Chapter 6: 1995–2004

Table 6.1: Decade snapshot: 1994–2004

	1994	2004
Business:	Insurance, newspapers, furniture retailing, candy, jewelry, encyclopedias, home cleaning systems, shoes, miscellaneous manufacturing, significant stakes in several public companies	Insurance, utilities, flight services, building products, furniture retailing, candy, jewelry, encyclopedias, home cleaning systems, shoes, newspapers, various finance businesses, miscellaneous 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:	$3.8 billion	$74.4 billion
Stockholders' equity:	$11.9 billion	$85.9 billion
Book value per share:	$10,083	$55,824
Float (average):	$3.1 billion	$45.2 billion

Major capital allocation decisions:

1. Purchased remaining half of GEICO for $2.3 billion (1996).
2. Issued $565 million of Class-B shares (1996).
3. Acquired FlightSafety for $1.5 billion in stock (1996).
4. Issued $500 million convertible preferred stock (1996).
5. Purchased $4.6 billion US Treasury Strips, 111.2 million ounces of silver (1997).
6. Acquired International Dairy Queen with $587.8 million cash/stock (1998).
7. Acquired Executive Jet for $700 million in cash/stock (1998).
8. Acquired General Reinsurance for $22 billion in stock (1998).
9. Acquired majority economic interest in MidAmerican Energy for $1.24 billion cash (2000).
10. Acquired Justin Industries for $570 million cash (2000).
11. Acquired Benjamin Moore for $1 billion cash (2000).
12. Acquired 87% of Shaw Industries for $2 billion (2000).
13. Acquired Johns Manville for $1.8 billion cash (2000).
14. Acquired Fruit of the Loom for $835 million cash (2001).
15. Invested additional $402 million convertible preferred and $1.27 billion trust preferred in MidAmerican to assist with Northern Natural and Kern River acquisitions.
16. Purchased Clayton Homes for $1.7 billion (2003).
17. Borrowed $2 billion to re-lend to Clayton (2003).
18. Acquired McLane from Walmart for $1.5 billion cash (2003).
19. Borrowed additional $1.6 billion to re-lend to Clayton (2004).

Noteworthy events:

1. On March 10, 2000, the NASDAQ hit its all-time high of 5,132 while Berkshire shares traded at their lowest level since 1997.
2. Berkshire adds new board members: William Gates III, David Gottesman, Charlotte Guyman, Donald Keough, and Thomas Murphy.
3. The September 11, 2001 terrorist attacks shake the insurance world and close stock markets until September 17.

Table 6.2: 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

The 1995–2004 decade was marked by compounding growth. Not only did the headline figures such as revenues, earnings, and shareholders' equity expand, but the sheer number of acquisitions increased noticeably.

Berkshire's 1996 acquisition of the second half of GEICO and the 1998 acquisition of General Reinsurance supercharged its insurance operations. These two acquisitions were the final two cornerstones of the Insurance Group, which would see average float balloon to over $45 billion during the decade.

Insurance was certainly a dominating force at Berkshire, but its many non-insurance acquisitions further diversified its earnings streams. A number of these new acquisitions, such as within the jewelry and furniture retailing segments, resulted from existing industry relationships Berkshire subsidiaries had with non-competitor peers. Some acquisition opportunities manifested suddenly after past troubles caused a need for new ownership. Other times, acquisitions occurred after financial buyers (such as private equity groups only interested in short-term profits) caused the businesses to falter, and which were revitalized under Berkshire's protective umbrella and conservative financing. Some acquisitions during this period, most notably MidAmerican and MiTek, came with additional outlets for cash after they made their own acquisitions.

All these acquisitions added to the family tree that was Berkshire but did not alter the overall structure of the company. The Berkshire Hathaway that ended the decade, like the one that began, was a conglomerate with many diverse businesses. At the end of the decade, it was just a larger and more rounded-out conglomerate. Insurance was the main engine, followed by its wholly-owned businesses and important long-term investments in

marketable securities. In order to comply with SEC regulations, Berkshire increased its directorship with five new members to its board of directors.

In some ways, Berkshire's size finally began catching up with it. Interest rates continued to decline during this period, making idle cash that much more painful to hold and driving up valuations in controlled businesses and marketable securities. The dotcom boom that started in the mid-1990s and continued into the first years of the new millennium did have one silver lining. While others were busy bidding up businesses with no cash flow or long-term prospects, Berkshire picked up numerous old-line businesses with long histories of producing cash. Yet even with these acquisitions Berkshire ended the decade with over $40 billion of cash and no immediate place to put it to profitable use.

Table 6.3: Select information 1995–2004

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
BRK book value per share - % change	43.1%	31.8%	34.1%	48.3%	0.5%	6.5%	(6.2%)	10.0%	21.0%	10.5%
BRK market value per share - % change	57.4%	6.2%	34.9%	52.2%	(19.9%)	26.6%	6.5%	(3.8%)	15.8%	4.3%
S&P 500 total return	37.6%	23.0%	33.4%	28.6%	21.0%	(9.1%)	(11.9%)	(22.1%)	28.7%	10.9%
US GDP Growth (real %)	2.7%	3.8%	4.4%	4.5%	4.8%	4.1%	1.0%	1.7%	2.9%	3.8%
10-year Treasury Note (year-end %)	5.7%	6.3%	5.8%	4.7%	6.3%	5.2%	5.1%	4.0%	4.3%	4.2%
US inflation (%)	2.8%	2.9%	2.3%	1.5%	2.2%	3.4%	2.8%	1.6%	2.3%	2.7%
US unemployment (%)	5.6%	5.4%	4.9%	4.5%	4.2%	4.0%	4.7%	5.8%	6.0%	5.5%

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

1995

The year 1995 represented the start of Buffett's fourth decade at the helm of Berkshire Hathaway. Often time executives think about retiring, or at least reducing their workload. Buffett reached the typical retirement age of sixty-five that August, and Munger was already seventy-one, so it was a fair question whether Berkshire's two capital allocators would soon slow down. While both were outwardly showing some signs of aging, their minds were not—if anything, they were getting *better* . As Charlie Munger would say at the Annual Meeting in March 1996, Buffett (though this also applied to Munger himself) was a "learning machine." Berkshire would benefit enormously by having top managers without any preconceived notions of retirement, allowing their knowledge to compound just like the capital under their control.

Defying Buffett's predictions (again) that Berkshire's size would be an anchor for future returns, headline figures for 1995 showed an enormous increase in net worth. After adjusting for shares issued in connection with two acquisitions, per-share book value increased an eye-popping 43.1% [303] compared to the S&P's increase of 37.6%. More exciting were three acquisitions that doubled Berkshire's revenue and significantly added to its long-term earning power.

During 1995, Berkshire acquired two non-insurance companies (Helzberg Diamond Shops and RC Willey Home Furnishings) using Berkshire shares

and half of an insurance company (GEICO, of which it already owned 51%) using cash. The GEICO acquisition technically closed January 2, 1996, so 1995 was filled with discussions about the upcoming event.

Helzberg Diamonds

The Helzberg acquisition closed on April 30, 1995. Founded in Kansas City, Missouri, Helzberg grew from one location in 1915 to 134 stores in twenty-three states by the mid-1990s. In 1994, the company had $282 million of revenues, which was an almost thirty-fold increase from the $10 million in revenues it had in 1974. Proving Buffett's point that the best strategic plan was no plan, the company arrived on Buffett's radar accidentally when Barnett Helzberg, the company's CEO and the grandson of its founder, saw Buffett on a street corner in New York City and app roached him.

Helzberg was comparable to Borsheims in that both sold jewelry at rates per square foot far above their competitors, and both had low overhead compared to their competition. But the businesses were different in other respects. For one, Helzberg operated a chain of stores that were predominantly in malls or strip malls. Borsheims was a one-store location that had over $50 million of inventory, a huge selection that couldn't be replicated over dozens of locations. As Buffett put it, "Borsheims can't be Helzbergs, and Helzbergs can't be Borsheims." But both were good businesses. It is interesting to note how good returns on capital can be produced in two different ways in the same industry.

Helzberg's success stemmed from its rock-bottom operating costs and prime locations in busy shopping malls nationwide. The average Helzberg store had $2 million of annual sales, far more than its competitors. Helzberg's higher sales also produced lower expense ratios compared to competitors. Helzberg was a quintessential Berkshire/Buffett acquisition of a good company with great management. For the selling family, it was a tax-free way to diversify their holdings.

RC Willey

Berkshire's other 1995 acquisition, also completed via a stock transaction, was RC Willey Home Furnishings. The RC Willey acquisition came about through Irv Blumkin of Nebraska Furniture Mart. Irv Blumkin, Rose

Blumkin’s grandson, knew RC Willey CEO Bill Child and had spoken to both Child and Buffett about the merits of a partnership. Like the Helzberg family, the Child family wished to diversify and take care of estate planning while continuing to run the family business. Berkshire was a perfect fit.

As with Helzberg and Borsheims, some differences existed between RC Willey and its sister company Nebraska Furniture Mart, which Berkshire purchased in 1983. Nebraska Furniture Mart, like Borsheims, was Omaha-based and operated out of a campus of adjacent buildings. Both RC Willey and Nebraska Furniture Mart had similar sales volume (RC Willey had $257 million in revenues in 1995), but unlike Nebraska Furniture Mart, RC Willey operated out of five (soon to be six) Utah-based locations. Both Nebraska Furniture Mart and RC Willey were also retailers, a business Buffett knew to be very difficult. Both were run by managers with long track records of success, a key criterion for Buffett, who told shareholders: “Buying a retailer without good management is like buying the Eiffel Tower without an elevator.” Also, just as Nebraska Furniture Mart had a lock on the Omaha market, RC Willey had over 50% of the furniture business in Utah.

The acquisition was funded by a combination of Berkshire stock and cash. The exact price was not disclosed.

GEICO

The third and largest acquisition of the year was the second half of GEICO, which legally closed on the second day of 1996. Shareholders were very familiar with GEICO, which had been on Berkshire’s books as a marketable security since 1976. Berkshire’s ownership grew from 33% to 51% in that time owing entirely to GEICO’s frequent share repurchases. In 1995, the opportunity arose to buy the remaining half of the business.

Compared to the $46 million it cost Berkshire to buy the first part of GEICO, the $2.3 billion price tag for the remaining portion was enormous. This implied a roughly $4.8 billion valuation for the whole company, or about 2.5 times its year-end 1995 book value of $1.87 billion. The price tag was large, but not exorbitant. GEICO had $3 billion of float, and its long history of profitable underwriting meant the float would be profitable and had a high probability of growing. This proved true. At the 1996 Annual

Meeting a discussion on float and GEICO suggested Berkshire got a bargain.

