is the amount of investments (including cash and cash-equivalents) that we own on a per-share basis. Arriving at this figure, we exclude investments held in our finance operation because these are largely offset by borrowings. Here’s the record since present management acquired control of Berkshire:

Year	Per-Share Investments*
1965	$ 4
1975	159
1985	2,407
1995	21,817
2006	$80,636
Compound Growth Rate 1965-2006	27.5%
Compound Growth Rate 1995-2006	12.6%

*Net of minority interests

In our early years we put most of our retained earnings and insurance float into investments in marketable securities. Because of this emphasis, and because the securities we purchased generally did well, our growth rate in investments was for a long time quite high.

Over the years, however, we have focused more and more on the acquisition of operating businesses. Using our funds for these purchases has both slowed our growth in investments and accelerated our gains in pre-tax earnings from non-insurance businesses, the second yardstick we use. Here's how those earnings have looked:

Year	Pre-Tax Earnings Per Share*
1965	$ 4
1975	4
1985	52
1995	175
2006	$3,625
Compound Growth Rate 1965-2006	17.9%
Compound Growth Rate 1995-2006	31.7%

*Excluding purchase-accounting adjustments and net of minority interests

Last year we had a good increase in non-insurance earnings — 38%. Large gains from here on in, though, will come only if we are able to make major, *and sensible*, acquisitions. That will not be easy. We do, however, have one advantage: More and more, Berkshire has become "the buyer of choice" for business owners and managers. Initially, we were viewed that way only in the U.S. (and more often than not by private companies). We've long wanted, nonetheless, to extend Berkshire's appeal beyond U.S. borders. And last year, our globe-trotting finally got underway.

Acquisitions

We began 2006 by completing the three acquisitions pending at yearend 2005, spending about $6 billion for PacifiCorp, Business Wire and Applied Underwriters. All are performing very well.

The highlight of the year, however, was our July 5th acquisition of most of ISCAR, an Israeli company, and our new association with its chairman, Eitan Wertheimer, and CEO, Jacob Harpaz. The story here began on October 25, 2005, when I received a 1¼-page letter from Eitan, of whom I then knew nothing. The letter began, "I am writing to introduce you to ISCAR," and proceeded to describe a cutting-tool business carried on in 61 countries. Then Eitan wrote, "We have for some time considered the issues of generational transfer and ownership that are typical for large family enterprises, and have given much thought to ISCAR's future. Our conclusion is that Berkshire Hathaway would be the ideal home for ISCAR. We believe that ISCAR would continue to thrive as a part of your portfolio of businesses."

Overall, Eitan's letter made the quality of the company and the character of its management leap off the page. It also made me want to learn more, and in November, Eitan, Jacob and ISCAR's CFO, Danny Goldman, came to Omaha. A few hours with them convinced me that if we were to make a deal, we would be teaming up with extraordinarily talented managers who could be trusted to run the business after a sale with all of the energy and dedication that they had exhibited previously. However, having never bought a business based outside of the U.S. (though I had bought a number of foreign stocks), I needed to get educated on some tax and jurisdictional matters. With that task completed, Berkshire purchased 80% of ISCAR for $4 billion. The remaining 20% stays in the hands of the Wertheimer family, making it our valued partner.

ISCAR's products are small, consumable cutting tools that are used in conjunction with large and expensive machine tools. It's a business without magic except for that imparted by the people who run it. But Eitan, Jacob and their associates are true managerial magicians who constantly develop tools that make their customers' machines more productive. The result: ISCAR makes money because it enables its customers to make *more* money. There is no better recipe for continued success.

In September, Charlie and I, along with five Berkshire associates, visited ISCAR in Israel. We — and I mean every one of us — have never been more impressed with any operation. At ISCAR, as throughout Israel, brains and energy are ubiquitous. Berkshire shareholders are lucky to have joined with Eitan, Jacob, Danny and their talented associates.

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A few months later, Berkshire again became "the buyer of choice" in a deal brought to us by my friend, John Roach, of Fort Worth. John, many of you will remember, was Chairman of Justin Industries, which we bought in 2000. At that time John was helping John Justin, who was terminally ill, find a permanent home for his company. John Justin died soon after we bought Justin Industries, but it has since been run exactly as we promised him it would be.

Visiting me in November, John Roach brought along Paul Andrews, Jr., owner of about 80% of TTI, a Fort Worth distributor of electronic components. Over a 35-year period, Paul built TTI from $112,000 of sales to $1.3 billion. He is a remarkable entrepreneur and operator.

Paul, 64, loves running his business. But not long ago he happened to witness how disruptive the death of a founder can be both to a private company's employees and the owner's family. What starts out as disruptive, furthermore, often evolves into destructive. About a year ago, therefore, Paul began to think about selling TTI. His goal was to put his business in the hands of an owner he had carefully chosen, rather than allowing a trust officer or lawyer to conduct an auction after his death.

Paul rejected the idea of a “strategic” buyer, knowing that in the pursuit of “synergies,” an owner of that type would be apt to dismantle what he had so carefully built, a move that would uproot hundreds of his associates (and perhaps wound TTI’s business in the process). He also ruled out a private equity firm, which would very likely load the company with debt and then flip it as soon as possible.

That left Berkshire. Paul and I met on the morning of November 15th and made a deal before lunch. Later he wrote me: “After our meeting, I am confident that Berkshire is the right owner for TTI . . . I am proud of our past and excited about our future.” And so are Charlie and I.

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We also made some “tuck-in” acquisitions during 2006 at Fruit of the Loom (“Fruit”), MiTek, CTB, Shaw and Clayton. Fruit made the largest purchases. First, it bought Russell Corp., a leading producer of athletic apparel and uniforms for about $1.2 billion (including assumed debt) and in December it agreed to buy the intimate apparel business of VF Corp. Together, these acquisitions add about $2.2 billion to Fruit’s sales and bring with them about 23,000 employees.

Charlie and I love it when we can acquire businesses that can be placed under managers, such as John Holland at Fruit, who have already shown their stuff at Berkshire. MiTek, for example, has made 14 acquisitions since we purchased it in 2001, and Gene Toombs has delivered results from these deals far in excess of what he had predicted. In effect, we leverage the managerial talent already with us by these tuck-in deals. We will make many more.

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We continue, however, to need “elephants” in order for us to use Berkshire’s flood of incoming cash. Charlie and I must therefore ignore the pursuit of mice and focus our acquisition efforts on much bigger game.

Our exemplar is the older man who crashed his grocery cart into that of a much younger fellow while both were shopping. The elderly man explained apologetically that he had lost track of his wife and was preoccupied searching for her. His new acquaintance said that by coincidence his wife had also wandered off and suggested that it might be more efficient if they jointly looked for the two women. Agreeing, the older man asked his new companion what his wife looked like. "She's a gorgeous blonde," the fellow answered, "with a body that would cause a bishop to go through a stained glass window, and she's wearing tight white shorts. How about yours?" The senior citizen wasted no words: "Forget her, we'll look for yours."

What *we* are looking for is described on page 25. If you have an acquisition candidate that fits, call me — day or night. And then watch me shatter a stained glass window.

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Now, let's examine the four major operating sectors of Berkshire. Lumping their financial figures together impedes analysis. So we'll look at them as four separate businesses, starting with the all— important insurance group.

Insurance

Next month marks the 40th anniversary of our entrance into the insurance business. It was on March 9, 1967, that Berkshire purchased National Indemnity and its companion company, National Fire & Marine, from Jack Ringwalt for $8.6 million.

Jack was a long-time friend of mine and an excellent, but somewhat eccentric, businessman. For about ten minutes every year he would get the urge to sell his company. But those moods — perhaps brought on by a tiff with regulators or an unfavorable jury verdict — quickly vanished.

In the mid-1960s, I asked investment banker Charlie Heider, a mutual friend of mine and Jack's, to alert me the next time Jack was "in heat." When Charlie's call came, I sped to meet Jack. We made a deal in a few minutes, with me waiving an audit, "due diligence" or anything else that would give Jack an opportunity to reconsider. We just shook hands, and that was that.

