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—GUY SPIER

THE COMPLETE FINANCIAL HISTORY OF Berkshire Hathaway

A Chronological Analysis of Warren Buffett & Charlie Munger's *Conglomerate Masterpiece*

Adam J. Mead

Foreword by CHRISTOPHER P. BLOOMSTRAN

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For Shelly, Abigai l, and Julia

Dedicated to teachers and lifelong learners

About this ebook edition

The hardcover edition of this book includes large data tables. These tables cannot be displayed legibly in ebook format and so they have been removed and placed on brkbook.com , where you are welcome to download a PDF version of these tables.

About the author

Adam J. Mead is a lifelong student of business and capital allocation.

He is the CEO and Chief Investment Officer of Mead Capital Management, LLC, a New Hampshire-based Registered Investment Advisor he founded in 2014.

Adam spent over a decade in banking in commercial credit, including observing first-hand the after-effects of the Great Recession and the long credit expansion afterward.

Adam has been investing in public securities markets since 2004. He owned two small businesses (non-financial) during college, and grew up in a family of small business owners. In addition to managing assets for his clients at Mead Capital, he is involved with numerous local non-profit organizations.

Adam holds a Master of Business Administration from Southern New Hampshire University, from which he graduated Summa Cum Laude in 2013. Previously he graduated Summa Cum Laude from Southern New Hampshire University in 2008 with an undergraduate degree in Business Studies and a Minor in Economics.

A native of Derry, NH for his entire adult lifetime, Adam lives in Derry with his wife Shelly, their two daughters, and their two dogs.

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This book could not have happened without much help, support, encouragement, and luck. First and foremost, I thank Warren Buffett and Charlie Munger, whose business creation is topped only by their genuine skill and passion for teaching. I'm grateful for the many founders, managers, and employees who carefully built each part of Berkshire into what it is today, and for those who will continue its legacy.

I'm lucky to follow in the footsteps of some incredible Berkshire scholars. Not least among them is Lawrence Cunningham, who went above and beyond to find me financial filings at the Library of Congress, in addition to reading an early draft of the manuscript. The staff at the Boston Public Library were incredibly helpful in researching Berkshire's early history. A special thank you to Todd Wheeler for lending me his signed copy of Phil Beuth's *Limping on Water* and recounting the story of his career at Capital Cities/ABC—these provided invaluable insights into the management philosophy of Tom Murphy and Dan Burke. Thank you to Carol Loomis for her early help with this project.

My good friends Andrew Wagner and Carter Johnson provided ideas, support, and guidance throughout the process of crafting Berkshire's history. I'm thankful for Guy Spier's friendship and support—and his reminder of just how special Berkshire's culture is. Chris Bloomstran provided invaluable suggestions and helped me find the right voice to convey Berkshire's long history. Jonathan Brandt suggested improvements to key parts of the manuscript. Marcy, Margaret, and Sarah Hawley, along with John Baskin, provided great ideas and helped me better understand the world of publishing. Jessie Rancourt enthusiastically read a draft of the manuscript and provided excellent feedback. Jeff Annello's detailed critique not only made the book better but helped me clarify its intended audience. Gautam Baid shared his experience writing and publishing *The Joys of Compounding* and encouraged me to paint my own canvas. I'm also thankful for Ron Lazaro's encouragement and keen eye on a later draft of the manuscript.

I wouldn't have found my new friends at Harriman House without Dan Pecaut and Austin Pierce. Craig Pearce at Harriman was a joy to work with

and shared my enthusiasm for bringing the full story of Berkshire Hathaway to life in a first-class way. Chris Parker created a beautiful cover that conveys the feeling of Berkshire in one concise snapshot. The care and devotion of the typesetting work done by Chris Wild shows on every page.

Eric Wing and Leakana Ly at MetroCreate crafted a beautiful companion website at theoraclesclassroom.com . They found ways to bring my particular and exacting ideas to life, which I know wasn't easy.

My editor, Erika Alison Cohen, became a trusted partner and friend along this long journey. Her work can only be fully appreciated next to the raw material I provided her. She proved not only an excellent editor but a patient teacher as well.

Two individuals not directly related to this project deserve attention for their contributions. The first is my high school welding instructor at Pinkerton Academy, Mr. Copp. He taught his students that a weld could be the best and strongest in the world, but if it looked sloppy no one would fully appreciate it. I've used that lesson as a metaphor in every walk of life since leaving his class. I must also thank Gary Vaynerchuk. He doesn't know it yet, but his message of pursuing one's passions with empathy and energy, no matter how small the audience, kept me going to the finish line.

Finally, and most important of all, I thank my wife Shelly. I'm incredibly lucky to have a loving partner who supports my endeavors, even ones that turn out bigger and much longer than originally envisioned. No project of this magnitude could be completed without a trusted companion by one's side to keep the rest of the world in order while pouring heart and soul onto the page.

For all this help, many mistakes and omissions undoubtedly remain. To someone now accustomed to the world of electronic media, a printed book preserving these faults in time is a terrifying prospect. They are mine alone.

Foreword by Christopher Bloomstran

The Library of Congress contains more than 200 volumes devoted to Berkshire Hathaway and the two gentlemen adorning the cover of this book. Add in newspaper and magazine articles, research reports, investment letters, social media messages, and Berkshire's own financial reporting and archives of its annual meetings, and it is safe to conclude that more has been written on the company and the two men running it than on any other business over the past three decades, perhaps over all time. The question must therefore be asked, "Why another book?"

I know I speak for countless others when I say Warren Buffett and Charlie Munger are my mentors—not in the classic sense, but for having had such a profoundly positive impact on my life as an investor and as a citizen.

It's hard to believe for the quarter-century following 1965, when Mr. Buffett bought control of Berkshire Hathaway, that he and the company were genuinely flying under the radar. Despite having compounded Berkshire's book value per share at 24% and its shares by 28% annually, against only a 10% return for the Standard & Poor's 500 index, Berkshire, Buffett, and Munger were not household names in the late 1980s and early 1990s. Today, of course, Messrs. Buffett and Munger are world-wide rock stars and Berkshire Hathaway is no longer just a company but a cult. Back then, I never heard those names uttered when I studied finance. Outside of the MBA program at Columbia University and a handful of schools with oddball professors, early Berkshire cultists to be sure, these three didn't exist on campuses. Following school, I worked at a large midwestern bank in trust investments. We didn't own or even follow Berkshire. To the old guard it was regarded as, "just an insurance company that's really no more than a leveraged mutual fund." When I studied for the CFA designation in the early 1990s, I only first learned of Berkshire when reading about the efficient market hypothesis and a highly regarded finance academician pointing to the company and to Mr. Buffett as aberrant, lucky anomalies.

In 1996 those aberrant anomalies issued their class "B" shares to the public and I set out to learn about the unusual company that would, on the first

page of the offering document, admonish prospective shareholders that:

- The shares being offered are not undervalued.
- The company will not grow as fast prospectively as in the past.
- The shares in recent years advanced faster than intrinsic value so to expect underperformance.
- The offering size is tailored to meet expected demand so to not expect a quick profit.

Who does this? I found and purchased a copy of the reprinting of the fourth edition of Benjamin Graham's *The Intelligent Investor* , on the cover of which Mr. Buffett claimed, "By far the best book on investing ever written." It is. The copy also contained bonus material, a new introduction and also an appendix, both written by Mr. Buffett. The appendix was an edited transcript of a talk given at Columbia University in 1984 commemorating the fiftieth anniversary of Ben Graham and David Dodd's *Security Analysis* . The speech was titled, "The Superinvestors of Graham-and-Doddsville." In a modern context it would be an "instant classic." As has been the case for so many investors, that was it. I read the entire book that night and read it again the following night. The light had gone on, a common occurrence for those first encountering this Grahamian, Buffett approach for the first time.

From Graham it was immediately on to Berkshire Hathaway. Despite having a research library nearly as large as a basketball court, the bank didn't have any annual reports on the Buffett-led conglomerate. Those were the days when you had to call a company to get reports. The 1993 to 1995 annuals, the three I'd requested, contained the most unusual Chairman's letters, which not only informed but taught. Ben Graham taught. It was obvious that Mr. Buffett modeled his own approach from his mentor and took it upon himself to educate as well, a giving back so contrary to what most would do. In a field as competitive as investments, why give away the secret sauce, the formula for Coca-Cola, when it would be so easy to copy? Back then, one could write to Berkshire's offices in Omaha and the company would mail you a three-volume bound set of Chairman's letters dating back to 1977. I can't recall how many times I've read these letters. Those pages contained pure gold for the young, aspiring investor. Value

investing took on an entirely new meaning. Nowhere else could you learn so logically about accounting (good and bad), valuation, stock-based compensation, corporate governance, the vagaries of inflation and taxes, derivatives as weapons of mass destruction, and the list goes on and on.

I bought shares of Berkshire Hathaway for the first time in February 2000. The stock had fallen by half from 1998 and offered seeming value. How much value I would only appreciate as the years passed (and the position size and my affection for all things Berkshire abounded…). The annual shareholders meeting by then had become a "thing," so off to Omaha as a first-time shareholder that April 29th I went. I've only missed one meeting since, the following year when my firstborn arrived just days prior to the meeting. Every year my understanding accumulated, taking in the wisdom offered so selflessly by the sages on the dais. Some would diligently scribe every word and provide transcripts of the discussion. I owe tremendous thanks to those that did, and so many of you are now great friends. Now the video recordings of these meetings have been graciously provided to CNBC and a wonderful online archive of every meeting back to 1994 is available free of charge and beautifully done. Even at critical moments, often at times of uncertainly or panic, Mr. Buffett would take to *Fortune* magazine and pen articles that put fears to rest or reset expectations. Mr. Munger would host his own annual meetings in Pasadena and Los Angeles for Wesco Financial and more recently the Daily Journal. Transcripts and recordings of the long Berkshire archive abound.

So again, "Why another book?" When you read this monumental effort by Adam Mead, the answer will be obvious. Despite all of the annual reports, all of the letters, all of the books, all of the interviews and annual meetings, none have done what history required. We the investors, the students of capital allocation, history really, needed the complete chronology of Berkshire Hathaway, dating to its days pre-Buffett when the original textile businesses that became today's Berkshire thrived, and then did not. With Mr. Buffett's encouragement, Adam has written the complete *business* and *investment* history of the company, leaving no acquisition, no investment, no cycle uncovered. He assimilated all of the annual reports, meeting transcripts and myriad other information and compacted it into this terrific, readable work. Biographies can be interesting and entertaining, but this detailed history of the greatest company and "Greatest of All Time" investors the world has ever seen was necessary.

The reader should pay special attention to the evolution of Mr. Buffett and of Berkshire. Over time, the business has undergone dramatic change. From the early pivot away from its New England textile origins to insurance, to subsequent well-timed transitions to and away from common stocks, to the outright ownership of businesses, the allocation of capital was brilliant. The book captures an evolving genius and ability to be presciently and invariably ahead of the crowd. It's as though Berkshire became the embodiment of the epigraph introducing *Security Analysis* , from Horace's *Ars Poetica* , "Many shall be restored that now are fallen, and many shall fall that are now in honor."

You will find the book arranged in a manner where information and details can be easily located and referenced. But read cover to cover, both the uninitiated to Berkshire and its most ardent followers will derive enormous utility and satisfaction from it. Privileged to get an early preview of the manuscript, despite my 25 years as a now self-described Berkshire cultist, I learned so many new and important things about Berkshire and its history. It is my pleasure to encourage you to enjoy this gem. I owe so much of my investment career and investing framework to the lessons of Warren Buffett and Charlie Munger. We all owe a heartfelt thanks to Adam Mead for writing the book on Berkshire that needed to be written.

Well done, Adam!

Christopher P. Bloomstran
President and Chief Investment Officer
Semper Augustus Investments Group

Introduction

Saturday, May 5, 2012. Omaha, Nebraska. 5:30 a.m. I am waiting in line to get into the arena for the Berkshire Hathaway Annual Meeting. I am a first-timer. A group of guys from Cincinnati, Ohio, welcomes me into their ritual of charging in to get seats on the floor close to Warren Buffett and Charlie Munger. We charge with the politeness of men in suits and the excitement of teenage girls seeing The Beatles in concert for the first time. I'd just found 40,000 friends who share a love for Berkshire.

On that day, I never could have imagined I'd have the chutzpah (to use a Charlie Munger term) to someday write a book on Berkshire Hathaway. Yet that first meeting was the beginning of a journey that led to what you now hold in your hands. I listened intently to the Oracle of Omaha and the witty Munger for hours and experienced first-hand the 200,000 square-foot exhibition hall which was truly a one-of-a-kind blend of celebration, reunion, trade show, and shopping spree. Dinner at Gorat's that evening with my new companions from Cincinnati solidified friendships which remain to this day. I've attended every Annual Meeting since, including the virtual one in 2020 due to Covid-19, and my friendships with wonderful people from all over the world are now too numerous to count.

Over the years, I've had the great fortune to meet fellow Berkshire shareholders, operating managers, and some directors during the Annual Meeting weekend. Two highlights were shaking Warren's hand during one of his stints working as salesman "Crazy Warren" at Borsheims and shaking the hand of investing great Jack Bogle. The bigger names like Buffett and Bogle garner press beyond the business world. Others like Ron Olson, Irv Blumkin, Tony Nicely, Todd Combs, and Ted Weschler occupy fame within the Berkshire and investing community. Countless others, like Kathy Sorensen at Johns Manville, Gregg Renner at MiTek, and the many managers, employees, and members of the Berkshire home office team, are lesser known but equally critical in creating the fabric that make up Berkshire's culture.

My insatiable curiosity and thirst for everything Berkshire grew as I collected Annual Meeting passes, books about Berkshire, and new friends.

Yet even with the volumes of books written about Berkshire, I found myself pining for something more. I wanted to go deeper than Warren's Chairman's letters and see the numbers that made him so excited about the businesses and Berkshire's future. I wanted to understand the accounting and the reasons why certain acquisitions were made. I wanted to see how the company evolved from a struggling textile company to a respected Fortune 500 company. I wanted to follow its evolution chronologically in one place. Not finding such a volume anywhere, I set out to create it using my knowledge of Berkshire and my skills as a former commercial loan officer and current investment manager. I've long harbored the idea of a project that would take years to complete and perhaps test the limits of my penchant for deferred gratification. Half a decade wasn't my original plan, but here we are …

I formalized my quest in 2016, which took me on a journey digesting over 10,000 pages of written material, including Moody's Manuals on the early Berkshire predecessor companies dating to the 1920s, each Berkshire Hathaway Annual Report from 1955 to 2019 (totaling some 4,000+ pages, including 900+ pages of Chairman's letters), most of Berkshire's 10Ks, and many of the 10Qs. I listened to and read the transcripts of each Annual Meeting from 1994 to 2020 (140+ hours of video and 3,000+ pages), analyzed financial filings and annual reports from subsidiary companies where they were available, read newspaper and magazine accounts, books on subsidiary companies, and of course, the multitude of other works on Berkshire completed over the decades.

The structure of this book follows my deep-seated inclination toward logic and order. The foundation rests on the Annual Reports and, especially during the Buffett years, on the Chairman's letters. The goal was to add to Buffett's analysis of each year and not outdo him, but go deeper and ask why and how. Each decade leads with a financial snapshot including key acquisitions and noteworthy events. Each decade ends with a review of the major events, key lessons, and appendices with detailed financials. In this way, the book is a guide through fifty-five years of history, both in long form and in review. This book is the synthesis of many materials filtered through the mind of one individual. It's not perfect and it is biased. With so many facts, figures, and calculations covering many years it is certain that errors exist. (I'd be grateful to know where I erred; please email me at brkbook@gmail.com .)

The longtime Berkshire shareholder or well-versed student will recognize additional possible shortfalls. When a business conglomerate covers more than five decades, even an exhaustive history requires cutting. What deserves to remain or be eliminated is not an easy task. The calculations in charts could lead to questions, as could information left out. I hope the book provides a single place to satisfy those looking to drink from the firehose that is all the wonderful details of Berkshire Hathaway. Perhaps future editions will include additional information deemed critical, and the true fanatic can (and should) go through as much original source material as possible.

I envision two broad audiences for this book. One is the new student of Berkshire or investing who wants to live through the company's history as it happened, year by year. That individual will gain an incredible appreciation for the process and decisions that transformed a struggling textile company into what it is today. They will better understand how to think about businesses, which will undoubtedly make them better at investing. (To use another Munger-ism, how could it be otherwise?)

The second broad audience is the longtime student or shareholder of Berkshire. For this audience, the book may serve more as a reference guide, a refresher on a particular year or years quickly digestible compared to the full financials. With a chronological layout, the book is compartmentalized to allow easy study of a particular year or decade.

The layout of the chapters may seem an odd choice at first, but there's a logic to it. Using Buffett's arrival in 1965 as the point of origin, I first went back a decade to see what the company looked like between 1955 and 1964. When I sent the first chapter to Warren, he suggested going back even further to examine the brief respite of profitability the predecessor companies experienced during WWII before resuming their economic slide. Having made the jump back in time, I couldn't stop. My curiosity wanted to know where *all* the predecessor companies came from. Thus, the book starts in the eighteenth century and follows the development of the textile industry.

The first chapters examine the rise of the textile industry in New England, from its origins combining proprietary textile manufacturing technology taken from England with seed capital harvested from a declining whaling industry. We see the shift of textile dominance to the South as technology

changed the economics of the industry. We follow the Berkshire predecessor companies through the 1930s and 1940s and see the challenges of the 1930s wipe out a host of textile companies before WWII showers profits on those that remained. Then we see the struggles return as foreign competition slowly begins decimating another once-powerful industry.

The year 1955 conveniently begins the decade Berkshire Fine Spinning Associates and Hathaway Manufacturing merged to create Berkshire Hathaway. Most surprising of all are the capital allocation decisions made by Buffett's predecessors. While Berkshire Hathaway was a business in decline and its managers stubborn, they acted rationally by shrinking the business and returning capital to shareholders. Those actions weren't enough to keep the stock price from falling below a level that attracted a young investment manager who saw a price/value discrepancy to exploit.

We begin in earnest in 1965, the year Buffett gained control of Berkshire and learned how hard it was to make money in textiles. Working capital and physical plant must do the job, not just the market's reevaluation of those assets in relation to the stock price. The textile business would drag down Berkshire's operating results and cause headaches for another twenty years. Yet those challenges provided crucial business lessons. One lesson was that even the most talented management team can't save a business with bad economics. Another was how swiftly capital allocation could shift the fortunes of a company for the better, which in this decade were the two large acquisitions of National Indemnity (1967) and the Illinois National Bank and Trust of Rockford (1969). These bold moves represented 28% and 44% of Berkshire's average equity capital at the time of purchase, respectively. By 1974, Berkshire was well on its way to changing course.

Between 1975 and 1984, Berkshire grew exponentially through acquisitions and investments, most notably the increased investment in and eventual merger with Blue Chip Stamps. With Buffett and Munger in control of Blue Chip, it purchased See's Candies in 1972, began purchasing Wesco in 1973, and acquired *The Buffalo News* in 1977. Berkshire also merged with Diversified Retailing in 1978. This decade is highlighted by Berkshire's entrepreneurial push into insurance and its entry into reinsurance.

Berkshire hits its stride in the 1985–1994 decade. Ajit Jain joins Berkshire and begins building an insurance powerhouse focused squarely on profitability. This is the decade where float swells and investment income

far surpasses any underwriting losses. The leveraged buyout fad of this time allows Berkshire to acquire Scott Fetzer (itself a mini-conglomerate) and Fechheimer. It also provides an opportunity for Berkshire to back Capital Cities in its bid for ABC. Berkshire invests $1.3 billion in Coca-Cola during this decade, a cost basis that remains unchanged today. The decade was also marked by challenges, most notably the Salomon Treasury bid-rigging episode which required nine months of Buffett's time while he worked to rescue Berkshire's $700 million investment and his reputation. Berkshire's investment in USAir nearly collapses, and its investment in footwear quickly deteriorates.

The 1995–2004 decade sees Berkshire build out the framework of its future. The acquisition of the remaining half of GEICO that it didn't already own solidifies its presence in primary insurance, and its acquisition of General Reinsurance brings initial headaches but creates a reinsurance powerhouse. Both moves add to the huge amounts of capital Buffett and Munger can allocate. One outlet for capital is the utilities sector, which provides predictable returns and the ability to invest large sums but with limited upside potential. The boom and subsequent bust of the dot-com wave also creates opportunities for Berkshire to welcome discarded but cash-generating businesses into its protective umbrella.

The 2005–2014 decade—the fifth under Buffett's control—sees additional large non-insurance acquisitions, including a major international one. The Great Recession mid-decade provides Berkshire an opportunity to put large amounts of capital to work in a short period of time. It also tees up the acquisition of Burlington Northern Santa Fe, which expands upon the utility platform acquired the prior decade by adding another large company with regulated investment returns and a place to make big investments. The largest reinsurance deals in history highlight Berkshire's willingness to use its capital strength when opportunities present themselves.

Finally, a half decade period covering 2015–2019 proves Buffett's assertion that Berkshire's incredible past record would weigh on future returns. Over 40% of the change in shareholders' equity between 1965 and 2019 occurred in these five years and proved the power of compounding. Berkshire's rate of return, however, falls to its lowest level in its modern history—a poor result only in comparison to its own record and impressive considering the size of the conglomerate and its conservative balance sheet, including huge

holdings of Treasuries. Berkshire makes several large investments during this period, including a partnership that takes control of Heinz and Kraft Foods. Its $35 billion investment in Apple demonstrates Berkshire's consistent pattern of making concentrated investments. Yet cash continues to build in an economy where private transactions and public equity markets are expensive by historical standards. Berkshire thus increasingly returns capital to shareholders in a series of share repurchases that may be the pattern for the remainder of the decade. The world is given a glimpse into succession with the promotions of Greg Abel and Ajit Jain to Vice Chairmen. Yet Warren Buffett and Charlie Munger, aged 89 and 95 respectively at the end of 2019, show no sign of slowing down.

Taking a step back we see Berkshire Hathaway among the greatest of human achievements. Berkshire's financial outcomes were a result of business mastery, the perfection of a system that cultivated human potential. The capitalist system put in place by America's Founding Fathers and the incredible tailwinds of the mid-twentieth century provided the rich soil to allow the genius of Warren Buffett and Charlie Munger to flourish. The full story of Berkshire Hathaway is worth understanding for what it can teach us about continuing timeless methods of excellence in business and in life.

As long as this book is, I hope to continue to add more to the understanding of Berkshire Hathaway over time. To that end, I have created a website called The Oracles Classroom (www.theoraclesclassroom.com) which contains an Excel file with the financial statements presented in the chapter appendices, an interactive Berkshire timeline, an archive of Berkshire and subsidiary financials, book recommendations, a blog, and more. I look forward to hearing from readers, shareholders, students, and others, as we all continue our journey as students of this remarkable conglomerate and its creators.

Adam Mead
Derry, New Hampshire
November 2020

Chapter 1: Textile Conglomerate

A proper history of Berkshire Hathaway prior to Warren Buffett taking control in 1965 could occupy an entire book unto itself. When we think of the conglomerate that is Berkshire Hathaway today, we think of a widely diverse enterprise spanning a multitude of different industries. The 1965 version was a large textile company comprised of many companies with stories of their own.

The Rise and Fall of an Industry

What gave rise to those textile companies and the industry itself is fascinating and instructive. We must therefore start at the beginning. [1] Samuel Slater brought the first water-powered textile mill to the United States in 1789. Slater snuck out of England [2] with the know-how to build a viable water-powered mill and did so with financial backers in Pawtucket, Rhode Island. [3] By 1809 there were twenty-seven Slater-type mills in New England. [4]

The next major innovation was financial and operational. Francis Cabot Lowell, a wealthy Boston merchant used a joint-stock corporation to create the Boston Manufacturing Company in 1813. He was the first to integrate his mills, the first of which was in Waltham, Massachusetts. It housed all operations needed to turn raw cotton into finished cloth. [5] They were profitable almost immediately. Lowell had thus discovered the optimal combination of size and integration to generate economies of scale out of the cotton mill. Not surprisingly, this innovation spread rapidly.

Having wrested all the power they could out of the Charles River in Waltham, the investors in the Boston Manufacturing Company (sometimes referred to as the Boston Associates) turned their sights on a new location. They chose a site on the Merrimack River in what was East Chelmsford, Massachusetts, and formed the Merrimack Manufacturing Company. [6] In Lowell, the company was more than just mills; it was a company town that by the 1840s had over 8,000 employed. [7] They used the surrounding farmland to build a boardinghouse, churches, company stores, and other

infrastructure for the many workers required to operate the mills. Many of the workers were women.

The next major improvement in textile mill operations came from the Amoskeag Manufacturing Company, formed in the late 1830s in Manchester, New Hampshire, along the Merrimack River. Whereas the Lowell-type mills were individually owned, the Amoskeag mills operated under one corporate umbrella. This allowed for bulk purchasing, sales, and other economies of scale. [8]

Why the North?

The early mills in the United States were thousands of miles from cotton fields, which raises a key question: Why develop the textile industry in the North? In short, the South did not find it immediately economical to do so, and the North had some distinct advantages, at least initially. Two initial Northern advantages were access to capital and a cheap power source.

Availability of capital was possibly the deciding factor as to why the textile industry first took hold in the Northeast. When Francis Cabot Lowell formed the Boston Manufacturing Company, he was already a successful businessman. He and his Boston Associates had access to capital from the whaling business. [9] By the mid-1800s, a large store of capital accumulated during the boom times of whaling was unleashed as whaling declined and the textile business grew. [10]

Other early advantages of the North were geographic. New England has many strong-flowing rivers that unleashed vast amounts of power as they descended to the ocean. [11] These rivers also provided a convenient means of transporting goods to and from the mills. [12] Secondly, the North's proximity to New York City, known as the fashion capital, may also have played a part since the Northeast knew sooner which products were most popular. (After all, information travelled much more slowly then.) [13]

According to *The Decline of a Textile City: A Study of New Bedford* , "the New England region obtained a virtual monopoly" in textiles with 70% of the active spindles in the United States housed there. By 1880, New England boasted more than 80 percent of active spindles. [14] This would prove to be the height of success for New England textile manufacturing—

it would only go down from there. This time also saw increased competition due to the formation of many new textile companies looking to get into the then-prosperous industry. Quick additions to capacity would be the hallmark of the textile industry during good times. It would ultimately lead to depressed prices.

Between the 1880s and the late 1920s, the North slowly lost its supremacy in textile manufacturing. As the economic landscape shifted, early advantages turned into shackles that accelerated the industry decline in the North. A major factor was a slow, grinding technical obsolescence. While the South first found it advantageous to grow the raw material to supply the Northern mills, [15] the South's late entrance allowed it to incorporate newer, more efficient machines such as automatic looms and ring spindles. Owners of northern plants found it hard to justify the new expenditures given their plants' marginal profitability. Over time, the gap between the North and the South widened, hastening the shift South. [16]

The shift away from water-powered plants also hurt the North. The North's strong rivers gave it an advantage over the South in the early days, but the rivers could only provide so much power. The South, by contrast, soon incorporated steam power into its mills, aided by a proximity to coal. When electricity became a viable source of energy to power the mills, the South too had a slight advantage as large electrical power plants were less prevalent in the North.

Other deciding factors favoring the South over the North were lower labor costs (including the effects of unionization) and lower taxes. [17] Later, the addition of air conditioning neutralized the North's advantage over the unbearable heat of the South. [18] The gap was also due to increasing demand for long-fiber cotton from west of the Mississippi, which saw no shipping advantages in the North over the South. [19]

Perhaps because the decline of the North's advantages was slow, it didn't see the long-term trends happening in plain sight. Periods of prosperity occasionally happened, such as during shortages of cotton caused by natural events or war. And when new uses for textiles were found, such as incorporation into billiard balls, tires, conveyor belts, and typewriter ribbons, [20] Northern mills quickly grabbed the business. But as had been the case before, the good times quickly led to bitter competition. By the time

some of the Berkshire Hathaway predecessor companies were merging in 1929, the industry was facing mostly headwinds. The North would try, but fail, to reclaim its dominance in the industry that defined the region for decades. The first step entailed a series of mergers and acquisitions that diminished the sheer number of competitors.

Berkshire Fine Spinning Associates, Inc.

The oldest predecessor company with identifiable direct connections to the Berkshire Hathaway of today is the Valley Falls Company. According to the Woonsocket, Rhode Island, history, [21] the Valley Falls Company was formed by Oliver Chace in 1839. The Chace family built a textile empire that brought prosperity to the villages of Cumberland and Central Falls, Rhode Island, as the family built and expanded its mills along the river.

From there, the history unfolds through a series of companies throughout New England as out lined below.

- 1929: Five companies, including Valley Falls Company, merged to form Berkshire Fine Spinning Associates, Inc. The other four were:
    - Coventry Co., formed in 1864 in Coventry, Rhode Island
    - Greylock Mills, formed in 1880 in Pittsfield, Massachusetts
    - Fort Dummer Mills, formed in 1910 in Brattleboro, Vermont [22]
    - Berkshire Cotton Manufacturing Company, formed in 1889 in Adams, Massachusetts

Berkshire Cotton Manufacturing was the largest of the five, so the new entity was named Berkshire Fine Spinning Associates, Inc. [23]

- 1930: King Philip Mills, formed in 1871 in Fall River, Massachusetts; and Parker Mills, formed in 1895 in Fall River, Massachusetts, merged into Berkshire Fine Spinning. (Parker Mills had merged with Hargraves Mills in 1921 after both Parker and Hargraves fell into financial difficulties. [24])
- 1955: This myriad group of textile mills and companies merged with the Hathaway Manufacturing Company to create Berkshire

Hathaway.

Hathaway Manufacturing Company

The history of the Hathaway side of Berkshire Hathaway is more straightforward. It was formed in 1888 at the height of textile manufacturing in New England; incorporated in 1889 in New Bedford, Massachusetts; and operated independently until the 1955 merger with Berkshire Fine Spinning. Hathaway was formed with $400,000 of initial capital from Horatio Hathaway [25] and several partners looking for their next business venture after the decline of New Bedford's sperm whaling industry, according to filings with the Massachusetts Secretary of State. One of those partners was Hetty Green, the rich heiress to a New Bedford shipping fortune. [26]

1930s

The two Berkshire Hathaway predecessor companies, Berkshire Fine Spinning and Hathaway Manufacturing, operated on parallel tracks throughout the 1930s. They largely faced the same struggles as New England-based textile manufacturers, including the relentless march south and the growing influence of overseas competition.

The Great Depression in the 1930s acutely affected New England textile manufacturers. The mills that had survived that far had largely done so by shifting production away from coarser goods and toward the finer textiles that the South had not yet mastered. The Great Depression softened demand for these higher-priced discretionary fine goods. Many mills saw production of such fine goods fall by over 50%, while volumes of coarser-grade staples fell less than 1%. [27]

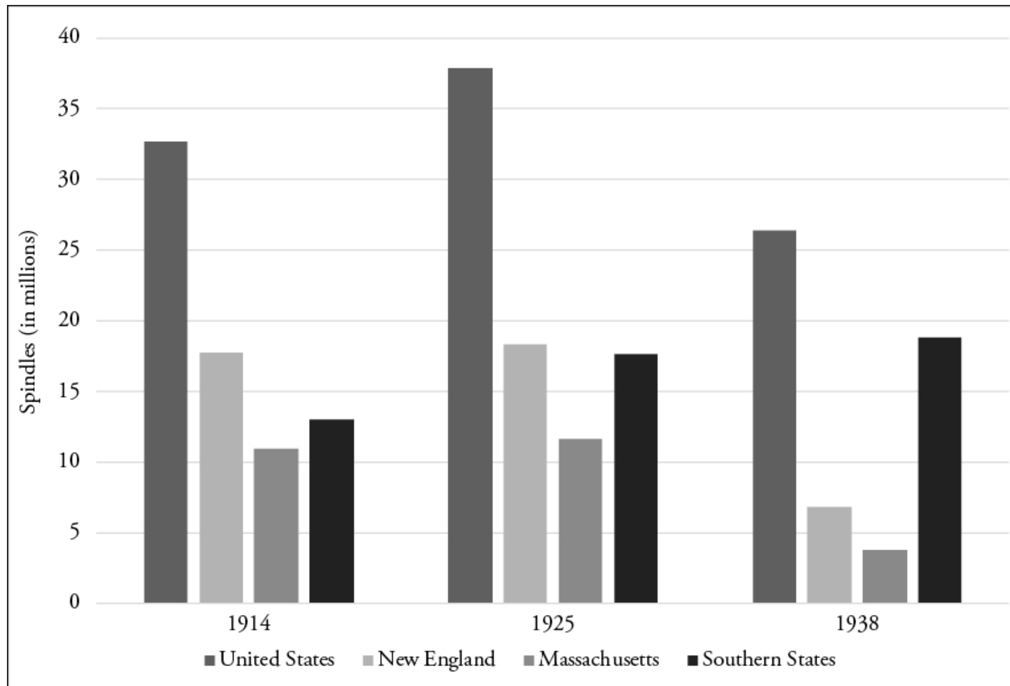
New England mills, including the Berkshire Hathaway predecessor companies, also shifted some production to silk and rayon during the 1930s. These two cotton substitutes were naturally suited for manufacturing in the North, at least initially, due to their similarities to fine-grade cotton. Hathaway Manufacturing shifted to these substitutes earlier, making it and another New Bedford mill that did the same, the Gosnold Mill, the most profitable in the region. [28]

Since material costs for cotton and its substitutes was largely market-driven, mill owners looked to the next largest cost, wages. Workers responded with strikes and walkouts, including the Uprising of ’34 in which a general textile strike impacted the entire industry. While both North and South were affected, the strike was more concentrated in the South. [29]

During the Uprising of ’34, 500,000 mill laborers walked off the job. The North self-interestedly lobbied against working conditions in the South. The South had lower wages and did not have the same restrictions against child labor, working hours, or working conditions that the North had imposed. With the implementation of the Fair Labor Standards Act of 1938, a standard uniform wage nationwide mitigated the labor differential between the North and the South. The North rejoiced, but it was bittersweet since the legislation came too late. As described in *The Decline of a Textile City: A Study of New Bedford* , the new law could not “bring back mills which were already liquidated, whose machinery was sold at auction, and whose buildings had been torn down.” [30] It also did nothing to stop the growing impact of overseas competition.

Some efforts to stem the shift of production to the South succeeded, but the forces against the North were strong. Data on spindles in place, a measure of industry capacity, illustrates the shift. Figure 1.1 shows the overall decline of the industry between 1914 and 1938, and the large gains by Southern cotton-growing states over that period.

Figure 1.1: Millions of spindles in place by year and location



Source: *The Decline Of A Cotton Textile City* (Wolfbein p. 161).

The US share of spindles in place in New England fell from 54% in 1914 to 26% in 1938—less than half its 1914 share. Meanwhile, the Southern cotton-growing states experienced the opposite trend, growing from 34% of spindles in place in 1914 to 71% of the total—a gain 1 percentage point greater than New England's loss. It is interesting to note that in 1925, the peak of textile production, production was almost evenly split, with 46% in the South and 48% in the North.

Data for Berkshire Fine Spinning Associates and Hathaway Manufacturing during the 1930s conform to the industry trends. Though early 1930s data is scarce, one can assume that the Berkshire Hathaway predecessor companies fared similar to industry and regional counterparts. Beginning with 1934, data on both constituent companies can be examined, and that is when differences start to appear.

Table 1.1: Comparative operational data for Berkshire Fine Spinning Associates and Hathaway Manufacturing

	Berkshire Fine Spinning	Hathaway Manufacturing
1934		
Net revenues *($ millions)*	$16.3	$3.9
Equity capital *($ millions)*	$13.8	$2.1

# spindles	900,000	79,000
# looms	20,000	3,200
1939		
Net revenues *($ millions)*	$18.4	$7.3
Equity capital *($ millions)*	$13.1	$2.2
# spindles	748,000	62,000
# looms	15,000	2,800
1935–1939 (average)		
Return on equity	0%	6.10%
Profit margin	1.40%	2.10%
Revenues/average equity[1]	$1.34	$3.15
Footnote: Revenues/average equity calculation is from 1936–39 because no data is available for 1935 for Hathaway Manufacturing.		

Note: No data on 1939 for BFS, but spindles/looms same in 1938 and 1940.

Sources: Moody's Industrial Manuals 1934-40 and author's calculations.

The most obvious difference is operational size. Berkshire had ten times more spindles than Hathaway and over six times more looms. This production capacity, though, did not translate into profitability. The last five years of the 1930s, a short but illuminating period, shows how Hathaway had a positive return on equity—and Berkshire had none. The natural question is, why? Both mills produced largely the same products of finer-grade cotton, and both had picked up silk and rayon production.

While five years is probably the shortest time for an examination of this sort (since many factors can come into play in the short run), the answer is likely due to two elements. Hathaway's mills were all located in New Bedford, Massachusetts, and all had the relative advantage of proximity to sea transport. Some Berkshire mills were close to the sea, but the company also had plants as far as Western Massachusetts and Vermont. The transport disadvantages of those geographically diverse plants, coupled with Berkshire managing an interstate network of plants, likely weighed on profitability. [31]

1940s

The difficult operating conditions of the northern textile mills in the 1930s likely would have continued unabated throughout the 1940s if it weren't for one major event. World War II created a temporary boom for the entire

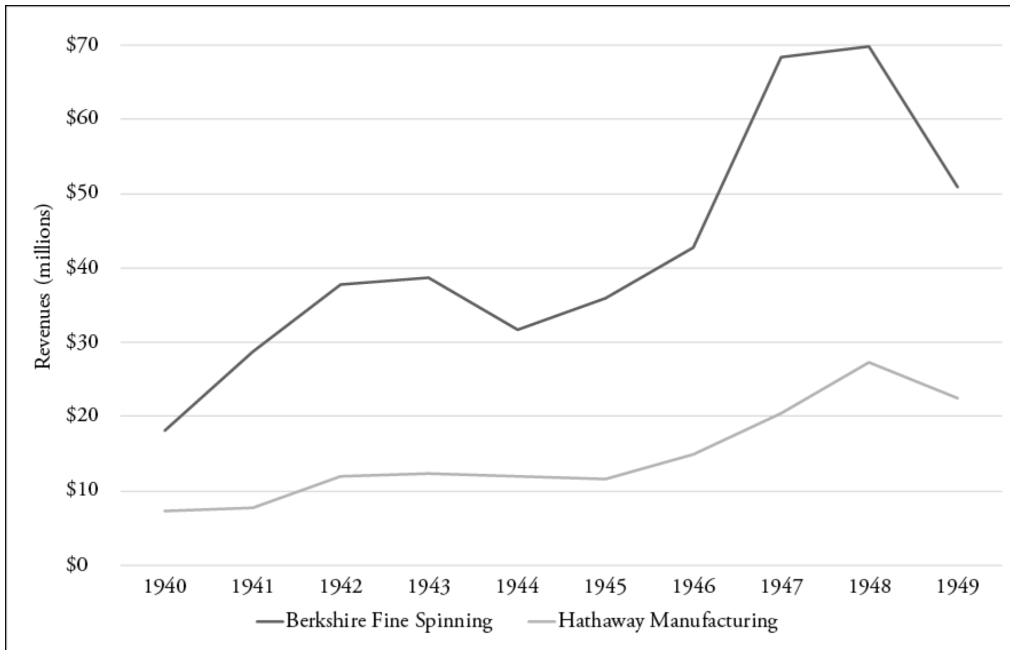
textile industry and offered the remaining mills in the North a brief flash of extreme profitability. Profits continued for northern mills, albeit briefly, through the 1940s, as the US economy brought itself out of the Great Depression aided largely by consumers' ability and willingness to spend. Very short flickers of profitability would periodically happen after this, but the 1940s would prove to be the last hurrah for the northern mills.

The 1940s wartime boom might have dissipated profitability for individual firms if it weren't for the many failures during the preceding decade that led to mill closures and decreased competition. Just in New Bedford, Massachusetts, twenty mills went out of business between 1930 and 1939. [32]

The firms that remained found themselves positioned to benefit enormously. The war effort required an immense production of textiles for military use including powder bags, camouflage cloths, ponchos and mosquito netting. The large-scale use of parachutes in the war required production of nylon, a relatively new material that was both lightweight and strong. The textile mills were initially hesitant to commit to large-scale production. It was only after Berkshire Fine Spinning made a large commitment that other mills followed suit. Berkshire Fine Spinning alone produced 5 million yards of nylon fabric for the war effort, and it and others found a new outlet for their many languishing spindles and looms. [33]

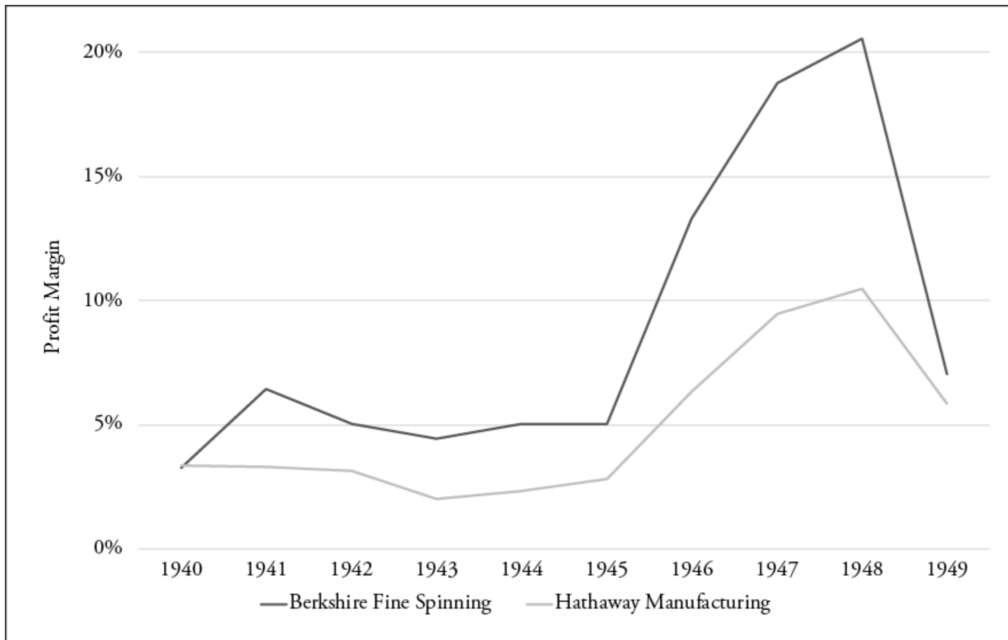
The effect on the northern mills' profitability was apparent, as seen in Figure 1.3. Berkshire's profit margins, which had been slightly negative in the five years ended 1939, increased to 4.9% for the five years ended 1944.

Figure 1.2: Revenues at Berkshire Fine Spinning and Hathaway Manufacturing from 1940–1949



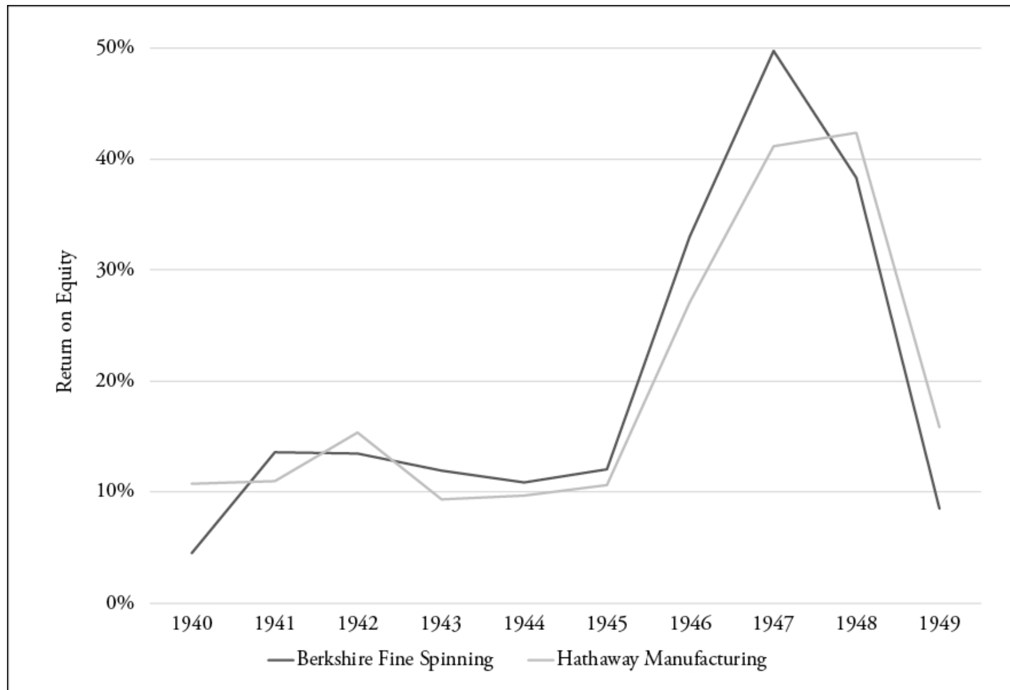
Sources: Moody’s Industrial Reports and Berkshire Hathaway Annual Reports.

Figure 1.3: Profit margins at Berkshire Fine Spinning and Hathaway Manufacturing from 1940–1949



Source: Moody's Industrial Reports and Berkshire Hathaway Annual Reports.

Figure 1.4: Return on equity at Berkshire Fine Spinning and Hathaway Manufacturing from 1940–1949



Sources: Moody's Industrial Reports and Berkshire Hathaway Annual Reports.

Hathaway Manufacturing experienced even greater gains in profitability. Its net profit margin averaged just 2.8% between 1940 and 1944, which was just 0.7 percentage points higher than the average of the preceding four years. But because of Hathaway's greater capital efficiency (it generated an average of $4.04 in revenues per dollar of equity between 1940 and 1944, compared to Berkshire's $2.20 during the same period), its return on average equity during those years averaged 11.2% compared to Berkshire's rate of 10.9%. (Remember, Berkshire's return on equity from 1935 to 1939 was zero.)

The latter half of the 1940s saw textile profitability reach greater heights than during the war years. The US economy boomed during the peace time that followed WWII. Real disposable personal income per capita (a measure of dollars available to consumers to spend) fell from $7,361 in 1929 to $6,468 in 1935. It then grew to $10,754 in 1944 before declining slightly to $9,927 in 1949 as the US entered another recession. [34]

The US consumer, with almost a third more income at their disposal in the 1940s than in the previous decade, began spending liberally. Goods formerly eschewed as being unnecessary, such as the fine-woven products made by the Northern textile mills, were once again in demand.

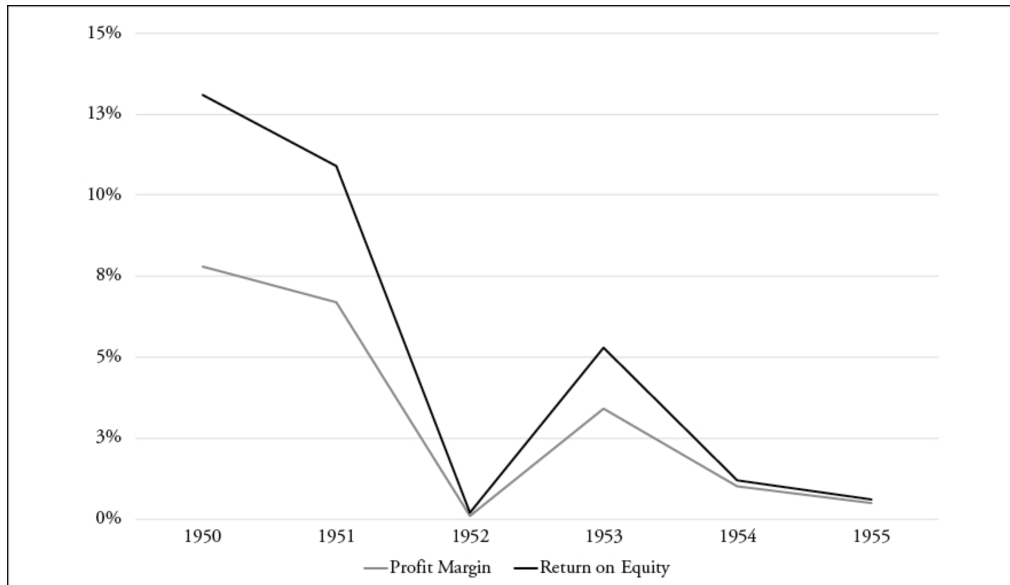
This was the real boom for the Berkshire Hathaway predecessor companies. High sales in the late 1940s led to greater margins. Net margins at the two companies exploded, with Berkshire averaging 12.9% between 1945 and 1949 and Hathaway reaching 7.0%. The combination of higher revenues and higher margins resulted in a dramatic increase in returns on shareholders' equity. At Berkshire its return on average equity was 28% per year during the 1945–49 period. Hathaway averaged a slightly lower—though by no means disappointing—27% per year during that same period.

1950–1954

The data on Berkshire Fine Spinning is sparse for this period. So the analysis of the next five-year period uses the pro forma consolidated financial information provided in the first combined Berkshire Hathaway Annual Report in 1955. The boom experienced during the 1940s did not exactly go bust in the 1950s; rather, it fizzled. The temporary profitability, caused by strong demand from World War II and a reinvigorated consumer after the war, faded to the background as the fundamental disadvantages of northern textile production became apparent.

Beginning in 1950, the Berkshire Hathaway predecessor companies experienced rapid declines in revenues and profitability, as shown in Figure 1.5. Having come from what was the peak of $97 million of combined revenues in 1948, revenues rebounded slightly in 1951 to $92 million but never recovered. The companies quickly lost their healthy profit margins too.

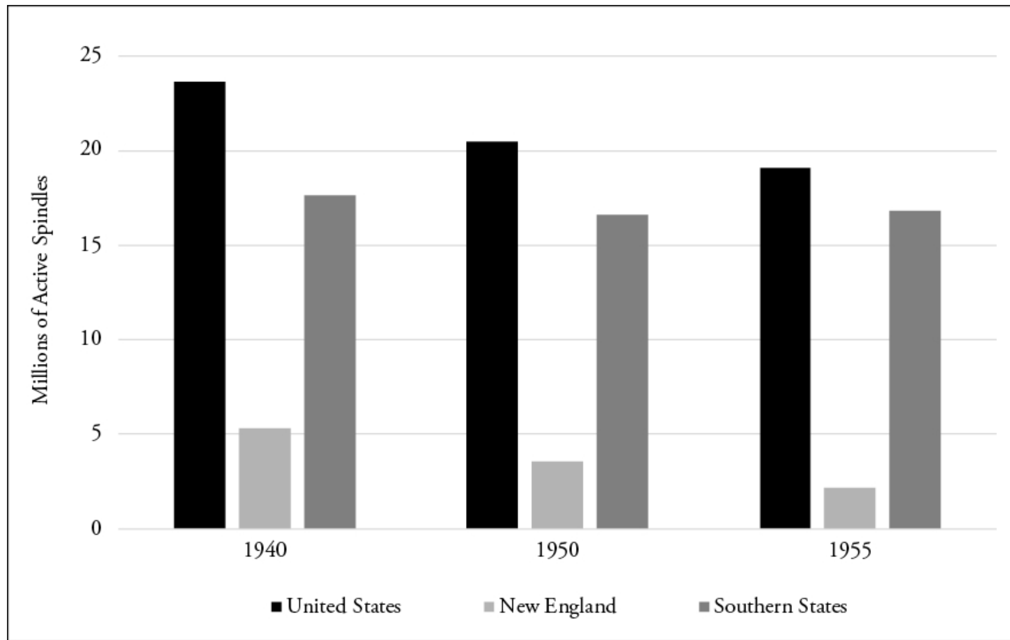
Figure 1.5: Pro forma profit margin and return on equity for Berkshire Hathaway 1950–1955



Sources: Moody’s Industrial Reports and Berkshire Hathaway Annual Reports.

The decline in northern textile production can also be seen in the statistics of active spindles [35] shown in Figure 1.6. The graph highlights the decline of the industry overall but shows the South held its ground, while the North continued to see losses.

Figure 1.6: Millions of active spindles by location 1940–1955



Note: Active spindles are different than spindles in place. The former is a measure of usage; the latter is a measure of capacity.

Source: *Changes in American Textile Industry* , Technical bulletin No. 1210. US Dept. Agriculture, Issued November 1959, p. 72, accessed via Google Books.

While New England states fell from 22% of total active spindles in 1940 to 12% in 1955, the South's share increased from 75% in 1940 to 88% in 1955. It is interesting to note that between 1950 and 1955, the inroads of the South were such that despite the US shrinking overall, it grew the number of active spindles—at the expense, of course, of the North.

Berkshire Hathaway, Inc.

The final merger that would impart the name on today's modern conglomerate occurred in 1955 when Berkshire Fine Spinning merged with Hathaway Manufacturing. The merger resulted primarily from continued relentless industry pressures. But it was set in motion by a flooding of the Hathaway Mill on Cove Street in New Bedford, Massachusetts, which was significantly damaged by Hurricane Carol in September 1954. Eager to remain in business, Seabury Stanton, Hathaway's leader, pursued a merger with Berkshire Fine Spinning. The merger was finalized on March 14, 1955.

Leading the new enterprise were John H. McMahon as chairman of the board, Seabury Stanton as vice chair, and Malcolm G. Chace, Jr., as

president. The managers were upbeat, writing in the first annual report in 1955:

> "The purpose of the combination of the two companies was to effect operating economies and greater diversification of products for each. The new Company can now supply the market not only with plain fine combed cotton goods, but also with fancy colored box loom fabrics and with rayon, nylon, dacron and other synthetic fabrics."

Unfortunately, that report also contained a portentous warning. Shortly after the merger, in July of that year, a strike caused a thirteen-week shutdown. The next month, Hurricane Diane severely damaged several plants in Rhode Island. These early episodes would set the stage for the many troubles and tough decisions that would be faced during the ensuing decade.

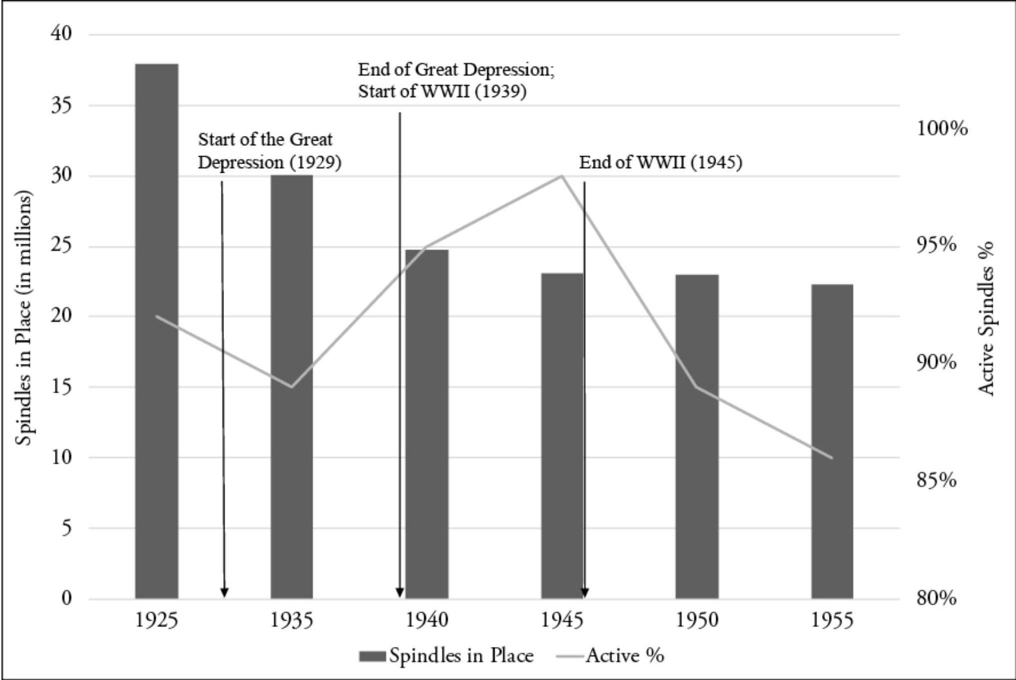
Conclusion

The many corporate mergers that occurred prior to the formation of the combined Berkshire Hathaway, Inc. (as we know it today) created a textile conglomerate. The business had locations throughout New England and was quite large with combined revenues of over $65 million in 1955. In 1956, the year after its combination, Berkshire Hathaway was 431st on the Fortune 500 list of the largest US companies, though it was far from being the largest textile company of its day. [36] [37]

The constituent companies that labored separately before joining largely faced the same headwinds leading up to the 1955 merger. Early advantages of the North during the nineteenth century turned into disadvantages in the twentieth century as the South built newer, more efficient plants. The North fell further behind as lower labor and energy costs accrued to the South. A major (though temporary) return to profitability after the Great Depression occurred during World War II in the 1940s. The fire the war lit under the economy quickly turned to cinders once it ended. The lower input cost advantages of the South reappeared in full force in the 1950s, leading to renewed industry decline and consolidation in the North.

Active spindle data for the country reflects the industry decline as it relates to world events and industry changes, as seen in Figure 1.7.

Figure 1.7: Active spindles (usage) versus spindles in place (capacity), 1925–1955



Spindles in Place (in millions)
Active Spindles %
40
35
30
25
20
15
10
5
0
100%
95%
90%
85%
80%
Start of the Great
Depression (1929)
End of Great Depression;
Start of WWII (1939)
End of WWII (1945)
1925
1935
1940
1945
1950
1955
Spindles in Place
Active %

Figure 1.7 shows that in times of tight industry capacity firms did well. But when supply exceeded demand, excess capacity lowered profits and oftentimes caused the weakest firms to falter and reduce production or clo se entirely.

Geographical differences are also telling. By running multiple shifts, sometimes around the clock, the South rang up a 122.6% utilization rate of its spindles. The North, by contrast, utilized just 78.6%, with Massachusetts the worst at 70.4%. [38] These types of statistics show the advantages the South had over the North, and how the South used them to grow profits. The small degrees of advantages in labor costs and better technology, coupled with high degrees of plant utilization, resulted in a distinct competitive advantage over the North.

As an interesting aside, the accounting practices of the textile mills could also have played a factor in their extended demise. Many mills (in both locations) improperly accounted for depreciation of plant and equipment. This would have made it seem the mills were operating at an economic loss under conditions of apparent profit. It also would have had the effect of distribution of capital that should have been reinvested in plant upkeep and modernization. [39] Proper accounting, of course, would not have prevented the economic reality from taking place. But it might have led to more rationality on the part of mill owners, however, who might have stopped money-losing operations sooner.

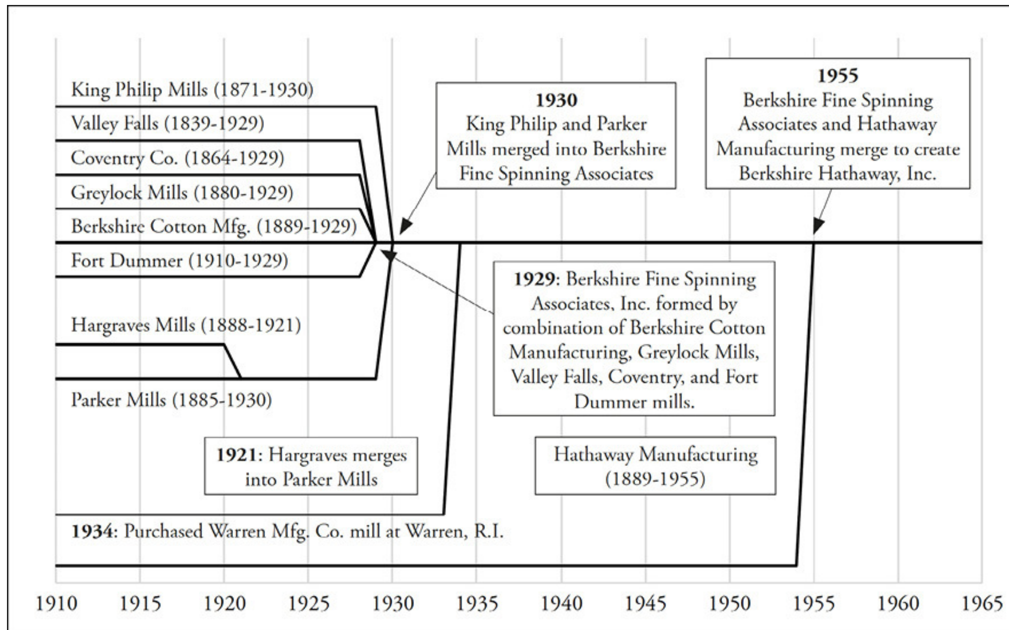
Despite the clear advantages of the South, textile operations in the North, and New England in particular, did not entirely disappear. Berkshire Hathaway did not cease all operations until 1985. One company, Burlington Industries, even weathered the storm up through the New Millennium, struggling mightily along the way with intense foreign competition. [40] [41]

The Berkshire Hathaway that existed a decade before Warren Buffett taking control was a melting snowball trying to maintain its size by furiously appending other wet, melting snow. Instead of recognizing the heat and seeking shelter or changing course, the managers of the 1955 Berkshire Hathaway conglomerate stayed on the same path, hoping for a different result. Some managers surely recognized the structural industry changes taking place, but most only knew one business, textiles. It would take one man, and a quirk of history, to turn a faltering business into one of the world’s most admired companies.

Lessons: Textile Beginnings to 1954

1. Knowledge can only confer a temporary advantage to a business. Eventually all industry participants have access to best practices. Even governmental protections cannot stop the spread of valuable information.
2. Sometimes the second mover has an advantage over the first mover. The South gained an advantage over the North by using the latest know-how when building from scratch.
3. Business mergers cannot alter a fundamentally disadvantaged economic position or trend. The many textile mergers that culminated in the creation of Berkshire Hathaway were the result of a shrinking industry and could delay, not stop, the inevitable.

Figure 1.8: The Beginnings of Today's Berkshire Hathaway, Inc.



Sources: Moody's Manual reports and Massachusetts Corporate Card Files accessed via the Boston Public Library.

Appendix Note : Source data for 1934–1945 are from Moody's Industrial Manuals accessed via Mergent Online. Source data for 1946–1955 come from the first Berkshire Hathaway Annual Report for the combined entity. The reader should be aware that data for net income and equity don't exactly match the sum of the constituent parts in years where there are both combined and individual data available.

This following tables have been omitted from the ebook version because formatting issues would have rendered them unreadable. The reader is welcome to download a pdf version of the omitted tables and bonus material at brkbook.com .

Table 1.2: Berkshire Fine Spinning Associates and Hathaway Manufacturing Company, select data, 1945–1955

Table 1.3: Berkshire Fine Spinning Associates and Hathaway Manufacturing Company, select data, 1934–1944

Table 1.4: Berkshire Fine Spinning Associates and Hathaway Manufacturing Company, pro forma combined, select data, 1945–1955

Table 1.5: Berkshire Fine Spinning Associates and Hathaway Manufacturing Company, pro forma combined, select data, 1934–1944

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1 The very beginning was handmade textiles. Workers would spin fibers of wool or cotton into yarn, and then would hand weave the fabric into clothes. This book is chiefly concerned about the large-scale, industrial textile manufacturing industry in the United States.

2 England had attempted to ban the export of its trade secrets by banning emigration of skilled workers until 1825, and the export of machinery until 1843. (Behemoth)

3 Joshua B. Freeman,. *Behemoth: A History of the Factory and the Making of the Modern World* (New York: W. W. Norton & Company, 2018), Kindle Edition, 45.

4 Ibid, 45.

5 Ibid, 46.

6 Later, after Francis Cabot Lowell died in 1817, the town was renamed in his honor.

7 "Lowell Mill Girls and the factory system, 1840," Gilder Lehrman Institute of American History, accessed on August 19, 2018, https://www.gilderlehrman.org/content/lowell-mill-girls-and-factory-system-1840 .

8 Ibid.

9 "Francis Cabot Lowell and the Boston Manufacturing Company," Charles River Museum of Industry & Innovation, accessed on August 12, 2018 https://www.charlesrivermuseum.org/francis-cabot-lowell-and-the-boston-manufacturing-company/ .

10 Seymour Lewis Wolfbein, *The Decline of a Cotton Textile City: A Study of New Bedford* (New York: Columbia University Press, 1944), 9.

11 Freeman, Behemoth: A History of the Factory and the Making of the Modern World, 45.

12 Wolfbein, *The Decline of a Cotton Textile City: A Study of New Bedford* , 64.

13 Ibid, 67.

14 Ibid, 60.

15 Ibid, 60.

16 Ibid,73.

17 Ibid, 74–80.

18 Alice Schroeder, *The Snowball: Warrant Buffett and the Business of Life* (New York: Bantam

Dell, 2008), 268.

19 Finer-quality finished textiles required long-fiber cotton, initially produced only in the North, which was grown west of the Mississippi. The difference in shipping costs to the South versus the Northeast were negligible according to Wolfbein (p. 64).

20 Wolfbein, *The Decline of a Cotton Textile City: A Study of New Bedford* , 19.

21 “Valley Falls Mill Village,” Woonsocket, My home town on the web, accessed on August 12, 2018, http://www.woonsocket.org/valleyfalls.html .

22 American Textile Reporter 1922, Google Books digitized production, 1177.

23 According to the 1930 Moody’s Manual entry on Berkshire Fine Spinning Associates, the balance sheet for the company as of September 30, 1928 (which must have been a pro forma accounting since the mergers did not happen until 1929) had $13 million of total capital (preferred, common, and surplus). According to the separate Moody’s account for Berkshire Cotton Manufacturing as of the same date, it had $6.9 million of total capital.

24 American Textile Reporter 1921, Google Books digitized production, 43.

25 Horatio Hathaway earlier formed the Acushnet Mill in New Bedford, Massachusetts. (*The Snowball* , p. 267.)

26 Schroeder, *The Snowball* , 267.

27 Wolfbein, *The Decline of a Cotton Textile City: A Study of New Bedford* , 102.

28 Ibid.

29 David Whiteman, Impact of The Uprising of ’34: a coalition model of production and distribution, *Jump Cut* , accessed on September 17, 2018, http://www.ejumpcut.org/archive/jc45.2002/whiteman/ .

30 Wolfbein, *The Decline of a Cotton Textile City: A Study of New Bedford* , 130–1.

31 The locational advantage Hathaway enjoyed is highlighted by its higher capital efficiency. Between 1936 and 1939, its revenues per dollar of average equity average was $3.15. Berkshire by contrast produced just $1.34. This magnified the average Hathaway margin on revenues (profit margin) of 2.1% that much more.

32 Ibid, 141.

33 Seabury Stantion, *Berkshire Hathaway, Inc.: A Saga of Courage* (New York: Newcomen Society of North America, 1962). Stanton made this address to the Newcomen Society in Boston on November 29, 1961.

34 Data from the Federal Reserve Bank of St. Louis using chained 2012 dollars.

35 Note that the term active spindles is a slightly different metric than spindles in place. The latter is a measure of capacity, whereas the former is a measure of usage. A more finely tuned measure of usages, active spindle hours, is also sometimes seen referenced.

36 There were others ahead of Berkshire Hathaway on the Fortune 500 in 1956. For example: Burlington Industries ranked 70th with revenues of $515 million, Cannon Mills ranked 184th ($194 million), Textron ranked 187th ($189 million), Cone Mills ranked 208th ($164 million), Riegel Textile ranked 344th ($86 million), and Pepperell Manufacturing ranked 352nd ($85 million).

37 Fortune 500 list for 1956, *Fortune magazine* , 1956, http://archive.fortune.com/magazines/fortune/fortune500_archive/companies/1956/B.html .

38 L.D. Howell, Marketing and Manufacturing Margins for Textiles, pdf version accessed (Washington, D.C.: U.S. Government Printing Office, 1952), 73.

39 Wolfbein, *The Decline of a Cotton Textile City: A Study of New Bedford* , 98.

40 Burlington Industries would ultimately find itself filing for bankruptcy in late 2001. Berkshire actually bid for it at auction, but the deal fell through and its business was split apart and sold. It remains today, at least in name, as part of the International Textile Group, which purchased its assets out of bankruptcy in 2003.

41 Burlington Industries, 2002 Annual Report.

Chapter 2: 1955–1964

Table 2.1: Decade snapshot: Pre-Buffett years

	1954*	1964
Business:	Textile manufacturing	Textile manufacturing
Key managers:	Chairman: John H. McMahon; Vice Chairman: Seabury Stanton; President: Malcolm G. Chace, Jr.	Chairman: Malcolm G. Chace, Jr.; President: Seabury Stanton
Annual revenues:	$66.9 million	$50 million
Stockholder equity:	$53.4 million	$22.1 million
Book value per share:	$23.25	$19.46

*Pro forma for the combined Berkshire Fine Spinning Associates, Inc. and Hathaway Manufacturing Company, which merged on March 14, 1955 to form Berkshire Hathaway, Inc.

Key capital allocation decisions:

1. Purchased the stock of Bourne Mills for $3.4 million (1956).
2. Closed unprofitable divisions and plants in response to ongoing losses.
3. Reduced investment in working capital by $19.8 million (-58%).
4. Reduced net investment in property, plant, and equipment by $9.7 million (-57%).
5. Returned $22.3 million to shareholders in the form of dividends and buybacks.

Noteworthy events:

1. Warren Buffett begins buying shares for Buffett Partnership Limited in 1962.

Introduction

An analyst or shareholder comparing Berkshire Hathaway’s 1955 and 1964 Annual Reports would have come away with two conclusions. First, profitability was down. The company that existed in 1964 earned about half of what was earned in 1955. Second, the company’s financial condition, although not necessarily in bad shape, had materially changed. What was formerly a company flush in cash and excess liquid resources at the end of 1954 became a company with substantially lower levels of cash and marketable securities, about half the investment in physical assets, and some debt. What transpired to cause Berkshire Hathaway to become half of its former self?

Note on year-ends : Berkshire Hathaway reported on a fiscal year basis until it adopted a calendar year in 1967. [42]

Table 2.2: Select information 1955–1964

	1955	1956	1957	1958	1959	1960	1961	1962	1963	1964
BRK book value per share - % change	(3.6%)	0.1%	(4.9%)	(11.1%)	6.0%	16.3%	(3.7%)	(10.3%)	(6.7%)	3.3%
US GDP Growth (real %)	7.1%	2.1%	2.1%	(0.7%)	6.9%	2.6%	2.6%	6.1%	4.4%	5.8%
10-year Treasury Note (year-end %)	3.0%	3.6%	3.2%	3.9%	4.7%	3.8%	4.1%	3.9%	4.1%	4.2%
US inflation (%)	(0.3%)	1.5%	3.4%	2.7%	0.9%	1.5%	1.1%	1.2%	1.3%	1.3%
US unemployment (%)	4.4%	4.1%	4.3%	6.8%	5.5%	5.5%	6.7%	5.6%	5.6%	5.2%

Sources: Berkshire Hathaway Annual Reports 1955–1964 and Federal Reserve Bank of St. Louis.

1954

Let's turn first to the balance sheet and assess the financial condition of the company that existed at year-end 1954. Because the merger between Berkshire Fine Spinning Associates, Inc. and Hathaway Manufacturing Company was not consummated until March 1955, this is actually an accounting look at what the companies would have looked like had they operated as one a year earlier (pro forma to use the modern jargon). The 1955 combined Berkshire Hathaway, Inc. report contained a lookback for comparison purposes, as shown i n Table 2.3.

Table 2.3: Berkshire Hathaway balance sheet, 1954

($ thousands)	9/30/54	%
Current assets		
Cash	$4,977	9%
Marketable securities	2,963	5%
Accounts receivable, net	3,200	5%
Inventories	27,669	48%
Other current assets	394	1%
Total current assets	39,202	67%
Property, plant & equipment, net	17,249	30%
Other assets	1,778	3%
Total assets	$58,230	100%
Current liabilities		
Notes payable	878	2%
Accounts payable	2,296	4%

Accruals & other	1,702	3%
Total current liabilities	4,875	8%
Long-term liabilities	0	0%
Shares outstanding (000's)	2,295	
Total stockholders' equity	53,354	92%
Total liabilities and stockholders' equity	$58,230	100%

Note: Amounts are rounded from actual dollars which may cause totals to differ slightly.

Source: Berkshire Hathaway Annual Report 1955.

A company's assets can be overly simplified into two general components: short-term assets and long-term assets. Short-term assets fall into three main categories: inventories (in Berkshire's case raw materials such as cotton, silk, and rayon; product in the process of being converted into finished product; and finished goods such as fabric); accounts receivable (monies owed from customers for goods sold on credit); and cash. At the end of 1954, these current assets made up about two-thirds of Berkshire's total assets.

Long-term assets, usually grouped under property, plant, and equipment, are the land, buildings, and equipment necessary to run the company. The 1955 Berkshire Hathaway Annual Report listed the following locations, whose land, buildings, and equipment would have been classified under long-term assets:

- Executive offices in Providence, Rhode Island
- Two sales offices in New York City
- Nine operating plants: five plants in Adams, North Adams, Holyoke, Fall River, and New Bedford, Massachusetts; three in Albion, Anthony, and Warren, Rhode Island; and one plant in Brattleboro, Vermont
- Bleachery & Dye Works in Lonsdale, Rhode Island
- Curtain factories in Warren, Rhode Island and Fall River, Massachusetts
- A laboratory and machine shop in Warren, Rhode Island

That $17.2 million figure for long-term assets, as shown in Table 2.3, may not seem large today, but adjusting for inflation it would be equal to over $150 million in 2020 dollars. In short, Berkshire Hathaway halfway through the sixth decade of the twentieth century owned a lot of property.

Looking next to the other side of the balance sheet, we can see how those assets were financed. Again, to grossly simplify, a company's funding sources can be grouped into two broad categories: owners (otherwise known as equity) and non-owners. The non-owners category can be further delineated into borrowed monies (debt) and spontaneous liabilities (usually short-term funds provided by trade partners and others in the general course of business). In Berkshire's case, at year-end 1954, the company's owners recorded an investment of $53.4 million, which financed a substantial portion of its assets. The remaining balance of just 8% was made up of accounts payable (likely owed to suppliers of raw materials); accrued wages, salaries, and taxes; and a small number of short-term notes payable. [43]

At the end of 1954 Berkshire had no long-term debt. In short, its financial condition could be described as excellent.

The trouble begins when we start assessing the returns generated by Berkshire's asset base. We will take up this analysis with data from 1955.

1955

Using data from 1954 and 1955, we can assess the return on capital generated by Berkshire. Even though its balance sheet was in good shape early in the decade, its profitability was not, and this would lead in turn to a deterioration in its balance sheet.

Going into fiscal year 1955 (starting September 30, 1954), the management team at Berkshire Hathaway had $53 million of invested capital. [44] During the next year, Berkshire generated annual revenues of $65.5 million. That sounds like a lot of money, and it is, but remember, revenue is only one side of the picture. The capital it takes to produce that revenue, and the margins earned on each dollar of revenue, are equally important. In 1955, the ratio of capital to revenues was high, [45] meaning Berkshire was a capital intensive business. Basically, it took a lot of money to sell a lot of product.

Why was Berkshire so capital intensive? Textile manufacturing required a lot of land and equipment, and many production lines—with inventory tied up in each step. Additionally, a portion of its sales were on credit. This required an investment in accounts receivable as it waited to collect cash from customers. And since its material suppliers and employees would not go long without being paid, there were only modest offsetting liabilities to reduce working capital requirements.

Berkshire Hathaway reported net income of $301,000 on revenues of $65.5 million in 1955. The resulting net profit margin, or the ratio of net income to revenues, was 0.46%. Every dollar in revenues required an investment of about $0.81, so to bring in $100 in revenues required approximately $81. Earning $0.46 on an investment of $81 equals a return on capital of about 0.6%. Even in an era of long-term interest rates around 3%, as was the case in the mid-1950s, this was not an inspiring return.