Is Float Better Than Equity?

In response to a question on the intrinsic value of Berkshire's insurance companies, Buffett offered insight into his and Munger's thinking on float. It was and is somewhat counterintuitive, but upon reflection is astoundingly simple and brilliant. Buffett, always one to use extremes to prove a point, posed a rhetorical question: "Would I trade that [Berkshire's float] for $7 billion [of equity] and not have to pay tax on the gain … but then have to stay out of the insurance business forever?" His answer was no. "We wouldn't even think about it very long." Buffett was saying he would not take a genie-in-a-bottle arrangement to magically transform a $7 billion liability into $7 billion of equity.

This should have caused everyone to sit on the edge of their seats.

The reason Buffett would not take such a hypothetical arrangement was that he expected the float to grow over time and at an attractive cost. Berkshire's insurance businesses were gems due to one simple fact. An insurance operation is valuable *only* if its float does not cost it money, or at worst costs what it would cost the government to borrow funds, which is cheaper than the cost a corporation would have to pay. Berkshire's insurance businesses were arranged over time, and not without some bumps and lessons along the way, to deliver cost-free float. [304] Float, a liability to the company, was more akin to equity than it first appeared. If float could grow over time, it would be that much more valuable.

This assertion that a liability could be considered equity can be a hard concept to grasp. It helps to think about what pure traditional equity is. Is not the equity owners put or retain in a company a liability due them at some unspecified future date? Does it not come without the requirement to pay interest? Why not then define equity as funds held by a company that have no explicit repayment terms and no explicit cost or interest rate? Following this logic, it stands to reason that the right kind of float could be considered equity—or in some cases better than equity if it generated an underwriting profit over time. Furthermore, such quasi-equity did not dilute shareholders ownership like a pure equity investment would.

Berkshire's float, and especially GEICO's, was money owed to policyholders in one form or another but that, because of its revolving nature, could not be called in its entirety like a loan. In other words, individual policies would be paid daily, but new premiums would be written collectively that could reasonably be expected to maintain the overall level of float. Considering Berkshire had a recent history of writing profitable business and growing float even under poor pricing conditions, this was an easy argument to make.

If we assume that GEICO's float would, at worst, break even and not grow, [305] it could appropriately be considered quasi-equity. Adding this quasi-equity to its book equity, we arrive at a purchase multiple of 1x book value (see Table 6.4). We can also use an earnings approach as a check. This framework results in an initial pre-tax earnings yield that may seem low. Considering this did not account for any expected growth, nor any look-through earnings from the investment portfolio, it is worthwhile validation of the $4.7 billion valuation for GEICO that Berkshire paid to acquire the rest of the company.

Table 6.4: GEICO acquisition analysis

Balance sheet approach	
($ billions)	
Price paid for 49%	$2.33
Implied value of 100%	4.76
Book value (12/31/95)	1.87
Price/book value	2.55x
Float	3.00
Book value + float	4.87
Float-adjusted price/book value	0.98x
Earnings approach	
($ millions)	
Premium volume	$3,000
Assumed combined ratio	96%
Pre-tax underwriting gain	120
Net investment income (1995)	227
Total pre-tax earning power	347
Implied acquisition valuation	4,755

Pre-tax earnings yield	7.3%

Sources: Berkshire Hathaway Annual Report 1995 and author's calculations.

Insurance

Underscoring the good year Berkshire had in 1995 was a third straight year of underwriting profit and yet another year of growth in float. All told, Berkshire's insurance operations generated a pre-tax underwriting profit of $21 million, and float increased 18% to $3.6 billion.

Table 6.5: Berkshire Hathaway—Insurance Underwriting

($ millions)	1995	1994
GEICO Corporation		
Premiums written	$2,856	$2,545
Premiums earned	2,787	2,473
Underwriting gain/(loss) - pre-tax	$92	$79
Berkshire Hathaway Reinsurance Group		
Premiums written	$777	$690
Premiums earned	718	688
Underwriting gain/(loss) - pre-tax	($21)	$81
Berkshire Hathaway Primary Group		
Premiums written	$247	$226
Premiums earned	240	235
Underwriting gain/(loss) - pre-tax	$41	$48
Total underwriting gain/(loss)	$21	$130
Year-end average float - total	3,607	3,057
Cost of float	(0.6%)	(4.3%)
Aggregate adverse (favorable) loss development	$56	$60

Note: Totals and ratios do not include GEICO. GEICO included for comparative purposes.

Sources: Berkshire Hathaway Annual Reports 1994–1995 and author's calculations.

It is worth highlighting the conservatism embedded in Berkshire's insurance operations, not only on an operating basis (i.e. its unwillingness to accept improperly-priced risks), but also on an accounting basis. For more attentive readers, the financial statements contained clues to the margin of safety built into Berkshire's accounting. Berkshire's reported results were better than the headline underwriting gains would suggest due to accounting

practices that did not factor in the time value of money. In its structured settlements business and certain reinsurance contracts, payments would be made years, or in some cases decades, in the future. This meant Berkshire benefitted from the use of the funds over time. However, the accounting required that all future expected losses (except for structured settlements, which were discounted) be booked on an undiscounted basis—that is, upfront. It was the economics that mattered most, not the accounting. If any grey area existed, Berkshire would err on the side of conservatism, even if it made results look worse. [306]

Conservatism and smoothness are sometimes lumped together, but they shouldn't be. Buffett liked conservatism and was also okay with lumpiness (or uneven results). Berkshire's entrance into the super cat business brought large policies and large (but infrequent) losses. Berkshire at this time was willing to underwrite a $1 billion policy, though it was rejected. The largest policy it wrote was $400 million. Large policies would create volatility but were also a competitive advantage that led to superior long-term results. Competitors preferred a smoother ride that ensured the safety of their jobs.

The Reinsurance Group wrote and earned higher premiums in 1995, but pricing began to soften as competitors flush with capital looked for business. Unfavorable loss development added $30 million to losses. Accounting charges from deferred charge amortization and discount accretion of structured settlements were also responsible for reinsurance swinging to a loss of $21 million from an underwriting profit of $81 million in 1994.

Berkshire's more traditional (and less lumpy) Primary Group performed magnificently. National Indemnity wrote to an 84.2% combined ratio, Home State operations turned in an 81.4% ratio, and Central States Indemnity grew volume 23% and underwriting profit by 59%. Buffett had nothing but praise for Ajit Jain, Don Wurster, Rod Eldred, Brad Kinstler, and John Kizer—all of whom Buffett pointed out were under forty-five years old.

GEICO, not yet part of Berkshire, turned in strong results in 1995 that rivaled Berkshire's entire existing insurance operations.

Manufacturing, Publishing, and Retailing

Berkshire's non-insurance operating subsidiaries had a few stumbles during 1995, and Buffett was quick to point them out. "Just tell me the bad news; the good news will take care of itself," was the philosophy Buffett attributed to Munger and what he followed in reporting to shareholders. The shoe businesses, *The Buffalo News* , and World Book all had different problems during the year, which led pre-tax earnings for the manufacturing, publishing, and retailing businesses to fall 1% to $332 million. Worse, pre-tax return on tangible invested capital fell eleven points to 38% because of higher average capital employed. After-tax return on equity was 26% (-6%).

In the Shoe Group, comprised of H.H. Brown, Dexter, and Lowell Shoe, pre-tax operating earnings fell 32% to $58.4 million. Buffett told shareholders he thought the problem was cyclical, not secular, and he expected operations would, "climb back to top-grade earnings in the future." If it was any consolation, Buffett reported that competitors in the industry "made only marginal profit s or worse."

Including *The Buffalo News* in the troubled category was no surprise to shareholders. Prior reports detailed the long and winding road from losses to profits to current challenges. The paper was still a good business, but it could no longer be considered an economically superior business like some of Berkshire's other gems. Pre-tax earnings declined 14% from the year before as cost pressures weighed on results. These included newsprint costs up 40% in one year, employee buyouts, and changes to depreciation schedules. Still, the business was pulling its weight with $47 million in pre-tax earnings. Not bad for a business that cost $35 million.

World Book was also not a surprise in this group of bad-news-first companies. Its print encyclopedias continued to struggle against fierce competition from CD-ROMs. Earnings that year plummeted 64% to $8.8 million as the business worked to remain viable in an electronic age, including shifting toward direct distribution channels. If any of the managers at these units were worried, Buffett provided some reassurance to them: "[T]here is not one of them we would replace." Going one step further at the Annual Meeting, he assured shareholders World Book would not be sold.

See's operating profits continued to churn higher even as the growing slate of businesses meant it received less attention. In 1995, revenue at See's grew 8.1% to $234 million as the company pushed into wholesale and mail

orders. Long beset by physical volume declines, pounds of candy increased 7.1%. Same-store sales, an important metric indicating demand from individual stores, was not disclosed. Operating profit increased 6% to $50 million—an incredible 21.1% operating profit margin and a return on tangible equity likely in the triple digits. [307]

Together with the results from insurance, Berkshire's consolidated pre-tax operating income declined a little less than 3% in 1995, to $815 million. This was not a bad result, but it wasn't great either. Buffett's comment that there's "no reason to do handsprings over 1995's gains" is borne out by this operating result. In fact, most of the 43.1% gain in per share book value was a result of the rising tide of the stock market pushing up the value of Berkshire's investment portfolio, not intrinsic business growth.

Convertible Preferred Stocks

Berkshire's goal with its five preferred stock investments was to do better than fixed-income securities available elsewhere. On average, it had done reasonably well. The superior performance of the Gillette issue saved the day and balanced out mistakes made with other investments in this class.

The 8.25% convertible preferred issue from Gillette had cost Berkshire $600 million. At the end of 1995, it was valued at over $2.5 billion owing to the performance of the common shares. This was a very good result, yet a more profitable path was possible. Berkshire would have earned $555 million more if it had purchased all common stock instead of the convertible issue.

On the negative side of the ledger, the Salomon preferred came with its infamous and relatively recent episode of management distraction and a serious risk of loss. The biggest mistake, though, was the USAir preferred. The airline's prospects looked better in 1995 than they did the year before, but Berkshire was not yet out of the woods.