When we were due to close the purchase at Charlie's office, Jack was late. Finally arriving, he explained that he had been driving around looking for a parking meter with some unexpired time. That was a magic moment for me. I knew then that Jack was going to be my kind of manager.

When Berkshire purchased Jack's two insurers, they had "float" of $17 million. We've regularly offered a long explanation of float in earlier reports, which you can read on our website. Simply put, float is money we hold that is not ours but which we get to invest.

At the end of 2006, our float had grown to $50.9 billion, and we have since written a huge retroactive reinsurance contract with Equitas — which I will describe in the next section — that boosts float by another $7 billion. Much of the gain we've made has come through our acquisition of other insurers, but we've also had outstanding internal growth, particularly at Ajit Jain's amazing reinsurance operation. Naturally, I had no notion in 1967 that our float would develop as it has. There's much to be said for just putting one foot in front of the other every day.

The float from retroactive reinsurance contracts, of which we have many, automatically drifts down over time. Therefore, it will be difficult for us to increase float in the future unless we make new acquisitions in the insurance field. Whatever its size, however, the all-important *cost* of Berkshire's float over time is likely to be significantly below that of the industry, perhaps even falling to less than zero. Note the words "over time." There will be bad years periodically. You can be sure of that.

In 2006, though, everything went right in insurance — *really* right. Our managers — Tony Nicely (GEICO), Ajit Jain (B-H Reinsurance), Joe Brandon and Tad Montross (General Re), Don Wurster (National Indemnity Primary), Tom Nerney (U.S. Liability), Tim Kenesey (Medical Protective), Rod Eldred (Homestate Companies and Cypress), Sid Ferenc and Steve Menzies (Applied Underwriters), John Kizer (Central States) and Don Towle (Kansas Bankers Surety) — simply shot the lights out. When I recite their names, I feel as if I'm at Cooperstown, reading from the Hall of Fame roster. Of course, the overall insurance industry also had a terrific year in 2006. But our managers delivered results generally superior to those of their competitors.

Below is the tally on our underwriting and float for each major sector of insurance. Enjoy the view, because you won't soon see another like it.

	(in $ millions)			
	Underwriting Profit (Loss)		*Yearend Float*	
Insurance Operations	*2006*	*2005*	*2006*	*2005*
General Re	$ 526	$(334)	$22,827	$22,920
B-H Reinsurance	1,658	(1,069)	16,860	16,233
GEICO	1,314	1,221	7,171	6,692
Other Primary	340**	235*	4,029	3,442
Total	$3,838	$ 53	$50,887	$49,287

* Includes MedPro from June 30, 2005.

** Includes Applied Underwriters from May 19, 2006.

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In 2007, our results from the bread-and-butter lines of insurance will deteriorate, though I think they will remain satisfactory. The big unknown is super-cat insurance. Were the terrible hurricane seasons of 2004-05 aberrations? Or were they our planet's first warning that the climate of the 21st Century will differ materially from what we've seen in the past? If the answer to the second question is yes, 2006 will soon be perceived as a misleading period of calm preceding a series of devastating storms. These could rock the insurance industry. It's naïve to think of Katrina as anything close to a worst-case event.

Neither Ajit Jain, who manages our super-cat operation, nor I know what lies ahead. We do know that it would be a huge mistake to bet that evolving atmospheric changes are benign in their implications for insurers.

Don't think, however, that we have lost our taste for risk. We remain prepared to lose $6 billion in a single event, *if* we have been paid appropriately for assuming that risk. We are not willing, though, to take on even very small exposures at prices that don't reflect our evaluation of loss probabilities. Appropriate prices don't guarantee profits in any given year, but inappropriate prices most certainly guarantee eventual losses. Rates have recently fallen because a flood of capital has entered the super-cat field. We have therefore sharply reduced our wind exposures. Our behavior here parallels that which we employ in financial markets: Be fearful when others are greedy, and be greedy when others are fearful.

Lloyd's, Equitas and Retroactive Reinsurance

Last year — we are getting now to Equitas — Berkshire agreed to enter into a huge retroactive reinsurance contract, a policy that protects an insurer against losses that have already happened, but whose cost is not yet known. I'll give you details of the agreement shortly. But let's first take a journey through insurance history, following the route that led to our deal.

Our tale begins around 1688, when Edward Lloyd opened a small coffee house in London. Though no Starbucks, his shop was destined to achieve worldwide fame because of the commercial activities of its clientele — shipowners, merchants and venturesome British capitalists. As these parties sipped Edward's brew, they began to write contracts transferring the risk of a disaster at sea from the owners of ships and their cargo to the capitalists, who wagered that a given voyage would be completed without incident. These capitalists eventually became known as "underwriters at Lloyd's."

Though many people believe Lloyd's to be an insurance company, that is not the case. It is instead a *place* where many member-insurers transact business, just as they did centuries ago.

Over time, the underwriters solicited passive investors to join in syndicates. Additionally, the business broadened beyond marine risks into every imaginable form of insurance, including exotic coverages that spread the fame of Lloyd's far and wide. The underwriters left the coffee house, found grander quarters and formalized some rules of association. And those persons who passively backed the underwriters became known as "names."

Eventually, the names came to include many thousands of people from around the world, who joined expecting to pick up some extra change without effort or serious risk. True, prospective names were always solemnly told that they would have unlimited and everlasting liability for the consequences of their syndicate's underwriting — "down to the last cufflink," as the quaint description went. But that warning came to be viewed as perfunctory. Three hundred years of retained cufflinks acted as a powerful sedative to the names poised to sign up.

Then came asbestos. When its prospective costs were added to the tidal wave of environmental and product claims that surfaced in the 1980s, Lloyd's began to implode. Policies written decades earlier — and largely forgotten about — were developing huge losses. No one could intelligently estimate their total, but it was certain to be many tens of billions of dollars. The specter of unending and unlimited losses terrified existing names and scared away prospects. Many names opted for bankruptcy; some even chose suicide.

From these shambles, there came a desperate effort to resuscitate Lloyd's. In 1996, the powers that be at the institution allotted £11.1 billion to a new company, Equitas, and made it responsible for paying all claims on policies written before 1993. In effect, this plan pooled the misery of the many syndicates in trouble. Of course, the money allotted could prove to be insufficient — and if that happened, the names remained liable for the shortfall.

But the new plan, by concentrating all of the liabilities in one place, had the advantage of eliminating much of the costly intramural squabbling that went on among syndicates. Moreover, the pooling allowed claims evaluation, negotiation and litigation to be handled more intelligently than had been the case previously. Equitas embraced Ben Franklin's thinking: "We must all hang together, or assuredly we shall hang separately."

From the start, many people predicted Equitas would eventually fail. But as Ajit and I reviewed the facts in the spring of 2006 — 13 years after the last exposed policy had been written and after the payment of £11.3 billion in claims — we concluded that the patient was likely to survive. And so we decided to offer a huge reinsurance policy to Equitas.

Because plenty of imponderables continue to exist, Berkshire could not provide Equitas, and its 27,972 names, unlimited protection. But we said — and I'm simplifying — that if Equitas would give us $7.12 billion in cash and securities (this is the float I spoke about), we would pay all of its future claims and expenses up to $13.9 billion. That amount was $5.7 billion above what Equitas had recently guessed its ultimate liabilities to be. Thus the names received a huge — and almost certainly sufficient — amount of future protection against unpleasant surprises. Indeed the protection is so large that Equitas plans a cash payment to its thousands of names, an event few of them had ever dreamed possible.

And how will Berkshire fare? That depends on how much “known” claims will end up costing us, how many yet-to-be-presented claims will surface and what they will cost, how soon claim payments will be made and how much we earn on the cash we receive before it must be paid out. Ajit and I think the odds are in our favor. And should we be wrong, Berkshire can handle it.