A high capital-to-revenues ratio is not necessarily bad in and of itself. There are, of course, many good businesses, such as today's Berkshire Hathaway-owned Burlington Northern Santa Fe Railroad and Berkshire's utility businesses, that use such a model. But these modern subsidiaries have higher margins and enjoy some form of protection from competition. The textile business was a commodity business that suffered from high domestic and international competition, without any government-sanctioned price protection. As seen in Chapter 1, Berkshire Hathaway also had the added disadvantage of being in New England, with high labor and electric costs. Unsurprisingly, margins were thin. In short, it had no competitive advantages.

Warren Buffett was not yet associated with Berkshire Hathaway in 1955, but the situation Berkshire found itself in alludes to his future involvement. Berkshire's weak profitability would ultimately attract his attention as a "cigar butt" [46] stock he could turnaround for a quick gain. After he instead went all in on Berkshire, the subpar economics would provide painful but important lessons. He would learn the extreme difficulty in operating a commodity-type business and the benefits of looking for companies with a "moat"—a metaphor for a sustainable competitive advantage that protected a company's return on capital.

Any business can expect ups and downs. Unfortunately for the 1955 Berkshire Hathaway, its problems were both structural and cyclical. Like

riding on a roller coaster, Berkshire experienced wild swings in profitability ultimately headed in one direction: down. It did experience brief respites of actual increases in profitability and returns when the stars aligned, but these too were only temporary. More typically, tough industry conditions were followed by attempts to resize, realign, or retool, followed by a brief period of improved profitability when inventories were low industry-wide, followed by industry overcapacity as firms raced to take advantage of what looked like a return to normal—all against a backdrop of increasing foreign competition.

The 1955 Annual Report contained clues as to the future profitability of the enterprise. In the jointly signed report by Chairman of the Board John H. McMahon, Vice Chairman Seabury Stanton, and President Malcolm G. Chace, Jr., the leaders noted several operational and competitive issues plaguing the company. Reading the report, it was clear Berkshire Hathaway was in a firefight, and they were losing.

A thirteen-week strike completely shut down operations mid-year. The strike was resolved with "slight concessions that have decreased the difference in labor costs between ourselves and many of our competitors." Additionally, a flood further caused a three-week shutdown.

Even the good news had a bad tinge. Management expected the new federal minimum wage of $1.00 per hour, up from $0.75, would help narrow the spread between Berkshire Hathaway's labor costs and those of its southern competitors. But the federal law would be of little help against foreign competitors. They noted the "flood of Japanese fabrics coming into the United States in ever increasing volume" and remarked upon the Japanese labor costs the equivalent of 15 cents per hour. They hoped governmental action (read: import tariffs) would help.

Not to end on a down note, the 1955 report concluded with expectations of improved future profitability due to "synergies" from the newly combined companies, though they didn't use that modern buzzword. McMahon, Stanton and Chace anticipated that a diversified product line, combined with cost reductions from the newly combined enterprise and relative labor cost parity with the rest of the United States, would result in a return to profitability. Unfortunately, that was not to be.

1956

In 1956, Berkshire Hathaway's management team acquired Bourne Mills of Tiverton, Rhode Island, for $3.4 million to diversify its product line. The Bourne plant was likewise in the textile manufacturing business and produced carded sateens, a different product from Berkshire's main lines. The Bourne acquisition also came with a subsidiary that had a wide distribution network reaching into Canada, and Berkshire management thought it might be useful for Berkshire's other products. Year-end results for 1956 provided management with some positive feedback for their capital allocation decisions: The company earned $923,000 that year—though the return on capital was just 1.7%. Industry developments also bolstered their confidence. "As a result of the recent increase in wages in the textile industry located in the South, our competitive position has been substantially improved, and we look to the future with confidence," management concluded in the Annual Report to shareholders.

But everything was not well. That same year cracks were widening in the core business. Labor shortages caused management to consolidate two plants in the Adams/North Adams, Massachusetts area. This would be the start of a long road of division and plant shutdowns followed by divestitures. It was the opposite of a growing, prosperous enterprise. The trouble was that the textile business in the United States was stuck in a long, slow decline into oblivion—it would just take a while to get there.

1957

During 1957, in response to depressed market conditions for textiles, Berkshire Hathaway took steps to maintain profitability. It curtailed some production rather than keep workers busy building excess inventories. The company also consolidated operations, eliminated higher cost plants, and invested in equipment to modernize operations in the remaining plants. In the 1957 letter to shareholders, Chairman Malcolm Chace, Jr. and President Seabury Stanton, stated, "With the operating economies resulting from our consolidation and modernization program, your company will be in a strong competitive position, and we expect that profitable operations will be resumed during 1958." It was not a great forecast.

1958

Profits were elusive in 1958. There was a severe depression in the industry, which necessitated numerous additional plant closures. The company closed the Greylock division in North Adams, Massachusetts; the Berkshire division in Adams, Massachusetts; the Holyoke division in Holyoke, Massachusetts; the Fort Dummer division in Brattleboro, Vermont; and the curtain factory, repair division and warehouse buildings in Warren, Rhode Island. The 1958 Annual Report to shareholders made clear that the remaining divisions would be expected to be profitable going forward.

Table 2.4: Select period data

	Sept. 27, 1958	Jan. 1, 1957	% Change
Spindles	480,980	874,332	(45%)
Looms	12,610	19,214	(34%)
Plants	8	14	(43%)

Source: Berkshire Hathaway Annual Report 1958.

Management anticipated operating losses during this reorganization, but expected the cash freed by reducing working capital would help cover reorganization costs and operating losses. But no reorganization could help Berkshire Hathaway get rid of equipment it wasn't using—equipment no one wanted to buy. This is what happens when downsizing amid a systemic industry contraction. Many companies are all trying to sell equipment that no one could put to profitable use. The task was extremely difficult, maybe even impossible. "The market for second-hand textile machinery and buildings has been overloaded for the past several years, owing to the large number of mill liquidations which have taken place in all sections of the country," management concluded in the 1958 Annual Report, "and it has been extremely difficult to find customers for our machinery and properties."

The year ended in a sea of red ink: The company reported a net loss of $5 million in 1958.

1959

Buoyed by a general economic recovery, the following two years brought a brief respite of profitability. Operating costs were lower because of the rationalizing of plant assets in prior years, and textile prices were higher

due to low industry-wide inventories. From the horrendous $5 million loss incurred in 1958, the bottom line rebounded to a $1.3 million profit in 1959. This likely gave management the confidence to maintain its policy of reinvesting in the business where they could "take full advantage of all technical improvements."

1960

The 1960 Annual Report informed owners of a change of business strategy. Management stated that, except for curtain fabrics and handkerchief fabrics, the company's entire production would now be sold in the gray (unfinished) state. This would be the operating plan going forward and would reduce risks associated with carrying finished goods.

The plan appeared to be initially successful. Though sales dropped almost 10%, profits swelled to $4.6 million, a net profit margin of 7.4% and a return on capital of 12%. Remember, this company had a net margin of 0.6% just five years earlier.

Spirits were high. Berkshire Hathaway was still debt free. However, as Buffett would later discover, such high points were a mirage. They merely served to keep everyone, owners and management alike, trudging forward.

The 1960 Annual Report noted an industry slowdown along with weakening prices. But with low inventories at the manufacturing level, satisfactory operating results were expected in the future. Again, management would be disappointed. It didn't take long for industry conditions to revert to a state of overproduction and low prices.

1961

Management stated in the 1961 Annual Report that sales volumes dropped materially and prices declined substantially, driven in part by continued imports of foreign textiles. Revenues declined almost 24% that year, to $48 million, and the company reported a $393,000 loss. This was not a terrible result given the significant contraction in revenues—but it was an indication of the pain to come.

1962

Choppy seas continued in 1962 with no signs of calm waters. Costs remained high and the company posted a $2.2 million loss, despite a 12% increase in revenues. That was not the worst of it. The company also recorded a $1.4 million charge for the "estimated loss on properties to be sold." In effect, it wrote down the value of its soon-to-be-divested plant assets but made the income statement look better (less bad, really) by recording the value as a charge to equity rather than flowing the loss through the income statement. Therefore, what would have been a $3.6 million loss was reduced by an accounting maneuver. [47] This ignored a dangerous undercurrent lurking below the surface.

Management's response to the negative industry trends was to again change course, though within the textile industry. A new three-year modernization program began on October 1, 1962, the beginning of fiscal year 1963. Walking back on its concentration on unfinished products, it ceased unprofitable production [48] of these gray goods. Initial success in selling finished curtains and handkerchiefs led management to focus on selling more of those items. They were simple to produce and thus had lower labor costs. For these new products, which had a "semi-proprietary interest" with less competition, management established a Home Fabrics division which sold throughout the US and Canada.

With hindsight we can see the relative ease of entry into these finished goods provided no true protection from competition, only a delay of the inevitable. Buffett spoke of this years later in his 1985 Chairman's letter, the year Berkshire decided to permanently close the textile division. "Should you find yourself in a chronically-leaking boat, energy devoted to changing vessels is likely to be more productive than energy devoted to patching leaks."

A note of historical significance is appropriate here. Buffett began purchasing shares of Berkshire Hathaway for his investment partnership, Buffett Partnership, Ltd., in 1962. These first shares were purchased for $7.50, which translated into a market capitalization of about $12 million—about one-third of book value and less than working capital.

1963

Reflecting on the year 1963, management reported the company lost $685,000, but that there was a trend toward profitable operations. The company continued to invest in its new Home Fabrics division, which showed a "satisfactory profit". Digging deeper revealed clues that business was much worse than the reported net loss would indicate. The letter to shareholders explained that the company had permanently closed its Valley Falls division, and discontinued operations in the Berkshire King Phillip A division in Fall River, Massachusetts. What the letter failed to note was a $1.5 million charge to equity, like the one taken in 1962. Had it been recorded in the income statement, the net loss would have ballooned to $2.2 million.

1964

The final year in our decade under review, 1964, again saw mixed results. On the surface the company had returned to profitability. The company permanently closed its Berkshire King Philip A and E plants in Fall River, Massachusetts, leaving three manufacturing plants in New Bedford, Massachusetts, and one in Warren, Rhode Island. A small profit of $176,000 was reported and management told shareholders that, "all divisions of the company were operating on a profitable basis at the end of the final quarter." Management also noted that the government subsidy program that existed since 1956, which subsidized foreign purchases of US cotton (to encourage exports and alleviate surplus production), was altered and allowed US manufacturers to obtain the same discount. If owners had not learned to dig deeper at this point, they should have. Another $3 million write-down to plant assets was recorded to equity. Likewise, if this was included as a true loss—as it most certainly should have been—it would have wiped out the small profit reported that year.

Decade in Review

With the decade concluded, let's take another assessment of Berkshire Hathaway in 1964. We find a business roughly half the size of its former self and one with a much weaker balance sheet.

Table 2.5: Select data from 1955 and 1964

($ thousands)	1964	1955	$	%

			Change	Change
Revenues	$49,983	$65,498	(15,515)	(24%)
Cash	920	4,169	(3,249)	(78%)
Working capital	14,502	33,022	(18,520)	(56%)
Plant, property, and equipment	7,571	16,655	(9,084)	(55%)
Debt	2,500	0	2,500	n/a
Shareholders’ equity	22,139	51,400	(29,261)	(57%)

Sources: Berkshire Hathaway Annual Reports 1955 and 1964.

The shriveled number of offices and plant locations at the end of 1964 illustrates the degree to which the business had contracted over the preceding decade. Save for one plant, operations had contracted to New Bedford, Massachusetts, including the executive offices and laboratory. The company still had two sales offices in New York City, and three Home Fabrics stores in Toronto, New York City, and Los Angeles. The report listed four plant locations, though three of those (the Hathaway Box Loom division, the Hathaway Synthetic division, and the Home Fabrics division) were in New Bedford, Massachusetts. The fourth was the King Philip D division, located in Warren, Rhode Island.

So, what happened over the decade? Between 1955 and 1964 Berkshire Hathaway generated aggregate revenues of $595 million yet its shareholders were punished for this with five separate years of losses that outstripped any profits made in better years. Worse yet, if the below-the-line write-downs to plant and equipment taken in 1962–1964 are included, the true economic result is even worse.

Table 2.6: Reconcilliation of shareholders’ equity 1955–1964

($ thousands)	Change	% Change
Beginning equity 1955	$53,354	
Net income	(4,118)	13%
Asset write-downs	(5,900)	19%
Dividends	(9,174)	29%
Share repurchases	(13,090)	42%
Bourne Mill gain	887	(3%)
Tax adjustments	180	(1%)
Change in equity during period	(31,216)	100%

Ending equity 1964	$22,139

Sources: Berkshire Hathaway Annual Reports 1955–1964.

Aside from the Bourne Mills acquisition in 1956, management acted rationally in shrinking the business, rather than continuing to acquire other mills in hopes of finding ever-elusive synergies. Over the course of the ten years ended in 1964, a net of $22.3 million, or about 42% of shareholders' equity from the beginning of the period, was sent to shareholders in the form of dividends and share repurchases. (Approximately $1.1 million of positive adjustments to equity were recorded over the decade relating to positive tax adjustments and an excess of assets acquired over the purchase price of the Bourne Mills acquisition.)

Table 2.7: Property, plant, and equipment: 1954–1964

($ thousands)	
Balance, end of 1954	$17,249
Depreciation	(17,809)
Plant write-downs	(5,900)
Capital expenditures	14,031
Balance, end of 1964	$7,571

Sources: Berkshire Hathaway Annual Reports 1955–1964.

Another key capital allocation decision (or rather a series of decisions) should be noted. Although management did shrink the company's investment in property, plant, and equipment over the decade, it had to spend money maintaining its fixed assets and investing in the latest technologies. Those decisions were expensive. Even though net property, plant, and equipment shrunk due to scaled-back operations, just maintaining existing equipment cost $14 million over that time. [49]

In short, management initially tried to make a go of it in the textile business by investing in new technology and merging with other mills. Instead, it found contraction—basically by half—was the only means of survival.

The Berkshire Hathaway that existed in 1964 was basically the same undiversified textile manufacturer that existed decades before. The business required large amounts of capital, had high labor requirements, and

experienced low profits. In sum, it was a poor business in an industry whose glory days had passed.

Over the decades preceding Buffett's control, Berkshire Hathaway and its predecessors suffered a long, slow decline in operating performance. The cause of the deterioration is generally attributed to a commoditization of the industry coupled with intense competition. While attempts were made to remain competitive, such as cutting expenses and investing in more efficient machinery, the efforts were futile. In addition to strong competition from other American textile manufacturers, there was also overseas competitors. American textile manufacturers in the South were destined to suffer intensely from competition overseas, but the fact remained that both groups of domestic and foreign competitors had advantages over Berkshire Hathaway.

The main advantage to an overseas textile manufacturer in the 1950s and 1960s was a familiar culprit: lower labor costs. Advances in the logistics of global commerce coupled with know-how from experts worldwide created favorable economics for importing textiles to the United States. American textile manufacturers countered this trend with investments in more efficient machinery but to no avail.

Compounding this general malaise was the fact that Berkshire Hathaway was a New England-based company. Differences in the electricity costs between the Northeast and South meant Berkshire was at an added disadvantage. And since textiles were, as Charlie Munger noted later, just "congealed electricity," the only way to compete was with better technology. But because that better technology was available to all competitors, the playing field was leveled. Buffett would later comment in the 1985 Annual Report on the illusory benefits of such capital investments:

> "Viewed individually, each company's capital investment decision appeared cost-effective and rational; viewed collectively, the decisions neutralized each other and were irrational (just as happens when each person watching a parade decides he can see a little better if he stands on tiptoes). After each round of investment, all the players had more money in the game and returns remained anemic."

In sum, all the gains from the investment flowed to the customer in the form of lower prices. Very little, if any at all, ended up, as Charlie Munger later said, "sticking to the ribs of owners."

If Berkshire Hathaway was to avoid a repeat of the decade ending in 1964, it would have to change course entirely, not just do something different within the textile industry. Fortunately for shareholders of Berkshire Hathaway going into 1965, Warren Buffett was about to enter the scene. Things would be very different going forward.

Lessons: 1955–1964

1. Qualitative indicators can lead to clues about a business's future.
2. The newest technology won't necessarily help a business, in terms of profitability, if that technology is available to all industry participants and that industry is commoditized.
3. Owners should always dig deeper into financial statements. Even if plant write-downs recorded in 1962, 1963, and 1964 were in accordance with accounting principles at the time, they were not trivial amounts. Management should have explained why $5.9 million was chopped off the value of their investment in property, plant, and equipment over three years.
4. Capital-intensive businesses can be difficult, if not protected by meaningful competitive advantages. With high amounts of capital required to generate each dollar of revenues, declining margins translate to declining returns on capital more forcefully.
5. Profit margins are important, but their absolute level is relatively unimportant. The more important metric is return on capital. A low margin business can produce a satisfactory return on capital provided capital requirements are low. Conversely, a business requiring a lot of capital can produce a satisfactory return if it achieves high margins. A business requiring a large capital investment with low margins (like the textile business during this decade), in an industry with surplus capacity and competitive disadvantages, was doomed.

This following tables have been omitted from the ebook version because formatting issues would have rendered them unreadable. The reader is welcome to download a pdf version of the omitted tables and bonus material at brkbook.com .

Table 2.8: Berkshire Hathaway, Inc. consolidated balance sheets, year-

end 1954–1964

Table 2.9: Berkshire Hathaway, Inc. consolidated income statements, 1954–1964

Table 2.10: Berkshire Hathaway, Inc. consolidated reconciliation of shareholders' equity, 1955–1964

Table 2.11: Berkshire Hathaway, Inc. selected data and ratios, 1954–1964

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42 It appears the method was inclusive of the last full week in September. This produced the oddities such as September 27, 1958 (a Saturday) and October 3, 1959 (also a Saturday).

43 The amount of short-term funding required by a business is called working capital. Its definition varies depending on the analyst, but broadly speaking working capital is the difference between a company's current assets and its current liabilities. The working part becomes apparent when the sales cycle of a business is examined. While plant and equipment will remain stationary, working capital comes and goes. Cash might be used to buy inventory, which is turned into a credit sale, that ends up as a receivable, which is collected in cash. The more inventory required or unsold, and the more accounts uncollected, the larger the investment. Reducing the required investment is the spontaneous liabilities such as accruals or accounts payable, which have the effect of providing funds to the business.

44 Here I am using the average of 1954 and 1955's equity plus debt capital (the same figure presented in the appendix at the end of this section). Another approach would be to arrive at the same figure by averaging its short- and long-term assets, and then subtracting the average spontaneous liabilities. The case could be made to deduct surplus liquid assets from the calculation, which would improve the capital-to-revenues ratio. Either way, the fact remains the business was capital intensive.

45 This equated to a revenues-to-capital ratio of $1.24. Said another way, it took $0.81 of capital to generate a dollar of revenues.

46 Buffett has frequently referred to his early approach of buying stocks selling for below their working capital as akin to finding a cigar butt on the ground. They aren't pretty but the last puff or two are free.

47 This may have been allowed by accounting conventions of the time, but management should have explained what was going on to owners in its communication to shareholders. Just a few years later Buffett would bring more candor to his communications to Berkshire Hathaway shareholders.

48 Berkshire closed the Coventry and Bourne Mills divisions in Anthony and Tiverton, Rhode Island, respectively; Valley Falls, in Albion, Rhode Island closed shortly after year-end.

49 Berkshire's experience during its textile years illustrates quite clearly Buffett's assertion that depreciation is a meaningful expense.

Chapter 3: 1965–1974

Table 3.1: Decade snapshot: 1964–1974

	1964	1974
Business:	Textile manufacturing	Textiles, insurance, banking, candy, publishing
Key managers:	Chairman: Malcolm G. Chace, Jr.; President: Seabury Stanton	Chairman & CEO: Warren E. Buffett; President: Kenneth V. Chase
Annual revenues:	$50 million	$101.5 million
Stockholders' equity:	$22.1 million	$88.2 million
Book value per share:	$19.46	$90.02

Major Capital Allocation Decisions:

1. Purchased National Indemnity Company and National Fire and Marine Insurance Company (collectively National Indemnity) for $8.6 million (1967).
2. Purchased The Illinois National Bank & Trust Company of Rockford for $17.7 million (1969).
3. Contributed approximately $25 million of additional equity capital to the Insurance Group to support its growth.
4. Borrowed $20 million in long-term debt to repay existing debt, provide capital for the Insurance Group, and maintain liquidity for future opportunities.
5. Purchased a 26% interest in Blue Chip Stamps for approximately $15 million (various).
6. Reduced working capital and fixed assets in the Textile Group to maintain an appropriate level of capital investment in relation to sales.
7. Allocated Insurance Group float into undervalued securities.
8. Returned $2.6 million to shareholders in the form of dividends ($0.1 million) and share repurchases ($2.5 million).

Noteworthy Events:

1. May 10, 1965: Warren Buffett gains control of Berkshire and is elected Chairman.
2. Price controls instituted by the Nixon Administration (1970).
3. United States abandons the gold standard (1971).

Introduction

A mere 12.5 cents set off the long chain of events that led Warren Buffett to go all-in on Berkshire Hathaway and ensured its (and his) place in history. Buffett first acquired shares in Berkshire for his investing partnership, Buffett Partnership Limited, using a playbook executed countless times before: find a business selling for less than its liquidating value and wait for a temporary market correction to sell at a profit. Berkshire had a history of share repurchases that Buffett saw as a catalyst to monetize his current holdings. He anticipated future repurchases and even struck what he thought was a deal with Seabury Stanton to tender his partnership's shares for $11.50 per share. The official offer came at

$11.375, or 12½ cents less. Feeling slighted, Buffett set out to seek control of Berkshire. [50]

Buffett made additional stock purchases on behalf of himself and his partnership, and gained the support of other existing shareholders, including Otis Stanton (Seabury's brother) and the Chace family. On May 10, 1965, Seabury and his son, Jack, resigned. The board immediately gave Warren Buffett control and placed Ken Chace in charge of operations. Berkshire thus became another investment vehicle through which Buffett could allocate capital.

Berkshire became Buffett's primary investment vehicle when he wound down Buffett Partnership Limited in 1969. Buffett took a deep value approach to investing, and the rise of the "nifty-fifty" and other high-priced growth stocks in the 1960s were completely at odds with that. He and some of the partners took Berkshire shares distributed during the liquidation of the partnership. Aside from some other outside investments (which as we will see eventually worked their way into Berkshire), Berkshire Hathaway remained as a permanent base of capital—the foundation on which Buffett's future business deals would be placed. [51]

This first decade of Berkshire Hathaway under Warren Buffett's control (1965–1974) is in some respects the most important. Like a caterpillar that morphs into a butterfly, Berkshire began a transition from a textile company to a conglomerate almost unrecognizable from its former self. Warren Buffett would learn many lessons during this decade, from the difficulty of commodity businesses to the benefit of starting with a good business. Buffett proved that over a relatively short period of time and with a careful, guiding hand, skillful capital allocation could help any business reach its highest potential. Also, he demonstrated that capital was a fungible commodity, not pre-destined to remain in the business or industry where it was originally invested.

Table 3.2: Select information 1965–1974

	1965	1966	1967	1968	1969	1970	1971	1972	1973	1974
BRK book value per share - % change	23.8%	20.3%	11.0%	19.0%	16.2%	12.0%	16.4%	21.7%	4.7%	5.5%
BRK market value per share - % change	49.5%	(3.4%)	13.3%	77.8%	19.4%	(4.6%)	80.5%	8.1%	(2.5%)	(48.7%)
S&P 500 total return	10.0%	(11.7%)	30.9%	11.0%	(8.4%)	3.9%	14.6%	18.9%	(14.8%)	(26.4%)
US GDP Growth (real %)	6.5%	6.6%	2.7%	4.9%	3.1%	0.2%	3.3%	5.3%	5.6%	(0.5%)
10-year Treasury Note (year-end %)	4.6%	4.8%	5.7%	6.0%	7.7%	6.4%	5.9%	6.4%	6.7%	7.4%
US inflation (%)	1.6%	3.0%	2.8%	4.2%	5.4%	5.9%	4.2%	3.3%	6.3%	11.0%
US unemployment (%)	4.5%	3.8%	3.8%	3.6%	3.5%	5.0%	6.0%	5.6%	4.9%	5.6%

Sources: Berkshire Hathaway Annual Reports 2018, 2019 and Federal Reserve Bank of St. Louis.

1965

The 1965 Berkshire Hathaway letter to shareholders, although signed by Chairman Malcolm Chace and President Kenneth Chace (no relation), was written by Warren Buffett. Reading that letter, one can begin to see Buffett's subtle influence, starting with its communications to shareholders.

From the beginning Buffett was transparent about company finances—sharing financial details usually hidden within below-the-line charges to shield the income statements from taking a hit. He also explicitly explained an important accounting change that would provide a more realistic, but less rosy, view of the financial picture.

In the very first paragraph, the reader learns that the earnings as reported do not contain any non-recurring losses sustained from closing two plants. The second paragraph of the letter alerts shareholders to an important accounting change. Because of losses incurred in previous years, Berkshire did not have to pay federal income taxes on its pre-tax earnings of $4.3 million in 1965. Reporting Berkshire's profits without taxes, however, might mislead shareholders as to the true earning power of their company. An estimate of taxes that would have been payable without the loss carryovers was therefore deducted. The $2 million charge, "equivalent to federal income taxes," reduced reported net earnings to $2.3 million.

Though subtle, the fact that a manager would intentionally choose to report earnings almost 50% lower than they *could* have was a loud signal to those

paying attention. It was also in marked contrast to accounting practices of the previous decade, whereby below the line charges were taken to equity. This had shielded the income statement from reporting losses on disposed plant and equipment, keeping shareholders out of the loop. Buffett chose the reverse. The charge taken for taxes was not actually payable due to the loss carryovers, and it was added back to equity in the reconciliation of accounts.

Operationally, Berkshire performed better in 1965. Revenues were flat compared to 1964 at $49.3 million, though profits grew to $2.3 million pre-tax. [52] In the letter to shareholders, Buffett noted a substantial reduction to overhead, and the company continued its program of investing in new technology to reduce costs and improve quality. Importantly, the economic results during the year represented a much-improved return on equity of 9.8%. [53]

Together the profits and capital freed as a result of reducing inventories allowed Berkshire to pay off $2.5 million in bank loans and repurchase 120,231 of its outstanding shares, or over 10% of the company. [54]

Buffett the capital allocator had arrived.

1966

On the surface, the year 1966 looked very similar to the prior year. Revenues totaled $49.4 million compared to $49.3 million in 1965; operating profit was up modestly to $4.8 million, from $4.7 million. But difficulties remained. Let's start with the product mix. Sales in the Synthetics division fell, though Home Fabrics increased. Box Loom gained, while sales within the King Phillip D division slackened. Then, the worst news: The latter half of 1966 was "one of generally depressed markets," not a good turn of events for an industry with generally depressed sales.

This story was unfortunately familiar. Overproduction in acetate fabrics and imports of nylon created oversupply. Anticipating future pain, the 1966 Annual Report noted that given the preceding weakness in synthetics, competitors were likely to increase cotton production. This would hurt the company's King Phillip D division. Rather than keep running at full steam, the company curtailed production for a week during October 1966 and noted that further shutdowns might be necessary to avoid inventory buildup.

Continued development in the new Home Fabrics products, a bright spot during the year, was meant to counter those slowdowns. But growth has a cost and would entail additional investment in inventories and receivables. It was the same old story, but one worth repeating: It takes money to make money. How much money? Buffett estimated up to $7 million.

Buffett operated the company under a policy of self-sufficiency, both for philosophical reasons and because of the challenges of the textile industry. He said outside funding was virtually unobtainable, which was one reason Berkshire maintained reserves of cash and marketable securities to have resources on hand. “Present uncertainties such as war, tax rates and decreased level of business activity also all combine to emphasize the continuing need for a strong financial condition,” he wrote. It’s worth noting that this approach has never changed and neither have the uncertainties, though diversification has lessened the risk to the overall enterprise.

The 1966 Annual Report concludes with a section entitled Dividends. Due to the state of the company’s balance sheet and the fact that it was profitable, Berkshire declared a dividend of $0.10 per share. This dividend, payable in 1967, was the last the company would pay—and likely will ever pay—under Buffett’s control. Buffett would later codify his thinking into a principle. [55] The capital under his stewardship was best retained if Berkshire could deliver more than a dollar of market value for each dollar of retained earnings, he explained. Paying a dividend not only deprived shareholders of the ability to have that dollar remain and compound on their behalf but was also tax inefficient. [56]

1967

The trouble anticipated the prior year was realized in 1967. In response to steep declines in sales volumes and pricing, Berkshire cut production by 15% to avoid building up inventories. But cutting production created another problem: the loss of trained labor. Because it couldn’t afford to maintain idle employees on the payroll while waiting for good times to return (if they returned at all), Berkshire was forced to lay off skilled labor. If Berkshire ramped up production in the future, it would face higher training costs to onboard new employees.

The ongoing weakness in the market for textiles necessitated the closing of another plant in 1967. The King Philip D plant in Warren, Rhode Island, which had a one-week shutdown in 1966 to avoid building excess inventories, closed permanently. The plant efficiently manufactured fine-combed lawns, but there was no longer demand for the product as cotton lawn products were being replaced by polyester blend fabrics. Further, there was little to no adaptability of the equipment f or new uses.

There were some bright spots in textiles. The Home Fabrics division expanded to a wider variety of fabrics, and Berkshire began an Apparel Fabrics division which sold finished yarn products into the women's apparel market. Both were profitable, but since the production orders were smaller and required more loom shifts, higher manufacturing costs reduced profits. By Buffett's own admission, company management and employees were hardworking and creative individuals.

Insurance

Buffett started allocating capital outside of the textile business—and in doing so, changed the face of Berkshire Hathaway forever. [57] The seminal event in 1967 was the acquisition of National Indemnity Company and its sister company, National Fire and Marine Insurance Company (considered together as National Indemnity [58]). The purchase of National Indemnity was perhaps the most important event in Berkshire's history, as it would provide a strong platform for future growth. More immediately it provided an outlet for the cash freed up by shrinking Berkshire's textile operations.

Jack Ringwalt and his brother Arthur founded National Indemnity in 1940. It was an unusual insurance company. The product didn't make it unusual. Insurance was and is a commoditized business with almost free entry. What made National Indemnity different was its philosophy of insuring risks other insurers rejected. The company began by insuring taxis. In addition to less-than-perfect drivers (the bulk of its business), the company insured risks others shunned entirely. The philosophy is best summed up by a quote from Jack Ringwalt: "There's no such thing as a bad risk, only bad rates." Ringwalt was willing to insure almost any risk, given an appropriate price. This included circus performers and lion tamers. [59] Even with more traditional risks, the insurance industry was like a pendulum, swinging between cycles of optimism and pessimism. National Indemnity's

willingness to accept higher risks (at higher rates) led to doing business when others walked away. It was a strategy built on discipline and a relentless attention to minimizing costs. It is no wonder Buffett was impressed.

Buffett was no stranger to insurance. He famously took a trip to Washington, D.C., as a Columbia University student to learn more about GEICO, which would later play a starring role at Berkshire. After the visit Buffett penned “The Security I Like Best”, featuring GEICO. National Indemnity operated in a different risk pool than GEICO (which focused on government employees with good driving records). But it had the basic characteristic of all insurance companies: a bucket of capital Buffett could allocate into undervalued businesses.

National Indemnity was on Buffett’s radar because of its headquarters in his hometown of Omaha. Buffett knew Ringwalt and had even tried unsuccessfully to persuade him to invest in the Buffett partnership years earlier. This time Buffett wanted to buy. He liked Ringwalt’s reputation as a manager and understood the business well. When an opportunity arose to buy National Indemnity, Buffett pounced. He also persuaded Ringwalt to stay on to manage the business, an acquisition strategy he became known for, and developed a friendship with him.

Buffett agreed to pay $8.6 million for National Indemnity, a $1.9 million premium over the tangible net worth of the company. Why would Buffett, whose personal fortune through that time was made largely by buying companies for less than their net worth, pay almost a 30% premium? The answer lay in the nature of the business and in Ringwalt.

Insurance is unlike most other businesses in that its assets are almost entirely comprised of securities. In the most basic construction of an insurance company balance sheet its assets are funded by policyholders (unearned premiums and claims waiting to be paid) and the balance is shareholders’ equity. Buying National Indemnity with Berkshire Hathaway meant Berkshire could allocate capital into securities it would buy anyway and, for a modest premium, also gain access to a well-run insurance operation. If Ringwalt (the expert insurance operator) could continue to earn an underwriting profit, those profits would pay for the upfront premium. Any additional gains Buffett could achieve by putting to work the

$19.4 million of investable float (explained more fully in the section on 1968) would be gravy. [60]

With hindsight we know this was one of the most important and attractive business acquisitions in Berkshire's history. But even Buffett admits it took him a while to realize just how good a deal National Indemnity was.

The 1967 Annual Report had little discussion of insurance company financial operations. [61] Berkshire's 1967 consolidated statement of earnings reported only National Indemnity's after-tax income: a $791,938 equity in earnings of unconsolidated subsidiaries. The report also disclosed a $100,147 after-tax realized investment gain attributable to National Indemnity's investment portfolio. Still, one sentence in the insurance discussion stood out: "All earnings of the insurance subsidiaries are being retained to build additional capital strength." It was a reminder that the dividends of 1967 would not return because Buffett's strategy was to invest in growth to bring more value to shareholders.

One final note should be made about 1967. Effective December 30, 1967, Berkshire changed its accounting year to a calendar year. As a result, the Annual Report for 1967 covered fifteen months. It reported the results for the twelve months that ended September 30, 1967, and the "stub" three-month period ending December 31, 1967. Efforts were made to provide shareholders with comparative figures to allow proper insight into business operations. [62]

1968

The 1968 letter to shareholders led off with a short, two-sentence paragraph starting this way: "Total operating earnings in relation to stockholders' investment still are not satisfactory… ." Buffett was alerting shareholders that in investing it's not the absolute level of profits that matter; it's whether the earnings are appropriate in relation to the amount invested. Berkshire's return on average shareholders' equity that year was 13.8%. This was not a poor result, and it was certainly better than Berkshire was accustomed to earning, but it was still below what Buffett considered satisfactory.

Textiles

Results for 1968 were separated into two paragraphs each for textiles and insurance, plus two additional paragraphs under a section titled, Marketable Securities and Acquisitions. Textiles that year were, not surprisingly, mixed. Revenues were up 14% to $46 million, led by Home Fabrics and Menswear Linings. The report pointed out that those areas were historically the most consistently profitable. Perhaps because of this, Berkshire had installed a new 150-inch loom for the coming year. Berkshire also held options on additional looms should volume materialize.

The Box Loom division was not part of that growth. Unlike Berkshire's more finished lines, the Box Loom division had historically suffered due to heavy imports and weak prices. Rather than continue operating in this area, Berkshire decided to phase out its operations of greige goods (raw textiles that are woven though not yet dyed or bleached). Additional losses from this division were forecast, though Berkshire anticipated improved overall results from textiles because of the change in strategy.

Insurance

The space devoted to commenting on the new insurance division (two paragraphs, like the textile division), clearly understated Buffett's enthusiasm for this new line of business. The division was performing so well that Berkshire would invest additional equity capital into operations and lay off less risk to reinsurers. (Reinsurers essentially buy a portion of the volume of business written by the primary insurer so that the primary insurer can continue to write business at levels appropriate in relation to its capital.) Buffett even suggested the possibility of entering the reinsurance field in the future.

After praising Jack Ringwalt for delivering a "splendid operating performance", Buffett explained the operating philosophy and strategy for the group. The focus would be on operating profits, not volume or market share. It was possible to operate at an underwriting loss like the industry as a whole and make up the difference with investment income, but Berkshire's insurance operations would seek underwriting profits first and foremost. It's worth noting that Berkshire still employs this strategy.

The financial disclosures for the Insurance Group in the 1968 letter were decidedly wanting. Despite owning 99% of the insurance businesses, the results were not consolidated with the parent company financial statements.

Instead, a line item on the balance sheet indicated an “investment in unconsolidated subsidiaries” of approximately $12.8 million. And the income statement only contained a line item for “equity in earnings of unconsolidated insurance companies” of $1.79 million (operating profits after tax) and $707,000 of after-tax investment gains.

It is unclear why more detailed results for the Insurance Group were not presented in 1968. However, complete statements for National Indemnity were included in 1969, with 1968 presented for comparison. Shareholders reading the 1968 Annual Report did not have the benefit of more detail, though fortunately we can examine each business more thoroughly during our review.

We will not venture into the fine detail of each insurance business but will instead look at the combined operations of the two subsidiaries as if they were one. Still, remember that National Fire and Marine was about one-tenth the size of National Indemnity, with premiums earned of $2.3 million compared to National Indemnity’s $20.3 million.

In 1968, combined premiums earned were just over $22.6 million. Net premiums written as a percentage of average equity were 221%. The Insurance Group was writing a significant volume of business. More importantly, it was being written profitably.

The single most important measure of profitability for an insurance company is captured in what is called the combined ratio. The combined ratio is made up of the loss ratio (amounts paid out to cover losses to insureds), and the expense ratio (expenses incurred to conduct operations and write additional premium volume, such as salaries and rent).

Equation 3.1

$$\text{Combined ratio} = \text{loss ratio} + \text{expense ratio}$$

or

$$\text{Combined ratio} = \frac{\text{loss expenses}}{\text{earned premiums}} + \frac{\text{underwriting expenses}}{\text{written premiums}}$$

In 1968, these ratios were 65.4% (loss ratio) and 32.1% (expenses), producing a combined ratio of 97.5%. It may seem counterintuitive, but a ratio below 100% is generally good and means an insurer is operating at an underwriting profit. In this case, Berkshire got to keep 2.5% of the insurance premiums it took in from policyholders, in addition to money earned from investing those funds.

It was not uncommon for insurers, then and now, to operate at an underwriting loss so long as investment earnings produced a satisfactory overall result. These investment operations are conducted with the monies collected by policyholders, but not yet paid out in claims. This pool of funds is called float and can contribute an enormous amount of value to an insurance operation since any profits from investing the float accrues to the insurer. [63] It is often self-serving for the managers of an insurance business to think they can write unprofitable business, and therefore capture more market share and make it up in the investment operations.

While this strategy could work, most insurance executives are poor investment professionals since they lack training in that area. [64] These two tendencies combine to produce subpar results for many insurance industry shareholders. Fortunately for Berkshire Hathaway shareholders, they had a profitable underwriting operation *and* a world-class investor working for them.

Concluding the 1968 Annual Report was a note on two acquisitions completed just after the year ended. At the beginning of 1969, Berkshire acquired 100% of Sun Newspapers and its related printing business, Blacker Printing Company, both based in Buffett's hometown of Omaha, Nebraska. The newspaper business of today pales in comparison to the industry that existed several decades ago. Back then, the business was profitable with high returns on capital for dominant papers. Buffett would build on this initial foray into the industry to earn strong profits for Berkshire shareholders. [65]

1969

The Berkshire Hathaway of earlier years could not call itself a conglomerate, but the present company could. Buffett wanted shareholders

to understand why this classification was so important and did so by opening the 1969 letter with a discussion of business strategy.

"Four years ago your management committed itself to the development of more substantial and more consistent earning power than appeared possible if capital continued to be invested exclusively in the textile industry." The paragraph goes on to explain that through two major acquisitions (the insurance subsidiaries, and a banking subsidiary acquired in early 1969), Berkshire averaged about a 10% return on shareholders' equity. This included the returns from the textile division, which were below 5%. For these reasons, the letter referred to the relatively new conglomerate as "reasonably successful"—when compared to other textile companies that remained or expanded solely in the textile industry. The underlying suggestion was clear: True success in textiles only would be hard or impossible to find.

Textiles

Despite this, textiles remained Berkshire's primary business operation, at least for now, and led off the first section of the letter. Not surprising for shareholders, textile sales in 1969 declined—12.1% to $40.4 million. The Box Loom division was shut down, causing substantial operating losses. The industry was in the throes of a recession worse than had been seen in many years because of an overall lack of demand.

In addition to closing the Box Loom division, Textile Group management instituted two-week shutdown periods to avoid building excess inventories. If a business believes demand will return in relatively short order, it may continue to produce product and store it for later sale. This keeps employees busy, but requires additional capital investment. Considering the severity of the 1969 slowdown, this would not have been wise. Even with the losses from Box Loom, the textile segment (after taxes) reported only a slight decrease in earnings, from $1.6 million in 1968 to $1.5 million a year later.

Insurance

Buffett led the insurance operations segment of his letter with praise for Jack Ringwalt and his team. (Buffett may have already been following his mantra of praise by name, criticize by category.) Under Ringwalt's leadership, Berkshire's insurance operations produced an underwriting

profit, compared to substantial underwriting losses for the fire and casualty insurance industry. This was a direct result of Ringwalt's policy of underwriting for a profit and not just for volume (recall the strategy discussion from 1968).

One interesting note as it pertains to Buffett's statement on underwriting profits is that the letter states the figure was an adjusted amount. This contrasted to the financial statements, which showed a combined (National Indemnity Insurance Company and National Fire & Marine Insurance Company) pre-tax underwriting *loss* of about $153,000. This is when it pays to read the fine print. The notes to the financial statements for the insurance companies contain the likely answer to these conflicting statements. Note 1, the Basis of Presentation, states that the financials are presented using insurance accounting principles, rather than Generally Accepted Accounting Principles (GAAP). While there are many specifics as to how these differ, the main takeaway is that insurance industry reporting standards are stricter. In other words, more conservative. [66]

A specific item worth noting from Note 1 is: While premium income is recorded pr0 rata over the period of the policy, the costs associated with writing the business are expensed immediately. Buffett knew that despite reporting losses that year, the business the insurance segment was underwriting would likely generate a profit over the lives of the policies. Spending money to bring in more business caused expenses to balloon, and there was no accounting convention for separating monies spent on expansion versus those for maintaining existing levels of business. Buffett needed shareholders to understand that Berkshire was investing in its insurance businesses with the expectation of future profit, reported profits falling where they may. A look at the combined ratio, which was below 100%, indicates a profitable year. [67]

A new surety department was doing well. It entered workman's compensation insurance with an office in Los Angeles, California and its reinsurance division was off to a strong start. Commenting on the latter, Buffett wrote that due to the nature of the business, it would take years before an intelligent verdict could be rendered. Berkshire had plans for a new Home State insurance operation (an insurance company operating in one state for regulatory reasons), and concluded, “Expectations are for continued growth in our insurance operations.”

Insurance results for 1969 illustrate Buffett's excitement about the segment. Premiums were growing at a double-digit rate, and the business was profitable, as judging by the sub-100% combined ratio. [68]

Table 3.3: Select Berkshire Hathaway insurance company data, 1968–69

($ millions)	1969	1968	Change
Premiums written	$28.8	$22.7	27%
Premiums earned	25.3	22.6	12%
Premiums written to average equity	215%	197%	18pts
Loss ratio	64.8%	65.4%	-0.7pts
Expense ratio	31.4%	32.1%	-0.6pts
Combined ratio	96.2%	97.5%	-1.3pts

Sources: Berkshire Hathaway Annual Report 1969 and author's calculations.

It's worth pausing to discuss the two premium figures contained in Table 3.3. Premiums written reflect the amount of business written during any given year. These are a direct consequence of the insurance company's sales force. Premiums earned are different. A policy written today that covers the next two years will be reflected in today's written results, but half will not be earned until the next year. Therefore it takes many years for underwriting skill to become apparent. Anyone can write a policy, but it takes an intelligent manager to write profitable business today while looking at tomorrow's risks.

Another major reason insurance premiums earned might differ from those written is due to reinsurance. Reinsurance is simply the practice of laying off or ceding some of the written policies to another insurer. This allows an insurance company to share some of the risk it undertakes and maximize its sales force. (In general, salespeople like writing business and don't like to stop because the insurer has too many policies on the books.) The amount of reinsurance can vary from substantial to negligible or nothing at all depending on the need or desire to diversify or maintain capital levels. Berkshire would not only look to retain the business it was writing, but grow naturally by taking on additional risk through its own reinsurance

operations. In its inaugural year, Berkshire wrote $2.7 million of reinsurance business. [69]

Banking

The major acquisition of 1969 was the purchase of the Illinois National Bank & Trust Company. Banking, like insurance, involves prudently managing risks that take time to materialize. A bank's long-term record tells a compelling story. Buffett provided a short history of the bank for shareholders, which is worth repeating here:

> "This bank had been built by Eugene Abegg, without addition of outside capital, from $250,000 of net worth and $400,000 of deposits in 1931, to $17 million of net worth and $100 million of deposits in 1969. Mr. Abegg has continued as Chairman and produced record operating earnings (before security losses) of approximately $2 million in 1969. Such earnings, as a percentage of either deposits or total assets, are close to the top among larger commercial banks in the country which are not primarily trust department operations."

To achieve such a growth rate over the preceding 38 years would have required an almost 12% return on equity, and an annual growth rate of 15.6% in the deposit base. Given the long history of sound and profitable operations, Buffett could rightfully conclude that, like Ringwalt, Abegg knew what he was doing.

The purchase price of the bank was not detailed, but we can back into it using the financial information contained in the Annual Report (see Table 3.4). This information shows that Berkshire paid approximately 1.05 times book value for the bank—a very attractive price given the quality of the bank. [70] This came to $17.7 million.

Table 3.4: The Illinois National Bank & Trust Co. of Rockford, acquisition analysis

($ millions)	
1969 ending carrying value	$18.9
Less: 1969 earnings	1.2
Berkshire purchase price	17.7
1968 Bank book value	16.8

Purchase multiple	1.05

Sources: Berkshire Hathaway Annual Report 1969 and author's calculations.

Buffett used Berkshire's now strengthened balance sheet to fund the purchase of the bank. Marketable securities were almost completely sold, raising approximately $11 million. [71] The shrinking textile operations provided almost $4.6 million through reductions in working capital and physical plant investment. Berkshire also augmented its funds by borrowing an additional $4.75 million. [72]

Berkshire, under the leadership of Warren Buffett, was becoming a very different company.

1970

Berkshire's mix of businesses produced equally mixed results in 1970. Its newly acquired bank did very well, insurance was mixed, and textiles were, unsurprisingly, mediocre.

Textiles

Still, the textile division's management team deserved compliments. Calling out Ken Chace by name, Buffett praised Chace and his group for their efforts to turn around the division while "swimming against a strong tide." That tide was the confluence of factors making the economics of textiles in New England unsustainable: high relative labor and electricity costs, coupled with stiff overseas competition.

In response to poor demand in both menswear linings and home fabrics, the division reduced production. This meant making sure inventories did not grow too far out of line from current sales levels. Over the preceding five years, inventories had averaged 25% of sales. With sales down 39% to $24.6 million in 1970, the ratio ballooned to 34%. Fluctuations in sales are not atypical in business, and if a manager expected a return to higher sales levels inventories might be maintained at the same dollar levels as before. With textiles though—a commodity whose finished products were subject to style trends, expensive to make, and where demand had dropped over time—waiting was not an option.

Despite the large drop in sales, the division eked out a tiny $107,000 profit. A good result relative to the large drop in sales, and certainly better than a loss, but far from satisfactory in relation to the capital employed in the business: $11.1 million in average non-cash working capital and $2.8 million in average property, plant, and equipment.

Insurance

The insurance segment turned in mixed, though generally satisfactory results, in 1970. Buffett said growth was outstanding, with premiums written and earned up over 55% to $45 million and $39 million, respectively. That included $7 million of written premiums in the reinsurance segment (over two and a half times the volume done the year before). But he was quick to point out that the growth in premiums was "accompanied by a somewhat poorer underwriting picture." This led to an underwriting loss of $330,000 for the Insurance Group, which meant that any earnings from the segment had to come from investing.

It is clear Buffett's enthusiasm for insurance remained strong despite the higher loss ratio. This is because he understood how the business worked. The operating philosophy of National Indemnity was to catch waves of business when it became profitable. That year a "surge of volume" resulted from more restricted markets (meaning other insurance companies pulling back after losing money).

Ringwalt's development of Home State insurance operations in 1970 signaled the future operational mantra of Buffett and Berkshire. The first operation was Cornhusker Casualty Company in Nebraska, a 100% owned subsidiary of National Indemnity. It wrote premiums of $249,000 that year. Buffett noted its "big-company capability and small-company accessibility," demonstrating the advantages of decentralized operations. Today, decentralization is the operating philosophy in all of Berkshire's operations. As the Berkshire Annual Reports would later remark, Berkshire's operations are managed via "delegation just shy of abdication." If readers were not yet convinced of Buffett's enthusiasm for this operation and for Ringwalt, Buffett let them know first that Ringwalt brought the concept to life and that there were plans to form more companies under the Home State banner.

Banking

Turning to Berkshire’s new banking operation, Buffett was all praise for Illinois National Bank. He noted that the bank’s operating return was the sign of “an exceptionally well-managed banking business.” The bank earned a strong 1.9% return on average assets (ROA [73]) in 1970. [74]

It’s worth pausing to note that while a 1.9% return may appear very low on an absolute basis—even lower than that of a basic savings account at the time—the economics of banking are such that it was truly an indication of a well-managed bank. Because banks have the advantage of using leverage (meaning they hold many more dollars in deposits than they do in equity capital), that 1.9% return on assets turned into a return on average equity (ROE) of 12.5%.

The concept is similar to the return on capital calculations used elsewhere in this book with leverage factored in. See the equations below:

Equation 3.2

$$\textbf{\textit{Bank:}}\ \underbrace{\frac{\textit{operating income}}{\textit{assets}}}_{\text{Return on assets}} \times \frac{\textit{assets}}{\textit{equity}} = \textit{return on equity}$$

$$\textbf{\textit{Non bank:}}\ \underbrace{\frac{\textit{profit}}{\textit{revenues}} \times \frac{\textit{revenues}}{\textit{total capital}}}_{\text{Return on capital}} \times \frac{\textit{total capital}}{\textit{equity}} = \textit{return on equity}$$

Using the figures from the Illinois National Bank, we can see how its ROA is an indication of good economics and translates into a satisfactory ROE. Because the bank had nearly seven times the amount of assets as it did equity capital, the ROA is multiplied or leveraged by that same factor. While the use of leverage in the bank may seem (and is) high compared to other businesses, from a banking perspective it is on the conservative side. Today's banks routinely use ten- or twelve-times leverage. This creates higher returns on equity but brings additional risk and is one reason why banks are so tightly regulated.

Table 3.5: Illinois National Bank, return on assets and return on equity calculation, 1970

($ thousands)	
Operating income, after-tax	$2,221
Average assets	119,758
Return on assets	1.9%
Average equity	17,704
Avg. assets / avg. equity	6.8
Return on equity	12.5%

Sources: Berkshire Hathaway Annual Report 1970 and author's calculations.

The results from Illinois National Bank were achieved while maintaining high levels of liquidity. Its average loans to deposits ratio was just 49%. For perspective, today's banks routinely loan up to 80% of deposits. The remainder of Illinois National Bank's assets were in the investment portfolio or sitting in cash, with a small portion in premises and equipment, and other assets.

In short, Illinois National Bank was a conservatively run bank that managed its costs exceptionally well and as a result was highly profitable. This was a testament to Eugene Abegg and his management team.

Having just acquired Illinois National, Berkshire learned it would be required to sell it. At the end of 1970, Congress amended the Bank Holding Company Act of 1956 to include one-bank holding companies. The law prohibited these companies from owning non-bank companies. This meant Berkshire would not only need to sell the bank it had just purchased, but also be subject to oversight by the Federal Reserve Board and have

restrictions on its acquisition activity. But Berkshire had some time. The law gave Berkshire ten years to sell, spin off, or otherwise dispose of Illinois National. In the meantime, as we'll see, Berkshire enjoyed the fruits of its ownership of Illinois National, and entered the banking business in other ways.

1971

In his opening paragraph to the 1971 Annual Report, Buffett included a reminder of his management objective. That objective was "to improve return on total capitalization … as well as the return on equity capital." Buffett noted that Berkshire's return on equity that year was 14%, which was above the average of corporate America. He highlighted his goal to improve return on total capitalization (the sum of long-term debt plus equity) as a reminder that Berkshire would not go about achieving high returns on equity by leveraging the balance sheet through excess borrowing. Although Berkshire would borrow funds at the parent level from time to time (and did so in 1971), these amounts would be very conservative. Notably, the satisfactory return on equity of 14% in 1971 included drag from inadequate earnings of the textile division. This highlights the success of the strategy to redeploy capital to greener pastures.

Textiles

Notwithstanding considerable efforts to reduce costs, the textile division struggled with low gross margins. A mild industry pickup was thought to be on the horizon, with more favorable volume and mix of business in the coming year.

The inadequacy of the Textile Group's returns is evident in its financial performance during the year. The meager operating profit represented a pre-tax return on capital of just 1.9% (see Table 3.6). No wonder Buffett was so quick to move on.

Table 3.6: Textile division, select data, 1971

($ millions)	1971	1970
Revenues	$26.0	$24.6
Operating profit	0.233	0.107

Capital employed	12.1	14.5
Return on capital, pre-tax	1.9%	0.7%

Source: Berkshire Hathaway Annual Reports 1970, 1972.

Insurance

Quite contrary to the industry headwinds experienced in textiles, the insurance division (whose financials were now reported together under Insurance Group) had a considerable tailwind in 1971. As a result of some significant good fortune, the industry experienced reduced auto accident frequency, higher premium rates, and an absence of major disasters. For Berkshire this translated into 47% growth in premiums written, to $66 million, and a solid 95% combined ratio that brought in $1.4 million of underwrit ing profits.

This was all good news if you took it at face value, but when viewed as the calm before the storm, it carried a warning. Buffett knew this and was quick to point it out. “We shared in these benefits, although they are not without their negative connotations,” he wrote. These strong results would bring more competitors into the marketplace. Those competitors would drive premiums to the point of unprofitability. It was only when competitors faced losses that they would either raise rates, pull back on writing business, or both. Until then, Berkshire’s insurance managers would focus on underwriting profitability—volume be as it may.

Keeping the focus on the long term, Berkshire continued the expansion of its Home State operations. During 1971 it formed Lakeland Fire & Casualty Company in Minnesota and Texas United Insurance in Texas (which legally formed in 1972). The Home State business accounted for just $1.5 million in premium volume, but volume was expected to double in 1972 with these new additions.

Another area of insurance growth in 1971 was the acquisition of Home & Automobile Insurance Company in Chicago on September 30. [75] With volume of $7.5 million a year, Buffett highlighted the similarities between its founder, Victor Raab, and Berkshire’s own star managers, Jack Ringwalt and Eugene Abegg. While National Indemnity accepted just about any risk from almost anyone (requiring pricing one-off policies), Raab focused on insuring those within Chicago’s urban areas, a more statistical-type

operation. Buffett saw so much potential in this new acquisition that he added capital to the business because Raab was continually up against capital limits that hindered growth.

Although we do not know the precise amount added to Home and Auto because it was consolidated with Berkshire's other insurance operations, an additional $8.5 million in equity was added to the Insurance Group to support its burgeoning premium volumes. [76] This amount was partially funded by a new $9 million loan. [77] (A portion of the proceeds repaid the outstanding balance of a prior note.)

Commenting on this debt financing in the latter part of the 1971 Chairman's letter, Buffett stressed that Berkshire wouldn't overburden its balance sheet. Berkshire's insurance and banking subsidiaries possessed a special fiduciary relationship with the public, and this required Berkshire to always remain very strongly financed. This meant that, at both the parent and the subsidiary level, Berkshire would always "unquestionably fulfill our responsibilities." From the consolidated balance sheet at year-end 1971, Berkshire owed a total of $9.6 million compared to equity of $56.2 million—a debt-to-total capital ratio of just 15%.

Banking

Berkshire's banking division faced a tough year in 1971. Interest rates declined, which caused a corresponding decrease in interest income for the bank. Compounding the challenges on the income side was the nature of Illinois National Bank's deposit base. Its deposits were becoming more time-based as opposed to demand-based. Time-based funding (e.g. certificates of deposits) are much more expensive to a bank than demand deposits (checking accounts) which typically pay little or no interest. Nonetheless, Abegg and his team continued to hold the line on expenses and maintained the bank's conservative investment strategy of high-quality loans.

1972

Buffett described 1972 as a highly satisfactory year in large part due to the 19.8% return on beginning shareholders' equity. Each division contributed to the overall success, although the Insurance Group led the charge,

partially due to the "unusual convergence of favorable factors" [78] described in 1971.

Before moving into a more detailed review of each division, Buffett took the time to comment on the past eight years of his direct management of Berkshire. Since he took control in May 1965, operating earnings were substantially higher, and the diversification and redeployment of capital outside of the textile industry "established a significantly higher base of normal earning power" for shareholders. Shares outstanding had been reduced by 14% through repurchases, and book value, which was $19.46 per share at year-end 1964, had climbed 16.5% annually, ending 1972 at $69.72 per share. Lest Buffett be accused of claiming the credit for himself, he praised Jack Ringwalt, Eugene Abegg, and Victor Raab, the individuals operating National Indemnity Company and National Fire & Marine Company, Illinois National Bank, and the Home & Auto Insurance divisions, respectively.

Textiles

It's worth pausing to examine some figures relating to the textile division for 1972. Inventories increased at a double-digit rate, but the increase in revenues was much more modest. Furthermore, a reduction in accounts receivable coupled with increases in payables, freed up capital from the textile division. Capital requirements were controlled through careful inventory management and suggested a positive outlook for 1973.

Another item deserving attention is the increase in payables. Because payables are monies owed to suppliers, the textile division was effectively borrowing from suppliers to finance its operations. This released capital from the division that could be reallocated by Buffett elsewhere. The practice could not go on forever, as suppliers must eventually be paid, but it is common. For example, Walmart has taken this financial management strategy to an extreme, using its large purchasing power to extract long terms from suppliers. This means suppliers are financing Walmart's balance sheet as the price for doing business with the retail giant.

In sum, combining the capital tied up in net working assets, fixed assets, and an estimate of the cash needed to operate the division, total capital employed in the textile division decreased by $1.5 million. This decrease in required capital coupled with the improvement in operating performance

translated into a 16% return on capital (see Table 3.7)—by far the best in many years and clearly a positive aberration.

Table 3.7: Textile division—select data

($ millions)	1972	1971
Revenues	$27.7	$26.0
Operating profit	1.697	0.233
Capital employed	10.5	12.1
Return on capital, pre-tax	16.1%	1.9%
Inventories	6.8	6.0
Inventories as % revenues	25%	23%
Accounts receivable (AR)	4.1	5.1
AR as % revenues	15%	20%

Sources: Berkshire Hathaway Annual Report 1972 and author's calculations.

Insurance

The textile industry had a very good year, but it dimmed in comparison to the insurance industry. Although overall premium volume declined, profits swelled due to very favorable loss experience. This included:

- National Indemnity's specialized business wrote premiums of $35 million (down 26%)
- Reinsurance wrote premiums of $11 million (down 24%)
- Home State operations had written premiums of $4.3 million (up more than 2.5 times)
- Home and Auto delivered written premiums of $6.9 million. Those were substantially higher than the $2 million written the prior year for Berkshire but down from $7.7 million written during the full year (remember Home and Auto was acquired on September 30, 1971).

Recall that a combined ratio of less than 100% is a good thing. The 1972 combined ratio was 93.7%. This meant that Berkshire's Insurance Group was being *paid* over 6% to do business with customers. This was on top of

the money it made investing the float that came with holding its customers' money until loss claims came in. Float at the end of 1972 amounted to $70 million. High interest rates meant Berkshire enjoyed an enormous economic advantage holding onto these funds. [79] Additionally, Berkshire's bond portfolio had unusually good call protection, which would protect the high yields on those investments.

Table 3.8: Insurance Group—select data

($ millions)	1972	1971
Premiums written	$58.0	$66.5
Premiums earned	59.6	60.9
Pre-tax underwriting gain	4.3	1.4
Pre-tax net investment income	6.6	5.0
Return on average equity	22.2%	21.6%
Loss ratio	62.0%	67.0%
Expense ratio	31.7%	28.1%
Combined ratio	93.7%	95.1%

Sources: Berkshire Hathaway Annual Report 1972 and author's calculations.

The extremely good profitability enjoyed during 1972 almost immediately attracted competition. Resulting volume declines starting in 1972 brought expectations of lower pricing for the near future. Although premiums earned fell only 2%, premiums written fell 13%. Berkshire would continue writing insurance at the right price, but would let volumes shrink if market rates were too low. Basing rates on long-term expectations, and accepting lower volume short term, was the best path to above-average long-term results.

If Berkshire was pulling back writing insurance business in the near term, it surely was not taking its foot off the gas in terms of building its *capacity* to write insurance. Berkshire planned to build on its acquisition of Home and Automobile Insurance of Chicago with new operations in Dade County, Florida and Los Angeles. Home State expanded with new ventures in Minnesota and Texas. All of these moves were made with an eye toward capturing more business when it materialized at appropriate prices.

Banking

Like Berkshire's Insurance Group, Eugene Abegg and his team at Illinois National Bank were excellent underwriters of risk and rightfully deserved Buffett's annual praise. Charge offs, or loans deemed uncollectible, were a mere 1/20th of those at other commercial banks. In 1972, the Bank wrote off $4,669 (no zeros omitted), or 0.0078% of its almost $60 million in loans, an exceptional banking record in any period.

1973

The Chairman's letter in 1973 contained a flurry of information for shareholders. First, however, Buffett led off with his customary quantitative disclosure of Berkshire's return on beginning shareholders' equity. That year's result, a gain of 17.4%, was down from the prior year's 19.8%. But Buffett was quick to point out that it was the *rate* of increase in book value, not the dollar amount, that mattered. Indeed, earnings per share had increased from $11.43 to $12.18. Buffett reiterated, "management's objective is to achieve a return on capital over the long term which averages somewhat higher than that of American industry generally—while utilizing sound accounting and debt policies." From the vantage point of history, we know this objective was achieved by a wide margin.

Textiles

The textile division reported strong results in 1973. High demand brought the trendline above average for Berkshire's textiles but still just average when judged from an absolute sense. [80]

Table 3.9: Textile division, select data

($ millions)	1973	1972	% Change
Revenues	$33.4	$27.7	21%
Operating profit	2.8	1.7	65%

Source: Berkshire Hathaway Annual Report, 1973 and author's calculations.

Partially holding back the Textile Group's performance were the Nixon Administration's Cost of Living Council's price controls. [81] Buffett said these "served to cut down some of the hills while still leaving us with the inevitable valleys." Textiles is a highly cyclical industry. Having a capped upside with unlimited downside was good for consumers, but terrible for a business owner.

In response to inflationary pressures on raw materials, the Textile Group changed its accounting from FIFO to LIFO. [82] LIFO, or last-in-first-out, is a method of accounting for inventory that matches most recent costs against current revenue. This was a change from FIFO, or first-in-first-out, which matches old costs against current revenue. If Berkshire had remained under FIFO, the rising price environment would leave it assigning low values to costs as it sold products, and thus incurring higher taxes. While other managements might have enjoyed the reported profitability boost that FIFO produced (since low cost = higher profit and vice versa), Buffett preferred the more favorable economic result, even if it depressed reported profits.

Insurance

Insurance results were generally very good, although not without difficulties. National Indemnity and sister company National Fire and Marine had an exceptionally fine year, Buffett said, a fitting capstone for Jack Ringwalt, who retired as president after thirty-three years at the helm (he remained CEO). National Indemnity reported a $4.4 million underwriting profit on earned premiums of $30 million. That is impressive considering earned premiums fell 21% from the prior year. Buffett praised his successor, Phil Liesche, as having the same qualities as Ringwalt.

The Reinsurance Group experienced similarly satisfactory results during the year. Unfortunately, it experienced slightly lower volumes due to the influx of competition chasing yesterday's good results. Underwriting profit came in at $353,000 on earned premiums of $12 million.

Overall, the Insurance Group wrote 13% less in premium volume and earned 11% less than the prior year. Its profitability remained intact, with the combined ratio increasing slightly, but still very satisfactory, to 95.3%. This was good for $3.3 million of underwriting profits. (National Indemnity's profits subsidized underwriting losses at Home and Auto and Home State.)

Additional challenges in the Insurance Group came from managerial issues. The Home State companies had good results in Nebraska and Minnesota, along with an expansion into Iowa, which combined with other successes provided optimism. But Texas was a problem that required a restart almost from scratch.

Another area of weakness was in Home and Auto's Chicago operations. Even after borrowing funds to bolster its capacity to write business, [83] it experienced very poor results from underwriting. The cause: inadequate rates. Inflation caused medical and repair costs to escalate rapidly. Such costs were borne by the insurer, which had to live with the premiums its insureds had paid for the coverage, even if they became inadequate. Another threat to insurance profitability was higher jury awards paid by insurance companies to insureds. These juries tend to be very sympathetic to claimants. Insurance companies can and do include estimates for such costs in their policy rates, but if costs rise dramatically during the year, the difference can result in subpar profitability.

Offsetting those inflationary costs was an ongoing oil crisis, which created higher gasoline prices and led consumers to take fewer long car trips. This in turn lowered accident frequency. Buffett told shareholders he was not as optimistic as some competitors that lower accident frequency would offset the inflation seen in repair and jury costs.

A weakness in the accounting system at Home and Auto highlighted the impact data quality has on insurance profitability. Information was not brought to management's attention in a timely manner and policies were being written at rates that did not adequately reflect the cost of doing business. Buffett assured shareholders the situation was being addressed. Home and Auto expanded into Florida and California as planned, though an assessment of the results through 1973 was too preliminary to determine its effectiveness.

Investments

A large portion of Berkshire's investment portfolio resided on the books of the Insurance Group. The bear market that began in 1973 (coinciding with an economic recession) negatively impacted Berkshire's investments. Over $12 million in unrealized losses that occurred during 1973 represented a distressingly large portion of the $67 million average common stock

portfolio within the Insurance Group. Despite such large reported losses, Buffett expressed confidence in the portfolio:

> "Nevertheless, we believe that our common stock portfolio at cost represents good value in terms of intrinsic business worth. In spite of the large unrealized loss at year-end, we would expect satisfactory results from the portfolio over the longer term."

Perhaps intentionally not stated in the letter to shareholders (for fear of arousing nervousness), Berkshire invested significant sums during 1973. The Insurance Group's financial reports show that over $15 million in bonds and preferred stocks were liquidated in order to invest over $32 million in common stocks and over $1.5 million in Blue Chip Stamps. One notable investment made in 1973 was $10.6 million for 467,150 shares in *The Washington Post* that declined to $7.9 million at year-end. [84] Berkshire could make such investments because it had both the resources and ample capacity to do so. [85]

Diversified Retailing

After two short paragraphs with the usual praise for Berkshire's banking subsidiary, Buffett turned his attention to a proposed merger with Diversified Retailing. If one had only been reading Buffett's reports to shareholders over the past nine years, you might have never heard of Diversified Retailing. The company ran a chain of women's apparel stores in addition to a reinsurance business. [86] The unusual reinsurance business line was the handiwork of Buffett, the controlling shareholder of Diversified. Buffett and Charlie Munger would weave such a complicated web of business lines and business ownership that the SEC would later investigate them for fraud. (Their dealings were above board, of course, though most financial fraud is accompanied by intricate accounting maneuvers meant to cover up misdeeds.) A merger would simplify much of the cross-ownership that got them into trouble in the first place.

The proposed merger, approved by Berkshire's directors, would be funded by issuing 195,000 Berkshire shares. Because Diversified owned 109,551 shares of Berkshire (you can see how a regulator might begin to suspect something was awry), dilution at Berkshire would be less than 86,000 shares. On 980,000 then outstanding Berkshire shares, dilution would come

to less than 10%. Presumably, Berkshire would be receiving at least as much in business value as it was giving up.

Buffett told shareholders that "its [Diversified] most important asset is 16% of the stock of Blue Chip Stamps." Berkshire itself owned some Blue Chip Stamps shares directly. Post-merger, Berkshire's ownership in Blue Chip would increase from 22.5% to 38%.

With or without the Diversified Retailing merger, exceeding the 20% ownership mark required Berkshire to report its proportional share of Blue Chip's earnings on its financial statements. Blue Chip's year ended in February, [87] compared to Berkshire's calendar year. Berkshire had to decide which period to include. One option, blessed by Berkshire's auditors, was to use the earnings and ownership level as of Blue Chip's prior audit. This would mean including the twelve months ended February 1973 [88] in Berkshire's results for the twelve months ended December 31, 1973. Buffett said that "such an approach seemed at odds with reality" considering the ten-month lag. He chose to use the unaudited results of Blue Chip for the twelve months ended November 1973. Even though Berkshire auditors couldn't officially okay them, this choice resulted in just one month of Blue Chip's results falling outside of Berkshire's, instead of ten.

Figure 3.1: Blue Chip's consolidation into Berkshire's financials

Audit exception

Closer to economic reality

(11 months of overlap)

Berkshire Hathaway	Blue Chip Stamps	
	December	Prior audit
January	January	Prior audit
February	February	Prior audit
March	March	Unaudited results
April	April	Unaudited results
May	May	Unaudited results
June	June	Unaudited results
July	July	Unaudited results
August	August	Unaudited results
September	September	Unaudited results
October	October	Unaudited results
November	November	Unaudited results
December		

No audit exception

Further from economic reality

(2 months of overlap)

Berkshire Hathaway	Blue Chip Stamps	
	March	Audited results
	April	Audited results
	May	Audited results
	June	Audited results
	July	Audited results
	August	Audited results
	September	Audited results
	October	Audited results
	November	Audited results
	December	Audited results
January	January	Audited results
February	February	Audited results
March		
April		
May		
June		
July		
August		
September		
October		
November		
December		

Buffett noted that Blue Chip had “important sources of earnings power in its See’s Candy Shops subsidiary as well as Wesco Financial… .” Wesco was a 54%-owned subsidiary of Blue Chip that operated a savings and loan business. Charlie Munger would serve as Wesco’s Chairman for many years until it was brought under Berkshire’s umbrella in a 2011 transaction (Wesco and its subsidiaries will be discussed later in the book).

Concluding the 1973 letter was a note on the Pulitzer Prize-winning Sun Newspapers. That group was last mentioned by Buffett in the 1969 Annual Report, though because of its small size got little attention. Despite this, the paper earned a Pulitzer, the highest honor in newspapers, for exposing the incredible story of fraud at Boys Town, a local Omaha-based charity that was hoarding money but claimed poverty. Buffett praised the paper’s management, journalists, and editorial staff for their achievement and signed off for the ninth time.

1974

Buffett wasted no time getting to the major driver of the relatively poor results achieved during 1974. Surprisingly, it was not the textile division. This time it was insurance. In his opening sentence to shareholders, Buffett shared that insurance underwriting had been dismal. Weakness was anticipated in his 1973 letter, but the extent of the 1974 reversal took him by surprise. Offsetting the weakness in insurance were quite satisfactory performance by both the Textile Group and the bank, the net result of which was a 10.3% return on beginning shareholders’ equity for Berkshire as a whole. Results for 1974 underscored the value in having numerous sources of operating earnings, a benefit Berkshire lacked before Buffett transformed the company using his capital allocation skills.

Textiles

Textiles achieved fleeting profitability in 1974 before signs of weakness appeared. The division operated at one-third of capacity, which would result in future operating losses in the coming year if sales volumes remained depressed. Despite this, the division’s $2.7 million in operating income, though down somewhat from the $2.8 million posted a year earlier, was something to celebrate.

As of 1974, the group primarily produced curtains, which were not necessities and thus sensitive to economic conditions. The ongoing recession caused consumers to defer purchases of such non-essential goods. Additionally, housing starts were down, which meant fewer windows needing curtains. If that wasn't enough, retailers were also trimming their inventories and making fewer purchases from Berkshire. [89]

Insurance

The confluence of competition, the trend of inflation running at approximately 1% per month, [90] and several mistakes that came to light in 1974, caused insurance underwriting results to deteriorate significantly. Battling competition that was very wary to increase premium rates to combat the rising costs of paying its insureds, Berkshire pulled back writing what it saw as unprofitable business. Each line of business reported an underwriting loss. The combined ratio, which had been in profitable territory at or below 100% since entering that business, now jumped to 111%. The $6.9 million underwriting loss wiped out three-quarters of the cumulative underwriting profits made in Berkshire's short seven-year history.

Premiums written and earned were $61 million, up 21% and 14%, respectively. But Berkshire's Insurance Group was writing far less business that it could have been. Since 1970, when net premiums written to average equity peaked at 272%, this ratio had declined steadily to 88% by 1974. [91] Whether due to a desire to maintain premium volume or simply because they had to, [92] the industry continued to write unprofitable business. Berkshire intelligently remained on the sidelines. It had both the ability and the willingness to reduce its volumes short term to remain profitable long term.

Though general industry conditions and stiff competition hurt results during the year, nothing was more painful than self-inflicted losses. After telling shareholders of plans to expand into the Florida market, Buffett now informed his partners that the decision to expand Home and Autoto that state "proved disastrous". Buffett calculated the financial cost of the mistake at $2 million, most of which was realized in 1974. [93] He summed up the mistake in one sentence: "In retrospect, it is apparent that our

management simply did not have the underwriting information and the pricing knowledge necessary to be operating in the area."

Still, there was reason for optimism. The Home State group continued to grow premiums (up 9%) while getting a handle on costs, and the restart in Texas appeared to be working. Long-term success came with temporary setbacks. Berkshire had the patience, and perhaps more important, the capital strength, to ride out the storm.

Berkshire's advantage, largely by design, was its large capital base invested in high-quality assets. As noted earlier, Berkshire wrote just a fraction of its capital base each year in premium volume, far below its competitors percentage wise. Though profitability was down, the group still reported net operating income during the year thanks to net investment income more than offsetting the underwriting losses. [94]

Weak operating results during the year had one, if not positive, at least mitigating consequence. On a consolidated basis, Berkshire incurred no tax expense during the year, and in fact it booked a tax credit. Although textiles and banking were strong and generated taxable income, these earnings were reported along with all of Berkshire for tax purposes. The tax loss in the Insurance Group was available to shield income from other parts of the business.

The Insurance Group overall reported a profit, but the components of that profit were taxed differently. For example, it held certain tax-exempt issues, and its dividends were taxed at a lower rate. This meant it could use the underwriting loss to shield taxable income elsewhere within Berkshire. In later years, Berkshire would gain enormous similar tax benefits from owning utilities under the same corporate parent, maximizing every benefit of the conglomerate structure.

Banking

Separate financials for the bank [95] reflected the tax advantage it received as a subsidiary of Berkshire. On pre-tax, pre-securities gain income of $4.2 million the Bank accounted for just $220,000 of income tax, a rate of about 5% and far below the federal statutory rate of 48%. This was a direct result of tax credits from the Insurance Group. Clearly this low level of taxation was not normal, and the Bank would have paid much more had its parent at

the time not been Berkshire Hathaway. The benefit to the Bank and Berkshire was real.

Accounting

Being owned by a conglomerate clearly created tax complications. Perhaps for this reason, or to remove the effect of changing tax rates over time, Buffett frequently commented on and used pre-tax profitability in his analysis of business results. At the end of the 1974 Annual Report was a new section entitled Management's Discussion and Analysis of the Summary of Operations. This new section was mandated by accounting standards [96] and contained additional details for readers of the financial statements. One sub-section contained a chart titled, Sources of Net Income, with data going back five years. The chart, reproduced in the appendix, separated each contributing source of income from corporate administrative and interest expense, realized investment gains/losses, and income taxes.

Elsewhere readers could see detail of the insurance premiums broken down by line. The section was largely a reproduction of the data Buffett had been giving readers all along. It would not be the first time Buffett was ahead of the accounting standards.