An important aspect to the USAir preferred is worth mention. The security was structured with a cumulative dividend provision. USAir had stopped paying the dividend owing to its operating troubles, but those skipped dividends were still owed to Berkshire and were compounding at a rate of 5% over the prime rate. The company would have to come out of its woes

to pay the monies it owed, but at least Berkshire had some protection as a creditor. [308]

1996

Few CEOs would state that they thought it a good thing that their company's stock price changed little during the year, yet this is exactly what Warren Buffett told shareholders in his 1996 Chairman's letter. Buffett and Munger wanted Berkshire's share price to closely track its underlying intrinsic value. During 1995, that relationship became unhinged and Berkshire's stock price got ahead of its underlying intrinsic value. A year later, its intrinsic value increased significantly and caught up with a slower-advancing share price.

How Berkshire's business results led to that correction is the story of 1996, but first it is worth examining the numbers behind the ratio. Beginning in the prior year's Annual Report, Buffett began supplying a table they believed would help people trying to estimate Berkshire's intrinsic value. The table showcased the two-column method of valuing Berkshire (see Table 6.6). It supplied readers with historical data on investments per share and pre-tax earnings per share, excluding all investment income. We can make some reasonable assumptions with that data to come up with an estimate of Berkshire's intrinsic value and, perhaps more important for this exercise, view the change in the price/value relationship.

The logical investment framework behind the two-column method is that Berkshire's value stems from its investment portfolio and a capitalized multiple of its operating earnings. It is important to note that, especially as it pertains to investments per share, Berkshire's capital structure was conservatively financed. Investments per share could have easily been funded via debt. Yet, at both year-end 1995 and 1996 Berkshire's borrowings amounted to under 10% of equity capital. Its assets were funded by float, but float was growing and profitable. It was therefore appropriate to ascribe investments per share to value per share. At year-end 1996, investments per share totaled $28,500, compared to $22,088 at year-end 1995.

The assumptions behind the capitalized value of operating earnings also deserve some careful thought. Since all assets are in some way tied to the

opportunity cost of risk-free investments, it is appropriate to look to the long-term US Treasury rate (in this case the 30-year bond) for comparison. Between year-end 1995 and 1996 this benchmark averaged around 6.50%. Using a 10% discount rate might be appropriate here since it provides a margin above the risk-free rate. [309] The discount rate is important when valuing cash flows. It is the rate at which future cash flows are brought back to the present. Because of the time value of money (a dollar today is worth more than a dollar in the future), the further into the future cash flows are, and the greater the uncertainty they will materialize, must be considered. [310] Here we'll use a 10% discount rate for simplicity, which implies a multiple of ten times. Based on this framework Berkshire's pre-tax operating earnings per share of $421.39 and $258.20 were worth about $4,214 and $2,582 at year-end 1996 and 1995, respectively. Adding the per share values of investments and operating earnings we find that Berkshire's per share intrinsic value increased by approximately 33% during 1996. Because the share price increased just 6% during that time, Berkshire's price-to-estimated-value decreased from a rich 1.30 times to 1.04 times—just about parity. [311]

Table 6.6: Berkshire Hathaway intrinsic value estimation

Per share:	1996	1995
Investments	$28,500	$22,088
Pre-tax operating earnings (ex. investment income)	421	258
Estimated value (investments + 10x operating earnings)	32,714	24,670
Year-end share price	34,100	32,100
Year-end book value per share	19,011	14,025
Price/estimated value	1.04x	1.30x
Price/book	1.79x	2.29x
Value/book	1.72x	1.76x
Change in estimated value	33%	
Change in share price	6%	

Sources: Berkshire Hathaway Annual Reports 1995, 1996; and author's calculations.

The valuation exercise above also lends itself to the discussion of the issuance of new B-shares during 1996. At the time, Buffett and Munger said the shares were not undervalued and their issuance would not decrease Berkshire's per-share intrinsic value. Since the shares were issued at a price

just over the year-end 1995 share price (which was at a price-to-estimated-value of 1.30 times), the assertion holds.

FlightSafety International

Berkshire's 1996 share count was also affected by the issuance of shares to acquire FlightSafety International, a new operating subsidiary that trained pilots using flight simulators. Berkshire paid a total of approximately $1.5 billion for the company and funded it with 51% cash and the remainder in A- and B-shares (see Table 6.7). Altogether 17,728 A-shares and 112,655 B-shares were issued to acquire FlightSafety.

The FlightSafety acquisition came to Berkshire via Richard Server, a shareholder of both Berkshire and FlightSafety who was familiar with Buffett's annual advertisement for seeking acquisitions.

FlightSafety was the result of a lifetime of work by then 79-year-old founder, Al Ueltschi. Ueltschi was an aviator who once piloted for Charles Lindbergh. The company manufactured and operated high-technology flight simulators for pilots of various types of aircraft. The flight simulators were indispensable to aircraft operators since they trained pilots in a realistic environment at a fraction of the cost, and perhaps more importantly, without the risk of operating an actual aircraft.

FlightSafety represented a shift in Berkshire's acquisition philosophy. The business was a capital-intensive operation with forty-one locations and 175 simulators. The simulators cost up to $19 million apiece to manufacture. Furthermore, they became outdated each time new aircraft were introduced into the market.

Balancing out the capital-intensive nature of the business was a huge moat —something Berkshire admired and sought in acquisitions. Since competitors would have to invest tens of millions of dollars for a single simulator, the price of entry was steep. This provided a potential competitive advantage. FlightSafety's long history also gave it a knowledge base to build simulators, supply its customers with numerous machines in numerous locations, and work with aircraft manufacturers to more quickly introduce machines for new aircraft. This deep well of knowledge earned it a joint venture with Boeing and a government contract through Raytheon.

Analyzing Berkshire's acquisition of FlightSafety, we can conclude it was a fair price for a good company. Berkshire's effective purchase price

(deducting excess investments on the balance sheet) resulted in a going-in pre-tax return of 8.7%. This seems very low at first glance—and it is. But Berkshire would benefit from FlightSafety's historical returns on capital and the moat protecting those returns. Any future growth the company might achieve, if anywhere near its historical returns on capital, would more than make up for the low initial return. On top of this, the company came with a passionate founder/manager. That he was 79 years old only endeared him to Buffett even more. "An observer might conclude from our hiring practices that Charlie and I were traumatized early in life by an EEOC bulletin on age discrimination. The real explanation, however, is self-interest: It's difficult to teach a new dog old tricks," Buffett wrote. Like Mrs. B at Nebraska Furniture Mart, Ueltschi was still at the top of his game.

Table 6.7: FlightSafety International acquisition analysis

	1995	1994	1993
Revenues *($ millions)*	$326	$301	$297
Revenues/average capital	$0.76	$0.76	$0.79
EBIT margin	36%	36%	34%
Pre-tax return on capital	27%	27%	27%
Purchase price (equity)	$1,500		
Assumed debt	40		
Less: excess investments	(194)		
Effective purchase price	1,346		
Purchase multiple	3.15x		
BRK going-in pre-tax return	8.7%		

Sources: Berkshire Hathaway Annual Report 1996; FlightSafety International Annual Reports 1993, 1995; and author's calculations.

Kansas Bankers Surety

Berkshire's other, much smaller, acquisition of 1996 provides another lesson in business moats. Kansas Bankers Surety, per its name, wrote insurance policies for banks. It provided directors and officers insurance, excess deposit insurance for depositors above the FDIC limit and other related areas of coverage. Due to its relatively small size, KBS was tucked into Wesco's Insurance operations. [312] The business was run by Don Towle and had just 13 employees. [313]

The lesson in Kansas Bankers Surety was that its relatively small size and limited opportunities for growth were the source of its competitive advantage. This sounds counterintuitive but is straightforward after some examination. The business required intimate relationships with hundreds of bankers, a process that takes time to build. With a limited number of clients and relatively slow turnover in bank executives, gaining an edge on Kansas Bankers Surety was hard. It was in a class of wonderful businesses that had a natural size limit but which generated a lot of surplus cash flow. Berkshire was more than happy to be a home to such a business.

Insurance

Berkshire's insurance operations fell into two broad categories: The Reinsurance Group included the super catastrophe lines (or super cat), the relatively plain vanilla reinsurance business of taking on the risk entered into by primary insurers, in addition to the structured settlements business. The Primary Group encompassed everything from National Indemnity's specialized auto line and Home State companies to the workers' compensation business. GEICO, now a wholly-owned subsidiary of Berkshire, fell squarely into the primary category. Owing to its size (GEICO's operations were more than ten times that of Berkshire's other primary lines combined), GEICO was reported separately.

Berkshire's Insurance Group, now led by GEICO, was hitting on all cylinders. The overall result for the group was a pre-tax underwriting gain of $222 million on earned premiums of $4.1 billion. Aided by GEICO, Berkshire's float nearly doubled, from $3.6 billion in 1995 to $6.7 billion in 1996.

Table 6.8: Berkshire Hathaway—Insurance Underwriting

($ millions)	1996	1995
GEICO Corporation		
Premiums written	$3,122	$2,856
Premiums earned	3,092	2,787
Underwriting gain/(loss) - pre-tax	$171	$92
Berkshire Hathaway Reinsurance Group		
Premiums written	$716	$777
Premiums earned	758	718

Underwriting gain/(loss) - pre-tax	($8)	($21)
Berkshire Hathaway Primary Group		
Premiums written	$268	$247
Premiums earned	268	240
Underwriting gain/(loss) - pre-tax	$59	$41
Total underwriting gain/(loss)	$222	$21
Year-end average float - total	6,702	3,607
Cost of float	(3.3%)	(0.6%)
Aggregate adverse (favorable) loss development	($90)	$56

Note: Data for GEICO in 1995 provided for comparative purposes. GEICO's results are not included in the totals.

Sources: Berkshire Hathaway Annual Reports 1995, 1998; and author's calculations.

Insurance – Reinsurance

Berkshire earned $758 million in reinsurance premiums in 1996 and wrote to a 101% combined ratio. [314] The segment was greatly aided by the super cat business, which turned in an underwriting profit of $167 million on earned premiums of $268 million. This was the third straight year of significant super cat underwriting gains, which prompted Buffett to warn that the ride would be bumpy despite expected satisfactory results long term. "What you must understand, however, is that a truly terrible year in the super cat business is not a possibility—it's a certainty. The only question is when it will come." He even advised shareholders to reduce their estimates for Berkshire's earnings during years of above-average profitability when calculating Berkshire's intrinsic value.