Scott Moser, the CEO of Equitas, summarized the transaction neatly: “Names wanted to sleep easy at night, and we think we’ve just bought them the world’s best mattress.&ddquo;

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Warning: It’s time to eat your broccoli — I am now going to talk about accounting matters. I owe this to those Berkshire shareholders who love reading about debits and credits. I hope both of you find this discussion helpful. All others can skip this section; there will be no quiz.

Berkshire has done many retroactive transactions — in both number and amount a multiple of such policies entered into by any other insurer. We are the reinsurer of choice for these coverages because the obligations that are transferred to us — for example, lifetime indemnity and medical payments to be made to injured workers — may not be fully satisfied for 50 years or more. No other company can offer the certainty that Berkshire can, in terms of guaranteeing the full and fair settlement of these obligations. This fact is important to the original insurer, policyholders and regulators.

The accounting procedure for retroactive transactions is neither well known nor intuitive. The best way for shareholders to understand it, therefore, is for us to simply lay out the debits and credits. Charlie and I would like to see this done more often. We sometimes encounter accounting footnotes about important transactions that leave us baffled, and we go away suspicious that the reporting company wished it that way. (For example, try comprehending transactions “described” in the old 10-Ks of Enron, even after you *know* how the movie ended.)

So let us summarize our accounting for the Equitas transaction. The major debits will be to Cash and Investments, Reinsurance Recoverable, and Deferred Charges for Reinsurance Assumed (“DCRA”). The major credit will be to Reserve for Losses and Loss Adjustment Expense. No profit or loss will be recorded at the inception of the transaction, but underwriting losses will thereafter be incurred annually as the DCRA asset is amortized downward. The amount of the annual amortization charge will be primarily determined by how our end-of-the-year estimates as to the timing and amount of future loss payments compare to the estimates made at the beginning of the year. Eventually, when the last claim has been paid, the DCRA account will be reduced to zero. That day is 50 years or more away.

What’s important to remember is that retroactive insurance contracts always produce underwriting losses for us. Whether these losses are worth experiencing depends on whether the cash we have received produces investment income that exceeds the losses. Recently our DCRA charges have annually delivered $300 million or so of underwriting losses, which have been more than offset by the income we have realized through use of the cash we received as a premium. Absent new retroactive contracts, the amount of the annual charge would normally decline over time. After the Equitas transaction, however, the annual DCRA cost will initially increase to about $450 million a year. This means that our other insurance operations must generate at least that much underwriting gain for our overall float to be cost-free. That amount is quite a hurdle but one that I believe we will clear in many, if not most, years.

Aren’t you glad that I promised you there would be no quiz?

Manufacturing, Service and Retailing Operations

Our activities in this part of Berkshire cover the waterfront. Let’s look, though, at a summary balance sheet and earnings statement for the entire group.

Balance Sheet 12/31/06 (in millions)

Assets		*Liabilities and Equity*	
Cash and equivalents	$ 1,543	Notes payable	$ 1,468
Accounts and notes receivable	3,793	Other current liabilities	6,635
Inventory	5,257	Total current liabilities	8,103
Other current assets	363		
Total current assets	10,956		
Goodwill and other intangibles	13,314	Deferred taxes	540
Fixed assets	8,934	Term debt and other liabilities	3,014
Other assets	1,168	Equity	22,715
	$34,372		$34,372

Earnings Statement (in millions)

	2006	*2005*	*2004*
Revenues	$52,660	$46,896	$44,142
Operating expenses (including depreciation of $823 in 2006, $699 in 2005 and $676 in 2004)	49,002	44,190	41,604
Interest expense	132	83	57
Pre-tax earnings	3,526*	2,623*	2,481*
Income taxes and minority interests	1,395	977	941
Net income	$ 2,131	$ 1,646	$ 1,540

*Does not include purchase-accounting adjustments.

This motley group, which sells products ranging from lollipops to motor homes, earned a pleasing 25% on average tangible net worth last year. It's noteworthy also that these operations used only minor financial leverage in achieving that return. Clearly we own some terrific businesses. We purchased many of them, however, at large premiums to net worth — a point reflected in the goodwill item shown on the balance sheet — and that fact reduces the earnings on our average *carrying* value to 10.8%.

Here are a few newsworthy items about companies in this sector:

- Bob Shaw, a remarkable entrepreneur who from a standing start built Shaw Industries into the country's largest carpet producer, elected last year, at age 75, to retire. To succeed him, Bob recommended Vance Bell, a 31-year veteran at Shaw, and Bob, as usual, made the right call. Weakness in housing has caused the carpet business to slow. Shaw, however, remains a powerhouse and a major contributor to Berkshire's earnings.

- MiTek, a manufacturer of connectors for roof trusses at the time we purchased it in 2001, is developing into a mini-conglomerate. At the rate it is growing, in fact, "mini" may soon be inappropriate. In purchasing MiTek for $420 million, we lent the company $200 million at 9% and bought $198 million of stock, priced at $10,000 per share. Additionally, 55 employees bought 2,200 shares for $22 million. Each employee paid *exactly* the same price that we did, in most cases borrowing money to do so.

  And are they ever glad they did! Five years later, MiTek's sales have tripled and the stock is valued at $71,699 per share. Despite its making 14 acquisitions, at a cost of $291 million, MiTek has paid off its debt to Berkshire and holds $35 million of cash. We celebrated the fifth anniversary of our purchase with a party in July. I told the group that it would be embarrassing if MiTek's stock price soared beyond that of Berkshire "A" shares. Don't be surprised, however, if that happens (though Charlie and I will try to make our shares a moving target).

- Not all of our businesses are destined to increase profits. When an industry's underlying economics are crumbling, talented management may slow the rate of decline. Eventually, though, eroding fundamentals will overwhelm managerial brilliance. (As a wise friend told me long ago, "If you want to get a reputation as a good businessman, be sure to get into a good business.") And fundamentals are definitely eroding in the newspaper industry, a trend that has caused the profits of our Buffalo News to decline. The skid will almost certainly continue.

  When Charlie and I were young, the newspaper business was as easy a way to make huge returns as existed in America. As one not-too-bright publisher famously said, "I owe my fortune to two great American institutions: monopoly and nepotism." No paper in a one-paper city, however bad the product or however inept the management, could avoid gushing profits.

  The industry's staggering returns could be simply explained. For most of the 20th Century, newspapers were the primary source of information for the American public. Whether the subject was sports, finance, or politics, newspapers reigned supreme. Just as important, their ads were the easiest way to find job opportunities or to learn the price of groceries at your town's supermarkets.

The great majority of families therefore felt the need for a paper every day, but understandably most didn't wish to pay for two. Advertisers preferred the paper with the most circulation, and readers tended to want the paper with the most ads and news pages. This circularity led to a law of the newspaper jungle: Survival of the Fattest.

Thus, when two or more papers existed in a major city (which was almost universally the case a century ago), the one that pulled ahead usually emerged as the stand-alone winner. After competition disappeared, the paper's pricing power in both advertising and circulation was unleashed. Typically, rates for both advertisers and readers would be raised annually — and the profits rolled in. For owners this was economic heaven. (Interestingly, though papers regularly — and often in a disapproving way — reported on the profitability of, say, the auto or steel industries, they never enlightened readers about their own Midas-like situation. Hmmm . . .)

As long ago as my 1991 letter to shareholders, I nonetheless asserted that this insulated world was changing, writing that "the media businesses . . . will prove considerably less marvelous than I, the industry, or lenders thought would be the case only a few years ago." Some publishers took umbrage at both this remark and other warnings from me that followed. Newspaper properties, moreover, continued to sell as if they were indestructible slot machines. In fact, many intelligent newspaper executives who regularly chronicled and analyzed important worldwide events were either blind or indifferent to what was going on under their noses.

Now, however, almost all newspaper owners realize that they are constantly losing ground in the battle for eyeballs. Simply put, if cable and satellite broadcasting, as well as the internet, had come along first, newspapers as we know them probably would never have existed.

In Berkshire's world, Stan Lipsey does a terrific job running the Buffalo News, and I am enormously proud of its editor, Margaret Sullivan. The

News' penetration of its market is the highest among that of this country's large newspapers. We also do better financially than most metropolitan newspapers, even though Buffalo's population and business trends are not good. Nevertheless, this operation faces unrelenting pressures that will cause profit margins to slide.