The new supplementary report also contained a section explaining the difference between statutory and GAAP accounting for the Insurance Group. Insurance authorities use a separate accounting system to analyze insurance companies that focuses on the insurance company's real ability to pay its claimants. Its aim is not economic reporting, but conservatism. That conservatism was important to understand because it placed restrictions on how much business the insurer could write and how its assets could be invested.

One of these adjustments was for deferred policy acquisition costs. These were the costs of acquiring new customers and included such expenses as brokers' commissions and marketing expenses. From an economic perspective, these expenses were assigned to the policies they sought to gain. As such, GAAP accounting placed some of the expense on the balance sheet as an asset, which was reduced over time as the insurer earned the policies. For statutory insurance accounting purposes, however, they were not included, since the monies had already been spent and would

not be available in the event the resources were required to pay policyholders.

A reconciliation of Berkshire's statutory accounting surplus to that under GAAP for 1974 highlights many of the big differences between the two accounting standards. These included:

- Unrealized gains on equity securities
- Excess carrying value of subsidiaries
- Goodwill
- Deferred policy acquisition costs (mentioned above)
- Excess statutory liability loss reserves
- Certain insurance receivables
- Other non-admitted assets
- Certain other tax effects and adjustments (relating to depreciation and write-offs, for example)

Table 3.10: Reconciliation of statutory surplus to GAAP shareholders' equity, 1974

($ thousands)	
Policyholder statutory surplus	$37,202
Unrealized gains on equity securities (excluding Blue Chip Stamps)	16,450
Excess of carrying value in Blue Chip Stamps	9,176
Deferred policy acquisition costs	4,400
Excess statutory liability loss reserves	1,851
Net recoverable from unauthorized reinsurers	1,788
Sundry nonadmitted assets	1,043
Income tax effects and adjustments	(1,678)
Capital stock and surplus - GAAP	$70,231

Source: Berkshire Hathaway Annual Report 1974.

Diversified Retailing

Disappointingly, the proposed merger with Diversified Retailing, which was approved by the directors of each company the prior year and put to a shareholder vote, had been terminated because the Securities and Exchange Commission (SEC) hadn't given its okay. [97] [98] Shareholders would have to wait until 1977 for the deal to finally close. That didn't stop Berkshire from increasing its ownership in Blue Chip Stamps to 25% at year-end.

Listed at the end of the 1974 Annual Report were Berkshire's Directors and Executive Officers. It stood out for the small number of individuals listed: Buffett, as board chair and CEO of Berkshire; Ken Chace, as president of Berkshire and COO of the Textile Group; Malcolm Chace, Jr., retired former Berkshire chairman; and J. Verne McKenzie, as VP, secretary, and treasurer. For a company with over $200 million in assets and annual revenues north of $100 million, it was a lean team. Buffett preferred it that way.

Decade in Review

Perhaps at no other time in Berkshire Hathaway's history did the company experience more change. Berkshire had seen dramatic ups and downs before as its textile business went through violent business cycles. But the change experienced in the decade ending in 1974 was noteworthy for its shift in business strategy and capital allocation. Rather than continue solely in textiles, Berkshire under Buffett was redeploying capital into new industries. Buffett was shaping Berkshire into not the best *textile* company, but the best company—period.

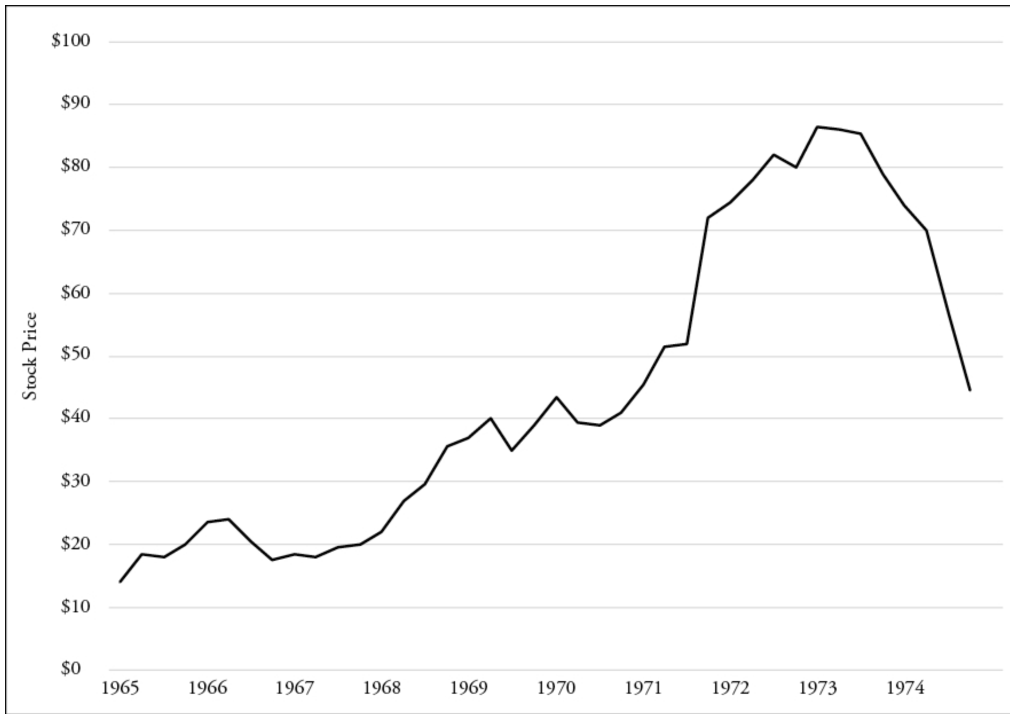
The extent of the change Berkshire experienced during the preceding decade under Warren Buffett's leadership cannot be overstated. Once a dying textile business, Berkshire now had many sources of earnings power. Owners of Berkshire in turn owned an insurance operation, a bank, a newspaper, and, through Blue Chip Stamps, an interest in a trading stamps business, another bank, and a candy company.

Beginning the decade (year-end 1964) Berkshire was a textile company with $22 million of equity and diminished earning power. Such a sorry state of affairs weighed on the stock price, which traded between $8.50 and $13.50 per share during 1964 despite being backed by a book value of $19.46 per share. [99] Fast forward a decade and Buffett had nearly

quadrupled Berkshire's consolidated equity. The stock followed suit with the price during the fourth quarter of 1974 ranging from a low of $40 to a high of $49 (down from a high of $93 during the first quarter of 1973 before the bear market did its damage).

Berkshire's stock price and valuation at the end of the decade reflected the general pessimism of the bear market of 1973/74. Despite the substantial progress made building value in the underlying business, the stock traded at a lower price to book value than it did at the beginning of Buffett's tenure (See Figures 3.2 and 3.3).

Figure 3.2: Berkshire Hathaway stock price, 1965–1974



Sources: *Of Permanent Value* (Kilpatrick), Berkshire Hathaway Annual Reports 1965–1974, and author’s calculations.

Figure 3.3: Berkshire Hathaway price to book ratio, 1965–1974

Sources: *Of Permanent Value* (Kilpatrick), Berkshire Hathaway Annual Reports 1965–1974, and author's calculations.

The capital allocation decisions made between 1965 and 1974 resulted in significant earnings, of which a portion was returned to shareholders in the form of dividends and share repurchases. The equity adjustments made in 1965 and 1966, [100] and other minor adjustments, made up the difference. To say that Berkshire had been transformed would be an understatement. Berkshire had a metamorphosis.

Table 3.11: Reconciliation of shareholders' equity 1965–1974

($ millions)	Amount	% Change
Net income - operations	$57	*86%*
Net income - realized gains	7	*11%*
Unrealized appreciation of investments	0	*0%*
Mergers/divestitures	0	*0%*
Dividends/treasury stock	(3)	*(4%)*
Other/misc.	4	*7%*
Change in equity during period	66	*100%*
Beginning of period shareholders' equity	22	
End of period shareholders' equity	$88	

Sources: Berkshire Hathaway Annual Reports 1965–1974 and author's calculations.

Examining Berkshire's balance sheet in greater detail we can see some of the major changes that occurred. Comparing 1964 to 1974, the reader will notice that the Insurance Group's assets and liabilities were now listed on Berkshire's consolidated balance sheet (see Table 3.15). Because of its size, the group was now presented on a consolidated basis. Essentially everything was disaggregated and presented alongside the Textile Group, rather than just the equity component being presented separately like The Illinois National Bank & Trust of Rockford, and Blue Chip Stamps.

The marketable securities portfolio stands out first. Now totaling $136 million, this important asset made up almost two-thirds (63%) of Berkshire's total consolidated assets (see Table 3.15). Offsetting these assets were the sizable sums on the liability side of the balance sheet, including the $73 million of losses and loss adjustment expenses, and the $22 million of unearned premiums. These two items, major components of the all-important float, were (and are) liabilities. However, they are liabilities without a specific due date and cannot be called by policyholders.

That float was the result of work building and expanding the Insurance Group. Buffett saw the success of National Indemnity and wished to expand on it. Reinsurance was the first logical step. The Home State companies were another logical expansion, as was the desire to expand beyond Home and Auto's base in Chicago into other urban areas. Both expansions were fraught with challenges and losses. They highlighted Buffett's entrepreneurial zeal and willingness to take calculated risks. The lessons learned during those expansionary years were crucial learning points for the entire insurance organization, Buffett included. And he was not shy about sharing his and the organization's failures in his annual communications with shareholders.

Table 3.12: Insurance Group, select information 1969–1974

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Other important assets on the 1974 consolidated balance sheet were the $22 million Investment in Bank subsidiary (Illinois National Bank), and $16.9 million common stock of Blue Chip Stamps.

What about the textile division? We can make an approximation of the capital employed in this group based on the known information on the balance sheet and detail provided in the Annual Report. Comparing data from 1964 and 1974 in Table 3.13, we can see that capital employed in the business shrunk by $14 million, or 57%. Perhaps more important, capital efficiency was increased by over 52% as the division eked out more volume with less capital investment.

Table 3.13: Textile division, select data

($ millions)	1974	1964
Cash[1]	$0.8	$0.9
Accounts receivable	4.4	7.5
Inventories	6.0	11.7
Plant, property & equipment	2.3	7.6
Less: current liabilities[2]	(3.1)	(3.2)
Capital employed in textile division	$10.4	$24.4
Textile revenues	$32.6	$50.0
Revenues / capital	$3.13	$2.05
Footnotes:		
1. 1974 cash estimated at 2.5% of revenues.		
2. 1974 current liabilities estimated by deducting Insurance Group from the consolidated financial statements.		

Sources: Berkshire Hathaway Annual Reports 1964, 1974 and author's calculations.

Readers already familiar with Berkshire's history may wonder why there was no lengthy discussion of See's Candies in this chapter given its importance. I have left this for later when Buffett discusses See's in his Chairman's letter. In this way, the reader following along chronologically will have the same information shareholders had. As far as shareholders might have known at the time, given the lack of disclosure other than minor details in the footnotes, See's was just one of many investments.

Lessons: 1965–1974

1. Capital allocation is a continuous, ongoing process. Not only must opportunities within an existing business be examined, options in entirely different industries must also be considered. If additional opportunities for investment are not available, management should consider returning capital to shareholders via buybacks and/or

dividends.

2. Owners should focus on the rate of return they are earning from a business, not the dollar amount. Higher earnings, or higher earnings per share, can be achieved through a low rate of return, which does not serve investors well over the long run.
3. Satisfactory business results can be achieved without undue risk or leverage (Illinois National Bank).
4. Mistakes in capital allocation, such as the losses experienced in Florida and Texas in Berkshire's Insurance Group, do happen. The key is making sure bad investments don't put the larger enterprise at risk, learning lessons from those mistakes, and communicating candidly with shareholders about them.

Note : The reader should be aware that Berkshire's fiscal year-end beginning in 1967 was changed to the Saturday closest to December 31. As a result, 1970 has two periods; one for the year ended January 3 (1969 results), and another for December 31 (1970 results).

Table 3.14: Sources of Net Income table from the 1974 Berkshire Hathaway Annual Report

($ thousands)	1974	1973	1972	1971	1970
Insurance	$892	$10,249	$10,701	$6,372	$2,639
Textile	2,660	2,837	1,697	233	104
Unconsolidated bank subsidiary	4,093	2,782	2,700	2,192	2,973
Blue Chip Stamps	1,164	1,124	142	68	0
Interest and corporate administrative expenses	(2,324)	(1,966)	(770)	(648)	(581)
Pre-tax operating earnings	6,485	15,026	14,470	8,217	5,135
Realized investment gain (loss)	(1,908)	1,331	1,359	1,028	(301)
Extraordinary item	0	0	0	0	282
Total pre-tax income	4,577	16,357	15,829	9,245	5,116
Less: Total income taxes (credit)	(2,466)	3,497	3,703	1,559	551
Net Earnings	$7,043	$12,860	$12,126	$7,686	$4,565

Notes:

1. Years rearranged for consistency of presentation.

2. Operating earnings line added.

Source: Berkshire Hathaway Annual Report 1974.

This following tables have been omitted from the ebook version because formatting issues would have rendered them unreadable. The reader is welcome to download a pdf version of the omitted tables and bonus material at brkbook.com .

Table 3.15: Berkshire Hathaway consolidated balance sheets, 1964–1974

Table 3.16: Berkshire Hathaway consolidated income statements, 1964–1974

Table 3.17: Berkshire Hathaway consolidated reconciliation of shareholders' equity, 1964–1974

Table 3.18: Berkshire Hathaway, select data and ratios, 1964–1974

Table 3.19: Berkshire Hathaway Insurance Group balance sheets, 1967–1974

Table 3.20: Berkshire Hathaway Insurance Group income statements, 1968–1974

Table 3.21: Berkshire Hathaway Insurance Group reconciliation of stockholders' equity, 1967–1974

Table 3.22: Berkshire Hathaway Insurance Group key ratios and figures, 1968–1974

Table 3.23: Illinois National Bank & Trust Co. of Rockford, balance sheets, 1968–1974

Table 3.24: Illinois National Bank & Trust Co. of Rockford, income statements, 1968–1974

Table 3.25: Illinois National Bank & Trust Co. of Rockford, key ratios and figures, 1969–1974

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50 Schroeder, *The Snowball* , 273.

51 Buffett later wrote that using Berkshire as his investment vehicle was a mistake. He said he should have purchased better businesses using a private partnership rather than effectively share the upside with others outside of the partnership (Berkshire's other shareholders).

52 $4.3 million before the provision for taxes noted above. I've used the Buffett-adjusted figure.

53 Using the lower $2.3 million figure.

54 Technically these repurchases can be attributed to the tender offer made by Stanton that irked Buffett and led him to seek control.

55 This is referring to the 1996 Owner's Manual, which has been kept up-to-date (though changing very little) since that time.

56 Shareholders wishing to keep their share of earnings in the company would first have to pay tax and reinvest the balance, possibly at a premium. This imposed one policy for all shareholders.

57 This process had already started with Buffett allocating Berkshire's marketable securities portfolio into his favorite stocks including American Express, Disney Productions, Florida Light & Gas, Investors Diversified Services A, John Blair & Co., Mass. Indemnity & Life Insurance Co., and Sperry & Hutchinson.

58 I use National Indemnity to refer to them collectively, although technically National Indemnity Company was the larger of the two and all but completely eclipsed its smaller affiliate.

59 Schroeder, *The Snowball* , 299.

60 Berkshire Hathaway, 2017 Annual Report.

61 The entire 1967 Annual Report was eight pages long and typical of the limited disclosures provided to investors in those years.

62 To reconcile the new accounting with the old, the earnings from the three-month stub period are included as an adjustment to the December 31, 1967 reconciliation of shareholders' equity in the accompanying summary financials.

63 It is liable for any losses too, which is why insurance is so heavily regulated.

64 Their focus is usually on sales of additional policies to drive premium volume.

65 *The Sun* was smaller than the *Omaha World Herald* and economically not as attractive. Buffett loved newspapers and admittedly stretched for it, paying $1.25 million for an initial yield of about

8% (*The Snowball* p. 325).
66 This makes sense given insurance commissioners' primary goal is to protect policyholders, not the owners of the insurance company.
67 This is an instance where the combined ratio of 96.2% indicates profit, yet the financial statements show a loss. This is due to the fact that the expense ratio is calculated on written premiums, while only earned premiums show up in the financial statements.
68 Note the discrepancy between the reported underwriting loss of $0.2 million and the 96.2% combined ratio. Such a ratio reflects an underwriting gain of approximately $1 million.
69 Berkshire Hathaway, 1971 10K report.
70 The average return on assets (ROA) in 1969 was 1.68% (after tax, before securities gains/losses).
71 Berkshire's marketable securities portfolio amounted to $5.4 million on the year-end 1968 balance sheet and was reduced to just under $300,000. The net proceeds were much higher. Due to the accounting rules at the time, which carried the value of the marketable securities at cost, funds raised were likely over $11 million. We know the value was $11.8 million at year-end 1968 but we cannot know for sure how the value changed between then and the liquidation.
72 A $6.25 million term loan replaced a $2 million bank loan. Quarterly principal payments of $375,000 were due until the $3.375 million balance matured on June 30, 1972. The interest rate was 0.50% over the prime rate for 90-day commercial loans of The First National Bank of Boston (which was the agent bank).
73 For the more technical reader here I am using return on average assets but keeping the ROA verbiage rather than ROAA.
74 Buffett's comment in the Chairman's letter was on the bank's return on deposits. This is a somewhat archaic metric. Buffett later began using return on assets.
75 The only information we can glean from the financial statements of the purchase is a $364,000 premium paid over the net assets of the business.
76 Net premiums written to average equity in the Insurance Group fell from 272% in 1970 to 241% in 1971 in part due to the additional equity capital contributed.
77 This loan called for quarterly principal payments of $500,000 beginning on June 30, 1973 with the balance of $3 million due on June 30, 1976. The interest rate was 0.50% over the prime rate for 90-day commercial loans of The First National Bank of Boston (which was the agent bank).
78 Low auto accident frequency, moderate severity, and absence of major catastrophes.
79 It is worth noting that the footnotes to the Insurance Group in 1972 first disclosed Berkshire's initial investment in Blue Chip Stamps, and by extension that of See's Candies. Buffett would have much more to say on See's in the future. For now, all that shareholders could glean was that they, via Berkshire's insurance subsidiary, owned a 17% stake in Blue Chip Stamps, up from 6% the year prior. (No additional disclosure was then made, as Blue Chip Stamps was simply one of many marketable securities.)
80 A precise value for capital employed is not readily calculable due to the aggregation of many figures in Berkshire's consolidated financial statements. It's highly likely the 1973 result was better than the 16% pre-tax return on capital employed achieved in 1972. Buffett called the 1973 textile results "reasonably commensurate with our capital investment."
81 Put in place in an effort to try and slow inflation. They didn't work.
82 The accounting of inventory is important so that a business understands what its true costs, and therefore its true profits, are. In an inflationary environment the method of accounting causes a divergence in reported profits for the very same economic activity.
83 In March 1973, Berkshire borrowed $20 million at 8% from a consortium of twenty banks in order to provide the Insurance Group with additional financial resources to support its growth.
84 Two other notable investments were National Presto shares that cost $3 million and were worth

$2.6 million, and Vornado, Inc., which cost $4.4 million and were worth $1.3 million at year-end 1973.
85 Insurance volume in 1973 represented just 89% of average equity (computed on a GAAP basis for consistency with prior years). Using statutory capital the ratio is 121%.
86 The 1973 Diversified Retailing 10K reveals the reinsurance unit to be Columbia Insurance Company. Columbia's sole business was engaging in reinsurance transactions with National Indemnity, which would have allowed National Indemnity to write that much more business.
87 Technically it was the Saturday closest to February 28, which sometimes caused the year-end to fall into the beginning of March.
88 Technically March 3, 1973.
89 The recession started in 1973 and lasted until the beginning of 1975. Unemployment was 7% at the end of 1974 and would peak at 9% in early 1975.
90 This was not the general rate of inflation but the cost of insurance. Buffett cited auto repair, medical payments, and compensation benefits.
91 Using GAAP figures for consistency. The 1974 ratio based on statutory capital was 164%.
92 Even an unprofitable contract brings cash in the door on day one.
93 Written premiums in Florida were $1.7 million in 1974 or about 25% of Home and Auto's total. Some of Buffett's $2 million figure would have included underwriting expenses, but it appears pricing was very inadequate.
94 The $136 million investment portfolio in the Insurance Group earned $7.9 million pre-tax, more than offsetting the $6.9 million pre-tax underwriting loss.
95 Audited financials for the bank and the Insurance Group were reported at the end of the Berkshire Hathaway Annual Report.
96 Management's Discussion and Analysis, Association of International Certified Professional Accountants, accessed on January 22, 2019, https://www.aicpa.org/Research/Standards/AuditAttest/DownloadableDocuments/AT-00701.pdf .
97 This was only the start; Buffett and Munger would be investigated by the SEC because it appeared, through their complex web of ownership between the many companies they controlled, they were intentionally trying to cover up unlawful behavior.
98 Alice Schroeder, *The Snowball: Warrant Buffett and the Business of Life* (New York: Bantam Dell, 2008), 407.
99 Moody's Manual, June 1966.
100 Made because of Buffett's desire to report earnings closer to economic reality, even though they were lower. Because Berkshire owed no actual tax, the amounts were added back to equity in the equity reconciliation section.

Chapter 4: 1975–1984

Table 4.1: Decade snapshot: 1974–1984

	1974	1984
Business:	Textiles, Insurance, Banking, Candy, Publishing	Insurance, Newspapers, Furniture Retailing, Candy, Banking, Textiles
Key managers:	Chairman & CEO: Warren E. Buffett; President: Kenneth V. Chase	Chairman & CEO: Warren E. Buffett; Vice Chair: Charles T. Munger
Annual revenues:	$101.5 million	$729 million
Stockholders' equity:	$88.2 million	$1.27 billion
Book value per share:	$90.02	$1,108.77
Float (average):	$79 million	$253 million

Major Capital Allocation Decisions:

1. Purchased Waumbec Mills in Manchester, NH for $1.7 million (1975).
2. Purchased Buffalo News for $35.5 million (1977).
3. Merged Diversified Retailing into Berkshire (1978).
4. Divested Illinois National Bank and Trust (1980).
5. Merged Blue Chip Stamps into Berkshire (1983).
6. Purchased Nebraska Furniture Mart for $60 million (1983).
7. Allocated 75% of $1.3 billion common equity portfolio into stock of GEICO, General Foods, Exxon, Washington Post.

Noteworthy Events:

1. Inflation averages 7.8% per year and peaks at 12.4% in 1980.

Table 4.2: Berkshire Hathaway earnings

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Introduction

Warren Buffett began his second decade at the helm of Berkshire Hathaway with a company worth four times as much as it was when he acquired control of it in 1965. Monetary value though was not the only differentiator. Instead of a failing textile business, shareholders now owned a large, successful conglomerate consisting of an insurance operation that provided profits and excess cash (float) to invest in marketable securities, a bank, and a newspaper. Plus, through an investment in Blue Chip Stamps, it owned an interest in a candy company and had more float to invest (value that would accrue to Berkshire's full benefit when the two companies merged). This was a Berkshire shaped in Buffett's image using his capital allocation skills and the resources and opportunities available to him at that time. The Berkshire Hathaway that would emerge from this second decade of work would also reflect this image but with a much larger shadow due to its sheer size (see Table 4.1).

Throughout the decade beginning in 1975, Berkshire would expand existing (profitable) operations, buy other operating businesses, and buy pieces of businesses via its investment portfolio. It would be forced to divest of its bank, and intentionally shrink another banking operation to reduce risk. Different businesses helped with Berkshire's growth in different ways. While the textile division was being shrunk to allow Berkshire's diversification into more profitable lines of business, the Insurance Group was a platform for expansion through organic growth and acquisitions.

The decade would also include notable changes in business relationships. Two of the largest investments, Diversified Retailing and Blue Chip Stamps, would be merged into Berkshire, bringing with them important and valuable subsidiaries. Blue Chip would become another platform for building a portfolio of wholly-owned operating businesses (all the while managing down its own dying trading stamp business). Through Blue Chip,

Berkshire would come to own another bank, Mutual Savings and Loan Association, a steel warehouse company, another newspaper, and See's Candies. The candy business would shine brightly throughout the decade, though not without some difficulties along the way. The Berkshire that emerged from Buffett's second decade would be the result of the successful allocation of over $1 billion of capital. This result would come in part from great patience and fortitude in the face of the economic recession of the mid-1970s, the large storm that hit the usually strong insurance industry during the latter half of the decade, record interest rates, troubles at the *The Buffalo News* , and other challenges along the way.

Table 4.3: Select information 1975–1984

	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984
BRK book value per share - % change	21.9%	59.3%	31.9%	24.0%	35.7%	19.3%	31.4%	40.0%	32.3%	13.6%
BRK market value per share - % change	2.5%	129.3%	46.8%	14.5%	102.5%	32.8%	31.8%	38.4%	69.0%	(2.7%)
S&P 500 total return	37.2%	23.6%	(7.4%)	6.4%	18.2%	32.3%	(5.0%)	21.4%	22.4%	6.1%
US GDP Growth (real %)	(0.2%)	5.4%	4.6%	5.5%	3.2%	(0.3%)	2.5%	(1.8%)	4.6%	7.2%
10-year Treasury Note (year-end %)	8.0%	6.9%	7.7%	9.0%	10.4%	12.8%	13.7%	10.5%	11.8%	11.5%
US inflation (%)	9.1%	5.8%	6.5%	7.6%	11.3%	13.5%	10.4%	6.2%	3.2%	4.4%
US unemployment (%)	8.5%	7.7%	7.1%	6.1%	5.9%	7.2%	7.6%	9.7%	9.6%	7.5%

Sources: Berkshire Hathaway Annual Reports 2018, 2019 and Federal Reserve Bank of St. Louis.

1975

The beginning of the second decade of Buffett’s control of Berkshire Hathaway was a challenging one. The previous year, Buffett had told shareholders that the outlook for 1975 was not encouraging. Now he reported that his forecast was “distressingly accurate.” The business produced the lowest return on equity since 1967—a bleak 7.6%. Even worse, profits included a one-time benefit from Federal income tax refunds. True ongoing operating results had been lackluster.

Amid the bad news came indications of better days. The textile industry had shown some degree of rationality in 1975, with industry participants cutting back production rather than competing to the point of massive operating losses like during prior industry slumps. Berkshire continued to increase its investment in Blue Chip Stamps. The big swing factor was insurance underwriting. Underwriting was hard to predict due to the actions of industry participants and the uncertainty of future loss claims; it could make or break any given year. Still, there were some favorable winds at Berkshire’s insurance back that hinted of possible underwriting improvements during the year.

Textiles

During the year Berkshire acquired Waumbec Mills and Waumbec Dyeing and Finishing Co. in Manchester, New Hampshire. On April 28, 1975 Berkshire purchased the company for $1.7 million, partially funding the purchase with $1.15 million of promissory notes issued by Berkshire at the parent company level. This followed a decade where Berkshire reduced production or sold off certain textile manufacturing locations. So why buy Waumbec?

Buying a company in a dying industry doesn't make sense on the face of it, but a few factors likely influenced the decision. First, Waumbec was like the Home Fabrics division and focused on the more profitable finished woven products, primarily drapery and apparel. Buffett thought it could complement Berkshire's existing operations.

Next, the purchase appealed to Buffett's instinct to acquire bargains. The purchase price for Waumbec was below book value, reflecting its diminished economic position. That means Berkshire paid less than what the net assets recorded in the books were worth, at least on paper. In the notes to the financial statements in Berkshire's Annual Report for 1975, a disclosure is made. To balance the purchase price against the book value of the company, no net property, plant, and equipment was carried onto the consolidated financials. By extension, no depreciation expense would be incurred either. This seems odd by today's accounting standards, but it was consistent with the accounting treatment at the time. [101]

Additionally, 1975 was a big year for the textile industry. The recession in 1974 hit textiles hard, but there were huge increases in the latter half of 1975. Many manufacturers reported going from operating two or three days a week to five or six days with three shifts a day.

The below-book value purchase price was a result of Waumbec's weak operating results. Waumbec was operating 55% of its looms at 50% of operating capacity. The business improved in the latter part of 1975, but the period leading up to Berkshire's purchase saw a lot of red ink. In fact, those losses resulted in $2.6 million of unused net operating loss carryovers at the time of purchase—essentially tax credits available to offset any future income from Waumbec.

While the headline textile revenue figure listed in the financial statements gave the appearance of an okay year, digging deeper told a more nuanced story. Berkshire did report an increase in sales of textiles during 1975. But

because the current year included results from Waumbec (which hadn't been under Berkshire's ownership the prior year), sales results were worse than at first glance (see Table 4.4). If Berkshire had owned Waumbec all of 1974, revenues would have reflected a 22% decline. The significant decline in revenues notwithstanding, strong profits in the fourth quarter brought the results into the black for the year. This also proved that revenues and profits do not always correlate—and can sometime diverge quite drastically.

Table 4.4: Textile Division—select data

($ millions)	1975	1974	% Change
Revenues	$32.8	$32.6	1%
Revenues (with Waumbec)	36.0	45.9	(22%)

Sources: Berkshire Hathaway Annual Report, 1975.

Buffett concluded his update on textiles with praise for Ken Chace and his team and said they and Berkshire would look for ways to increase business without undue investment. Buffett considered it unwise to make major investments in new fixed assets in the textile industry due to the "relatively low returns historically earned," a comment which seems to confirm the low purchase price indeed made the Waumbec acquisition appealing.

Insurance

"The property and casualty insurance industry had its worst year in history during 1975. We did our share." So Buffett began his report to shareholders about the insurance segment. Berkshire's insurance companies suffered disproportionately due to weakness in auto and long-tail lines. [102] Insurance underwriting results suffered due to multiple aspects of one overall trend: inflation. Three aspects were of particular concern:

- A surging general rate of inflation. This caused the costs to deliver on promises (i.e. to repair property and pay for medical costs) to soar above the level expected when the premiums were written.
- Social inflation was a growing problem. Juries were issuing large restitution payments to claimants at a far higher rate than had previously been experienced. To compound matters, these large

awards led to more lawsuits and more restitution payments. Buffett summed this up nicely: Juries were "in effect adding coverage [to customers] beyond what was paid for." Insurance companies had to payout the awards and price future policies accordingly.

- Other (weaker) insurance companies who underpriced or under-reserved went out of business. Their losses were effectively subsidized by other insurers through Guaranty Funds—comparable to today's Federal Deposit Insurance Corporation (FDIC) for banks. In the FDIC's case and in the Guaranty Funds' case, industry participants (banks and insurance companies, respectively) basically pay an insurance premium to cover failed firms.

Challenges aside, all was not doom and gloom in insurance. The Home and Auto business was now included along with the Home State companies under Home State multiple lines. After a disastrous expansion into Florida, the business receded to its home turf of Chicago. Buffett wrote that adjusted for start-up costs the Texas United Insurance Company made outstanding progress. Cornhusker Casualty, the oldest and largest of the Home State operations, turned in both higher premiums and, more importantly, a combined ratio under 100%.

Expected premium growth for 1976 reflected an anticipated repricing of premiums to match the inflated costs—rather than growth in the number of policies. "Under normal circumstances such a gain in volume would be welcome, but our emotions are mixed at present," Buffett explained.

Overall, the Insurance Group reported a combined ratio of 117.8% (see Table 4.5). Its loss ratio, which had jumped from 62% in 1973 to almost 78% in 1974, creeped up to 81% in 1975. Together with expenses of 36.9% (likely reflecting some of the previously mentioned start-up costs and higher relative fixed expenses on lower premium volume), results were truly horrific. The combined ratio was predicted to remain above 100% in 1976.

Table 4.5: Insurance Group, select information

($ thousands)	1975
Premiums written, net	$58,975
Premiums earned	
Specialized auto and general liability	38,513

Workers’ compensation	3,632
Reinsurance	12,407
Home state multiple lines	6,670
	61,222
Underwriting gain (loss), pre-tax	
Specialized auto and general liability	(7,450)
Workers’ Compensation[1]	(342)
Reinsurance	(2,651)
Home State multiple lines	(907)
	($11,350)
Combined ratio (statutory)	117.8%

Footnote:
1.Workers’ Compensation coverage written by Home State is not broken out per the footnote to the financial statements.

Note: The data in this table was taken from the segment results section of the Annual Report and differs in some cases with figures listed in earlier reporting periods. I’ve chosen to use the data from the 1979 report as it is more consistent. Comparative data for prior years is available, but due to inconsistencies it was thought best to omit it here.

Source: Berkshire Hathaway Annual Report 1979.

Even though insurance underwriting and insurance investing are inextricably linked, they are also nonetheless separate. Buffett delegated the day-to-day underwriting to others, while retaining the investing—meaning capital allocation—to himself. This two-pronged approach to operating the insurance businesses and evaluating their results is still in use at Berkshire today.

Berkshire placed little emphasis on year-to-year realized and unrealized gains and losses. Buffett was rather looking for business results, no different than Berkshire’s subsidiaries:

> “Our equity investments are heavily concentrated in a few companies which are selected based on favorable economic characteristics, competent and honest management, and a purchase price attractive when measured against the yardstick of value to a private owner.”

Like the two-pronged approach to insurance overall, the general investment criteria have remained steadfast.

Banking

Eugene Abegg and Illinois National Bank continued to impress. During 1975, the bank had average loans of about $65 million, yet loan losses were a mere $24,000 (or 0.04% of loans). That record is outstanding—then and now. While one year may be an aberration, the long-term track record spoke for itself. In 1975, the bank earned over 2% on assets, compared to a fourth of that or 0.5% for the largest thirty banks in the country.

A fan of history (especially business history), Buffett gave shareholders a glimpse into the beginnings of Illinois National. Eugene Abegg founded the bank in 1931 with $250,000 in capital and earned $8,782 during its first full year in 1932. Fast forward forty-four years and the bank was earning $3.5 million annually with equity approaching $22 million—a compounded annual rate of return of 10.7%, That is even better than it seems since the bank paid regular dividends to owners over those years.

Signing off the 1975 letter was a reminder of Berkshire's operating philosophy: A "conservatively financed and highly liquid business—possessing extra margins of balance sheet strength consistent with the fiduciary obligations inherent in the banking and insurance industries—which will produce a long-term rate of return on equity capital exceeding that of American industry as a whole." Under Buffett's control, that return on equity capital was 15% compounded annually—a doubling every five years.

1976

After a very difficult 1975, the new year brought a pleasant surprise. Insurance underwriting, led by Phil Liesche of National Indemnity Group, turned in results that exceeded the most optimistic projections. Berkshire's overall operating earnings of $16 million reflected a return on equity of 17.3%, above Berkshire's long-term average of 15% in the Buffett era.

Berkshire repurchased its own shares during 1976 (see Table 4.6). Though the amount repurchased represented less than 1% of Berkshire's outstanding shares, it shed light on Buffett's view of the attractiveness of the stock, which continued to be priced attractively.

Table 4.6: Berkshire Hathaway share repurchases, 1976

Cost	$432,055
Shares repurchased	6,647

Average cost per share	$65.00
Average shares outstanding	976,246
Implied valuation	$63,455,990
Average book value	$104,091,663
Price / book value	0.61

Sources: Berkshire Hathaway Annual Report 1976 and author calculations.

Textiles

There was a dark spot among the good news, and unsurprisingly, it was in textiles. Returns on revenues and on capital were back to trend and inadequate. [103] The Waumbec Mill, acquired only a year earlier, was not pulling its weight. The entire group continued a long slide into economic oblivion. Still, Buffett believed "reasonable returns on average are possible." He told shareholders that the Textile Group was an important source of employment in New Bedford, Massachusetts and Manchester, New Hampshire. His words come across as conscious of the social ramifications of operating according to strict economic yardsticks that might not consider the people who depended on the plants for their livelihoods. Berkshire, even then, was guarding its reputation.

As the textile business was shrinking, so too were the details of its operations in the financial statements. This was, of course, partly because Berkshire had grown significantly in size and scope into many other business lines. Some detail on textile inventories were provided, but revenues were now grouped into "net sales of manufactured products". This was probably due to the acquisition of K&W Products, [104] a small automotive chemical company in California, and it now made sense from a financial reporting standpoint to report its finances with the Textile Group.

Insurance

When assessing the performance of a conglomerate, component results must be analyzed. These parts often have different economic characteristics and performance. This was the case with Berkshire's subsidiaries. While the Textile Group faltered, the Insurance Group flourished. The industry,

including Berkshire's Insurance Group, had improved, as shown in Table 4.7.

Table 4.7: Combined ratio, selected groups

	1976	1975
Stockholder-owned property/casualty	103.0%	108.3%
Stockholder-owned auto lines	107.4%	113.5%
Berkshire Hathaway	94.6%	117.8%

Note: The Berkshire Hathaway figures differ slightly from those presented by Buffett in his letter (1976: 98.7%; 1975: 115.4%). Buffett used the statutory figures which immediately expensed deferred premium acquisition costs.

Sources: Berkshire Hathaway Chairman's letter 1976 and author's calculations.

Notably, the combined ratio dipped below 100%. [105] Instead of having a float or capital cost of 17.8% of the premiums it earned, policyholders essentially paid Berkshire 5.4% for the privilege of holding their cash. Some insurers, then and now, are content to operate at levels above 100%, reasoning that the float, or money they get to hold and invest, will make up the difference. [106] Berkshire always strives for superior underwriting results.

Table 4.8: Insurance Group, select information

($ thousands)	1976	1975
Premiums written, net	$94,773	$58,975
Premiums earned		
Specialized auto and general liability	50,778	38,513
Workers' Compensation	5,815	3,632
Reinsurance	17,220	12,407
Home State multiple lines	11,058	6,670
	84,871	61,222
Underwriting gain (loss), pre-tax		
Specialized auto and general liability	4,768	(7,450)
Workers' compensation[1]	(1,093)	(342)
Reinsurance	(2,879)	(2,651)
Home State multiple lines	(548)	(907)
	$248	($11,350)
Combined ratio (statutory)	94.6%	117.8%

Footnote:
1. Workers' Compensation coverage written by Home State is not broken out per the footnote to the

financial statements.

Note: The data in this table was taken from the summary of segment results section of the Annual Report and differs in some cases with figures listed in earlier reporting periods.

Source: Berkshire Hathaway Annual Report 1979.

While direct business, such as the auto and general liability lines, showed a marked improvement during the year as higher premiums covered costs, the reinsurance business fared slightly less well. Reinsurers insure other insurance companies, so their results lag behind those writing the direct policies. Consequently, Berkshire's reinsurance operations continued to feel the effects of a weak 1975 during 1976, with Buffett cautioning shareholders that "the near term outlook still is not good for our reinsurance business."

The acquisition of a small reinsurance operation hinted at bullishness on the long-term prospects of reinsurance. The K&W Products manufacturing company (described earlier) included a sister operation engaged in the reinsurance business and an insurance brokerage. In January, Berkshire acquired Kerkling Reinsurance Corporation, also headquartered in Nebraska. [107] The company assumed excess business from National Indemnity's reinsurance arm (about $1 million premium volume annually). The $2 million purchase price was equal to book value.

Home State operations were another bright spot. Premiums grew 66% and Berkshire planned to form another Home State operation during the year. The Home and Auto business in Chicago moved to a six-month direct bill policy which allowed more frequent repricing (and therefore the ability to correct underpriced policies).

Overall, Berkshire expected a better year in 1977, though concerns about continued economic and social inflation remained. Additionally, the significant industry rebound to profitability during the year was a siren call that competition might again drive down profitability.

Investments

A new table appeared in the Annual Report detailing equity investments (common + preferred) with a cost of over $3 million. The combined portfolio totaled $75 million (at cost [108]), with Government Employees Insurance Company (GEICO) accounting for nearly a quarter of it at $23.5

million ($19 million in convertible preferred stock and $4 million in common stock). Buffett had continued to follow the company after first learning about it as a student at Columbia Business School and understood what made the company special. [109] GEICO had strayed beyond its core business of insuring above-average drivers, losses mounted, and the market concluded there was a real risk the company wouldn't make it. Buffett's insight was that the company's core business would allow it to survive. The size of the GEICO investment presaged the starring role the company would ultimately play in Berkshire's future. Another notable investment listed in the table was the $10.6 million investment in *The Washington Post* Company first purchased in 1973.

Berkshire's investment in Blue Chip Stamps was *not* included in the table. Berkshire's $27 million investment was carried on the balance sheet separately since it owned about 33% of the business. [110] Berkshire first invested in Blue Chip Stamps in 1971, when it owned 6% of the company.

Banking

Buffett as usual had good things to say about Berkshire's banking operations, and 1976 was no exception. Perennial praise for Eugene Abegg was followed by a financial reporting of its success. The bank continued to earn 2% on assets while maintaining high levels of liquidity and paying out maximum rates of interest to depositors. The only negative factor that was on Buffett's mind concerning the bank was its impending divestiture. New banking regulations required Berkshire to divest its star asset by the end of 1980.

1977

Buffett led off the 1977 letter to shareholders with a note on how he viewed capital gains and losses: "While too much attention should not be paid to the figure in any single year, over the longer term the record … is of significance." He wanted to remind shareholders to think like owners. That is, long term.

He also continued his practice of tempering expectations. Buffett cautioned shareholders to view Berkshire's 37% increase in earnings per share as "considerably less impressive than it might appear at first glance" because

beginning capital was up 24%. By turning the attention to the *rate* of return on shareholders' equity, not earnings per share, Buffett was calling out a mischievous practice that continues to this day. "We find nothing particularly noteworthy in a management performance combining, say, a 10% increase in equity capital and a 5% increase in earnings per share. After all, even a totally dormant savings account will produce steadily rising interest earnings each year because of compounding," he wrote. Berkshire's results were impressive nonetheless.

Weighed down by its roots as a textile company Berkshire's 1977 results were that much more impressive. Meanwhile, Blue Chip Stamps and the Insurance Group continued to shine.

Berkshire's repurchase of its own shares was again relegated to the footnotes of the financial statements. Perhaps due to the relatively small amount (about ¼ of 1% of outstanding shares), Buffett didn't think it worth mentioning (see Table 4.9). The price paid implied a valuation higher than that of the previous year, but still below book value.

Table 4.9: Berkshire Hathaway share repurchases, 1977

Cost	$229,162
Shares repurchased	2,244
Average cost per share	$102.12
Average shares outstanding	971,800
Implied valuation	$99,242,260
Average book value	$128,540,768
Price / book value	0.77

Sources: Berkshire Hathaway Annual Report 1977 and author calculations.

Textiles

Berkshire remained in textiles despite its shrinking size and dismal prospects. Of its $379 million of identifiable assets at year-end 1977, just $22 million were in the textile division. Still, Buffett put himself in the shoes of a minority shareholder and asked the question: Why was Berkshire continuing to operate the Textile Group when it seemed to present nothing but problems, and where opportunities clearly existed to redirect the capital elsewhere? He then answered himself.

> "Our reasons are several: (1) Our mills in both New Bedford and Manchester are among the largest employers in each town, utilizing a labor force of high average age possessing relatively non-transferable skills. Our workers and unions have exhibited unusual understanding and effort in cooperating with management to achieve a cost structure and product mix which might allow us to maintain a viable operation. (2) Management also has been energetic and straightforward in its approach to our textile problems. In particular, Ken Chace's efforts after the change in corporate control took place in 1965 generated capital from the textile division needed to finance the acquisition and expansion of our profitable insurance operation. (3) With hard work and some imagination regarding manufacturing and marketing configurations, it seems reasonable that at least modest profits in the textile division can be achieved in the future."

The fate of textiles was coming, but not for several more years.

Insurance

Berkshire bought National Indemnity and National Fire and Marine for $8.6 million in 1967 when it had annual premium volume of $22 million. A decade later, the Insurance Group had grown to combined premium volume of $159 million. [111] More impressive was that this was done without the issuance of any shares of Berkshire stock. (In fact, it had repurchased shares during th is period.)

Berkshire founded or acquired for cash several insurers during the preceding decade:

- 1970: Cornhusker Casualty Company
- 1971: Lakeland Fire & Casualty Company
- 1972: Texas United Insurance Company
- 1973: The Insurance Company of Iowa
- 1977: Kansas Fire and Casualty Company

The newest addition to the Berkshire family of insurance companies was Cypress Insurance Company, acquired in late 1977. Cypress, in South Pasadena, California, was writing about $12.5 million in workers'

compensation volume annually. Although National Indemnity had its own worker's compensation operation, Cypress and National Indemnity would operate independently by utilizing different marketing strategies. Buffett was not one to make any changes to what he considered a first-class operation.

First class did not mean perfect. Buffett pointed to four mistakes made by Berkshire's existing insurance operations to date:

- The surety operation attempted in 1969
- A money-losing venture in aviation insurance
- The failed expansion attempt of Home and Auto into Florida
- And attempting to build out workers' compensation in California (which was now back in action and proceeding in earnest)

But he did not linger on them. "It is comforting to be in a business where some mistakes can be made and yet a quite satisfactory overall performance can be achieved. In a sense, this is the opposite case from our textile business."

Table 4.10: Insurance Group, select information

($ thousands)	1977	1976	1975
Premiums written, net	$158,704	$94,773	$58,975
Premiums earned			
Specialized auto and general liability	80,690	50,778	38,513
Workers' Compensation	18,916	5,815	3,632
Reinsurance	24,100	17,220	12,407
Home State multiple lines	19,382	11,058	6,670
	143,088	84,871	61,222
Underwriting gain (loss), pre-tax			
Specialized auto and general liability	7,800	4,768	(7,450)
Workers' Compensation[1]	(1,644)	(1,093)	(342)
Reinsurance	(1,251)	(2,879)	(2,651)
Home State multiple lines	896	(548)	(907)
	$5,801	$248	($11,350)
Combined ratio (statutory)	93.2%	94.6%	117.8%

Footnote:
1. Workers' Compensation coverage written by Home State is not broken out per the footnote to the financial statements.

Note: The data in this table was taken from the summary of segment results section of the Annual Report and differs in some cases with figures listed in earlier reporting periods.

Source: Berkshire Hathaway Annual Report 1979.

Buffett appreciated the Insurance Group's generally high performance but was more interested in explaining results and looking ahead than highlighting stellar performance. "The winds in insurance underwriting were squarely behind us." Removed from the disastrous years of the 1974–1975 period, which resulted in competitors and capacity leaving the market, rates were now on the rise, offsetting inflation (now rising at 1% per *month* [112]).

Buffett also foresaw a return to stiff competition in future years as high prices lured others back into the market. "As markets loosen and rates become inadequate, we again will face the challenge of philosophically accepting reduced volume." Berkshire's insurance operations didn't operate in secret. There were no real barriers to entry, hence wild swings as competition waxed and waned. To remain competitive over the long haul, Berkshire would require "unusual managerial discipline" to focus on profitability, not volume.

In 1975, the Reinsurance Group wrote just under $10 million of premiums. Fast forward to 1977 and its volume was $24 million. Although underwriting profitability was not met (and had an underwriting loss in each of the prior three years), it still generated large sums that were available for investment.

Reinsurance is the sharing or offloading of risk. Essentially, insurers pay part of the premiums they collect from policyholders to a reinsurance company, and in exchange, the reinsurance company agrees to share in losses and/or cover losses above certain limits. This kind of business came in spurts and those spurts could come in quite large chunks. The liabilities assumed were often of longer duration. [113] This meant Berkshire could invest the float for a longer period than say, automobile insurance, which was written on a six- or twelve-month basis and paid out about as quickly. [114]

Investments

Insurance investments, at cost, grew from $135 million to $253 million over the preceding two years. Fueling this growth was capital gains on investments and net underwriting profit along with large increases in premium volume and the consequential float generated. Chief among these float generators was reinsurance.

The Chairman's letter now detailed equity holdings of the Insurance Group for each holding over $5 million of market value. The combined value of Berkshire's investment in GEICO Common Stock and Convertible Preferred Stock still represented almost a quarter of the $181 million portfolio of equities (see Table 4.11). The remainder was comprised of simple, easy-to-understand businesses including aluminum companies, advertising agencies, and communications/broadcasting.

Table 4.11: Berkshire Hathaway equity portfolio, 1977 (Insurance Group)

Shares	Company	Market Value ($ thousands)	% Total
934,300	The Washington Post Company Class B	$33,401	18%
1,986,953	GEICO - Convertible Preferred	33,033	18%
592,650	The Interpublic Group of Companies, Inc.	17,187	9%
220,000	Capital Cities Communications, Inc.	13,228	7%
1,294,308	GEICO - Common	10,516	6%
324,580	Kaiser Aluminum & Chemical Corporation	9,981	6%
226,900	Knight-Ridder Newspapers, Inc.	8,736	5%
170,800	Ogilvy & Mather International, Inc.	6,960	4%
1,305,800	Kaiser Industries, Inc.	6,039	3%
	Others	41,992	23%
	Total equities	$181,073	100%

Note: Percentages are rounded and don't add exactly to 100%.

Sources: Berkshire Hathaway Chairman's letter 1977 and author's calculations.

Buffett used Capital Cities [115] to illustrate a finer point to shareholders about how he thought of Berkshire's part-ownership in companies via ownership of their publicly traded shares. In 1977 Berkshire paid $10.9 million for its stake in Capital Cities. Earnings on those 220,000 shares amounted to about

$1.3 million. However, only $40,000 of those earnings (the dividend Capital Cities paid Berkshire), showed up on Berkshire's bottom line.

Because of the way accounting works, Berkshire reported as income just a tiny fraction (the dividend) of the true economic earnings (the $1.3 million). The accounting was obscuring the economic reality. Why, asked Buffett, would Berkshire prefer to seek out a wholly-owned business to buy like Capital Cities when such an investment would cost at least twice as much as an investment in Capital Cities' common stock? "We can obtain a better management result through non-control than control. This is an unorthodox view, but one we believe to be sound." He continued, "excellent business results by corporations will translate over the long term into correspondingly excellent market value and dividend results for owners, minority as well as majority."

Berkshire would continue to use economics as its guide and explain to shareholders the shortfalls of conventional accounting.

Banking

Buffett had nothing but ongoing praise for the now 80-year-old Eugene Abegg and the Illinois National Bank. This time, he punctuated it with some more facts and figures. Since Berkshire purchased the bank in 1969, it had paid Berkshire $20 million in dividends. Berkshire paid $17.7 million for the bank, meaning it had recouped its investment and more in dividends, and still owned an asset generating good returns.

Abegg asked that year that a successor be brought in. Peter Jeffrey was brought in as president and CEO (from Omaha-based American National Bank). Abegg would continue as chairman.

Merger with Diversified Retailing

The benefit of hindsight allows us to see the effects of different accounting methods on the presentation of the same economic results. Since the Diversified Retailing merger was not completed until December 30, 1978, we have two views of the 1977 Berkshire Hathaway financial statements: once from the original 1977 report, and another from the post-merger report for 1978 that contained a comparison to 1977. More detail on this merger will be presented in the following segment. For now it is worth noting a few of these changes, as they apply to 1977.

The merger caused Blue Chip Stamps to become fully consolidated with Berkshire's financials, rather than its equity being presented on one line on the balance sheet as an asset and its earnings similarly on one line on the income statement. In effect, the revised presentation of the financials illustrated to Berkshire shareholders Buffett's notion of look-though earnings (instead of just earnings, shareholders had much more detail on revenues, expenses and other items.). Table 4.12 highlights a few key figures from Berkshire's financial statements for 1977, as originally reported, and as restated the following year.

Table 4.12: Berkshire Hathaway, select financial information

($ millions)	(Original) 1977	(Restated) 1977	Change
Total assets	$379	$572	$193
Total liabilities	237	370	133
Minority interest	0	48	48
Equity	$141.8	$154.6	$12.8
Revenues	$198	$363	$165
Total expenses	182	333	151
Minority interests	0.0	1.9	1.9
Net earnings	$26.7	$30.4	$3.7

Sources: Berkshire Hathaway Annual Reports 1977, 1978; and author's calculations.

From the 1978 financial statements, Diversified Retailing had $27.1 million of equity at the beginning of 1977. Since it earned $3.7 million in 1977, [116] we would have expected Berkshire's equity to reflect a $30.8 million increase (beginning equity plus retained earnings). But it didn't, it increased just $12.8 million. Why?

Part of the reason was that Diversified Retailing had itself repurchased shares prior to combining with Berkshire. These repurchases amounted to approximately $1.2 million, above and beyond those made by Berkshire itself during the year.

But the primary reason was that each company owned a piece of the other. In combining the two companies, the cross-ownership needed to be reconciled and eliminated. [117] Accounting is (most often) logical, but it can be messy.

1978

Late in 1978, Berkshire finally completed the merger with Diversified Retailing and simplified some of the byzantine ownership between the two companies and the major shareholders. It was a long time coming. The merger was originally proposed in 1973, but the deal was first called off due to an SEC investigation. Finally, on December 30, 1978, Berkshire Hathaway and Diversified Retailing Company merged as one.

Diversified Retailing operated on a parallel course to Berkshire throughout the mid-1960s and 1970s. Diversified was a holding company formed on January 31, 1966 by Warren Buffett, Charlie Munger, and their friend and future Berkshire director, David Gottesman. Buffett's investment partnership, Buffett Partnership Limited, owned 80%, and Munger and Gottesman each owned 10%. They planned to use the company to acquire retailers. The first acquisition was Hochschild Kohn, a lower-tier department store in Baltimore purchased for $12 million using $6 million of debt early in 1966. Buffett and his partners quickly realized the many challenges and pitfalls of department store retailing. Hochschild Kohn was sold in December 1969 for $11 million. [118] An outstanding issue of debentures with restrictive provisions and tax considerations resulted in Diversified retaining the proceeds of the sale.

That capital was ultimately invested in Blue Chip Stamps, and the formation of Reinsurance Corporation of Nebraska in 1970 (later renamed Columbia Insurance Company), which took reinsurance business off the books of National Indemnity. [119] In 1974, through Columbia, Diversified also bought Southern Casualty Company, which wrote workers' compensation insurance in Louisiana. The major operating business at the time of the Diversified/Berkshire merger was another department store.

Diversified Retailing paid $6 million for Associated Retail Stores, Inc., in April 1967. Berkshire now owned 100% of Associated Retailing, a chain of seventy-five women's apparel stores operating under various names. Buffett, always a fan of business history, gave a brief background: "Associated was launched in Chicago on March 7, 1931 with one store, $3,200, and two extraordinary partners, Ben Rosner and Leo Simon." After Simon died, Rosner operated the business alone and it faced many challenges inherent in retailing. Buffett said, "Ben's combination of

merchandising, real estate and cost containment skills has produced an outstanding record of profitability, with returns on capital … often in the 20% after-tax area." Associated accounted for a fraction of Berkshire's consolidated operating earnings, but Buffett cherished his association with Rosner, who was 75-years-old and still going strong.

The Berkshire/Diversified merger was a business marriage and like a traditional marriage, was beneficial to shareholders but not without its complexities. As married couples know, no matter when vows are taken (it could be January 1 or December 31) the Internal Revenue Service views the couple as having been married throughout the whole year. Accounting principles generally work the same way, with one exception. Instead of looking back one year, accounting conventions at the time required the assumption that both companies had been one *since their formation* . [120]

Buffett did his best to explain some of the changes for the shareholders not well-versed in accounting intricacies. For one, shareholders comparing the 1977 Annual Report to figures in the 1978 report for 1977 would have seen very different numbers for revenues, expenses, assets, liabilities, and other items. (Select figures are presented below in Table 4.13; see the table at the end of the 1977 segment for the full presentation.)

Table 4.13: Berkshire Hathaway, select parent-level information

($ millions)	1977 Original	1977 Restated
Cash	$4.9	$14.0
Investments	252.8	332.0
Total assets	379.2	572.1
Total liabilities	237.5	417.6
Shareholders' equity	141.8	154.6
Total revenues	$197.9	$363.6
Net income	26.7	30.4

Sources: Berkshire Hathaway Annual Reports 1977 and 1978.

Secondly, Berkshire's ownership investment in Blue Chip was now 58%, and this meant that Blue Chip's accounts would be fully consolidated. Prior to the merger with Diversified Retailing, it was included as one line on the balance sheet and income statement.

The net effect of all this accounting maneuvering was the obfuscation of the financial statements. The merger consolidated many different businesses, some wholly owned and some partly owned. Buffett said this combination “tends to obscure economic reality more than illuminate it. In fact, it represents a form of presentation that we never prepare for internal use during the year and which is *of no value to us in any management activities.* ” (Emphasis added) [121]

For this reason, Buffett included separate financial disclosures on the various segments of the business that shareholders and managers alike would find useful. This was Buffett imagining himself in the shoes of shareholders and providing the information he would want if roles were reversed. The data was presented in the Chairman’s letter and focused on the income statement. No balance sheet information was provided. [122] The table was entitled Sources of Earnings and began in the 1978 report with a comparison to 1977. Presented this way, the information was very useful at assessing the various operating businesses (see Table 4.2).

Importantly, the table stripped away much or all the noise. Items such as capital gains and losses, taxes, and, later, amortization of goodwill, were presented as separate line items. This left the economic results of each business largely unobscured by accounting conventions that Buffett (rightly) thought twisted reality. To this day, Berkshire presents its operating results in a similar fashion, though the categories have been renamed and broadened to accommodate the growing roster of businesses.

Insurance

The Insurance Group once again wrote to an overall combined ratio below 100%. Remember, a ratio below 100% means the operation earned a profit on top of any profits made by investing the float. For the Insurance Group in 1978 this translated into an underwriting profit of $3 million. That was on top of net investment income of almost $20 million and ignores gains on the sale of investments. Buffett called the three years from 1975 to 1978 a bonanza for the industry, with good premium growth and low loss ratios. Indeed, it was a bonanza for Berkshire, as premiums written and earned doubled over that time.

Table 4.14: Insurance Group, select information

($ thousands)	1978	1977	1976
Premiums written, net	$198,313	$158,704	$94,773
Premiums earned			
Specialized auto and general liability	96,126	80,690	50,778
Workers' Compensation	29,893	18,916	5,815
Reinsurance	30,160	24,100	17,220
Home State multiple lines	29,894	19,382	11,058
	186,073	143,088	84,871
Underwriting gain (loss), pre-tax			
Specialized auto and general liability	11,543	7,800	4,768
Workers' Compensation[1]	(3,944)	(1,644)	(1,093)
Reinsurance	(2,443)	(1,251)	(2,879)
Home State multiple lines	(2,155)	896	(548)
	$3,001	$5,801	$248
Combined ratio (statutory)	96.7%	93.2%	94.6%

Footnote:
1.Workers' Compensation coverage written by Home State is not broken out per the footnote to the financial statements.

Note: The data in this table was taken from the summary of segment results section of the Annual Report and differs in some cases with figures listed in earlier reporting periods.

Source: Berkshire Hathaway Annual Report 1979.

There were reasons not to over-celebrate. For one, the Home State operation had a disappointing year which was that much worse against the backdrop of profitability elsewhere. The loss was in part due to both storms that hit the Midwest and subpar underwriting. The Workers' Compensation line also had a difficult year due to continued cost increases related to increasingly large jury awards that its solid premium growth couldn't cover. Reinsurance also reported a loss, but the long-tail nature of its business (and its long-duration float) made the loss less painful than that of the primary insurers.

Buffett's eye and pen were pointed to the future. Such good results for the industry over the prior three years could only mean one thing: a return to lower profitability as competitors entered the market and cut rates. Still, he was optimistic on the longer-term outlook for insurance. Berkshire had excellent managers that possessed the ability and willingness to write policies that were profitable, regardless of volume. Berkshire would continue to buy and build insurance businesses, "since the rewards for success in this field can be exceptional." They most certainly were.

Investments

In addition to Berkshire's significant investment in wholly-owned insurance businesses, it also had a large investment in another insurance company via its equity portfolio. SAFECO, comprising almost 12% of Berkshire's insurance equities portfolio of $221 million at year-end 1978, was Berkshire's third-largest individual equity investment behind GEICO (17%) and *The Washington Post* (20%).

Buffett had high praise for SAFECO calling it "probably the best property and casualty insurance company in the United States … a much better insurance operation than our own." Berkshire's investment was made below book value, which meant Berkshire acquired its interest below the cost to even build a similar business from scratch. According to Buffett, other less-well-run insurers had been purchased by others for much higher than 100 cents on the dollar. Buffett was content to let SAFECO's management—who had proven themselves highly capable of operating the insurer—run the operation without interruption. When he found good managers, he let them be, as he knew he was not perfect. "Some of our expansion efforts—largely initiated by your Chairman, have been lackluster, others have been expensive failures." Berkshire would be better off economically if Buffett did not let his ego come into play.

Textiles

There is not much to say on textiles as it relates to the business and industry itself. The brutal economics were still at work. The business was fading relative to its own historical record—even more so relative to the diverse and growing stable of businesses now under Berkshire's control. Still, for shareholders reading Buffett's letters, his comments offered clues to Buffett's thought process.

Buffett began by commenting on the low return of 7.6% in textiles. It was produced by $1.3 million of after-tax earnings on $17 million of capital employed in the business. Yet even this calculation was generous: The plant and equipment in the Textile Group was heavily depreciated on the books, though it retained its usefulness. In other words, to replace the equipment would cost much more, and therefore the Textile Group's balance sheet

showed a “bargain cost” for its fixed assets. The economics were even worse than at first blush.

Even with this lower-than-economic cost, capital turnover (revenues to capital) was very low, “reflecting required high investment levels in receivables and inventory compared to sales.” This in and of itself would not be a problem if it weren’t for the low margin on revenues. After all, the revenue/capital ratio multiplied by the profit/revenue ratio equals return on capital. The ratio can be low on one side if it is offset by a higher ratio on the other—but low on both sides equate to mediocrity.

Buffett then listed several remedies to improve the situation: “differentiation of product, lowered manufacturing cost through more efficient equipment or better utilization of people, redirection toward fabrics enjoying stronger market trends, etc.” The problem was Berkshire’s textile management, as well as everyone else in the industry, was trying those same things. So the textile operation had no competitive advantage. If anything, it had a competitive disadvantage. Buffett summed up the ruthless economics at work: “As long as excess productive capacity exists, prices tend to reflect direct operating costs rather than capital employed.”

I believe Buffett uses this ultra-simplified framework for all his business experience. It is just the start of the analysis, of course. How much capital is needed in the business? What are profit margins? The investor then pays a price/capital employed ratio that determines his/her going-in rate of return. Buffett then thinks through how capital levels might change in the future, and what profit margins might do, all through the lens of barriers to entry and competitive advantage. Textiles were a lesson on how hard things could get.

Blue Chip Stamps

It is a fitting time to examine Berkshire’s history with Blue Chip Stamps, since the merger of Diversified Retailing and Berkshire Hathaway meant Blue Chip would be consolidated into Berkshire’s financials and much of the finer detail would be lost. [123] Berkshire’s share grew from a modest 6% ownership interest in 1971 totaling $4 million to a significant 36.5% ownership interest in 1977 totaling $36 million (see Table 4.15). The Diversified merger brought it to 58% of the company. [124]

Table 4.15: Berkshire Hathaway history with Blue Chip Stamps

1971 : Berkshire owns 6% of Blue Chip at year-end
1972 : Berkshire increases its interest to approximately 17%
1973 : Blue Chip first mentioned in Chairman's letter; additional disclosure made in Berkshire's footnotes
1974 : Berkshire's interest increased to 25.5%; separate section on Blue Chip added the Chairman's letter
1975 : Blue Chip mentioned in opening section of Chairman's letter; interest increased to 31.5%
1976 : Ownership interest increased to 33%
1977 : Ownership interest increased to 36.5%
1978 : Merger with Diversified Retailing causes ownership interest to increase to 58%. Blue Chip now fully consolidated with Berkshire's financials

Sources: Berkshire Hathaway Annual Reports 1971–1978.

Over eight years, Blue Chip became an increasingly important asset to Berkshire shareholders. At the time of the merger, Blue Chip's subsidiaries represented 35% of Berkshire's earnings. [125] The merged operations had many operational similarities. Like Berkshire Hathaway, Blue Chip was a company undergoing transformation. An examination of select data (see Table 4.16) reveals how Blue Chip changed over a relatively short period. Blue Chip replaced income from its original business line of trading stamps with income from acquisitions unrelated to the dying stamp business. It was the Berkshire Hathaway playbook implemented by the same capital allocators.

Table 4.16: Blue Chip Stamps, select financial information

	Fiscal year-end:	
($ thousands)	12/30/1978	02/27/1971
Balance sheet items:		
Cash	$3,357	$531
Marketable securities & short-term investments	76,494	113,168
Fixed assets, net	40,603	4,213
Investment in Wesco Financial	49,370	0
Total assets	216,872	142,138
Liability for unredeemed trading stamps	66,832	87,429
Long-term debt	18,247	10,840
Shareholders' equity	$114,325	$43,296
Income statement items:		
Stamp service income	$16,531	$118,374

Merchandise promotions and motivation business	3,791	1,719
Candy revenues	73,653	0
Newspaper	44,674	0
Total revenues	143,586	127,567
Net income	$14,280	$8,584

Sources: Blue Chip Stamps 10K Reports 1971, 1975, 1978.

The Blue Chip that existed as of 1971 was the same business it had always been—trading stamps. The company sold trading stamps to 23,000 retail locations across Arizona, California, Nevada and Oregon, which in turn provided them to customers as a promotion. The customers could redeem the stamps for products or cash at any one of Blue Chips' eighty-nine redemption stores. [126] The business was very much like insurance where cash was received ahead of product delivery. Like an insurer, a trading stamp company could make money not only from its products, but by investing the cash it held in the meantime.

The majority of its assets at year-end 1971 were invested in marketable securities. Those assets were funded by the float inherent in the unredeemed trading stamps, which were carried on the balance sheet as a liability. The remainder of the assets were funded by long-term debt and equity. Fast forward to year-end 1978 and Blue Chip's financial picture had changed significantly. A look at the income statement revealed the dramatic decline in trading stamp revenues over the preceding half-decade and the corresponding growth of other, newer subsidiaries. What capital allocation decisions were made to create such a transformation over eight years?

Blue Chip's balance sheet shared characteristics of Berkshire's higher-quality insurance companies, but its operations faced challenges more akin to textiles. Stamp service revenues reached $126 million in 1970, and that would prove to be the high-water mark. Its business faced competition not only from other trading stamp and promotional companies, but from the retailers themselves who introduced discount merchandising. The 1978 Blue Chip Stamps annual report also pointed to the 1973 gasoline shortage, which caused many service stations to eliminate stamps entirely. As Buffett and Munger acquired a greater interest in Blue Chip over time, the two men came to control the capital allocation decisions of the company. They recognized the continued decline in the trading stamp business and worked

to reallocate Blue Chip's significant assets and liquidity into higher-returning businesses.

See's Candies

The first such reallocation was the acquisition of See's Candy Shops, Inc. Between January 3, 1972, and March 4, 1972, Blue Chip acquired 93% of See's. The ownership increased to 99% on March 3, 1973. The purchase price was $34.7 million but excess cash on its balance sheet brought the effective purchase price lower. [127]

See's represented Buffett's first time paying a high multiple for a business, and he attributes the decision to Charlie Munger's insights. Munger convinced Buffett it was worth the high multiple since the underlying business was so good. See's was earning over 50% pre-tax on tangible capital. Even after paying three times the underlying capital in the business, Blue Chip earned a satisfactory return. And if See's could expand, which it turned out it could (though slowly), the incremental returns would enhance the initial economics of the purchase. As a bonus, this high-return business had protection against inflation. Since 1972 when Blue Chip bought See's, pre-tax earnings grew from $4.2 million to $12.6 million with very little incremental investment.

Table 4.17: See's Candy Shops, Inc., select data

($ millions)	1972
Revenues	$29.0
Pre-tax earnings	4.2
Tangible capital base	8.0
Revenues/capital	$3.63
Pre-tax margin	14.5%
Return on capital - pre-tax	52.5%
Purchase price	$34.7
Excess cash	(10.0)
Effective purchase price	$24.7
Purchase price/tangible capital	3.1x
Blue Chip Stamps earnings yield[1]	17.0%

Footnote:
1. Blue Chip Stamps' earnings yield represents See's pre-tax return on capital divided by the multiple Blue Chip paid for See's tangible capital. (An alternative method to calculate this would be to divide the pre-tax earnings of See's into the Blue Chip Stamps purchase price.)

Sources: Blue Chip Stamps Annual Report 1973, Berkshire Hathaway Chairman's letter 1991 and author's calculations.

It did not take long for Buffett to realize the full potential of See's—and the potential pitfalls. In a letter to CEO Chuck Huggins in December 1972, [128] Buffett urged Huggins to create a narrative around the See's brand in order to protect its image. "The surroundings in which our candy is offered affect potential customers' mental—and even gastronomical—impression of our quality," he wrote. Comparing See's to Coors beer, which benefitted from its availability solely in Colorado at the time, Buffett said: "We might be able to tell quite a story about the little kitchen in California that has become the kitchen known 'round the world.'" He thought See's should tightly control all aspects of marketing and distribution and highlight its insistence on fresh ingredients rather than have it displayed alongside inferior products. "It should be very hard to get, available only periodically, and then (to the consumer) apparently only in limited quantities."

Over time, Buffett would come to appreciate See's not only for the business it was, but the education it provided him on recognizing the inherent value in high-quality businesses—and their limitations. It would not be a stretch to say the lessons from See's would shape the future of Berkshire Hathaway. Buffett would become more at ease paying higher multiples for businesses with protected economic positions. He would later credit his experience with See's for allowing him to see the value in Coca-Cola, a major investment made in the next decade. See's would also become a training ground of sorts for Buffett. The high returns on capital enjoyed by See's naturally created a desire for expansion. The numerous attempts and mixed success over the years to expand See's beyond its protected West Coast niche would provide Berkshire's capital allocators with first-hand evidence of the boundaries of economic moats. Considering this educational aspect and the turning point it represented in Buffett's investment philosophy, See's may well have been one of Buffett's best investments.

Wesco Financial Corporation

Blue Chip's next major subsidiary was Wesco Financial Corporation. Blue Chip began acquiring shares in 1973, and by the end of that fiscal year it owned 21.9% of the company. After it sought and obtained approval to

increase ownership beyond 25%, Blue Chip purchased an 80.1% stake in Wesco over the next five years. Amassing that stake hadn't come easy. To get there Buffett and Munger convinced Wesco's controlling shareholder, Elizabeth Caspers Peters (daughter of Wesco's founder), to nix a deal to sell to another bank and instead sell to them. [129]

Wesco was the holding company for a bank, Mutual Savings and Loan Association. As of 1973, Mutual Savings operated out of ten locations across four California counties and primarily provided real estate loans to individuals. It financed its $452 million balance sheet, including a $390 million loan portfolio, mainly with savings deposits. [130]

By 1978 Wesco had opened six new branches in Southern California. Its asset base at year-end 1978 was $646 million, [131] including $465 million of loans, that were financed by $488 million in savings deposits. Throughout this time, Wesco also owned its headquarters location in Pasadena, which included third-party tenants. [132]

Why was Wesco an attractive investment? Wesco appeared to be a well-run operation with a history of satisfactory returns. It probably helped that it was headquartered in Charlie Munger's figurative backyard in Pasadena, California. Based on Blue Chips' original purchase price for 21.9% of Wesco, the company was valued at just 0.56 times its underlying book value at the time of purchase [133] (see Table 4.18). By 1978, the company was earning $11.7 million pre-tax—a 30% return on Blue Chip's aggregate investment.

Table 4.18: Wesco Financial Corporation, select data

($ thousands)	
Blue Chip 1973 investment	$8,099
Percentage of company owned	21.9%
Implied market value	$36,982
Wesco 1973 average shareholders' equity	$65,785
Price / book	0.56x
Pre-tax earnings, 1972	$8,436
Blue Chip going-in return	22.8%
Return on assets (pre-tax, avg. 5 years)	1.64%

Sources: Blue Chip Stamps Annual Report 1973; Wesco Annual Reports 1970, 1973.

Table 4.19: Blue Chip Stamps' investment and equity in earnings of Wesco Financial Corporation

This table has been omitted from the ebook version because formatting issues would have rendered it unreadable. The reader is welcome to download a pdf version of the omitted tables and bonus material at brkbook.com .

The Buffalo Evening News

The third major acquisition was *The Buffalo Evening News* . [134] On April 15, 1977, Blue Chip acquired the paper [135] for cash (in addition to the assumption of pension liabilities). The purchase was partially financed with a $30 million bank loan which was repaid to $13.5 million by year-end 1977.

The Buffalo News , as it later came to be known, operated a weekday newspaper in Buffalo, New York. At the time, it was a two-newspaper town, with *The News'* chief competitor being *The Courier-Express* . *The Buffalo News* had the highest percentage of circulation among newspapers in Upstate New York with two-thirds of households subscribing. [136] It published six days a week. *The Courier-Express* published the dominant Sunday paper. Buffett's investment thesis was simple: The two-newspaper town was soon destined to become a one-newspaper town, and with *The Buffalo News* being stronger financially, it was more likely to survive. Buying in at book value meant that if such a winner-take-all situation occurred in Buffalo, Blue Chip, Berkshire, and Buffett and Munger would win big.

Buffett got early signs his prediction would come true. *The Buffalo News* made plans for a Sunday edition in November 1977, not long after the purchase. It was soon hit with a lawsuit that lingered until one of the papers went out of business. Though things ultimately worked out in favor of *The News* , at the time the situation was precarious and not at all certain. [137] The first eight months Blue Chip owned the paper (April to December 1977), it earned just $751,000. In 1978, it lost $2.9 million. The red ink was destined to flow for a while.

Table 4.20: The Buffalo Evening News—acquisition analysis

($ thousands)	

Cash consideration	$34,000
Pension liabilities assumed	1,433
Total purchase price	$35,433
Underlying net assets	$34,679
Excess of purchase price	$754
Price/book	1.02x

Source: Blue Chip Stamps Annual Report 1977

After the Diversified Retailing merger with Berkshire Hathaway, Blue Chip's subsidiaries became much more important to Berkshire's overall success. Because of the varying degrees of ownership at each subsidiary level (and there were many), determining the individual impact on the economic success of Berkshire became that much more difficult. This is why a new table appeared in Buffett's 1978 Chairman's letter (see Table 4.2 at the beginning of the chapter). This table showed the operating earnings of each subsidiary business, as adjusted for Berkshire's ownership interest and irrespective of its parent company. [138] In this way Berkshire's shareholders could assess for themselves how much emphasis and attention to place on each source of Berkshire's earnings. With Buffett and Munger using Blue Chip as a platform for expansion, understanding the impact on Berkshire was important. Buffett was once again putting himself in the shareholders' shoes. [139]

Like Berkshire, Blue Chip had transformed itself from a dying, single-line business into a diverse enterprise with multiple sources of earnings and valuable assets. Buffett and Munger were using their capital allocation skills to shape Blue Chip in Berkshire's image.

1979

Changes to accounting rules necessitated another lesson on accounting in 1979. The prior year required an update due to the complexities surrounding the merger with Diversified Retailing. This time it was the Insurance Group's accounting that required some explaining. Specifically, the accounting rules regarding marketable securities were changed to record

values at market, rather than at the lower of aggregate cost or market. The result was a substantial increase to reported equity.

The resulting change caused the Insurance Group's 1978 equity, as shown on the balance sheet, to increase $61 million to $204 million. Nothing had really changed from an economic perspective. To confuse things even more the accounting change only applied to insurance companies. This meant that Blue Chip Stamps, which was fully consolidated with Berkshire, reported its equity investments the old way, at the lower of aggregate cost or market. The same security owned by Berkshire's insurance companies and Blue Chip would therefore be reported at two different values. Shareholders were therefore given the information on aggregate cost *and* market value of securities in the footnotes to the financial statements regardless of where they were held in Berkshire.