While the policies Berkshire wrote in 1996 were large, they were not unreasonable compared to its capital position. Buffett thought a worst-case, after-tax loss from a "true mega-catastrophe" to be around $600 million—less than 3% of Berkshire's book value and easily absorbed by earnings from its other businesses. Berkshire could do better than its peers over time by striving to underwrite each deal profitably and letting results fall where they may, rather than attempting for a smooth outcome each year. Indeed, Berkshire's reinsurance business model could be described as profiting from the desire of other insurers to smooth their underwriting experiences in an uncertain world.

Berkshire had three major competitive advantages in the super cat business.

1. *The marketplace* : Berkshire had a reputation of having the capital to pay its claimants and paying them fast, even under the very worst of circumstances.
2. *Price and timing* : Berkshire would always have a great willingness to write business at the right price. When times became tough other reinsurers might pull back from the marketplace. Berkshire's reputation was now such that it was earning "stand-by" fees from other reinsurers. This gave the other reinsurers comfort that Berkshire would write them a policy if others wouldn't.
3. *Large policies* : Berkshire had the ability and willingness to write large policies. Buffett, and Berkshire's insurance whiz, Ajit Jain, stood ready to commit to evaluate risks, price coverage, and respond to its customers very quickly.

Perhaps demonstrating how open the insurance business really was, Buffett wrote that Berkshire tried "to price our super cat exposures so that about 90% of total premiums end up being eventually paid out in losses and expenses." Berkshire's advantage was that it was willing to walk away from risks it didn't understand. Others relied on computer models that offered a false sense of comfort. Some direct writers were unknowingly the biggest super cat writers. Companies writing business in certain geographic areas, such as on Long Island, might have the most risk. A single large hurricane could cause wind damage to an entire portfolio of claimants diverse in all ways except their geographic exposure to one large, infrequently occurring risk. "They don't think of themselves as being in the super-cat business … [but] they are very exposed."

The other half of Berkshire's reinsurance operations, making up $490 million of earned premiums in 1996, was the property and casualty excess-of-loss and quota-share business. This line was more straightforward and less volatile than the super cat business. Though the segment turned in an underwriting loss of $101 million in 1996, and similar-sized losses in prior years, these were long-tail-type policies that produced the significant float for Berkshire. When priced appropriately, they would produce satisfactory results over time.

Insurance – Primary Group

Berkshire's legacy primary lines, its bread-and-butter insurance businesses, produced excellent results. On $268 million of earned premiums, the group turned in a combined ratio of 78.2%, [315] good for an underwriting profit of $59 million. Buffett singled out the managers responsible for producing this achievement for Berkshire: Don Wurster at National Indemnity, Rod Eldred of the Home State operation, John Kizer at Central States Indemnity, and Brad Kinstler, who ran the workers' compensation group and expanded it into six new states during 1996.

Insurance – GEICO

Berkshire's new gem, GEICO, run by Tony Nicely on the underwriting side and Lou Simpson on the investment side, also received well-earned praise. Buffett was clearly excited about its prospects. There was nothing complicated about GEICO, but its advantages were huge. GEICO's competitive advantage stemmed from being the low-cost operator and using a direct-to-consumer business model among competitors entrenched in a broker model. In 1996, GEICO's customers referred one million others to the company, which produced better than 50% of its new business. The savings on acquisition expenses were then passed on to customers, in a virtuous cycle.

Employees at GEICO, from Nicely down, focused on two metrics: growth in voluntary policies in force [316] and the profitability of seasoned business (business on the books for more than a year). It was a very simple operating philosophy. Bring in more customers and make sure those that stayed were profitable. This incentive structure formed the basis of all bonuses at GEICO.

The two-part structure was carefully designed to maximize the benefit for GEICO's owners, now Berkshire Hathaway shareholders. By focusing on the profitability of seasoned business, the underwriting part of the equation sought to ensure GEICO was pricing its product appropriately for the long-term and rejecting unprofitable risks. Because it excluded customer acquisition expenses associated with bringing in new business, which hurt profitability in the short-term, the structure incentivized actions that built

long-term value. This allowed for liberal spending to drive future results of the business.

As simple as this incentive structure was, GEICO's competitors, and especially public companies, followed other paths. Beholden to the short-term-thinking of Wall Street, these companies often put near-term earnings first and sometimes starved their marketing budgets. GEICO's path from being the sixth or seventh largest auto insurer in the country to being one of the largest was the result of its long-term strategy.

It is worth noting that Simpson, GEICO's long-time investment manager, remained on to manage GEICO's investment portfolio after the merger. This said a lot about how highly Buffett viewed Simpson's investment prowess. With every other insurance acquisition, Buffett had taken over the investment part of the equation and left the managers to focus on the underwriting side.

In 1996, GEICO's first year under the Berkshire roof wholly owned, it wrote to a 94.5% combined ratio, producing an underwriting gain of $171 million pre-tax.

Manufacturing, Publishing, and Retailing

The manufacturing, publishing and retail segment continued impressive operations. Earning $378 million pre-tax in 1996, the group produced a pre-tax return on invested capital of 30%. [317] In isolation it represented a great result, but it marked a sharp decline from the 38% return earned in 1995 and the 49% result in 1994. Deteriorating profitability in the Shoe Group over the past few years explained part of the decline. The addition of capital-intensive FlightSafety explained the drop in 1996. [318] Most of the businesses in this category continued to contribute as they had in the past. A few business units are worth highlighting.

While the going was still tough at World Book, the business had made some progress. It was now the only direct-seller of encyclopedias after Encyclopedia Britannica stopped its business line. World Book also partnered with IBM and invested heavily in a new CD-ROM product. Pre-tax operating earnings at the unit grew 43% to $12.6 million but remained below the $25 million profit earned in 1994.

Operating earnings at *The Buffalo News* grew 7.7% to $50.4 million. The gain was partly because the prior year had higher one-time charges due to employee severance costs and certain depreciation adjustments. The current year benefitted from lower newsprint costs, which came back down after skyrocketing in 1995.

The Shoe Group saw profits increase 5.5% to $61.6 million, but they remained far below the $86 million earned just two years before. Management successfully capitalized on opportunities to market and distribute product and lower overhead costs. More profits were expected in the coming year.

Helzberg, Berkshire's newest jewelry acquisition, stumbled during 1996 and brought jewelry profits down 18% to $28 million. Increased expenses in anticipation of a large revenue increase that never materialized caused the disappointment. Buffett said CEO Jeff Comment was "addressing the expense problem in a decisive manner" and that he expected increased earnings in 1997.

USAir – Update

The saga of Berkshire's investment in USAir preferred stock continued. Only this time it was news to the upside. Despite the many mistakes Buffett admitted making with the investment, there was one bright spot. The preferred stock included an unusual provision stipulating penalty dividends 5 percentage points over the prime rate for payments that were in arrears. Since USAir had skipped two years of preferred dividend payments due to operating troubles, this provision was triggered. The regular 9.25% dividend was now closer to 14% for the last two years.

This penalty provision gave USAir an incentive to pay the amount in arrears. Buffett praised company CEO Stephen Wolf for working to right the ship. While he asserted that USAir "still has basic cost problems that must be solved," Wolf's actions saved Berkshire's investment such that Buffett now thought it worth its $358 million par value.

Not one to bask in glory, Buffett admitted to twice trying to unload the USAir stock, first in 1995 and again in early 1996. Both efforts failed. Buffett told shareholders after the second attempt, "You're lucky: I again failed in my attempt to snatch defeat from the jaws of victory."

The Walt Disney Company

In March 1996, The Walt Disney Company acquired Capital Cities/ABC in a cash and stock transaction. The deal was borne of a meeting between Michael Eisner of Disney and Tom Murphy of Cap Cities/ABC at a Sun Valley retreat. While Buffett attributed the meeting to his influence, he later said that he thought the deal would have eventually materialized on its own. Berkshire received a total of $2.5 billion, of which $1.2 billion was in Walt Disney stock, which Berkshire retained, and the remainder in cash. The event caused a $2.2 billion realized gain.

Salomon Debt Issue

During 1996, Salomon Brothers, Berkshire's go-to investment bank, sold an unusual security for Berkshire. The security was a $500 million, five-year debt issue that was convertible into shares of Salomon stock owned by Berkshire. Responding to a question about the issue at the 1997 Annual Meeting Buffett noted that, "it's a way of taking the capital out of that block of stock at a low-interest cost to use elsewhere, while retaining a limited portion of the upside in the Salomon stock." With stocks generally trading at elevated levels, [319] Berkshire was again taking advantage of favorable financing opportunities independent of any immediate need for capital.

Investment Lessons

Buffett provided some explicit words of wisdom for investors in his Chairman's letter and at the Annual Meeting. He stressed the advantages of a low-cost index fund, which he thought would over time beat "the great majority of investment professionals." Addressing attendees at the Annual Meeting, he said investing is "the only field in the world … where the amateur, as long as he recognizes he's an amateur, will do better than the professional."

Buffett frequently pointed to his own shortcomings and limitations with respect to investing. He thought investors wanting to strike out on their own and construct their own portfolios should clearly define their circle of competence and stick to it. "You don't have to be an expert on every company, or even many," he wrote shareholders. "Your goal as an investor should simply be to purchase, at a rational price, a part interest in an easily-

understandable business whose earnings are virtually certain to be materially higher, five, ten and twenty years from now." These companies were rare so investors should load up when they found one. Buffett pointed to Berkshire's own look-through earnings, which had risen in tandem over time with Berkshire's stock price, as an example of his counsel in action.

The best part about investing was that it was cumulative. Buffett had studied many businesses for years, even using FlightSafety as an example of one he read about for twenty years before learning enough to purchase it. All it took to be knowledgeable about many businesses and industries was time and an interest in continual learning. Compounding knowledge would lead to compounding money.

Class B Common Stock Issuance [320]

Up until 1996 Berkshire Hathaway had only one class of common equity. Buffett's unwillingness to split the stock to cultivate and maintain a certain shareholder base meant its shares were priced significantly higher than the average issue. Companies typically split shares to keep prices in the "affordable" range of $20 to $100. [321] Berkshire's shares had never been split and its per share price—over $33,000—reflected that fact. This caused some problems for shareholders wishing to make gifts, but the problems were surmountable. [322] The 1996 proposal to issue Class B shares was a defensive move on Berkshire's part: It was partly to protect potential investors, and partly to protect Berkshire's reputation.