True, we have the leading online news operation in Buffalo, and it will continue to attract more viewers and ads. However, the economic potential of a newspaper internet site — given the many alternative sources of information and entertainment that are free and only a click away — is at best a small fraction of that existing in the past for a print newspaper facing no competition.

For a local resident, ownership of a city's paper, like ownership of a sports team, still produces instant prominence. With it typically comes power and influence. These are ruboffs that appeal to many people with money. Beyond that, civic-minded, wealthy individuals may feel that local ownership will serve their community well. That's why Peter Kiewit bought the Omaha paper more than 40 years ago.

We are likely therefore to see non-economic individual buyers of newspapers emerge, just as we have seen such buyers acquire major sports franchises. Aspiring press lords should be careful, however: There's no rule that says a newspaper's revenues can't fall below its expenses and that losses can't mushroom. Fixed costs are high in the newspaper business, and that's bad news when unit volume heads south. As the importance of newspapers diminishes, moreover, the "psychic" value of possessing one will wane, whereas owning a sports franchise will likely retain its cachet.

Unless we face an irreversible cash drain, we will stick with the News, just as we've said that we would. (Read economic principle 11, on page 76.) Charlie and I love newspapers — we each read five a day — and believe that a free and energetic press is a key ingredient for maintaining a great democracy. We hope that some combination of print and online will ward off economic doomsday for newspapers, and we will work hard in Buffalo to develop a sustainable business model. I think we will be successful. But the days of lush profits from our newspaper are over.

- A *much* improved situation is emerging at NetJets, which sells and manages fractionally-owned aircraft. This company has never had a problem growing: Revenues from flight operations have increased 596% since our purchase in 1998. But profits had been erratic.

  Our move to Europe, which began in 1996, was particularly expensive. After five years of operation there, we had acquired only 80 customers. And by mid-year 2006 our cumulative pretax loss had risen to $212 million. But European demand has now exploded, with a net of 589 customers having been added in 2005-2006. Under Mark Booth's brilliant leadership, NetJets is now operating profitably in Europe, and we expect the positive trend to continue.

  Our U.S. operation also had a good year in 2006, which led to worldwide pre-tax earnings of $143 million at NetJets last year. We made this profit even though we suffered a loss of $19 million in the first quarter.

  Credit Rich Santulli, along with Mark, for this turnaround. Rich, like many of our managers, has no financial need to work. But you'd never know it. He's absolutely tireless — monitoring operations, making sales, and traveling the globe to constantly widen the already-enormous lead that NetJets enjoys over its competitors. Today, the value of the fleet we manage is far greater than that managed by our three largest competitors *combined*.

  There's a reason NetJets is the runaway leader: It offers the ultimate in safety and service. At Berkshire, and at a number of our subsidiaries, NetJets aircraft are an indispensable business tool. I also have a contract for personal use with NetJets and so do members of my family and most Berkshire directors. (None of us, I should add, gets a discount.) Once you've flown NetJets, returning to commercial flights is like going back to holding hands.

Regulated Utility Business

Berkshire has an 86.6% (fully diluted) interest in MidAmerican Energy Holdings, which owns a wide variety of utility operations. The largest of these are (1) Yorkshire Electricity and Northern Electric, whose 3.7 million electric customers make it the third largest distributor of electricity in the U.K.; (2) MidAmerican Energy, which serves 706,000 electric customers, primarily in Iowa; (3) Pacific Power and Rocky Mountain Power, serving about 1.7 million electric customers in six western states; and (4) Kern River and Northern Natural pipelines, which carry about 8% of the natural gas consumed in the U.S.

Our partners in ownership of MidAmerican are Walter Scott, and its two terrific managers, Dave Sokol and Greg Abel. It's unimportant how many votes each party has; we will make major moves only when we are unanimous in thinking them wise. Six years of working with Dave, Greg and Walter have underscored my original belief: Berkshire couldn't have better partners.

Somewhat incongruously, MidAmerican owns the second largest real estate brokerage firm in the U.S., HomeServices of America. This company operates through 20 locally-branded firms with 20,300 agents. Despite HomeServices' purchase of two operations last year, the company's overall volume fell 9% to $58 billion, and profits fell 50%.

The slowdown in residential real estate activity stems in part from the weakened lending practices of recent years. The "optional" contracts and "teaser" rates that have been popular have allowed borrowers to make payments in the early years of their mortgages that fall far short of covering normal interest costs. Naturally, there are few defaults when virtually nothing is required of a borrower. As a cynic has said, "A rolling loan gathers no loss." But payments *not* made add to principal, and borrowers who can't afford normal monthly payments early on are hit later with *above-normal* monthly obligations. This is the Scarlett O'Hara scenario: "I'll think about that tomorrow." For many home owners, "tomorrow" has now arrived. Consequently there is a huge overhang of offerings in several of HomeServices' markets.

Nevertheless, we will be seeking to purchase additional brokerage operations. A decade from now, HomeServices will almost certainly be much larger.

Here are some key figures on MidAmerican's operations:

	Earnings (in $ millions)	
	2006	2005
U.K. utilities	$ 338	$ 308
Iowa utility	348	288
Western utilities (acquired March 21, 2006)	356	N/A
Pipelines	376	309
HomeServices	74	148
Other (net)	226	115
Earnings before corporate interest and taxes	1,718	1,168
Interest, other than to Berkshire	(261)	(200)
Interest on Berkshire junior debt	(134)	(157)
Income tax	(407)	(248)
Net earnings	$ 916	$ 563
Earnings applicable to Berkshire*	$ 885	$ 523
Debt owed to others	16,946	10,296
Debt owed to Berkshire	1,055	1,289

*Includes interest earned by Berkshire (net of related income taxes) of $87 in 2006 and $102 in 2005.

Finance and Financial Products

You will be happy to hear — and I'm even happier — that this will be my last discussion of the losses at Gen Re's derivative operation. When we started to wind this business down early in 2002, we had 23,218 contracts outstanding. Now we have 197. Our cumulative pre-tax loss from this operation totals $409 million, but only $5 million occurred in 2006. Charlie says that if we had properly classified the $409 million on our 2001 balance sheet, it would have been labeled "Good Until Reached For." In any event, a Shakespearean thought — slightly modified — seems appropriate for the tombstone of this derivative business: "All's well that ends."

We've also wound up our investment in Value Capital. So earnings or losses from these two lines of business are making their final appearance in the table that annually appears in this section.

Clayton Homes remains an anomaly in the manufactured-housing industry, which last year recorded its lowest unit sales since 1962. Indeed, the industry's volume last year was only about one-third that of 1999. Outside of Clayton, I doubt if the industry, overall, made *any* money in 2006.

Yet Clayton earned $513 million pre-tax and paid Berkshire an additional $86 million as a fee for our obtaining the funds to finance Clayton's $10 billion portfolio of installment receivables. Berkshire's financial strength has clearly been of huge help to Clayton. But the driving force behind the company's success is Kevin Clayton. Kevin knows the business forward and backward, is a rational decision-maker and a joy to work with. Because of acquisitions, Clayton now employs 14,787 people, compared to 6,661 at the time of our purchase.

We have two leasing operations: CORT (furniture), run by Paul Arnold, and XTRA (truck trailers), run by Bill Franz. CORT's earnings improved significantly last year, and XTRA's remained at the high level attained in 2005. We continue to look for tuck-in acquisitions to be run by Paul or Bill, and also are open to ideas for new leasing opportunities.