Buffett reminded shareholders how he viewed Berkshire's short- and long-term operating performance. He took the view that operating earnings prior to any securities gains and losses was the correct numerator for any calculation. For the denominator, he used the prior year's ending equity with securities valued at cost, not market. The equation looked like this:

Equation 4.1

$$\textit{Operating performance} = \frac{\textit{Operating earnings (prior to securities gains or losses)}}{\textit{prior year's ending equity (securities valued at cost)}}$$

The rationale was to provide the most accurate representation of managerial performance, since a decline in equities valued at market would unduly depress the denominator and make performance the next year look artificially high. Conversely, a strong year for capital gains would cause good operating performance to look less impressive than it might otherwise have been due to a larger denominator.

Long term, Buffett looked to include everything: all capital gains/losses, and any one-time or non-recurring items. He would also use securities valued at market for this calculation. Buffett warned against measuring results with earnings per share. "The primary test of managerial performance is the achievement of a high earnings rate on equity capital employed (without undue leverage, accounting gimmickry, etc.) and not the achievement of consistent gains in earnings per share," he wrote. Some real numbers summed up the achievements since 1964: On September 30, 1964 (the then year-end) Berkshire's book value was $19.46 per share. At year-end 1979 that figure (again, with securities valued at market) was $335.85 per share—a compounded annual gain of 20.5%.

Though certainly a good result, Berkshire's 20.5% rate of return was insufficient to produce real gains in purchasing power if inflation continued running double digits and taxes remained at current levels. One must ask the question, what was the alternative? If a 20% return was insufficient, what other investment at the time could have maintained or grown purchasing power in a world of high inflation? Buffett had no solution to this problem, other than to use opportunity cost as his guide.

Sources of Earnings

The new table presented in the Chairman's letter provided shareholders with a wealth of direct and meaningful information on Berkshire's operating performance throughout the year. Buffett was again role-reversing and giving shareholders information he would want if he were in their shoes. What a story it told. [140] (See Table 4.2)

Textile earnings, once the sole source of Berkshire's earnings, generated less than 4% of the nearly $47 million of earnings before taxes and securities gains (but after interest). The largest source of earnings power was in the Insurance Group. See's Candies, the Illinois National Bank and

Trust, and Mutual Savings and Loan were the only subsidiaries after insurance whose earnings contributed 10% or more to Berkshire's pre-tax earnings.

Table 4.21: Berkshire Hathaway summary sources of operating earnings 10% or more, 1979

Insurance underwriting	8.0%
Insurance net investment income	51.7%
Total insurance	59.7%
See's Candies	16.2%
Illinois National Bank	12.0%
Mutual Savings and Loan	10.1%
All others, combined	14.4%
Interest on debt	(12.5%)
Total	100.0%

Note: Totals do not add up to 100% due to rounding.

Sources: Berkshire Hathaway Chairman's letter 1979 and author's calculations.

Sharp-eyed readers would have noticed a new business reported in the table in 1979. Precision Steel Warehouse, Inc., an 80%-owned subsidiary of Blue Chip, [141] contributed almost $1.5 million to Berkshire's earnings in 1979. In the letter to Blue Chip shareholders included as an appendix to the Berkshire Annual Report, Chairman Charlie Munger reported that Blue Chip purchased its interest in the steel company in February 1979 for $15 million. [142] Writing to Blue Chip's shareholders, Munger wrote:

> "A steel service center business may strike some of our shareholders as a peculiar addition to a candy company, even one already joined to a savings and loan business. However, Precision Steel shares an extremely important quality with See's: a company-wide culture of constant concern for customer interests and fair dealing."

Both Munger and Buffett were concerned not about the product per se, but about businesses they understood and that had good economic characteristics. Candy or steel, it did not matter.

The summary table showed Berkshire's creditors they had little to worry about. Earnings covered interest almost nine times over and the $52.6 million of earnings before interest would have been nearly enough to pay

off *all* of Berkshire's direct financial debt. To be fair, the earnings figure was a look-through number that accounted for Berkshire's share of all underlying earnings as adjusted for its ownership percentages. A corresponding balance sheet look-through number was not provided. Berkshire's unconsolidated ownership interests had some debt of their own, which, under a proper analysis would be accounted for. The main point is Berkshire's creditors were very safe because they had a debtor with a large and growing stream of earnings on top of a conservatively financed bal ance sheet.

Textiles and Retailing

Given the gloom associated with textiles, the fact that textiles and retailing were combined under the same heading likely would not be comforting to a manager. Yet Buffett had praise for Ben Rosner, head of Associated Retail Stores, who "continues to pull rabbits out of the hat—big rabbits from a small hat." The praise also gave shareholders a glimpse into Buffett's thinking on earnings. Cash was king. Those earnings produced by Associated Retail were, "realized in cash and not in increased receivables and inventories as in many other retail businesses."

Insurance

Insurance underwriting again turned in a profit, meaning Berkshire's cost of float was negative. [143] But Berkshire was the exception; the industry reported an underwriting loss that year. Negative cost of float, remember, was a very good thing since it meant Berkshire was getting paid to hold policyholders' money above and beyond any investment income. Still, Berkshire had some variation in its own results.

Table 4.22: Insurance Group, select information

($ thousands)	1979	1978	1977
Premiums written, net	$186,185	$198,313	$158,704
Premiums earned			
Specialized auto and general liability	90,646	96,126	80,690
Workers' compensation	19,350	29,893	18,916
Reinsurance	30,864	30,160	24,100
Home State multiple lines	41,089	29,894	19,382
	181,949	186,073	143,088

Underwriting gain (loss), pre-tax			
Specialized auto and general liability	7,845	11,543	7,800
Workers' compensation[1]	5,130	(3,944)	(1,644)
Reinsurance	(4,338)	(2,443)	(1,251)
Home State multiple lines	(4,895)	(2,155)	896
	$3,742	$3,001	$5,801
Combined ratio (statutory)	97.2%	96.7%	93.2%
Footnote: 1.Workers' Compensation coverage written by Home State is not broken out per the footnote to the financial statements.			

The data in this table was taken from the summary of segment results section of the Annual Report and differs in some cases with figures listed in earlier reporting periods.

Source: Berkshire Hathaway Annual Report 1979.

According to Buffett, "really extraordinary results were turned in by National Indemnity." The details proved his words were not an exaggeration. Buffett highlighted the portion of National Indemnity's business operated by Phil Liesche, which underwrote to a profit of $8.4 million on $82 million of earned premiums—a combined ratio just under 90%. [144] Workers' Compensation premiums earned fell by 35%, yet profitability soared. This result, Buffett said, was, "far, far better than we had any right to expect at the beginning of 1979" and was due in large part to favorable results in California, which finally began pulling its weight after years of struggles.

In Berkshire's other areas of insurance, the numbers were not so good. Home State reported disappointing results in 1979. Part of the problem lay with Cornhusker Casualty Company, which had poor underwriting results on top of other issues that required the attention of Jack Ringwalt. Nonetheless, efforts to expand what Buffett viewed as a sound long-term business in Home State insurance continued with the formation of a Colorado subsidiary.

Losses were also reported in reinsurance following the trend of the industry overall. Tempering the loss (but only partially) was the meaningful source of float reinsurance provided t o Berkshire.

Buffett remained optimistic for the insurance business, even though he expected a tough five-year period ahead with an industry-wide combined ratio in the area of 105%. Part of the problem, he explained, was interest rates. High interest rates were causing managers of insurance businesses to

take on less profitable business, since even a modest cost of float (somewhere above 100%) would be a cheaper source of funds than could be obtained elsewhere. Another source of optimism was high gas prices, which caused people to drive less and therefore lowered auto accident frequencies. [145]

Investments

Though Berkshire preferred equities, bonds were an important part of the investment portfolio. At year-end 1979, bonds on the insurance balance sheet (at amortized cost) amounted to $186 million, compared to equities (at market) of $337 million.

Buffett pointed to accounting conventions as a major contributor to the "extraordinary amount of money" lost in bonds by insurance companies. Because those conventions reported their value at amortized cost, the fluctuations in market values (due to changes in interest rates) were not realized (either in the accounting sense or in the cerebral sense; some managers had no idea that bonds could lose so much value). Instead, some insurance companies were blind to the fact that high interest rates caused the real, economic value of their bond investments to decrease in value. (As the ubiquitous line in financial reporting goes, bond prices move inversely to yield.) Buffett speculated that if managers were forced to recognize the value of their bonds at market value, and not at amortized cost, managers might have "been focused much earlier on the dangers of a very long-term bond contract."

A master at analogy, Buffett used an example to illustrate the inconsistency of insurance company managers. Managers were cutting back on issuing one-year policies reasoning (correctly) that six-month policies would better protect them from the rising prices of delivering on their insurance promises. Yet those same managers took insurance premiums and "sold the money" (i.e. invested it) at a fixed price for thirty or forty years. It was interesting, thought Buffett, that buyers seeking a fixed price contract for any other product or service over the same time would be laughed down, yet the buyer of money could lock in a fixed interest rate for a generation or more.

Buffett's criticisms were not only for others; he was, in fact, hardest on himself for the mistakes he made in bonds. "You do not adequately protect

yourself by being half awake while others are sleeping. It was a mistake to buy fifteen-year bonds, and yet we did." Instead of staying in a tough situation in bonds, he should have realized his mistake and sold at a loss. It was a lesson, he told readers, he should have learned from the textile business, noting "we should have realized the futility of trying to be very clever … in an area where the tide was running heavily against us."

Banking

The Bank Holding Company Act of 1969 set a deadline of December 31, 1980, for Berkshire to divest Illinois National Bank and Trust. Buffett asked shareholders to give Eugene Abegg, its founder and manager, a standing ovation for his achievements. And well-deserved they were. The year 1979 was not only the last under Berkshire Hathaway, but the bank had its best year on record with a return on average assets of 2.3%—three times greater than the average major bank.

To comply with the law, Berkshire was, "investigating the possible sale of between 80% and 100% of the stock of the bank." Buffett informed shareholders that the sale would not be based on price alone. He genuinely cared about the post-Berkshire ownership of Illinois National, and took as much care with its divestment as he had in its original selection. He warned shareholders that such a high-quality asset would not be easy to replace: "You simply can't buy high quality businesses at the sort of price/earnings multiple likely to prevail on our bank sale." More will be said on Illinois National in the summ ary of 1980.

Financial Reporting; Prospects

In a section entitled Financial Reporting, Buffett informed shareholders that Berkshire now traded on the NASDAQ. All shareholders would be able to hear from Dow Jones, the financial news giant, at the same time when Berkshire reported earnings. Buffett told shareholders that while the quarterly reporting would be light, his annual communications would be comprehensive and fitting to an owner of a business. "Your Chairman has a firm belief that owners are entitled to hear directly from the CEO as to what is going on and how he evaluates the business," just as they would with a private company.

Buffett was unconventional in the transparency he showed in his Chairman's letter to shareholders. Those shareholders were also unconventional. Buffett pointed out that 98% of the shares outstanding at the end of year were held by people who were shareholders at the beginning of the year. This loyalty is notable given that stocks are traded daily on the financial markets and frequently have high turnover ratios. [146]

Concluding the 1979 Chairman's letter under a section entitled Prospects, Buffett tempered expectations for the coming year. He expected higher operating earnings but predicted the *rate* of increase to decline. He warned that the dollar figures could come in lower depending on the timing of the sale of Illinois National. Nonetheless, he expressed long-term optimism about the businesses under Berkshire's umbrella.

Berkshire's policy to have centralization of capital allocation and decentralization of operating authority was a formula for success because it was highly scalable. This system would not change in the coming years and would lead to even more success. In 1979, it was still the early days.

1980

Operating earnings of $41.9 million were sufficiently above the $36 million reported the prior year, but the *rate* of increase in book value (with securities valued at cost) fell from 18.6% to 17.8%. Berkshire also crossed an important (yet arbitrary) milestone in 1980: year-end assets topped $1 billion.

For the third year in a row, shareholders were treated to a lesson on accounting. This lesson was how the financial results of Berkshire's ownership interests in companies were reported to Berkshire shareholders. The accounting treatment depended on whether Berkshire owned 100%, between 50% and 100% of the business, between 20% and 50%, or less than 20%. In all cases, the only thing that mattered to Buffett was the proportionate economic performance—whether Berkshire owned 100% of a business or one share didn't matter. The accounting was another matter, and Buffett wanted Berkshire's shareholders to understand how it could skew the financial picture.

100% Ownership: This is a wholly-owned subsidiary, and the most straightforward case. Financial results are fully consolidated with the parent

company. Its balance sheet items (cash, receivables, inventory, fixed assets, liabilities, etc.) and income statement items (revenues, expenses, etc.) are reported together with the parent company's financials. Such accounting treatment makes sense since the new or subsidiary business becomes a part of the parent, even if its results are detailed separately. This was the case for Berkshire's original textile operation in New Bedford, Massachusetts, and its Waumbec operation in Manchester, New Hampshire.

One problem with such accounting arises when a parent company owns many diverse businesses. Remember back to the 1978 discussion of the Berkshire-Diversified Retailing merger. The merger caused the fully consolidated results to become nonsensical, or at best of little value since the accounting obscured reality. Berkshire therefore began providing a separate table to shareholders to help them make sense of the noise.

50%–99% Ownership: When a business owns between 50% and 100% of another business, the minority shareholders (those owning 49% or less) must be considered. In these instances, a '1a' item can be added to the fully consolidated method of accounting. The solution is to keep the accounts consolidated like the example above (along with the accounts of the majority owner), but to add an entry on the financial statements for minority interests. The financial accounts are lumped together with the parent, and both the equity and equity in earnings attributable to the other shareholders is accounted for with a single line item. [147]

20%–49% Ownership: With this level of ownership, the accounting treatment is like the minority interest accounting above, only the parent company in question is the minority owner. To use a Berkshire-specific example, Blue Chip Stamps was accounted for in this way until Berkshire's investment crossed the 50% threshold with the Diversified Retailing merger. Prior to that time, the only entry attributable to Blue Chip was an "equity in Blue Chip Stamps" representing Berkshire's proportional ownership in Blue Chip, and a similar entry on the income statement accounting for its share of earnings named "equity in earnings of Blue Chip Stamps."

Less than 20% Ownership: This is where economics and accounting diverge. Accounting rules dictate that only the dividends received from an investee in this class can be counted as income. To use an oversimplified example, if Berkshire owned 19.99% of a company with $100 in net after-

tax earnings paying out no dividends, it would record no earnings from this investment. If it instead owned 20% of the same company, it would record an entry for “equity in earnings of XYZ” of $20. It’s the same economics; just drastically different accounting.

Berkshire’s insurance companies owned significant amounts of stock, many of which fell into that last category. And since many of these investees retained most of their earnings (in other words, paid out little of their earnings as dividends) the income did not appear in Berkshire’s financial statements. In fact, Berkshire’s share of the income of these investees (called look-through earnings) were larger than the total reported operating earnings of Berkshire. To paint the mental picture, Buffett described a large iceberg mostly hidden below the surface of the water. The substance was there, one just needed to look more closely to see it.

Buffett warned shareholders that his views were unconventional. He needed them to understand that he focused on the economics, not the accounting. Buffett showed he could immediately increase Berkshire’s reported results, even though such an action “tempts us not at all.” All he would have to do is sell Berkshire’s equity portfolio and use the proceeds to buy long-term tax-free bonds. Such a move would increase accounting earnings by over $30 million (representing over 50% additional after-tax reported earnings). But it would also be detrimental to Berkshire’s economic position since its claim on the underlying earnings of companies in the equity portfolio were worth more. [148] As a controlling shareholder in Berkshire, Buffett could follow the path that made the most sense in pure economic terms, rather than be tempted by the apparent prosperity allowed by accounting.

As it turned out, inflation peaked at 13.5% in 1980. Buffett likened inflation to an implicit tax on capital. When combined with the explicit income tax, an owner of a business (even a very good business) could lose purchasing power. The example Buffett used was a business earning 20% return on equity in a world of 12% inflation. Someone in the 50% tax bracket would, if he or she was paid out all earnings as dividends, end up with a 10% after tax return and *lose* 2 percentage points of purchasing power a year. Since Berkshire was not immune to inflation, Buffett wanted shareholders to be aware of its pernicious effects even if he had no solution to the problem.

Sources of Earnings

Berkshire's pre-tax operating earnings increased 16% to $54 million (see Table 4.2). The primary driver was improved results from insurance (presented in more detail below) followed by increases at See's and Blue Chip Stamps. To provide Berkshire shareholders with as much relevant information on their investment as possible, for several years Buffett had included the letters to shareholders from its major investees, Blue Chip Stamps, and Wesco, at the end of Berkshire's report. The letters were penned by Chairmen Charlie Munger and Louis Vincenti, respectively. In 1980 both told the story of Wesco's divestiture of most (fifteen locations) of its Mutual Savings branch network. [149]

The sale resulted from a desire to mitigate the effects of inflation on a borrow-short-lend-long operation like a bank. The sale of the branch network, save for the bank's headquarters office building and one satellite branch, was, "motivated by the margin-of-safety considerations intrinsic in engineering and still appropriate, we think, in financial institutions" to reduce an "earthquake risk," according to Munger's letter to Blue Chip shareholders.

The buyer of the branch network was Brentwood Savings, another local savings and loan institution. The sale consisted of the transfer of $307 million of savings account liabilities, an equal amount of mortgage loans, and the physical assets of the branch offices. It resulted in a net pre-tax gain of $5.9 million to Wesco ($2.8 million pre-tax to Berkshire). Though the transaction would reduce Wesco's average yield on its assets from 9.3% to 7.7%, it would come with a significant decrease in leverage and, importantly, help protect Wesco from the ravaging effects of inflation. The sources of earnings table presented in the Berkshire report took pains to separate the gain on the sale from Wesco's operating results.

Berkshire's investments in non-controlled businesses (those in the less than 20% category) had a combined market value of $530 million and a cost of $325 million. At $13 million, the combined earnings attributed to Berkshire's ownership interest in Aluminum Company of America (ALCOA) and Kaiser Aluminum and Chemical Corp were larger than most of Berkshire's wholly-owned subsidiaries. Those investments made up 10% of Berkshire's equity portfolio (at market) at year-end but their full economic earnings did not show up in financial statements due to conventional accounting rules.

Another much larger non-controlled investee was GEICO. Berkshire's 7.2 million shares represented a 33% interest in the insurer, [150] and its earnings attributable to Berkshire that one year were $20 million. Berkshire bought the shares for $47 million in 1976 and four years later they were worth $105 million (20% of the portfolio). Buffett used GEICO to show how the stock market frequently provides opportunities to buy great businesses at less than private market values. Buffett said buying a similar ownership interest in $20 million of earnings would cost at least ten times as much. Yet Berkshire was able to acquire its shares in GEICO at a bargain price and was content to let management run the business as they saw fit, including choosing the dividend policy.

One quirk related to Berkshire's investment in GEICO should be noted. Normally a 33% ownership interest would call for the investee accounting treatment, with Berkshire's proportional interest in earnings reported on the income statement. But because of Berkshire's other insurance holdings, it had transferred its right to vote the shares to an independent party. This special order from Washington, D.C., and the New York Insurance Departments, allowed Berkshire to own more of GEICO than it otherwise could have but necessitated an accounting treatment similar to that of a non-controlled business (reporting only its dividends in earnings).

Insurance

The insurance industry turned in a year similar to Buffett's prediction. The industry combined ratio was 103.5% in 1980, which meant its float (monies held but ultimately destined to policyholders and others) cost 3.5%. This was not a terrible result given that interest rates at that time were in the double digits. In fact, some managers outside of Berkshire rationalized the writing of business at a combined ratio over 100% for just that reason. That same interest rate environment was causing other, even more irrational behavior within the investment portfolios of some insurers.

An environment of rising interest rates generally has a negative effect on bond prices. This is because a lower price (denominator) is needed to cause the same coupon payment (numerator) to represent a higher ratio or yield. In an equity portfolio, these declines in market price would be reflected as a corresponding decrease in book value. For bonds, they were carried on the books at amortized cost, effectively protected from market swings on paper.

An insurer couldn't sell a lower yielding bond (even to trade to a higher yielding issue) without incurring a capital loss. At best, some held on to avoid the potential embarrassment of showing a loss on the income statement. Others were forced to maintain the investments since realizing losses would have reduced an already thin shareholder equity account. [151] The bond portfolios of most insurers were usually multiples of shareholder equity and were typically funded primarily by policyholder premiums. The insurer was thus incentivized to write business at any cost to maintain its float. The rational course when reporting underwriting losses would be to realize the capital losses and move into taxable bonds to capture a higher after-tax yield.

Berkshire was not immune to the above scenario, and Buffett even chided himself for not acting earlier to sell unattractive bond holdings at a loss. Berkshire was protected in two ways. First, its investment portfolio had a higher concentration of equites and a corresponding lower concentration in bonds. Second, Berkshire's insurance businesses wrote far less volume in relation to equity capital than its peers. Its $185 million in premiums written amounted to just 56% of average ending equity of $331 million. [152] Furthermore, its bond portfolio represented just under 50% of equity capital at year-end compared to 300% (or three times) for other insurers. This meant any losses in bonds had less impact on Berkshire's capital. Still, as Buffett noted, "troubles for the industry mean troubles for us."

Table 4.23: Insurance Group, select information

($ thousands)	1980	1979	1978
Premiums written, net	$184,864	$186,185	$198,313
Premiums earned			
Specialized auto and general liability	88,404	90,646	96,126
Workers' compensation	19,890	19,350	29,893
Reinsurance	33,804	30,864	30,160
Home State multiple lines	43,089	41,089	29,894
	185,187	181,949	186,073
Underwriting gain (loss), pre-tax			
Specialized auto and general liability	7,395	7,845	11,543
Workers' compensation[1]	4,870	5,130	(3,944)
Reinsurance	(233)	(4,338)	(2,443)
Home State multiple lines	(5,294)	(4,895)	(2,155)
	$6,738	$3,742	$3,001

Combined ratio (statutory)	96.4%	97.2%	96.7%
Footnote: 1.Workers' Compensation coverage written by Home State is not broken out per the footnote to the financial statements.			

The data in this table was taken from the summary of segment results section of the Annual Report and differs in some cases with figures listed in earlier reporting periods.

Sources: Berkshire Hathaway Annual Reports 1979, 1982.

Buffett gave a frank assessment of Berkshire's insurers. National Indemnity continued to produce good results under a self-imposed reduction of premium volume due to insufficient pricing. National Indemnity's reinsurance business reflected the ongoing weaknesses of the primary market and wasn't expected to have much future growth. Buffett said the delay factor in reinsurance caused him to bemoan industry conditions "that were transforming the reinsurance market into amateur night." People were lured by ease of entry into the business, large amounts of upfront cash, and delayed expenses. It set the stage for even larger swings in profitability and required a significant amount of discipline over many years. Even so, the small underwriting loss in reinsurance during 1980 was a very good result considering its associated float (assuming business on the books was appropriately reserved).

With the exception of a good performance in Kansas, Home State insurance operations were poor. Results were so bad in Iowa that the Insurance Company of Iowa, founded in 1973, was shut down and merged into Cornhusker Casualty.

With much negative industry information to report, Buffett apparently forgot to mention that Berkshire's own insurance companies collectively turned in a great year. The combined ratio improved and a record underwriting profit was achieved. This was on top of nearly $31 million of investment income. Nonetheless, Buffett again left off with a prediction for the following year. He anticipated lower volume and poorer underwriting results in 1981, but that Berkshire's results would be above the industry average.

Textiles and Retail Operations

In 1980, the report on Berkshire's textile operations and its Associated Retail operation was moved away from the beginning of the letter. That was

because the scope of the textile business was reduced. Buffett informed shareholders that New Bedford's loom capacity was reduced by one-third, and that operations ceased at Waumbec in Manchester, New Hampshire. The rest of the operation was split into independent manufacturing and sales divisions. Even though the Textile Group had, "more than doubled capacity in our most profitable textile segment through a recent purchase of used 130-inch Sauer looms," capital employed in the segment was being reduced.

Though lumped together in the same segment as the faltering textile operations, Buffett praised Associated Retail. He noted that in 1981 Associated Retail would celebrate fifty years in operation, all under the leadership of Ben Rosner.

Illinois National Bank and Trust of Rockford

The news on Berkshire's banking subsidiary, Illinois National, was doubly sad. First, Berkshire was forced to divest of the well-run and highly profitable bank, which was completed on December 31, 1980, to comply with Federal Law. Then its founder, Eugene Abegg, died on July 2, 1980 at the age of 82. Buffett had much praise for Abegg and fondly recalled their eleven-year business relationship.

"As a friend, banker and citizen, he was unsurpassed," said Buffett. Buffett admired both Abegg's under-promise and over-deliver business approach, and his strength of character. "The seller has dozens of opportunities to mislead the buyer …" yet he, "laid all negative factors face up on the table." Yet Abegg hid, or forgot to mention, positive factors that came with Berkshire's purchase when they periodically materialized.

Buffett's praise read like a business obituary (though the business was not dead) and eulogy wrapped together. Abegg started the bank in the 1930s at the request of George Mead (no known relation to the author [153]), a wealthy industrialist at the time. He ran it for close to fifty years, producing record industry results. When other banks were failing or trying to figure out how to pay depositors after the one-week bank holiday of 1933, Abegg had enough cash on hand to pay all depositors in full. His "fiduciary attitude was always dominant," said Buffett. High praise indeed.

The financial divestiture of the bank was complicated but designed in the best interests of both Berkshire's shareholders and those of the bank. The

divestiture would not be entirely financially motivated—Buffett wanted to reciprocate the fair treatment received by Abegg in the purchase and operation of the bank with an equally fair sale. Though the mechanism was somewhat complex, the process amounted to an I-cut-you-choose type of split. As the controlling shareholder in the bank and Berkshire, Buffett designed the exchange ratio. Since he designed it, he left himself as the exchanger of last resort.

Berkshire's 1,300 shareholders were left with three options:

- Proportional option: Maintain an equal ownership in Berkshire and the bank post-divestiture, with the only difference being having two stock certificates after the divestiture. Chosen by: Twenty-four shareholders.
- Bank-preferred exchange: Increase ownership in the bank while decreasing ownership proportionally in Berkshire. Chosen by: Thirty-nine shareholders.
- Berkshire-preferred exchange: Reverse of the second option, with ownership increasing in Berkshire and ownership decreasing, up to the entire amount, in the bank. Chosen by: 1,237 shareholders.

The bank was left with sixty-five shareholders, all of whom chose to become a shareholder. Because the divestiture was accomplished via a transaction to existing Berkshire shareholders, its equity on the books of Berkshire was removed in a treasury shares transaction, which gave the appearance of Berkshire repurchasing 41,086 shares for nearly $29 million.

Financing

During 1980, Berkshire sold $60 million of 12.75% notes due August 1, 2005. The bonds contained a sinking fund arrangement that would take effect in 1991. A sinking fund is a technical term for money set aside to repay a debt in regular installments. It's a lot like a monthly mortgage payment of principal and interest. Unlike a conventional mortgage, however, corporate debt often contains unique provisions. In this case, Berkshire would have use of the original $60 million from 1980 until 1991, and during that time would only be required to remit interest payments. In 1991, the loan would start amortizing, meaning the principal would begin to

be repaid. Such a provision decreases the risk to a lender. It allows the debt to be repaid over a known period rather than relying on a new loan to repay the full amount once the original loan comes due. Even though Berkshire did not have an immediate use in mind for the proceeds, they were raised in anticipation of opportunities arising. Buffett was thinking into the future, knowing full well that the time to borrow money was when one didn't need it.

1981

Berkshire's after-tax operating earnings of $39.7 million in 1981 produced a 15.2% return on beginning equity capital (at cost). Maintaining such a rate of return would require favorable opportunities to purchase more businesses in whole or in part via the stock market. Given this, Buffett laid out Berkshire's acquisition strategy.

Berkshire was okay with either total ownership of a business or part ownership (in the form of marketable securities). He went so far as to say many of Berkshire's non-controlled investments (stocks) were better than its controlled businesses because of the mispricing opportunities presented by the market from time to time. In either case, no attention was paid to accounting over economics. The economics won out every time, even if the earnings attributable to Berkshire's share never appeared on financial statements. Combined, these unreported-but-economically-real earnings already exceeded Berkshire's reported earnings and were why Buffett took pains to illustrate what was going on.

Four of Berkshire's investees are good examples: GEICO, General Foods, R.J. Reynolds Industries, and *The Washington Post* had combined undistributed earnings attributable to Berkshire totaling $35 million. This was over half of Berkshire's 1981 earnings before interest. [154] Though very little of that money appeared on Berkshire's financials because of low dividend payout ratios, it would eventually show up as capital gains as the market recognized the accumulating value in the underlying businesses. In the short run, the accounting could skew down the annual return on equity calculation, but over time it would show up in book value for Berkshire's shareholders. [155]

Buffett looked down on companies that preferred accounting over economics, but he understood why managers made that choice. They were type-A personalities who, “seldom are deficient in animal spirits and often relish increased activity and challenge.” These managers, Buffett said, knew exactly where they stood on *Fortune Magazine* ’s Fortune 500 list of largest companies by revenues. But how many knew their ranking based on profitability? Few, he conjectured. These managers would buy the proverbial toad they thought they could kiss and turn into a superstar. A few managed such a feat, and Buffett named them: Ben Heineman at Northwest Industries, Henry Singleton at Teledyne, Erwin Zaban at National Service Industries, and especially Tom Murphy at Capital Cities Communications. Murphy got extra praise for being skilled in both acquisitions and operations. Notably, Buffett explicitly excluded himself from such managerial accolades.

The topic of inflation remained a concern as the rate of inflation continued to run near double digits. Buffett said inflation acted like a “gigantic corporate tapeworm,” consuming investment dollars regardless of the health of the host. The less prosperous a business, the greater proportion of dollars were consumed. Not only would taxes and inflation combine to reduce individual investors’ real purchasing power over time, businesses would be forced to retain earnings. To maintain unit volume over time required continual reinvestment in capital such as receivables, inventories, and fixed assets. One of the worst parts about inflation was its distorting effects on managerial decision-making. Reductions in purchasing power and forced reinvestment were real issues. The problem, it seemed, was that some managers and owners did not make decisions that took inflation and changes in interest rates into account.

Sources of Reported Earnings

The now-familiar table in the Chairman’s letter (see Table 4.2), gives a broad look at how the budding Berkshire conglomerate fared during 1981. Action was concentrated in two areas: insurance and candy. Insurance dominated 85% of the year’s pre-tax operating earnings. Insurance underwriting, which was viewed and managed distinct from investment income, declined but was still profitable. The underwriting profit together with an increase in net investment income was enough to bring the

Insurance Group's total contribution to pre-tax operating earnings above that of the prior year. Such a comparison is slightly misleading since Berkshire had used $28.75 million of its $60 million of proceeds raised the prior year to add to the Insurance Group's equity capital.

Table 4.24: Berkshire Hathaway summary sources of operating earnings 10% or more, 1981

Insurance underwriting	3.1%
Insurance net investment income	82.2%
Total insurance	85.3%
See's Candies	26.4%
All others, combined	15.0%
Interest on debt	(26.8%)
Total	100.0%

Note: Totals do not add up to 100% due to rounding.

Sources: Berkshire Hathaway Chairman's letter 1981 and author's calculations.

See's Candies' $12.5 million of pre-tax earnings (Berkshire's share), [156] representing over a quarter of the total, jumps out as the second largest contributor. In his letter to Blue Chip's shareholders, Charlie Munger described See's in more detail. The figures below in Table 4.25 showed a modest annualized increase in pounds. The ability of See's to pass on increases in prices, however, resulted in double-digit growth in revenues and an even greater increase in profits during that time.

Table 4.25: See's Candies, select data

($ and pounds in millions)	1981	1972	% Change	% / Yr.
Pounds sold	24	17	41%	3.9%
Revenues	$113	$31	260%	15.3%
After-tax profits	$11	$2	450%	20.9%

Sources: Blue Chip Stamps Chairman's letter 1981 and author's calculations.

In 1981, profits at See's increased 41%. [157] Such increases were that much more impressive, said Munger, considering the industry was basically stagnant.

Why was this so? Munger, always one to seek out the why behind any result (good or bad), attributed the success of See's to a couple of factors. First, customers preferred its taste and texture over competitors. This was likely the result of its "fanatic insistence on expensive natural quality control and cheerful retail service." Second, See's controlled the distribution of its candy very carefully, owning all its stores and handling distribution to those stores itself. See's was therefore rewarded, said Munger, with, "extraordinary sales per square foot … frequently two to three times those of competitors." With such excellent business attributes See's was clearly worth far in excess of the $38.3 million carrying value Blue Chip attributed to it on the books.

The remainder of Berkshire's sources of earnings in 1981 made up just 15% of the total, but some were of interest. After divesting its branch network in 1980, Mutual Savings and Loan lived up to expectations and saw its pre-tax earnings drop from $2.8 million to $0.8 million. *The Buffalo Evening News* , a subsidiary of Blue Chip Stamps, continued to struggle with litigation issues from its competitor and turned in a loss of $0.7 million for Berkshire shareholders. Shareholders would also have noticed the jump in interest expense. A direct result of the $60 million borrowed in 1980, interest expense jumped from $9.4 million to $12.7 million in 1981.

Insurance

Irrational pricing by insurance industry participants in 1981 continued throughout the year and gave Buffett the confidence to predict in his Chairman's letter (written in early 1982), "that 1982 will be the worst year in recent history for insurance underwriting." Industry data (see Table 4.26) showed a correlation between the yearly change in premiums written and the impact on profitability the ensuing year. In an inflationary world, low increases in premiums meant insurers weren't covering their costs; and profitability, expressed in a combined ratio above 100%, was trending the wrong way.

Table 4.26: Select insurance industry data

	1981	1980	1979
Growth in written premiums	3.6%	6.0%	10.3%
Growth in earned premiums	4.1%	7.8%	10.4%
Combined ratio	105.7	103.1	100.6

	%	%	%

Source: Best's Aggregates and Averages, as quoted in the 1981 Berkshire Hathaway Annual Report.

Over the preceding three years, premium growth industrywide fell to single digits. Consequently, the combined ratio deteriorated. Based on then-current trends in quarterly data, which were quickly deteriorating, things were expected to get much, much worse. Because of the open book nature of the insurance industry, rates were generally subject to the actions of the least rational competitor. That is, that outfit would attract the most business and others would feel the need to follow. Berkshire, unwilling to write business at an obvious loss, wrote almost 20% less volume in 1981 compared to 1980. (Part of the decline came from shuttering the Iowa Home State operation during 1980.)

Table 4.27: Insurance Group, select information

($ thousands)	1981	1980	1979
Premiums written, net	$148,000	$184,864	$186,185
Premiums earned			
Specialized auto and general liability	73,177	88,404	90,646
Workers' compensation	18,193	19,890	19,350
Reinsurance	29,446	33,804	30,864
Home State multiple lines	38,197	43,089	41,089
	159,013	185,187	181,949
Underwriting gain (loss), pre-tax			
Specialized auto and general liability	3,020	7,395	7,845
Workers' compensation[1]	2,822	4,870	5,130
Reinsurance	(3,720)	(233)	(4,338)
Home State multiple lines	(644)	(5,294)	(4,895)
	$1,478	$6,738	$3,742
Combined ratio (statutory)[2]	101.6%	96.4%	97.2%

Footnotes:
1.Workers' Compensation coverage written by Home State is not broken out per the footnote to the financial statements.
2. The 1981 combined ratio illustrates the divergence between statutory and GAAP combined ratios. When underwriting is near breakeven, apparent inconsistencies can arise when using the statutory combined ratio.

Note: The data in this table was taken from the summary of segment results section of the Annual Report and differs in some cases with figures listed in earlier reporting periods.

Sources: Berkshire Hathaway Annual Report 1979, 1982.

Shareholder Designated Contributions

Berkshire's new charitable giving program was the brainchild of Berkshire Vice Chairman Charlie Munger. It gave Berkshire's shareholders the option to designate contributions to any charity, with the amount based on the number of shares they owned (Berkshire set the per share amount). This option was limited to shareholders who owned shares in book name (that is, directly registered and not through a broker). In the first year 90% of shareholders (95.6% if Buffett's own shares were included) elected to participate. In total, $1.8 million was paid to 675 charities. Berkshire was effectively paying a tax-free dividend to shareholders that was immediately sent to their favorite charity.

1982

Buffett's prediction of a poor year for insurance underwriting came true. This, in addition to two other factors, caused his benchmark return on beginning shareholders' equity to come in at 9.8%. This subpar number was reported in the very first sentence of his 1982 Chairman's letter. The two other factors contributing to the decline were the growth in the equity capital base and higher levels of investment in non-controlled businesses.

Maintaining high rates of growth on Berkshire's capital was more challenging with each passing year. Berkshire's practice of retaining all earnings resulted in capital accumulating much faster than at other businesses that paid a dividend or regularly bought back shares. Accompanying (and in part because of) Berkshire's large and growing investment in non-controlled businesses via the stock market, Berkshire's reported earnings did not fully reflect actual economic earnings. The iceberg Buffett described in a previous letter was growing, but it was doing so largely below the surface.

For this reason, Buffett proposed a change to his preferred yardstick. Instead of looking at the ratio of operating earnings to beginning equity capital (valuing securities at cost), he suggested the annual change in net worth or book value (valuing securities at market). [158] This measure would allow the retained earnings of non-controlled businesses to show their worth, albeit with stock prices gyrating year-to-year around their intrinsic value.

Buffett provided several examples to back up his rationale for changing his yardstick. The four companies mentioned in the prior report (GEICO, General Foods, The Washington Post Co., and R.J. Reynolds Industries) had earnings of $54 million attributable to Berkshire in 1982. Yet only dividends showed up on Berkshire's income statement, so only $14 million of the earnings were included. GEICO only contributed $3.5 million after tax to Berkshire's accounting earnings—an additional $23 million of GEICO's undistributed earnings remained below the surface. A large portion of Berkshire's economic earnings in many other non-controlled businesses in its $921 million equity portfolio were similarly *hidden* .

This new yardstick proposal by Buffett raised the "only 9.8%" return to 40%, since the gain in net worth came to $208 million—a whopping 6.6 times the $31.5 million of accounting operating earnings. Buffett came right out and said what he would have been thinking if he were in shareholders' shoes: "You should be suspicious of such an assertion. Yardsticks seldom are discarded while yielding favorable results," he said. "We generally believe in pre-set, long-lived, and small bullseyes," not, "shoot[ing] the arrow of business performance into a blank canvas and then carefully draw[ing] the bullseye." Buffett's logic was sound, and for Berkshire it made sense to readjust the performance gauge to make up for the vagaries of financial accounting.

Sources of Reported Earnings

Sticking out like a sore thumb, the $21.6 million pre-tax underwriting loss from the Insurance Group was enough to put a pit in one's stomach. The swing to a loss, though anticipated, was still hard to comprehend. One positive factor within insurance (which will be discussed in more detail below), or at least a mitigating factor to the large underwriting loss, was the $41.6 million of pre-tax net investment income in 1982. It must have been somewhat comforting knowing the insurance business overall was profitable.

Table 4.28: Berkshire Hathaway summary sources of operating earnings 10% or more, 1982

Insurance underwriting	(77.7%)
Insurance net investment income	150.0%
Total insurance	72.3%

See's Candies	51.3%
Wesco Financial - parent	10.6%
All others, combined[1]	12.6%
Interest on debt	(46.8%)
Total	100.0%
Footnote: 1. Blue Chip Stamps - parent represented 9.0%.	

Sources: Berkshire Hathaway Chairman's letter 1982 and author's calculations.

While still reporting operating losses ($0.7 million pre-tax attributable to Berkshire that year), the success of *The Buffalo News* in attracting Sunday readership presaged good things to come. *The News* had grown Sunday circulation to 367,000. This was an incredible feat given that six years prior it had no Sunday edition. Further, when Sunday was entirely served by *The News'* competitor, *The Courier-Express* , the circulation was just 272,000. In a market with very little household growth, these figures pointed toward the value subscribers found in the paper. The managers Henry Urban, Stan Lipsey, Murray Light, Clyde Pinson, Dave Perona, and Dick Feather, were singled out by name in the Chairman's letter.

Another entry in the same sources of earnings table [159] would have stuck out. Mutual Savings and Loan, the now one-headquarters-one-branch bank owned through Blue Chip's Wesco subsidiary, had lost money pre-tax (Berkshire's share was $2,000, no zeroes omitted) but had generated an after-tax *profit* of over $1.5 million. What was going on?

Charlie Munger explained this in his report to Blue Chip shareholders. He told shareholders that the peculiar result of pre-tax loss and after-tax gain, was of "less-than-highest quality" since it arose due to tax savings as part of being consolidated for tax purposes with Blue Chip. [160] Munger also pointed to another quirk. Mutual Savings and Loan's operating earnings, notwithstanding the tax boost, earned just 7.1% on its $46.2 million of beginning shareholders' equity. Because Blue Chip purchased its interest in Mutual Savings and Loan at a discount, its rate of return was 18.1%. [161]

Mutual Savings and Loan operated a lot like Illinois National Bank and Trust, the bank Berkshire was forced to divest two years prior. Mutual Savings and Loan had a policy of holding high levels of equity in relation to interest-bearing deposits, a high percentage of assets in short-term cash and

cash equivalents, and above average amounts of assets in tax-exempt issues yielding more than typical mutual banks' mortgage portfolios. During 1981, deregulation of banks and thrifts unleashed changes and stiff competition that Munger likened to a hurricane. Mutual Savings largely escaped damage because it shed its branches in 1980 and because of its conservative operating philosophy.

Blue Chips' two other major subsidiaries, See's Candies and Precision Steel, had divergent years. See's did well; Precision Steel did poorly. "See's is by far the finest business we have ever purchased," wrote Munger. Its earnings rose 13.4% to $14.2 million in 1982, continuing to benefit from the fanaticism described in the account of 1981 above. Although it still reported a profit, Precision Steel suffered due to a severe recession in the industry on top of an unprofitable precision measuring tool line closed at an after-tax cost of $650,000.

Textile results improved over 1981 (though textiles still lost over $1.5 million pre-tax). The business continued to shrink. Sales were $21.8 million and total assets just $12.9 million, including inventories of $4.4 million (receivables were not separately detailed). The group was literally fading to a footnote.

Insurance

In every area of business volume was down, and all but one group, workers' compensation, turned in an underwriting loss. The two major killers were National Indemnity's specialized auto and general liability, and the reinsurance business. Berkshire's insurance underwriting deteriorated far more than the overall industry in 1982. As was his style, Buffett did not sugar-coat this fact; he stated it plainly.

Table 4.29: Insurance Group, select information

($ thousands)	1982	1981	1980
Premiums written, net	$149,091	$148,000	$184,864
Premiums earned			
Specialized auto and general liability	69,026	73,177	88,404
Workers' compensation	15,951	18,193	19,890
Reinsurance	27,408	29,446	33,804
Home State multiple lines	37,552	38,197	43,089
Structured settlements and portfolio reinsurance	3,008		

	152,945	159,013	185,187
Underwriting gain (loss), pre-tax			
Specialized auto and general liability	(12,647)	3,020	7,395
Workers' compensation[1]	2,658	2,822	4,870
Reinsurance	(7,524)	(3,720)	(233)
Home State multiple lines	(3,949)	(644)	(5,294)
Structured settlements and portfolio reinsurance	(96)		
	($21,558)	$1,478	$6,738
Combined ratio (statutory)[2]	115.0%	101.6%	96.4%

Footnotes:
1.Workers' Compensation coverage written by Home State is not broken out per the footnote to the financial statements.
2. The 1981 combined ratio illustrates the divergence between statutory and GAAP combined ratios. When underwriting is near breakeven, apparent inconsistencies can arise when using the statutory combined ratio.

Note: The data in this table was taken from the summary of segment results section of the Annual Report and differs in some cases with figures listed in earlier reporting periods.

Sources: Berkshire Hathaway Annual Reports 1979, 1982.

In the reinsurance line, underwriting losses jumped for two reasons. First, storms in the US Southwest during the beginning of 1982 caused immediate claims. The second was adverse loss development.

The nature of reinsurance is that claims stretch out over years, yet management must make an initial estimate of all future costs immediately (regardless of how far in the future they are expected to be incurred). When those prior year loss estimates change, as they did for Berkshire's reinsurance business during 1982, loss development charges are booked in the year the adjustment is made. Adverse loss development occurs when initial estimates of costs are found to be too low. [162] The long time horizon is good from the standpoint of creating long-lived float, but management's estimates are subject to optimism at best and outright deception at worst, frequently leading to inadequate reserving.

Competitive pressures not only kept rates down industrywide but allowed risk to increase as well. National Indemnity's specialized auto and general liability segment had a massive swing in underwriting profitability. Berkshire self-admittedly accepted some of this business. It tried an undefined attempt to counter the adverse trends which, in retrospect but still without explanation, were "ill-conceived and poorly executed."

The Home State group continued to struggle with profitability. Underwriting was so bad in Minnesota that Berkshire closed Lakeland Fire and Casualty Company, the entity formed in 1971 to conduct business in that state. The workers' compensation group was the only ray of sunshine. It turned in a fourth consecutive year of profits.

Berkshire's 115% combined ratio in 1982 was bad in its own right; it was even worse compared to the 109.5% ratio Buffett estimated for the industry overall. And it would be a bloodbath in just a few more years if trends continued. Buffett called the industry average estimates a best case. Because of the significant discretion management had in estimating future losses, much mischief could be done.

Buffett did not name names but said several other insurers used questionable accounting in 1982 to lessen the blow of the significant losses affecting the industry. Buffett put it bluntly: "In insurance, as elsewhere, the reaction of weak managements to weak operations is often weak accounting." His dig continued with one of the aphorisms he was known for: "It's difficult for an empty sack to stand upright." [163]

Others thought the weaknesses in pricing would subside and move toward better profitability, just as in other insurance cycles. But not Buffett. He foresaw continued losses in 1983 and 1984. Insurance was a commodity-type business with ease of entry. Its very nature of delayed recognition of the profitability of underwritten business caused over-capacity to arise more often than not. Also, there were no government-imposed prices. Industry participants were free to price as they please.

Such unrestrained competition hadn't always ruled. In decades past, such as between 1950 and 1970, the industry averaged a 99.0% combined ratio. Buffett said the industry then worked with "a legal quasi-administered pricing system fostered by insurance regulators" where competition was not pervasive. If they became unprofitable, all participants would work in a gentlemanly manner to correct them. Insurance companies were in fact prevented by law from undercutting one another on price. That day was gone and the only way to correct the misery was to decrease industry capacity (meaning supply).

Issuance of Equity

The very first sentence under a section entitled Issuance of Equity foretold the future: “Berkshire and Blue Chip are considering a merger in 1983.” That should have made readers sit up and pay close attention. Buffett did not expound on the merger itself. Instead he described share-based mergers and acquisitions in general, and the all-too-often value-destroying practices they produce.

Remember the metaphor about mergers being a business marriage? The wise would not go into marriage without a lot of thought and knowledge. Buffett’s long explanation of mergers was his way of sharing knowledge. Commenting on Berkshire’s policy relating to share- issuances, he said: “Our share issuances follow a simple basic rule: we will not issue shares unless we receive as much intrinsic business value as we give.” Don’t all other managers act in such a rational manner? No. Quite frequently, Buffett explained, one or a combination of the managers’ thirst for deals, or the valuation of either side of a merger, caused value-destructing action for one of the parties involved. Most often, it was the acquirer that engaged in value-destroying practices (usually by issuing undervalued shares or overpaying for a target), but it’s possible for either side to destroy value.

Buffett used the example of a family farm. A hypothetical merger of a 120-acre farm with a neighboring sixty-acre farm would result in a 180-acre farm. The merger provides an equal partnership between the two farmers. Yet this calculation sees the owner of the larger farm experience a 25% reduction in ownership (from 100% of 120 acres to 50% of 180 acres, or ninety acres pro rata). This happens all the time in business mergers.

Even if the two farms were of equal size, their relative valuations could cause a value-destroying result. For example, if one of the two farms were selling for half of their worth, the result would be the same as the scenario Buffett described above since the undervalued side would be giving up more than they were getting. Buffett thought managers and directors should ask themselves if they would sell 100% of the business at the same valuation as they were considering selling part of it. This train of thought was identical to that used by Buffett when buying less than 100% of a business, public or private. Start with the valuation of the whole, and then split it into pieces to determine the per-share price one is willing to pay.

The crux of the issue was that CEOs had different incentives than owners. By using stock rather than debt or cash, he (for the vast majority of CEOs at

the time were male) would end up with more kingdom to manage at the expense of owners. Such mergers or acquisitions were frequently done on the basis that either future business value would materialize, growth for growth's sake was needed, or for perceived tax reasons (giving some consideration in stock because the manager had to).

Buffett was priming his shareholders for the proposed Blue Chip merger and letting them know he would act in their best interests. He reminded them that the only other such merger under his management of Berkshire that caused the issuance of shares took place in 1978 with the merger of Diversified Retailing. [164] With the impending Blue Chip merger Buffett promised to, "not equate activity with progress or corporate size with owner-wealth." Since Buffett was Berkshire's largest shareholder, and therefore proportionately affected by all capital allocation decisions, minority partners should have felt ease about having him at the helm.

Businesses Wanted!

Buffett's 1982 Chairman's letter included a short advertisement. This was the first of such advertisements—not for product, but rather for business acquisition prospects—that would remain essentially unchanged over the ensuing decades, save for the size of the business sought. Here are Buffett's criteria, as laid out in 1982:

"We prefer:

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

> We will not engage in unfriendly transactions. We can promise complete confidentiality and a very fast answer as to possible interest—customarily within five minutes. Cash purchases are preferred, but we will consider the issue of stock when it can be done on the basis described in the previous section."

Berkshire would, over time, find several businesses this way.

1983

Buffett's 1983 letter to Berkshire Hathaway shareholders opened with the report, almost in passing, that Berkshire had merged with Blue Chip Stamps, previously its 60%-owned mini-conglomerate. Buffett now had 2,900 owners to report to, up from 1,900, so he summarized the major business principles Berkshire followed pertaining to the manager-owner relationship. These principles would later be codified into Berkshire's Owners' Manual.

The thirteen principles, as laid out in the 1983 Chairman's letter, were as follows (summarized):

1. "Although our form is corporate, our attitude is partnership." Buffett and Munger, "view the company as a conduit through which our shareholders own the assets."
2. Directors are all major shareholders and four out of five have over 50% of family net worth in Berkshire. "We eat our own cooking."
3. Their long-term goal is increase in intrinsic value *per share* —not the overall size of Berkshire.
4. Their preference is to own 100% of businesses, but they would also own parts of businesses and prefer those "that generate cash and consistently earn above-average returns on capital."
5. Buffett and Munger look to economic performance, not accounting. They, "virtually ignore [Berkshire's] consolidated numbers." Despite this, they promise to provide the information they would want if they were a non-controlling shareholder.
6. Like above, they do not care about accounting consequences and want shareholders to know that some economic earnings don't show

up (referring to the undistributed earnings of non-control investees).

7. They "rarely use much debt and … will reject interesting opportunities rather than over-leverage our balance sheet."
8. We "will only do with your money what we would do with our own."
9. They measure performance as delivering at least $1 in market value for each $1 retained over a five-year rolling basis.
10. Berkshire will only issue shares, "when we receive as much in business value as we give."
11. Buffett wanted existing and new shareholders to know that they didn't engage in what Buffett called "gin rummy capitalism." They would not sell good businesses regardless of price and would hang on to subpar ones if they promised to generate some cash and if relations with management were good.
12. They promised to be candid and present the business facts as if their positions were reversed and Buffett and Munger were the shareholders.
13. For competitive reasons, their candor could not extend to what they were buying, thinking of buying, or had bought in the open market.

Nebraska Furniture Mart

Buffett's birthday present to himself in 1983 was a business. After long admiring Nebraska Furniture Mart and its founders, the Blumkin Family, Buffett finally struck a deal to acquire 90% of the business on August 30, 1983. The business was located in his hometown of Omaha, Nebraska.

The description of the family matriarch, Rose Blumkin, or Mrs. B., read almost like an obituary. Yet at 90 years old in 1983, she was still very much alive and active in the business. The business was her life and she spent seven days a week at the store. She had escaped Russia and labored to establish her family in America before saving $500. With that seed capital, she started her home furnishings store in Omaha. Over the ensuing years the hard-working Mrs. B. clashed with competitors, who couldn't match her low prices. One fight ended up in a court battle culminating in the judge buying carpet from her.

Buffett admired Mrs. B's self-taught business-sense (more impressive considering she was illiterate), which she turned around and instilled in her son, Louie, and then in his three sons, Ron, Irv, and Steve. When Berkshire took control, Nebraska Furniture Mart sold over $100 million annually out of one 200,000 square foot store. That was more than any other home furnishings store in the country and more than all Omaha competitors combined.

The Nebraska Furniture Mart purchase, laid out on a one-and-a-half-page contract, called for Berkshire to buy an 80% economic interest in the company. This math contrasts with the 90% majority interest quoted earlier because of a 10% option set aside allowing key members of the management team to buy into the business. The 80% figure assumes this option is acted on. [165] The rest would remain in the Blumkin family.

What did Buffett see in Nebraska Furniture Mart? To start, it was in his hometown. Also, the store kept growing over time and he could see that Mrs. B's attitude toward pricing was making life hard on her competitors.

Nebraska Furniture Mart benefitted from classic economies of scale. The more it sold, the lower its fixed overhead became as a percentage of revenues. The lower its relative costs, the lower it was willing to charge, on and on in a virtuous, reinforcing cycle. Add in a huge selection of merchandise, and Nebraska Furniture Mart had a recipe for both saving its customers money and delivering superior returns to its owners. Once firmly entrenched, the business had a virtually impregnable moat that protected it from the onslaught of competition. [166]

Table 4.30: Nebraska Furniture Mart, select data and valuation, 1983

($ millions)	
Purchase price	$55.4
Ownership interest	90%
Valuation	$61.5
1983 revenues[1]	$100
1983 pre-tax margin[1]	7%
Tangible assets	$35.0
Pre-tax return on capital	20.0%
BRK price/tangible assets	1.75x
BRK going-in return, pre-tax	11.4%
Footnotes:	

1. These are approximate values stated by Buffett in response to a question at the 2014 Annual Meeting.

Sources: Berkshire Hathaway Annual Reports 1983, 2013; 2014 Annual Meeting Q&A.

Goodwill and its Amortization: The Rules and The Realities

Berkshire's book value grew 32% that year to $975.83 per share. The nineteen-year record, since Buffett took control in 1965, was 22.6% compounded annually. Buffett wanted shareholders to know, loud and clear, that they should not expect similar results in the future. "Those who believe otherwise should pursue a career in sales, but avoid one in mathematics." Buffett said he reported book value because it was a decent proxy for intrinsic business growth, "the measurement that really counts." He also provided a comparative description: Book value tells what is put in the business and intrinsic business value is what can be taken out, which is why it matters more.

The explanation came because Buffett thought Berkshire's intrinsic value now exceeded its book value. This was due to Berkshire venturing heavily into marketable securities (some of whose values were not reported at market), and its purchase of higher quality businesses above their book value (necessitating the inclusion of intangible accounts). Despite the accounting depressing book value and the higher quality businesses now part of the company, Berkshire's stock price rarely traded above book value. Sparing those not so well-versed in accounting the gory details, Buffett only alluded to his appendix on goodwill. We will dig in.

Over four pages, Buffett's appendix on goodwill provided those willing to spend the time with a valuable lesson on business. He was quick to point out that it was economic and accounting goodwill he was referring to, not customers' feelings of a company's product or service.

Buffett explained that goodwill arises due to the difference between the purchase price of a business, and the accounting value of its assets. Usually the purchase price is higher than the underlying assets and, therefore, an entry on the asset side of the balance sheet must be made so that the transaction balances out. [167] To make the lesson more concrete Buffett used See's Candies as an example.

When Blue Chip purchased See's in 1972 for $25 million, it had about $8 million [168] of net tangible assets [169] and earned about $2 million after tax, or 25% on its net tangible assets. The difference between the $25 million and $8 million was placed on the balance sheet as $17 million of goodwill. Prior to November 1970, this goodwill would simply remain on the balance sheet. After 1970, a charge to earnings was required for GAAP purposes (but not for tax purposes) to amortize the balance to zero. Most managements, Berkshire included, chose to do this over the maximum 40 years.

Buffett viewed the amortization charge, which was included in expenses and therefore depressed reported earnings, as an artificial construct. He thought the economic reality of a See's-type of business, one that earned much higher returns on its net tangible assets than other companies with similar resources, should be recognized by analysts and thus needed an accounting correction. The $425,000 charge to earnings that GAAP required Berkshire take every year ($17 million divided by forty years) was not real and could be safely be ignored.

All transactions where the purchase price was greater than the underlying tangible assets required recognition and related amortization of goodwill, but not all those businesses were good. An eager management team on the hunt for a deal could overpay for a business and throw shareholders' money down the drain. Only a business with economic goodwill, one with a "consumer franchise…allow[ing] the value of the product to the purchaser, rather than its production cost, to be the major determinant of selling price," deserved such a treatment by analysts. Other such consumer franchises with true economic goodwill included those with a governmental advantage or monopoly, such as a TV station, or the low-cost producer in an industry, like GEICO.

To further complicate matters, the 1983 Berkshire merger with Blue Chip Stamps caused additional goodwill to be added to the equation for See's. Because Berkshire owned just 60% of Blue Chip prior to the merger, the purchase of the remaining 40% (via its increased ownership of Blue Chip) caused $28.4 million of additional goodwill to be added to the balance sheet along with its own amortization schedule against earnings. The goodwill amortization for See's would increase to $1 million annually for the next twenty-eight years and then decline to $0.7 million for the following twelve

years as the two pieces of the amortization reached their accounting conclusion. Having two separate amortization schedules for two pieces of the same business was an accounting oddity without an easy solution.

There was another lesson in this side-note discussion of goodwill, and it was related to inflation. Buffett countered the “traditional wisdom—long on tradition, short on wisdom” that tangible assets were the way to protect against inflation. Again, using See’s as an example, he imagined the hypothetical doubling of prices and its effect on required investment in net tangible assets. With $8 million of combined net tangible assets (receivables, inventories, fixed assets, etc.), a doubling of prices would cause the owner of See’s to ante up an additional $8 million of capital to maintain the same unit volume. A business with the same earnings but requiring $18 million of capital (that is, a business earning a lower rate of return on its capital) would require $18 million from its owners just to stand still. Clearly, the business with lower capital requirements would be worth more to its owners.

Buffett wanted Berkshire’s owners to realize the value in true, economic goodwill, because Berkshire would likely move in the direction of acquiring other businesses requiring similar treatment. The value of the goodwill asset on Berkshire’s books totaled over $79 million at year-end 1983 and would likely continue to grow. Like the accounting for non-controlled businesses via the stock market, goodwill accounting told a story much different from the underlying economics—and it was the economics about which Berkshire cared most. Berkshire probably wouldn’t find another business like See’s, which was earning $13 million after tax on $20 million of net tangible assets—but a business even close would be worth paying up for.

Buffett hinted at Berkshire’s valuation in the discussion of value-given-vs-value-received as it related to using shares as currency in a transaction. He noted that the true cost of the Blue Chip merger was slightly higher because, “the market value of Berkshire shares given up in the merger was less than their intrinsic business value.”

We can estimate the valuation used in the Berkshire/Blue Chip Stamps merger. Using Berkshire’s high and low share prices during the third quarter of 1983 (when the merger would have taken place) values Berkshire between $900 million and $1.2 billion (see Table 4.31). The resultant average price-to-book valu e was 1.35x.

Table 4.31: Berkshire Hathaway implied valuation in Blue Chip Stamps merger

Shares outstanding (year-end 1982)	986,509
BRK share price Q3 1983 (high)	$1,245
BRK share price Q3 1983 (low)	$905
Implied market value (high)	$1,228,203,705
Implied market value (low)	$892,790,645
Book value mid-1983 (estimated)	$784,000,000
Price-to-book value (high)	1.57x
Price-to-book value (low)	1.14x
Average price-to-book value	1.35x

Sources: Berkshire Hathaway Annual Report 1983 and author's calculations.

Sources of Reported Earnings

Due to the merger with Blue Chip in mid-1983, special care was needed in reading the earnings summary table in the Chairman's letter. Since the ownership in Blue Chip increased from 60% to 100%, that change alone was enough to skew Berkshire's share of Blue Chip's (and its subsidiaries') earnings up, all things being equal. Looking at the company-level results instead of the share attributable to Berkshire's ownership solved this issue. [170]

Table 4.32: Earnings of Berkshire Hathaway subsidiaries, company-level

($ thousands)	1983	1982
Insurance Group:		
Underwriting	($33,872)	($21,558)
Net investment income	43,810	41,620
Buffalo Evening News	19,352	(1,215)
Nebraska Furniture Mart[1]	3,812	
See's Candies	27,411	23,884
Associated Retail Stores	697	914
Blue Chip Stamps - parent[2]	(1,422)	4,182
Mutual Savings and Loan	(798)	(6)
Precision Steel	3,241	1,035
Textiles	(100)	(1,545)
Wesco Financial - parent	7,493	6,156

Amortization of goodwill[3]	(532)	151
Interest on debt	(15,104)	(14,996)
Shareholder-designated contributions	(3,066)	(891)
Other	10,121	3,371
Operating earnings, pre-tax	61,043	41,102
Special GEICO distribution	21,000	
Sales of securities and unusual sales of assets	67,260	36,651
Total earnings - all entities (pre-tax)	$149,303	$77,753

Footnotes:
1. 1983 figures are those for October through December.
2. 1982 and 1983 are not comparable; major assets were transferred in the mid-year 1983 merger of Blue Chip Stamps.
3. Amortization of goodwill is included in Other for years prior to 1982.

Note: This table presents each company's earnings on a company-level basis. It differs from the presentation elsewhere which adjusts for Berkshire's ownership interest in each company.

Source: Berkshire Hathaway Annual Report 1983.

Leading off the table was insurance underwriting, whose losses had swollen on the heels of industry weakness. Berkshire's results were again worse than the industry average. The Insurance Group was profitable overall thanks only to its net investment income. More will be said about the Insurance Group below. Other notable entries in the table in 1983 were *The Buffalo News* , See's Candies, Blue Chip Stamps, Precision Steel, and a special distribution from GEICO.

The Buffalo News , long mired in a fight with its competitor, *The Courier-Express* , won its long battle [171] and was rewarded with soaring profits. The elimination of a competitor surely helped but other factors also accounted for the success of *The Buffalo News* . First, a stable population in the Buffalo area made citizens highly interested in current events. Second, *The Buffalo News* had an earned reputation for editorial quality. Third, by design it provided more news than other papers: about 50% compared to an average in the upper 30% range for competitors. Because of all these things, Sunday circulation (that was previously provided only by the competitor) increased from 314,000 to 376,000. This was even more impressive against a backdrop of little to no population growth.

Never one to bask in the glow of good news, Buffett pointed out two extraordinary factors leading to the large swing in the profitability of *The Buffalo News* that year. Because of the substantial losses incurred in prior

years, the business owed a "subnormal" amount of state income taxes. Additionally, there was a large drop in the cost of newsprint, a critical cost.

Continuing to examine Table 4.32 from 1983, we can see that Blue Chip Stamps reported a loss compared to a sizable profit the year before. The two years weren't comparable because major assets were transferred in the merger. When the merger took place, Blue Chip's subsidiaries became direct subsidiaries of Berkshire and accounts not associated with any entity would have transferred too. It's unclear why Blue Chip remained as a reporting line and why it continued to lose money to the tune of $2 million per year (the footnotes did not mention it). Such a large swing in profitability, while notable, probably wasn't overly concerning given the circumstances.

Precision Steel's profitability was depressed in 1982 due to weak industry factors and a business line venture into the measuring tool business that did not work out. In 1983 its profits rose threefold compared to that low base. Charlie Munger told Wesco shareholders, and Berkshire's as the report was shared with them, about the mistake. (Munger replaced Louis Vincenti as chairman after Vincenti was forced to retire because of health reasons.) Overall, Munger thought that Precision Steel would do well in 1984.

See's Candies

Berkshire owned 100% of See's after the Blue Chip/Berkshire merger. While an exceptional business, See's faced its share of challenges. These were twofold: raw material costs rising faster than inflation and difficulty growing unit volume. Raw material costs were not a problem at the time, but they could become one given See's "fanatical" (Munger's word) adherence to quality. Buffett told shareholders See's would only buy the finest ingredients, regardless of price. "We regard product quality as sacred," he said.

The second problem, pounds sold per store, was mainly an industry phenomenon, as per capita consumption of chocolate slowly declined. The increased prices at See's, a recession, and an already high market share probably all played a role. Poundage growth was hard to come by. Pounds sold declined 0.8% on a same-store basis during 1983. Cumulatively, volumes had declined 8% since 1979. Although revenues were up due to a combination of price increases (related to and on top of inflation) and new

stores, focus was rightly placed on pounds sold per store. Cutting right to the key economic variable for See's and other retailers, Buffett told shareholders that "we regard the most important measure of retail trends to be units sold per store rather than dollar volume." More will be said in the discussion of 1984 results, which contain a history of revenues, operating profits, poundage, and number of stores for See's.

Insurance

Bleak prospects and irrational competition dogged Berkshire's insurers and the industry. The 1982 revised figure for the industry combined ratio came in at 109.7%. The estimate for 1983: 111%. Berkshire's own combined ratio in 1983 was an atrocious 122.8% (see Table 4.33). Noting the delayed nature of the business, Buffett placed the blame on his own shoulders. Prior to hiring Mike Goldberg to manage the Insurance Group, Buffett had made mistakes that finally materialized in 1983. Those mistakes included placing the wrong personnel in key operational positions, as well as direct and indirect mispricing of business.

Table 4.33: Insurance Group, select information

($ thousands)	1983	1982	1981
Premiums written, net	$149,849	$149,091	$148,000
Premiums earned			
Specialized auto and general liability	68,148	69,026	73,177
Workers' compensation	18,849	15,951	18,193
Reinsurance	26,889	27,408	29,446
Home State multiple lines	35,328	37,552	38,197
Structured settlements and portfolio reinsurance	3,266	3,008	
	152,480	152,945	159,013
Underwriting gain (loss), pre-tax			
Specialized auto and general liability	(14,880)	(12,647)	3,020
Workers' compensation[1]	(1,091)	2,658	2,822
Reinsurance	(8,387)	(7,524)	(3,720)
Home State multiple lines	(8,834)	(3,949)	(644)
Structured settlements and portfolio reinsurance	(680)	(96)	
	($33,872)	($21,558)	$1,478
Combined ratio (statutory)[2]	122.8%	115.0%	101.6%

Footnotes:
1.Workers' Compensation coverage written by Home State is not broken out per the footnote to the financial statements.

2. The 1981 combined ratio illustrates the divergence between statutory and GAAP combined ratios. When underwriting is near breakeven, apparent inconsistencies can arise when using the statutory combined ratio.

Note: The data in this table was taken from the summary of segment results section of the Annual Report and differs in some cases with figures listed in earlier reporting periods.

Sources: Berkshire Hathaway Annual Reports 1982, 1984.

Buffett praised his managers, whom he said swam a good race against strong industry tides that year. He singled out National Indemnity's Roland Miller for delivering improved results while competitors had opposite performance. He also identified Tom Rowley, who had joined Berkshire a year prior, to run Continental Divide Insurance, a Colorado Home State operation.

Against the backdrop of weak industry results and underwriting losses across all of Berkshire's insurance segments, Buffett was optimistic for the reinsurance segment. That segment had reported losses in each year dating back to 1975. Still, it had an ability to generate large float and, importantly, a way to monetize Berkshire's financial conservatism. The long period between buying reinsurance and when it might be needed meant a counterparty to a reinsurer wanted to know the reinsurer would be around when collection time came. Berkshire fit this mold perfectly. Its premier financial strength could be marketed as a differentiator.

Putting this unparalleled financial strength to use, Berkshire entered the structured settlements business. In exchange for an upfront premium (which the insurer could invest) that converted a lump sum settlement into a stream of cash flows, this long-tail line of insurance paid out claims over many years. For some claimants dependent on receiving lifetime financial security, the viability of the insurer paying the claims is all important.

Insurance—GEICO

Berkshire's one-third interest in GEICO was proportionally larger than Berkshire's other insurance interests combined. Objectively speaking, it was better too. If proportionally divided based on ownership, Berkshire's share of GEICO's premium volume would have been $270 million in 1983. GEICO's combined ratio of 96% was by all accounts stellar. Such a financial result was reflected in the market value of the business. Berkshire's stake cost $47 million and had a market value of $398 million at year-end 1983. Buffett had nothing but admiration for the trio

responsible: managers Jack Byrne and Bill Snyder, and GEICO's investment manager, Lou Simpson.

The summary of earnings table included a $21 million entry for a special GEICO distribution. This was a de facto dividend from GEICO, accomplished via a tender offer that maintained Berkshire's ownership interest. Since it was treated as a dividend rather than a sale, Berkshire got away with paying an effective income tax rate of just 6.9%, compared to the 28% due if the transaction was recognized as a capital gain.

Stock Splits and Stock Activity

Calls to split Berkshire's stock intensified as the price crossed the $1,000 mark for the first time. Buffett thought that splitting Berkshire's stock was the wrong thing to do. Berkshire's communications practices were designed to cultivate a rational base of owners that sensibly considered the prospects of the underlying business and priced the stock accordingly. He preferred owners who cared about business results, and not the ever-fluctuating price of a stock. A high stock price discouraged frequent trading. In a simple example, Buffett asked rhetorically whether an owner of one Berkshire share valued at $1,300 (where the stock then traded) would be better off if Berkshire split 100 for one and he owned more shares equaling the same value. Buffett very clearly liked rational owners over ones "preferring paper to value."

It was not just the optical illusion of such artificially constructed stock splits that Buffett disliked. It also laid a cost on owners. If taken as a group, a company's owners were paying upwards of 2% of the market value of a business just for the privilege of moving in and out. Academia praised such liquidity as did those who profited from the turnover (stockbrokers, and exchanges, etc.). Buffett disagreed. More shares would equal more fees since those fees were often based on the number of shares traded. "Splitting the stock would increase that cost, downgrade the quality of our shareholder population, and encourage a market price less consistently related to intrinsic business value. We see no offsetting advantages." As logical as Buffett's arguments were, and the clear disadvantages of a split, calls for splitting Berkshire's stock would continue.

1984

Continuing his practice of leading with the bad news first, Buffett opened his 1984 Chairman's letter to shareholders saying that the nearly $153 million gain in net worth during the year was mediocre. Such an amount of money was (and still is) quite a large sum; the problem was it represented just a 13.6% increase on the prior year's book value. This was far short of the 22.1% compounded annual gain over the previous twenty years. "Economic gains must be evaluated by comparison with the capital that produces them," wrote Buffett.

Berkshire Hathaway's equity capital crossed the $1 billion threshold during 1983. This was partly due to the merger with Blue Chip Stamps. Maintaining high rates of return on that capital would get more difficult every year. To achieve even a 15% annual gain would require adding $3.9 billion to book value over the ensuing decade, assuming no dividends were paid. Such a rate of return seemed modest, but it represented a doubling every five years—not an easy feat for *any* business, let alone one Berkshire's size.

Accomplishing high rates of growth on Berkshire's equity base would, "require a few big ideas—small ones just won't do." Rather than try to lay out a detailed plan of action, Buffett continually searched and waited for ideas to come. The question was when? "[O]ur experience has been that they pop up occasionally," he said. "How's that for a strategic plan?" Buffett was not being curt, just realistic. Rather than try to force ideas to happen, and therefore potentially make a mistake, patience would be the default course of action. Later in the letter, in discussing Berkshire's equity portfolio, Buffett commented, "we find doing nothing the most difficult task of all."

Sources of Reported Earnings

Berkshire's operating results were best viewed on a company-level pre-tax basis considering the merger with Blue Chip Stamps the prior year. This view also stripped out the goodwill amortization charges required by accounting standards and placed them on a single line.

Table 4.34: Earnings of Berkshire Hathaway subsidiaries, company-level

($ thousands)	1984	1983
Insurance Group:		

Underwriting	($48,060)	($33,872)
Net investment income	68,903	43,810
Buffalo News	27,328	19,352
Nebraska Furniture Mart[1]	14,511	3,812
See's Candies	26,644	27,411
Associated Retail Stores	(1,072)	697
Blue Chip Stamps - parent[2]	(1,843)	(1,422)
Mutual Savings and Loan	1,456	(798)
Precision Steel	4,092	3,241
Textiles	418	(100)
Wesco Financial - parent	9,777	7,493
Amortization of goodwill[3]	(1,434)	(532)
Interest on debt	(14,734)	(15,104)
Shareholder-designated contributions	(3,179)	(3,066)
Other	4,932	10,121
Operating earnings, pre-tax	87,739	61,043
Special GEICO distribution[4]		19,575
Special General Foods distribution	8,111	
Sales of securities and unusual sales of assets	104,699	67,260
Total earnings - all entities (pre-tax)	200,549	147,878

Footnotes:
1. 1983 figures are for October through December.
2. 1982 and 1983 are not comparable; major assets were transferred in the mid-year 1983 merger of Blue Chip Stamps.
3. Amortization of goodwill is included in Other for years prior to 1982.
4. The accounting of the GEICO special dividend was changed during 1984.

Note: This table presents each company’s earnings on a company-level basis. It differs from the presentation elsewhere which adjusts for Berkshire’s ownership interest in each company.

Source: Berkshire Hathaway Annual Report 1984.

Front and center was insurance underwriting (discussed in more detail later), again posting a miserable result. Weak industry conditions, coupled with self-inflicted wounds, were causing the red ink to continue flowing in Berkshire’s underwriting. Net investment income had again saved the day to bring the Insurance Group out of the red.

Related to insurance, the special GEICO distribution reported in 1983 again garnered attention in 1984. Though the distribution was technically accomplished via a share repurchase, it had functioned more like a dividend since Berkshire’s ownership interest remained unchanged. This is how Berkshire had viewed it, as had the Omaha office of its auditor, Peat,

Marwick, Mitchell & Co. However, in 1984, the New York office of the auditor reversed course. It said the transaction should be viewed as a repurchase, with some of the proceeds being recorded against (that is, reducing) the carrying value of the stock on Berkshire's books. There were no tax consequences and the economics remained unchanged, but the accounting did. Berkshire expressly disagreed with the auditors' conclusion but went along with it rather than incur a qualified opinion of the financial statements.

The GEICO special distribution might have gone unrevised had it not been for a very similar transaction with General Foods in 1984. With General Foods, the share repurchases had been over time, whereas with GEICO it was a one-time event. The total amount received from General Foods was $21.8 million and Berkshire's ownership interest remained at exactly 8.75%. The difference between the reported amount of $8.1 million and the total amount received was recorded as a capital gain.

Buffett was a fan of the type of share repurchases conducted by GEICO, General Foods, and others, since the shares were selling below intrinsic value at the time of repurchase. Share repurchases below intrinsic value increased underlying value to continuing shareholders, but also shrunk the size of the business that the manager operated. Managers not focused on their owners (shareholders) would seldom conduct such transactions or would blindly repurchase shares without considering valuation. These managers were short-sighted, thought Buffett. The obvious reward for conducting value-add share repurchases was a gain in per share intrinsic value for continuing shareholders. The less obvious and longer-term reward was a share price that reflected the sound management of the company. Buffett preferred to partner with "shareholder-conscious managers."

Nebraska Furniture Mart

Nebraska Furniture Mart was still earning an excellent return on capital for shareholders, but it provided just as much value to customers through lower prices for high-quality merchandise.