Berkshire had successfully foiled many plans to create a unit trust stocked solely with Berkshire shares by appealing to the promotors of the trusts. Now it seemed someone was ignoring those pleas and at least one trust might be created. [323] The potential unit trust would buy Berkshire shares on the open market and then sell shares in the trust to prospective investors wishing to buy less than whole shares of Berkshire common stock. Buffett and Munger thought such a proposal would harm investors in two ways. First, through the fees that would cause the investment to lag that of true Berkshire shares. Second, the incentive to grow those fees would cause the promoter to market the trust by promoting the high rate of return which had been achieved in the past, but which Buffett said was not repeatable. There was also the issue of supply and demand. The unit trust would have a fixed number of shares. Heavy promotion might cause the price to exceed the

value of the underlying Berkshire shares. Investors would do worse than the underlying Berkshire shares as the discrepancy corrected itself over time.

The high expectations of such a Berkshire unit trust investment could also harm Berkshire and Buffett's reputation. If purchasers of such a trust bought in at a high price relative to the underlying Berkshire stock, its performance would surely be disappointing over time. Even if Berkshire were not to blame, which it wouldn't have been, the negative association would remain.

To thwart the promotors, Berkshire devised a plan to create a sub-class of shares that would represent direct ownership, but at slightly disadvantageous terms. The newly created B shares would be priced at 1/30th of that of an A share (the original share class) but they would have voting rights of just 1/200th of the A shares. Further, only the A- shares would be eligible for the charitable contribution program. In this way, there would be a slight advantage to owning the A-shares, but the newer B-share investors would still be owners of the company.

Berkshire went even further to temper expectations and take the idea of a unit trust off the table. Guided by basic economics, Berkshire stated that it would issue as many shares as investors wanted. This would eliminate any possibility of outsized demand from temporary excitement since Berkshire would just issue new shares to satisfy demand. Additionally, the A-shares would be convertible at the option of the holder into 30 B-shares, but the privilege would not go the opposite way. If B-shares traded higher than the equivalent A-shares for some reason, arbitrage would ensure the differential would not become too great. (An investor could buy A-shares, convert them to B-shares, and then sell them at a higher price. The parts would be more valuable than the whole.)

Lastly, Berkshire publicly stated (including in the prospectus offering) that both Buffett and Munger did not think Berkshire was undervalued at the issue price and that they were not interested in purchasing shares at that price. Some shareholders thought this meant Berkshire was overvalued. Buffett made clear that should not be inferred. He said saying that Berkshire was not undervalued was not the same as saying it was overvalued. Based on Berkshire's book value at the end of 1995, the new shares would have valued the company at over twice book value.

When the actual issuance was completed, the expected $100 million offering was oversubscribed. Berkshire ultimately ended up issuing 517,500

new B-class shares, which brought in just under $565 million. With no immediate plans for the money, Berkshire put it into the pool of capital available for other opportunities. Munger put the new shares in context. At about 1% dilution, he said the creation of the B-shares was a non-event.

Berkshire shareholders, not surprisingly, voted at the 1996 Annual Meeting to approve the B-share issuance. The Berkshire unit trust idea never resurfaced, and Berkshire's reputation and shareholders we re unharmed.

The complete language of the offering—vastly different than anything typically found on Wall Street—is worth reading in its entirety:

> WARREN BUFFETT, AS BERKSHIRE'S CHAIRMAN, AND CHARLES MUNGER, AS BERKSHIRE'S VICE CHAIRMAN, WANT YOU TO KNOW THE FOLLOWING (AND URGE YOU TO IGNORE ANYONE TELLING YOU THAT THESE STATEMENTS ARE "BOILERPLATE" OR UNIMPORTANT):
>
> 1. Mr. Buffett and Mr. Munger believe that Berkshire's Class A Common Stock is not undervalued at the market price stated above. Neither Mr. Buffett nor Mr. Munger would currently buy Berkshire shares at that price, nor would they recommend that their families or friends do so.
>
> 2. Berkshire's historical rate of growth in per-share book value is NOT indicative of possible future growth. Because of the large size of Berkshire's capital base (approximately $17 billion at December 31, 1995), Berkshire's book value per share cannot increase in the future at a rate even close to its past rate.
>
> 3. In recent years the market price of Berkshire shares has increased at a rate exceeding the growth in per-share intrinsic value. Market overperformance of that kind cannot persist indefinitely. Inevitably, there will also occur periods of underperformance, perhaps substantial in degree.
>
> 4. Berkshire has attempted to assess the current demand for Class B shares and has tailored the size of this offering to fully satisfy that demand. Therefore, buyers hoping to capture quick profits are almost certain to be disappointed. Shares should be purchased only by investors who expect to remain holders for many years.

1997

With stock markets continuing their upward trend, Buffett likened Berkshire's 34.1% per share increase in book value to a rising tide. He said Berkshire was the duck and even though its gain beat the S&P (by 0.7 percentage points) it was more attributable to luck than business acumen. That is not to say Berkshire did not make important gains during 1997. Buffett estimated intrinsic valued increased in tandem with book value.

Using the two-column method and our arbitrary though consistent 10x multiplier on pre-tax operating earnings, we can calculate that Berkshire's intrinsic value grew about 38%, which is close to the 34% increase in book value (see Table 6.9).

Table 6.9: Berkshire Hathaway intrinsic value estimation

Per A-share	1997	1996
Investments	$38,043	$28,500
Pre-tax operating earnings (ex. investment income)	718	421
Estimated value (investments + 10x operating earnings)	$45,221	$32,714
Year-end share price	$46,000	$34,100
Year-end book value per share	25,488	19,011
Price/estimated value	1.02x	1.04x
Price/book	1.80x	1.79x
Value/book	1.77x	1.72x
Change in estimated value	38%	
Change in share price	35%	

Sources: Berkshire Hathaway Annual Reports 1996, 1997; and author's calculations.

Buffett made sure to temper any enthusiasm. Berkshire's super cat business again experienced no major claims and GEICO had an unusually good year. Additionally, a rising stock market was making it harder to find good values there. He said prices were high and "if we swing, we will be locked into low returns." Buffett knew the value in waiting for the "fat pitch" but found some things during 1997 to keep himself out of trouble.

Unusual Commitments

For Buffett, keeping himself out of trouble meant finding market inefficiencies to exploit. This involved three unusual investments: oil contracts, zero-coupon US government bonds, and silver. The first was an investment in futures positions for 14 million barrels of oil. This was the remainder of a contract established in 1994 and 1995. The total profit from 45.7 million barrels of oil for those years created $62 million of profit for Berkshire.

The second was the purchase of $4.6 billion (at amortized cost) of US Treasury zero-coupon obligations. Paying no interest, they were a significant bet on a downward move in interest rates. The bet risked looking foolish if rates rose, but the odds were judged favorable. At year-end 1997, this bet was working out to the tune of almost $600 million.

The third investment was in silver and proved the remarkable power of staying true to simple economic concepts. In this case, supply and demand. Berkshire had a position of 111.2 million ounces of silver at year-end 1997. Buffett and Munger invested in silver because they thought that the world's supply and demand equation had gotten out of whack, and that a higher price would be necessary to resolve the discrepancy. Buffett stressed that inflation played no part in the calculation.

The logic was this: The world at that time used about 800 million ounces of silver each year. With 500 million ounces being produced, and another 150 million ounces being reclaimed annually, a 150 million-ounce shortfall existed. Since inventories were low, the demand would soon outstrip supply and cause a rise in price.

There was an important nuance to this investment, and it highlighted the concept of inelasticity. Very simply, elasticity in economics refers to the degree to which a given thing is price sensitive. Since the supply of silver came largely as a by-product of mining other metals, its supply was price inelastic. This meant that no one was out there prospecting simply for silver. Supply of silver was based on the fundamentals of other metals; more demand did not induce additional supply. The demand side also had some inelasticity. Silver was used in photography and jewelry, but demand for silver was not overly sensitive to price. Combine these factors and it created a situation that clearly favored an upward price-shift eventually. (Like other investments, Buffett knew the *if* but not the *when* .)

Charlie Munger pithily dismissed the investment at the 1998 Annual Meeting as being something that Buffett patiently studied for decades only to invest 2% of Berkshire's assets. In other words, it was not something to be excited about because it wasn't going to move the needle at Berkshire. Compared to Berkshire's multibillion-dollar investments in Coke, Gillette, and others, it really was a non-event. Still, for our purposes the investment is interesting and instructive.

Insurance

Aided by several positive factors, the Insurance Group hit it out of the park in 1997. Insurance earned almost $4.8 billion of premiums and wrote to an underwriting gain of $462 million before tax.

Table 6.10: Berkshire Hathaway—Insurance Underwriting

($ millions)	1997	1996
GEICO Corporation		
Premiums written	$3,588	$3,122
Premiums earned	3,482	3,092
Underwriting gain/(loss) - pre-tax	$281	$171
Berkshire Hathaway Reinsurance Group		
Premiums written	$955	$716
Premiums earned	967	758
Underwriting gain/(loss) - pre-tax	$128	($8)
Berkshire Hathaway Primary Group		
Premiums written	$309	$268
Premiums earned	313	268
Underwriting gain/(loss) - pre-tax	$53	$59
Total underwriting gain/(loss)	$462	$222
Year-end average float - total	7,093	6,702
Cost of float	(6.5%)	(3.3%)
Aggregate adverse (favorable) loss development	($131)	($90)

Sources: Berkshire Hathaway Annual Report 1998 and author's calculations.

Insurance – Reinsurance Group

With no super catastrophes in 1997, $283 million out of $310 million of catastrophe excess-of-loss premiums fell to the bottom line as profit. But the possibility of losses materializing in any given year were meaningful, and they were certain to occur at some point in the future. With an enlarged capital base and appetite for new deals, Berkshire was willing to suffer a $1 billion loss without any discomfort. Berkshire had confidence in its pricing of risks and knew that over time the odds would be in its favor. Losses in other property/casualty lines of $73 million, and $82 million in losses from retroactive reinsurance and structured settlements brought the Reinsurance Group gain down to $128 million.

While the lack of loss experience (catastrophes and ensuing expensive damage claims) in super cat was a near-term positive, it did bring unwelcome consequences. The insurance industry had long suffered from the ebbs and flows of capital coming into the industry during times of small losses, only to retreat when large losses came. The budding threat was now a new financial instrument dubbed catastrophe bonds.

Buffett disliked catastrophe bonds, but not because they represented competition. He disliked them primarily because he thought they would likely be sold to unsophisticated buyers. Buffett defined them as “investors,” using quotes to suggest they were not informed buyers. The word bond would induce prospective buyers to associate them with the safety inherent in traditional bonds, such as those sold by corporations or governments, when in fact they were really an instrument designed to circumvent state laws preventing unlicensed insurance activity. He also called them an Orwellian misnomer because they were not like a bond at all. They were more like a mispriced layer of insurance.