Here's a breakdown of earnings in this sector:

	(in millions)			
	Pre-Tax Earnings		*Interest-Bearing Liabilities*	
	2006	*2005*	*2006*	*2005*
Trading – ordinary income	$ 274	$ 200	$ 600	$1,061
Gen Re Securities (loss)	(5)	(104)	1,204*	2,617*
Life and annuity operation	29	11	2,459	2,461
Value Capital (loss)	6	(33)	N/A	N/A
Leasing operations	182	173	261	370
Manufactured-housing finance (Clayton)	513	416	10,498	9,299
Other	158	159	N/A	N/A
Income before capital gains	1,157	822		
Trading – capital gains (losses)	938	(234)		
Total	$ 2,095	$ 588		

*Includes all liabilities

Investments

We show below our common stock investments. With two exceptions, those that had a market value of more than $700 million at the end of 2006 are itemized. We don't itemize the two securities referred to, which have a market value of $1.9 billion, because we continue to buy them. I could, of course, tell you their names. But then I would have to kill you.

			12/31/06	
Shares	*Company*	*Percentage of Company Owned*	*Cost**	*Market*
			(in millions)	
151,610,700	American Express Company	12.6	$ 1,287	$ 9,198
36,417,400	Anheuser-Busch Cos., Inc.	4.7	1,761	1,792
200,000,000	The Coca-Cola Company	8.6	1,299	9,650
17,938,100	Conoco Phillips	1.1	1,066	1,291
21,334,900	Johnson & Johnson	0.7	1,250	1,409
6,708,760	M&T Bank Corporation	6.1	103	820
48,000,000	Moody's Corporation	17.2	499	3,315
2,338,961,000	PetroChina "H" shares (or equivalents)	1.3	488	3,313
3,486,006	POSCO	4.0	572	1,158
100,000,000	The Procter & Gamble Company	3.2	940	6,427
229,707,000	Tesco	2.9	1,340	1,820
31,033,800	US Bancorp	1.8	969	1,123
17,072,192	USG Corp	19.0	536	936
19,944,300	Wal-Mart Stores, Inc.	0.5	942	921
1,727,765	The Washington Post Company	18.0	11	1,288
218,169,300	Wells Fargo & Company	6.5	3,697	7,758
1,724,200	White Mountains Insurance	16.0	369	999
	Others		5,866	8,315
	Total Common Stocks		$22,995	$61,533

*This is our actual purchase price and also our tax basis; GAAP "cost" differs in a few cases because of write-ups or write-downs that have been required.

We are delighted by the 2006 business performance of virtually all of our investees. Last year, we told you that our expectation was that these companies, in aggregate, would increase their earnings by 6% to 8% annually, a rate that would double their earnings every ten years or so. In 2006 American Express, Coca-Cola, Procter & Gamble and Wells Fargo, our largest holdings, increased per-share earnings by 18%, 9%, 8% and 11%. These are stellar results, and we thank their CEOs.

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We've come close to eliminating our direct foreign-exchange position, from which we realized about $186 million in pre-tax profits in 2006 (earnings that were included in the Finance and Financial Products table shown earlier). That brought our total gain since inception of this position in 2002 to $2.2 billion. Here's a breakdown by currency:

Total Gain (Loss) in Millions

Australian dollar	$247.1	Mexican peso	$106.1
British pound	287.2	New Zealand dollar	102.6
Canadian dollar	398.3	Singapore dollar	(2.6)
Chinese yuan	(12.7)	South Korean won	261.3
Euro	839.2	Swiss franc	9.6
Hong Kong dollar	(2.5)	Taiwan dollar	(45.3)
Japanese yen	1.9	Miscellaneous options	22.9

We've made large indirect currency profits as well, though I've never tallied the precise amount. For example, in 2002-2003 we spent about $82 million buying — of all things — Enron bonds, some of which were denominated in Euros. Already we've received distributions of $179 million from these bonds, and our remaining stake is worth $173 million. That means our overall gain is $270 million, part of which came from the appreciation of the Euro that took place after our bond purchase.

When we first began making foreign exchange purchases, interest-rate differentials between the

U.S. and most foreign countries favored a direct currency position. But that spread turned negative in 2005. We therefore looked for other ways to gain foreign-currency exposure, such as the ownership of foreign equities or of U.S. stocks with major earnings abroad. The currency factor, we should emphasize, is not dominant in our selection of equities, but is merely one of many considerations.

As our U.S. trade problems worsen, the probability that the dollar will weaken over time continues to be high. I fervently believe in *real* trade — the more the better for both us and the world. We had about $1.44 trillion of this honest-to-God trade in 2006. But the U.S. also had $.76 trillion of *pseudo*-trade last year — imports for which we exchanged no goods or services. (Ponder, for a moment, how commentators would describe the situation if our imports were $.76 trillion — a full 6% of GDP — and we had *no* exports.) Making these purchases that weren't reciprocated by sales, the U.S. necessarily transferred ownership of its assets or IOUs to the rest of the world. Like a very wealthy but self-indulgent family, we peeled off a bit of what we owned in order to consume more than we produced.

The U.S. can do a lot of this because we are an extraordinarily rich country that has behaved responsibly in the past. The world is therefore willing to accept our bonds, real estate, stocks and businesses. And we have a vast store of these to hand over.

These transfers will have consequences, however. Already the prediction I made last year about one fall-out from our spending binge has come true: The "investment income" account of our country — positive in every previous year since *1915* — turned negative in 2006. Foreigners now earn more on their

U.S. investments than we do on our investments abroad. In effect, we've used up our bank account and turned to our credit card. And, like everyone who gets in hock, the U.S. will now experience "reverse compounding" as we pay ever-increasing amounts of interest on interest.

I want to emphasize that even though our course is unwise, Americans will live better ten or twenty years from now than they do today. Per-capita wealth will increase. But our citizens will also be forced every year to ship a significant portion of their current production abroad merely to service the cost of our huge debtor position. It won't be pleasant to work part of each day to pay for the over-consumption of your ancestors. I believe that at some point in the future U.S. workers and voters will find this annual "tribute" so onerous that there will be a severe political backlash. How that will play out in markets is impossible to predict — but to expect a "soft landing" seems like wishful thinking.

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I should mention that all of the direct currency profits we have realized have come from forward contracts, which are derivatives, and that we have entered into other types of derivatives contracts as well. That may seem odd, since you know of our expensive experience in unwinding the derivatives book at Gen Re and also have heard me talk of the systemic problems that could result from the enormous growth in the use of derivatives. Why, you may wonder, are we fooling around with such potentially toxic material?

The answer is that derivatives, just like stocks and bonds, are sometimes wildly mispriced. For many years, accordingly, we have selectively written derivative contracts — few in number but sometimes for large dollar amounts. We currently have 62 contracts outstanding. I manage them personally, and they are free of counterparty credit risk. So far, these derivative contracts have worked out well for us, producing pre-tax profits in the hundreds of millions of dollars (above and beyond the gains I've itemized from forward foreign-exchange contracts). Though we will experience losses from time to time, we are likely to continue to earn — overall — significant profits from mispriced derivatives.

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I have told you that Berkshire has three outstanding candidates to replace me as CEO and that the Board knows exactly who should take over if I should die tonight. Each of the three is much younger than

I. The directors believe it's important that my successor have the prospect of a long tenure.

Frankly, we are not as well-prepared on the investment side of our business. There's a history here: At one time, Charlie was my potential replacement for investing, and more recently Lou Simpson has filled that slot. Lou is a top-notch investor with an outstanding long-term record of managing GEICO's equity portfolio. But he is only six years younger than I. If I were to die soon, he would fill in magnificently for a short period. For the long-term, though, we need a different answer.

At our October board meeting, we discussed that subject fully. And we emerged with a plan, which I will carry out with the help of Charlie and Lou.

Under this plan, I intend to hire a younger man or woman with the potential to manage a very large portfolio, who we hope will succeed me as Berkshire's chief investment officer when the need for someone to do that arises. As part of the selection process, we may in fact take on several candidates.

Picking the right person(s) will not be an easy task. It's not hard, of course, to find smart people, among them individuals who have impressive investment records. But there is far more to successful long-term investing than brains and performance that has recently been good.

Over time, markets will do extraordinary, even bizarre, things. A single, big mistake could wipe out a long string of successes. We therefore need someone genetically programmed to recognize and avoid serious risks, *including those never before encountered*. Certain perils that lurk in investment strategies cannot be spotted by use of the models commonly employed today by financial institutions.