How did it do this? In short, it sold a lot of merchandise through one location and relentlessly controlled expenses. Nebraska Furniture Mart operated on a gross profit margin [172] in the mid-20% range. By comparison Levitz Furniture, the industry leader at the time, had a gross profit margin

of 44.4%. Levitz's operating expenses (all the other costs that go into running a store such as payroll, advertising, and upkeep of the buildings) amounted to 35.6% compared to Nebraska Furniture Mart's costs of 16.5%. Buffett estimated that Nebraska Furniture Mart saved its customers over $30 million each year due to its lean operating structure. All of this is that much more impressive since Buffett considered the Levitz operation well managed.

What was the secret? Buffett compared the Blumkin family to Ben Franklin and Horatio Alger and said they applied themselves with enthusiasm and energy, stayed within their circle of competence, and always acted honestly. Buffett saw the best of himself and Berkshire in the Blumkin Family.

See's Candies

Table 4.35: See's Candies, select data

($ and lbs in thousands)

Year	Revenues	Profit[1]	Pounds sold	# Stores	Price / lb	Profit / lb
1984	$135,946	$13,380	24,759	214	$5.49	$0.54
1983	133,531	13,699	24,651	207	5.42	0.56
1982	123,662	11,875	24,216	202	5.11	0.49
1981	112,578	10,779	24,052	199	4.68	0.45
1980	97,715	7,547	24,065	191	4.06	0.31
1979	87,314	6,330	23,985	188	3.64	0.26
1978	73,653	6,178	22,407	182	3.29	0.28
1977	62,886	6,154	20,921	179	3.01	0.29
1976	56,333	5,569	20,553	173	2.74	0.27
1975	50,492	5,132	19,134	172	2.64	0.27
1974	41,248	3,021	17,883	170	2.31	0.17
1973	35,050	1,940	17,813	169	1.97	0.11
1972	$31,337	$2,083	16,954	167	$1.85	$0.12
				Total gain:	197%	340%
				Compounded:	9.5%	13.1%

1. Operating profit after tax.

Sources: Berkshire Hathaway Annual Report 1984 and author’s calculations.

If Nebraska Furniture Mart earned Buffett’s high praise, See’s really got his blood pumping. According to the 1984 Annual Report, identifiable assets for See’s averaged $63 million and after-tax profits of $13.4 million equated to a return of 21%. On tangible assets of $28.2 million, the return was even higher: 47%. The actual economic return of See’s was even better considering not all aspects of the business were part of the accounting. The report only listed tangible assets; it did not account for the spontaneous liabilities associated with conducting business, such as accounts payable. Since others provided part of the capital to operate the business, the company did not need to fund it. Given this assumption and the use of a seasonal line of credit to fund short-term inventory, the returns on net tangible assets, or equity, were likely well above 100% for the candy company.

Still, the business wasn’t perfect. The boxed-chocolate industry suffered from marginal profitability and slow growth. The latter ailment also beset See’s. Same-store sales fell 1.1% in 1984, though total poundage was up 0.6% because of store growth. If pounds sold only grew through physical store expansion, the per-pound selling cost would, by definition, increase—a result that could not go on forever.

Despite these problems See's had clear pricing power. Over the thirteen years that Berkshire (via Blue Chip) had owned See's, it was able to increase its per-pound selling price by 9.5% per year, and its per-pound profits by 13%. Over that same period the price level increased, on average, 7.9% per year.

Given the success of See's against the backdrop of weak industry conditions, the natural question is how? Buffett said it was the company's relentless focus on quality. Competitors, he said in his letter, would, "add preservatives or freeze the finished product in order to smooth the production cycle and thereby lower unit costs. We reject such techniques … ." See's was willing to put up with the headaches that came with trying to produce and deliver product in a short window of time during the holiday season using nothing but the freshest ingredients.

The month prior to Christmas accounted for 40% of the volume and 75% of the profit for the year. Easter and Valentine's Day also did well but the remainder of the year was spent treading water. The success of See's seemed to stem from the company's willingness to think and act long term and to accept short-term pain in exchange for long-term profitability. It focused on the customer and built its business around it, rather than trying to smooth out operations and manage the business from an accounting viewpoint first. See's was an excellent cash cow for Berkshire—one that would continue to deliver profits to Omaha for redeployment into the ever-growing Berkshire empire.

The Buffalo News

The Buffalo News delivered a $27.3 million pre-tax profit to Berkshire in 1984. Compared to what it earned in 1983, [173] this represented an almost $8 million or 41% increase. Competition, or the lack thereof now that *The Courier-Express* folded, was a major contributor to the success of *The Buffalo News* . So too were its customer-centric policies which were, somewhat unexpectedly at first glance, very similar to See's.

Coming out on top in a winner-takes-all contest helped tremendously, but the paper deserved its success. Like See's, it delivered (no pun intended) more value to its customers than the competition. Buffett summed up its strategy this way: "Since high standards are not imposed by the marketplace, management must impose its own." This was no different than

the self-imposed quality standards at See's, which paid for the highest-quality ingredients, almost regardless of cost.

The newspaper's news hole, meaning its ratio of news to total printed pages, was 50.9% in 1984. This compared to more typical levels between 35% to 40% at similar papers. *The News* was willing to incur the additional cost of newsprint paper as well as more newsroom staff than competitors. It was rewarded with higher readership, which was in turn valued by advertisers.

Two other related factors played an important role in the paper's success. For one, the readership of the paper was concentrated into the Buffalo, New York area. This translated into high value to advertisers. Paid advertising by a grocery store that was viewed by a reader 100 miles away, for example, would be wasted. In fact, the term used for such an occurrence was wasted circulation.

The penetration ratio was another success factor. Since *The Buffalo News* reached a very high percentage of Buffalo residents, advertisers wanting to reach those subscribers could easily do so. The paper's penetration ratio and the relevance of readership to potential advertisers can be thought of visually as two overlapping circles. The wider the circles, the greater the penetration ratio; the more overlap between the two circles, the more shared customers between the paper and its paid advertisers.

Insurance

Berkshire's underwriting loss in 1984 resulted in a what Buffett called a humbling combined ratio of 136% [174] (see Table 4.36). The industry, by comparison, wrote at a ratio of 117.7% and was not increasing premiums fast enough to make up for increases in underlying costs. This was the third year in a row that Berkshire's experience was worse than the industry.

Table 4.36: Insurance Group, select information

($ thousands)	1984	1983	1982
Premiums written, net	$133,558	$149,849	$149,091
Premiums earned			
Specialized auto and general liability	64,003	68,148	69,026
Workers' compensation	22,665	18,849	15,951
Reinsurance	16,066	26,889	27,408
Home State multiple lines	32,598	35,328	37,552

Structured settlements and portfolio reinsurance	4,910	3,266	3,008
	140,242	152,480	152,945
Underwriting gain (loss), pre-tax			
Specialized auto and general liability	(16,049)	(14,880)	(12,647)
Workers' compensation[1]	(12,560)	(1,091)	2,658
Reinsurance	(12,703)	(8,387)	(7,524)
Home State multiple lines	(4,101)	(8,834)	(3,949)
Structured settlements and portfolio reinsurance	(2,647)	(680)	(96)
	($48,060)	(33,872)	($21,558)
Combined ratio (statutory)	135.9%	122.8%	115.0%
Footnote: 1. Workers' Compensation coverage written by Home State is not broken out per the footnote to the financial statements.			

Note: The data in this table was taken from the summary of segment results section of the Annual Report and differs in some cases with figures listed in earlier reporting periods.

Sources: Berkshire Hathaway Annual Reports 1982, 1984.

The poor industry performance and even poorer Berkshire results did not dissuade Buffett. That year, Berkshire added capital to its reinsurance unit, Columbia Insurance Company, to continue growing the structured settlements business. He expected a lot of competition but satisfactory returns. Berkshire would continue to use its financial strength to its advantage, and only write business that made sense.

The financial strength was hard to see precisely on Berkshire's consolidated financials. Prior to 1981, Berkshire had presented separate condensed group financial statements that provided some additional detail on balance sheet items such as the investment portfolio, plant and equipment, loss liabilities, unearned premiums, and other items. From these it was clear exactly how much shareholders' equity was attributable to the Insurance Group. Detail on the income statement items largely remained in subsequent reports, but a holistic balance sheet was not provided. Even without the specific detail it was clear Berkshire remained heavily weighted toward insurance. [175]

Making some assumptions, [176] we can estimate that Berkshire's written volume in 1984 would have represented just 17% of equity capital—a ratio far below the capacity of an insurer [177] and an indication as to how much Buffett and his managers had put the brakes on operations during the period of weak pricing.

GEICO dwarfed Berkshire's Insurance Group. Looking through to Berkshire's share of GEICO's premiums (Berkshire owned 36% of GEICO at this time), Berkshire's share of its premium volume in 1984 was $320 million. Buffett praised its managers, Jack Byrne, Bill Snyder, and Lou Simpson for creating and sustaining a "major, sustainable competitive advantage" in an industry where such an advantage was almost unheard of. He heaped additional praise on Simpson, who, "has the rare combination of temperamental and intellectual characteristics that produce outstanding long-term investment performance."

As good as GEICO was—and it was (and is) a very good business—its advantage stopped at its core business. It was natural for a management team to build on its success and expand into adjacent areas. Yet attempts to do so had largely failed, and this refocused GEICO's management back on the core automobile insurance business.

Errors in Loss Reserving

The business lesson for 1984 was on a topic central to insurance, Berkshire's largest and most important division. It also shed some light onto what created the large underwriting losses of the last several years and why management couldn't immediately stem the red ink. Central to the insurance business are estimates of its future losses. Because they are just that, estimates, they are subject to error at best. At worst they can lead to lying and fraud.

In a normal business, profits or losses are known fairly rapidly. A box of chocolates that cost $4 to produce and sell and that was sold for $5 would clearly generate a profit of $1. An insurer, on the other hand, takes in its revenues first (whether earned or unearned) and must estimate upfront what its future costs will be over the life of the insurance contract. It not only doesn't know how *much* it will cost, but it might not even know *when* the cost will come.

In short-tail lines of insurance, like automobile insurance, policies are written for six months to a year and claims are paid out accordingly. There may be a slight delay in when a claim happens and when it is reported (these are referred to as incurred but not reported losses or IBNR), but generally the insurer knows very quickly.

In long-tail lines of business, such as with Berkshire's reinsurance or specialty units, claims might take years or even decades to come to light. Results from year to year understandably move around, though provided the insurer sets premiums at a level that reflects its costs *over time* , it will ultimately report a profit.

Insurers track their guesses for future profitability of the business they write in what are known as loss development tables. [178] As time goes on and claims are paid out, the true profitability emerges. This can take some time and the road can be bumpy. Buffett's 1984 letter contained a table of the five years ended in 1984 that listed underwriting results both as originally reported and as corrected one year later. The table showed one year of favorable loss development (1980) followed by three years of results that deteriorated in hindsight. The question mark left in the table suggested the loss in 1984 was anyone's guess. Berkshire tried to be conservative in its underwriting, but the track record suggested results would only worsen.

Table 4.37: Insurance underwriting profit/(loss)

($ thousands)	Original report	One year later
1984	($45,413)	?
1983	(33,192)	(50,974)
1982	(21,462)	(25,066)
1981	1,478	(1,118)
1980	6,738	14,887

Note: Excludes structure settlement and loss-reserve assumption business.

Source: Berkshire Hathaway Chairman's letter 1984.

Not only was Berkshire suffering from current industry weakness, but the business it wrote in years past was haunting it. Accounting and insurance reporting conventions dictate that as loss estimates for prior years worsen, revisions are included with the current year's underwriting results. For example, consider a $100 policy written in year one, with an expected profit of $5. Now consider that in the next year that profit was revised to a loss of $5. The $5 profit would remain in the first year (the insurer wouldn't restate its earnings) but instead a $10 loss would be booked to losses in year two. It was simply the nature of the business and its accounting conventions and made for a bumpy ride. To add insult to injury, an optimistic insurer who overestimated profit paid more tax than would have otherwise been

necessary. These overpayments eventually correct themselves but there is no interest received on the amount overpaid.

Buffett was more than embarrassed by the missed estimates. He felt he had let shareholders down and said so in his letter. He wrote that his error in reporting "is a source of particular chagrin to me because (1) I like for you to be able to count on what I say; (2) our insurance managers and I undoubtedly acted with less urgency than we would have had we understood the full extent of our losses."

Revisions in 1984 to prior year estimates totaled $17.8 million, or 12.7% of premiums earned that year. These revisions stemmed primarily from the reinsurance segment, which itself was subject to the estimates provided by the primary insurers whose business they took on. Most of the remainder of the change in loss reserves was due to workers' compensation, which was another long-tail type of insurance whose ultimate profitability took time to materialize.

The insurance business had another quirk which made trust and track records important. The revisionary-type scenario above is simply a part of the business. Any one year or a few years might be poor, so an insurer with a long-term track record of overly optimistic reserving would find itself nearly out of business. In such a case, its management could forestall that day of reckoning by continuing to write new business—even at a rate that would ensure a loss. Since premiums generate cash upfront to pay claims later, unscrupulous managements could bring the ship right up to the edge of a cliff before falling straight off. As Buffett put it: "insurance is different: you can be broke but flush."

Buffett openly worried about the effect of these "walking dead" type companies, and their effect on Berkshire. Not only would Berkshire suffer once as a competitor when those companies drove down premium rates, but again via state guarantee-type arrangements which bailed out policyholders of failed firms. He urged regulators to more strictly police the industry to mitigate the damage from such events.

Washington Public Power Supply System

From late 1983 through mid-1984, Berkshire's Insurance Group purchased large quantities of bonds in Washington Public Power Supply System (WPPSS). Specifically, Berkshire's $139 million investment was in Projects

1, 2 and 3. This distinction was important as Projects 4 and 5 were abandoned and $2.2 billion of related bonds languished in default. The default was what presented the opportunity to Berkshire.

There was acknowledged risk that the investment could prove unsatisfactory, but both Buffett and Charlie Munger judged the risk appropriate. The default issues with Projects 4 and 5 meant they could pay a lower price (and therefore receive a higher yield) for the investment in Projects 1, 2, and 3 compared to other bonds available at the time. Those projects also had important differences in credit quality. Berkshire's $139 million investment earned $22.7 million after tax, equating to a 16.3% unleveraged return. He said a similar-earning business might fetch between $250 million and $300 million.

The description of the investment read like that of an equity investment, but the WPPSS investment was in its bonds, an important distinction. Buffett wrote that a "bond-as-a-business" mindset "may strike you as a bit quirky. However, we believe that many staggering errors by investors could have been avoided if they had viewed bond investment with a businessman's perspective." Focusing on the underlying business—the ultimate source of interest payments to bondholders *and* any residual earnings accruing to equity holders—led to more rational thinking.

The bond-as-a-business investment was a large one. Just like Berkshire's equity investments, it did not make inconsequential investments in attractive bond investments. The $139 million investment represented almost 12% of Berkshire's 1984 average equity and 7% of its average assets. If these WPPSS bonds defaulted like Projects 4 and 5, Berkshire would take a large hit. Buffett and Munger were willing to make such "intelligent-but-with-some-chance-of-looking-like-an-idiot" investments because they thought the odds were in their favor. Controlling 47% of Berkshire's stock between them also helped.

Berkshire's financial strength played a role in allowing it to take calculated risks in pursuit of superior returns. In writing far less business than it otherwise was capable, financial strength often penalized Berkshire's results. In cases such as WPPSS, Berkshire could make the investment without much fear of backlash from insurance regulators because it possessed a large margin of safety in its capital position. Other insurers often wrote as much as their balance sheets would allow. This handicapped

them since their capital position was “not strong enough to withstand a big error, no matter how attractive an investment opportunity might appear when analyzed on the basis of probabilities.” The result was that these insurers had to invest much more conservatively, hurting their long-term investment results.

The WPPSS bonds were an attractive security in an asset class that did not generally interest Berkshire. Even though inflation had diminished substantially, it was always lurking just around the corner. Owners of businesses would be hurt by inflation, to be sure, but bondholders would be in a far worse position that could potentially wipe out their advantageous capit al position.

Mutual Savings

Charlie Munger’s Chairman’s letter to Wesco shareholders (again included in the Berkshire Annual Report) provided readers with an education on banking. His comments on the thrift (savings and loan) industry contrasted Mutual Savings’ conservative operating practices to a world where competitors were increasingly taking on significant risks.

For Berkshire shareholders who had become familiar with the banking business via their investment in the now-divested Illinois National Bank, Mutual Savings would seem familiar. Munger said Mutual Savings had three major characteristics. It:

1. Maintained a high level of shareholders’ equity compared to total assets and savings account liabilities;
2. Held a large proportion of cash and marketable securities to offset those liabilities;
3. And had a low-yielding mortgage portfolio, primarily a result of its branch divestiture in 1980.

Though the average yield on its mortgage portfolio was below the bank’s cost of funds paid to depositors, it had remained profitable every year due to its large marketable securities portfolio. Just like Berkshire’s Insurance Group, Mutual Savings was waiting for the right terms and conditions on which to do additional business.

The summary data on Mutual Savings provided in the Berkshire Annual Report illustrated its conservatism. Its assets were funded by a stable source of deposits and backed by a large amount of shareholders' equity and liquid resources. [179]

Table 4.38: Mutual Savings and Loan, select data, 1984

($ millions)	
Cash and marketable securities	$189
Loan portfolio	95
Total assets	295
Savings account liabilities	228
Shareholders' equity	62
Loan portfolio (% total assets)	32%
Loan portfolio (% deposits)	42%
Shareholders' equity (% total assets)	21%

Sources: Berkshire Hathaway Annual Report 1984 and author's calculations.

Banking then and now, almost by definition, involved borrowing short and lending long. A bank took its depositors' money, most of which was usually on demand, and lent it on terms to borrowers to purchase homes, finance businesses, and for other needs. The mismatch between the typically lower short-term interest rates paid to depositors and the typically higher rates received from borrowers (the spread) is how a bank makes money. Such an arrangement carried a small risk that interest rates would increase rapidly and cause the cost of money (the interest rate paid) to exceed the rate at which it was lent out.

Savings and loan institutions (also known as thrifts) such as Mutual Savings benefitted from quasi-governmental protections over other traditional banking operations. These protections gave them a slight edge over traditional banks and reduced competition. When regulations changed allowing free competition for deposits (i.e. no limit on interest rates paid), some banks (and more acutely thrifts) found themselves paying higher rates to depositors than those earned from lending—a disastrous backward result.

Mutual Savings was staying far away from more lenient lending practices. In addition to the cost of money (interest paid to depositors), a banking institution also faced costs from losses on bad loans. Just like the insurance

business, those losses can take time, sometimes years, to materialize. Munger described “a sort of Gresham’s law” where “bad loan practice drives out good,” and where some institutions, attempting to cover rising interest costs, began lending to increasingly riskier borrowers.

Munger knew it was only a matter of time before trouble arose. He decried the actions of competitors not just because it hurt Mutual Savings, but because competitors were profiting from using the government’s credit. Since depositors benefitted from government guarantees on their savings if the institution failed, they were indifferent to how their money was used. Losses above a bank’s equity capital would ultimately accrue, in the case of the thrift industry, to the Federal Savings and Loan Insurance Corporation (FSLIC), the government arm that insured their deposits.

Munger used an automobile insurance example to illustrate Mutual Savings’ position: Mutual Savings was like the sober and careful driver who drove few miles but had to pay an insurance premium based on the risk attributes of a larger pool of drivers. Those other drivers drove a high number of miles and led other-than-sober lives. Through the premiums it paid for deposit insurance, Mutual Savings was subsidizing the rest of the industry. Munger praised Federal Home Loan Bank Board Chairman Edwin R. Gray for taking on the unenviable task of reining in the risky behaviors of less conservative industry participants.

Mutual Savings’ unwillingness to participate in risking lending practices had caused a decline in business, but there was some good news. In accounting terms Mutual Savings’ loan portfolio declined by 11% to $95 million. However, during the year it agreed to forward purchase a $30 million pool of government-guaranteed mortgages that yielded 15% on its $19 million purchase price. [180] In coming years, the loan portfolio yield of Mutual Savings would start covering its funding cost as these higher-yielding mortgages became part of the mix. The commitment to purchase these mortgages in the future was the economic equivalent of making a loan during 1984. Munger told Wesco shareholders that in substance its mortgage portfolio had *increased* by 7%.

Dividend Policy

Buffett repeatedly told shareholders why he disliked dividends. He used a long section in his 1984 Chairman’s letter to illustrate why in detail. Buffett

considered capital allocation crucial and thought "managers and owners should think hard about the circumstances under which earnings should be retained and under which they should be distributed." He did not like the fixed percentage-of-earnings dividend payout ratios that other managements blindly targeted without any thought to alternative uses for that capital. Instead, opportunity cost should be front of mind and attention paid to economic reality.

The key was getting managers to think like owners and compare *all* investment opportunities—even if they lay outside of the manager's own business. Some managers displayed contradictory behavior. On the one hand they might tell an under-earning subsidiary to give the parent company its earnings, which were then reinvested into a high-earning one (a rational decision on its own). The problem was those managers would then turn around and have earnings retained at the parent level, even though there were higher-earning opportunities elsewhere.

The other consideration relating to dividend policy was inflation. In an inflationary environment, a capital-intensive business required reinvestment to maintain its unit volume. Even if a business showed a bottom line profit, the economic reality could be such that a portion, or even 100%, of those profits weren't economically real. [181] A business that paid out in dividends more than its economic earnings would face oblivion as its competitive position and/or financial strength eroded. As an example, recall the textile companies from the first part of this book. A business that faced higher costs due to inflation and did not have the capital on hand to pay was no different than the textile companies in the early part of the twentieth century that paid out dividends when they should have used that cash to replenish depreciated equipment. [182] Those textile companies eventually suffered mightily, and so too would the owner of a capital-intensive business operating in an inflationary environment.

Buffett said Berkshire's own dividend policy would be to retain all earnings. Berkshire met the test of creating one dollar of market value for every dollar retained and would have done shareholders a disservice by instituting a dividend. Looking forward, he even teased a future use of those retained earnings: He thought the insurance industry was set for a rebound in 1985, and a financially strong competitor like Berkshire stood to do well with available cash to invest.

Buffett's 1984 letter concluded with two advertisements. One was the same business-wanted advertisement as prior letters looking for acquisition candidates. The other was an invitation for his shareholder-partners to the annual meeting in Omaha where a purchase at Nebraska Furniture Mart could "save far more than enough to pay for your trip." After twenty years under Buffett's leadership, Berkshire had become a far more diversified and profitable business, and one where shareholders might have—dare it be said—fun.

Decade in Review

The changes that occurred during Warren Buffett's second decade at the helm of Berkshire Hathaway can be summed up in two words: size and scope. Its equity capital grew by a factor of more than fourteen, from $88.2 million to almost $1.3 billion. Its insurance operations grew both organically and from investments in multiple Home State operations, workers' compensation, and reinsurance. Berkshire grew its stable of wholly-owned businesses into diverse industries such as steel products and newspapers, and through Blue Chip Stamps and its marketable securities portfolio, into many diverse enterprises.

The question of just where all that additional equity capital came from can be summed up in a few categories:

Table 4.39: Reconciliation of shareholders' equity, 1965–1984

($ millions)	1965–74	1975–84	1965–84
Beginning of period shareholders' equity	$22	$88	$22
Net income - operations	57	366	423
Net income - realized gains	7	199	207
Unrealized appreciation of investments	0	486	486
Mergers/divestitures	0	133	133
Dividends/treasury stock	(3)	0	(3)
Other/misc.	4	0	4
End of period shareholders' equity	$88	$1,272	$1,272
Change in equity during period	$66	$1,184	$1,250

Sources: Berkshire Hathaway Annual Reports and author's calculations.

Table 4.40: Contribution toward change in equity during period

	1965–74	1975–84	1965–84
Net income - operations	86%	31%	34%
Net income - realized gains	11%	17%	17%
Unrealized appreciation of investments	0%	41%	39%
Mergers/divestitures	0%	11%	11%
Dividends/treasury stock	(4%)	0%	(0%)
Other/misc.	7%	0%	0%
Total	100%	100%	100%

Note: The 1965–84 category does not add to 100% due to rounding.

Sources: Berkshire Hathaway Annual Reports and author's calculations.

Table 4.40 illustrates the degree to which Berkshire's investment portfolio became the driver of growth. Berkshire took advantage of chances to buy businesses outright but found more opportunity to buy pieces of good businesses via investments in their publicly traded stock. Accounting considerations were relegated to the background in favor of economic reality, though pains were taken to reconcile the two in communications with shareholders. Even Berkshire's largest division, insurance, found itself shadowed by the investment portfolio (which, to be fair, funded a large portion of it). By the end of the decade Berkshire's share of GEICO's premium volume eclipsed that of its own group of insurance businesses. The mergers/divestitures net row above aggregates three distinct and important transactions:

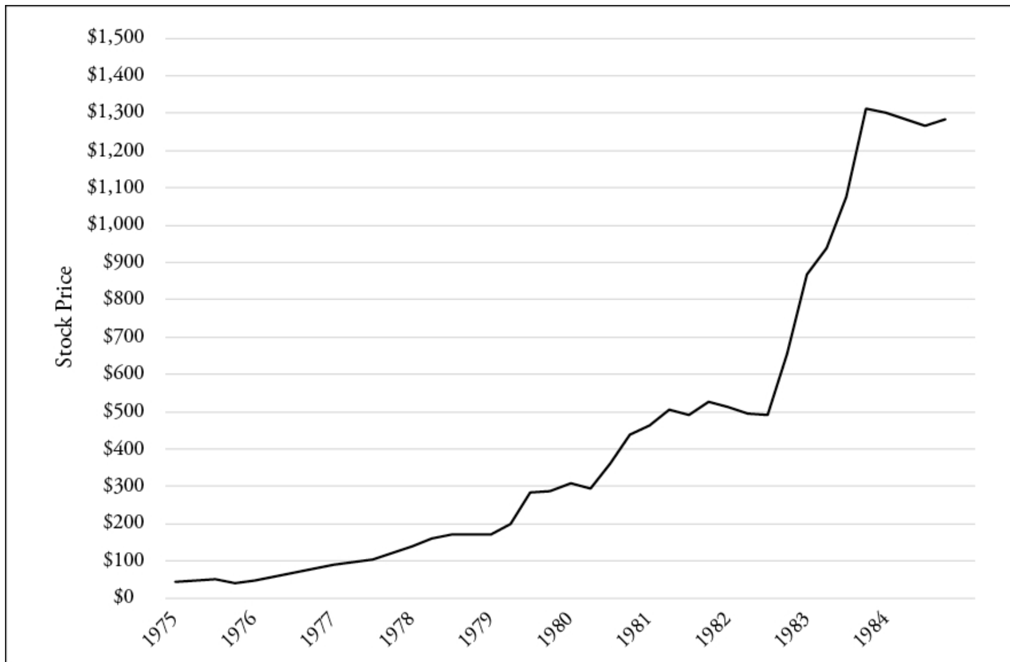
1. In 1977, Berkshire merged with Diversified Retailing, which resulted in a net of about $9 million added to Berkshire's equity capital. [183]
2. In late 1980, Berkshire divested of the Illinois National Bank and Trust. That transaction (effectively accomplished via a treasury stock transaction) reduced Berkshire's equity by approximately $29 million.
3. In 1983, Berkshire merged with Blue Chip Stamps, adding a net of about $154 million to Berkshire's equity.

The result for shareholders was that book value per share increased from $90.02 at year-end 1974 to $1,108.77 at year-end 1984—a compounded annual rate of return of 28.5%. Importantly, this result was on a *per share*

basis. There had been some dilution to shareholders as shares outstanding grew from 980,000 to 1,147,000 (1.6% per annum) over the preceding ten years, but by and large Buffett had not enlarged his managerial kingdom at the expense of shareholders. On the contrary, during the Diversified, Illinois National, and Blue Chip transactions, he went out of his way to ensure fairness to his shareholder partners.

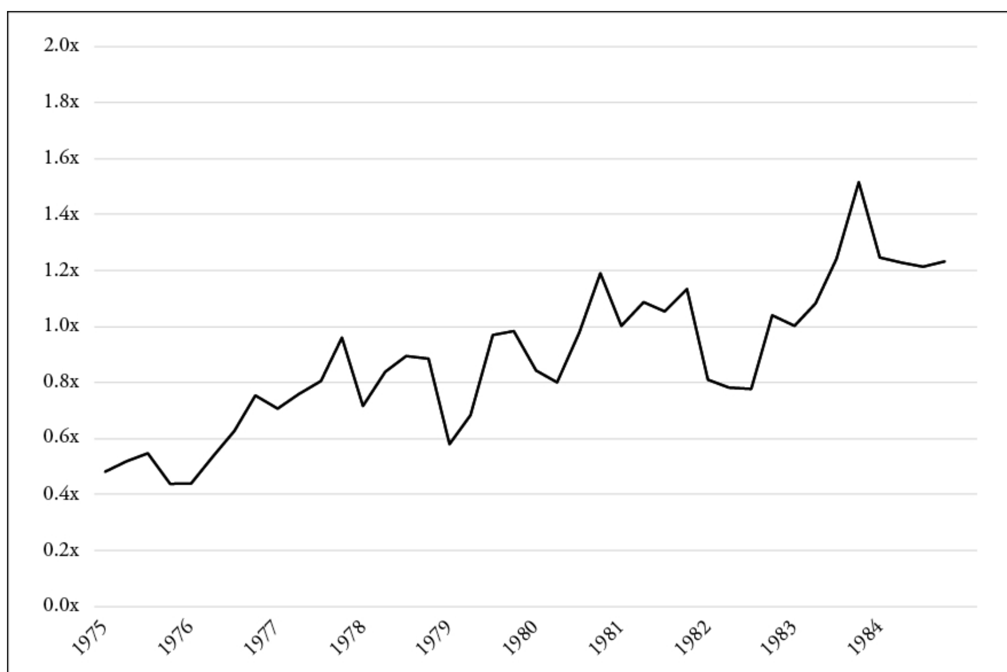
A powerful tailwind pushed Berkshire's stock price upward over the decade. The market rewarded the high growth rate of underlying intrinsic value (proxied by the change in book value) with an increasingly higher price-to-book value. Steadfast investors owning Berkshire for the entire decade were rewarded with a return of 40% *per year* .

Figure 4.1: Berkshire Hathaway stock price, 1975–1984



Sources: *Of Permanent Value* (Kilpatrick), Berkshire Hathaway Annual Reports 1975–1984, and author's calculations.

Figure 4.2: Berkshire Hathaway price to book ratio, 1975–1984



Sources: *Of Permanent Value* (Kilpatrick), Berkshire Hathaway Annual Reports 1975–1984, and author's calculations.

The fuel for this remarkable growth was largely Berkshire's Insurance Group. Growth over the preceding decade was impressive, even after pulling back toward the end of the decade because of industry weakness. Yet the financials understated Berkshire's massive push into insurance, as its 36% investment in GEICO was responsible for an additional $336 million in premiums on a look-through basis. [184]

Table 4.41: Berkshire Hathaway, select data

	1984	1974
Written insurance premiums	$134	$61
Earned insurance premiums	140	61
Float, average	253	79
Cash and investments	$1,714	$140
Investment income	84	8

Sources: Berkshire Hathaway Annual Reports 1974, 1984.

Berkshire's investment portfolio grew steadily, funded through funds generated via float, retained earnings, and additional capital contributed to the insurance companies. The composition of the portfolio at the beginning

and end of this decade highlights Buffett's propensity for holding companies for a long time and his increasing tendency to concentrate bets. Of the $1.3 billion common stock portfolio at year-end 1984, almost one-third was GEICO. The top four positions (GEICO, General Foods, Exxon, and *The Washington Post*) represented 75% of the entire portfolio in 1984. The top four positions in 1974 represented 48% of the portfolio. *The Washington Post* , which represented a quarter of the portfolio in 1974, was the only investment in the top four that extended over the entire decade and had dropped to fourth place. Berkshire was much more concentrated at the end of the decade than at the beginning.

Table 4.42: Berkshire Hathaway common stock portfolio, select detail

($ thousands)	1984	% of total	1974	% of total
Affiliated Publications	$32,908	2.6%	$1,023	2.9%
American Broadcasting Companies, Inc.	46,738	3.7%		
California Water Service Co.			3,151	9.1%
Exxon Corporation	175,307	13.8%		
GEICO Corporation	397,300	31.3%		
General Foods Corporation	226,137	17.8%		
Handy & Harmon	38,662	3.0%	1,337	3.8%
Interpublic Group, Co.	28,149	2.2%	2,772	8.0%
Munsingwear, Inc.			2,094	6.0%
National Preso Industries			2,592	7.4%
Northwest Industries	27,242	2.1%		
Ogilvy & Mather International			1,550	4.5%
Omaha National Corporation			1,066	3.1%
Sperry & Hutchinson Company			1,758	5.1%
Time, Inc.	109,162	8.6%		
Washington Post Company - Class B	149,955	11.8%	8,000	23.0%
All others	37,326	2.9%	9,458	27.2%
Total common stocks	$1,268,886	100.0%	$34,802	100.0%

Notes:

1. Totals do not add to 100% due to rounding.

2. 1974 & 1984: Market values.

3. 1974: Detail on investments greater than $1 million in value. All others represents 36 companies.

4. 1984: Detail taken from the Chairman's letter in the Berkshire Hathaway Annual Report.

Sources: Berkshire Hathaway 10K filing 1974, Berkshire Hathaway Annual Report 1984, and

author's calculations.

Buffett was comfortable with this level of investment concentration because he had conviction, and because Berkshire's financial strength allowed for it. The float generated by the Insurance Group was technically the result of the assumption of liabilities to finance additional asset purchases. But these liabilities had no due date and could be controlled for the most part by writing additional business. Berkshire's financial debt at year-end 1984 was low, and at $127 million, it represented just 10% of shareholders' equity. What's more, it consisted of long-term notes with varying maturities stretching over twenty years into the future.

Berkshire's diverse sources of earnings power also contributed to its ability and willingness to concentrate its investment portfolio. Berkshire could count on cash coming in the door from the recently acquired Nebraska Furniture Mart, its now-profitable Buffalo News, See's Candies, and the various businesses under the Wesco umbrella. Pre-tax operating earnings from its non-insurance businesses after deducting interest (but excluding amortization of goodwill and the discretionary shareholder-designated contributions) amounted to $66 million in 1984. This figure was also outside of the $69 million of pre-tax net investment income largely attributable to the insurance segment.

The Berkshire that emerged from Buffett's two decades of polishing, painting, and refining was radically changed from the money-losing textile operation he inherited in 1965. Shareholders owned, through Berkshire, investments in many diverse business operations—some in whole, some in part. They could look forward to communications that did not just report troubles but opportunities. Berkshire going into Buffett's third decade of control had *prospects* .

Lessons: 1975–1984

1. Even good businesses can experience challenges. Buffett and Munger faced many problems from the Insurance Group during the decade and oversaw massive underwriting losses toward the end of it. Even See's Candies, a wonderful business by all accounts, had its problems dealing with certain input costs.
2. Competition can be brutal and sometimes irrational. The actions of

competitors in the insurance industry and their lack of understanding about the true, long-term cost of doing business, caused industry premiums to be inadequate. Not only did those specific competitors suffer but others, including Berkshire, suffered as well. In a completely different business, *The Buffalo News* , the paper almost failed because of competition. There was no room for two competing papers, but the competitor did not go down without a protracted legal fight.

3. Inflation wreaks havoc on *all* businesses, and especially those with high capital requirements. It causes some earnings to be illusory or, to use Buffett's words, ersatz or restricted. It forces capital to be reinvested in a business just to stand still and maintain unit volume. Sometimes inflation can be other than just monetary, such as the social inflation in jury awards.
4. Mergers/divestitures are okay if done at an appropriate valuation. What truly matters to shareholders is not the size of a company, but its growth in *intrinsic value per share* . Managers can destroy value by issuing undervalued shares to complete acquisitions.
5. Economics vs. accounting. Owners' wealth is built over the long run by focusing on economic realities. Accounting is only the starting point of the analysis, and it oftentimes "obscures rather than illuminates," according to Buffett. In Berkshire's case, this was an acute problem since significant value resided in the look-through earnings of its investees via its marketable securities portfolio.

This following tables have been omitted from the ebook version because formatting issues would have rendered them unreadable. The reader is welcome to download a pdf version of the omitted tables and bonus material at brkbook.com .

Table 4.43: Berkshire Hathaway consolidated balance sheets, 1974–1984

Table 4.44: Berkshire Hathaway consolidated statements of income

Table 4.45: Berkshire Hathaway consolidated reconcilliation of shareholders' equity, 1974–1984

Table 4.46: Berkshire Hathaway Insurance Group balance sheets,

1974–1984

Table 4.47: Berkshire Hathaway Insurance Group statements of income, 1974–1984

Table 4.48: Berkshire Hathaway Insurance Group select ratios, 1974–1984

Table 4.49: Insurance Group select information, 1974–1984

Table 4.50: The Illinois National Bank & Trust Co. of Rockford consolidated balance sheets, 1968–1979

Table 4.51: The Illinois National Bank & Trust Co. of Rockford consolidated statements of income, 1968–1979

Table 4.52: The Illinois National Bank & Trust Co. of Rockford select data and ratios, 1968–1979

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101 Accounting Principles Board Opinion No. 16.

102 Long-tail lines are insurance contracts that take a long time to play out. An insurance policy covering one year has losses that are known within that 12 months. A reinsurance contract covering a decade would by contrast take that much longer before profitability was known.

103 This was how Buffett summarized the results for the year. Pre-tax earnings fell from $1.3 million in 1975 to $1.1 million in 1976.

104 Buffett had noted the purchase of K&W in his 1975 letter to shareholders. He described its $2 million of revenues as relatively small but noted it had consistent earnings.

105 A ratio above 100% means an insurer has costs exceeding its premiums.

106 The magnitude of this effect depends on the general level of interest rates and opportunity cost.

107 Technically, the acquiring entity was National Fire & Marine Insurance Company.

108 Insurance accounting at the time valued securities at cost. The market value of the portfolio of preferred and common stock was $45 million greater.

109 GEICO's advantage stemmed from its direct-to-consumer model that reduced underwriting expenses below that of its competitors who were entrenched in a broker model. GEICO will be discussed in more detail later.

110 This is the equity method of accounting. Berkshire's share of Blue Chip Stamps' equity and equity in net earnings were reported on its balance sheet and income statement, respectively.

111 The original figure Buffett quoted in the 1977 Chairman's letter was $151 million. The amount was revised in 1978 after the Diversified Retailing merger.

112 It should be made clear that it was not just the general price inflation Buffett was counting, but the other social inflation factors due to increasing number of lawsuits resulting in large jury awards.

113 The economics are such that one upfront premium is paid covering losses that (usually) develop over long periods of time. Losses are usually more weighted toward the present. For example, a reinsurer might payout 20% in each of the first three years followed by three years at 10% with the balance over a decade or more. Reinsurance contracts vary *widely* (this is just an example). Pricing reinsurance policies can be difficult and are fraught with risk.

114 Short-tail insurance can be just as valuable if it is steady, which makes it a revolving fund.

115 Capital Cities would become an important investment for Berkshire, with Buffett joining its

board of directors. Capital Cities' star manager, Tom Murphy, would later join Berkshire's board.
116 As adjusted for Berkshire's equity in earnings included in Diversified's reported earnings.
117 The Diversified shares owned by Berkshire were carried on its books net of tax at approximately $16.8 million. Adjusting for these figures, including the $1.2 million in repurchases, the $12.8 million increase in equity upon combination of the two companies is reconciled.
118 The Buffett Partnership letters detail the proceeds as follows: $5,045,205 cash and $6,540,000 notes due over the following year and a half. Buffett said the present value of the notes were about $6 million, hence the $11 million figure.
119 To illustrate how close Berkshire and Diversified already were at the time of the merger, National Indemnity handled all of the bookkeeping and administrative functions for the insurance subsidiaries of Diversified.
120 This method, known as the pooling of interests method, was eliminated in 2001.
121 It is primarily for this reason that I was hesitant to present the full, consolidated accounts at the end of the chapter. It was an accounting requirement but since Buffett thought it added no value, it made no sense to reproduce them in this book after this decade (they are very messy indeed). Instead, in subsequent chapters I have attempted to present as much detail as I would have wanted as a shareholder looking at each year. The separate division financials are presented as appropriate or necessary.
122 Though not unimportant, the balance sheet was less informative than the sources of earnings table, at least for disaggregating results. Berkshire preferred to use very little debt and typically held it at the parent level. Financial debt represented just 22% of stockholders' equity and only 7.5% of total assets at year-end 1978. Most of the liabilities on the balance sheet were held in the Insurance Group in losses and adjustment expenses, and unpaid premiums.
123 Berkshire shareholders could still see the Blue Chip Stamps standalone results by obtaining its filings from the SEC. However, this was much more difficult before the information age.
124 According to the 1977 Blue Chip Stamps 10K filing, Buffett beneficially owned 13% of Blue Chip Stamps. This consisted of his personal ownership of 550,090 shares, Susan Buffett's 125,455 shares, and his ownership via Berkshire Hathaway and Diversified Retailing.
125 Pre-tax operating earnings, calculated based on the Sources of Earnings table from the 1978 Berkshire Chairman's letter.
126 Blue Chip Stamps, 1971 Annual Report.
127 The See's purchase price is often quoted as $25 million. This is because See's had excess cash on its balance sheet, which reduced the effective price to that amount. (In the 1991 Berkshire Hathaway Annual Report, Buffett quotes the $10 million excess cash figure.)
128 Letter from Warren E. Buffett to Charles N. Huggins, December 13, 1972.
129 Buffett and Munger's willingness to purchase shares of Wesco stock at a higher than market price also factored into the SEC investigation of Blue Chip Stamps.
130 Wesco, 1973 Annual Report.
131 Included in Wesco's assets was a 21.5% stake in the Detroit International Bridge Company, which owned its namesake bridge into Canada. It is interesting to note the nesting doll-like ownership structure in which Buffett and Munger purchased assets using cash available in various subsidiaries.
132 Wesco, 1978 Annual Report.
133 A consequence of acquiring shares below book value was the amortization into income of the excess of book value acquired on top of the purchase price over a period of 40 years. This contrasts to today's usual situation where an excess of purchase price over the assets acquired is amortized into expense.
134 The paper had been offered to *The Washington Post* first, which had turned it down (*The*

Snowball , p. 463).

135 The purchase was technically structured as an asset purchase, whereby Blue Chip Stamps organized a new subsidiary of essentially the same name (The Buffalo Evening News, Inc.) which in turn purchased the paper's assets and assumed certain of its liabilities.

136 Blue Chip Stamps, 1977 Annual Report, p.7.

137 *The News* had labor unions which Buffett and Munger knew could put it out of business if they went on strike for any meaningful amount of time. The pair told the unions as much and were successful in avoiding a strike.

138 Adjustments were also made to isolate the economic performance of the subsidiaries beyond accounting. For example, amortization of goodwill and interest on debt were removed to separate lines, but these were reconciled to GAAP earnings.

139 This is a phrase both Buffett and Munger have used on many occasions, including in their written communications.

140 Unless otherwise noted, I am referring to Berkshire's share of pre-tax earnings. In this way, figures are comparable from year-to-year without any distorting effects of taxes.

141 Precision Steel was technically owned by Wesco Financial Corporation, the entity that also owned Mutual Savings and which was in turn owned by Blue Chip. From an economic perspective, the holding structure is inconsequential.

142 The table in the 1979 Berkshire Chairman's letter indicated Precision Steel earned $3.25 million pre-tax in 1979. This would equate to a 21.6% pre-tax return (4.6 times earnings) on the $15 million purchase price. The steel business was cyclical, and it's unclear to what degree this was factored into the purchase price.

143 In Buffett's Chairman's letter, he states that the combined ratio *decreased* from 98.2% to 97.1%. The discrepancy to Table 4.22 is the result of the fact that Buffett, I believe, did not include deferred policy acquisition costs (DPAC). DPAC are not detailed in the summary figures in the Annual Report from which I have based my calculation.

144 National Indemnity's business would have fallen primarily within the specialized auto and general liability category but also included business categorized elsewhere.

145 Fewer accidents meant that (all things being equal) insurance claims were lower and profits higher, leading companies to lower their premiums rates.

146 The turnover ratio measures how many shares trade hands during a particular period of time. It is not uncommon to see over 100% turnover ratios. This means (in theory) the corporation has an entirely new set of owners from one year to the next.

147 The reverse of the next category of between 20% and 49% ownership.

148 To use the iceberg analogy from above, the income from the bonds would show up above the surface but be less valuable than a claim on a hidden (but larger) iceberg. A switch to bonds would also entail paying capital gains taxes.

149 Blue Chip Stamps owned stock in Wesco, which owned Mutual Savings. So both men were discussing Mutual Savings, an important asset to each company, in their reports to their respective shareholders (which of course had considerable overlap).

150 Berkshire had added to its holdings and GEICO also began buying back stock.

151 In reality these losses and reductions to capital were already there.

152 This is based on GAAP equity. A ratio using statutory capital would have been higher but still below that of industry peers.

153 As an amateur genealogist, I would be most obliged to anyone that could connect my family line to the George Mead referenced here.

154 I'm using earnings before interest to base the comparison on the underlying earning power of the Berkshire subsidiaries irrespective of the fact that Berkshire financed part of their purchase price with

borrowed money.

155 We can quantify this. The operating earnings above are $40 million. If $4 million of the undistributed investee earnings of $35 million were paid out it would increase Berkshire's earnings by 10%. Berkshire's reported return on equity would increase by 1.5 percentage points.

156 The figure reported for Berkshires share of See's Candies' earnings in 1981 was $13 million. This is an example of the minor discrepancies between the original year and the lookback year in the following years' Annual Report. I have used the 1982 figure for 1981 results as these are presumably more correct having had the benefit of time.

157 The 41% referenced here is lower than the 44% increase shown in the table in Munger's letter. Munger used the company-level figures. I've used the figures included in the Berkshire Chairman's letter for consistency. The difference arises due to state income taxes paid by Blue Chip Stamps.

158 The calculation included an adjustment for the taxes that would be due if any gains were realized.

159 Buffett's letter included pre-tax earnings both on the company level and for Berkshire's share, in addition to Berkshire's share of after-tax earnings. Table 4.2 includes only the pre-tax earnings for Berkshire's share.

160 Mutual Savings realized a loss on the sale of mortgage-backed securities. This created a tax benefit.

161 Blue Chip carried Wesco on its books at $18.2 million. It also benefitted from a small boost from a positive amortization into income of the discount to purchase price.

162 Favorable loss development can occur too, but most often seen is unfavorable or adverse development since optimism pervades estimates.

163 Buffett used this in quotes. The quote is attributed to Benjamin Franklin.

164 While technically true, this assertion is not 100% accurate since the spin off of the Illinois National Bank and Trust at year-end 1980 necessitated Buffett setting the price (exchange ratio) of both Berkshire and the bank. And in fact the divestiture was accounted for with a treasury stock transaction.

165 The contract laid out the purchase of 90% of the business with 10% retained by Louis Blumkin and his family. Berkshire also made 10% available as an option to allow key members of the management team to buy into the business. The exact figures here are somewhat ambiguous. Table 4.30 calculates the value based on the contractual price and ownership amount. As late as the 1984 Berkshire Hathaway Annual Report, the ownership is stated as 90% but the economic interest as 80%. Ignoring the time value of money and assuming the 10% option was exercised immediately in 1983 (and on the same basis as the purchase price), Berkshire's 80% interest would have cost $49.2 million. These figures are also close to Buffett's statement at the 2014 Annual Meeting Q&A that the 100% basis was $60 million.

166 Writing in his 1988 Chairman's letter Buffett recounted how Dillard's, a large successful department store, entered the Omaha, Nebraska market but without a furniture line, choosing not to even try to compete with Nebraska Furniture Mart.

167 There are instances where the purchase price is below the value of the underlying assets. Blue Chip Stamps' purchase of its interest in Mutual Savings and Loan is such an example. In these cases of a bargain purchase the excess is amortized into income—the reverse of the more typical case and that described here.

168 This $8 million figure is inconsistent with Buffett's 1991 Chairman's letter, in which he states See's had $7 million of net tangible assets.

169 Buffett points out here that he considered accounts receivable to be a tangible asset, "a definition proper for business analysts."

170 The table presented three columns: pre-tax at the company level, pre-tax for Berkshire's share,

and after tax for Berkshire's share. Consistency is key in analysis. The value lay in correctly communicating to shareholders how the businesses were doing. A pre-tax, company-level analysis removed the distortions arising from varying tax rates and ownership levels. I have attempted to use the most appropriate comparison at each juncture, here presenting the company-level figures during the year of transition.

171 *The Courier-Express* closed in 1983, making Buffalo a one-paper town as Buffett rightly predicted.

172 The amount left over on a sale after paying for the goods sold, but before other operating expenses.

173 At a company level, pre-tax. *The Buffalo News* was owned via Blue Chip Stamps, so a comparison of Berkshire's proportional share of the paper would not have made sense.

174 This ratio was calculated directly from the reported financial statements. Buffett calculates a ratio of 134% which excluded structured settlements and the assumption of loss reserves. The two figures are close enough; both reflect a terrible underwriting experience.

175 Without more detailed information, what could be gleaned from the 1984 Annual Report was that the insurance segment represented $1.6 billion of the $2.0 billion of identifiable assets at year-end. Clearly a large chunk of the $1.3 billion of consolidated Berkshire equity was attributable to the insurance companies, though the specific amount was unknown.

176 If we assume that equity was 50% of total assets, an assumption made based on the known 1980 ratio, Berkshire's insurance companies would have had roughly $800 million of equity at year-end 1984.

177 Ratios above 100% were not uncommon, according to later Berkshire Annual Reports.

178 Berkshire's 10K reports began including loss development tables for the 2001 reporting period. Until then, shareholders could only glean information from the aggregate loss development figure presented in the footnotes to the financial statements.

179 It is not uncommon to see banks with loans equal to 80% of assets and over 100% of deposits.

180 The higher effective yield arises due to the discount paid relative to the face value of the mortgages. It is just like buying a bond at a discount.

181 The terms Buffett used were ersatz and restricted.

182 Consider another example. You are in a business selling one item annually. You have $90,000 invested in the business, which represents the entire cost of that one item. You sell the item for $100,000, netting a $10,000 profit. The next year the cost of the item, because of inflation, increases to $100,000. You must now take your entire profit from the prior year of $10,000 plus your original capital of $90,000 just to buy the item to sell the next year. Even if your profit on the next year's sale went up by the same amount, you'd still be left with a permanent and required investment into the business that had to come from profit (or borrowed money or additional equity).

183 This figure does not include the $3.7 million of additional net income added that year due to the merger. It is included in the Net income – operations line.

184 A look-through analysis takes a company-level figure, in this case premiums but most often earnings, and adjusts for the level of ownership.

Chapter 5: 1985–1994

Table 5.1: Decade snapshot: 1984–1994

	1984	1994
Business:	Insurance, newspapers, furniture retailing, candy, banking, textiles	Insurance, newspapers, furniture retailing, candy, jewelry, encyclopedias, home cleaning systems, shoes, misc. manufacturing, significant stakes in several public companies
Key managers:	Chairman & CEO: Warren E. Buffett; Vice Chair: Charles T. Munger	Chairman & CEO: Warren E. Buffett; Vice Chair: Charles T. Munger
Annual revenues:	$729 million	$3.8 billion
Stockholders' equity:	$1.27 billion	$11.9 billion
Book value per share:	$1,108.77	$10,083
Float (average):	$253 million	$3.06 billion

Major Capital Allocation Decisions:

1. Shut down textile operations (1985).
2. Contributed additional equity to Insurance Group (various).
3. Invested $517.5 million into Capital Cities/ABC (1985).
4. Acquired Scott Fetzer for $410 million (1986).
5. Purchased Fechheimer (1986).
6. Purchased $700 million issue of Salomon Brothers Convertible Preferred Stock (1987).
7. Acquired Borsheim's (1989).
8. Purchased Coca-Cola shares for $1.3 billion (1988–94).
9. Purchased convertible preferred stock issues from Gillette ($600 million); USAir ($358 million); Champion International ($300 million) (1989).
10. Issued $900 million Zero Coupon debt (1989).
11. Acquired H.H. Brown Shoe (1991).
12. Repaid a significant amount of debt (1991–92).
13. Acquired Lowell Shoe (1992).
14. Acquired Dexter Shoe for $433 million, issuing 25,303 shares (1993).
15. Exited savings and loan business (Wesco/Mutual Savings; 1993).

Noteworthy Events:

1. Berkshire enters the super catastrophe (super-cat) business in a big way (1990).
2. Ken Chace retires from Berkshire Board, replaced by Susan Buffett (1990).
3. Malcolm G. Chace, Jr. retires from Berkshire Board, replaced by son, Malcolm "Kim" Chace III.
4. Rose "Mrs. B." Blumkin turns 100 years old (1993).

Table 5.2: Berkshire Hathaway Earnings

This table has been omitted from the ebook version because formatting issues would have rendered it unreadable. The reader is welcome to download a pdf version of the omitted tables and bonus material at brkbook.com .

Introduction

Focusing just on the third decade of Warren Buffett's control of Berkshire Hathaway we find a company hitting its stride. Up until 1985, Buffett and his business partner, Berkshire Vice Chairman Charlie Munger, had something of a weight around their ankles in the form of the company's former identity, namely the textile division. Even with this anchor, they achieved an incredible amount in the prior decade, reallocating capital to more profitable businesses. In 1985, Berkshire freed itself from its past by closing the textile division. This really allowed the wind to fill its sails.

The magnitude of the changes Berkshire Hathaway experienced during the 1985–1994 decade were incredible. Revenues grew from $729 million in 1984 to $3.8 billion at year-end 1994. Shareholders' equity, while somewhat augmented by issuing stock, increased almost tenfold to $11.9 billion and resulted in a similar magnitude change in per share book value. Many capital allocation decisions created that change. They fell into two broad categories: allocation of capital into new wholly-owned subsidiaries, and the purchase of part ownership interests in very good public companies.

Berkshire acquired several simple yet highly profitable new businesses during this decade. Major additions included Scott Fetzer, a mini conglomerate whose largest divisions, World Book Encyclopedias and Kirby vacuum cleaners, were well-known to the general public. Unexpectedly, Berkshire also moved into the shoe industry in a big way.

Under the direction of expert capital allocators Buffett and Munger, Berkshire acquired large stakes in several well-known public companies and in some cases joined the boards. The company issued and redeemed a significant amount of debt during this time, and also issued shares in connection with a sizable acquisition. The 1985–1994 decade was one where Berkshire Hathaway moved swiftly to implement its leaders'

understanding of good businesses, and in particular the potential for value creation in its insurance operations.

Table 5.3: Select information 1985–1994

	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994
BRK book value per share - % change	48.2%	26.1%	19.5%	20.1%	44.4%	7.4%	39.6%	20.3%	14.3%	13.9%
BRK market value per share - % change	93.7%	14.2%	4.6%	59.3%	84.6%	(23.1%)	35.6%	29.8%	38.9%	25.0%
S&P 500 total return	31.6%	18.6%	5.1%	16.6%	31.7%	(3.1%)	30.5%	7.6%	10.1%	1.3%
US GDP Growth (real %)	4.2%	3.5%	3.5%	4.2%	3.7%	1.9%	(0.1%)	3.5%	2.8%	4.0%
10-year Treasury Note (year-end %)	9.3%	7.1%	9.0%	9.1%	7.8%	8.1%	7.1%	6.8%	5.8%	7.8%
US inflation (%)	3.5%	1.9%	3.6%	4.1%	4.8%	5.4%	4.2%	3.0%	3.0%	2.6%
US unemployment (%)	7.2%	7.0%	6.2%	5.5%	5.3%	5.6%	6.9%	7.5%	6.9%	6.1%

Sources: Berkshire Hathaway Annual Reports 2018, 2019 and Federal Reserve Bank of St. Louis.

1985

Having labored through some difficult years in the past, the year 1985 was a good one for Berkshire Hathaway. Not just because of the record 48.2% gain in net worth. Its insurance businesses, though still struggling with underwriting losses, were moving in the right direction (as was the industry). And the insurance business was bolstered by new volume acquired via a quota-share arrangement. Berkshire also received a windfall from its General Foods investment when that company was taken over in a leveraged buyout.

Not one to bask in glory no matter how richly deserved, Buffett tempered the results with some history and math. Increasing Berkshire's net worth by 15% per annum over the next decade would require Berkshire to earn profits of $5.7 billion. Only fifteen companies in the US managed such a feat over the preceding decade. Although "our scope is not circumscribed by history, structure, or concept … we will also need a full measure of good fortune to average our hoped-for 15%."

Tempering expectations was classic Buffett, but it was especially appropriate in 1985. Berkshire's stock usually sold at a slight discount to intrinsic value, but recently it had started trading at a premium. This would be a boon to exiting shareholders, but not new ones. For their results to match Berkshire's underlying results, that premium would have to remain. If it shrunk to its historical below-intrinsic value level then good business

results at Berkshire could translate into less-than-satisfactory results for those new shareholders. Buffett would continue to subtly influence the share price via Berkshire's candid disclosures.

Shutdown of the Textile Business

Reflecting on the past, Buffett considered buying control of Berkshire a colossal mistake. It led his original partnership investors (himself included) to give up a fraction of the ownership of much better businesses acquired though Berkshire, rather than buy them through another entity. And that was to say nothing of the now two decades of frustrations watching an industry decline into oblivion. As Buffett put it, the unpleasant job of shuttering the remnants of Berkshire's past was largely completed by July 1985. He was sympathetic to the managers and employees associated with the textile operations, but in the end economics won out. Berkshire couldn't remain in a competitively disadvantaged business that required ongoing capital investment at subpar returns.

The figures were unambiguous: Over the nine years prior to Buffett's involvement, Berkshire Hathaway was entirely engaged in textile manufacturing. During that time it lost $10 million on a total of $530 million of revenues. By comparison, See's Candies earned $2 million on revenues of $31 million the first year it was purchased. Although textiles did deliver some profits in the 1960s, they were not adequate compared to the capital required to produce them. As the years wore on the division's profits only worsened, and as the competitive disadvantages accrued, it became obvious that the business was not viable.

Buffett praised the division's managers, Ken Chace and Garry Morrison as "resourceful, energetic, and imaginative" in their efforts to operate the Textile Group profitably. He even put those managers on the same level as those running a gem like See's. The textile business failed not because of them, but despite their monumental efforts. They were simply dealt a bad hand. Berkshire's employees and their unions were praised, too, for accepting below-average wages and understanding the economic position of their employer. Even after the decision to liquidate the mills was made, both management and the employee base performed superbly, said Buffett.

Buffett summed up his predicament in allowing the mills to operate at subpar levels for so long:

> "I won't close down businesses of sub-normal profitability merely to add a fraction of a point to our corporate rate of return. However, I also feel it inappropriate for even an exceptionally profitable company to fund an operation once it appears to have unending losses in prospect. Adam Smith would disagree with my first proposition, and Karl Marx would disagree with my second; the middle ground is the only position that leaves me comfortable."

His statement reflected the owner-related business principle of not participating in "gin rummy capitalism" contained at the beginning of the Annual Report. Berkshire would buy for keeps, and as a rule would not sell underperforming units in an effort to redeploy the capital into higher earning assets. Buffett communicated his position to shareholders in the past by reminding them that Berkshire's textile workers were largely older and possessed almost no skills outside of textile manufacturing. Many were also foreign-born and spoke very little English and would have been severely hurt by closure of the mills. Many were hurt with the 1985 mill closure, but Buffett could at least point to efforts to cushion the blow.

The problem was that the textile business, especially in New England, was not economically viable. The liquidation of the mills' assets told the story:

Table 5.4: Berkshire Hathaway Textile division, select data

Employees	1,000
Space occupied *(sq. ft.)*	750,000
Select data on textile equipment ($ thousands):	
Original cost	$13,000
Balance sheet value	866
Cost to replace in 1985	30,000 to 50,000
Liquidation proceeds	163

Source: Berkshire Hathaway Chairman's letter 1985.

Equipment of enormous importance in prior years was rendered economically useless over time by the onslaught of competitive pressures. In the end it was sold for almost nothing.

A commodity-type business like Berkshire's textile operation faced illusory investment options. Each opportunity for investment, say a new machine that promised to reduce costs, was rational from the standpoint of the

individual firm. But when *all* companies in the industry made such decisions the advantages disappeared. Buffett summed it up as akin to standing on one's tiptoes watching a parade. It helps for a fleeting moment —until everyone else does the same. Then you see no better and have achy legs.

Considering the situation of Berkshire's textile operations in 1985, it was quite clear that the industry was, at best, difficult. Yet some textile mills remained. Burlington Industries was the largest US textile company from the time Buffett took over Berkshire until it closed the division. In 1964, Burlington had revenues of $1.2 billion compared to Berkshire's $50 million. In the twenty-one years that followed Burlington made $3 billion of capital expenditures. Revenues in 1985 were just $2.8 billion. It was a devastating result that led Burlington's share price to essentially remain unchanged at $60 over that period. Considering the consumer price index had risen threefold over that time, Burlington shareholders who stayed on for the ride saw their real purchasing power shrink commensurately. [185]

Berkshire's shareholders would surely have faced the same agonizing decline if it weren't for the arrival of Warren Buffett and his capital allocation skills. Instead of oblivion, Berkshire's shareholders saw a newcomer harness the textile business's dying breaths to create a profitable enterprise with a diversified stream of earnings. With the aid of Chace, Morrison, and the employees of the textile operations, Berkshire slowly reduced its investment in textiles. Monies raised by selling off plant and equipment, and shrinking investments in receivables and inventories, were recycled into more profitable investments in operating businesses, such as National Indemnity and Illinois National Bank, and into marketable securities.

The liquidation of the textile operations in 1985 and 1986 was the end of an era. What began as an association with the country's first mill operators and continued for almost two centuries in various forms, ended with a money-losing fire sale. Although its original business of textiles was no longer part of the picture, the story of those who built Berkshire Hathaway would always have a place in history because of Warren Buffett.

Three Very Good Businesses (and a Few Thoughts About Incentive Compensation)

As the textile business faded into history the businesses it spawned flourished. Buffett used some figures on Nebraska Furniture Mart, See's, and *The Buffalo News* to opine on incentive compensation. It was also an excellent lesson on business economics and the importance of thinking through facts and figures carefully.

The three businesses just mentioned earned $72 million pre-tax for Berkshire Hathaway in 1985 and represented about half of pre-tax operating earnings (prior to interest expense) for that year. Those businesses were earning about $8 million fifteen years earlier, before Berkshire purchased any of them. Buffett cautioned against seeing such an increase as automatically good. That record was good, but there was information missing. To properly appreciate the economic characteristics of a business and whether growth is good, it must properly be compared to the capital required to produce those earnings.

For *The Buffalo News* , See's, and Nebraska Furniture Mart, the incremental return on capital investment was highly satisfactory, said Buffett, being understated as usual. Doing some simple math illustrated the excellent economics of those businesses: The rate of return pre-tax was 160% (see Table 5.5). This result stands out when compared to other businesses Berkshire could have purchased. "The average American business has required about $5 of additional capital to generate an additional $1 of annual pre-tax earnings," he said. Such a rate of return of 20% pre-tax was not a poor result—but it wasn't 160% either.

Table 5.5: The Buffalo News, See's, and Nebraska Furniture Mart incremental return on capital analysis

($ millions)	
Pre-tax earnings, 1985	$72
Pre-tax earnings, 1970	8
Increase	64
Incremental capital required	$40
Incremental return on capital	160 %

Source: Berkshire Hathaway Chairman's letter 1985.

The only problem, if it could be called one, was the businesses possessed such low reinvestment requirements that they could hardly reinvest their earnings. In fifteen years, those businesses found opportunities to invest just

$40 million. [186] Berkshire would have invested another $40 million if it could find anything close to the 160% incremental return seen over the previous fifteen years. Instead, they shipped the excess cash off to Omaha for reallocation into other investment opportunities.

Nebraska Furniture Mart was a low-cost operation with one location. This allowed it to set prices below its competitors and still earn a good result for its owners. See's, though still an excellent business, continued to face the industry headwind of declining per capita consumption of boxed chocolates. Declining pounds meant per-pound cost pressures, which were difficult to fully compensate through price increases. *The Buffalo News* , with exceptional penetration rates near 80%, had little room for future growth within its territory. It could expand advertising with preprints (advertisers supplying inserts vs. on-page advertisements) but those were less profitable and subject to competition. The common thread with all three was exceptional management.

Buffett was not opposed to paying large sums for above-average performance, but he disliked compensation for average performance. He thought managers whose companies increased earnings at the same pace as capital invested in the business deserved no applause. These average managers (and those compensating them) focused blindly on increased dollar earnings. What mattered more was the *rate* of change.

An ordinary savings account provided an ultra-simplified example. An account earning 8% would quadruple its annual earnings in eighteen years. The manager of the account would have done nothing but sit back and let the interest accumulate and compound. The above-average manager found ways to increase value. Value enhancement might come in the form of increasing the rate of return on capital through better margins, or perhaps by conducting the same level of operations with less capital. It could also come in the form of expanding a difficult-to-grow business while maintaining good rates of return on capital.

Another way to make money doing nothing was with fixed-price options for company shares. Managers who issued themselves such options were incented to retain earnings even if it made more sense to payout some or all of them to shareholders. The larger the pie at the end of their option period, the bigger their payout. This really got Buffett's blood boiling.

Buffett wanted managers to think and act like owners. He said owners would understand that there was a cost to capital and that rates of return mattered more than simply increasing earnings. He also thought options should only be issued to those responsible for the overall performance of the business. Though Berkshire didn't issue options, he thought it entirely appropriate for the manager of a well-performing subsidiary to receive a large bonus even though Berkshire overall performed poorly in comparison. Conversely, a well-performing Berkshire would not automatically mean a big check if the individual unit performed poorly. Many other corporations acted against this rational approach. Their owners paid for it quite literally by giving up a portion of their interest to the managers.

Insurance Operations

The insurance industry presented another perplexing year in 1985. Despite an estimated 20.9% increase in premium volumes, combined ratios remained elevated. The 1985 estimated industry combined ratio of 118%, and Berkshire's own overall ratio of 105% [187] was because losses remained high. Part of the problem was the persistent social inflation where judges and juries awarded far more than insurers had priced into policies. The real issue, though, was the addition of reserves, which reflected the sins of prior years' underwriting.

Table 5.6: Insurance Group, select information

($ millions)	1985 Amount	1985 %	1984 Amount	1984 %
Primary Group				
Premiums written	$269.1		$118.1	
Premiums earned	184.3	100.0%	119.3	100.0%
Losses and loss expenses	140.0	76.0%	110.5	92.6%
Underwriting expenses	52.5	28.5%	41.6	34.9%
Total losses and expenses	192.5	104.4%	152.1	127.5%
Underwriting gain/(loss) - pre-tax	(8.1)		(32.9)	
Unfavorable (favorable) loss development included in losses and loss expenses	*0.1*	*0.0%*	*8.1*	*6.8%*
Statutory combined ratio		95.5%		127.9%
Reinsurance Group				
Premiums written	$178.5		$10.5	
Premiums earned	82.9	100.0%	16.1	100.0%
Losses and loss expenses	85.7	103.4%	23.7	147.6%
Underwriting expenses	27.2	32.8%	4.9	30.5%
Total losses and expenses	112.9	136.2%	28.6	178.2%
Underwriting gain/(loss) - pre-tax	(30.0)		(12.6)	
Unfavorable (favorable) loss development included in losses and loss expenses	*19.4*	*23.5%*	*9.7*	*60.2%*
Statutory combined ratio		118.6%		194.2%
Structured settlements and portfolio reinsurance				
Underwriting gain/(loss) - pre-tax	(6.1)		(2.6)	
Total Insurance Group underwriting gain/(loss) pre-tax	($44.2)		($48.1)	
Insurance Group overall statutory combined ratio		104.7%		135.9%

Notes:

1. Totals may not add due to rounding.

2. The loss and expense ratios are shown as they were reported in the Annual Reports, which is on a GAAP basis. The GAAP basis ratios are calculated with underwriting expenses divided by earned premiums. This contrasts to the statutory basis calculation, where the ratio uses written premiums. In both the GAAP and statutory calculations, losses and loss adjustment expenses are divided by earned premiums.

Sources: Berkshire Hathaway Annual Reports 1985, 1987; and author's calculations.

Due to the nature of the insurance business, which requires estimating all future costs today for policies that may cover risks stretching far into the future, operating results are subject to much less precision than normal businesses. When an insurance company determines that estimated losses

for prior years are inaccurate (usually they are too low), it must record a charge to the current years' operating results. Innocently named reserve development, these adjustments are really mistakes. These mistakes are a part of the business, though they sometimes tempt unscrupulous managers to fiddle with the estimates.

In Berkshire's case in 1985, its Insurance Group began the year with an estimate for future claims (termed unpaid losses and loss expense) of $243.3 million. During 1985, with hindsight, Berkshire determined it had underestimated losses it really incurred for business written prior to 1985 by $22.9 million. This amount was then included in the current years' income statement under item losses and loss adjustment expenses.

Details in the footnotes revealed some important information about the adverse loss development. The segment attributed to the Primary Group (Berkshire's collection of primary or direct operations), recorded a $63,000 prior-year adjustment. Although the segment still wrote at a loss, the losses were all tracking as expected through 1985. The story of the 1985 adverse loss development was largely in the reinsurance segment, which booked charges of $19.4 million—a massive 41% of the balance attributable to reinsurance at the beginning of the year.

About two-thirds of the loss reported from the Reinsurance Group [188] in 1985 was the result of adverse loss development on policies written in prior years (the other third represented losses on business written in 1985). Such a loss was large but not uncommon. The reinsurance business is typically long-tail (requiring many years for actual profitability to materialize) and subject to the primary insurance company's estimates, making revisions of prior year loss estimates common. It is also a contributing factor to the number of entrants to the business when business is seemingly good. Since losses take many years to materialize, the feedback loop is also long and pricing errors can go undetected and uncorrected for many years.

The insurance industry in general has a unique capacity feature, one that can exacerbate the problems of reinsurance. Most commodity industries (indeed most businesses) take time to react to demand and/or pricing and bring additional capacity online. This is because plants must be designed and built, equipment ordered, and personnel hired. Conversely in insurance, capacity can materialize instantly since it is of a financial nature. This feature also leads to quick changes in the other direction. When times are

tough—such as a major hurricane or earthquake that leads to industry losses —insurers and their capital backers pull back.

This pull back of industry capacity was when Berkshire shone brightest. The year 1985 was one such year of tight capacity, in which others, having suffered through years of losses, lost the ability or willingness to write new business. Berkshire, on the other hand, lived for such years. In 1985, Berkshire's Insurance Group wrote 372% more premium volume compared to 1984 and it earned 226% greater premiums. The winds were finally favorable, but if history was any guide they wouldn't last long.

The increased pricing caused by tight supply in 1985 caused new entrants and reentrants into the market. In 1985, fifteen insurers raised over $3 billion to capture the better industry pricing, according to Buffett. Buffett knew it would only be a matter of time before this new capital pushed prices down below the cost of doing business, and the cycle would start all over again. There was a bright spot in the darkening cloud Buffett painted, one uniquely suited for Berkshire.

Berkshire had built a unique advantage through a combination of its excellent track record, good reputation, and significant capital base. The latest cycle reminded some insurance buyers that premiums only paid for an IOU, and that if the insurer or reinsurer went belly up payment wasn't guaranteed. (Most consumer-type insurance contracts have some industry protections, but others, like reinsurance contracts, do not.) Berkshire's unparalleled financial strength meant that buyers of insurance or reinsurance knew their backer would be around if and when it came time to pay.

Fireman's Fund Quota-Share Contract

A major new source of insurance business presented itself during 1985 when Jack Byrne, CEO of GEICO, departed to run Fireman's Fund, another insurer. Berkshire struck an arrangement to participate in 7% of virtually all [189] of the business of Fireman's Fund for four years. Directly and through some subsidiaries (including a newly formed subsidiary at Wesco), Berkshire would be remitted premiums and pay claims promptly. It would be as if Berkshire created a brand-new insurance company of its own overnight, complete with favorable float characteristics (which it could

invest as it saw fit, unlike a direct investment in equity) and a well-seasoned manager in Byrne.

The business from Fireman's Fund would be managed by Berkshire's National Indemnity Company and a newly formed Wesco Financial Insurance Company (Wes-FIC). National Indemnity would write five-sevenths of the business while Wes-FIC would take the remaining two-sevenths. Since Fireman's Fund was doing about $3 billion of business, that meant the 7% share for Berkshire represented over $200 million of premium volume.

Even though Berkshire had a majority ownership in Wesco and could direct its activities, it deferred to the Peters and Caspers families (descendants of Wesco's founder who still held a minority position) in deciding whether to enter the reinsurance business with Fireman's Fund. This was an unusual degree of deference for a majority owner to show, but it was also a very shrewd, quiet, advertisement to demonstrate to others how Berkshire treated its financial partners. This reputation would pay off in the future with other acquisitions.

Investments

Practically jumping off the page (see Table 5.2) was a large $469 million gain on sales of securities during 1985. Buffett tempered the enthusiasm for this by likening it to the day of a college graduation where nothing more is learned yet the degree is suddenly bestowed. Like the college degree, Berkshire's large securities gains in 1985 were the result of years of behind the scenes accumulation.

A significant part of that year's realized gains was due to a $338 million pre-tax gain from the sale of General Foods. Buffett was content to let Berkshire own General Foods (which it purchased in 1980) indefinitely, owing to the combination of good business economics and management quality. However, the stock was successfully targeted as a takeover by Philip Morris, and Berkshire found itself with cash instead.

In addition to the large capital gain realized on the sale of its General Foods stock, Berkshire recognized a $4.1 million special distribution (which occurred prior to the takeover). It also recorded a $14.9 million special distribution from The Washington Post Company. Both were structured as share repurchases but acted (and were taxed by the IRS) as dividends owing

to the exact same pre- and post-sale ownership percentages. These were like the GEICO special distributions/buyback arrangements done in prior years.

Berkshire's investment portfolio continued to show high degrees of concentration. At year-end 1985 the portfolio had a market value of just under $1.2 billion, with a cost of $275 million. The biggest change in the portfolio over the preceding 12 months was the elimination of the $152 million (year-end 1984 value) position in Exxon Corporation.

GEICO, the largest holding by far, reflected Buffett's degree of confidence in the insurer. The GEICO investment had a cost basis of just $46 million and a market value at the end of 1985 representing 50% of the total portfolio. That Buffett was willing to maintain 50% of the portfolio in one company and 85% in just four reflected his belief in concentration. It also reflected the relative scarcity of great investment opportunities.

The Washington Post provided a good example of how investors' attitudes had changed from pessimistic to optimistic. *The Washington Post* , valued by the stock market at around $100 million when Berkshire first purchased its $10 million stake in 1973, was now worth twenty times that much. The increase reflected the managerial skill of Katherine "Kay" Graham and her willingness (with Buffett's urging) to repurchase shares when they were depressed. It also reflected a growing sense of optimism for stocks in general.