Whereas a true bond requires the issuer to repay the debt using income and is usually backed by assets, these were more like reinsurance and put the greater risk on the purchaser. This is how it worked: Investors put up money to back a pool of risks. If no risks materialized, the investor would receive a payment. Unlike a traditional bond, however, if a loss event did occur, the bond capital was used to make the issuer whole—leaving the bond holders empty handed. Like other times of capital influx, lower volumes were expected in the years ahead.

Insurance – GEICO

GEICO, already a shining gem, shone brighter than ever in 1997. After a record-setting 10% growth in 1996, GEICO, led by Tony Nicely, rocketed to 16% growth of in-force business in 1997. GEICO turned in an underwriting profit of $281 million, up 64% from the previous year. The resulting 91.9% combined ratio reflected GEICO's low-cost operation and generally favorable conditions industrywide. Using the same two-pronged compensation arrangement focused on growth in policies-in-force and the profitability of seasoned business, 10,500 GEICO employees shared a $71 million bonus pool that amounted to almost 27% of base salaries.

For GEICO an underwriting gain of over 8%, while not unwelcome, was too high. Targeting a 4% gain (meaning a combined ratio of 96%), GEICO planned to cut its rates in the coming year. GEICO would do better over time passing the benefits of its low-cost operation back to customers to drive future growth. It planned to spend over $100 million on advertising in the coming year to capture some of the $115 billion market—huge potential to grow GEICO's 3% market share.

Insurance – Primary Group

Berkshire's other primary lines wrote to a 15% underwriting profit during 1997. Premiums earned increased 17% from the prior year and reflected the progress of the many smaller-but-excellent insurance subsidiaries in that group.

Manufacturing, Publishing, and Retailing

Berkshire's financial reports reflected its growth. Insurance (including investment income) made up 78% of pre-tax operating earnings (up from 65% in 1994) so it was natural that more information was added to each segment as time progressed. The businesses in the non-insurance segment, by contrast, increasingly made up a smaller portion of the growing conglomerate. Consequently, certain businesses were lumped together for reporting purposes, but that didn't make them any less valuable. Together these businesses earned 32.8% on average invested capital (up from 29.6%).

Both Kirby and World Book were combined into one line along with the Scott Fetzer Manufacturing Group. Together, Scott Fetzer made up just 7% of Berkshire's consolidated pre-tax operating earnings in 1997. The Scott

Fetzer finance operation remained a separate line item. The newly reconstituted Scott Fetzer (excluding finance) reported a 2% decline in pre-tax earnings to $119 million.

Most of the other non-insurance operating businesses did better in 1997 than in 1996. An exception was the Shoe Group. Reflecting overall industry weakness, sales volume declined 12% at Dexter, which was struggling against a tough retail environment that included imports. The company planned a new marketing strategy using global advertising. Pre-tax earnings from the Shoe Group declined 21% to $49 million.

See's was the bright star that never seemed to dim. In 1997, the business grew revenues 8.2% to $269 million. Long struggling with declines in pounds sold, the year saw a 5.5% increase in poundage. The reason is unclear. Perhaps it was the legions of shareholders returning home with memories of their candy indulgences during the Annual Meeting who helped increase quantity and mail order volume at See's. In any event, See's was finding ways to increase its unit volumes while continuing to implement annual price increases.

It is interesting to compare FlightSafety, Berkshire's first admittedly capital-intensive acquisition, to See's (see Table 6.11). Looking solely at operating margins, one might conclude by the 7.5 percentage point difference that FlightSafety was the better business. Here the lesson of capital intensity comes into play. While FlightSafety generated a larger profit margin on revenues, its capital requirements were similarly large. [324] FlightSafety had nineteen times the assets of See's but generated only 50% more revenues. The greater operating margin at FlightSafety did not make up for the company's low level of revenues compared to its capital employed in the business. As a result, See's enjoyed a spectacular 65% return on assets compared to just 7% at FlightSafety.

See's did not possess the ability to reinvest that FlightSafety enjoyed. This illustrated one of the many tradeoffs in business. See's generated excellent returns on capital but had no place to put the earnings except distributing them to Berkshire. FlightSafety, by contrast, could reinvest larger sums but at lower rates of return. Berkshire welcomed, and needed, both businesses. [325]

Table 6.11: Comparison of FlightSafety and See's Candies, select 1997

data

	FlightSafety	See's Candies
($ millions)		
Revenues	$411	$269
Identifiable assets	1,679	88
Operating margin	29%	21%
Revenues/assets	0.24	3.06
Return on assets	7%	65%

Sources: Berkshire Hathaway Annual Report 1997 and author's calculations.

Star Furniture and International Dairy Queen

Another year, another acquisition. In 1997 Berkshire agreed to acquire Star Furniture and Dairy Queen, though the latter closed in early 1998. Buffett recounted how Irv Blumkin of Nebraska Furniture Mart, and later Bill Child of RC Willey, had both identified Star as a well-run furniture store. When Melvyn Wolff and his sister, Shirley Toomin, decided to sell the family business, they reached out to Salomon Brothers who in turn introduced them to Buffett. Not long after, a deal was made to purchase the twelve-store, Texas-based furniture business. The price was not disclosed. 326

International Dairy Queen was a bread-and-butter (burgers and fries, really) operation that fit well with the Berkshire family of businesses. When Berkshire Hathaway agreed to purchase the company in 1997 it had 5,792 Dairy Queen locations. It sold hamburgers, fries, and ice cream, among other similar offerings, and operated in twenty-three countries. The International Dairy Queen parent also operated 409 Orange Julius and forty-three Karmelkorn franchise locations that sold other treats. In addition, there were 190 treat centers, that combined some or all three of those brands. Most locations were franchised.

Dairy Queen had a troubled history. After some years of operation that saw a jumbled mess of varying franchise agreements and too much debt, a Minneapolis group purchased the business in 1970. In 1997, one of the two owners died and his estate sought to sell the business.

The International Dairy Queen deal was structured similar to the FlightSafety acquisition. A combination of cash and Berkshire stock was

offered, with the cash portion slightly richer to entice sellers to choose that over stock. [327] Despite this nudge, only 45% of Dairy Queen shareholders chose cash. The total purchase price was $587.8 million, and the merger closed on January 7, 1998 (see Table 6.12). Like Berkshire's other acquisitions during this period, it paid a premium price for a company earning very good returns on capital.

Table 6.12: International Dairy Queen acquisition analysis

($ millions)	1996	1995	1994
Revenues	$412	$372	$341
Revenues/avg. capital	$2.39	$2.27	$2.31
Pre-tax margin	13%	14%	15%
Pre-tax return on capital	32%	32%	34%
Purchase price[1]	$588		
Assumed debt	4		
Effective purchase price[2]	$591		
Purchase multiple	3.44x		
BRK going-in pre-tax return	9.3%		

Footnote:
1. Cash on the balance sheet at year-end 1996 was $38 million, which would suggest excess cash. The effect on the economics of the transaction would have been very modest.
2. Total does not add due to rounding.

Sources: Berkshire Hathaway Annual Report 1997, 1998; International Dairy Queen Annual Report 1996; and author's calculations.

International Dairy Queen was a different economic model from McDonalds, a stock Berkshire previously owned and sold. [328] While both companies were (and are) franchisors, McDonalds owned and operated about one-third of its locations and owned the underlying real estate of most locations. By contrast, International Dairy Queen operated a few of its locations but was mostly a franchisor. That arrangement made for a relatively small investment in capital compared to McDonalds. International Dairy Queen treated its franchisees fairly with a franchise fee of 4% of revenues, which was at the low end of the spectrum for the industry.

Under a section of his 1997 letter entitled, A Confession, Buffett wrote that the International Dairy Queen and FlightSafety-type acquisitions made with Berkshire shares had cost shareholders money. He was clear that such value-detracting moves were not due to the underlying companies, but instead because Berkshire's existing group of businesses were so great. He

used a baseball analogy to demonstrate his point. Trading any player for a .350 hitter was a good idea in most cases. Except when it was at the expense of a .380 hitter. [329] His point was that Berkshire already had a star roster filled with wonderful businesses. Issuing Berkshire stock in any future acquisition meant trading away a small percentage of the ownership of these wonderful businesses. For this reason, Buffett wrote that "you can be sure Charlie and I will be very reluctant to issue shares in the future."

Even though it was flagged as a mistake, Buffett did not say Berkshire would stop issuing shares. Instead, Berkshire would offer splits such as that used in the International Dairy Queen acquisition that encouraged cash over stock. The stock-type deals would remain, but as an option in the cases where sellers desired stock as a currency.

Investments

While usually changing at the speed of molasses, the Berkshire investment portfolio was not immune to some fluctuations. The inevitables, a word Buffett coined in 1996 to describe those companies destined to do very well over time, were still there: Berkshire had 49 million shares of American Express, 200 million shares of Coke, [330] 1.7 million shares of *The Washington Post* , and 6.7 million shares of Well Fargo. In addition, Berkshire still held its 64 million shares of Freddie Mac and 48 million shares of Gillette.

All told, the $7.2 billion cost common stock portfolio had a market value of $36.2 billion at year-end 1997, with Coke making up almost 37% of it. The next largest was American Express at 12%. The listed securities (those with a market value over $750 million) totaled eight in name and represented almost 88% of the portfolio.

Table 6.13: Berkshire Hathaway common stock portfolio, select detail

($ millions, at market value)	1997	*% total*
American Express Company	$4,414	*12%*
The Coca-Cola Company	13,338	*37%*
The Walt Disney Company	2,135	*6%*
Federal Home Loan Mortgage Corp.	2,683	*7%*
The Gillette Company	4,821	*13%*
Travelers Group, Inc.	1,279	*4%*

Washington Post Company	841	*2%*
Wells Fargo & Company	2,271	*6%*
Others	4,467	*12%*
	$36,248	*100%*

Notes:

1. Figures may not add due to rounding.

2. The reporting threshold was $750 million.

Sources: Berkshire Hathaway Chairman's letter 1997 and author's calculations.