Temperament is also important. Independent thinking, emotional stability, and a keen understanding of both human and institutional behavior is vital to long-term investment success. I've seen a lot of very smart people who have lacked these virtues.

Finally, we have a special problem to consider: our ability to keep the person we hire. Being able to list Berkshire on a resume would materially enhance the marketability of an investment manager. We will need, therefore, to be sure we can retain our choice, even though he or she could leave and make much more money elsewhere.

There are surely people who fit what we need, but they may be hard to identify. In 1979, Jack Byrne and I felt we had found such a person in Lou Simpson. We then made an arrangement with him whereby he would be paid well for sustained overperformance. Under this deal, he has earned large amounts. Lou, however, could have left us long ago to manage far greater sums on more advantageous terms. If money alone had been the object, that's exactly what he would have done. But Lou never considered such a move. We need to find a younger person or two made of the same stuff.

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The good news: At 76, I feel terrific and, according to all measurable indicators, am in excellent health. It's amazing what Cherry Coke and hamburgers will do for a fellow.

Some Changes on Berkshire's Board

The composition of our board will change in two ways this spring. One change will involve the Chace family, which has been connected to Berkshire and its predecessor companies for more than a century. In 1929, the first Malcolm G. Chace played an important role in merging four New England textile operations into Berkshire Fine Spinning Associates. That company merged with Hathaway Manufacturing in 1955 to form Berkshire Hathaway, and Malcolm G. Chace, Jr. became its chairman.

Early in 1965, Malcolm arranged for Buffett Partnership Ltd. to buy a key block of Berkshire shares and welcomed us as the new controlling shareholder of the company. Malcolm continued as non-executive chairman until 1969. He was both a wonderful gentleman and helpful partner.

That description also fits his son, Malcolm "Kim" Chace, who succeeded his father on Berkshire's board in 1992. But last year Kim, now actively and successfully running a community bank that he founded in 1996, suggested that we find a younger person to replace him on our board. We have done so, and Kim will step down as a director at the annual meeting. I owe much to the Chaces and wish to thank Kim for his many years of service to Berkshire.

In selecting a new director, we were guided by our long-standing criteria, which are that board members be owner-oriented, business-savvy, interested and truly independent. I say "truly" because many directors who are now deemed independent by various authorities and observers are far from that, relying heavily as they do on directors' fees to maintain their standard of living. These payments, which come in many forms, often range between $150,000 and $250,000 annually, compensation that may approach or even exceed all other income of the "independent" director. And — surprise, surprise — director compensation has soared in recent years, pushed up by recommendations from corporate America's favorite consultant, Ratchet,

Ratchet and Bingo. (The name may be phony, but the action it conveys is not.)

Charlie and I believe our four criteria are essential if directors are to do their job — which, by law, is to faithfully represent *owners*. Yet these criteria are usually ignored. Instead, consultants and CEOs seeking board candidates will often say, "We're looking for a woman," or "a Hispanic," or "someone from abroad," or what have you. It sometimes sounds as if the mission is to stock Noah's ark. Over the years I've been queried many times about potential directors and have yet to hear *anyone* ask, "Does he think like an intelligent owner?"

The questions I instead get would sound ridiculous to someone seeking candidates for, say, a football team, or an arbitration panel or a military command. In those cases, the selectors would look for people who had the specific talents and attitudes that were required for a specialized job. At Berkshire, we are in the specialized activity of running a business well, and therefore we seek *business* judgment.

That's exactly what we've found in Susan Decker, CFO of Yahoo!, who will join our board at the annual meeting. We are lucky to have her: She scores very high on our four criteria and additionally, at 44, is young — an attribute, as you may have noticed, that your Chairman has long lacked. We will seek more young directors in the future, but never by slighting the four qualities that we insist upon.

This and That

Berkshire will pay about $4.4 billion in federal income tax on its 2006 earnings. In its last fiscal year the U.S. Government spent $2.6 trillion, or about $7 billion per day. Thus, for more than half of one day, Berkshire picked up the tab for *all* federal expenditures, ranging from Social Security and Medicare payments to the cost of our armed services. Had there been only 600 taxpayers like Berkshire, no one else in America would have needed to pay *any* federal income or payroll taxes.

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Our federal return last year, we should add, ran to 9,386 pages. To handle this filing, state and foreign tax returns, a myriad of SEC requirements, and all of the other matters involved in running Berkshire, we have gone all the way up to 19 employees at World Headquarters.

This crew occupies 9,708 square feet of space, and Charlie — at World Headquarters West in Los Angeles — uses another 655 square feet. Our home-office payroll, including benefits and counting both locations, totaled $3,531,978 last year. We're careful when spending your money.

Corporate bigwigs often complain about government spending, criticizing bureaucrats who they say spend taxpayers' money differently from how they would if it were their own. But sometimes the financial behavior of executives will also vary based on whose wallet is getting depleted. Here's an illustrative tale from my days at Salomon. In the 1980s the company had a barber, Jimmy by name, who came in weekly to give free haircuts to the top brass. A manicurist was also on tap. Then, because of a cost-cutting drive, patrons were told to pay their own way. One top executive (not the CEO) who had previously visited Jimmy weekly went immediately to a once-every-three-weeks schedule.

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Every now and then Charlie and I catch on early to a tide-like trend, one brimming over with commercial promise. For example, though American Airlines (with its "miles") and American Express (with credit card points) are credited as being trailblazers in granting customers "rewards," Charlie and I were far ahead of them in spotting the appeal of this powerful idea. Excited by our insight, the two of us jumped into the reward business way back in 1970 by buying control of a trading stamp operation, Blue Chip Stamps. In that year, Blue Chip had sales of $126 million, and its stamps papered California.

In 1970, indeed, about 60 *billion* of our stamps were licked by savers, pasted into books, and taken to Blue Chip redemption stores. Our catalog of rewards was 116 pages thick and chock full of tantalizing items. When I was told that even certain brothels and mortuaries gave stamps to their patrons, I felt I had finally found a sure thing.

Well, not quite. From the day Charlie and I stepped into the Blue Chip picture, the business went straight downhill. By 1980, sales had fallen to $19.4 million. And, by 1990, sales were bumping along at $1.5 million. No quitter, I redoubled my managerial efforts.

Sales then fell another 98%. Last year, in Berkshire's $98 billion of revenues, all of $25,920 (*no* zeros omitted) came from Blue Chip. Ever hopeful, Charlie and I soldier on.

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I mentioned last year that in my service on 19 corporate boards (not counting Berkshire or other controlled companies), I have been the Typhoid Mary of compensation committees. At only one company was I assigned to comp committee duty, and then I was promptly outvoted on the most crucial decision that we faced. My ostracism has been peculiar, considering that I certainly haven't lacked experience in setting CEO pay. At Berkshire, after all, I am a one-man compensation committee who determines the salaries and incentives for the CEOs of around 40 significant operating businesses.

How much time does this aspect of my job take? Virtually none. How many CEOs have voluntarily left us for other jobs in our 42-year history? Precisely none.

Berkshire employs many different incentive arrangements, with their terms depending on such elements as the economic potential or capital intensity of a CEO's business. Whatever the compensation arrangement, though, I try to keep it both simple and fair.

When we use incentives — and these can be large — they are always tied to the operating results for which a given CEO has authority. We issue no lottery tickets that carry payoffs unrelated to business performance. If a CEO bats .300, he gets paid for being a .300 hitter, even if circumstances outside of his control cause Berkshire to perform poorly. And if he bats .150, he doesn't get a payoff just because the successes of others have enabled Berkshire to prosper mightily. An example: We now own $61 billion of equities at Berkshire, whose value can easily rise or fall by 10% in a given year. Why in the world should the pay of our operating executives be affected by such $6 billion swings, however important the gain or loss may be for shareholders?