Table 5.7: Berkshire Hathaway common stock portfolio, select detail

($ thousands)	1985	*% of total*	1984	*% of total*
Affiliated Publications	$55,710	*4.6%*	$32,908	*2.6%*
American Broadcasting Companies, Inc.	108,997	*9.1%*	46,738	*3.7%*
Beatrice Companies, Inc.	108,142	*9.0%*		
Exxon Corporation			175,307	*13.8%*
GEICO Corporation	595,950	*49.7%*	397,300	*31.3%*
General Foods Corporation			226,137	*17.8%*
Handy & Harmon	43,718	*3.6%*	38,662	*3.0%*
Interpublic Group, Co.			28,149	*2.2%*
Northwest Industries			27,242	*2.1%*
Time, Inc.	52,669	*4.4%*	109,162	*8.6%*
Washington Post Company - Class B	205,172	*17.1%*	149,955	*11.8%*
All others	27,963	*2.3%*	37,326	*2.9%*
Total common stocks	$1,198,32	*100.0%*	$1,268,88	*100.0%*

	1		6	
Reporting threshold	$25,000		Unknown	

Note: Totals may not add due to rounding.

Sources: Berkshire Hathaway Chairman letters 1984, 1985; and author's calculations.

The bond portfolio is also worth a note, especially Washington Public Power Supply System (WPPSS) bonds. Of the roughly $400 million of tax-exempt bonds held in the insurance subsidiaries, almost half, or $194 million at amortized cost, were WPPSS bonds. The WPPSS bonds alone provided Berkshire with around $30 million of tax-exempt interest annually, amounting to one-third of Berkshire's $95 million investment income that year. [190]

Capital Cities/ABC, Inc.

The news Buffett couldn't wait to tell shareholders in his letter (both literally as it had to be disclosed, but more so because it was exciting news) was Berkshire's investment in Capital Cities/ABC, Inc. ("Cap Cities"). Berkshire purchased 3 million shares of Cap Cities at the beginning of 1986. The $517.5 million purchase was made to assist Cap Cities in financing its $3.5 billion purchase of ABC. The deal was a white knight situation that helped Cap Cities avoid the destructive tendencies of the leveraged buyout trend of the 1980s. It also brought Berkshire together with Thomas Murphy and Dan Burke, two managers Buffett highly admired. "I've been on the record for many years about the management of Cap Cities: I think it is the best of any publicly-owned company in the country."

Berkshire provided Murphy and Burke with an extraordinary agreement that spoke to Buffett's confidence in them. Provided that either Murphy or Burke occupied the CEO role, Cap Cities would have an irrevocable proxy to vote Berkshire's 18.7% interest in the company for ten years. Why do this? Handing Berkshire's vote to Cap Cities would allow the managers to focus on running the business and not lose any sleep looking over their shoulder and wondering what their new owner might do in the future. The move amounted to providing the management of a public company an advantage of a private company: the ability to think and act long term rather than appease an ever-changing roster of s hareholders.

Miscellaneous

Reflecting its growing equity base, Berkshire raised the threshold of businesses it was looking for in its recurring businesses-wanted advertisement to $10 million of pre-tax earnings. The equity base was now over $1.8 billion at year-end 1985. Berkshire and its subsidiaries would continue to seek and close "tuck-in" acquisitions [191] (smaller acquisitions of businesses folded into existing units) that made sense but Buffett wanted to focus on the big fish.

The Illinois National Bank, which had been divested by Berkshire at the very end of 1980—by law and not by choice—was sold in 1985 to Americorp Financial. Having cut the cake and let shareholders choose first, Buffett was pleased that any slice (shareholders could choose all-Berkshire, all-bank, or a combination of the two) had been reasonably equitable.

Overall, the year 1985 was a good one for Berkshire. Its existing businesses, including its primary line of business, insurance, were doing well. It also found profitable new investment opportunities in Cap Cities, and a new major subsidiary in Scott Fetzer, a nesting-doll of a business which had subsidiaries and subsidiaries of subsidiaries that would join the Berkshire family in early 1986. The closure of the textile business was bittersweet but necessary. Berkshire was moving firmly and swiftly into the future.

1986

Results for 1986 for the most part did not disappoint. The acquisition of Scott Fetzer in January and later, in June, of Fechheimer Brothers, pushed consolidated revenues past the $2 billion mark, up from under $1 billion just a year earlier. Insurance, Berkshire's largest line of business, improved and GEICO, its major insurance investee, continued to prosper. Berkshire did face some headwinds in 1986. A rising stock market helped Berkshire's investment portfolio but also left fewer investment opportunities since companies became more fully priced. A major tax law change in 1986 affected Berkshire's businesses and its investees in different—and not always positive—ways.

Buffett took pains to point out that Berkshire's growth (book value increased $492.5 million or 26.1% in 1986) was of a very high quality. Some companies grew their businesses by issuing new shares, which gave

management a larger business to manage but left shareholders, on a per share basis, worse off. Berkshire, by contrast, had grown by 10,600% (or 23.3% compounded annually) over the twenty-two years under Buffett's management, all while diluting shareholders' ownership interests by less than 1% per year.

As Buffett saw it, he and Charlie Munger had a two-pronged job description. One was attracting and motivating managers who ran the various subsidiaries. One of Buffett's favorite ways to praise managers was naming them in his Chairman's letter: the first page of the 1986 letter praised the Blumkin family of Nebraska Furniture Mart, Mike Goldberg who ran the Insurance Group, Chuck Huggins at See's, Stan Lipsey at the *The Buffalo News* , and two newcomers: the Heldmans who ran Fechheimer, and Ralph Schey at Scott Fetzer.

The other part of that two-pronged job description was capital allocation. Because Berkshire's businesses were so good—they used very little capital and generated gobs more—and because Berkshire retained all its earnings, Buffett's job was a "considerably more important challenge than at most companies." Shareholders used to reading his Chairman's letters knew that he was not showing off. It was simply basic math. As Buffett put it: "In a company adding only, say, 5% to net worth annually, capital-allocation decisions, though still important, will change the company economics far more slowly." Berkshire was like a ship (and a very fast moving one at that) with a very sensitive rudder. One wrong move, a twitch even, could send the ship off in the wrong direction. For that reason, Buffett preferred to patiently wait for the right opportunities. Finding few in 1986 (Scott Fetzer closed in 1986 but was really a decision made in the prior year), Berkshire's "main capital allocation moves in 1986 were to pay off debt and stockpile funds."

Looking at Berkshire's consolidated balance sheet for year-end 1986 we can see just how conservatively financed it was. About half (55%) of Berkshire's $4.44 billion in assets were funded with equity (including minority equity stakes), the most permanent of funding sources. The liabilities section, because of Berkshire's insurance businesses, was somewhat obscured. The $2.02 billion in liabilities were surely real, but their nature was unique. The insurance float that Buffett so loved was made up of the liabilities owed to policyholders for premiums not yet earned by

the insurer or claims not yet paid. These liabilities were of a higher quality because they had no due date and were regenerated each time the Insurance Group wrote additional business.

At $414 million at year-end 1986, the deferred income tax line item funded over 9% of Berkshire's assets. Like insurance float, deferred tax liabilities benefitted Berkshire because there was no contractual due date. The liabilities arose largely from significant investment portfolio appreciation, in addition to other tax-to-GAAP timing differences. In the case of taxes due on unrealized appreciation of investments, the tax was only due to the government if or when the security was sold. In this way, Berkshire could put more funds to work than it otherwise could have if it had sold the investments and paid the taxes every year. Deferred taxes were, as Buffett would later write, an "interest-free loan from the government" and would become an important, though not well understood, source of funds in future years. Berkshire, like most other companies, also had an interest-free funding source from the spontaneously generated working liabilities such as accounts payable and accruals, but these were a more normal part of doing business and largely not controllable.

The only true debt on Berkshire's 1986 year-end balance sheet was $95 million of long-term borrowings. After paying a premium to retire an obligation from 1980, [192] Berkshire only had about $17 million of term debt at the parent level. Its subsidiaries, including its newest acquisition, Scott Fetzer (which came to Berkshire with debt of its own), had a total of about $78 million of debt at year-end. To put this in perspective, Berkshire could pay off the entire $95 million using just seven months of 1986 after-tax operating earnings. [193]

Scott & Fetzer Company

On January 6, 1986, Berkshire Hathaway acquired Scott & Fetzer Company, a small conglomeration of seventeen businesses based in Cleveland, Ohio. The addition of Scott Fetzer's $700 million in revenues nearly doubled Berkshire's revenue base.

Scott Fetzer came to Berkshire after a few zigs and zags. The company had been in play for several years, having been pursued by corporate raiders. After a failed attempt to take the company private via an employee stock ownership plan, Buffett wrote its CEO, Ralph Schey, expressing interest in

purchasing the company. Buffett and Munger met with Schey for dinner in Chicago and Berkshire signed an acquisition contract a week later.

Scott Fetzer had a rich history. Its namesake founders, George Scott and Carl Fetzer, founded the company in 1914 in Cleveland, Ohio as a machine shop. Scott and Fetzer were soon joined by Jim Kirby, inventor of the Kirby vacuum cleaner, and over the ensuing years acquisitions fueled the company's growth.

The largest of Scott Fetzer's subsidiaries in 1986 was World Book, Inc. World book represented 40% of Scott Fetzer's business and had pre-tax earnings of $22 million under Berkshire's first year of ownership. With twice the unit sales of its nearest competitor and more than the top four competitors combined, World Book dominated the industry. Like Nebraska Furniture Mart, this scale allowed World Book to sell its product for less than competitors and still maintain excellent economics for its owner. The encyclopedias were expensive as a set, but on a per page basis cost just 5 cents. Additionally, the books were well edited and consumer focused. Longer entries started simply and built on themselves using increasingly complex words so kids could understand them (the company ranked over 44,000 words by difficulty). Selling World Book was a calling for over half of its salespeople who were teachers or former teachers (and to a lesser extent librarians).

The other major standalone Scott Fetzer subsidiary—almost as big as World Book with pre-tax earnings of $20.2 million in 1986—was Kirby. Kirby sold high-priced but long-lasting vacuum cleaners. It had been doing so since the company was founded by its namesake founder, Jim Kirby, in 1906. Although Kirby and its sister company, World Book, were very different, they shared one important trait. Both Kirby and World Book were sold via the direct sales model, at the time often referred to as door-to-door.

Other Scott Fetzer companies, though not of the same size or scale as World Book or Kirby, nonetheless possessed similar economic characteristics. They were basic, almost boring businesses, such as Campbell Hausfeld air compressors and Wayne burners and water pumps. They also included Adalet, France, Halex, Meriam, and Northland, which made products and components for industrial use or small parts that would ultimately end up in finished products sold to consumers. The basic-but-critical nature of many of the products, combined with their low relative prices compared to the

price of the end product meant the businesses were able to generate strong returns on capital. These businesses collectively earned $25.4 million in 1986.

Scott Fetzer also came with a small finance organization. [194] Both World Book and Kirby were supported by subsidiaries which allowed customers to buy on credit. These receivables and installment loans were in turn partly financed by term debt. Buffett considered a conservative amount of debt appropriate for such an operation, which was akin to a small bank that paid a rate of interest for interest-bearing accounts and earned a spread on what it charged customers for loans.

Buffett was thrilled by the acquisition and called it "a prototype—understandable, large, well-managed, a good earner." Judging by the financial results Scott Fetzer was indeed a good earner. Over the ten years ending in 1984 (the last full year available), Scott Fetzer earned an average pre-tax return on capital of 22.5%. If adjusted for excess cash on the balance sheet, [195] this figure rises to 28.2%. Scott Fetzer's past success had resulted in the company carrying cash and short-term investments of upwards of 50% of shareholders' equity. Upon purchase, Scott Fetzer paid Berkshire a $125 million dividend. This reduced Berkshire's $410 million purchase price (including $90 million of assumed debt) to $285 million. Even after paying a modest multiple for Scott Fetzer's underlying capital, Berkshire would earn a 25% pre-tax return on its investment in 1986.

Table 5.8: Scott & Fetzer, key metrics and acquisition data

	1986	1984	1983	1982	1981	1980	1979
Revenues ($ thousands)	$677,240	$695,382	$615,396	$544,859	$592,589	$570,191	$697,401
Revenues/average capital[1]	$3.20	$3.26	$2.97	$2.64	$2.92	$2.53	$3.06
EBIT margin	11%	10%	8%	8%	8%	5%	9%
Return on capital - pre-tax	34%	33%	25%	20%	25%	13%	28%
Berkshire's purchase multiple[2]	1.35x						
Berkshire's going-in return, pre-tax	25.1%						

Footnotes:
1. Average capital used for 1979–1984. Capital adjusted for cash and investments in excess of 5% of revenues.
2. Berkshire's purchase price was $410 million including assumed debt of $90 million. I've reduced the purchase price by the $125 million Scott Fetzer distributed to Berkshire in 1986, which

represented excess cash on the balance sheet at the time of purchase.

Note: Scott Fetzer did not file a public report its 1985 because it was acquired by Berkshire.

Sources: Berkshire Hathaway Annual Report 1986, Scott Fetzer Annual Reports 1980–1984, and author's calculations.

The Fechheimer Bros. Co.

Berkshire's second acquisition of the year was Fechheimer Bros. Co., which closed on June 3. The company came to Berkshire as a direct result of Buffett's annual advertisement in his Chairman's letters. As Buffett told the story, early in 1985 he received a letter from Bob Heldman in Cincinnati informing him that the company he chaired passed Buffett's test.

Fechheimer passed the simple test with flying colors. Founded in 1842, it manufactured and distributed uniforms. Though a simple business, Fechheimer was highly profitable. The underlying business was earning 50% or more on capital per year. [196] Like Scott Fetzer and many other companies of the 1980s, Fechheimer had gone through the unpleasant experience of being owned by those seeking short-term profits. In 1981, the company was the subject of a leveraged buyout transaction that saw management, including Bob Heldman and his brother George, president of the company, retain an interest in the business. Having ridden the wave for the typical five-to-seven year holding period, the venture capitalists wanted out. The Heldmans' father Warren, who had originally gotten the family involved in the business in 1941, sought a permanent home for Fechheimer.

They found that home in Berkshire Hathaway.

A short history of leveraged buyouts provides an important backdrop to 1986. The 1980s was marked by a boom and bust cycle in private equity that included a wave of leveraged buyouts. In a typical takeover, a corporate raider buys enough stock to gain control. In a leveraged buyout, a company's own executives are often doing the buying. The deals are often financed with high yield but risky bonds called junk bonds. These kinds of buyouts are hostile. In 1986, a third of mergers and acquisitions were of this type. [197] Fechheimer was not the only company Berkshire owned or invested in that was affected. The deal with Cap Cities helped it avoid a leveraged buyout and Berkshire received a windfall when General Foods was taken over in a leveraged buyout.

In Fechheimer, Berkshire received an excellent business at a fair price. Fechheimer's underlying business was earning 50% or more on capital and Berkshire's purchase multiple gave it a 26% pre-tax return. Like Nebraska Furniture Mart, Fechheimer was run by a devoted multigenerational family.

Table 5.9: Fechheimer, acquisition analysis

($ thousands)	1986
Acquisition price	$46,000
Percentage of company	84%
Implied valuation	54,762
Pre-tax earnings (June 3 - Dec. 31)	$8,400
Annualized	14,400
Capital employed	$26,704
Pre-tax return on capital	54%
Berkshire's purchase multiple	2.05x
Berkshire's going-in return, pre-tax	26%

Sources: Berkshire Hathaway Annual Report 1986 and author's calculations.

Sources of Reported Earnings

The changes in Berkshire's sources of earnings was evident in the now-familiar table in the 1986 Chairman's letter (refer to Table 5.2).

To say the addition of Scott Fetzer was a milestone for Berkshire would be an understatement. Scott Fetzer, coupled with improvements in the operating earnings of other Berkshire subsidiaries in 1986, pushed consolidated pre-tax operating earnings to almost $196 million, up more than 56% from 1985.

Ten years into its ownership of *The Buffalo News* , and with its competitor *The Courier-Express* gone, Berkshire's paper was thriving: pre-tax earnings reached $35 million—equal to the entire 1977 purchase price. Under the leadership of Stan Lipsey, the paper was controlling its costs while continuing to provide readers with a 50% news hole. Probably because of this commitment to above-average content, its Sunday paper penetration ratio now topped 83%—even higher than the 63% *The Courier-Express* achieved during its long period of Sunday dominance.

Buffett praised the amazing Blumkin family at Nebraska Furniture Mart who "continue to perform business miracles." Operating out of a single store (though with an expanded warehouse), Nebraska Furniture Mart was generating $132 million of annual revenues. With little organic growth in population locally in Omaha, customers were coming from far and wide to take advantage of its everyday rock-bottom prices.

See's Candies operated in a tough environment and nonetheless increased earnings almost 5% to $30 million. Buffett thought profits should stay at about their present level owing to stagnant same-store poundage. Though See's was able to increase prices minimally and did increase overall poundage by 2%, this was done only by adding stores. See's was (and is) an excellent business with high returns on capital, but this excellence came at the cost of little-to-no unit growth.

Insurance

The Insurance Group's headline $55.8 million pre-tax underwriting loss appeared to run counter to Buffett's prediction of better industry conditions in 1986. Looking more closely at the results between the Primary Group and the Reinsurance Group revealed a slightly different story.

Table 5.10: Insurance Group, select information

($ millions)	1986 Amount	1986 %	1985 Amount	1985 %
Primary Group				
Premiums written	$594.6		$269.1	
Premiums earned	463.1	100.0%	184.3	100.0%
Losses and loss expenses	347.5	75.0%	140.0	76.0%
Underwriting expenses	112.1	24.2%	52.5	28.5%
Total losses and expenses	459.6	99.2%	192.5	104.4%
Underwriting gain/(loss) - pre-tax	3.5		(8.1)	
Unfavorable (favorable) loss development included in losses and loss expenses	16.0	3.5%	0.1	0.0%
Statutory combined ratio		93.9%		95.5%
Reinsurance Group				
Premiums written	$398.4		$178.5	
Premiums earned	344.4	100.0%	82.9	100.0%
Losses and loss expenses	282.6	82.0%	85.7	103.4%
Underwriting expenses	111.2	32.3%	27.2	32.8%
Total losses and expenses	393.7	114.3%	112.9	136.2%
Underwriting gain/(loss) - pre-tax	(49.4)		(30.0)	
Unfavorable (favorable) loss development included in losses and loss expenses	21.0	6.1%	19.4	23.5%
Statutory combined ratio		110.0%		118.6%
Structured settlements and portfolio reinsurance				
Underwriting gain/(loss) - pre-tax	(10.0)		(6.1)	
Total Insurance Group underwriting gain/(loss) pre-tax	($55.8)		($44.2)	
Insurance Group overall statutory combined ratio		101.8%		104.7%

Notes:

1. Totals may not add due to rounding.

2. The loss and expense ratios are shown as they were reported in the Annual Reports, which is on a GAAP basis. The GAAP basis ratios are calculated with underwriting expenses divided by earned premiums. This contrasts to the statutory basis calculation, where the ratio uses written premiums. In both the GAAP and statutory calculations, losses and loss adjustment expenses are divided by earned premiums.

Sources: Berkshire Hathaway Annual Report 1987 and author’s calculations.

For the first time since 1981, the Primary Group reported a pre-tax underwriting gain. This was a result of strength in specialized auto and general liability reflecting tighter market conditions (read: higher premiums were obtainable). Workers’ compensation and Home State again wrote to losses, but these were not enough to prevent an overall profit of $3.5 million and a combined ratio of 93.9%.

The industry increased premiums by over 22% in both 1985 and 1986. As a result, the industry combined ratio had declined markedly from a high of almost 118% in 1984 to an estimated 108.5% in 1986. Though over 100%, indicating underwriting cost industry participants money, it was in the range of 107%–112% and that was enough to produce breakeven results after considering the earnings from float. [198]

Industry tightness and the higher pricing that went along with it factored into the overall doubling of premiums written in Berkshire's primary segment, to $595 million. Earned premiums grew even more: about two-and-a-half times, to $463 million. The only significant black mark on the primary insurers' results was $16 million of adverse loss development included in 1986 results. Representing 7.5% of beginning reserves, the adjustment was, "outside of the more respectable plus-or-minus 5% range" that the Annual Report quoted as a target. Buffett called attention to this fact in the Chairman's letter, "If the psychological rules that applied to Pinocchio apply to me, my nose would now draw crowds."

The story of the Reinsurance Group in 1986 was one of generally improving results on a fast-growing book of business. Premiums written and earned were up 222% and 415% respectively. This was largely driven by the 7% quota-share arrangement with Fireman's Fund. The combined ratio was not ideal at 110% and resulted in a $49.4 million pre-tax underwriting loss. But it was better than the 119% ratio recorded in 1985, and far better than the 194% recorded in 1984. The reinsurance business could stand higher combined ratios, though probably not much higher than the 1986 result. Remember, the long-tail nature of reinsurance means premiums are held longer before being paid as claims, providing more time to earn investment income. A 110% combined ratio implied a 10% loss from underwriting results. Making up anything more than this from investments would be difficult.

According to Buffett's estimates, Berkshire was the fastest-growing large insurer between 1984 and 1986. This contrasted starkly to having been the slowest-growing insurer in the few preceding years. The vacillations were not intentional but market driven. Berkshire was the industry's most steadfast participant, said Buffett—at the right price. Berkshire was willing to write almost any business if it thought the price was right, and the risks manageable and appropriately sized to its capital base. Prior to 1985, it had

found the market unreasonable and therefore wrote less business; when the industry tightened, Berkshire wrote more business.

For an employee at one of Berkshire's insurance subsidiaries, these swings might have caused apprehensions about job security. To properly incentivize writing only profitable business, Berkshire instituted a no-layoff policy at its insurers. Other insurers paid more attention to volume, either explicitly or via misaligned incentives that caused employees to reason they needed to book business at any cost. Berkshire thought it better to incur a slightly higher expense ratio now rather than a much worse loss ratio in the future. This overall approach focused attention solely on long-term profitability.

GEICO had an outstanding year in 1986, and because Berkshire had a 41% ownership interest in the insurer, it shared in its success. Berkshire's share of GEICO's premiums in 1986 was over $500 million, almost equal to Berkshire's primary insurers combined. GEICO's rock-bottom operating costs created a moat protecting it against competitors and Buffett loved moats. He called what GEICO had built a "valuable and much-sought-after business castle" and said GEICO's book of business was "one of the best in the world of insurance, far better indeed than Berkshire's own book."

GEICO wrote 16% more volume in 1986 than the year before. Better yet, it did so at a 96.9 combined ratio. [199] All the while it was repurchasing its own shares, ending 1986 with 5.5% fewer shares than the beginning of the year. The 6,850,000 shares Berkshire carried on its books at a cost of $45.7 million had a market value at year-end 1986 of almost $675 million.

But excellent economics driven by low-cost operations was not GEICO's only advantage. GEICO had another asset worthy of Buffett's praise in GEICO Vice Chairman Lou Simpson, the individual responsible for its investments. Simpson had an investment track record that rivaled Buffett's. Buffett even joked that it was only because of his controlling interest in Berkshire that he was comfortable sharing Simpson's record in his Chairman's letter.

Investments

At year-end 1986 Berkshire boasted a $1.87 billion common stock portfolio and a bond portfolio of $1.27 billion largely held within the Insurance

Group. [200] Consistent with its owner-mindset, Berkshire continued to maintain a highly concentrated common stock portfolio:

Table 5.11: Berkshire Hathaway common stock portfolio, select detail

($ thousands)	1986	*% of total*	1985	*% of total*
Affiliated Publications			$55,710	*4.6%*
American Broadcasting Companies, Inc.			108,997	*9.1%*
Beatrice Companies, Inc.			108,142	*9.0%*
Capital Cities/ABC, Inc.	$801,694	*42.8%*		
GEICO Corporation	674,725	*36.0%*	595,950	*49.7%*
Handy & Harmon	46,989	*2.5%*	43,718	*3.6%*
Lear Siegler, Inc.	44,587	*2.4%*		
Time, Inc.			52,669	*4.4%*
Washington Post Company- Class B	269,531	*14.4%*	205,172	*17.1%*
All others	36,507	*1.9%*	27,963	*2.3%*
Total common stocks	$1,874,033	*100.0%*	$1,198,321	*100.0%*
Reporting threshold	$25,000		$25,000	

Note: Totals may not add due to rounding.

Sources: Berkshire Hathaway Chairman letters 1985, 1986.

Buffett told shareholders that he viewed Berkshire's three largest investments as permanent holdings and that he would probably not sell them even if they were to become overvalued. He thought a "'til-death-do-us-part policy" would set the right tone and allow the managers of those companies to operate without the fear of a large change in ownership. Buffett was communicating his long-term ownership philosophy outside of Berkshire's wholly-owned subsidiaries to those of its major investees, and it was done in self-interest. [201]

The bond portfolio exhibited similar concentration. The Washington Public Power Supply System (WPPSS) Projects 1, 2, and 3 bonds were valued at $310 million, or 24% of the bond portfolio. From these Berkshire received $31.7 million in annual tax-exempt interest. In 1986, Berkshire purchased an additional $700 million of tax-exempt bonds with maturities ranging from eight to twelve years. But these purchases were made not so much for their superior investment potential as the most palatable of options available. Buffett liked the prospects of neither stocks nor bonds in 1986,

but Berkshire had to hold marketable securities of some kind in its insurance companies and invest them. (He even called the bonds “mediocre investments” and “least objectionable.”) Of the $118 million of interest and dividend income earned in 1986, nearly $72 million was from issues exempt from federal tax.

NHP, Inc.

Buffett chose to highlight NHP, Inc., one of the smaller equity investments that did not make the cut for the table in the Chairman’s letter. At year-end, Berkshire had a $23.7 million stake in NHP, representing 45% of the company. Highlighting this small investment showed his penchant for storytelling, as well as the relative dearth of great investment ideas at that time. NHP was an unusual corporation formed to develop and manage affordable housing for low- and moderate-income tenants. It was the product of a political creation, and as such law required that one of its subsidiaries have three directors appointed by the president of the United States and confirmed by the Senate. At the time of Berkshire’s investment, NHP managed around 500 properties in forty states, the District of Columbia, and Puerto Rico, or 80,000 total housing units. NHP was owned by Berkshire, Weyerhauser (22% stake) and a group led by NHP’s CEO, Ron Heller, in addition to about sixty major corporations with interests no greater than 2%.

Taxation

On October 22, 1986, President Reagan signed into law The Tax Reform Act of 1986. This law significantly altered the US tax code. There were positives and negatives, but the net effect for Berkshire was negative:

- For owners of Berkshire stock wishing to sell (and assuming business value tracked Berkshire’s intrinsic value with corresponding increases in share price), the new 28% capital gain rate would leave fewer net proceeds than the old 20% rate.
- Corporate capital gains tax rates increased from 28% to 34%, effective in 1987. Importantly, GAAP reporting still used the old 28% rate at present, meaning $73 million would disappear from Berkshire’s net worth when the financial accounting caught up with

the new tax changes.

- Dividend and interest income received by insurance companies would be taxed at a higher effective rate, a significant negative. Previously only 15% of dividends received from domestic corporations would be taxed; that proportion now increased to 20%. Additionally, for property/casualty insurance companies, the remaining 80% would be taxed at 15%. Finally, interest on bonds purchased by property/casualty companies after August 7, 1986 would be only 85% tax-exempt.

There were also a few positives:

- The tax rate on corporate ordinary income was going down from 46% to 34%, a net positive for Berkshire and most of its investees.
- A fresh start provision offset some of the negatives affecting insurance. This provision effectively gave Berkshire a double deduction as a one-time benefit by offsetting changes in loss reserve deductions for tax purposes.

The tax law affected property/casualty insurers acutely, and Buffett estimated it would reduce the earning power of Berkshire’s Insurance Group by at least 10%. Because many insurers had different tax situations (due to prior loss carry forwards, or because they were part of other companies), each would respond to the changes differently.

The law also affected Berkshire’s non-insurance companies in other ways. Buffett posed the question: What really happens when tax rates change? That is, do corporations pass along the increases or decreases to consumers via prices, or are they absorbed by the corporation with corresponding increases or decreases in profitability? Buffett said the answer depended on the type of business. He laid out three:

1. A utility-type organization: Would largely be required by regulators to pass along any changes.
2. Price-competitive businesses: Though not publicly regulated, the free market caused prices to adjust in response to tax changes.
3. Unregulated businesses with strong franchises (or moats) protecting

them: In these cases, such as with See's, *The Buffalo News* , and many of Berkshire's other investees (owned in whole or in part), pricing power shielded the businesses from market-driven price adjustments.

The 1986 Tax Act also repealed the General Utilities Doctrine. The Doctrine formerly protected owners from double taxation (once at the corporate level and again at the personal level) during corporate liquidations. It did not affect Berkshire directly since Berkshire was long past the point of considering liquidating, but it would impact other companies such as oil and gas, some media companies, and real estate businesses, where the operating economics were meaningfully altered because of the change. This meant prospective investments must be evaluated more carefully.

Miscellaneous

Jokingly starting this next section with a tiny-sized font, Buffett informed shareholders that Berkshire bought a corporate jet in 1986. Falling on his sword and admitting he changed his mind on what he had previously bemoaned as an unnecessary luxury, he said he experienced a counter-revelation. The jet made travel a lot easier, but costlier. Buffett did note he bought the jet used, as depreciation affects planes and cars proportionally. Later dubbed "The Indefensible", Buffett was perhaps eased into such a purchase by the fact that Scott Fetzer owned a plane. [202]

Owner Earnings

Buffett excused shareholders from reading his accounting update if they so chose, removing it to an appendix to his Chairman's letter. Entitled, Purchase-Price Accounting Adjustments and the "Cash Flow" Fallacy, it used Scott Fetzer's before-and-after financial statements (prior to and after Berkshire's purchase) to illustrate his concept of owner earnings. Under two columns labeled O (old) and N (new), he asked the hypothetical question: which company was worth more? O showing higher earnings, or N showing lower earnings. The answer, of course, was that they were the same Scott Fetzer, only manipulated for accounting changes required due to Berkshire having purchased it.

The figures for Scott Fetzer are unimportant, but understanding the changes that occur when one company buys another illustrates how economics diverges from accounting. When an acquisition like this occurs, assets and liabilities are appraised at current market values. If inventory was carried on the books at a low price, it is marked up to what it would cost at the time of the acquisition. Similar revisions occur with real estate. Liabilities too, if they do not reflect current values, are revised (though they are often very accurate). If there is anything left over between the purchase price and the net asset value it is placed on the balance sheet as goodwill.

The net effect of these accounting revisions is often higher-valued assets. This affects future accounting in three ways:

1. Higher-cost inventory means reported profits are lower.
2. Higher-valued real estate (except land, which is not depreciated) causes higher depreciation expense.
3. Goodwill amortization (at the time it was amortized for both tax and GAAP purposes) is expensed and lowers profits.

The net effect is a new company on paper with greater assets and lower earnings. To an owner, however, the cash flows and intrinsic values were identical. The economics are the same; only the accounting changed.

Buffett’s owner earnings formula was simple and intuitive:

Owner earnings = Reported earnings + depreciation, depletion, amortization, and any other non-cash charges – any capitalized expenditures and related working capital needs required to maintain unit volume.

As could be seen in the Scott Fetzer example, earnings charges for amortization created simply by adding and then expensing a new goodwill asset were not real business expenses. But depreciation, and the deduction for capital expenditures were very real. Buffett bemoaned the use of the newly trendy cash flow or EBITDA (earnings before interest, taxes, depreciation, and amortization) figures being used by Wall Street, since they improperly (and intentionally) omitted capital spending in an attempt to justify certain transactions. Buffett later lamented this accounting mechanism. In 1989, he said it would "induce lenders to finance even sillier transactions" and called it a "sawed off yardstick" as it was delusional and ignored depreciation. [203]

Thus 1986 ended with a Berkshire Hathaway sticking—quite profitably it might be added—with sound business principles, logic, and patience.

1987

With the benefit of hindsight, we can view the 1987 results through a different lens. Included at the end of the 1988 Annual Report were separate unaudited financial statements that distinguished between Berkshire's main operating activities and included a comparison to 1987. This breakdown better informed shareholders of the economic characteristics of each business line and more fully told the story of Berkshire's $464 million or 19.5% increase in book value during the year.

The first of these categories was the Insurance Group, Berkshire's primary economic engine, which held the majority of its assets (including most of its marketable securities portfolio), liabilities, and equity. Next was the Manufacturing, Publishing, and Retailing Businesses, which aggregated such operating subsidiaries as *The Buffalo News* , Nebraska Furniture Mart, See's Candies, Fechheimer, Precision Steel, and the many Scott Fetzer subsidiary businesses. The Finance-Type Businesses category included Wesco's Mutual Savings and Loan, as well as the Scott Fetzer Financial Group. Lastly, the Non-Operating Activities segment held everything that did not fit into the other categories, including general corporate overhead for Berkshire headquarters and parent-company debt. Importantly, the Non-Operating Activities segment also included goodwill and property account adjustments, and their related amortization, which were separated from the business acquisitions that created them. GAAP accounting conventions

included such amortization with each business, which obscured the underlying business results.

Insurance Group

Looking at the Insurance Group it is quickly apparent that its twelve individual subsidiaries constituted the bulk of Berkshire Hathaway's operating activities. Even after the Scott Fetzer acquisition in 1986, which added a host of operating businesses (and very good ones at that), Berkshire Hathaway was still primarily an insurance company. The Insurance Group accounted for 77% of Berkshire's year-end 1987 consolidated assets and a full 84% of its equity.

Table 5.12: Insurance Group, select information

($ millions)	1987 Amount	1987 %	1986 Amount	1986 %
Primary Group				
Premiums written	$412.7		$594.6	
Premiums earned	441.6	100.0%	463.1	100.0%
Losses and loss expenses	338.6	76.7%	347.5	75.0%
Underwriting expenses	105.8	24.0%	112.1	24.2%
Total losses and expenses	444.4	100.6%	459.6	99.2%
Underwriting gain/(loss) - pre-tax	(2.7)		3.5	
Unfavorable (favorable) loss development included in losses and loss expenses	*(9.4)*	*(2.1%)*	*16.0*	*3.5%*
Statutory combined ratio		102.3%		93.9%
Reinsurance Group				
Premiums written	$328.0		$398.4	
Premiums earned	372.8	100.0%	344.4	100.0%
Losses and loss expenses	287.6	77.2%	282.6	82.0%
Underwriting expenses	112.9	30.3%	111.2	32.3%
Total losses and expenses	400.5	107.4%	393.7	114.3%
Underwriting gain/(loss) - pre-tax	(27.7)		(49.4)	
Unfavorable (favorable) loss development included in losses and loss expenses	*4.5*	*1.2%*	*21.0*	*6.1%*
Statutory combined ratio		111.6%		110.0%
Structured settlements and portfolio reinsurance				
Underwriting gain/(loss) - pre-tax	(25.0)		(10.0)	
Total Insurance Group underwriting gain/(loss) pre-tax	**($55.4)**		**($55.8)**	
Insurance Group overall statutory combined ratio		109.3%		101.8%

Notes:

1. Totals may not add due to rounding.

2. The loss and expense ratios are shown as they were reported in the Annual Reports, which is on a GAAP basis. The GAAP basis ratios are calculated with underwriting expenses divided by earned premiums. This contrasts to the statutory basis calculation, where the ratio uses written premiums. In both the GAAP and statutory calculations, losses and loss adjustment expenses are divided by earned premiums.

Sources: Berkshire Hathaway Annual Report 1987 and author's calculations.

The 1987 insurance underwriting results looked very similar to the prior year with a pre-tax underwriting loss of $55.4 million compared to $55.8 million in 1986. But important differences existed beneath the surface. Written premiums, which are assigned to the year in which they are written but earned over time, fell by 25%. Earned premiums, because of the

aforementioned lag relating to when premiums are actually earned, were essentially flat. Berkshire's combined ratio [204] increased slightly from 103% to 105%. This was very similar to the industry overall, but Berkshire's business model meant it generated more float.

In fact, Berkshire's average float in 1987 increased from $800 million to $1.3 billion. Importantly, it cost just 4.4% compared to government bonds that yielded 9%. [205] Higher float directly contributed to the $153 million pre-tax net investment income in 1987, a $45 million increase.

There were also important differences within each insurance segment. The Primary Group, which wrote policies directly to those incurring the insured risks, wrote to a combined ratio of 102.3%, compared to 93.9% the year before. The results for 1987 were slightly worse than it seemed, however, when we consider that the $2.7 million pre-tax underwriting loss was after $9.4 million of favorable loss development. Although a positive factor in itself, the inclusion of favorable loss development meant that business written in 1987 was technically not as profitable as the headline 102.3% might suggest, though its true profitability would take time to pan out.

The 1987 results for Berkshire's Reinsurance Group, which through that time excluded structured settlements and portfolio reinsurance, were markedly improved. Coming down from a high of 194% in 1985 the combined ratio for the segment registered at 112% in 1987. This nearly halved the pre-tax underwriting loss compared to the year before and included just 1.2 percentage points of unfavorable loss development.

The last category of the Insurance Group, which would be combined with the reinsurance segment beginning in 1990, was structured settlements and portfolio reinsurance. These activities, while strictly insurance, were more akin to incurring debt with a roughly known coupon rate. These activities contributed $25 million to the pre-tax underwriting loss from insurance in 1987. While we cannot know for sure, we must assume the area was a profitable one for Berkshire because it remained in the business.

Given the improving underwriting and increased float and related investment income, the Insurance Group could have been considered on the upswing. Quick to temper expectations, Buffett told shareholders "the party is over." Looking forward, Buffett saw the mediocre 8.7% increase in industry written premiums as inadequate to cover his estimate of the minimum of 10% year-over-year volume increases required to cover the

ever-increasing costs of social inflation. Breaking 1987 down into quarterly figures, Best's (an industry publication), showed year-over-year volume increases for the industry falling to below 6% in the second half of 1987. Industry capacity, lured by improving profitability, was already sowing the seeds of its own demise.

Berkshire had seen this story play out before and had been warning shareholders of its arrival for several years. Opportunity and ease of entry led to increased premium volume, but not long-term financial gain. Buffett was a long-term pessimist for the industry overall but a long-term optimist for Berkshire's insurance operations. In doing so, he reminded shareholders of Benjamin Disraeli's observation: "What we learn from history is that we do not learn from history."

Berkshire, though, was different and could rise above the pack in two ways. First, through capital strength. Though buyers of coverage in short-tail lines such as auto or homeowners would not pay much attention to Berkshire's balance sheet, those buying long term or larger insurance protection would understandably care more deeply about its counterparty's ability to pay when times got tough. [206] This financial flexibility also gave Berkshire the ability to invest in assets that carried expectations of higher returns over the long run. It could hold higher concentrations of stocks compared to bonds, or even own whole businesses within the insurance companies. The tight capital ratios maintained by other insurers sometimes prevented them from holding higher levels of stocks or illiquid investments.

The second factor providing Berkshire an edge over its competition was its total indifference to volume. Because of its financial flexibility and the industry's characteristic of ease of entry, Berkshire could stand by until industry conditions were favorable. Buffett had seen the ill effects of other companies focused on volume over profitability and instituted a culture focused on profitability above all else. As discussed in the segment on 1986, he even maintained a policy of no layoffs to ensure managers and employees would not be tempted to make decisions based on short-term gains.

Manufacturing, Publishing, and Retailing

Berkshire's small but growing non-insurance operating business segment represented 8% of its total consolidated assets and 6% of its equity.

Berkshire would not formalize the category until the 1988 Annual Report, however the Chairman's letter for 1987 included clues to its formalization as a separate business unit, at least in Buffett and Munger's minds.

Buffett dubbed the largest of these non-insurance businesses the "Sainted Seven." They included: *The Buffalo News* , Fechheimer, Kirby, Nebraska Furniture Mart, Scott Fetzer Manufacturing Group, See's Candies, and World Book. They were excellent businesses with excellent leaders. Human nature leads most business leaders to tell others that his/her managers are wonderful but Berkshire's operating managers truly deserved their high praise.

This group of "Sainted Seven" businesses earned $180 million before interest and taxes in 1987, and $178 million after $2 million of interest expense. [207] Though the tiny amount of interest expense was information enough to judge the businesses as conservatively financed, there is more to the story. Earnings had to be compared to the capital that was required to produce the earnings to fully assess the economic performance. As it was, this group required just $175 million, which put their after-tax return on equity capital at a mouth-watering 57%.

But that was not the whole story. The $175 million figure was the historical cost basis of those companies' capital, an important distinction. Because Berkshire paid a premium to acquire them, the accounting required adjustments to certain accounts and the addition of goodwill. These were not insignificant: Berkshire paid approximately $222 million more than that $175 million. Buffett thought that the operating managers should not be judged on the higher figure, since his agreeing to pay a higher price than the underlying capital didn't magically give those managers additional capital to employ. Having paid that premium, Buffett could rightly be judged by the lower 25% after-tax return.

The first-class problem that came with owning such wonderful businesses was that of reinvestment. The businesses earned high returns on capital but could not profitably reinvest much more capital at such high rates, though they tried. As a result, excess cash was usually sent to Omaha to find the best use for it. Buffett and Munger could reinvest it in other subsidiaries with growth potential (the Insurance Group was a recipient of numerous capital injections over the years), purchase other operating businesses, or buy marketable securities. The important thing was that the operating

managers had a relief-valve for excess capital that mitigated making subpar investment decisions, and they were incented to grow only if that growth was profitable.

The 1987 Chairman's letter gave a quick update on each of the major operating units within the Manufacturing, Publishing, and Retailing segment. Buffett noted that his brevity was not a lack of recognition for good work, but that much had already been said in the past, and little had changed. As he wrote, "Experience … indicates that the best business returns are usually achieved by companies that are doing something quite similar today to what they were doing five or ten years ago." Buffett therefore kept his updates brief:

- Nebraska Furniture Mart was humming along nicely, with sales at its one store up 8% to $143 million.
- *The Buffalo News* continued to dominate its market and maintain high penetration rates, driven by local reporting. Its commitment to a 50% news hole would remain unchanged even if margins declined and profits fell, which they were expected to do given skyrocketing newsprint costs.
- Fechheimer, with three generations consistently driving the simple uniform business, increased profits to a record $13.3 million pre-tax.
- See's sold a record 25 million pounds of candy and had flat same-store sales. Flat same-store sales was praiseworthy compared to six years of declines amid ever-shrinking consumption by consumers.
- Scott Fetzer increased pre-tax earnings by 10%, all the while decreasing average capital employed.

Clearly these businesses and their managers deserved the loud informed applause Buffett gave.

Finance-Type Businesses

The two businesses making up this segment in 1987 were Wesco's Mutual Savings and Loan, and Scott Fetzer Financial Group (part of Scott Fetzer). The latter was a separate operating subsidiary under the Scott Fetzer umbrella setup to finance consumer purchases of such products as World

Book and Kirby. While Mutual Savings was in fact a bank, Scott Fetzer Financial Group operated as one. Both were highly leveraged as measured by an assets-to-equity ratio. However, unlike Mutual Savings, which primarily used savings accounts and other deposits to fund itself, Scott Fetzer Financial financed its assets wit h term debt.

Viewing this segment as a bank we can observe that at year-end 1987 it had equity amounting to 15.5% of its total assets. This was akin to a bank's capital ratio, and at that level would be considered well-capitalized. Another standard metric by which banks are measured is return on average assets, which measures operating performance. An estimate [208] of the 1986 return on assets for Berkshire's Finance-Type Businesses of 2.6% would have ranked it among the very best banks.

Non-Operating Activities

The Non-Operating Activities segment was the proverbial kitchen sink. It held accounts including acquisition-created property adjustment and goodwill. These two items alone totaled about $210 million and accounted for almost 60% of the assets reported in the segment. The income statement of the segment suffered from the related amortization charges. While the segment did hold some real assets, such as cash and marketable securities, it was clear the breakout was meant more as a cleanup to reconcile to the GAAP financials rather than to provide substantive analytical value. [209]

Investments

Primarily held within the Insurance Group, Berkshire's marketable securities were viewed as a separate entity from underwriting activities. The latter were managed by the various operating managers, while the former was entirely under the direction of the chairman and vice chairman. Buffett's evolving attitude toward owning great businesses for the long term started to show when he elevated several equity investments to the level of a permanent operating-company status. To be sure, they were subject to sale if the Insurance Group needed the funds to pay claims. However, he thought of three of Berkshire's partial ownership positions as essentially no different than wholly-owned ones. Buffett summed it up succinctly: "Eventually our economic fate will be determined by the economic fate of the business we own, whether our ownership is partial or total."

These three permanent holdings were the relatively recently acquired 3,000,000 shares of Capital Cities/ABC, Inc., the 6,850,000 shares of GEICO, and the 1,727,765 shares of The Washington Post Company. Together they had a market value of over $2.1 billion at year-end 1987 and represented most of the $2.3 billion total equity portfolio.

The attitude of permanence for the select few marketable securities investments could not overcome two distinct advantages a wholly-owned business afforded Berkshire. One was capital allocation. Though it seldom did in practice, Berkshire could direct the operating subsidiaries as it saw fit, including reallocating excess capital elsewhere. The second advantage of control was taxes. Berkshire could reallocate capital within and across subsidiaries without any tax consequences. With investments below an 80% ownership position, such as in the case of its marketable securities portfolio, Berkshire was subject to double taxation of dividends and a higher capital gains rate.

If the three permanent holdings of common stock Berkshire held at the end of 1987 were de facto operating subsidiaries, then that left the $222 million other equities as everything else. To place over 44% in one company (Cap Cities/ABC), and over 90% in its top three holdings reflected a significant degree of concentration by Wall Street standards. But it also reflected the paucity of investment opportunities available at that time. Some of that $222 million remainder was invested in short-term arbitrage positions (taking advantage of short-term pricing differentials, usually upon an announced merger or acquisition), but otherwise Buffett found stocks unattractive. The October 19, 1987, Black Monday crash that led stocks to tumble over 22% was dramatic, to be sure. It was one of the worst stock market crashes in the history of Wall Street. But the quick rebound and already-high levels of the market still left the index up 2.3% for the year and Berkshire unable to find a bargain.

The fixed maturity portfolio (read: bonds) was no different. Considering the possibility of inflation and the United States' enormous trade deficit, Buffett wrote that he and Berkshire would "continue to have an aversion to long-term bonds," and even posed the possibility that medium-term bonds would be similarly disadvantaged. Instead, like the equity portfolio, Berkshire concentrated its $2 billion [210] bond portfolio. A full $240 million

of that was the Washington Public Power Supply System (WPPSS) tax-exempt bonds.

Almost 35% of the fixed maturity portfolio [211] was comprised of the carrying value of a new investment in Salomon, Inc. The 9% convertible preferred stock investment worth $700 million received much fanfare from the business press. [212] Though the investment into one of Wall Street's leading investment banks would later haunt him, at the time Buffett viewed it as a medium-term fixed-income investment with an "interesting conversion possibility." (The issue was convertible after three years into Salomon common stock at $38 per share.) Another large part of the fixed maturity portfolio was $104 million of Texaco bonds. The short-maturity bonds were purchased after Texaco had filed for bankruptcy. Owing to the Insurance Group's strong capital position, Berkshire was able to make the investment into the significantly marked down bonds where another insurer could not.

Wesco, K&W and Harry Bottle

Included as a regular part of the Berkshire report was Charlie Munger's Wesco Chairman's letter. In it, he continued to urge Wesco (and Berkshire) shareholders not to think of Wesco as a miniature Berkshire Hathaway. Its Mutual Savings subsidiary was mediocre, Munger wrote, because of tough industry conditions. These conditions stemmed from less-well-behaved participants using the government's credit to attract deposits and then turn around and lend them in a risky manner. A $1.9 million after-tax charge Mutual Savings took in 1987 to write off prepayments of its deposit insurance premiums (presumably now economically worthless) reflected Munger's pessimism. Mutual Savings did have some bright spots in its well-located headquarters building and its 31 building lots under development. All in all, Munger thought Mutual Savings could average 10% per year on the after-tax proceeds which could be realized from its liquidation. [213]

Moving to Wesco's better operating subsidiaries, Munger described the 100-year flood that hit Precision Steel that year. Actual flood damage caused a $672,000 loss after a severe rainstorm in August 1987. Munger was a frequent critic of aggressive accounting, including of managers who

repeatedly excluded such one-time items from earnings discussions. But he had no hesitation excluding this one-off mishap from a natural disaster.

Wesco-Financial, Wesco's newly formed insurance subsidiary, received another $45 million from the parent entity to take advantage of the Fireman's Fund's increasing volume. In 1987, premiums earned by Wes-FIC amounted to over $73 million and afforded Wesco with use of the related float.

In more good news, a $9 million venture capital-type investment in a resuscitated Bowery Savings Bank was sold for an after-tax gain of $5 million after a friendly takeover. The risk-reward bet [214] had paid off handsomely. Some investors in the project are now-familiar names: the Tisch family, the family behind the Loews Corporation, and Richard Rosenthal, a former Salomon partner who died in a tragic plane crash that year. [215]

A final anecdote completed Buffett's 1987 Chairman's letter. He wrote of the déjà vu experience of working with Harry Bottle. Bottle earned his reputation with Buffett when he quickly turned around an investment Buffett Partnership Limited had in Beatrice, Nebraska-based Dempster Mill in 1962. Twenty-four years later Munger tapped Bottle to turnaround Wesco's K&W Products subsidiary. The small automotive compound manufacturer struggled under its previous CEO, who lost focus. Munger "made him CEO, and sat back to await the inevitable," wrote Buffett. Very soon Bottle had cut receivables and inventories by 20% while growing profits more than 300%. Bottle clearly deserved his reputation for turnarounds, which left Buffett to muse that he'd be first on the list to call if another situation arose. For now, though, Berkshire and its subsidiaries were in good shape.

1988

The resiliency of the Berkshire Hathaway model under the leadership of Warren Buffett and Charlie Munger shone through in 1988. While Berkshire found a couple of new investment opportunities that year, the investment climate was largely against them. Nonetheless, Berkshire's momentum carried it forward to a 20.0% gain in book value. That was due to past capital allocation decisions and the dedication and ongoing

commitment of Berkshire's managers and employees. The compounded annual rate of return for the twenty-four years under Buffett's leadership was 23.0%—a doubling almost every three years.

Repeating the past record would be very difficult, if not impossible. The major problem Berkshire faced was its past success. Such high rates of historical return had grown shareholders' equity from a mere $22 million in 1964 to over $3.4 billion in 1988. Even just 15% growth would necessitate earning $10.3 billion over the ensuing decade. Berkshire had great businesses, such as the "Sainted Seven" non-insurance operating subsidiaries (*The Buffalo News* , Fechheimer, Kirby, Nebraska Furniture Mart, Scott Fetzer Manufacturing Group, See's, and World Book), but these could only do so much.

Berkshire faced other strong headwinds. The stock market had become more fully-priced and was thus less attractive. In a similar vein, plentiful credit drove up prices of entire businesses and corporate tax rates were less favorable than the past due to a series of tax overhauls starting in 1986. Finally, Berkshire's permanent investments (its significant ownership interests in Capital Cities/ABC, GEICO, and *The Washington Post*) faced more difficult industry operating conditions.

Accounting Changes

Major changes to Generally Accepted Accounting Principles (GAAP) mandated the full consolidation of subsidiaries on Berkshire's balance sheet and income statements in 1988. Mutual Savings and Scott Fetzer Financial (the entity that provided financing to World Book and Kirby customers) had been included on an equity basis. The results were condensed into net profit and equity, and Berkshire's ownership interest in each was included on the income statement and balance sheets, respectively. Now everything would be broken out, with appropriate minority interests deducted in separate line items. This was not unlike the treatment for many of Berkshire's other operating subsidiaries, such as the 84%-owned Fechheimer, or the 90%-owned Nebraska Furniture Mart. The change would affect the comparative periods in Berkshire's 1988 financial statements, but not the economic reality.

Possibly due to the above-mentioned accounting changes, Berkshire presented a supplement in the Annual Report beginning in 1988. It broke

down its business lines into groupings more closely aligned with economic reality:

- Insurance Group
- Manufacturing, Publishing, and Retailing businesses
- Finance-Type Businesses (Mutual Savings and Scott Fetzer Financial)
- Non-Operating Activities

Buffett had long said that Berkshire's consolidated parent-level financial statements were of little analytical value to shareholders. For this reason, he presented significant detail in the Chairman's letters for each segment to aid shareholders' analysis of Berkshire. Buffett said the number and diversity of Berkshire's subsidiaries made this segmented data essential to answer three key questions:

1. How much is the company worth?
2. Is the company likely to meet its future obligations?
3. How well are managers doing with the hand they are dealt?

These were the questions Buffett asked, and he believed shareholders would also want answers. The supplemental data aided analysis without overloading shareholders with details. Buffett and Munger had always had easy access to this data. Putting themselves in shareholders' shoes (something they did often), they realized shareholders would also want this information.

Sources of Reported Earnings

From the summary table provided in the Chairman's letter (refer to Table 5.2) it was quickly apparent that 1988 was a highly satisfactory year for Berkshire. The Insurance Group, which we will analyze later, posted improved underwriting and net investment income also increased noticeably. Most non-insurance businesses performed very well in 1988.

Manufacturing, Publishing, and Retailing

The overall results for the Manufacturing, Publishing, and Retailing Segment were a $202.3 million pre-tax profit which translated into $121.7 million of after-tax earnings for Berkshire. Pre-tax return on tangible capital was an astounding 89.2%. The group generated a 107.2% and 66.8% pre- and after-tax return on average tangible equity, [216] respectively, while employing just 18% leverage from borrowed funds.

Led by the still-hard-charging 95-year old Rose Blumkin, Nebraska Furniture Mart turned in even higher profits of $18 million pre-tax (up 10%). The store had just opened a detached 20,000 square foot Clearance Center to continue to provide rock-bottom prices to customers. Dillard's, a large, nationwide department store, entered the Omaha market that year without its customary furniture department. This was a testament to the power Nebraska Furniture Mart had in Omaha. Buffett relayed comments that went further. Paying Nebraska Furniture Mart and the Blumkin's a high honor, Chairman William Dillard said, "We don't want to compete with them. We think they are about the best there is." High praise indeed.

The Buffalo News , led by Stan Lipsey, delivered a record pre-tax profit of $42.2 million (up 8%), all while continuing to provide readers with an above-average 50% news hole. The expected decline in operating margins hadn't occurred. Chuck Huggins led See's to sell a record 25.1 million pounds (increasing pre-tax profits 2% to $33 million) against a backdrop of tough industry conditions. More impressive, a full 90% of the candy company's profits were earned in the month of December.

At Fechheimer, the uniform manufacturer, Buffett displayed his trust in the Heldman family by allowing them to make "a fairly good-sized acquisition" that year without either Buffett or Munger's permission. Their trust was well-earned and the Heldman's delivered, with pre-tax profits improving 6% to $14 million in 1988. Buffett heaped much praise on Ralph Schey at Scott Fetzer. In addition to operating Scott Fetzer's nineteen subsidiaries, Schey was on the boards of many non-profit institutions in the Ohio region. Though the Scott Fetzer Manufacturing Group (everything other than World Book, Kirby, and the Scott Fetzer finance businesses) saw pre-tax earnings decline 7% to $29 million, Scott Fetzer's two largest subsidiaries (broken out separately) did well. World Book improved pre-tax earnings by 8% to $28 million and Kirby improved them by 20% to $27 million.

Insurance

A.M Best estimated written premiums for the insurance industry grew just 3.9% in 1988. This was below the 10% threshold Buffett estimated it needed to maintain profitability amid social and general inflation. As a result, the industry's combined ratio ticked up from 104.6% to 105.4%, and Buffett estimated it would get worse considering insurance industry executives' tendency to under reserve.

Public anger over insurance rates made an already-challenging industry even more challenging. The commodity-type business economics of insurance made it difficult to raise prices and resulted in poor results. A new California law compounded these challenges. Proposition 103 required prior approval before insurance companies could issue rates. Soon after passing, it was suspended pending court review. Proposition 103 was the result of outraged consumers trying to keep down insurance costs. Though Berkshire typically walked away from subpar rates anyway, its major investee, GEICO, wrote about 10% of its business in California. More worrisome for GEICO, and perhaps for Berkshire overall, would be if other states saw similar ballot or legislative initiatives.

In another negative for Berkshire's insurance operations, its four-year 7% quota-share with Fireman's Fund expired in late 1989. As a result Berkshire would have to return an estimated $85 million of unearned premiums, reducing its float. The returned premiums would flow through the premiums written account as a negative figure but wasn't expected to significantly impact profits.

Table 5.13: Insurance Group, select information

($ millions)	1988 Amount	1988 %	1987 Amount	1987 %
Primary Group				
Premiums written	$218.8		$412.7	
Premiums earned	292.3	100.0%	441.6	100.0%
Losses and loss expenses	196.2	67.1%	338.6	76.7%
Underwriting expenses	78.7	26.9%	105.8	24.0%
Total losses and expenses	274.8	94.0%	444.4	100.6%
Underwriting gain/(loss) - pre-tax	17.5		(2.7)	
Unfavorable (favorable) loss development included in losses and loss expenses	*(29.1)*	*(10.0%)*	*(9.4)*	*(2.1%)*
Statutory combined ratio		103.1%		102.3%
Reinsurance Group				
Premiums written	$203.3		$328.0	
Premiums earned	229.3	100.0%	372.8	100.0%
Losses and loss expenses	170.5	74.3%	287.6	77.2%
Underwriting expenses	73.3	32.0%	112.9	30.3%
Total losses and expenses	243.8	106.3%	400.5	107.4%
Underwriting gain/(loss) - pre-tax	(14.5)		(27.7)	
Unfavorable (favorable) loss development included in losses and loss expenses	*0.0*	*0.0%*	*4.5*	*1.2%*
Statutory combined ratio		110.4%		111.6%
Structured settlements and portfolio reinsurance				
Underwriting gain/(loss) - pre-tax	(14.1)		(25.0)	
Total Insurance Group underwriting gain/(loss) pre-tax	**($11.1)**		**($55.4)**	
Insurance Group overall statutory combined ratio		107.4%		109.3%

Notes:

1. Totals may not add due to rounding.

2. The loss and expense ratios are shown as they were reported in the Annual Reports, which is on a GAAP basis. The GAAP basis ratios are calculated with underwriting expenses divided by earned premiums. This contrasts to the statutory basis calculation, where the ratio uses written premiums. In both the GAAP and statutory calculations, losses and loss adjustment expenses are divided by earned premiums.

Sources: Berkshire Hathaway Annual Reports 1987, 1988; and author's calculations.

Overall pre-tax underwriting losses shrunk 80% from $55 million in 1987 to just $11 million in 1988. The Primary Group, where premiums written and earned fell 47% and 34% respectively, nonetheless turned in a combined ratio of 103.1%. The 1988 result benefited from $29.1 million of favorable loss development, the second year in a row that occurred.

Within the Reinsurance Group, premiums were similarly off by 38% both on a written and earned basis. The segment's combined ratio of 110.4% was another improvement over prior years and included no impact from loss development. Structured settlements, separated from reinsurance for the time being, contributed $14.1 million of pre-tax loss to the overall $11.1 million Insurance Group pre-tax loss.

Commenting on the significant decline in premium volume Buffett wrote, "So be it." Berkshire would continue to write business solely on profitability, results fall as they may. It would wait patiently, ready for the deluge of insurance business that would someday come its way. Berkshire's 1988 insurance experience of significantly reduced written and earned premiums combined with improved underwriting results and significantly higher investment income, made it, in the words of Nassim Taleb, anti-fragile. Berkshire positioned itself so that no matter what happened in the industry, it benefitted. When pricing made sense and volume was there, its capital base and AAA Standard and Poor's credit rating (the highest level possible) enabled it to write huge amounts of premiums; when rates were inadequate, it let business fall off and continued to benefit from previously sound underwriting practices and float.

Float grew from $1.46 billion in 1987 to $1.54 billion in 1988. This highlights the fact that growth in float is only partially dependent upon premium volume. Float can grow while premiums fall if premiums and incurred losses are held longer.

Finance-Type Businesses

The Finance-Type Businesses (Mutual Savings and Scott Fetzer Financial Group) did well in 1988. Largely due to the absence of the one-time Federal Savings and Loan Insurance Corporation write-offs, in addition to strong volume at World Book and Kirby, pre-tax profit rose 47% to $13.5 million. This translated into an after-tax return on equity of 13.4%. [217]

Investments

Buffett considered five investment categories Berkshire's Insurance Group could choose from: (1) long-term common stock commitments, (2) medium-term fixed income securities, (3) long-term fixed income, (4) short-term cash equivalents, and (5) short-term arbitrage. [218]

In 1988, Berkshire made two major commitments to the first option. One was The Coca-Cola Company and the other was Federal Home Loan Mortgage Corporation, better known as Freddie Mac. Coca-Cola cost $592 million for 14.2 million shares and Freddie Mac cost $72 million for 2.4 million shares of Preferred Stock. The latter was considered the "financial equivalent to a common stock" since it had a claim on residual earnings and so was included in the table. [219] It was also the maximum allowed by law, representing 4% of the company. The investment rationale was described by Munger in his letter to Wesco shareholders (the Freddie Mac shares were held at Wesco in the Mutual Savings subsidiary) and is discussed below.

Table 5.14: Berkshire Hathaway common stock portfolio, select detail

($ thousands)	1988
Capital Cities/ABC, Inc.	$1,086,750
The Coca-Cola Company	632,448
Federal Home Loan Mortgage Corp.[1]	121,200
GEICO Corporation	849,400
Washington Post Company - Class B	364,126
Reporting threshold	$100,000

Footnote:
1. Nominally a preferred stock, Buffett said it was financially equivalent to a common stock.

Note: Buffett's Chairman's letter only included select investments and did not inlcude a total. I have elected not to take data from the footnotes of the Annual Report since Buffett's classifications historically differed slightly from GAAP reporting.

Source: Berkshire Hathaway Chairman's letter 1988.

The Coca-Cola investment was another permanent holding, though Buffett did not say so. He only hinted at it. (Berkshire was feverishly buying all the shares of Coke it could get. Buying continued into 1989.) Given the backdrop of an expensive stock market, finding Coca-Cola at an attractive valuation suggested the market did not yet fully appreciate its excellent business attributes. Those attributes included a basic business selling syrup to bottlers who turned around and sold it to consumers. [220] Population growth coupled with increasing per capita incomes meant Coke had a long runway. Coke's unmatched distribution system put its products in front of consumers worldwide, and those consumers increasingly guzzled the company's products. Coca-Cola was like See's in its high margins and low capital requirements.

Perhaps most importantly, Coca-Cola had an attribute See's lacked: reinvestment opportunities. Growth at high incremental rates of return meant Berkshire's seemingly-low going-in return (or said another way the high price) would quickly become more favorable. In hindsight Berkshire's purchase of Coca-Cola looked like a bargain. Coca-Cola was one of "only a handful of businesses about which we have strong long-term convictions," Buffett said, adding that its management had both integrity and ability and loved the business. This praise was akin to that of Berkshire's permanent holdings of Capital Cities/ABC, GEICO, and *The Washington Post* .

Table 5.15: Coca Cola Company, key data and analysis

	1988	1987	1986	1985	1984
Revenues *($ millions)*	$8,338	$7,658	$6,977	$5,879	$5,442
Revenues/average capital	$1.43	$1.33	$1.46	$1.42	$1.45
EBIT margin	19%	17%	13%	14%	16%
Return on capital - pre-tax	27%	23%	19%	19%	23%
Return on equity	33%	28%	29%	25%	22%
Berkshire's purchase multiple	5.43x				
Berkshire's going-in return	6.1%				

Sources: The Coca-Cola Company Annual Report 1988 and author's calculations.

Berkshire also chose investment option number five: arbitrage. Berkshire's $282 million RJR Nabisco investment was an arbitrage commitment. [221] The commitment, which had a market value of $305 million at year-end 1988, and which was eliminated shortly thereafter at the beginning of 1989 at a "better-than-expected" profit of $64 million, came about after an announced tender offer from the takeover specialist Kohlberg, Kravis, Roberts & Co. The takeover company had a long history of completing its deals and Buffett admired its managers. Buffett would have liked to purchase more RJR Nabisco stock, but Salomon was involved in the transaction and Buffett and Munger were on its board. Thus their "directorships cost Berkshire significant money." Salomon would also soon cost Buffett much time, headache, and even risk to his well-earned reputation.

Wesco

Buffett's 1988 Chairman's letter urged shareholders to read Charlie Munger's Wesco letter, which he said contained "the best description of the events that produced the present savings-and-loan crisis." The unfolding crisis centered on the savings and loan or thrift industry. Thrifts were simple banks designed to take in customers' deposits and re-loan them out as safe consumer loans such as home mortgages and car loans. They were *supposed* to provide the basic function of moving excess money from savers to qualified borrowers. As a result, they were given special government-mandated privileges to conduct business. Abuses of these privileges led to the downfall of the system.

A history buff, Munger excitedly described the story of the Federal Savings Loan Insurance Company. The FSLIC operated much like the Federal Deposit Insurance Company (FDIC). Wesco's Mutual Savings and other such banks paid premiums to the FSLIC to insure depositors against losing their deposits if banking institutions failed. Thrifts were supposed to run on boring business models, such as keeping a required 60% of assets in housing-related loans or securities. To help the thrifts carry on their business and attract deposits to fund their loans, legislation gave them a 0.25% advantage over traditional banks (in other words, they could pay a higher rate of interest on savings accounts). Unchecked interest rate competition between all types of banks had been allowed before the Great Depression but was stopped afterward as lawmakers thought it had allowed insolvent banks to attract capital.

Despite this funding advantage, the thrifts still faced the built-in risk that interest rates would rise sharply and cause fixed-rate assets to yield less than the bank's variable-rate funding sources. Under Louis Vincenti and then Charlie Munger's leadership, Mutual Savings had seen this risk and sought to avoid it. Others attempted to grow their way out through ever-increasing amounts of loans funded by ever-increasing deposits. When their balance sheets became stretched, meaning assets grew faster than equity and the ratio of equity to assets fell, they petitioned and received legislation to decrease required equity levels.

Much changed during the 1980s that caused trouble for thrifts. Inflation and the related rising interest rates led to large losses. The thrifts first lost their funding advantage through competition to money market funds, and then in 1986 to other banks when the Congress eliminated interest rate caps and

allowed deposit competition among banks and thrifts. To make things worse, the managers of the thrifts had every incentive to push the envelope into riskier assets since the government was effectively subsidizing the interest rate costs by providing deposit insurance. [222]

The result was a “runaway-feedback mode” of the negative sort, said Munger. He described it as a new form of Gresham’s law (bad behavior drives out good) where “bad lending drives out good”. Accounting allowed losses to be delayed or temporarily covered, the system incented growth to average higher-yielding new assets with lower-yielding existing portfolios, and insolvency caused managers who had nothing on the line personally to risk it all like a desperate gambler trying to make up losses by doubling down. The system naturally attracted risk takers, crooks, and other “helpers” such as brokers paid to bring in the deposits necessary to fund the expansion of assets. These brokers were shopping around with the government’s credit, to borrow a phrase from Munger.

Munger derided the United States League of Savings Institutions, an industry lobbying association, which “combined a blind loyalty to silly ideas with a blind loyalty to member associations.” In a portent of what was to come, Munger wrote: “If the League does not act more responsibly in the future, Mutual Savings will resign.” Munger thought the FSLIC was doomed and that its insolvency would result in a combination of some or all of: higher deposit premiums, higher equity requirements, curtailed investment options for thrifts, limits on growth of deposits, tougher accounting, quicker closure of questionable institutions, more regulation and oversight by Congress, a moratorium on new charters, and/or new overall state and federal banking laws. He saw the need for such reforms but knew it was probably wishful thinking given the politics of the situation.

Finding investment opportunity when others face adversity is a defining characteristic of Berkshire Hathaway. In 1988, this was on display with Mutual Savings’ investment in Freddie Mac, a hybrid operated by the Federal Home Loan Bank Board and owned by private investors.

Freddie Mac’s business was simple: It purchased housing mortgage loans from originators and packaged them into securities that it guaranteed and sold. It earned a fee and spread while avoiding interest rate risk. This was

an essential financial function for the economy and its owners could earn returns on equity north of 25%.

Munger laid out his and Buffett's investment thesis. (They were willing to do so because they had hit the maximum they could otherwise legally purchase.) Munger wrote that given Freddie Mac's connection with government its securities were perceived as having government backing. This gave Freddie Mac an enormous advantage. Between 1985 and 1988, this advantage was reflected in a return on equity ranging from the high twenties to 30%—an indication of a very good business. Perhaps due to its recency and vividness, some thought the same bureaucrats that ruined the FSLIC would cause Freddie Mac to suffer through mismanagement or through unfair dealings with owners. But the institutions and regulators were different. Munger considered the risk unlikely, at least for the time being. He also thought that investors generally had a lack of familiarity with Freddie Mac. The fact that the shares were trading around $50 per share, compared to the $30 per share purchase price, was an indication of a correct investment thesis, at least for the time being.

Financing

Comments [223] on a new $250 million issue of debt that closed in early 1988 demonstrated the subtle-yet-powerful logical reasoning of Buffett and Munger. Counterintuitively, at first glance, Berkshire borrowed the $250 million with nothing in mind to do with the money. This meant the loan was costing Berkshire money up front. Berkshire borrowed at 10% and then invested it at 6.5% while waiting for good opportunities to come along. The cost of this waiting: about $160,000 a week. [224] Why would Berkshire borrow money when the only prudent investment was *below* its cost?

"Unlike many in the business world we prefer to finance in anticipation of need rather than in reaction to it," Buffett wrote." The rationale was clear cut: A business's assets and liabilities can be managed separately, so why not focus on maximizing each independently to get the highest-possible return on assets and the lowest-possible cost of liabilities? Reason tells us that the best time to buy assets or acquire companies and the best time to borrow money rarely coincided exactly and are often exactly opposite, Buffett said. Therefore "action on the liability side should sometimes be taken independent of any action on the asset side." Though expensive on

the surface, Buffett said if Berkshire found the right sort of business within five years, the wait would have been worth the interest paid on the debt.

New York Stock Exchange Listing

Berkshire's shares began trading on the NYSE on November 29, 1988, after the exchange agreed to allow Berkshire to be measured in 10-share round lots instead of the usual 100. [225] In a letter sent to shareholders in August that year and reiterated in his Chairman's letter, Buffett told shareholders that the primary reason for the listing was *not* to maximize Berkshire's share price. Instead, he and Munger wished to reduce transaction costs for shareholders. The listing allowed shareholders to buy or sell without the hidden "tax" of high commissions and wide bid-ask spreads. Providing this environment would let shareholders prosper alongside business results, not suffer share price gyrations unnecessarily. In short, they wished it to operate more like a private business, with infrequent turnover of shareholders and a share price that tracked intrinsic value more closely.

The NYSE listing also brought with it a requirement to add another independent director, since only Malcolm Chace, Jr. met the test. To meet the requirement, Berkshire added Walter Scott, Jr., CEO of Peter Kiewit Sons', Inc., an Omaha-based construction company, to the board. [226]

David L. Dodd

Buffett concluded his 1988 letter to shareholders with a eulogy of sorts to David Dodd. Dodd, the behind-the-scenes investment partner of Benjamin Graham and co-author of *Security Analysis* died that year at 93 years old. Buffett fondly remembered Dodd's friendship and tutelage, and praised his teaching of "simple, sound, useful, and enduring" investment principles. Paying Dodd the highest compliment, Buffett wrote that Berkshire's "prosperity is the fruit of their [Dodd and Graham's] intellectual tree."

1989

The year 1989 marked a quarter-century of Berkshire under Buffett's management. The milestone was a cause for reflection and mild celebration. Buffett, characteristically, let others do the celebrating and instead focused

on his mistakes over the past twenty-five years. First though, a review of the more recent past was in order.

Berkshire's gain in book value during the year amounted to a whopping $1.5 billion, or 44.4%. This brought the compounded annual rate of return over the past twenty-five years to 23.8%. Buffett used science to explain why such a result could not repeat: "In a finite world, high growth rates must self-destruct," he wrote, explaining this was especially true at Berkshire which had a large and ballooning equity capital base of $5 billion. "A high growth rate eventually forges its own anchor." The outlier year in 1989 was because of (to borrow a term from Charlie Munger) a "lollapalooza", or a confluence of factors working in the same direction.

Berkshire's marketable securities portfolio caused the bulk of the 1989 gain. Secondary were excellent results from wholly-owned subsidiaries. Within the investment portfolio two factors were at play: First was the growth in intrinsic business value of the holdings due to good management and secondly, a catch-up factor where the market correctly reappraised upward its estimate of those companies' values. Such catch-ups were one-time events, and future gains would come from the lower-but-still-satisfactory increases in intrinsic business value. Berkshire's equity portfolio was $5.3 billion at year-end and amounted to 56% of total assets and over 100% of shareholders' equity. The growing size of Berkshire's equity portfolio meant that just a 10% decline in its quoted market value could cause book value to decline in any given year.

Taxes

Berkshire's common stock portfolio had a $5.3 billion carrying value at year-end 1989 and $3.6 billion of it was unrealized gains (increases in market value over cost that had yet to be sold). Like other forms of income, the government taxed gains on the sale of assets (known as capital gains). However, the tax was only due when the asset was sold. This led to an interesting economic benefit for the holder of the asset akin to an interest-free loan from the US Treasury. [227]

Here's how it worked: Due to the power of compounding without interruption, an asset held for a long period of time (assuming its value increased) would grow at a higher compounded annual rate of return by paying one tax at the end versus lots of little taxes in between. This is

somewhat counterintuitive since one would think that a tax paid every year would be the same as one paid at the end. But it is not. The accrued tax incurred, but not paid, appreciates and a portion of this subsequent gain is shared with the owner. The net result of a tax deferred over many years is a much higher rate of return. [228]

At year-end 1989, Berkshire included a liability on its balance sheet for the $1.1 billion that it would owe if it sold all its investments and realized the gains heretofore left accruing. Buffett posed and answered two questions:

1. Q: Was the tax the same as any other liability, such as a trade payable or debt due a creditor?
   A: It was different since the holder could defer payment indefinitely and choose the period in which the gain was realized.
2. Q: Was the liability a "meaningless accounting fiction"?
   A: No, since the tax was very real, but deferred.

Berkshire intended to hold its investments in its permanent holdings for a long period of time, so it would continue to benefit from this interest-free loan.

Sources of Reported Earnings

Berkshire's large common stock portfolio is relevant to the discussion of its operating earnings and intrinsic value, as shown in the table of operating earnings (refer to Table 5.2). Net investment income of $244 million dwarfed every other operating subsidiary and made up a large portion of the $393 million of pre-tax operating earnings for Berkshire. Importantly, this did not include any gains on the sale of investments, which were reported separately.

But this was only part of the story.

In addition to the interest and dividend income coming from the portfolio, Berkshire's common stock investees retained a large portion of their earnings for reinvestment. The five major holdings making up the bulk of the portfolio (Capital Cities/ABC, Coca-Cola, Freddie Mac, GEICO, and *The Washington Post*) netted Berkshire $45 million in dividends after tax. The retained earnings amounted to around $212 million pre-tax. If these so-

called look-through earnings [229] were added to Berkshire's after-tax operating earnings of $300 million its operating earnings after tax might be in the area of $500 million—that's 66% higher than reported.

Insurance

The Insurance Group did not have a great year on the surface:

- On a consolidated basis, premiums written and earned each slid over 30% after similar declines the prior year.
- Total earned premiums in 1989 were just $394 million—a decline of more than 52% from the peak of $825 million in 1986 and 1987.

Judged by these metrics, the year would have been considered a disappointment. But remember, Berkshire's Insurance Group measured itself on profitability. On that score, the group performed better.