Included in the top eight was a new name: Travelers Group, Inc. Berkshire's 23.7 million shares of Travelers were as a result of the merger of Salomon with Travelers that netted Berkshire common and preferred stock. The architect of the Travelers deal was Sandy Weill, whom Buffett praised as a great manager with a proven record. Such comments provided an answer for why Berkshire continued with the investment. [331]

Responding to a question at the Annual Meeting about Coke, Buffett provided some remarkably candid insights into his and Munger's thinking on the investment. The question was whether and how to include the periodic gains reported by the company via its sales of bottlers. Buffett said he completely ignored such gains and instead focused on two variables. "The two important elements in [valuing] Coke are unit case sales and shares outstanding," he said. Looking forward a decade or two, if one thought (which presumably he did) that Coke would be selling "multiples of its present volume" and the number of outstanding shares were expected to go down (the company was a repurchaser of its own shares), it was "as far as you needed to go" in analysis. Of course, there was more to that conclusion, including the knowledge of the superiority of Coke's worldwide distribution system. At the end of the day, those two variables remained and told a compelling story. No wonder Coke made up over one-third of the portfolio.

In addition to disposing of the McDonalds investment, Berkshire also trimmed its holdings in certain larger positions including Walt Disney (down 12% to 21.6 million shares), Freddie Mac (down 0.5% to 64 million shares), and Wells Fargo (down 8% to 6.7 million shares). In total, about 5% of the beginning value of the portfolio was sold and shifted into fixed maturity investments, including increased holdings in Treasuries and other

government securities. One noteworthy category of bonds largely missing from the mix were corporates. At year-end 1997, the portfolio contained just a $35 million allocation, largely unchanged from 1996.

On the whole, Berkshire's 1997 investment portfolio was comprised of $10.3 billion of fixed maturity investments and $36.2 billion of equity securities. The resulting stock/bond split was 78/22. This compared to the 1996 portfolio with $6.4 billion in bonds and $27.8 billion in equities, a split of 81/19. Buffett thought the equity market was at such a level that little-to-no margin of safety existed at current prices. *If* interest rates remained where they were or fell, and *if* returns on equity remained high (as they were in late 1997 and early 1998) then markets would not be overvalued. Judging by Berkshire's actions, Buffett seemed to be leaning toward a judgement of overvaluation.

1998

"Normally, a gain of 48.3% would call for handsprings—but not this year," Buffett wrote to shareholders in his 1998 Chairman's letter. After several years of such talk (Berkshire delivered average annual gains in per-share book value of 39% over the prior four years compared to 31% for the S&P 500), shareholders might again dismiss this as Buffett being Buffett. But this year really was different. Berkshire did find sensible things to do during 1998, especially against a backdrop of an evermore expensive stock market, but the per-share gains in book value were not as good as they looked.

The gain in 1998 was mostly due to issuing shares to make business acquisitions. For someone who had written just a year earlier that it was a mistake to issue shares in prior acquisitions, 1998 was a veritable spending spree with shares. So why did Berkshire do it? Presumably, Buffett and Munger thought their simple test had been met: In these cases, Berkshire received as much in value as they gave by issuing new shares. During the year Berkshire acquired three new businesses: the International Dairy Queen merger at the beginning of January (discussed in the 1997 section), Executive Jet, and Berkshire's largest acquisition to date, General Reinsurance (sometimes referred to as General Re). Because these deals all involved issuing above-book-value shares of Berkshire, the transactions instantly increased per-share book value figures. What wasn't instantaneous

was a change in per-share intrinsic value if equal intrinsic value was given as received. [332]

Berkshire's per-share intrinsic value did increase during the year, but it was well short of the gain in book value per share and therefore not a cause for celebration. Continuing to use the two-column method (see Table 6.14), Berkshire's intrinsic value increased an estimated 16%—far short of the change in book value. Two items in the 1998 analysis deserve extra attention. One is the fact just discussed that Berkshire's book value increased along with the issuance of shares. If we presume a 1:1 exchange of value, this had the effect of decreasing the proper price/book multiple necessary to arrive at Berkshire's intrinsic value. [333] This decline was probably less than the change shown in the table due to the second factor: General Re reported a loss in 1998 which depressed Berkshire's operating earnings. Had Berkshire not acquired General Re operating earnings would have increased slightly. [334]

Table 6.14: Berkshire Hathaway intrinsic value estimation

Per A-share	1998	1997
Investments	$47,647	$38,043
Pre-tax operating earnings (ex. investment income)	474	718
Estimated value (investments + 10x operating earnings)	$52,392	$45,221
Year-end share price	$70,000	$46,000
Year-end book value per share	37,801	25,488
Price/estimated value	1.34x	1.02x
Price/book	1.85x	1.80x
Value/book	1.39x	1.77x
Change in estimated value	16%	
Change in share price	52%	

Sources: Berkshire Hathaway Annual Reports 1997, 1998; and author's calculations.

General Reinsurance Corporation

Berkshire completed the $22 billion acquisition of General Re on December 21, 1998. Issuing 272,200 A-equivalent shares for the company, it was by far Berkshire's largest acquisition to date.

General Reinsurance was, as its name suggested, a reinsurance business. The name General Re was technically the parent company that conducted professional property and casualty reinsurance under the names of General Reinsurance Corporation and National Reinsurance Corporation, the largest such outfit in the United States. General Re also owned an 82% interest in Cologne Re, a major international reinsurer and the oldest in the world. Through Cologne Re, General Re also reinsured life and health insurers. [335]

Why was Berkshire interested in acquiring General Re? The answer required a word previously anathema to both Buffett and Munger: synergy. [336] The reasons were laid out in the press release announcing the acquisition:

1. Many investments: General Re would almost double Berkshire's investment portfolio with its $24 billion, or $80,000 per A-share (equivalent) issued.
2. Expansion of General Re's ability to write business: Earnings volatility would not factor into underwriting decision-making as was the case when it was a public company.
3. The ability to expand internationally.
4. Tax considerations: Berkshire's large base of taxable earnings outside of reinsurance would allow General Re to maximize the value of its investment portfolio.
5. Abundance of capital: Berkshire's large capital base would allow General Re to operate unconstrained and write any business that made sense.

The merger was summed up as follows: "These synergies will be coupled with General Re's pristine worldwide reputation, long-standing client relationships and powerful underwriting, risk management and distribution capabilities. This combination virtually assures both Berkshire and General Re shareholders that they will have a better future than if the two companies operated separately."

General Re was like Berkshire's home-grown reinsurance business in that it was paid for absorbing the volatility of other insurers. It was unlike Berkshire's existing insurance business in that it was publicly held. Publicly held companies are praised for their smoothness, which goes against the

nature of reinsurance. Under Berkshire's umbrella, General Re could take on more volatility (assuming it was properly priced) and live up to its potential. Hidden risks would soon come to light, but this potential was the basis of the acquisition.

Buffett also thought highly of General Re's management team. CEO Ron Ferguson was offered a position on Berkshire's board of directors, but he declined. Like Berkshire's other acquisitions, Ferguson would be left alone to run his business, although General Re's investment portfolio would now be under Buffett's direction. Cologne Re would remain as it was prior to the Berkshire acquisition, with its portfolio managed as before.

Some figures illuminate the size of General Re's operations. As evident in the $22 billion price tag its business was large (see Table 6.16). Compared to the Berkshire Hathaway Reinsurance Group, which wrote just under $1 billion in premium volume during 1998 and earned slightly less, General Re was huge. In 1998 General Re wrote and earned about $6.1 billion of premium volume across three main reporting lines. The largest, at about $2.7 billion or 44% of its premiums, was the North American property/casualty segment. International property/casualty followed at $2.1 billion or 35%, and the Life/Health division wrote and earned about $1.3 billion or 21% of General Re's volume.

General Re's $370 million underwriting loss in 1998 was the one apparent blemish. This translated into a combined ratio of 106.1%. The company's long-term track record of success told a better story. Over the prior fifty years, General Re stood out for its nearly breakeven combined ratio of 100.4%, [337] though this included the most recent five- and ten-year track record averaging 101%.

General Re brought with it approximately $14 billion of float. This tripled Berkshire's float in one year's time to $22.8 billion at year-end 1998. To acquire this float Berkshire paid a premium of 1.57x (the $22 billion price tag vs the $14 billion of float) for General Re. Float, as Buffett noted many times, could be very valuable, especially if it grew and/or came at a low or negative cost. But General Re's large float came with a near-breakeven cost and Buffett did not expect it to grow very much. There were the synergies laid out in the press release, but could these facts alone justify the purchase price? Paying up for a business like GEICO, with its profitable and rapidly

growing float made sense, but why pay such a premium for what seemed to be average-quality float?

The answer might lie with the valuation of the Berkshire currency at the time—in other words, Berkshire's share price. The merger was completed late in 1998, but the price was established mid-year based on an average closing price over a 10-day period. [338] At the time, Berkshire was trading at over $80,000 per A-share. Even conservatively estimating Berkshire's intrinsic value using the year-end 1998 figures, which includes General Re (book value grew between mid-year and year-end), it appears the shares issued in the merger were overvalued by as much as 54%. [339] Adjusting for this overvaluation, we can conclude the price paid for General Re was not as rich as at first glance. This is consistent with Buffett's comments that as much intrinsic value was given as gained.

Table 6.15: General Re acquisition analysis, 1998

Acquisition price *($ millions)*	$22,000
Shares issued	272,200
Implied BRK.A share price	$80,823
BRK.A estimated intrinsic value 12/31/98[1]	$52,392
Implied price/intrinsic value per share	1.54x
General Re float *($ millions)*	$14,000
Adjusted acquisition price *($ millions)* [2]	$14,261
Price/float multiple[3]	1.02x

Footnotes:
1. Using the two-column method based on per-share investments of $47,647 and ten times per-share operating earnings of $474.45, which includes General Re. The valuation is almost identical to a multiple of 1.75x applied to Berkshire's pre-merger book value on June 30, 1998.
2. Adjusted for the implied price/intrinsic value multiple.
3. The multiple increases to 1.07x using the higher per share operating earnings from 1997.

Sources: Berkshire Hathaway Annual Report 1998 and author's calculations.

One last item is noteworthy with respect to General Re. The acquisition brought analyst attention to Berkshire because of General Re's institutional shareholder base. [340] One of those analysts was Alice Schroeder, who later wrote *The Snowball* , the only authorized biography of Buffett. Schroeder, then an analyst at PaineWebber, wrote a research report [341] on Berkshire that Buffett praised greatly. The analyst attention would also provide a benefit for Berkshire, or at least Buffett, in that they could field calls from

institutions or others about Berkshire. Since Berkshire had no investor relations department and Buffett wanted a level playing field between all investors (i.e. no special meetings with him even for large shareholders), the few analysts that now covered Berkshire were a plus.