You've read loads about CEOs who have received astronomical compensation for mediocre results. Much less well-advertised is the fact that America's CEOs also generally live the good life. Many, it should be emphasized, are exceptionally able, and almost all work far more than 40 hours a week. But they are usually treated like royalty in the process. (And we're certainly going to keep it that way at Berkshire. Though Charlie still favors sackcloth and ashes, I prefer to be spoiled rotten. Berkshire owns The Pampered Chef; our wonderful office group has made me The Pampered Chief.)

CEO perks at one company are quickly copied elsewhere. "All the other kids have one" may seem a thought too juvenile to use as a rationale in the boardroom. But consultants employ precisely this argument, phrased more elegantly of course, when they make recommendations to comp committees.

Irrational and excessive comp practices will not be materially changed by disclosure or by "independent" comp committee members. Indeed, I think it's likely that the reason I was rejected for service on so many comp committees was that I was regarded as *too* independent. Compensation reform will only occur if the largest institutional shareholders — it would only take a few — demand a *fresh* look at the whole system. The consultants' present drill of deftly selecting "peer" companies to compare with their clients will only perpetuate present excesses.

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Last year I arranged for the bulk of my Berkshire holdings to go to five charitable foundations, thus carrying out part of my lifelong plan to eventually use all of my shares for philanthropic purposes. Details of the commitments I made, as well as the rationale for them, are posted on our website, www.berkshirehathaway.com. Taxes, I should note, had nothing to do with my decision or its timing. My federal and state income taxes in 2006 were exactly what they would have been had I not made my first contributions last summer, and the same point will apply to my 2007 contributions.

In my will I've stipulated that the proceeds from all Berkshire shares I still own at death are to be used for philanthropic purposes within ten years after my estate is closed. Because my affairs are not complicated, it should take three years at most for this closing to occur. Adding this 13-year period to my expected lifespan of about 12 years (though, naturally, I'm aiming for more) means that proceeds from *all* of my Berkshire shares will likely be distributed for societal purposes over the next 25 years or so.

I've set this schedule because I want the money to be spent relatively promptly by people I *know* to be capable, vigorous and motivated. These managerial attributes sometimes wane as institutions — particularly those that are exempt from market forces — age. Today, there are terrific people in charge at the five foundations. So at my death, why should they not move with dispatch to judiciously spend the money that remains?

Those people favoring perpetual foundations argue that in the future there will most certainly be large and important societal problems that philanthropy will need to address. I agree. But there will then also be many super-rich individuals and families whose wealth will exceed that of today's Americans and to whom philanthropic organizations can make their case for funding. These funders can *then* judge firsthand which operations have both the vitality and the focus to best address the major societal problems that *then* exist. In this way, a market test of ideas and effectiveness can be applied. Some organizations will deserve major support while others will have outlived their usefulness. Even if the people above ground make their decisions imperfectly, they should be able to allocate funds more rationally than a decedent six feet under will have ordained decades earlier. Wills, of course, can always be rewritten, but it's very unlikely that my thinking will change in a material way.

A few shareholders have expressed concern that sales of Berkshire by the foundations receiving shares will depress the stock. These fears are unwarranted. The annual trading volume of many stocks exceeds 100% of the outstanding shares, but nevertheless these stocks usually sell at prices approximating their intrinsic value. Berkshire also tends to sell at an appropriate price, but with annual volume that is only 15% of shares outstanding. At most, sales by the foundations receiving my shares will add three percentage points to annual trading volume, which will still leave Berkshire with a turnover ratio that is the lowest around.

Overall, Berkshire's business performance will determine the price of our stock, and most of the time it will sell in a zone of reasonableness. It's important that the foundations receive appropriate prices as they periodically sell Berkshire shares, but it's also important that incoming shareholders don't overpay. (See economic principle 14 on page 77.) By both our policies and shareholder communications, Charlie and I will do our best to ensure that Berkshire sells at neither a large discount nor large premium to intrinsic value.

The existence of foundation ownership will in no way influence our board's decisions about dividends, repurchases, or the issuance of shares. We will follow exactly the same rule that has guided us in the past: What action will be likely to deliver the best result for shareholders over time?

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In last year's report I allegorically described the Gotrocks family — a clan that owned all of America's businesses and that counterproductively attempted to increase its investment returns by paying ever-greater commissions and fees to "helpers." Sad to say, the "family" continued its self-destructive ways in 2006.

In part the family persists in this folly because it harbors unrealistic expectations about obtainable returns. Sometimes these delusions are self-serving. For example, private pension plans can temporarily overstate their earnings, and public pension plans can defer the need for increased taxes, by using investment assumptions that are likely to be out of reach. Actuaries and auditors go along with these tactics, and it can be decades before the chickens come home to roost (at which point the CEO or public official who misled the world is apt to be gone).

Meanwhile, Wall Street's Pied Pipers of Performance will have encouraged the futile hopes of the family. The hapless Gotrocks will be assured that they *all* can achieve above-average investment performance — but only by paying ever-higher fees. Call this promise the adult version of Lake Woebegon.

In 2006, promises and fees hit new highs. A flood of money went from institutional investors to the 2-and-20 crowd. For those innocent of this arrangement, let me explain: It's a lopsided system whereby 2% of your *principal* is paid each year to the manager even if he accomplishes nothing — or, for that matter, loses you a bundle — and, additionally, 20% of your profit is paid to him if he succeeds, even if his success is due simply to a rising tide. For example, a manager who achieves a gross return of 10% in a year will keep 3.6 percentage points — two points off the top plus 20% of the residual 8 points — leaving only 6.4 percentage points for his investors. On a $3 billion fund, this 6.4% net "performance" will deliver the manager a cool $108 million. He will receive this bonanza even though an index fund might have returned 15% to investors in the same period and charged them only a token fee.

The inexorable math of this grotesque arrangement is certain to make the Gotrocks family poorer over time than it would have been had it never heard of these "hyper-helpers." Even so, the 2-and-20 action spreads. Its effects bring to mind the old adage: When someone with experience proposes a deal to someone with money, too often the fellow with money ends up with the experience, and the fellow with experience ends up with the money.

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Let me end this section by telling you about one of the good guys of Wall Street, my long-time friend Walter Schloss, who last year turned 90. From 1956 to 2002, Walter managed a remarkably successful investment partnership, from which he took not a dime unless his investors made money. My admiration for Walter, it should be noted, is not based on hindsight. A full fifty years ago, Walter was my sole recommendation to a St. Louis family who wanted an honest and able investment manager.

Walter did not go to business school, or for that matter, college. His office contained one file cabinet in 1956; the number mushroomed to four by 2002. Walter worked without a secretary, clerk or bookkeeper, his only associate being his son, Edwin, a graduate of the North Carolina School of the Arts.

Walter and Edwin never came within a mile of inside information. Indeed, they used "outside" information only sparingly, generally selecting securities by certain simple statistical methods Walter learned while working for Ben Graham. When Walter and Edwin were asked in 1989 by *Outstanding Investors Digest*, "How would you summarize your approach?" Edwin replied, "We try to buy stocks cheap." So much for Modern Portfolio Theory, technical analysis, macroeconomic thoughts and complex algorithms.

Following a strategy that involved no real risk — defined as permanent loss of capital — Walter produced results over his 47 partnership years that dramatically surpassed those of the S&P 500. It's particularly noteworthy that he built this record by investing in about 1,000 securities, mostly of a lackluster type. A few big winners did not account for his success. It's safe to say that had millions of investment managers made trades by a) drawing stock names from a hat; b) purchasing these stocks in comparable amounts when Walter made a purchase; and then c) selling when Walter sold his pick, the *luckiest* of them would not have come close to equaling his record. There is simply *no* possibility that what Walter achieved over 47 years was due to chance.

I first publicly discussed Walter's remarkable record in 1984. At that time "efficient market theory" (EMT) was the centerpiece of investment instruction at most major business schools. This theory, as then most commonly taught, held that the price of any stock at any moment is not demonstrably mispriced, which means that no investor can be *expected* to overperform the stock market averages using only publicly-available information (though some will do so by luck). When I talked about Walter 23 years ago, his record forcefully contradicted this dogma.