Table 5.16: Insurance Group, select information

($ millions)	1989 Amount	1989 %	1988 Amount	1988 %
Primary Group				
Premiums written	$169.7		$218.8	
Premiums earned	188.9	100.0%	292.3	100.0%
Losses and loss expenses	125.9	66.6%	196.2	67.1%
Underwriting expenses	58.8	31.1%	78.7	26.9%
Total losses and expenses	184.7	97.8%	274.8	94.0%
Underwriting gain/(loss) - pre-tax	4.2		17.5	
Unfavorable (favorable) loss development included in losses and loss expenses	*(20.0)*	*(10.6%)*	*(29.1)*	*(10.0%)*
Statutory combined ratio		101.3%		103.1%
Reinsurance Group				
Premiums written	$66.0		$203.3	
Premiums earned	146.8	100.0%	229.3	100.0%
Losses and loss expenses	109.4	74.5%	170.5	74.3%
Underwriting expenses	48.6	33.1%	73.3	32.0%
Total losses and expenses	158.0	107.6%	243.8	106.3%
Underwriting gain/(loss) - pre-tax	(11.2)		(14.5)	
Unfavorable (favorable) loss development included in losses and loss expenses	*0.2*	*0.1%*	*0.0*	*0.0%*
Statutory combined ratio		148.2%		110.4%
Structured settlements and portfolio reinsurance				
Underwriting gain/(loss) - pre-tax	(17.4)		(14.1)	
Total Insurance Group underwriting gain/(loss) pre-tax	**($24.4)**		**($11.1)**	
Insurance Group overall statutory combined ratio		115.4%		107.4%

Notes:

1. Totals may not add due to rounding.

2. The loss and expense ratios are shown as they were reported in the Annual Reports, which is on a GAAP basis. The GAAP basis ratios are calculated with underwriting expenses divided by earned premiums. This contrasts to the statutory basis calculation, where the ratio uses written premiums. In both the GAAP and statutory calculations, losses and loss adjustment expenses are divided by earned premiums.

Sources: Berkshire Hathaway Annual Report 1988, 1990; and author's calculations.

The Primary Group underwrote to a 101.3% combined ratio. Digging deeper, favorable loss experience of $20 million was responsible for 11 percentage points of the combined ratio, meaning Berkshire's results for 1989 reflected a still-weak industry backstop. Because of the precipitous decline in premium volume written the expense ratio was higher than prior

years. A large portion of that decline was attributed [230] to the New York City-based Commercial Casualty and Professional Liability and Special Risks Divisions. Peaking at $93 million in 1987, business premium volume was just $20.2 million in 1989 due to inadequate pricing.

The Reinsurance Group (still excluding structured settlements and portfolio reinsurance) saw its 1989 combined ratio jump from 110% to 148%. The $11.2 million pre-tax underwriting loss was even more impressive compared to the $15 million from a year earlier considering that premiums written fell off a cliff and were down 68% to $66 million. Even the longest of payout tails wouldn't overcome that bad result, but it would have been worse if not for earned premiums falling slower than written premiums, as underwriting expenses could be reduced only so far in a short period. Earned premiums fell by *just* 35% due to strong volumes in prior years from the 7% quota-share arrangement with Fireman's Fund, which expired in mid-September 1989. Though Berkshire returned approximately $55 million in unearned premiums (net of ceding commissions), it remained liable for future losses that would not be complete until many years later.

A large contributor to the underwriting loss result for the overall Insurance Group was a $17.4 million loss from structured settlements and portfolio reinsurance. Due to their differing float characteristics (as has been noted in discussions of prior years), this line was not comparable to Berkshire's other lines of insurance underwriting activities.

Insurance generated an overall profit for Berkshire of almost $220 million in 1989 because of the significant investment income produced by float, now over $1.5 billion. While that float would have to be replenished via new written premiums to continue to be a profitable source of funds, Berkshire's strategy of focusing on profitable underwriting front and center was clearly working. Berkshire's large marketable securities portfolio will be discussed separately later as it was and is considered distinct from underwriting activities.

Considering a 2.1% estimated increase in industry premiums in 1989, industry combined ratios were forecast to remain elevated. History suggested a natural reversion to better pricing and stronger underwriting profitability, but this wasn't automatic. In the past the industry operated in a cartel-like environment where regulators and others largely abided by the same rates. Now the industry was a more commoditized marketplace.

Industry profitability would not automatically come back. Instead low industry pricing would cause losses, followed by participants and capacity leaving and a return to tighter conditions with more favorable pricing. The timing of this sequence of events was unknown.

Berkshire's willingness to write large volumes of business acted as an industry stabilizer. When pricing was right, Berkshire would be willing to write as much as $250 million of coverage that it would retain itself. Virtually no other insurer could match Berkshire in this area. Capital restrictions, or the possibility of looking foolish, prevented others from writing business despite satisfactory long-term expectations. Conversely, Berkshire was "willing to *look* foolish as long as we don't feel we have *acted* foolishly," said Buffett. After two unusual and disrupting events in 1989, Hurricane Hugo and a California earthquake, Berkshire wrote a substantial amount of catastrophe coverage at what it deemed appropr iate prices.

Borsheims

A new non-insurance subsidiary joined Berkshire in 1989. Borsheims is an Omaha-based jewelry store with more than a few connections to Nebraska Furniture Mart, Berkshire's Omaha-based furniture retailer. Long admired by Buffett, Borsheims was operated by Louis and Rebecca Friedman, who purchased the store in 1948. They came to Omaha from Russia in 1922, escaping through Latvia with only their "extraordinary combination of brains, integrity, and enthusiasm for work."

If the Friedman's story sounded similar to that of Rose Blumkin, who had escaped Russia through Manchuria about the same time, it was no coincidence. Rebecca Friedman was Rose's sister. And like Nebraska Furniture Mart, Borsheims flourished by operating under the same "sell cheap and tell the truth" credo. Though worlds apart in terms of product, Borsheims and Nebraska Furniture Mart were economic cousins. Each operation had the same fundamentals:

1. One location with a massive amount of inventory across various price ranges;
2. Daily attention to detail by top management (featuring generations of each family);

3. High turnover;
4. Astute buying;
5. And low expenses for its industry.

With four generations of Friedmans in the business, Buffett wrote that "Charlie and I will stay on the sidelines where we belong" and let them run the business.

Borsheims was too small in terms of purchase price and annual revenues to be detailed in the Berkshire Annual Report. If not for Buffett's commentary a reader of Berkshire's financials would not know of the new subsidiary.

Manufacturing, Publishing, and Retailing Businesses

Buffett's prior bestowal upon this group of businesses the title of "Sainted Seven" posed a small literary problem with the addition of Borsheims in 1989. Perhaps eager to move on or simply unable to find a new moniker, he now dubbed the group, "The Sainted Seven Plus One." So much for originality. Buffett compared this so-called divine assemblage to the 1927 all-star line-up of the New York Yankees. Pre-tax earnings of $204.8 million increased 1.2% from 1988 and produced a pre-tax return on tangible capital of 78.6% and a 56.5% after-tax return on average tangible equity capital without any net leverage (cash was greater than funded debt).

Borsheims, the Omaha-based jewelry store and newest of the Saints, met all expectations with sales twice what they were four years prior and four times ten years prior. [231] The jeweler had one store with over 4,000 customers on a busy day. Rebecca Friedman, her son, Ike, and their family, sold a high volume of goods at great value, all the while delivering a good economic result for its new owner, Berkshire. Because of high volumes and careful overhead cost control, costs for Borsheims were about one-third of other jewelry stores.

At See's Candies, poundage grew 8% to 27 million pounds as a result of additional advertising. Even more impressive, same-store sales, which had been stagnant, finally began to grow. With 225 stores and the close attention of Chuck Huggins, See's delivered to Berkshire strong profits of $34 million (up 5%).

Nebraska Furniture Mart created some distressing news for shareholders. It wasn't the fact that pre-tax earnings declined slightly to $17 million. That still produced an excellent economic result. Instead, it was that Mrs. B., after a spat with her family members over a flagging carpet department, had quit. But at 96 years old she did not retire. She started a competing business across the street selling furniture and carpet. Buffett would later bemoan that he did not have Mrs. B. sign a non-compete agreement. Only at Berkshire would an executive nearing 100-years-old pose a competitive threat upon departure. Mrs. B.'s short departure gave the next generations a spot in the limelight. [232] The carpet department (the source of the split) had a 75% market share of the carpet business in the Omaha region, up from 68% in 1988 and over six times its nearest competitor.

The Buffalo News , led by Editor Murray Light and Publisher Stan Lipsey, continued to amaze. Amid a declining population in the Erie County area, the primary distribution area of the paper, Sunday readership increased to an average of 292,700 copies compared to the 207,500 copies sold by its former competitor *The Courier-Express* during earlier, more populous times. While many other major papers saw profits decline, *The Buffalo News* delivered a seventh consecutive year of profits, with pre-tax earnings rising 9% to $46 million.

Fechheimer's pre-tax earnings fell 11% to $12.6 million due to integration issues related to its 1988 acquisition. The result still represented an excellent return on invested capital and illustrated one of the benefits of owning wonderful businesses. Even when they encounter the occasional issue, their previously high rates of return on capital allow a buffer against missteps.

Even with its challenges, Scott Fetzer continued to increase earnings and its return on invested capital remained excellent. In 1989, it was the lesser known businesses that carried the day. Pre-tax earnings at Kirby fell 3% to $26.1 million, and at World Book 8% to $25.6 million. Part of the decline at World Book was due to a decentralization of its single Chicago location into four locations. At Kirby, although unit sales were up strongly—international sales doubled in the last two years and quintupled in the last four—the company was gearing up to introduce a new 1990s model vacuum cleaner. This required additional operating expenses and an

investment of $11.2 million in capital expenditures in 1989, compared to depreciation of just $3.3 million.

In 1989, the Manufacturing, Publishing, and Retailing segment recorded total revenues of $1.5 billion and delivered pre-tax earnings of almost $205 million. Though largely unchanged from the $202 million of pre-tax earnings in 1988, the group generated a return on average equity of 92% pre-tax and 57% after-tax, all while employing little debt. That the group did not grow was okay. These were an excellent collection of businesses, but ones without the ability to reinvest large sums. Redeployment of excess capital was Buffett's job and fortunately, as will be discussed in the investment section, he found an outlet for some of the surplus cash.

Finance-Type Businesses

Mutual Savings continued to contribute modestly to Berkshire's results. Combined with the Scott Fetzer Finance Group, the two entities reported net earnings after tax of $10.7 million in 1989. This was good for a 2.1% return on assets and a 14.7% return on equity.

Non-Operating Activities

A cursory glance at the dumping ground that was the Non-Operating Activities (the all other segment) reveals a large decrease in equity, to a deficit of almost $260 million. This was partly due to the accumulated effects of required accounting charges for intangible assets, but largely because of an additional $517 million of parent-level debt (including a zero-coupon convertible issue discussed below). The capital was contributed to operating units, including the Insurance Group. It nonetheless remained unassigned and reduced equity of the Non-Operating Activities segment since there was no corresponding increase in assets.

Investments

Despite an elevated level of the overall stock market in 1989, Buffett continued to add to Berkshire's shares of Coca-Cola. But the market hadn't fully caught on. By year-end, Berkshire held 23.4 million shares with a cost of just over $1 billion and a market value of about $1.8 billion. Buffett chided himself on taking over fifty years to recognize the excellent qualities

of Coke, whose products he had sold in the 1930s as one of his first entrepreneurial ventures. [233]

The truth was that Buffett was somewhat slow to recognize the value being unleashed by CEO Roberto Goizueta, and President Don Keough. Coke had drifted somewhat in the 1970s, taking its focus away from its core syrup business. Now Goizueta and Keough were at the helm and the "mesh of marketing and finance is perfect and the result is a shareholder's dream." As discussed in the section on 1988, Buffett saw a ubiquitous product combined with virtually exploding international sales sold by a business with low capital requirements. He decided to load up on shares of Coke.

Table 5.17: Berkshire Hathaway common stock portfolio, select detail

($ thousands)	1989
Capital Cities/ABC, Inc.	$1,692,375
The Coca-Cola Company	1,803,787
Federal Home Loan Mortgage Corp.[1]	161,100
GEICO Corporation	1,044,625
Washington Post Company - Class B	486,366
Reporting threshold	$100,000
Footnote: 1. Nominally a preferred stock, Buffett said it was financially equivalent to a common stock.	

Source: Berkshire Hathaway Chairman's letter 1989.

Berkshire went so far as to advertise in the Annual Reports its special interest in purchasing convertible preferred issues as a long-term investment. In 1989, Berkshire filled its appetite almost completely [234] by spending $600 million on a Gillette issue (razors), $358 million on a USAir Group issue (airline), and $300 million on a Champion International Group issue (paper producer).

Buffett thought well of each management team and considered Gillette's long-term prospects favorable enough to join its board of directors. But he could not see as clearly the future of these companies, so Berkshire structured the investments differently. Each of the preferred issues carried approximately the same terms. Contractual dividend rates, which were cumulative, ranged from 8.75% to 9.25%. Each issue required mandatory redemption in ten years, and each was convertible into common shares at prices modestly above their then-current market prices. The issues were

structured to provide the investees with a long-term and interested capital partner, with a mediocre downside possibility for Berkshire if they didn't work out, and upside potential if the underlying companies did very well. Munger put it well in his letter to Wesco shareholders (Wesco also invested in a smaller portion of the same issues) saying "we regard these investments in the aggregate as sound but not exciting."

Zero-Coupon Securities

Augmenting its already-strong capital position still further, Berkshire issued $902.6 million of Zero-Coupon Convertible Subordinated Debentures in September 1989.

The nomenclature and workings of zero-coupon bonds is less foreign than at first glance. Berkshire's issue was no different than US Savings Bonds issued at a lower price than the common $25 face amount. Most savers are familiar with these instruments, and while the US Treasury does not call them zero-coupon bonds, they are in fact just the same. Most bonds require regular interest payments, usually semiannually. A zero-coupon bond, or savings bond, requires none as the investor (or Berkshire bondholder) pays a purchase price that is lower than the face value at maturity.

Berkshire's zero-coupon bonds were issued at 44.314% of face value, bringing in $400 million minus $9.5 million in fees. Instead of paying periodic interest, Berkshire would be required to pay back the full $900 million in fifteen years when it came due. For Berkshire, this was the mathematical equivalent of a 5.5% interest rate. Better still, the imputed interest was tax deductible each year since it was technically accruing. [235]

Berkshire's zero-coupon issue also came with a conversion privilege. Each $10,000-denominated bond could be converted into 0.4515 shares of Berkshire Hathaway stock. At a cost of $4,431 (the 44.314% issue price) the conversion implied a $9,815 share price for Berkshire (see Table 5.18), which was a 15% premium to its price at the time of purchase.

This conversion price, with a little manipulation, can give us a window into Buffett's thinking regarding Berkshire's valuation at that time:

Table 5.18: Berkshire Hathaway implied valuation, 1989

Bond face value	$10,000
Issue price	44.314%

Cost	$4,431
Conversion rate	0.4515
Implied value per share	$9,814
BRK shares outstanding	1,146,000
Implied BRK market value	$11,246,790,698
Berkshire shareholders' equity	$4,925,126,000
Conversion price/book value	2.28x

Sources: Berkshire Hathaway Annual Report 1989 and author's calculations.

The effective conversion price implied Buffett was willing to issue shares in Berkshire at a price-to-book value of about 2.3x. Buffett had thus positioned Berkshire for the use of $390 million of capital that would do one of two things: cost it less than 5.5% after considering the favorable effects of interest deductibility; or at a valuation that did not dilute existing shareholders. [236] It was a win-win, and classic Buffett. [237]

But that is not always the case. Buffett observed abuses of similar-type instruments. Wall Street, he wrote, classically took a good idea and went too far. Since it was "impossible to default on a promise to pay nothing" (remember, there were no interim payments due, only the one balloon payment at the end), an issuer could technically not miss a payment. Some on Wall Street used these features to fund the leveraged-buyout boom (buying a company almost entirely using debt) with zero-coupon securities and their cousin, pay-in-kind (or PIK) bonds. [238]

Acquiring a company using a significant amount of debt is risky. It was now possible for a company to borrow far more than it economically could be expected to repay, considering its debt servicing capacity and capital expenditure needs. Cash was not needed immediately for payments, so Wall Street coined the term EBDIT, or earnings before depreciation, interest, and taxes (a similar moniker to today's EBITDA, with the A being amortization). Wall Street reasoned that if the interest was not due, it didn't need to be counted. A company with $100 million of earnings could incur debt with $90 million of interest due currently and an additional $60 million of annual PIK interest that would accrue but not be paid in cash (a total of $150 million year one). That company would remain operational despite more debt service than income.

Such "models of modern finance" were rightly considered delusional to Buffett and Munger, who thought that not only were the zero-coupon-type accruals of interest very real expenses, but so was the depreciation that was ignored. Summing up the whole debacle quite elegantly, Buffett wrote: "A base business cannot be transformed into a golden business by tricks of accounting or capital structure." His warning was precise as it was brief: "Financial alchemy" doesn't work. [239]

Wesco

Wesco made headlines with the public resignation of Mutual Savings and Loan from the League of Savings. Both Buffett and Munger decided to resign after becoming disgusted with the League's behavior. The League lobbied on behalf of savings and loan institutions who purchased some of the same zero-coupon issues described above from shaky borrowers, just to record the earned-but-not-received interest.

The one-page letter, signed by Munger and released to the press "as one small measure of protest … for such attention as may ensue," lambasted the League for its behavior. The letter dismissed the idea that such trade associations were expected to behave only in ways that are not counter to their members' interests, even if it meant endorsing egregious behavior like the "micky-mouse accounting" of "institutions dominated by crooks and fools." Munger thought a responsible association should attempt to clean up the mess which it had created, and which he estimated would cost taxpayers over $100 billion. Instead, he wrote, the association "persists in prescribing continuation of loose accounting principles, inadequate capital and, in effect inadequate management," rather than become a constructive player in the reform. Wesco would continue alone until some sort of resolution occurred.

In the meantime, Wesco had some bright spots. Not the least of which was Precision Steel, and a new operating subsidiary, New America Electrical Corporation, 80% of which was purchased for $8.2 million at the end of 1988.

Wes-FIC, the insurer set up to hold the business of Fireman's Fund, whose share arrangement had ceased as of the latter part of 1989, continued writing some business of its own, though just $438,000 in direct premiums in 1989. More promising was a new agreement, effective January 1, 1990,

to reinsure half of Berkshire's Cypress Insurance Company, one of its workers' compensation insurance businesses.

Mistakes of the First Twenty-Five Years

Reflecting on a quarter-century at the helm of Berkshire Hathaway, Buffett devoted two entire pages of his Chairman's letter to a "condensed version" of his mistakes and the lessons he learned.

1. Mistake number one: Purchasing control of Berkshire to begin with (which may come as a surprise to readers). He was "enticed to buy because the price looked cheap" but quickly realized that such a price reflected the difficult business conditions.
   - The lesson: "time is the friend of the wonderful business, the enemy of the mediocre."
2. Mistake number two: Buying several mediocre businesses at seemingly low prices.
   - The lesson: "It's far better to buy a wonderful company at a fair price than a fair company at a wonderful price."
3. Mistake number three: An unseen force Buffett termed the institutional imperative. This was a tendency for managers to make irrational decisions and misspend shareholders' money by blindly following others in the business community. This was quite contrary to what was taught in business schools.
   - The lesson: Manage Berkshire to minimize the influence of institutional imperatives and "attempt to concentrate our investments in companies that appear alert to the problem."
4. Mistake number four: Berkshire often partnered with managers such as Chuck Huggins, Ralph Schey, and the Blumkin's who were liked, trusted and admired, and who led successful companies. But not always.
   - The lesson: While above-average managers would not cure a below-average business, he preferred such individuals to others —even if it meant slightly lower results for Berkshire. "We've never succeeded in making a good deal with a bad person."
5. Mistake number five: One oft-forgotten category of mistakes were those of omission. Contrary to mistakes of commission, which are

explicit, those of omission are the decisions or investments that should have been made.

- The lesson: Buffett admitted to taking a pass when good deals were served up on a platter and said "the cost of this thumb-sucking has been huge."

In summation, Buffett said Berkshire used "consistently-conservative financial policies" that "may appear to have been a mistake, but in [his] view were not." He wrote that Berkshire probably could have increased the 23.8% compounded annual return it had achieved by borrowing more money, but he was uncomfortable with even a 1% chance of failure. Even at 99:1 odds, he and Munger would not have been comfortable with the risks.

Ending his discussion on mistakes was a subtle reassurance to shareholders that despite his personal fortune of $4.2 billion (placing him second on the Forbes 400 list of wealthiest Americans [240]), Buffett was not done painting his picture: "Charlie and I have never been in a big hurry: We enjoy the process far more than the proceeds—though we have learned to live with those also."

The First 25 Years—1965 to 1989

Figure 5.19: Selected financial data at five-year intervals (reproduced from the 1989 Annual Report)

($ thousands, except per share amounts)	1989	1984	1979	1974	1969	1964
Revenues:						
Sales and service revenues	$1,526,459	$496,971	$286,493	$32,592	$40,427	$49,983
Insurance premiums earned	394,279	140,242	181,949	60,574	25,258	0
Investment income, insurance group	250,723	69,281	24,747	7,916	2,017	0
Realized investment gain (loss)	223,810	114,136	10,769	(1,908)	5,722	0
Total revenues	2,483,892	861,388	560,381	100,384	73,424	49,983
Earnings (loss):						
Before realized investment gain	299,902	70,201	35,921	8,383	3,863	(2,824)
Realized investment gain (loss)	147,575	78,694	6,896	(1,340)	4,090	0
Net earnings (loss)	447,477	148,895	42,817	7,043	7,953	(2,824)
Earnings (loss) per share:						
Before realized investment gain (loss)	262.46	61.21	34.97	8.56	3.92	(2.41)
Realized investment gain (loss)	127.55	68.61	6.71	(1.37)	4.15	0.00
Net earnings (loss)	390.01	129.82	41.68	7.19	8.07	(2.41)
Year-end data:						
Total assets	9,459,594	2,297,516	1,433,863	216,214	95,746	27,887
Term debt and other borrowings	1,007,516	127,104	134,416	21,830	7,419	2,500
Shareholders' equity	4,925,126	1,271,761	344,962	88,199	43,918	22,139
Common shares outstanding *(thousands)*	1,146	1,147	1,027	980	980	1,138
Shareholders' equity per outstanding share	$4,296.01	$1,108.77	$335.85	$90.04	$44.83	$19.46

Source: Berkshire Hathaway Annual Report 1989.

Having just covered the mistakes of the first twenty-five years, it is worth taking a moment to put into perspective the incredible change in Berkshire during Warren Buffett's control. The table above (Table 5.19) tells a compelling story. While change in any individual year was smaller or focused on a few things, taken as a whole those changes collectively transformed Berkshire Hathaway into an economic powerhouse.

It is also instructive to take a closer look at how that 23.8% compounded annual rate of return on book value was created. [241] Beginning with just $22 million of equity capital in a self-described subpar textile business, Berkshire Hathaway was transformed completely. Over twenty-five years, shareholders' equity grew to $4.9 billion. The sources of that increase were, roughly:

- 48% from unrealized gains on marketable securities;

- 30% from operating activities: the wholly-owned subsidiaries, plus dividends and interest from investees;
- 19% from realized gains on marketable securities;
- And 3% from the addition of Diversified Retailing and Blue Chip Stamps during the 1975–1984 decade. (A very small change was due to dividends, treasury stock transactions, and miscellaneous.)

Table 5.20: Reconciliation of shareholders' equity, 1965–1989

($ millions)	
1964 ending shareholders' equity	$22
Net income - operations 1965–1989	1,493
Net income - realized gains 1965–1989	936
Unrealized appreciation of investments	2,341
Mergers/divestitures	133
Dividends/treasury stock	(4)
Other/misc.	4
1989 ending shareholders' equity	$4,925

Sources: Berkshire Hathaway Annual Reports and author's calculations.

Taking apart the twenty-five years, we can see how Berkshire earned its gains over that time. The first ten-year period (1964–1974) was largely driven by operating activities. During the next decade (1975–1984) the contribution of operations to book value growth shrunk to one-third of the total change, with over half coming from a combination of realized gains and unrealized gains on appreciation of investments. It was in this decade that saw a meaningful portion of the change in net worth come from the addition of Diversified Retailing and Blue Chip Stamps, both of which merged with Berkshire.

The change during the five-year period from 1985–1989, while shorter than a decade, nonetheless illustrates the continued shift toward the importance of the marketable securities portfolio. During that five-year span almost three-quarters of the change in Berkshire's book value came from realized or unrealized appreciation of investments, with unrealized appreciation accounting for a full half of the change.

Table 5.21: Reconciliation of shareholders' equity, 1965–1989

($ millions)	1965–74	1975–84	1985–89	1965–89
Beginning of period shareholders' equity	$22	$88	$1,272	$22
Net income - operations	57	366	1,070	1,493
Net income - realized gains	7	199	729	936
Unrealized appreciation of investments	0	486	1,855	2,341
Mergers/divestitures	0	133	0	133
Dividends/treasury stock	(3)	0	(1)	(4)
Other/misc.	4	0	0	4
End of period shareholders' equity	$88	$1,272	$4,925	$4,925
Change in equity during period	$66	$1,184	$3,652	$4,903

Sources: Berkshire Hathaway Annual Reports and author's calculations.

Table 5.22: Reconciliation of shareholders' equity, 1965–1989

	1965–74	1975–84	1985–89	1965–89
Net income - operations	86%	31%	29%	30%
Net income - realized gains	11%	17%	20%	19%
Unrealized appreciation of investments	0%	41%	51%	48%
Mergers/divestitures	0%	11%	0%	3%
Dividends/treasury stock	(4%)	0%	(0%)	(0%)
Other/misc.	7%	0%	0%	0%
Total	100%	100%	100%	100%

Sources: Berkshire Hathaway Annual Reports and author's calculations.

1990

While the first twenty-five years of Berkshire Hathaway under Warren Buffett's control ended on a high note, it began lackluster, and the next twenty-five followed that pattern. Book value grew just 7.3% in 1990. The Berkshire of the bygone era was a textile business with dim prospects, while that of 1990 featured a conglomerate with much potential. The off year in 1990 was largely caused by Berkshire's significant common equity portfolio, which made up over half of its average assets and fluctuated along with changes in the overall stock market. While the current rate of book value growth was well below Buffett's goal of 15% per annum,

Berkshire's businesses continued to be exceptional, with most of those businesses making good progress during the year.

Look-Through Earnings

The annual change in Berkshire's book and market values could swing wildly from year to year and diverge significantly from each other (see Table 5.23).

Table 5.23: Berkshire Hathaway change in book and market values

	1990	1989
Change in book value	7.4%	44.4%
Change in market value	(23.1%)	84.6%
Difference (book-market)	30.5pts	(40.2pts)

Source: Berkshire Hathaway Annual Report 2018.

This was because accounting obscured important information about Berkshire's economic earning power. Capital Cities/ABC was an extreme case. In 1990, Berkshire owned 17% of the company. Berkshire's share of its 1990 earnings was over $83 million, yet Berkshire only recorded income of $600,000. Why? Because Cap Cities paid Berkshire $600,000 in dividends, and accounting conventions only counted those—completely ignoring roughly $82 million that Cap Cities retained for reinvestment on Berkshire's behalf. Many of Berkshire's other investees had similar, though not so extreme, disparities. If those companies continued to do well their underlying earning power would *eventually* translate into corresponding gains in market value.

The solution for this accounting problem was look-through earnings (see Table 5.24). Look-through earnings accounted for retained earnings and adjusted for the taxes that would have been due if paid as dividends. The total for 1990: $591 million. It was an approximate figure to be sure, though one more closely-aligned to economic reality. [242]

Table 5.24: Berkshire Hathaway look-through earnings, 1990

($ millions)	
Operating earnings retained by investees (BRK share)	$250
Less: taxes owed if paid out as dividends	(30)

Net operating earnings attributable to BRK	220
Berkshire Hathaway after-tax operating earnings	371
Total look-through earnings	$591

Source: Berkshire Hathaway Annual Report 1990.

Manufacturing, Publishing, and Retailing

Berkshire's non-insurance economic engine continued to impress. Taken as a whole, the group contributed $216.8 million pre-tax to Berkshire's earnings in 1990, representing a pre-tax return on average tangible capital of 73% and equity of over 83%. The after-tax return on tangible equity was an equally impressive 51% and, importantly, was achieved with no net debt. [243] Such high returns on capital were scarce, and there were few incremental growth opportunities available within the subsidiaries themselves. As a result, most funds were sent to Omaha for reinvestment. In fact, over 80% of the Manufacturing, Publishing, and Retailing businesses' earnings were sent to the parent company over the prior five years.

Amid weak economic conditions (the US entered a recession in 1990 marked by hundreds of bank failures), Borsheims turned in revenue growth of 18%. [244] From one store (which Buffett estimated to be the largest after Tiffany's New York City location) the Friedman family continued to operate from a simple and effective playbook. They maintained rock bottom operating costs, which produced a positive feedback loop from low prices driving additional demand. This kept operating costs as a percentage of revenue low. It was the Nebraska Furniture Mart playbook, only for jewelry. Such low prices attracted shoppers from far beyond Omaha. The store had grown outside its physical footprint with a mail-order service that shipped assortments of pieces valued at upwards of $100,000 to all over the country, counting on people's honesty to pay for them or return them. This seemingly risky business had yet to produce a loss from customer dishonesty. [245]

Nebraska Furniture Mart continued its relentless progress. Revenues grew 4% to $159 million in 1990 by attracting shoppers from far and wide. Profits ticked up 1% to $17 million. Nebraska Furniture Mart ranked number three in popularity in Des Moines, Iowa, which was 130 miles away (the equivalent of driving from Washington D.C. to Philadelphia). It

outranked seventeen stores closer to Des Moines. Its low prices, like those of its sister company Borsheims, created an “irresistible magnet” that lured shoppers from far outside a traditional market radius and allowed Nebraska Furniture Mart to maintain even lower prices by avoiding opening additional stores.

Taking advantage of Nebraska Furniture Mart’s popularity, See’s had a cart in the Omaha store. In what Buffett termed a “counter-revelation” against his dislike of the term “synergy,” this cart did more business than some California-based standalone stores. These successes, coupled with a 5% price increase, led See’s to increase pre-tax profits nearly 16% to $39.6 million. This was despite a Christmas season that fell slightly below the mark.

Reporting on *The Buffalo News* , Buffett wrote that, “the business showed far more vulnerability to the early stages of a recession than has been the case in the past.” He openly questioned whether the paper’s 5% decline in pre-tax profits to $44 million was temporary, or an indication of a permanent situation. The relative weakness was also a window into the impact alternative advertising channels were having at two of Berkshire’s major investees, Capital Cities/ABC and *The Washington Post* . Berkshire and *The Buffalo News* remained committed to its customers, however. Buffett wrote that it would not deviate from providing the quality of news that led it to success in the first place. “Regardless of earnings pressures, we will maintain at least a 50% news hole. Cutting product quality is not a proper response to adversity.”

At Fechheimer, pre-tax profits grew just 4%, to $12.9 million. Fechheimer continued to have excellent prospects. It moderated or solved some of the issues that its large 1988 acquisition had thrown up. Still, amid a recessionary environment, the fact that it grew revenues and profits was a meaningful achievement.

Scott Fetzer, under the leadership of Ralph Schey, turned in a result that would have placed it near the top of the Fortune 500 based on return on equity. Pre-tax earnings came in at $101.9 million. [246] Scott Fetzer’s finance businesses earned a record $12.2 million pre-tax in 1990. Pre-tax earnings from its World Book unit increased 25% to $31.9 million despite lower unit sales. [247] At Scott Fetzer’s Kirby unit, the new Generation 3 vacuum cleaner was an unqualified success. Costs associated with the new product

introduction kept earnings down temporarily, but increased unit volumes and strong international demand portended strong results for 1991. Campbell Hausfeld, a Scott Fetzer subsidiary and producer of small- and medium-sized air compressors, earned a mention in the 1990 Chairman's letter for its particularly fine year. [248]

Insurance

Weakness in pricing continued to be the story in insurance, though Berkshire did find a way to put its reputation and capital base to profitable use in 1990.

Table 5.25: Insurance Group, select information

($ millions)	1990 Amount	1990 %	1989 Amount	1989 %
Primary Group				
Premiums written	$139.1		$169.7	
Premiums earned	154.0	100.0%	188.9	100.0%
Losses and loss expenses	102.0	66.2%	125.9	66.6%
Underwriting expenses	51.5	33.4%	58.8	31.1%
Total losses and expenses	153.5	99.7%	184.7	97.8%
Underwriting gain/(loss) - pre-tax	0.5		4.2	
Unfavorable (favorable) loss development included in losses and loss expenses	*(18.3)*	*(11.9%)*	*(20.0)*	*(10.6%)*
Statutory combined ratio		103.3%		101.3%
Reinsurance Group				
Premiums written	$435.2		$66.0	
Premiums earned	437.5	100.0%	146.8	100.0%
Losses and loss expenses	432.2	98.8%	109.4	74.5%
Underwriting expenses	32.5	7.4%	48.6	33.1%
Total losses and expenses	464.7	106.2%	158.0	107.6%
Underwriting gain/(loss) - pre-tax	(27.2)		(11.2)	
Unfavorable (favorable) loss development included in losses and loss expenses	*0.0*	*0.0%*	*0.2*	*0.1%*
Statutory combined ratio		106.3%		148.2%
Structured settlements and portfolio reinsurance				
Underwriting gain/(loss) - pre-tax[1]	NR		(17.4)	
Total Insurance Group underwriting gain/(loss) pre-tax	**($26.7)**		**($24.4)**	
Insurance Group overall statutory combined ratio		104.9%		115.4%

Footnote:
1. In 1990, Berkshire began including structured settlements and portfolio reinsurance with reinsurance.

Notes:

1. Totals may not add due to rounding.

2. The loss and expense ratios are shown as they were reported in the Annual Reports, which is on a GAAP basis. The GAAP basis ratios are calculated with underwriting expenses divided by earned premiums. This contrasts to the statutory basis calculation, where the ratio uses written premiums. In both the GAAP and statutory calculations, losses and loss adjustment expenses are divided by earned premiums.

Sources: Berkshire Hathaway Annual Reports 1990, 1992; and author’s calculations.

Berkshire’s Primary Group wrote and earned almost 20% lower volume, totaling $139 million for premiums written and $154 million for premiums earned. The primary businesses continued to ignore volume for its own sake and remained focused on profitable underwriting. In one such example, premium volume in the New York City office fell from a high of $93

million in 1987 to just $18 million in 1990. The combined ratio for the primary businesses, at 103.3%, benefited from a fourth consecutive year of favorable loss development. Expecting a trend like that to continue was dangerous since it could be decades before all cases were settled.

The real story in the Insurance Group in 1990 was the reinsurance division. Having written just $66 million in 1989, the Reinsurance Group wrote $384 million in 1990—multiples of the year before. [249] The large increase in premiums was driven by $378 million of 1990 volume related to insuring large risks. Considering the volatility inherent in such business, Buffett took pains to explain the logic.

He said that while volume in other lines "continues to be small but satisfactory," Berkshire was pursuing business in the super cat (short for super catastrophe) area of reinsurance. This line of business reinsured other insurance companies for large losses from natural disasters, typically above a pre-determined threshold of loss for the primary insurer (no different than a deductible). The advantage Berkshire brought to this arena was both its willingness to write large policies and its financial strength. The latter was less important to consumers but all-important to large buyers of reinsurance. For the right price Berkshire was willing to concentrate risk rather than lay it off. Profits were expected over time, but they came at the expense of volatility. For this segment alone, the combined ratio could be zero in some years, or as high as 300% when earthquakes, hurricanes, and other natural events struck. Measured over a period of a decade, Buffett thought that Berkshire's overall results would be better than insurers who preferred to lay off the risk to others in exchange for smoother sailing. He summed it up nicely: "Charlie and I always have preferred a lumpy 15% return to a smooth 12%."

Buffett's basic framework, and how he thought insurers should be measured, was the cost of float. This was determined based on a ratio of underwriting loss to average float. In this way the cost of float (assuming a combined ratio over 100%) was akin to the cost of debt. Comparing the cost of float to an interest rate benchmark would provide a gauge for the quality of float generated. Most insurers could still produce a breakeven result with a cost of float between 7% and 11%. Under long-tail situations where a long time period elapsed from premium collection to the payout of losses, a higher combined ratio of 115% or more could be profitable.

Berkshire first entered the insurance industry with the purchase of National Indemnity in 1967. Between 1967 and 1990, Berkshire underwrote to a profit in half of those years (see Table 5.26). This meant its cost of float was negative. [250] In seven additional years, its cost of float was below that of long-term US government bonds, meaning the Insurance Group was borrowing at a cost lower than the US government. In the remaining five years, Berkshire's cost of float was higher than the long-term government bond. The worst year was 1984 with a differential of 7.4 percentage points. In short, Berkshire generated a large and growing amount of float at an attractive cost. In 1990, Berkshire's $1.6 billion of float cost it just 1.6%, far below the 8.2% cost incurred by the US government.

Table 5.26: Berkshire Hathaway Insurance Group Float and cost of float compared to U.S. Government Bonds

	Underwriting Loss ($ mil.)	Average float ($ mil.)	Approximate cost of Funds	Year-end Yield on Long-Term Gov't Bonds
1967	profit	$17.3	less than zero	5.5%
1968	profit	19.9	less than zero	5.9%
1969	profit	23.4	less than zero	6.8%
1970	$0.37	32.4	1.14%	6.3%
1971	profit	52.5	less than zero	5.8%
1972	profit	69.5	less than zero	5.8%
1973	profit	73.3	less than zero	7.3%
1974	7.36	79.1	9.30%	8.1%
1975	11.35	87.6	12.96%	8.0%
1976	profit	102.6	less than zero	7.3%
1977	profit	139.0	less than zero	8.0%
1978	profit	190.4	less than zero	8.9%
1979	profit	227.3	less than zero	10.1%
198	profit	237.0	less than zero	11.9%

0				
1981	profit	228.4	less than zero	13.6%
1982	21.56	220.6	9.77%	10.6%
1983	33.87	231.3	14.64%	11.8%
1984	48.06	253.2	18.98%	11.6%
1985	44.23	390.2	11.34%	9.3%
1986	55.84	797.5	7.00%	7.6%
1987	55.43	1,266.7	4.38%	9.0%
1988	11.08	1,497.7	0.74%	9.0%
1989	24.40	1,541.3	1.58%	8.0%
1990	26.65	1,637.3	1.63%	8.2%

Source: Berkshire Hathaway Annual Report 1990.

Keying shareholders into his thoughts on valuation, Buffett wrote that the Insurance Group's intrinsic value was "worth far more than its carrying value." Even though its variability in results caused the intrinsic value of Berkshire's insurance operations to be harder to value than the non-insurance businesses, it was, he said, the one with the greatest potential.

Investments

Given the Berkshire philosophy of viewing common stock investments as equivalent to ownership of entire businesses, it comes as no surprise to see little activity in its holdings. That was the case in 1990. As Buffett put it: "Lethargy bordering on sloth remains the cornerstone of our investment style. This year we neither bought nor sold a share of five of our six major holdings." This meant there was no trading activity for Capital Cities/ABC, Coca-Cola ("the most valuable franchise in the world," according to Buffett), Freddie Mac, GEICO, or *The Washington Post* . The only real activity in the equity portfolio in 1990 was purchasing Wells Fargo shares.

While Berkshire began buying shares the year before, it was not disclosed anywhere in the Annual Report, since very few shares were acquired in

1989. By the end of 1990, Berkshire had acquired 5,000,000 shares at an average cost of under $58 per share, or about $290 million. [251] This was equivalent to three times pre-tax earnings or five times after-tax earnings. Berkshire's ownership was equal to 10% of Wells Fargo. The way Buffett described it reflected his attitude toward buying a portion of any business public or private. Berkshire's Wells Fargo stake was "roughly equivalent to [Berkshire] buying 100% of a $5 billion bank." Wells Fargo had about $56 billion of assets at the time. While Buffett and Munger were not big fans of the banking business due to the risks inherent in a highly leveraged enterprise, the quality of Wells Fargo and its manager, Carl Reichardt, coupled with the attractiveness of its share price, presented a worthwhile investment opportunity.

Wells Fargo stock had recently fallen over 50% in a short period due to concerns that a real estate bust tied to the recession would cause large losses at West Coast banks. Buffett's rational logic explained his reasoning for why Wells Fargo would fare just fine amid the landscape of bank failures nationwide:

> "Consider some mathematics: Wells Fargo currently earns well over $1 billion pre-tax annually, after expensing more than $300 million for loan losses. If 10% of all $48 billion of the bank's loans—not just its real estate loans—were hit by problems in 1991, and these produced losses (including foregone interest) averaging 30% of principal, the company would roughly break even."

Such a low-level possibility event, wrote Buffett, would cause Wells Fargo to report no profit that year, and then go on earning 20% on growing equity.

The fixed-maturity portion of Berkshire's investment portfolio saw few changes in 1990. Berkshire increased its holdings of RJR Nabisco bonds to $440 million but avoided other below-investment-grade issues. Even though the logic of acquiring junk bonds as a portfolio was sound if purchased at the right price, Wall Street had characteristically taken the idea too far. There was a key difference between the bonds of former investment grade companies, such as RJR Nabisco, which were downgraded, and those that originated as junk bonds. The former had managers who worked to regain the company's investment grade status while the latter had no benchmark to guide their behavior. Though he was writing about the savings and loan industry, Charlie Mungers' label of "knaves and fools"

would have done well for a description of some of the junk-bond company managers and their Wall Street brethren pushing them at the time. (Buffett used a similar term: financiopath.)

There was some mixed news on Berkshire's four major convertible preferred stock issues:

- The $700 million Salomon issue and the $300 million Champion International issue were performing as expected.
- The USAir issue was likely worth substantially less than the $358 million purchase price. The airline was struggling due to continued industry weakness and integration problems with another airline it purchased.
- Berkshire's $600 million of Gillette Company convertible preferred, though worth somewhat more than it had paid, was about to go away. The issue had been called, and as a result Berkshire would receive 12 million shares of Gillette on April 1, 1991. [252] Berkshire would give up over $50 million of annual preferred stock dividends, but it would continue to hold a nearly equal asset in its claim to 11% of Gillette's earning power.

Wesco

The savings and loan crisis was a slow-moving financial disaster that began in 1986 and ended a decade later with about a third of savings and loan institutions out of business. With additional time to study the issue, Munger used ten pages of his Wesco Chairman's letter to provide excellent observations as to why Wesco didn't fall for the tactics that led to bank failures. [253] Munger wrote out of "overwhelming disgust with the present scene" and was inspired by a long association to an eccentric fellow (Buffett), who "encourages this kind of writing."

Munger said the cause of the savings and loan crisis was a confluence of events. One issue was government-provided deposit insurance, which effectively allowed bankers to use the government's credit to obtain low-cost funding. Related to that was a structural weakness in that short-term sources of funds were used to finance long-term assets, creating interest-

rate risk. A weak regulatory structure allowed a bank to shop for its regulator and this caused a lowest-common-denominator effect where the weakest banks were attracted to the easiest regulator.

Then came deregulation of interest rates and low-overhead money market funds. This caused a higher cost of funds for all banks (thrifts and commercial banks). That in turn produced the natural effect of riskier lending as banks needed higher-yielding assets to cover their higher costs. Some banks even went so far as to advertise a willingness to fund a portion of consumers' vacations, among other risky lending activities. Banks were not alone in risky lending. The 1980s heralded the invention of large-scale original-issue junk bonds pushed by the likes of Michael Milken. Before the 1980s, few people issued junk bonds. They became common in the early 1980s as a way for young companies with no credit to issue bonds and get early funding. This practice came to a temporary halt at the end of the 1980s as default rates rose, though it did return in future decades.

Munger's analysis started with a question. "How then does bad lending occur so often?" he asked. The answer, he said, was because humans are social animals with "predictable irrationalities." This leads them to follow the crowd and copy bad behavior. The effect of such folly was predictable: "many bank insolvencies will come." He was right. By 1995, over 1,000 banks were out of business.

Munger offered a possible solution, or at least mitigation of the above deficiencies. One solution was significantly reducing deposit insurance. Quite the opposite of shoring up the weak deposit system, Munger wrote that additional deposit insurance might weaken it, since it raised banks' costs above those of money market funds, which paid no deposit insurance. His other ideas included the elimination of money market funds via legislation, or bringing back interest rate controls, both of which were technically possible but unlikely. Still other ideas, which could be used alone or in combination, were forcing weak banks to close or merge with local or non-local banks. Banks that closed should do so before they became insolvent. (Munger thought it bonkers that regulators would wait until the very end, at which point large losses to the deposit insurer were almost guaranteed.)

Another option Munger proffered up would affect the accounting of banks and their brethren. He thought discussions of accounting were not focused

on the right area. Discussions centered on how to delay loan write-offs via accounting maneuvers. Munger felt this created poor incentives for bank managers to front-end interest and fee income from loans, especially with new classes of risky loans having as-yet-to-be-determined loss characteristics. This encouraged lending to riskier borrowers since income could be booked immediately that might ultimately have to be reversed. Munger called this "reality denial" and believed much more conservatism was needed to begin with. Munger's system would be more like insurance, in which future losses would be estimated upfront using logical and conservative methods and then corrected as time went on. [254] He thought offering a carrot in the form of tax savings, in addition to the regulatory sticks, would incent the right behavior on the part of managers and boards of directors.

Toward the end of the 1990 Berkshire Hathaway Chairman's letter was the familiar advertisement seeking acquisition candidates. Buffett augmented his usual plea by including as an appendix a two-page letter written to an owner considering selling to Berkshire (the business was not named). Entitled Some Thoughts on Selling Your Business, Buffett's letter went through the advantages of selling to Berkshire. It was also candid: "You would be no richer after the sale than now … A sale would [only] change the form of your wealth" from 100% of one business to cash and investments in other businesses.

The letter offered some insight into Buffett's thinking on acquiring family-built companies. Although Berkshire would "adapt to [the sellers'] methods rather than vice versa," he had a few stipulations. One was that he preferred the selling family maintain a 20% ownership interest. This put Berkshire's ownership at the 80% level needed for tax purposes. More important, it maintained the proper alignment of incentives so Berkshire could be hands-off. "The areas I get involved in are capital allocation and selection and compensation of the top man," he wrote. The latter was another key policy that helped avoid ballooning compensation costs given that just about all other decisions would be made at the operating company level.

Finally, Buffett informed shareholders that Ken Chace had decided to step down from the board. Buffett's wife, Susan, would be nominated to succeed him. An informed board member, she had the second-largest ownership

stake in Berkshire after her husband and shared his views on succession and preserving the Berkshire culture he so painstakingly put into place.

1991

Berkshire Hathaway's book value shot up 39.6% in 1991. Like the previous year (which saw an increase of just 7.4%), the current year was heavily influenced by Berkshire's large investment portfolio. Of the $2.1 billion gain in book value in 1991, over three-quarters of it (or $1.6 billion) was due to appreciation of just two stocks: the recently purchased 7% interest in Coca-Cola and newly converted shares in Gillette. Against a backdrop of a general recession in the United States in 1991, Berkshire's operating companies did well, though less well than the year before. Pre-tax operating earnings fell 17% to $401 million. Berkshire also found a new operating company to buy in H.H. Brown Shoe.

Also, Warren Buffett reluctantly found a second job running (and saving) Salomon, Inc. The story of Buffett's interlude running Salomon is a cautionary one and well worth the effort to study in full. [255]

Berkshire first purchased a $700 million convertible preferred stock issue from Salomon in 1987, which put Buffett and Charlie Munger on its board to represent Berkshire's 12% voting interest. Several years went by without a problem. Then, in mid-1991, news came to light that one of Salomon's employees had broken the law by abusing Salomon's privilege as a primary dealer in US Treasury securities when he improperly used customers' accounts. [256] The fact that Salomon had committed the transgression wasn't the real sin. The real problem was CEO John Gutfreund knew about it and did not tell the government.

The series of events which followed are like a Greek tragedy. The Salomon employee set the scene by committing the crime more than once during the beginning of 1991. Salomon's management made it a tragedy by not reporting the wrongdoing to Salomon's regulator, the New York Federal Reserve Bank. The General Counsel took the matter to his boss, CEO John Gutfreund, who did nothing, precipitating his own downfall. Gutfreund believed it would either go away or at worst result in nothing more than a slap on the wrist. This was a fatal error of judgement.

Instead, the situation blew up as Gutfreund not only failed to inform the government of Salomon's violations of the law, but also didn't inform Salomon's board, including Buffett and Munger. What happened next was a run on Salomon as its creditors rightly assumed it could fail if the government stopped doing business with it. Gutfreund found himself out of a job and Buffett found himself chairman of a teetering investment bank. He explained it this way:

> "In 1989, when I—a happy consumer of five cans of Cherry Coke daily—announced our purchase of $1 billion worth of Coca-Cola stock, I described the move as a rather extreme example of putting our money where my mouth was. On August 18 of [1991] when I was elected Interim Chairman of Salomon Inc., it was a different story. I put my mouth where my money was."

What followed was a heroic, nearly ten-month-long rescue mission that stretched into 1992. Buffett feared that many innocent Salomon employees would lose their jobs. He feared for the entire financial system given Salomon's deep ties to the financial world. He also feared for his own reputation. So Buffett pleaded with government officials to maintain Salomon's status as a dealer in Treasuries and not shut down the bank. At the very last hour, he was successful. If Buffett had been unsuccessful, the firm surely would have failed. Instead, Buffett risked his well-earned reputation to save Salomon and then handed off the reins to Deryck Maughan, an insider with deep knowledge who could credibly claim innocence since he was stationed at the firm's Tokyo office at the time. [257]

The Salomon episode would later burnish Buffett's reputation, not just because he had saved the firm. His forthrightness and honesty, including waiving attorney-client privilege during investigations, set a high bar and showed how a crisis should be managed (made easier of course because he had no hand in the making of it). At every Berkshire Hathaway Annual Meeting, Buffett plays a clip of himself testifying at a Congressional hearing. [258] "Lose money for the firm and I will be understanding. Lose a shred of reputation for the firm and I will be ruthless," is Buffett's now-famous message. It is a message worth repeating.

The other Salomon lesson was that Berkshire could operate fine without him. The Salomon stint did not impact Berkshire to any significant degree because Berkshire's managers were capable and in control. Still, Buffett

was quick to point out the word interim in his new Salomon "Interim Chairman" title. "Berkshire", he wrote shareholders, "is my first love and one that will never fade."

Sources of Reported Earnings

Look-through earnings declined by 14%, from $602 million in 1990 to $516 million in 1991. [259] Both Berkshire's operating income and its share of investees earnings contributed to the decline. Media companies Cap Cities/ABC and *The Washington Post* suffered due to changing industry economics. Wells Fargo posted a loss that hurt investee look-through earnings, but which was offset by dividends received (and counted toward Berkshire's operating earnings). Berkshire's largest operating division, insurance, recorded significantly lower but still excellent profits. Pre-tax operating earnings from insurance, including underwriting and investment income, dropped from $300 million in 1990 to $212 million in 1991 because of a large underwriting loss.

Table 5.27: Berkshire Hathaway look-through earnings, 1990–1991 (reproduced from the 1991 Chairman's letter)

Berkshire's major investees	Berkshire's ownership of company at year-end		Berkshire's share of undistributed operating earnings ($ millions)	
	1991	1990	1991	1990
Capital Cities/ABC, Inc.	18.1%	17.9%	$61	$85
The Coca-Cola Company	7.0%	7.0%	69	58
Federal Home Loan Mortgage Corp.[1]	3.4%	3.0%	15	10
The Gillette Company[2]	11.0%	0.0%	23	0
GEICO Corp.	48.2%	46.1%	69	76
The Washington Post Company	14.6%	14.6%	10	18
Wells Fargo & Company[3]	9.6%	9.7%	(17)	19
Berkshire's share of undistributed earnings of major investees			230	266
Hypothetical tax on these undistributed investee earnings			(30)	(35)
Reported operating earnings of Berkshire			316	371
Total look-through earnings of Berkshire			$516	$602

Footnotes:
1. Net of minority interest at Wesco.
2. Earnings for the nine months after Berkshire converted its preferred stock on April 1.
3. Earnings calculated on average ownership for the year.

Note: Amounts are after tax.

Source: Berkshire Hathaway Annual Report 1991.

A Change in Media Economics and Some Valuation Math

In a section of his Chairman's letter so entitled, Buffett illustrated quite simply how media companies, such as Cap Cities/ABC, *The Washington Post* , and *The Buffalo News* , had weaker performance than in years past. The discussion also included Buffett's thinking on the three types of businesses in the business universe.

Type one : The most valuable business, regardless of industry, was an economic franchise. Not to be confused with the more commonly known lease-a-concept business operation, Buffett defined a business franchise as one that: "(1) is needed or desired; (2) is thought by its customers to have no close substitute and; (3) is not subject to price regulation." Such businesses, which included media companies prior to 1991 and might have

included them then, had pricing power and earned high returns on capital. Also, they were largely immune to inept management.

Type two : A good business. Buffett was realizing that media companies were becoming less franchise-like and more akin to a good business. The only way for a business to earn high returns on capital was to be the low-cost operator. This was usually the result of an above-average manager. Media companies' valuations suffered as their operations faced a slide in quality. As a franchise, many media companies regularly grew earnings 6% per year without the need for additional capital. This pricing power provided solid earnings and returns on capital. But media businesses were losing their ability to price aggressively and be managed loosely as competition intensified and the companies lost some of their franchise strength.

Quite understandably, investors priced them to suit: Assuming a 10% discount rate and 6% perpetual growth, such a business would rationally be worth twenty-five times earnings. [260] But when that cost-free growth disappeared due to the shift in economics favoring alternative forms of advertising, such a business would only be worth ten times earnings. Such normal businesses could still be good investments, but they would require additional capital to grow. Buffett was trying to explain that growth was not some ethereal concept to be plugged into a model without thought. It took knowledge of how underlying operations worked.

A business was usually restricted due to capital requirements. Growth could not be had unless more capital was put up through retained earnings, additional equity, or borrowing (or a combination of the three). Absent additional capital, Buffett said a "'bob around' pattern is indeed the lot of most businesses." Berkshire shareholders could look to Scott Fetzer, or more broadly the Manufacturing, Publishing, and Retailing segment, to see that high returns on capital did not automatically come with growth. Buffett had noted in his 1990 letter that 80% of the Manufacturing, Publishing, and Retailing businesses' earnings were paid out as dividends to Omaha. This was okay since the underlying returns on capital were satisfactory. It just meant searching elsewhere for a place to allocate the excess capital above and beyond those businesses' needs.

Type three : Buffett did not discuss the third type of business, essentially everything other than a franchise or a good business. He presumed

shareholders could figure that out for themselves. High-cost commodity operations [261] and/or those requiring a lot of capital with no attendant growth would fall into this last category. Of those there were many. Perhaps Buffett didn't want to discuss the poster child for such a business—Berkshire's own textile businesses of the prior decade.

Insurance

The 30,000-foot view of the operating earnings summary showed the Insurance Group posting a large loss from underwriting, but positive earnings overall due to investment income. Insurance earnings were down significantly but they were nonetheless excellent in context. The underwriting loss provided a cost of float of 6.3%, lower than the long-term Government Bond rate of 7.4%, and float grew 16% to an average of $1.9 billion. The Insurance Group was following a basic recipe for success: more float at an attractive cost.

Table 5.28: Insurance Group, select information

($ millions)	1991 Amount	1991 %	1990 Amount	1990 %
Primary Group				
Premiums written	$135.5		$139.1	
Premiums earned	141.0	100.0%	154.0	100.0%
Losses and loss expenses	95.2	67.5%	102.0	66.2%
Underwriting expenses	48.3	34.3%	51.5	33.4%
Total losses and expenses	143.5	101.8%	153.5	99.7%
Underwriting gain/(loss) - pre-tax	(2.5)		0.5	
Unfavorable (favorable) loss development included in losses and loss expenses	*(23.8)*	*(16.9%)*	*(18.3)*	*(11.9%)*
Statutory combined ratio		103.2%		103.3%
Reinsurance Group				
Premiums written	$667.0		$435.2	
Premiums earned	635.4	100.0%	437.5	100.0%
Losses and loss expenses	731.9	115.2%	432.2	98.8%
Underwriting expenses	20.6	3.2%	32.5	7.4%
Total losses and expenses	752.5	118.4%	464.7	106.2%
Underwriting gain/(loss) - pre-tax	(117.1)		(27.2)	
Unfavorable (favorable) loss development included in losses and loss expenses	*(30.0)*	*(4.7%)*	*0.0*	*0.0%*
Statutory combined ratio		118.3%		106.3%
Total Insurance Group underwriting gain/(loss) pre-tax	**($119.6)**		**($26.7)**	
Insurance Group overall statutory combined ratio		115.1%		104.9%

Notes:

1. Totals may not add due to rounding.

2. The loss and expense ratios are shown as they were reported in the Annual Reports, which is on a GAAP basis. The GAAP basis ratios are calculated with underwriting expenses divided by earned premiums. This contrasts to the statutory basis calculation, where the ratio uses written premiums. In both the GAAP and statutory calculations, losses and loss adjustment expenses are divided by earned premiums.

3. In 1990, Berkshire began including structured settlements and portfolio reinsurance with reinsurance.

Sources: Berkshire Hathaway Annual Report 1992 and author’s calculations.

It is important to understand the impact of the type of premiums written by the Insurance Group and the related accounting conventions. Berkshire was moving into the greener pastures of super cat insurance, using its superior capital strength and willingness to write large policies to its advantage. The super cat business had the benefit of producing a lot of float, but it also came with risk and volatility in reported earnings. Such lines could cause a

$100 million profit in a good year or a $200 million loss in a bad one. Berkshire priced the business to pay out 90% of premiums over the long term, which it thought would produce a profit over time.

Accounting for super cats and other long-tail types of insurance was even more difficult than the primary or direct lines—and even those weren't easy. The nuances were important for shareholders to understand. Even in a good year where no super cat events occurred and Berkshire earned all its large $100 million annual premium volume, it was economically accruing risk and future losses that would—someday—be paid out as claims. Accounting conventions, however, did not allow for reserving for such near-certain future losses, and so reported results could swing wildly.

Super cats were not the only possibilities for accounting confusion. The notes to the financial statements provided important accounting disclosures as there was potential for readers to be misled. Even though Berkshire had recorded yet another year of favorable loss development, including a full $30.6 million relating to the quota-share reinsurance contracts previously shared with Fireman's Fund and others, there was still a chance for unfavorable development in future years. Berkshire was not immune to unfavorable surprises, but on balance its financial statements usually exhibited elements of conservatism.

One important disclosure for readers to be aware of was deferred charge amortization for retroactive reinsurance contracts. A retroactive reinsurance contract provides insurance for known loss events that are expected to extend into the future, but which a primary or other reinsurer wishes to lay off. [262] Since claims come in the future (sometimes far into the future) and float is available for a long time to generate income to offset future losses, reinsurers appropriately accept premiums lower than the expected future payouts. [263]

The accounting for retroactive reinsurance contracts can cause some confusion if not properly understood. The day a contract is booked the reinsurer receives an upfront cash premium. Since the earned premium is offset by losses larger than the premium received, the losses are split into two buckets. One is equal to the premium just received and expensed immediately as an incurred loss. Second, the day-one excess of loss over the premium received is placed on the balance sheet as an asset. While somewhat counterintuitive at first, this accounting generally makes sense.

In theory this new deferred charge asset will be amortized away via the expense account, offset by earnings from the investment income generated by the upfront cash received, hopefully with a small profit leftover. While this theory is sound, it has the effect of causing apparent underwriting losses in future periods as the deferred charge asset is expensed without any offsetting premium being earned. [264] (Remember, the entirety of the premium is earned day one, with the economics of the transaction based partly on the ability to generate investment income.)

In 1991, Berkshire disclosed $26.2 million of underwriting loss associated with such deferred charges on retroactive reinsurance. In addition, a $22.8 million underwriting loss was booked with respect to structured settlements. Structured settlements were also based on time-value-of-money concepts and caused similar accounting issues like retroactive reinsurance. In short, the favorable economics of these contracts (holding cash for a long time) could be overshadowed by what looked like losses (amortization of the asset) due to the accounting. [265]

Manufacturing, Publishing, and Retailing

The manufacturing, publishing, and retailing businesses reported pre-tax earnings of $214.5 million, down 1% from the prior year. Revenues grew 4.6% to $1.65 billion but also contained revenues from acquisitions, including H.H. Brown mid-year. Flat earnings seem unimpressive until translated into a pre-tax return on tangible capital of 57.2%. That result is impressive on its own, no doubt. But it fell from 73% in 1990. The cause? A recession and Berkshire's continued acquisition of very good but slightly less spectacular businesses. After-tax return on equity fell from 51.1% to 39.3%.

Berkshire's history with See's Candies illustrates the economics of a wonderful business. When Blue Chip Stamps purchased See's in 1972 it was already a very good business. Its pre-tax return on capital was north of 50%. Nineteen years later in 1991, See's was doing even better. Pre-tax earnings had grown tenfold while the capital needed to operate the business had only tripled. The result: an explosion of profitability with a pre-tax return on capital in the triple-digits. A truly mouthwatering result.

With such large numbers it was easy to conclude the growth of See's was a success; it was not as apparent with other businesses. Buffett laid out his

analysis: “For an increase in profits to be evaluated properly, it must be compared with the incremental capital investment required to produce it.” Using this framework, See’s required an investment of $17 million to increase earnings by $38 million—a wonderful return by any standard.

Table 5.29: See’s Candies, select data

($ millions)	1991	1972	Change
Revenues	$196.0	$29.0	6.8x
Pre-tax earnings	42.4	4.2	10.1x
Tangible capital	25.0	8.0	3.1x
Incremental earnings	$38.2		
Incremental capital	17.0		
Incremental return on capital	225%		
Revenues/capital	$7.84	$3.63	
Return on capital, pre-tax	170%	53%	

Source: Berkshire Hathaway Annual Report 1991.

How was this possible, especially given the frequent commentary by Buffett and Munger that the industry was very tough? The answer was the company’s untapped pricing power. Said another way, its customers were not overly price sensitive. This was evident in the fact that 1991 results were better, even in the face of a new tax on snack food. Same-store poundage fell 5% but pre-tax earnings increased 7% to $42.4 million. Lower cost inflation helped to cause that result, but See’s was still an excellent business.

The $410 million of earnings distributed to Blue Chip/Berkshire Hathaway by See’s over the prior two decades was sweet, but the company brought something else that was perhaps more valuable. The lessons learned from See’s made Berkshire significant money by teaching Buffett and Munger the advantages of owning great businesses.

H.H. Brown Shoe

Berkshire’s latest acquisition [266] was H.H. Brown Shoe Co., the leading North American manufacturer of work shoes and boots at the time. Buffett reported that the Massachusetts-based business earned fine margins on sales

and assets. It was founded by Ray Heffernan and later run by his son-in-law, Frank Rooney. After Heffernan's death, the family decided to look for a home for the business and found one in Berkshire. Like many other Berkshire subsidiaries, Rooney had no monetary need to work but continued to do so because he loved the business.

The H.H Brown acquisition put Berkshire on a path back to manufacturing, this time in the shoe business. New England was a hotbed for shoe manufacturing. In the 1970s, there were 1,100 shoe manufacturing plants in the US, but by 1985 only about 500 remained. The decline in American shoe manufacturing employment was in full force in 1991. This may sound ominous and the factors just described probably played a part in the price Berkshire was willing to pay. [267]

H.H. Brown's unusual compensation program warmed Buffett's heart. Company managers were paid an annual salary of just $7,800, with the remaining compensation coming from a percentage of profits, after a capital charge. "These managers, therefore, truly stand in the shoes of owners," wrote Buffett. The business joined Berkshire on July 1, 1991 and earned $13.6 million pre-tax for Berkshire that year.

Nebraska Furniture Mart increased revenues 4% to $171 million amidst a sluggish retail environment. Pre-tax profits, however, decreased 17% to $13.9 million as the company lowered its prices (which were already very low), "in order to protect and reinforce its image as a low-cost supplier." It also purchased a small business in Lincoln, Nebraska, though details were not provided.

The Buffalo News saw pre-tax profit decline 15.6% to $36.6 million as demand for print advertising fell off a cliff. Berkshire disclosed in a footnote that it thought profits would continue to decline as a result of increased competition from direct mail and a continued decline in newspaper advertising. Additionally, the footnote disclosed a $2 million buyout offer made to printers and pressman early in 1992.

At World Book, profits fell almost 30% to $22.2 million, though this was compared to a record high year in 1990. Profits fell 12% compared to a more normal year like 1989. The decline was partly attributable to the recession and in larger part due to a costly change in a marketing strategy.

Despite the recession, which caused sales and profits to falter at some other Berkshire subsidiaries, the Kirby unit did well in 1991. Driven primarily by

the introduction of the new Generation 3 vacuum cleaner, revenues increased 2% to $192 million. With lower start-up costs compared to 1990 (when the new model was released) pre-tax profit ballooned almost 31% to $37 million.

The story was similar at Fechheimer. As a result of growth in retail operations, a new fire-protection line, and higher sales of marching band uniforms, revenues increased 6% to $100 million and pre-tax profit increased 4% to $12.2 million. Integration-related problems experienced in prior years abated and Fechheimer managers were cautiously optimistic going into 1992—the company's 150th anniversary.

Investments

There were a few things to note in Berkshire's investment portfolio for 1991, including its first significant foreign investment. In 1991 Berkshire acquired 31.2 million shares of Guinness PLC, maker of the famous namesake stout beer, for just under $265 million. Berkshire's stakes in its remaining six permanent investments did not change in 1991 in terms of number of shares held.

Berkshire found some fixed income replacements for its recently converted Gillette preferred stake into common stock, and its RJR Nabisco preferred, which was also eliminated due to an exchange offer. Berkshire increased its holdings of preferred shares in ACF Industries, a railcar manufacturer, to $94 million at cost, and established a position in American Express preferred stock, purchased for $300 million but valued at $263 million at year-end. [268] It also purchased $40 million of First Empire State preferred. The bank was run by Bob Wilmers, whom Buffett greatly admired. Reflecting a "risk that the industry will remain unprofitable for virtually all participants in it," Berkshire wrote down the value of its USAir preferred stock by 35% to $232.7 million. Overall the fixed-income portfolio had treated Berkshire well by earning more than comparable fixed-income portfolios.

Characteristically, Buffett did not let an opportunity go by for airing his mistakes. Over more than half a page in his letter he chided himself for missing an investment opportunity in Fannie Mae, a similar entity to that of Freddie Mac. He wrote that such mistakes of omission never showed up

anywhere, but that they were still costly. Buffett estimated this mistake cost Berkshire about $1.4 billion.

Miscellaneous

Malcolm G. Chace, Jr., retired in 1991. At 88 years old, Chace had a long history with Berkshire that began in 1931 at Berkshire Fine Spinning Associates and continued to his chairmanship of Berkshire in 1957. It was Chace that made it possible for Buffett to buy into Berkshire in the first place. Chace's son, Malcolm "Kim" Chace III, was nominated to replace his father.

Berkshire began paying off some of its high-cost debt in 1991, including a $22 million partial redemption of a 9.75% issue and $50 million of a 10% debenture (both at the Berkshire-parent level). With interest rates at their lowest since the mid-1970s (the 10-year Treasury fell below 7% at the end of 1991), more debt reduction was slated for 1992. This included the remaining $100 million portion of the 10% debenture and $36 million of subsidiary-level debt with interest rates close to 10%. Given Berkshire's high levels of liquidity and few great prospects for investments, such capital allocation moves made sense.

1992

In 1992, Berkshire Hathaway's increase in per share book value comfortably exceeded Buffett's 15% target threshold, rising 20.3% and adding $1.5 billion to the equity account. But this high growth rate affected Berkshire's balance sheet equity and the per share rate of increase slightly differently. More than 98% of the growth came from Berkshire's usual operating company and investing activities; the balance came from the issuance of 2,162 shares after Berkshire called its convertible debentures and some holders elected to convert. [269]

These new shares priced Berkshire Hathaway at a market value of about $13.5 billion (see Table 5.30). Using Berkshire's average equity during the year, that valuation was equal to 1.7x book value—not an unreasonably high or low valuation. Viewed another way, the $13.5 billion price tag would provide owners with a 4.5% earnings yield against Buffett's own

estimate of owner earnings. For a company regularly exceeding a 15% growth rate such a valuation would not have been unreasonable. [270]

Table 5.30: Berkshire Hathaway implied valuation

Issue price	$11,719
BRK shares outstanding	1,152,547
Implied market value *($ millions)*	13,507
1991 average book value *($ millions)*	8,138
Price/book value	1.66x
Estimated owner earnings *($ millions)*	604
Earnings yield	4.5%

Sources: Berkshire Hathaway Annual Report 1992 and author's calculations.

After ten months, Buffett concluded his Salomon interlude. Buffett praised the managers responsible for the remarkable turnaround: CEO Deryck Maughan, Bob Denham, Don Howard, and John Macfarlane. He also praised Ron Olson, Charlie Munger's partner at the law firm Munger, Tolles & Olson, who helped manage the complex maneuvering through different financial and regulatory agencies. Buffett said he was delighted to be back full-time running Berkshire.

His delight turned to exhilaration with the acquisition of several new businesses in 1992. One was the purchase of 82% of Central States Indemnity, an Omaha-based insurer of credit card payments for the disabled or unemployed. Central States was writing $90 million of premiums and earning profits of about $10 million. [271] One of Berkshire's newer acquisitions, H.H. Brown Shoe, acquired Lowell Shoe Company during the year. Berkshire's other subsidiaries found four other add-on acquisitions. Buffett called such add-ons low-risk, high-return propositions since they "enlarge the domain of managers we already know to be outstanding." This is a strategy Berkshire has continued to successfully employ to this day. It was not unlike increasing the ownership positions of existing marketable securities holdings.

Insurance

Judged by cost of float, Berkshire's Insurance Group did well in 1992. Its nearly $2.3 billion of average float, up almost 21% from 1991, cost it just

4.8% [272] compared to the Long-Term US Government Bond rate of 7.4%.

Understanding these gains and losses requires a close look at what was happening in 1992. In August, Hurricane Andrew (a category five hurricane) hit the East Coast of the US and caused large damages. Buffett thought that about four points of the industry's estimated combined ratio of 115% in 1992 could be attributed to that storm. Berkshire fared better than most. Berkshire sustained about $125 million of losses from Hurricane Andrew, but since it took in almost the same amount in premiums, the result for the super cat business line was breakeven. GEICO sustained after-tax losses of $50 million from the storm, which translated into about $25 million on a look-through basis for Berkshire (which now owned 50% of GEICO as a result of continued buybacks; Berkshire's original investment remained unchanged).

Table 5.31: Insurance Group, select information

($ millions)	1992 Amount	1992 %	1991 Amount	1991 %
Primary Group				
Premiums written	$132.4		$135.5	
Premiums earned	152.8	100.0%	141.0	100.0%
Losses and loss expenses	98.0	64.1%	95.2	67.5%
Underwriting expenses	46.8	30.6%	48.3	34.3%
Total losses and expenses	144.8	94.8%	143.5	101.8%
Underwriting gain/(loss) - pre-tax	8.0		(2.5)	
Unfavorable (favorable) loss development included in losses and loss expenses	*(36.4)*	*(23.8%)*	*(23.8)*	*(16.9%)*
Statutory combined ratio		99.5%		103.2%
Reinsurance Group				
Premiums written	$607.2		$667.0	
Premiums earned	511.5	100.0%	635.4	100.0%
Losses and loss expenses	589.7	115.3%	731.9	115.2%
Underwriting expenses	38.8	7.6%	20.6	3.2%
Total losses and expenses	628.5	122.9%	752.5	118.4%
Underwriting gain/(loss) - pre-tax	(117.0)		(117.1)	
Unfavorable (favorable) loss development included in losses and loss expenses	*0.0*	*0.0%*	*(30.0)*	*(4.7%)*
Statutory combined ratio		121.7%		118.3%
Total Insurance Group underwriting gain/(loss) pre-tax	**($109.0)**		**($119.6)**	
Insurance Group overall statutory combined ratio		115.1%		115.1%

Notes:

1. Totals may not add due to rounding.

2. The loss and expense ratios are shown as they were reported in the Annual Reports, which is on a GAAP basis. The GAAP basis ratios are calculated with underwriting expenses divided by earned premiums. This contrasts to the statutory basis calculation, where the ratio uses written premiums. In both the GAAP and statutory calculations, losses and loss adjustment expenses are divided by earned premiums.

3. In 1990, Berkshire began including structured settlements and portfolio reinsurance with reinsurance.

Sources: Berkshire Hathaway Annual Report 1992 and author's calculations.

In the Primary Group, results for 1992 were generally favorable. Earned premiums increased 9% to $153 million, reflecting some minor thawing in the competitive environment. Even better, underwriting returned to profitability with an $8 million underwriting gain compared to a $2.5 million loss the previous year. Other data points included:

- Motor vehicle/general liability earned premiums declined 5% to $85 million.
- The commercial casualty/professional liability/specialty risk group (which had seen its premiums fall to $14 million in 1991 from a high of $93 million in 1987) earned $27 million of premiums.
- The Home State group earned generally flat volume of $41 million in 1992 compared to the two prior years.

The year benefitted from both the higher volume of specialty risk earned and from over $36 million of favorable loss development—a considerable 23.8% of earned premiums. [273] The footnotes to the financial statements again cautioned readers not to get too comfortable with what was now the sixth year of favorable loss development.

Taken as a whole, the Reinsurance Group in 1992 wrote to a combined ratio of 121.7%. It was a year that saw losses continue at an elevated level on lower written and earned premium volume. Even with 20% lower earned premium volume, continued growth in long-tail lines such as retroactive reinsurance, and others, led to growth in float. Buffett praised Ajit Jain ("simply the best in this business") for steadfastly holding to Berkshire's high underwriting standards. Berkshire rejected 98% of business offered to it—an impressive display of discipline.

It's worth noting an important accounting treatment with respect to super cat-type policies. With other insurance policies, premiums were recorded over the life of the policy. By contrast, Berkshire recognized super cat premiums as earned revenues when either a loss event occurred or when the policy expired. It did this because the likelihood of a super cat policy causing losses was greater at the end of the year. Of the ten largest insured losses as of 1992, nine occurred in the later part of the year. Consequently, quarterly results were essentially meaningless.

Manufacturing, Publishing, and Retailing

Coming out of the recession of the year before, and with new businesses included in the category, the businesses in the manufacturing, publishing, and retailing segment reported pre-tax earnings up 17.6% to $252.2 million on revenues that increased 7.2% to $1.8 billion. Pre-tax return on tangible capital remained very strong at 55.6% (down 1.6 percentage points). After-

tax return on tangible equity remained attractive at 36.9%. These businesses were splendid, but they would never achieve the heights of returns achieved just a few years before.

Over a handful of short paragraphs in his Chairman's letter, Buffett summarized the fascinating ongoing story that was the life of Rose "Mrs. B" Blumkin, now 99 years old. Remember that Mrs. B feuded with her children and grandchildren in 1989 over the Nebraska Furniture Mart carpet department. The company was doing fine without her (pre-tax earnings rebounded 19% to $17.1 million in 1992), but Mrs. B missed her work. Not one to slow down, she purchased a building across the street from Nebraska Furniture Mart and set up shop again. Mrs. B made amends with her family and offered to sign a non-compete agreement. The price tag to buy her new business was $5 million. [274] "Mrs. B. belongs in the Guinness Book of World Records on many counts. Signing a non-compete at age 99 merely adds one more," Buffett wrote reverently.

Scott Fetzer earned $110 million pre-tax on just $116 million of equity capital. Scott Fetzer was a perfect example of the type of growth Buffett valued. What impressed Buffett was growth while maintaining high rates of return on capital and employing very little debt. In Scott Fetzer's case, the business was simultaneously growing while shrinking its use of capital. In other words, return on capital was improving. This made it possible for Scott Fetzer to distribute over 100% of its earnings to Berkshire since its acquisition seven years before. It also earned Ralph Schey Buffett's accolades.