And what did members of the academic community do when they were exposed to this new and important evidence? Unfortunately, they reacted in all-too-human fashion: Rather than opening their minds, they closed their eyes. To my knowledge *no* business school teaching EMT made any attempt to study Walter's performance and what it meant for the school's cherished theory.

Instead, the faculties of the schools went merrily on their way presenting EMT as having the certainty of scripture. Typically, a finance instructor who had the nerve to question EMT had about as much chance of major promotion as Galileo had of being named Pope.

Tens of thousands of students were therefore sent out into life believing that on every day the price of every stock was "right" (or, more accurately, not demonstrably wrong) and that attempts to evaluate businesses — that is, stocks — were useless. Walter meanwhile went on overperforming, his job made easier by the misguided instructions that had been given to those young minds. After all, if you are in the shipping business, it's helpful to have all of your potential competitors be taught that the earth is flat.

Maybe it was a good thing for his investors that Walter didn't go to college.

The Annual Meeting

Our meeting this year will be held on Saturday, May 5th. As always, the doors will open at the Qwest Center at 7 a.m., and a new Berkshire movie will be shown at 8:30. At 9:30 we will go directly to the question-and-answer period, which (with a break for lunch at the Qwest's stands) will last until 3:00. Then, after a short recess, Charlie and I will convene the annual meeting at 3:15. If you decide to leave during the day's question periods, please do so while *Charlie* is talking.

The best reason to exit, of course is to *shop*. We will help you do that by filling the 194,300 square foot hall that adjoins the meeting area with the products of Berkshire subsidiaries. Last year, the 24,000 people who came to the meeting did their part, and almost every location racked up record sales. But records are made to be broken, and I know you can do better.

This year we will again showcase a Clayton home (featuring Acme brick, Shaw carpet, Johns Manville insulation, MiTek fasteners, Carefree awnings and NFM furniture). You will find that the home, priced at $139,900, delivers excellent value. Last year, a helper at the Qwest bought one of two homes on display well before we opened the doors to shareholders. Flanking the Clayton home on the exhibition floor this year will be an RV and pontoon boat from Forest River.

GEICO will have a booth staffed by a number of its top counselors from around the country, all of them ready to supply you with auto insurance quotes. In most cases, GEICO will be able to give you a special shareholder discount (usually 8%). This special offer is permitted by 45 of the 50 jurisdictions in which we operate. (One supplemental point: The discount is not additive if you qualify for another, such as that given certain groups.) Bring the details of your existing insurance and check out whether we can save you money. For at least 50% of you, I believe we can. And while you're at it, sign up for the new GEICO credit card. It's the one I now use (sparingly, of course).

On Saturday, at the Omaha airport, we will have the usual array of aircraft from NetJets available for your inspection. Stop by the NetJets booth at the Qwest to learn about viewing these planes. Come to Omaha by bus; leave in your new plane. And take all the hair gel that you wish on board with you.

In the Bookworm's corner of our bazaar, there will be about 25 books and DVDs — all discounted — led again by *Poor Charlie's Almanack.* (One hapless soul last year asked Charlie what he should do if he didn't enjoy the book. Back came a Mungerism: "No problem — just give it to someone more intelligent.") We've added a few titles this year. Among them are *Seeking Wisdom: From Darwin to Munger* by Peter Bevelin, a long-time Swedish shareholder of Berkshire, and Fred Schwed's classic, *Where are the Customers' Yachts?* This book was first published in 1940 and is now in its 4th edition. The funniest book ever written about investing, it lightly delivers many truly important messages on the subject.

An attachment to the proxy material that is enclosed with this report explains how you can obtain the credential you will need for admission to the meeting and other events. As for plane, hotel and car reservations, we have again signed up American Express (800-799-6634) to give you special help. Carol Pedersen, who handles these matters, does a terrific job for us each year, and I thank her for it. Hotel rooms can be hard to find, but work with Carol and you will get one.

At Nebraska Furniture Mart, located on a 77-acre site on 72nd Street between Dodge and Pacific, we will again be having "Berkshire Weekend" discount pricing. We initiated this special event at NFM ten years ago, and sales during the “Weekend” grew from $5.3 million in 1997 to $30 million in 2006. I get goose bumps just thinking about this volume.

To obtain the Berkshire discount, you must make your purchases between Thursday, May 3rd and Monday, May 7th inclusive, and also present your meeting credential. The period’s special pricing will even apply to the products of several prestigious manufacturers that normally have ironclad rules against discounting but which, in the spirit of our shareholder weekend, have made an exception for you. We appreciate their cooperation. NFM is open from 10 a.m. to 9 p.m. Monday through Saturday, and 10 a.m.

to 6 p.m. on Sunday. On Saturday this year, from 5:30 p.m. to 8 p.m., NFM is having a special shareholder picnic featuring chicken and beef tacos (and hamburgers for traditionalists like me).

At a remodeled and expanded Borsheim’s, we will again have two shareholder-only events. The first will be a cocktail reception from 6 p.m. to 10 p.m. on Friday, May 4th. The second, the main gala, will be held on Sunday, May 6th, from 9 a.m. to 4 p.m. On Saturday, we will be open until 6 p.m.

We will have huge crowds at Borsheim’s throughout the weekend. For your convenience, therefore, shareholder prices will be available from Monday, April 30th through Saturday, May 12th. During that period, please identify yourself as a shareholder by presenting your meeting credentials or a brokerage statement that shows you are a Berkshire holder.

On Sunday, in a tent outside of Borsheim’s, a blindfolded Patrick Wolff, twice U.S. chess champion, will take on all comers — who will have their eyes wide open — in groups of six. Last year I carried on a conversation with Patrick while he played in this manner. Nearby, Norman Beck, a remarkable magician from Dallas, will bewilder onlookers. Additionally, we will have Bob Hamman and Sharon Osberg, two of the world’s top bridge experts, available to play bridge with our shareholders on Sunday afternoon.

To add to the Sunday fun at Borsheim’s, Ariel Hsing will play table tennis (ping-pong to the uninitiated) from 1 p.m. to 4 p.m. against anyone brave enough to take her on. Ariel, though only 11, is ranked number one among girls under 16 in the U.S. (and number 1 among both boys and girls under 12). The week I turned 75 I played Ariel, then 9 and barely tall enough to see across the table, thinking I would take it easy on her so as not to crush her young spirit. Instead she crushed me. I've since devised a plan that will give me a chance against her. At 1 p.m. on Sunday, I will initiate play with a *2-point* game against Ariel. If I somehow win the first point, I will then feign injury and claim victory. After this strenuous encounter wears Ariel down, our shareholders can then try their luck against her.

Gorat's will again be open exclusively for Berkshire shareholders on Sunday, May 6th, and will be serving from 4 p.m. until 10 p.m. Please remember that to come to Gorat's on that day, you must have a reservation. To make one, call 402-551-3733 on April 1st (*but not before*).

In the 2006-2007 school year, 35 university classes, including one from IBMEC in Brazil, will come to Omaha for sessions with me. I take almost all — in aggregate, more than 2,000 students — to lunch at Gorat's. And they love it. To learn why, come join us on Sunday.

We will again have a reception at 4 p.m. on Saturday afternoon for shareholders who have come from outside of North America. Every year our meeting draws many people from around the globe, and Charlie and I want to be sure we personally greet those who have come so far. Last year we enjoyed meeting more than 400 of you from many dozens of countries. Any shareholder who comes from other than the U.S. or Canada will be given a special credential and instructions for attending this function.

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Charlie and I are extraordinarily lucky. We were born in America; had terrific parents who saw that we got good educations; have enjoyed wonderful families and great health; and came equipped with a "business" gene that allows us to prosper in a manner hugely disproportionate to other people who contribute as much or more to our society's well-being. Moreover, we have long had jobs that we love, in which we are helped every day in countless ways by talented and cheerful associates. No wonder we tap-dance to work. But nothing is more fun for us than getting together with our shareholder-partners at Berkshire's annual meeting. So join us on May

5th at the Qwest for our annual Woodstock for Capitalists. We'll see you there.

February 28, 2007

Warren E. Buffett
Chairman of the Board