An analysis of Scott Fetzer contains a glimpse into the small unofficial bank Berkshire was building. While the Scott Fetzer parent company used scarce amounts of borrowed money, its finance subsidiary wasn't shy about borrowing. Why the difference? Why wasn't Berkshire using some of its excess liquidity to eliminate or substantially reduce this debt? Viewed along the lines of a regular operating business, the capital structure was risky. But considered as the economic equivalent of a bank with financial assets funded by financial liabilities, it was appropriate. The assets of Scott Fetzer Financial Group were comprised largely of interest-bearing receivables it purchased from Kirby and World Book. Since the sales were complete only credit risk remained, and as such it was appropriate to borrow to finance them.

Kirby sales were essentially flat (down 1%) due to weakness in foreign unit sales, though pricing and expense management helped pre-tax earnings grow 19% to $17.1 million. World Book had a 21% decline in revenues and pre-tax earnings grew almost 30% to $29 million. The unit discontinued its unprofitable syndication business and reduced certain reserves for sales draws, both of which were one-time items.

At See's, poundage fell 4% but was offset by a 5% price increase. A new 8.5% sales tax on snack foods in California, which had since been repealed, likely affected pre-tax earnings at See's, which were unchanged from the year before at $42.4 million.

Fechheimer added ten stores, bringing its total to fifty-three. This growth accounted for a 10% increase in revenues during 1992. The result was a 6% increase in pre-tax earnings to $13.7 million.

Rebounding from the recent recession, pre-tax profits of *The Buffalo News* ballooned almost 30% to $47.9 million. Increased levels of advertising and a 20% reduction in the cost of newsprint (offset by a $2.9 million charge for an employee buyout) led to these results.

Investments

Berkshire's equity portfolio saw some modest changes in 1992. The now-familiar names were all there—Cap Cities/ABC, Coca-Cola, Freddie Mac, GEICO, Gillette, Guinness, *The Washington Post* , and Wells Fargo. Berkshire added moderately to Guinness and Wells Fargo and doubled its stake in Freddie Mac. There was one newcomer: General Dynamics, a defense contractor, originally purchased as an arbitrage opportunity. General Dynamics was run by Bill Anders, one of the first men to orbit the Moon on Apollo 8. It turned out Anders was a good capital allocator and Berkshire ended the year with 14% of the company as a new long-term investment.

Buffett sought to clarify the "fuzzy thinking" that he believed led investors to choose between growth and value investing. The two terms had become (and largely continue to be) one of the key ways investment funds are marketed. Buffett correctly saw them as connected: "In our opinion, the two approaches are joined at the hip: Growth is *always* a component in the calculation of value, constituting a variable whose importance can range

from negligible to enormous and whose impact can be negative as well as positive."

Readers of shareholder letters from the average public company can come away with the misconception that growth is always good. [275] What's missed by those managers and investors who seek out and reward such thinking is that bigger doesn't always equal better. Growth is good *only* when it comes at satisfactory rates of return on incremental capital employed. Opportunity cost, or alternative uses of capital, should also factor into the analysis. It is a mistake to buy a company just because it is growing, or to avoid one because it isn't. What really matters is price relative to value. Growth (like the above quote states) is simply one component of the equation.

Within its fixed income portfolio Berkshire added to its holdings of ACF Industries debentures. A portion of the Washington Public Power Supply System bonds were called, reducing its stake in that company. And Berkshire sold its entire stake in RJR Nabisco. Investing wisdom accompanied the news of these changes. Buffett wrote that the secondary market (where existing shares of stock and bonds are traded) as contrasted to the primary or new issue market, was the better arena for investors. First-issue shares were (and are) usually priced much more rationally in the primary market due to the control that issuers and their investment banks have over timing. In the secondary market, an investor can benefit from taking advantage of Mr. Market. They may even find that "shares worth *x* in business value have sold in the market for ½ *x* or less." Berkshire's negotiated purchases of preferred stock, including the convertible preferred issue from Gillette, proved this rule. Buffett said Berkshire had done well in those investments, but perhaps not as well as if he had taken his own advice.

Two New Accounting Rules and a Plea for One More

In keeping with his intent to educate and inform, Buffett's 1992 Chairman's letter included important accounting updates. In a section entitled Two New Accounting Rules and a Plea for One More, he provided three lessons.

Lesson one : a new rule related to deferred taxes. The new rule, which Buffett thought reasonable, required accruing deferred tax at one uniform rate, then 34%. Prior to this change, which would take effect in 1993, Berkshire used a two-tiered system where $6.4 billion of its unrealized

appreciation on investments was taxed at a 34% rate and the $1.2 billion balance at the older 28% rate. The result of the new rule would be a $70 million increase to the tax liability and a corresponding decrease to equity.

Lesson two : Businesses must now recognize present value liabilities related to post-retirement healthcare benefits. Prior to 1993, GAAP had only required companies to record the present value of their pension liabilities, but Buffett said it illogically ignored liabilities for health benefits extending past the time of employment. The change would have little effect on Berkshire because its future obligations to its 22,000 employees were negligible. This was no accident. Buffett and Munger avoided acquiring businesses burdened with post-retirement healthcare obligations; they also tended to avoid buying the stocks of companies with such liabilities. This new accounting rule would force the recognition of a previously ignored economic reality that such obligations were a real, if not precisely quantifiable, liability.

Lesson three : how to value stock options. The crux of the matter was that companies did not account for the issuance of stock options as an expense on their books. Stock options are difficult to value and are non-cash in nature, so executives and others argued that they should not be included on a company's books. Buffett, as usual, cut through the fog and opined: "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?"

This third lesson, though not associated with an accounting change, got more ink than the first two combined. And rightly so. Buffett wrote that accountants and regulators should be shamed by letting companies and their executives strong-arm them into such egregious accounting. Since the issuance of equity directly affected an investor's return from their investment, it was an extremely important issue for the accounting profession to tackle, imprecise and messy as it might be. This was a battle Buffett would long fight until the expensing of options was made mandatory in the mid-2000s. [276]

While Berkshire did not use stock options, it did have an outstanding issue of 5.5% zero-coupon convertible debentures issued in September 1989, which were called that year. [277] Buffett did not like the prospect of Berkshire shareholders not knowing exactly what their ownership interest was at any

given time. “Berkshire shareholders are disadvantaged by having a conversion option outstanding.” The terms of the debenture looked less favorable to Berkshire after interest rates declined and book value nearly doubled in that short time.

Miscellaneous

Wrapping up his 1992 letter to shareholders, Buffett relayed what he called two pieces of regrettable news. His long-time assistant, Gladys Kaiser, who had been with him twenty-five years, was retiring after the 1993 Annual Meeting. Additionally, Verne McKenzie was stepping down as CFO, leaving the post to his understudy, Marc Hamburg. [278]

His usual invitation to Omaha for the Annual Meeting followed. As did the customary plea to shop at Nebraska Furniture Mart and Borsheims during the visit.

1993

The year 1993 could be described as a prototypical year for Berkshire Hathaway. It found one large acquisition candidate, largely left its investment portfolio intact, maintained its insurance underwriting discipline in the face of continued so-so pricing, and polished around the edges of its various other businesses.

Berkshire’s gain in book value was 14.3% during the year, falling just below Buffett’s stated goal of 15% per year. [279] Berkshire’s net worth increased by $1.5 billion and was affected by several non-operating items. Two factors were positive and two were negative.

The two negative factors were related to a change in Generally Accepted Accounting Principles (GAAP). They pertained to accruing for deferred taxes on unrealized appreciation of securities gains. The first, discussed in the 1992 segment, called for all unrealized gains (and losses, if applicable) to be netted against the 34% corporate tax that would be due if/when sold, rather than the previous bifurcating practice depending on when the securities were purchased. The second related factor was a 1% increase in the tax rate to 35% that went into effect in late 1993, which meant accruing additional tax. The tax itself was straightforward. The accounting, however, necessitated that both one-time charges be deducted from earnings, even

though the unrealized appreciation never was. [280] Taken together these amounted to approximately $145 million of charges that reduced Berkshire's net worth.

Offsetting these charges were two positive factors. One was a change in the way common equity securities were valued on Berkshire's balance sheet. Beginning in 1993, all common stocks would be valued at market, in contrast to being carried at cost. The change increased Berkshire's reported net worth by $172 million in 1993. The increase in net worth from this change would have been much larger had it not been for the fact that Berkshire's Insurance Group already valued its common stock holdings at market, an accounting convention that began in 1979. The accounting fixed a peculiarity that valued the same security differently depending on which subsidiary held the asset. [281]

The second factor positively affecting Berkshire's net worth was the issuance of shares. Some 3,944 shares were issued in January relating to the conversion of the convertible debentures called for redemption (some investors elected for shares, the remaining for cash). [282] Another 25,203 shares were issued in connection with the 1993 acquisition of Dexter Shoe, discussed below. Thus Berkshire's net worth increased by about $478 million due to the issuance of 29,147 shares. Because they were issued at a price above book value, their issuance increased per share book value. More shares meant a higher benchmark to meet the 15% annualized return target. Instead of $1.8 billion, Berkshire would need to increase its book value by $1.85 billion by the year 2000 to meet its goal.

Dexter Shoe

One of Berkshire's largest acquisitions this decade was Dexter Shoe based in Dexter, Maine. Harold Alfond founded the business in 1956 with $10,000 of initial capital and grew it into one of the largest American footwear manufacturers and retailers with the help of his nephew, Peter Lunder. By 1993, Dexter was selling over 7.5 million pairs of shoes from seventy-seven retail locations. Though some were manufactured in Puerto Rico, most were manufactured in Maine. This countered the prevailing wisdom that imports made such arrangements uncompetitive. [283] Dexter's shoes were sold in familiar retailers including Nordstrom and J.C. Penney.

Berkshire paid $433 million for Dexter, [284] exchanging 25,203 shares for the business. Buffett held out the Dexter acquisition as an example to others of the Berkshire system. The deal came together because of Frank Rooney, manager of H.H. Brown Shoe, who knew Alfond and Dexter Shoe well. Alfond made a deal with Buffett for an all-share purchase, rather than cash. It highlighted some of the advantages Berkshire could provide a seller. In addition to saving on taxes by using shares instead of cash, Alfond traded "a 100% interest in a single terrific business for a smaller interest in a large group of terrific businesses." Where Rose Blumkin had declined such an offer ten years earlier for Nebraska Furniture Mart (instead opting for cash), Alfond took Buffett up on what amounted to a tax-free diversification for Alfond and his family's business holdings.

The Dexter acquisition provided a great example of Berkshire's strategic planning—or lack thereof. "Five years ago we had no thought of getting into shoes. Now we have 7,200 employees in that industry," Buffett said. It proved the wisdom of always being ready for action. Berkshire expected the Shoe Group (H.H. Brown, Lowell Shoe, Dexter) to earn around $85 million pre-tax on revenues of $550 million in the coming year.

Insurance Operations

Berkshire's main economic engine was insurance. Insurance comprised $16.2 billion of Berkshire's $19.5 billion of identifiable assets at year-end 1993 and showed no signs of slowing down. Though patience and a willingness to walk away from business was still the rule, Berkshire saw a large opportunity to put its superior financial strength to use in marketing super cat and other reinsurance products where staying power counted. This did not mean that reinsurance was immune to competition. Almost $5 billion of capital had recently been raised to form new entities to compete in the reinsurance space. What it did mean was Berkshire had the financial strength and prowess to weather business cycles and eventually come out ahead.

Berkshire's Insurance Group was proudly holding its own in 1993. As a whole the Insurance Group wrote and earned about the same volume in 1993 as it did in 1992: $737 million and $651 million, respectively (see Table 5.32). It also marked the first overall underwriting profit—$30

million pre-tax—since 1981. Better still both the primary and reinsurance segments wrote to combined ratios below 100%.

Table 5.32: Insurance Group, select information

($ millions)	1993 Amount	1993 %	1992 Amount	1992 %
Primary Group				
Premiums written	$208.4		$132.4	
Premiums earned	208.3	100.0%	152.8	100.0%
Losses and loss expenses	99.8	47.9%	98.0	64.1%
Underwriting expenses	95.8	46.0%	46.8	30.6%
Total losses and expenses	195.6	93.9%	144.8	94.8%
Underwriting gain/(loss) - pre-tax	12.7		8.0	
Unfavorable (favorable) loss development included in losses and loss expenses	*(41.7)*	*(20.0%)*	*(36.4)*	*(23.8%)*
Statutory combined ratio		93.9%		99.5%
Reinsurance Group				
Premiums written	$528.7		$607.2	
Premiums earned	442.4	100.0%	511.5	100.0%
Losses and loss expenses	350.9	79.3%	589.7	115.3%
Underwriting expenses	74.2	16.8%	38.8	7.6%
Total losses and expenses	425.1	96.1%	628.5	122.9%
Underwriting gain/(loss) - pre-tax	17.3		(117.0)	
Unfavorable (favorable) loss development included in losses and loss expenses	*0.0*	*0.0%*	*0.0*	*0.0%*
Statutory combined ratio		93.4%		121.7%
Total Insurance Group underwriting gain/(loss) pre-tax	**$30.0**		**($109.0)**	
Insurance Group overall statutory combined ratio		92.2%		115.1%

Notes:

1. Totals may not add due to rounding.

2. The loss and expense ratios are shown as they were reported in the Annual Reports, which is on a GAAP basis. The GAAP basis ratios are calculated with underwriting expenses divided by earned premiums. This contrasts to the statutory basis calculation, where the ratio uses written premiums. In both the GAAP and statutory calculations, losses and loss adjustment expenses are divided by earned premiums.

3. In 1990, Berkshire began including structured settlements and portfolio reinsurance with reinsurance.

Sources: Berkshire Hathaway Annual Reports 1992, 1994; and author’s calculations.

Examining the larger segment, the Reinsurance Group wrote to a 93.4% combined ratio and turned in a $17.3 million pre-tax underwriting gain. The bulk of premiums earned came from the larger super cat policies and quota-share arrangements with other insurers.

Over the prior three years Berkshire all but walked away from retroactive reinsurance and structured settlements due to unfavorable pricing.

Premiums earned in these lines fell 88% between 1991 and 1993, from $363 million to $44 million. The underwriting loss from these business activities was $64.3 million in 1993. These losses were almost entirely due to the amortization of deferred charges and did not accurately reflect economic results since Berkshire continued to benefit from the use of float. Remember, float from these long-tail policies was usually considerable in relation to premium volume and its benefits were seen in insurance investment income, not underwriting.

In contrast, the Primary Group had premium growth in 1993 and earned a $13 million underwriting profit. Premiums earned and written were both $208 million, up 57% and 36% respectively. Part of the reason for the increase was Central States Indemnity, Co., the newest addition to the team acquired the year before, which turned in a $5 million underwriting gain on premiums of $69 million. Reflecting overly conservative loss reserving, the segment again benefitted from favorable loss development. The favorable loss development represented 20% of premiums earned and 7.4% of the amount of reserves at the start of the year. [285] This favorable development was largely attributable to National Indemnity's traditional commercial auto business. The Home State companies, seemingly needing a new name, expanded beyond their borders and planned additional expansion in the coming years. Headwinds were likely coming, however, as industry capacity remained abundant.

Manufacturing, Publishing, and Retailing

The new Shoe Group, together with the other businesses in the manufacturing, publishing, and retailing segment, continued to churn out excellent results for Berkshire. Pre-tax earnings grew 8% to $272.5 million on revenues up 10.6% to $2 billion. Pre-tax return on tangible capital, however, fell from 55.6% in 1992 to 48.2% in 1993. Likewise, after-tax return on tangible equity fell from 36.9% to 31.3%, achieved basically without debt (cash exceeded debt by three times). Returns were declining from the stratosphere but remained highly satisfactory.

Nebraska Furniture Mart was reunited with its matriarch, Mrs. B, who turned 100 years old in 1993 and showed no signs of slowing down. Nebraska Furniture Mart turned Mrs. B's location across the street into an outlet store and planned a 100,000 square feet expansion for an appliance

and electronics superstore. Pre-tax profits swelled 26% to a record $22 million.

At World Book revenues continued to slide substantially, falling 19% to $47.3 million. Pre-tax earnings fell 31% to $20 million as electronic competition from CD-ROMs weighed on its paper-based product. Though the company could not say whether the decline would reverse, World Book was not waiting to find out. It was working on its own electronic version to compete with the likes of Microsoft and others trying to take market share.

The Buffalo News saw a modest increase in revenues from increased advertising and circulation. Its pre-tax profits grew 6% to $51 million. The story was largely the same at Kirby (pre-tax profits up 10% to $39 million), See's (down 3% to $41 million) and most of the other units in the manufacturing, publishing, and retailing segment. Revenues and earnings "bobbed around" but were not specifically noteworthy. A new mail order program at See's was put in place to try to mitigate the inch-by-inch decline in poundage experienced almost every year since Blue Chip purchased it.

Wesco

Surprisingly, Buffett's Chairman's letter did not discuss a relatively major event at Mutual Savings. During 1993, Wesco exited the savings and loan business by transferring its savings account liabilities (offset by a mortgage portfolio and cash) to CenFed Bank, headquartered in Pasadena, California. Munger wrote Wesco shareholders that he and Wesco's management cared about what happened to Mutual Savings customers and CenFed, as it was known, was chosen since it "was considered likely to serve depositors safely and well."

Wesco formed a new holding company for its real estate including its headquarters (the bottom floor of which was now a CenFed branch), the remaining ocean-side lots, and some troubled loans that would slowly be liquidated. It stayed in the housing finance business. Wesco held on to 7.2 million shares of Freddie Mac, the lower-cost competitor to the now-extinct Mutual Savings thrift. The Freddie Mac shares, which cost $72 million, now had a market value of almost $360 million (these were included with Berkshire's total of almost 14 million shares).

Finance Businesses

The shutdown of Mutual Savings caused some important changes to the Finance Businesses supplemental segment now included at the end of the Berkshire Annual Report. Whereas in 1992 the segment included Mutual Savings and Scott Fetzer Financial Group, in 1993 Mutual Savings was replaced by Berkshire Hathaway Credit Corporation. Very little was disclosed about this new entity. What could be gathered from the footnotes to the financial statements is this: it held high-quality, short-term mortgage-backed securities funded by investment agreement borrowings that were structured to match the duration of the assets. It was as if Berkshire had formed its own mini bank without depositors or the strings associated with operating a regulated bank. The Freddie Mac shares retained by Wesco were now included in the Insurance Group segment along with Berkshire's own shares of the mortgage company.

Investments

As Berkshire's marketable securities portfolio grew (now $12.5 billion at year-end), the threshold for reporting also grew. In 1993, the cutoff was $250 million but there was not much to report. This was as it should be, said Buffett. It was hard to find outstanding businesses to purchase, and an owner of a small part of a good company should, like his or her counterpart owning the entirety of a business, hold on "with the same tenacity." The lower investment portfolio turnover compared to years past was in part due to Berkshire's growing size, which limited the investable universe, and in part due to Buffett's increasing appreciation for high-quality businesses.

Long holding periods also confer meaningful compounding advantages through the way taxation works. Buffett's extreme example was a doubling of a dollar for twenty years with a 35% tax rate on the investment. Paying tax annually would result in over $22,370 at the end of two decades. Counterintuitively, allowing the compounding to take place and paying one 35% tax at the end would result in a far better outcome: A result of over $680,000—all due to the power of deferring taxes.

Berkshire's portfolio contained significant unrealized capital gains. At year-end 1993, its marketable securities portfolio had over $8.2 billion in unrealized appreciation—a 300% gain. The most extreme examples were GEICO and *The Washington Post* . Berkshire's GEICO stake had

appreciated thirty-eight times its original cost to $1.7 billion; *The Washington Post* Company over forty-five times to $440 million.

Table 5.33: Berkshire Hathaway equity portfolio, 1993

($ millions)	Cost	Market	Unrealized Gain/(Loss)
Capital Cities/ABC, Inc.	$345	$1,239	$894
The Coca-Cola Company	1,024	4,168	3,144
Freddie Mac	308	681	374
GEICO Corp.	46	1,760	1,714
General Dynamics Corp.	95	401	306
The Gillette Company	600	1,431	831
Guinness PLC	333	271	(62)
The Washington Post Company	10	440	430
Wells Fargo & Company	424	879	455
Other	1,134	1,271	136
Total	$4,318	$12,540	$8,222

Sources: Berkshire Hathaway Annual Report 1993 and author's calculations.

Despite the headwinds faced in some parts of its business such as insurance, Berkshire in 1993 was proving the resiliency of a financially strong business operated for the long term.

1994 Annual Meeting

Looking back, we have the benefit of hindsight. Now, thanks to technology we also can sit in on the Annual Meetings, which were filmed for the first time in April 1994 and made available to the public in 2018. [286] A few interesting discussion topics from that first recorded meeting are worth noting.

One was the degree to which Buffett and Munger thought about public companies as private ones. Buffett's shareholder letters around this time started discussing Berkshire's rising share price, which had never been split and which had recently crossed the $10,000 per share mark. At the 1994 Annual Meeting, the question about share price was asked by a shareholder. Charlie Munger, as usual, cut right to the chase: "I think the idea of carving ownerships in an enterprise into little, tiny $20 pieces is almost insane …. I don't see why there shouldn't be a minimum as a condition of joining some

enterprise … we'd all feel that way if we were organizing a private enterprise." Even in the early 1990s, a share of a private company or partnership very likely required more than $10,000. [287]

Other questions touched on how Buffett went about finding and valuing businesses. He thought just about anyone could do what he and Munger did by reading annual reports and other communications from companies and their competitors. Buffett said they simply looked at a company's products, distribution systems, and finances. Then they tried to determine if they could assess what the economics of the business and industry would look like ten or twenty years out. He said 95% of the businesses he looked at wouldn't make the cut due to their falling outside of his circle of competence or for other reasons. Another important insight was to ignore noise, including that from pundits and others about the general economy. Charlie Munger said it was best to be "agnostic about macro factors and therefore devote all your time to thinking about individual businesses and individual situations."

One key component to valuing businesses was growth. Buffett thought that this was a concept misunderstood by others, including managers and analysts. What mattered, he said, was the amount of cash that could be taken out of a business from now until forever, discounted back to the present. Growth was simply a variable, not something always positive, as others seemed to insinuate. If physical or unit growth required additional capital to grow that was okay, so long as the rate of return on capital was satisfactory. "There's a huge difference in the business that grows and requires a lot of capital to do so, and the business that grows, and doesn't require capital," he said in response to a question. As a conglomerate, Berkshire was structured so it could take the cash generated from slow or no-growth businesses with good returns on capital, such as Scott Fetzer, and put it to use elsewhere.

Another theme of questions was on management compensation. The answers illustrated the fact that even though Berkshire's arrangements were usually very simple, much thought was put into them. The trick was to structure compensation so it aligned managers with owners. Buffett and Munger suggested a few guiding principles:

- It didn't make sense for an operating manager to be compensated on

Berkshire as a whole, since only Buffett and Munger controlled that outcome.

- The aim was a system that was symmetrical, meaning a manager was rewarded for good performance but suffered if poor performance was delivered.
- The arrangement should be structured based on the economics of the business, since all businesses were different.

In short, management compensation was best when it aligned the interests of managers to that of owners, regardless of the situation.

By any standard of executive compensation, Warren Buffett and Charlie Munger were paid almost nothing. Their $100,000 salaries remain unchanged to this day. Considering their track record, they could have easily justified seven- or eight-figure salaries like their Fortune 500 contemporaries. But they chose not to, and it sends a strong message. They were already rich, each had most of their net worth in Berkshire, and they loved their work—the perfect example of management alignment.

1994

The effects of Berkshire's size were starting to show. A $1.45 billion increase in net worth during the year equated to just 13.9% growth and resulted in Berkshire's equity climbing to almost $12 billion at year-end 1994. Buffett had been warning shareholders for years that size was forging an anchor to future returns. However, past results far above the 15% goalpost seemed to contradict him. [288]

While Berkshire's growing size was beginning to bring down its rate of return, its methods were largely unchanged. Buffett would continue to learn and improve but Berkshire, he wrote shareholders that year, would "stick with the approach that got us here." Importantly, Berkshire would not relax its standards. "A fat wallet, however, is the enemy of superior investment results," he quipped.

Insurance

Berkshire's float—specifically the cost of it if forced to choose—was probably *the* most significant aspect of Berkshire's growth over time.

Berkshire’s float at year-end 1994 averaged over $3 billion. Better still, its cost (as measured by the underwriting gain/loss in relation to average float) registered negative for the second year in a row. Negative is a good thing in this case, since it meant the Insurance Group wrote to a profit and its cost compared to a government bond [289] was less than zero.

Profits of $129 million in 1994 produced an 86% combined ratio. The 1967 National Indemnity acquisition was beginning to look like a bargain.

Table 5.34: Insurance Group, select information

($ millions)	1994 Amount	1994 %	1993 Amount	1993 %
Primary Group				
Premiums written	$225.7		$208.4	
Premiums earned	234.8	100.0%	208.3	100.0%
Losses and loss expenses	88.4	37.6%	99.8	47.9%
Underwriting expenses	98.1	41.8%	95.8	46.0%
Total losses and expenses	186.5	79.4%	195.6	93.9%
Underwriting gain/(loss) - pre-tax	48.3		12.7	
Unfavorable (favorable) loss development included in losses and loss expenses	*(53.9)*	*(23.0%)*	*(41.7)*	*(20.0%)*
Statutory combined ratio		81.1%		93.9%
Reinsurance Group				
Premiums written	$689.8		$528.7	
Premiums earned	688.4	100.0%	442.4	100.0%
Losses and loss expenses	476.9	69.3%	350.9	79.3%
Underwriting expenses	130.8	19.0%	74.2	16.8%
Total losses and expenses	607.7	88.3%	425.1	96.1%
Underwriting gain/(loss) - pre-tax	80.7		17.3	
Unfavorable (favorable) loss development included in losses and loss expenses	*37.0*	*14.1%*	*0.0*	*0.0%*
Statutory combined ratio		88.2%		93.4%
Total Insurance Group underwriting gain/(loss) pre-tax	**$129.0**		**$30.0**	
Insurance Group overall statutory combined ratio		86.1%		92.2%

Notes:

1. Totals may not add due to rounding.

2. The loss and expense ratios are shown as they were reported in the Annual Reports, which is on a GAAP basis. The GAAP basis ratios are calculated with underwriting expenses divided by earned premiums. This contrasts to the statutory basis calculation, where the ratio uses written premiums. In both the GAAP and statutory calculations, losses and loss adjustment expenses are divided by earned premiums.

3. In 1990, Berkshire began including structured settlements and portfolio reinsurance with reinsurance.

Sources: Berkshire Hathaway Annual Report 1994 and author’s calculations.

One reason for the extreme profitability had to do with Berkshire’s new super cat business, into which it was moving more heavily to put its superior capital strength to work. While it could be profitable in the long run, such business was prone to down periods. Berkshire just hadn’t seen many of them yet. With the exception of an earthquake in California, Berkshire experienced an absence of large insured losses in 1994. This

meant most super cat premiums went right to the bottom line and put the loss experience above trend. Such outsize profits could not continue indefinitely, and very well could have started in the other direction.

In 1994, Berkshire's Reinsurance Group wrote and earned just under $700 million of premium volume. Catastrophe excess of loss reinsurance contracts (super cat), which had grown three-fold to $447 million, contributed to the 56% overall increase in reinsurance premiums. Earned premiums declined in other areas including quota-share, structured settlements, and retroactive reinsurance. As noted earlier, profits from the super cat business were a major reason behind reinsurance underwriting profits swelling from $17 million in 1993 to $81 million in 1994. Profits would have been even higher had it not been for $37 million of adverse loss development. [290]

The Primary Group also grew premiums written and earned. The segment turned in a combined ratio of 81% on $235 million of earned premiums (up 13%), although some markets remained soft. Favorable loss development in traditional commercial auto and commercial casualty/professional liability/special risks led to 23 percentage points of positive adjustment. While a favorable adjustment added to reported profitability and could be termed conservative, the change reflected the imprecise nature of reserve estimation. Such a large adjustment in either direction corresponded to meaningful past underwriting errors. [291]

Manufacturing, Publishing, and Retailing

The addition of Dexter for a full year (compared to two months in 1993) was a big contributor to the 20% increase in revenues (to $2.4 billion) and 23% increase in pre-tax profit (to $336 million) for the Manufacturing, Publishing, and Retailing segment. Pre-tax return on average invested capital remained strong at 49.3%, up from 48.2%. After-tax return on tangible equity improved from 31.3% to 32.4% without the use of leverage.

The Shoe Group completed a small acquisition of eleven stores located in Maryland, Pennsylvania, and Virginia and added a new computerized distribution center which was expected to increase operating efficiencies. One fact from the summary table (see Table 5.2) of the Chairman's letter stands out. In 1993, Buffett stated that the Shoe Group, made up of H.H. Brown, Dexter, and Lowell, would probably earn about $85 million in the

coming year. The actual result: $85.5 million. This was probably a coincidence, but it also demonstrated that the businesses Berkshire was buying were simple and understandable with somewhat predicable futures.

See's, long beset by declines in poundage, saw an impressive 5.3% increase in pounds sold from increased mail-order business and larger orders. Revenues increased 7.5% to $216 million and pre-tax income rose 15.6% to $48 million. Its operating margin remained a mouthwatering 21.6%.

World Book continued to see declines in unit volume of physical book sets but was optimistic that some offset would be seen in increases of sales of CD-ROM sets and upgrades. Though revenues declined 3.8% to $191 million, pre-tax income rose over 25% to $24.4 million, largely due to a $3.3 million charge taken in 1993.

The Home Cleaning Systems segment, led by Kirby, improved unit sales marginally in the domestic US market but increased them 14% internationally. This resulted in a 7% increase in revenues and pre-tax income, to $208 million and $43.9 million, respectively.

Listed under Home Furnishings, Nebraska Furniture Mart, with its new 100,000 square foot Mega Mart in service, increased revenues 17.6% to $245 million. Owing to its strategy of maintaining extremely low prices and because of a $2.3 million charge to write off unused fixed assets, pre-tax operating income declined 20% to $16.9 million. Its operating margin, already low historically, dropped to 6.9% that year from around 10% in prior years. Against such paper-thin margins, it was no wonder Nebraska Furniture Mart's competitors stayed far away from Omaha.

The Buffalo News continued to be an exceptional business even though it was operating in a tougher environment than previous years. In 1994 it saw pre-tax income increase 6.5% to $53.7 million on revenues that increased 3.7% to $151 million. Judging by the financial results, business was okay. The retail price of the paper increased from 35 cents to 50 cents, and this price increase was more than enough to offset the continual decline in circulation. Going into 1995, newsprint cost increased almost 40%, enough to temper expectations for the coming year.

At Fechheimer, Berkshire's uniform subsidiary, the company scored a big win with a contract to supply all the New York City Fire Department with uniforms and safety accessories for three years. As a result, sales increased almost 24%. However, operating profit increased just 6% to $14 million

due to start-up costs associated with building out the related distribution infrastructure needed for the NYC contract. In addition, a new computer system and problems with recent retail store acquisitions held down profits. [292]

Investments

Berkshire's equity portfolio saw a few changes in 1994. Gannett, Co., Inc., a newspaper holding company, and PNC Bank were new. Berkshire also enlarged its holdings of Coca-Cola by about 7 million shares to 100 million shares [293] and its American Express holdings increased to almost 28 million shares with a cost of $723 million. [294] American Express was a company Buffett was very familiar with, having purchased 5% of the company for $13 million in the mid-1960s for his investment partnership. He continued to follow the company and remarked that a long-term familiarity with a company is often helpful in evaluating it. Such familiarity with businesses was built over many years and was the result of reading hundreds of annual reports per year. Such wide and deep reading provided the proper reference points to compare various investment alternatives and was a critical component to Berkshire's success.

Table 5.35: Berkshire Hathaway common stock portfolio, select data

($ millions)	1994
American Express Company	$819
Capital Cities/ABC, Inc.	1,705
The Coca-Cola Company	5,150
Federal Home Loan Mortgage Corp.	644
Gannett Co., Inc.	365
GEICO Corporation	1,678
The Gillette Company	1,797
PNC Bank Corporation	411
Washington Post Company	419
Wells Fargo & Company	985

Notes:

1. Buffett's Chairman's letter only included select investments and did not include a total. I elected

not to take data from the footnotes of the Annual Report since Buffett's classifications historically differed slightly from GAAP reporting.

2. The reporting threshold was $300 million of market value.

Source: Berkshire Hathaway Chairman's letter 1994.

The summary earnings table in the Annual Report (see Table 5.2) contained a glaring item. Deteriorating conditions at USAir culminated in the company deferring the preferred dividend, so Berkshire wrote down its investment in its preferred stock by $268.5 million to $89.5 million. Buffett was quick to chastise himself both in his letter to shareholders and at the Annual Meeting. The original $358 million purchase of the preferred stock issue was an unforced error that came about solely due to bad analysis on Buffett's part. He "simply failed to focus on the problems that would inevitably beset a carrier whose costs were both high and extremely difficult to lower."

USAir was run by a competent and able manager, but the company was battling basic economics. Its labor costs, driven by unions, were out of line (a "relic of a regulated market" he told shareholders at the Annual Meeting) with lower-cost competitors. Buffett felt stuck with the investment due to its size and structure. Preferred stocks are ahead of common shares but behind any bonds. Unlike common shares, preferred shares have similar characteristics of fixed, coupon-paying securities such as bonds, but are between the two in terms of claims on a company's assets. USAir's bondholders would have a priority claim on its assets if the company went bankrupt, and if a recognized expert in investing did not want the preferred stock its sale price might have to be extremely low. Instead, Berkshire wrote it down and continued to hold onto it, though both Buffett and Munger also decided to step down from the USAir board.

Another mistake Buffett pointed out was the sale of 10 million shares of Cap Cities during the year. He thought it a mistake since after he sold it, the investment continued to appreciate. The $222.5 million forgone gain on those shares (Buffett did the math for shareholders) wasn't the mistake, it was that this was the second time he'd sold Cap Cities shares and seen them continue to go up. The business was one he understood well and knew had favorable long-term prospects, yet he sold part of it anyway. Buffett was probably being a little too hard on himself. Responding to a question at the Annual Meeting, he noted that Berkshire tendered the shares to lead the

way on an offer from Cap Cities to buy back shares. Berkshire had participated in similar situations in the past (GEICO, General Foods) and perhaps felt somewhat obligated. Berkshire retained 20 million shares in Cap Cities and Buffett would cling to these for some time.

Book Value and Intrinsic Value

Buffett had at times more subtly and at other times more explicitly commented on Berkshire Hathaway's intrinsic value. In 1994, he was more explicit. In his letter and at the shareholders' meeting, he guided investors to Berkshire's approximate true worth. [295] He also attempted to unlink intrinsic value from a strict book value-based approach. Buffett assured shareholders he was not doing this to pump up Berkshire's stock price. Rather, he and Munger preferred to see the stock rise and fall in lockstep with intrinsic value, such that shareholders would obtain an investment result in line with Berkshire's business performance.

Buffett used Scott Fetzer to demonstrate. When Berkshire bought the business in 1986, it paid a premium of 1.8 times Scott Fetzer's underlying equity capital. [296] Through 1994, and without the use of leverage, [297] Scott Fetzer paid out more in dividends than it earned, which reduced its book value. Yet during that time, earnings steadily increased from $40 million in 1986 to $79.3 million in 1994. One can see why Buffett would heap such praise on Scott Fetzer's manager, Ralph Schey. He took a business earning $40 million a year to one earning close to double that, all while releasing capital employed in the business. It was an amazing achievement.

Schey unquestionably had a genuine passion for his business. He also had an incentive to find ways of increasing returns and sending cash to Omaha as that was how he was compensated. The key underlying idea was to align management with owners, and one of the most important areas to incentivize was the use of capital. While Berkshire's compensation arrangements with managers varied widely depending on the economic characteristics of the business under consideration, all were focused on capital and return on capital. Buffett disclosed that Scott Fetzer (and others) were charged a high rate [298] for incremental capital used in the business. Importantly, bonus arrangements also "credit them at an equally high rate for the capital [managers] release." Put very simply, Buffett said it reflected a "money's-not-free-approach."

The lesson did not end there. The difference between the purchase price of a business and the original book value (the plug number) was goodwill, which at that time was amortized over a forty-year period. Between 1986 and 1994 this goodwill asset had been amortized from $142.6 million to $54.2 million. Berkshire's carrying value for Scott Fetzer was half of what it paid for it, yet the business was earning close to double what it was when Berkshire purchased it. Clearly accounting book value was not the definitive guide to business value, as this vividly demonstrated.

Table 5.36: Scott Fetzer, book value and carrying value

($ millions)	Scott Fetzer Book Value	Berkshire's Carrying Value
Beginning book value, 1986	$172.6	$172.6
Purchase premium over beginning book value		142.6
Berkshire's purchase price, 1986		315.2
Cumulative earnings, 1986–94	555.4	555.4
Cumulative dividends, 1986–94	(634.0)	(634.0)
Ending book value, 1994	94.0	94.0
Cumulative purchase-premium charges (1986–94)		(88.4)
Ending carrying value, 1994		$148.2

Source: Berkshire Hathaway Annual Report 1994.

The Scott Fetzer example provided a more tangible framework for Buffett's comments on the divergence of book value and intrinsic value. It directly related to Berkshire's activities in buying equities, and it also applied to Berkshire itself. Though not precise, the concept of intrinsic value is all-important in investing. Berkshire's Annual Report sought to supply all the figures necessary to estimate its intrinsic value through candid and meaningful disclosures, including additional unaudited reports when GAAP wasn't fully up to the task.

Buffett was hinting that Berkshire's valuation was getting too high. Berkshire's look- through earnings increased between 1990 and 1994, but the market placed an outsize valuation on those earnings (see Table 5.37). We can observe this effect in the price-to-book value increasing from around 1.5x between 1990 and 1992, to 2x in 1994.

Table 5.37: Berkshire Hathaway look-through earnings and valuation, 1990–1994

($ millions)	1994	1993	1992	1991	1990
Berkshire's share of undistributed earnings of major investees	492	422	298	230	266
Hypothetical tax on these undistributed investee earnings	(68)	(59)	(42)	(30)	(35)
Reported operating earnings of Berkshire	606	478	348	316	371
Total look-through earnings of Berkshire	$1,030	$841	$604	$516	$602
Market value of Berkshire at year-end	$24,031	$19,231	$13,501	$10,371	$7,650
Price/book value at year- end	2.02x	1.84x	1.52x	1.41x	1.45x
Change in book value	14%	17%	21%	40%	
Change in market value	25%	42%	30%	36%	

Notes:

1. Earnings are after tax.

2. Earnings for major investees are calculated based on average ownership for the year.

Sources: Berkshire Hathaway Annual Reports 1991, 1993, 1994; and author's calculations.

Guiding shareholders to Berkshire's intrinsic value cultivated and enhanced its shareholder base. The goal was to encourage a partnership feel despite Berkshire's large (and growing) size. Once lost, a long-term oriented shareholder base was hard to regain. One of the ways Berkshire sought to repel buyers of stock keen on turnover was to not split its stock, which crossed the $20,000 mark in 1994.

Preferred Stock Authorization

Berkshire's proxy statement for 1994 included a proposal to allow it to issue preferred stock for future acquisitions. Buffett told shareholders that the request was in response to the realization that it could be useful in future acquisitions. Even after taking pains to make clear that the shares wouldn't be used to harm shareholder interests, enough shareholders voted against it that he took some time at the beginning of the 1995 Annual Meeting to discuss the matter and expand upon his reasoning. He said he wanted to ensure Berkshire had the right "currency" available for an acquisition if a seller decided they wanted something other than either cash or Berkshire stock. A preferred issue, whether straight preferred, adjustable preferred, or convertible preferred, could provide what a seller wanted without Berkshire giving up more in intrinsic value than it received.

Buffett thought there wasn't a downside to the proposal, but the way some shareholders voted prior to the Annual Meeting indicated that his

explanation in the Annual Report did not convince shareholders of this fact. It was simply a matter of form, he said, and it did not matter what the accounting treatment might be for Berkshire. [299] So long as the value-for-value test was met, Berkshire was willing to issue any form of security, with this preferred authorization giving the advantage of flexibility, including a possible tax-free transaction with a prospective seller. “If we do something stupid with this,” he told shareholders at the Annual Meeting, “we would do something [stupid] with cash” or stock.

Berkshire shareholders then approved the issuance of up to 1 million shares of preferred stock, sending a clear message they trusted Buffett and Munger’s judgement.

Decade in Review

That one man had headed a company for three decades was a relatively unusual statistic. What that man achieved during that time (with some help) put him in a league of his own. The Berkshire Hathaway that existed at year-end 1994 was very different from just a decade before, but it was unrecognizable from that which existed at the beginning of 1965. A few key figures tell the story.

Table 5.38: Reconciliation of shareholders’ equity, 1965–1994

($ millions)	1965–74	1975–84	1985–94	1965–94
Beginning of period shareholders’ equity	$22	$88	$1,272	$22
Net income - operations	57	366	2,869	3,292
Net income - realized gains	7	199	1,354	1,561
Unrealized appreciation of investments	0	486	5,877	6,363
Mergers/divestitures	0	133	433	566
Dividends/treasury stock	(3)	0	69	66
Other/misc.	4	0	0	4
End of period shareholders’ equity	$88	$1,272	$11,875	$11,875
Change in equity during period	$66	$1,184	$10,602	$11,852

Note: Figures may not add due to rounding.

Sources: Berkshire Hathaway Annual Reports and author’s calculations.

Table 5.39: Contribution toward change in equity during period

	1965–	1975–	1985–	1965–

	74	84	94	94
Net income - operations	86%	31%	27%	28%
Net income - realized gains	11%	17%	13%	13%
Unrealized appreciation of investments	0%	41%	55%	54%
Mergers/divestitures	0%	11%	4%	5%
Dividends/treasury stock	(4%)	0%	1%	1%
Other/misc.	7%	0%	0%	0%
Total	100%	100%	100%	100%

Note: Figures may not add due to rounding.

Sources: Berkshire Hathaway Annual Reports and author's calculations.

Shareholder equity ballooned each decade, as did net income from operations. But this ballooning net income from operations was not the reason for the huge jump in shareholder equity. Berkshire's operations between 1985 and 1994 contributed an additional $2.9 billion to equity, both from existing subsidiaries and new ones acquired during this time—many dollars but only slightly more than a quarter of the total increase. In fact, as a percentage of the change, net income from operations shrunk with each decade and net income from realized gains remained mostly unchanged. The main driver of growth, as we can see when we look at Table 5.39 of major contributors to growth, was the result of investment outside of direct operating subsidiaries, meaning the investment portfolio.

Berkshire's investment portfolio, specifically its common stock portfolio, produced over $1.3 billion of after-tax securities gains during the 1985–94 period. On top of that, another $5.9 billion remained on the books as unrealized gains. [300] Thus a combined $7.2 billion—or 68% of the total change in shareholders' equity during the decade—came from the successful allocation of capital to businesses not controlled or managed by Berkshire Hathaway. That unrealized gains grew so much reflected Berkshire's evolution toward investing in higher-quality businesses and holding them longer.

Insurance fueled a lot of this growth. Here Berkshire had two very important sources of value: insurance underwriting and float. Remember that float is money held by Berkshire but owed, ultimately, to policyholders and others. A large portion went into the marketable securities portfolio, which enabled the multibillion-dollar gains in that area. It also provided

capital for business acquisitions and allowed Berkshire to operate with very little borrowed money in the traditional sense.

Part and parcel with float, and in fact its source, was insurance underwriting. Berkshire started the decade with an imperfect understanding of the value of its insurance subsidiaries, recognizing its float-generating capacities but making pricing mistakes along the way. Those mistakes led to a cumulative $285 million pre-tax loss from underwriting activities over ten years, an expensive but ultimately valuable education. As the decade went on Berkshire finetuned its underwriting skills and held fast to its belief that policies should only be written with the expectation of a profit.

Later in the decade Berkshire moved more heavily into reinsurance, and specifically into the super catastrophe or super cat world. Berkshire found it could use its large capital position to its advantage by writing large policies for sophisticated buyers, which were usually other reinsurers. [301] By the end of 1994, Berkshire was one of the largest reinsurers in the world, and probably the largest single-risk writer.

The super cat business, and related lines, also produced large amounts of float for Berkshire against relatively small premium volume (compared to short-tail lines). This contributed to average float growth each year despite a significant decline in premium volume mid-decade. Berkshire came to understand that the stability of its float—the fact that it could be replenished as a revolving fund—would almost equate it to that of equity capital, and Buffett even alluded to its being a big part of Berkshire's intrinsic value.

Table 5.40: Berkshire Hathaway Insurance Group Float and cost of float compared to U.S. Government Bonds

	Underwriting Loss ($ millions)	Average float ($ millions)	Approximate cost of Funds	Year-end Yield on Long-Term Gov't Bonds
1967	profit	$17.3	less than zero	5.5%
1968	profit	19.9	less than zero	5.9%
1969	profit	23.4	less than zero	6.8%
1970	$0.37	32.4	1.1%	6.3%
1971	profit	52.5	less than zero	5.8%
197	profit	69.5	less than zero	5.8%

2				
1973	profit	73.3	less than zero	7.3%
1974	7.36	79.1	9.3%	8.1%
1975	11.35	87.6	13.0%	8.0%
1976	profit	102.6	less than zero	7.3%
1977	profit	139.0	less than zero	8.0%
1978	profit	190.4	less than zero	8.9%
1979	profit	227.3	less than zero	10.1%
1980	profit	237.0	less than zero	11.9%
1981	profit	228.4	less than zero	13.6%
1982	21.56	220.6	9.8%	10.6%
1983	33.87	231.3	14.6%	11.8%
1984	48.06	253.2	19.0%	11.6%
1985	44.23	390.2	11.3%	9.3%
1986	55.84	797.5	7.0%	7.6%
1987	55.43	1,266.7	4.4%	9.0%
1988	11.08	1,497.7	0.7%	9.0%
1989	24.40	1,541.3	1.6%	8.0%
1990	26.65	1,637.3	1.6%	8.2%
1991	119.59	1,895.0	6.3%	7.4%
1992	108.96	2,290.4	4.8%	7.4%
1993	profit	2,624.7	less than zero	6.4%
1994	profit	3,056.6	less than zero	7.9%

Source: Berkshire Hathaway Annual Report 1994.

During the decade, Berkshire partnered with many additional managers that it trusted and admired. Through the acquisition of entire businesses such as Scott Fetzer, Fechheimer, Borsheims, H.H. Brown Shoe, Dexter Shoe, and others, Berkshire brought many new family members into the Berkshire fold. One other way in which Berkshire partnered with managers was through its publicly owned holdings. Buffett and Munger came to view Berkshire's investments in companies such as Coca-Cola, GEICO, Washington Post, Cap Cities/ABC, and others, as permanent holdings, and wrote glowingly of management at those companies.

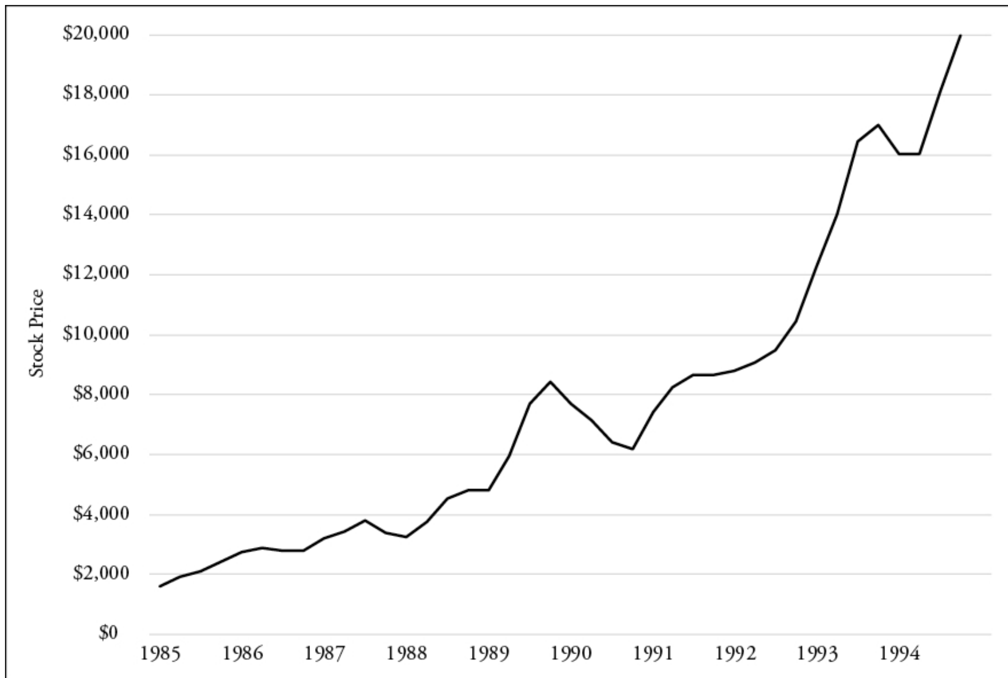
Berkshire did have some stumbles along the way, but they were minor relative to its size then and now. One was selling part of its stake in Capital Cities/ABC (a multi-part mistake in fact, since Buffett had previously sold some before). Another mistake was the purchase of USAir preferred stock. Buffett wrote that he missed the basic economic situation completely, and Berkshire ended the decade with its investment written down to 25 cents on the dollar.

Berkshire's purchase of Salomon preferred was a mistake in hindsight. Not only was Salomon a company in which Buffett and Munger admittedly did not have a great understanding of where the industry would end up in a decade or two, but it cost Buffett a lot of time. During a ten-month stint as CEO of Salomon, he risked his reputation to save the company and Berkshire's $700 million investment.

The market finally recognized Berkshire's track record and its ability to compound book value at high rates. Berkshire's book value per share increased from $1,600 to $20,000 in this decade—a gain of 24.7% per year. Underlying book value increased at 25% per year, with the small 0.3% difference resulting from the net change in average shares outstanding. Like the prior decade, an outsize increase in the stock price came from a higher price-to-book ratio on top of underlying intrinsic value growth. This added an additional 5.5% per year to the share price and took the average price-to-book ratio over 2.0x by year-end 1994. [302] Part of the premium price-to-book ratio can be explained by interest rates. The 10-year Treasury rate fell from 11.5% at the beginning of the decade to under 5.5% by the end of 1993; rates increased to 7.8% at the end of 1994. When the market got ahead of itself and priced Berkshire over 2x book value, Buffett stepped in

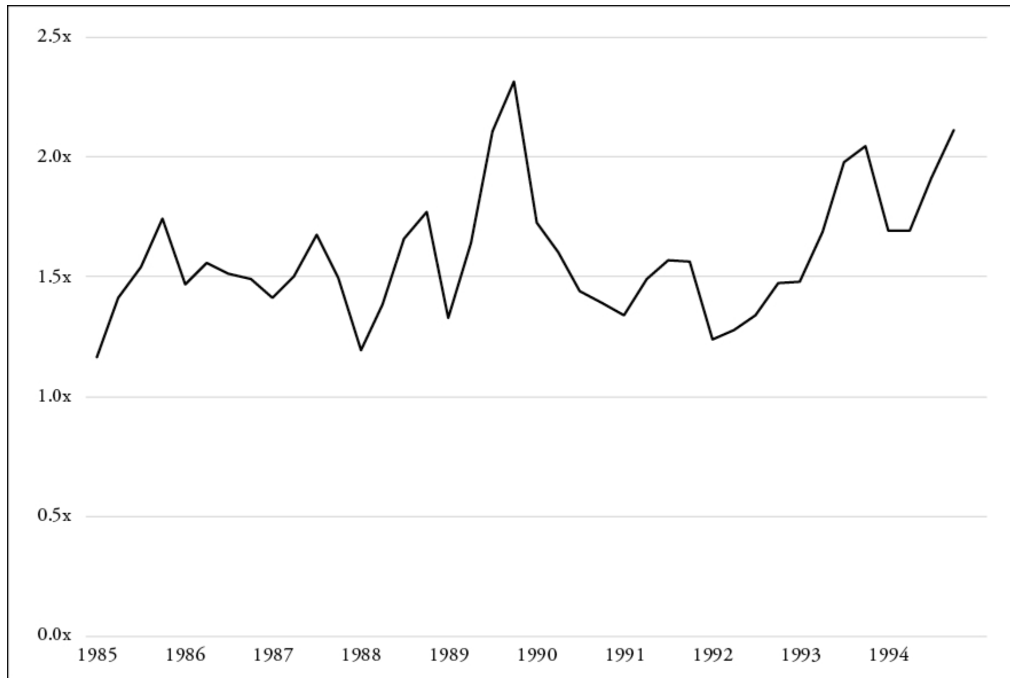
to subtly nudge onlookers toward a proper valuation, something almost unheard of.

Figure 5.1: Berkshire Hathaway stock price, 1985–1994



Sources: *Of Permanent Value* (Kilpatrick), Berkshire Hathaway Annual Reports 1985–1994, and author's calculations.

Figure 5.2: Berkshire Hathaway price to book ratio, 1985–1994



Sources: *Of Permanent Value* (Kilpatrick), Berkshire Hathaway Annual Reports 1985–1994, and author's calculations.

At the end of 1994, Berkshire Hathaway, like its equity portfolio, was a compounding machine with two capital allocators, Warren Buffett and Charlie Munger, who were not slowing down. Notably, this was the decade where Berkshire made the final split with the textile industry by liquidating its remaining mills. Berkshire had come a long way over the preceding three decades—and much more was to come.

Lessons: 1985–1994

1. Businesses don't need to be complicated to be great and have excellent returns on capital. The 1986 acquisition of Scott Fetzer, with its World Book, Kirby, and other simple operating subsidiaries was a wonderful purchase for Berkshire. Scott Fetzer distributed to Berkshire hundreds of millions of dollars (more than its purchase price in fact), doubled its earning power and, best of all, was essentially debt free. Fechheimer, a uniform business; the Shoe Group; Borsheims, jewelry; and others, demonstrated the money to be made in simple industries.
2. Simple businesses need superb managers who always keep their eye on the ball. Many of Berkshire's operating subsidiaries were not, to

use Buffett's term, franchise businesses. See's, Nebraska Furniture Mart, Borsheims, and others, were all in tough industries. Their managers loved what they did, knew the businesses inside and out, and focused relentlessly, which allowed for some spectacular business results.

3. Businesses can thrive inside of a conglomerate structure, and they can do better for owners given greater capital allocation choices. Many of the wholly-owned businesses inside of Berkshire earned great returns on capital but could not reinvest that capital to any meaningful degree. Berkshire solved this problem by allowing those businesses to distribute excess cash to Omaha for redeployment into other Berkshire subsidiaries, or outside of Berkshire via its investments.
4. Economies of scale are powerful, and feedback loops are important. Berkshire first saw the advantages of a high-volume, low-margin business in Nebraska Furniture Mart. The idea applied equally to Borsheims and the jewelry business. A wide selection at low prices attracts shoppers, and the large volume of resulting sales allow for continued low prices and rates of overhead far below competitors.
5. Float, the money held by insurers but owed to claimants and others, can grow significantly while remaining at an attractive cost relative to long-term government bonds.

This following tables have been omitted from the ebook version because formatting issues would have rendered them unreadable. The reader is welcome to download a pdf version of the omitted tables and bonus material at brkbook.com .

Table 5.41: Berkshire Hathaway, select parent-level financial information

Table 5.42: Berkshire Hathaway consolidated reconciliation of shareholders' equity, 1985–1994

Table 5.43: Insurance Group, select information

Table 5.44: Insurance Group, select information

Table 5.45: Insurance Group, income statements, 1986–1994

Table5.46: Insurance Group, balance sheets, 1987–1994

Table 5.47: Insurance Group, key ratios and figures, 1986–1994

Table 5.48: Manufacturing, Publishing, and Retailing Businesses: Balance sheets, 1987–1994

Table 5.49: Manufacturing, Publishing, and Retailing Businesses: Income statements, 1986–1994

Table 5.50: Manufacturing, Publishing, and Retailing Businesses: Key ratios and figures, 1986–1994

Table 5.51: Finance Businesses: Balance sheets, 1987–1994

Table 5.52: Finance Businesses: Income statements, 1986–1994

Table 5.53: Finance Businesses: Key ratios, 1986–1994

Table 5.54: Non-operating activities: Balance sheets, 1987–1994

Table 5.55: Non-operating activities: Income statements, 1986–1994

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185 Burlington Industries would ultimately find itself filing for bankruptcy in late 2001. Berkshire actually bid for it at auction, but the deal fell through and its business was split apart and sold. It remains today, at least in name, as part of the International Textile Group, which purchased its assets out of bankruptcy in 2003.

186 Above and beyond depreciation expense.

187 This figure is calculated on the statutory basis and is based on the summary of insurance underwriting activities. It includes structured settlements and portfolio reinsurance. The Annual Report calculates the ratio using underwriting expenses to premiums earned (the GAAP basis calculation) to arrive at a ratio of 114%. The large difference arises due to the fact that the $497.4 million of premiums written were 57% greater than the $317.1 million premiums earned.

188 Other than structured settlements and portfolio reinsurance.

189 The arrangement did not include the reinsurance Fireman's Fund wrote for unaffiliated companies.

190 The footnotes to the financial statements report that total tax-exempt interest income in 1985 was $36.6 million. The footnotes also disclose that $16.8 million of tax was saved because of the tax-exempt status.

191 Later termed "bolt-on" acquisitions.

192 Berkshire paid a $5.4 million premium to retire the $60 million, 12.75% 1980 debentures.

193 After appropriately adding back amortization and purchase-price accounting charges, and shareholder-designated contributions.

194 Berkshire reported these earnings in its Other category.

195 I've considered cash and short-term investments in excess of 5% of revenues to be excess cash. I've used a higher percentage than the typical 2.5% due to the fact that Scott Fetzer had two financial subsidiaries supporting World Book and Kirby sales.

196 That Fechheimer had historically earned this return on capital is an assumption based on the analysis of the 1986 data, and the company's earnings subsequent to Berkshire's purchase of the company. These facts, and Buffett's preference for demonstrated earnings power, point to the high probability the business was stable prior to 1986.

197 Robert B. Reich, "Leveraged Buyouts: America Pays The Price," *The New York Times* , January 29, 1989, https://www.nytimes.com/1989/01/29/magazine/leveraged-buyouts-american-pays-the-

price.html .

198 Berkshire's investment income easily covered its underwriting loss because its premium volume was far lower than competitors.

199 Statutory ratio after policyholder dividends (GEICO 1986 Annual Report).

200 Equity securities were held at market value in the insurance subsidiaries and at the lower of cost or market elsewhere. The difference between cost and market was trivial in 1986. The bond portfolio was held at cost of $1.12 billion and had a market value of $1.27 billion at year-end.

201 Buffett said that the Lear Siegler, Inc. investment was an arbitrage position.

202 Robert P. Miles, *The Warren Buffett, CEO, Secrets from the Berkshire Hathaway Managers* (New Jersey: John Wiley and Sons, 2001), 274.

203 To be clear, it was primarily depreciation Buffett focused on (and to a lesser extent amortization). EBIT, or earnings before interest and taxes, accounted for depreciation and amortization expense and is not derided by Buffett like EBITDA.

204 I am using the figures supplied by Buffett in his 1987 Chairman's letter since they exclude structured settlements and financial reinsurance.

205 Source for the float and cost of float information is the 1994 Chairman's letter.

206 A measure of balance sheet utilization is premiums written to average equity. The notes to the 1987 financial statements disclose a statutory premiums-to-surplus ratio of 0.27:1 (or 27%) compared to an industry ratio of approximately 1.9:1 (or 191%).

207 The "Sainted Seven" made up almost all of the Manufacturing, Publishing, and Retailing businesses. In total, the group earned $181.9 million on $207.3 million of capital ($168.5 million equity plus $38.8 million term debt and other borrowings).

208 The 1987 report does include a separate set of accounts for Mutual Savings and Scott Fetzer Financial. However, the combined figures differ somewhat from those presented in the Finance-Type Businesses segment in the 1988 Annual Report.

209 To the extent that this 'kitchen sink' accounting concentrated and highlighted the various accounting-created adjustments, it did add value to readers of Berkshire's financial statements.

210 The fixed maturity portfolio was held at $1.94 billion amortized cost on the balance sheet, but had a market value of $2.05 billion at year-end 1987.

211 Calculated on the basis of the $674 million carried within Berkshire's accounts. The remaining $26 million was held at Mutual Savings, which was not consolidated with the Berkshire parent (Mutual Savings was held on an equity basis on Berkshire's books).

212 More will be said later on Salomon. The investment received so much attention probably because Buffett had so often criticized Wall Streets' behaviors and excesses. Both Buffett and Munger joined Salomon's board after Berkshire's investment.

213 Too detailed to discuss in any great length, Mutual Savings had, up until 1968, taken significant bad debt write-offs for tax purposes. This had the effect of reducing Wesco's tax basis to the point that in 1987, as the footnote to the Wesco financial statements stated, it was limited to distributing $5 million of retained earnings before incurring additional tax. If its $47 million of bad debt reserves (counted as equity for GAAP purposes) were taxed at the then-current capital gains rate of 22% this would reduce Mutual Savings' liquidating value by over $10 million. Thus, Munger was implying that Mutual savings might earn somewhere around $4.5 million long term after tax on equity.

214 Munger described this in the 1986 letter.

215 Wolfgang Saxon, Obituary of Richard Rosenthal, *The New York Times* , April 19, 1987, https://www.nytimes.com/1987/04/19/obituaries/richard-rosenthal-arbitrager.html .

216 Consistent with the segment presentation, these are the company-level metrics which do not include purchase-price accounting adjustments.

217 Return on assets was 2.0% with a 14.9% capital ratio.

218 There are two types of arbitrage under this category that Buffett employed over the years. Riskless arbitrage profited from small discrepancies in the price of the same security (or similar securities in credit markets) in two different markets. Risk arbitrage, or merger arbitrage, on the other hand, was buying in anticipation of a pending merger. Mergers sometimes fell through causing stock prices to fall, hence the term risk arbitrage.
219 The security was called participating preferred.
220 Coca-Cola over the years has gone through periods where it owns bottlers and at other times has divested of them.
221 Because it was considered an arbitrage investment Buffett did not include it in his table in the Chairman's letter. It was, however, included along with Berkshire's other equity investments in the financial statements.
222 Depositors did not really care if their institution went bankrupt because the FDIC (and/or the government) would ensure the safety of their deposits (to a certain threshold).
223 Buffett discussed this in the 1987 Annual Report.
224 This 3.5% spread is against the short-term rate. Comparing Berkshire's 10% coupon to the 30-year Treasury Bond at the time the spread was probably less than 2%. This reflected Berkshire's capital strength and its S&P rating of AA+.
225 Buffett noted that a 10-share Berkshire round lot would have a greater value than any 100-share round lot of a NYSE-listed company. Shares were then trading around $5,000. The exchange rules required at least 2,000 shareholders of a company have a 100-share round lot to qualify for listing.
226 Berkshire's headquarters in Omaha remains in the Kiewit building.
227 Deferring tax also aids the government since its ultimate tax is higher than it otherwise would have been, the only difference is it has to wait to receive it.
228 An example will illustrate. A $100 investment earning 10% compound interest for 25 years without interruption will grow to $1,083. Paying a hypothetical 35% tax results in a net gain of $738 for a net return of 8.3% per year. Paying a tax of 35% each year reduces the annual compounding rate to 6.5%. Such a rate of return grows $100 to $483 by the end of 25 years—a significant difference.
229 Buffett's formula for look-through earnings took the share of the operating earnings retained by its investees and subtracted the tax that would have been due if those investees paid out all their operating earnings as dividends. Buffett frequently pointed to the fact that capital gains in any particular year were meaningless but that, over long periods of time, were important to Berkshire. As such, capital gains were ignored in the calculation.
230 According to the notes to the financial statements.
231 The level of revenues were still not disclosed.
232 Mrs. B. would eventually return to Nebraska Furniture Mart, though the incident did cost Berkshire about $5 million—the amount Buffett paid Mrs. B. for her new location, which became part of Nebraska Furniture Mart. Source: *The Snowball p. 503* .
233 Alice Schroeder, *The Snowball: Warren Buffett and the Business of Life* (New York: Bantam Dell, 2008).
234 After the investments in 1989 Buffett's usual advertisement for businesses to purchase, which included the desire to purchase controlling blocks of stock or preferred, said that Berkshire, "was now close to the maximum position we feel appropriate" for preferred.
235 This deductibility was fair from the standpoint of the US Treasury since holders of the debt paid tax every year on the accrued-but-not-received interest payments.
236 If Berkshire's intrinsic value was below 2.3x book value (which it most certainly was), issuing shares at that valuation meant bondholders that chose to convert were buying in at an expensive price.
237 Another important attribute of the issue was the fact, according to the footnotes to the financial

statements, that there were “no materially restrictive covenants”.
238 PIK bonds were payments of interest in more bonds rather than cash and functioned just like zero-coupon bonds.
239 Leaving aside the inclination of the Wall Street enablers, it is simply amazing that managements and boards of directors would push the envelope so far. Some of the reasons why they do it are their competitive natures and agency-type misalignment of incentives that create the opportunity for abuse. These systems that put gain before risk go entirely against the Berkshire attitude, which is encapsulated from a quote in the 1987 Chairman’s letter: “We do not wish it to be only likely that we can meet our obligations; we wish that to be certain.”
240 Ellen Wulfhorst, “*Forbes* lists 400 richest Americans,” UPI, October 10, 1989, https://www.upi.com/Archives/1989/10/10/Forbes-lists-400-richest-Americans/5214623995200/ .
241 Examining the table at the beginning of this section more closely, the calculated rate of annual book value and per share book value growth (24.1%) appears to differ from Buffett’s calculation of 23.8%. The difference arises due to two factors: one being the miniscule 0.03% per annum growth in shares outstanding (essentially nothing, an amazing feat), and the other is because of the extra three months one must include in 1964. Berkshire’s 1964 figure was actual as of September 30. Using the precise timeframe of twenty-five years, three months, we arrive at Buffett’s calculation of 23.83%, rounded to 23.8%.
242 Securities gains and losses were ignored in the calculation. These were not unimportant but were erratic by nature. Any gains or losses (over an appropriate period of time) would (or should) reflect the undistributed earnings of investees and show up as capital gains.
243 Leverage in a traditional sense (debt to shareholders’ equity) was just 0.13:1 or 13%.
244 Still no specific information was provided on the earnings from Borsheims.
245 Buffett said customers did not need to be known to Borsheims but always came well recommended.
246 No comparative data is available because the earnings from the Scott Fetzer finance businesses are not broken out. We only have the data Buffett provided.
247 This was attributed to the success of decentralization efforts, which had hurt earnings in 1989.
248 Revenues reached $109 million with over 30% coming from products introduced over the preceding five years.
249 The reader should note that beginning in 1990 Berkshire began consolidating the structured settlements and portfolio reinsurance segment with the overall reinsurance segment. The $66 million figure is the original 1989 presentation. By contrast, the 1990 presentation for 1989 results show volume of $126 million.
250 Despite the unfavorable-seeming nomenclature, a negative cost of float was a good thing. It meant Berkshire was being paid to hold its customers’ funds. This is akin to a negative interest rate in which the creditor pays the borrower.
251 With Berkshire’s ownership of 10% of the bank Berkshire’s $290 million purchase price equated to a $2.9 billion value for the entire bank. That value was equal to Wells Fargo’s 1989 ending shareholders’ equity (source: Wells Fargo Annual Report, 1989).
252 Callable preferred stock is a type of preferred stock where the issuer has the right to call in or redeem the stock at a fixed number of common shares at a certain date.
253 I am using this term loosely to encompass all bank-like companies, such as thrifts and commercial banks.
254 Munger anticipated the Current Expected Credit Loss or CECL (pronounced “Cecil”) framework issued by FASB in 2016.
255 Schroeder, *The Snowball* ; Carol Loomis, “Warren Buffett’s Wild Ride at Salomon,” October 27, 1997, *Fortune* magazine, http://fortune.com/1997/10/27/warren-buffett-salomon/ .

256 Primary dealers were the wholesalers of government securities. The government conferred upon a few investment banks the privilege of making a market, buying securities for their own and customers' accounts, effectively channeling them into the economy. The banks earned a spread for this service, in exchange for abiding by strict rules designed to minimize abuse of their monopoly-like status.
257 Salomon ended up paying a $290 million fine. In 1997, Salomon was sold to Travelers for $9 billion, with Berkshire's stake amounting to $1.7 billion.
258 This clip is easily found online.
259 The attentive reader will notice a discrepancy between the $591 million figure reported in the section on 1990 and this amount. The figure reported here came from Buffett's Chairman's letter. His data were likely more precise looking back from the vantage point of early 1992 (when the 1991 letter was written).
260 The formula I am alluding to is the "Gordon growth model" which, very simply is Value = Earnings / (Discount rate – Growth rate).
261 Commodity here is not necessarily referring to businesses in the physical commodity industries (such as metals, coal, etc.) but also includes basic, easily copied businesses with no competitive advantages whatsoever.
262 Perhaps because they need to free-up space to write more business, or perhaps because the timing and amount of such losses aren't known for sure.
263 Reflecting the time value of money.
264 The contracts were also imperfect, with adjustments made along the way as both the magnitude and timing of the loss experience was determined.
265 Given the clear time-value-of-money concepts at work here some had proposed allowing discounting of reinsurance contracts, which would have had the effect of eliminating the need for the deferred charge asset and its related amortization. Buffett thought it sound logic but inappropriate due to the clear risk of abuse of such a system. (Some state insurance regulators did allow discounting.)
266 The purchase price was not disclosed. The footnotes to the financial statements disclose that $161 million was paid for business acquisitions, but this would not have been entirely attributable to H.H. Brown. Nebraska Furniture Mart purchased a business during the year, and other, smaller "tuck-in" acquisitions may have occurred that were not disclosed.
267 Alina Selyukh, "Why The American Shoe Disappeared And Why It's So Hard To Bring It Back," NHPR, June 19, 2019, https://www.npr.org/2019/06/19/731268823/why-the-american-shoe-disappeared-and-why-its-so-hard-to-bring-it-back ; David Purcell, "Maine's shoe industry struggles to survive. Determined to stay in business, firms look to Washington for some help in competing against imports," *The Christian Science Monitor* , April 4, 1985, https://www.csmonitor.com/1985/0404/nshoes-q.html ; Pamela G. Hollie, Shoe Industry's Struggle, *The New York Times* , May 28, 1985, https://www.nytimes.com/1985/05/28/business/shoe-industry-s-struggle.html .
268 The table presented in the Chairman's letter noted that the value had been determined by Buffett and Munger. This write-down likely reflected the large drop in AMEX's stock price during 1991. The preferred was subject to a mandatory conversion after three years.
269 An additional 3,944 shares were issued after year-end 1992 relating to the same debentures.
270 Berkshire's shares traded in a range of $8,850 to $11,750 that year.
271 Based on the data, that would be an excellent 88.8% combined ratio.
272 For the close-eyed reader, the 115.1% statutory combined ratio resulted in a lower cost of float due to the significant growth in average float. If float did not grow as it did in 1992 the cost of float would have been higher.
273 The loss development amounted to 6.4% of beginning reserves. This figure was still above a 5%

threshold cited in earlier years as acceptable.
274 Schroeder, *The Snowball* , 503.
275 Usually the focus is on revenues or earnings when it should be the rate of return on capital. Negative growth (i.e. shrinking) a company with a poor return on capital can *add* value. Berkshire did this by shrinking its early textile business to release the capital trapped in a poor business, which was then reinvested elsewhere at a higher rate of return.
276 Financial Accounting Series, Financial Accounting Standards Board publication, December 2004, https://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1218220124271&acceptedDisclaimer=true .
277 Called for payment on January 4, 1993.
278 McKenzie was slowing down not stopping, remaining connected to Berkshire via a consulting arrangement.
279 Buffett stated in his letter to shareholders that intrinsic value also increased by 14% in 1993, roughly matching the increase in book value. Shares appreciated by 39% that year.
280 Here's an illustration of what happened. Suppose Berkshire had an unrealized gain of $1 million. Under the old system a $280,000 tax (the previous tax rate of 28%) was accrued as a deferred tax liability and the balance of $720,000 was recorded as a direct increase to shareholders' equity. The income statement was not affected at all. To correct for the new 35% tax rate (assuming the unrealized gain remained $1 million), an additional 7% tax or $70,000 was included as an expense on the income statement which then increased the deferred tax liability (since it wasn't paid) and a corresponding decrease to shareholders' equity was recorded.
281 The change also pertained to other securities with characteristics of common stocks.
282 Some investors converted prior to year-end 1992 while others did so just after year-end. In total 6,106 shares were issued in relation to the debentures.
283 Imports would later wreak havoc on the domestic footwear industry and Buffett would regret issuing shares for Dexter.
284 The footnotes to the financial statements indicate $428.4 million in new shares were issued, and $4.7 million of Treasury shares (25,203 shares in total) were used to fund the acquisition.
285 Such an adjustment, while favorable, is large enough to be considered a mistake.
286 The definitive collection: Buffett in his own words, CNBC archive, accessed on July 5, 2018, https://buffett.cnbc.com/ .
287 The focus on stock price is evidence, in my mind, of a focus on quantity over quality. Shareholders somehow feel better owning more shares, even if the economics haven't changed at all.
288 See the table at the beginning of the Annual Report listing the change in Berkshire's book value against that of the S&P 500.
289 At the time long-term bonds were yielding close to 8%.
290 The footnotes to the Annual Report do include a reconciliation of unpaid losses and loss adjustment expenses for just the property/casualty segment. This table showed a $60 million unfavorable development in 1994, $11 million in 1993, and $29 million in 1992. On beginning net unpaid losses and loss adjustment expense balances of around $2.5 billion, these figures were essentially breakeven.
291 A proper comparison would use beginning net loss reserves not premiums earned. In either case it was likely still outside of a tolerable range.
292 It is striking the honesty and candor which is included in the Annual Reports, including the footnotes. The fact that its recent store acquisitions were experiencing problems could easily have been omitted.
293 This was Berkshire's final purchase of Coca-Cola shares, which represented 7.8% of the company's then outstanding shares. The $1.299 billion cost basis remains as of 2020.

294 Buffett described the AMEX holding as “enlarged” even though it was not named in the table in the 1993 report. Berkshire also owned convertible preferred stock in AMEX which was not included in the table.
295 In the 1994 Annual Report, he stated that Berkshire’s book value gain of 13.9% approximated the gain in intrinsic value.
296 The attentive reader will note the difference between the figure of $410 million used in the section on 1986 and the $315.2 million used here. This analysis focuses on Scott Fetzer’s equity capital, while the latter considered total capital (debt plus equity). They are two different ways of looking at the same company.
297 Aside from the finance subsidiary.
298 Disclosed as between 14% and 20% at the Annual Meeting Q&A. Buffett also stated that short-term uses of parent-company capital by subsidiaries were charged a rate based on LIBOR, but that generally it was kept very simple.
299 Buffett noted that other companies care more about the accounting treatment, and would, presumably, give up more in intrinsic value than they received just to avoid having to explain the situation to shareholders. Berkshire focused on the economics of transactions first and foremost, and knew its shareholder body was “intelligent enough to understand the economic reality of a transaction.”
300 These unrealized gains were after taking into account taxes that would have been owed upon sale.
301 Table 5.47 contains data on premiums written to average equity. Berkshire’s ratio in the single digits was an indication of its superior financial strength and capacity to write business.
302 The amount was a whopping 7.2% *per year* when using period-end figures.