Table 6.16: Berkshire Hathaway—Insurance Underwriting

($ millions)	1998	1997
GEICO Corporation		
Premiums written	$4,182	$3,588
Premiums earned	4,033	3,482
Underwriting gain/(loss) - pre-tax	$269	$281
General Re		
Premiums written	$6,084	
Premiums earned	6,095	
Underwriting gain/(loss) - pre-tax	($370)	
Berkshire Hathaway Reinsurance Group		
Premiums written	$986	$955
Premiums earned	939	967
Underwriting gain/(loss) - pre-tax	($21)	$128
Berkshire Hathaway Primary Group		
Premiums written		$309
Premiums earned	328	313
Underwriting gain/(loss) - pre-tax	$17	$53
Total underwriting gain/(loss)	$265	$462
Year-end average float - total	15,070	7,093
Cost of float	(1.8%)	(6.5%)
Aggregate adverse (favorable) loss development	($195)	($131)

Notes:

1. Totals and ratios do not include General Re as it was only owned for ten days in 1998.

2. Berkshire Hathaway Primary Group written premiums were not detailed beginning in 1998.

Sources: Berkshire Hathaway Annual Report 1998 and author’s calculations.

Berkshire Hathaway Reinsurance Group

Berkshire's existing reinsurance operations swung to a $21 million loss on earned premiums of $939 million (down 3%). Super cat premiums declined 8% to $286 million but another year of low loss events left a $155 million profit. Losses from other property/casualty business totaled $86 million, and retroactive reinsurance and structured settlements recorded underwriting losses of $90 million.

GEICO

"GEICO, once again, simply shot the lights out." Those were Buffett's words of praise in his 1998 Chairman's letter. Even after reducing pricing on average 3.3% to lower its underwriting profit to its target level of 4%, favorable weather conditions and lower accident severity led GEICO to deliver big for Berkshire. Premiums written were up 16% over 1997 and GEICO's underwriting profit of $269 million (or 6.7% of premiums) remained too high. Additional price cuts would be necessary in 1999.

GEICO brought in 1.3 million new voluntary auto policies during the year, which took total policies-in-force to over 3.5 million. The growth in new policies, together with the outsized underwriting profit, produced great results for Berkshire and for GEICO's 9,313 associates. GEICO paid out a record $103 million, or almost one-third of base salaries in bonuses, to its employees. This was the highest on record for the company. Not slowing down one bit, GEICO planned to spend $190 million on advertising in the coming year to spur growth. The campaign was working: market share had risen from 3% to 3.5% in 1998.

Berkshire Hathaway Primary Group

Berkshire's other slate of insurance businesses continued slow yet below-the-radar success in 1998. The group earned $328 million in premiums and turned in a combined ratio of 94.8%. This myriad group that had formed Berkshire's foundation now accounted for just a fraction of its total volume given the General Re acquisition. As small as they were individually or even collectively, they were still an important contributor to Berkshire. This was especially true given their ability to generate negative cost float.

Since the General Re acquisition did not close until very late in 1998, its 1998 underwriting loss did not materially affect Berkshire's consolidated insurance results. In all, including the ten days of General Re's results, and

largely due to GEICO, Berkshire's Insurance Group reported a pre-tax underwriting gain of $265 million—another year of cherished negative cost float.

Investments

The General Re merger moved Berkshire's investment portfolio even heavier into bonds, a direction Berkshire was purposely heading. Changes in 1997 took Berkshire's bond allocation from 19% of its $47 billion portfolio to 22%. General Re maintained a higher concentration of bonds, and Berkshire requested that it dispose of its 250-stock equity portfolio prior to the merger. Post-acquisition, Berkshire's investment portfolio grew to $61 billion, with a 35% allocation to bonds.

There were some important changes in the composition of the bond portfolio year-over-year. Most notable were higher exposures to foreign governments and a more meaningful investment in corporate bonds.

Table 6.17: Berkshire Hathaway fixed maturity portfolio

(At market value, in millions)	1998		1997	
US Treasuries, governments, agencies	$2,528	*12%*	$6,490	*63%*
States, municipalities and political subdivisions	9,647	*45%*	2,209	*21%*
Obligations of foreign governments	2,864	*13%*	0	*0%*
Corporate bonds	4,609	*22%*	35	*0%*
Redeemable preferred stocks	355	*2%*	1,280	*12%*
Mortgage-backed securities	1,243	*6%*	284	*3%*
Total	$21,246	*100%*	$10,298	*100%*

Note: Totals may not add due to rounding.

Sources: Berkshire Hathaway Annual Report 1998 and author's calculations.

There were also some meaningful changes to the equity portfolio during 1998. The elimination of McDonalds was discussed earlier, which in hindsight Buffett regretted selling. Buffett also reduced or eliminated smaller positions and added to American Express, buying an additional 1.08 million shares.

With stock markets reaching new heights in general, [342] and tech-fever raging, Buffett and Munger received several questions at the next Annual Meeting about investing in dot-coms. Why, some asked, if Buffett so

admired companies such as Intel and Microsoft, hadn't Berkshire invested in technology? Buffett reiterated his philosophy: he and Charlie looked for businesses about which they could be fairly certain of their ten to fifteen-year prospects. Technology companies didn't pass through that filter.

Buffett said that in 1998, just 400 companies in the United States earned $200 million a year after tax. Yet there were many internet companies with no such earnings being valued on the same basis as some long-established (and profitable) enterprises. The math just didn't work out, he said. "In the end, they have to succeed as businesses."

This sound explanation did not stop other shareholders from prodding Buffett about his reluctance to change his ways. Fortunately for Berkshire shareholders, both he and Munger were comfortable owning basic boring businesses. Afterall, a dollar earned in a technology operation was worth the same as one from an old-fashioned business. Change may be exciting for speculators and good for the citizenry at large, but it was a threat to long-term investment returns.

Executive Jet

The newest non-insurance subsidiary joined Berkshire in August 1998. Executive Jet was the third company acquired with the issuance of shares in 1998 following General Re and International Dairy Queen. The purchase price of $700 million required half to be paid with Berkshire shares. Unfortunately, we cannot readily determine the valuation Berkshire placed on Executive Jet because its results were not detailed separately.

Executive Jet was a simple business. The company sold fractional interests in various aircraft, which were then managed by the company for use by its multiple owners. These fractionally owned aircraft supplemented a fleet of company-owned aircraft that Executive Jet could have available on short notice. The company was founded by Rich Santulli, who Buffett credited with creating the fractional ownership industry in 1986.

Although both Executive Jet and FlightSafety were classified into the same Flight Services category, the businesses had important differences. Whereas FlightSafety was a capital-intensive business requiring significant upfront investment in simulators, Executive Jet was a capital-light operation. An aircraft's owners—whether a single-owner or multiple owners—put up the

capital to buy the plane. Owners also paid Executive Jet a monthly management fee and a fee to cover hours flown.

Owing to the capital-light nature of the business, and its advantages over direct ownership of single planes, Buffett was enthusiastic about the business. He had started using the service prior to owning the company. After buying Executive Jet, he even sold The Indefensible, Berkshire's own corporate plane. The company had real growth prospects, and adding more owners and planes would drive costs down as dead head time (planes flying empty to pick up passengers) was reduced. In addition, more planes across the country meant shorter wait times for customers. Already the company accounted for 31% of all corporate jets ordered in the entire world. Executive jet was half of the Flight Services category (FlightSafety and Executive Jet). This category earned $181 million and represented 10% of Berkshire's 1998 pre-tax operating income.

Manufacturing, Service, and Retailing

If there was any question about the diminished relative importance of other businesses in this category, the word publishing was replaced by service in the segment header beginning in 1998. Flight Services was mostly in a league of its own among Berkshire's non-insurance businesses with its 10% of pre-tax operating earnings. (The only other non-insurance business to earn as much was the collective of Berkshire's Finance and Financial Products businesses.) Within the now Manufacturing, *Service* , and Retailing businesses only Scott Fetzer (excluding its finance operations) came close, at 7% of Berkshire's total. Scott Fetzer earned $137 million pre-tax, up 15% from the year before. [343] Its after-tax profits of $96.5 million was an astounding 86% return on its $112 million of net worth. Also worth mentioning, not for its size but its 22% increase in earnings, were the jewelry businesses, which earned $39 million. *The Buffalo News* had another tough year and earned $53 million, down 5%, and See's increased its earnings by 5% to $62 million.

Finance and Financial Products

The inclusion of General Re's finance subsidiary in Berkshire's Finance and Financial Products segment brought Berkshire's operations in this area back to the forefront, and with it a Wall Street-esque look to the balance sheet

due to its complexity. Previously the balance sheet primarily comprised borrowed funds, annuity liabilities, and equity, which financed interest-bearing receivables and investments. It now included securities marked to market, trading securities, and repo securities, [344] among others. While some of this complexity would wind down over time, as it stood the segment had a portfolio containing huge notional amounts of securities.

The interest rate and currency swap agreements were largest, at over half a trillion dollars ($514,935 *million*) of notional value. The balance sheet had $88 billion of options written and $90 billion of options purchased, in addition to significant futures and forwards contracts. While all of this netted against each other to a more modest $6.2 billion of trading account assets/liabilities, it posed significant hidden risk for General Re and for Berkshire.

Accounting Lessons

Buffett took no less than three pages in the 1998 Chairman's letter to rail against the accounting abuses committed by corporate America. Using General Re as an example, he wrote that the acquisition "put a spotlight on an egregious flaw in accounting." Namely, that Berkshire would replace General Re's option plan with an economically equivalent cash plan. Since options had not been counted in the income statement, Buffett told readers that the proxy statement describing the merger contained a $63 million adjustment to correct for this fact.

Buffett said that he and Munger made similar revisions to the earnings of the public companies they followed. It wasn't uncommon for the adjustments to reach a very meaningful 5% or 10% of earnings. In some cases, such adjustments were the difference between purchasing a stock or passing on a purchase. [345]

Restructuring charges were another sore spot. Companies would lump in all sorts of adjustments into one quarter, which would then be explained away and ignored by analysts. Even more egregious, such maneuvers sowed the seeds for future so-called earnings when charges were reversed. Such accounting machinations were the result of a hyper-competitive environment with CEOs eager to please Wall Street and auditors that blessed such arrangements. Not surprisingly, both Buffett and Munger thought such practices despicable.

Buffett lauded SEC Chairman Arthur Levitt for going after such abuses and urged shareholders to read a recent speech on the subject. [346] As for Berkshire, Buffett would tell it as it is. Regular readers of his shareholder letters would know that Buffett was telling the truth. If anything, Buffett took too many pains to point out his and Berkshire's shortcomings. Perhaps Berkshire was the better for it.

1999

The underperformance that Buffett had long predicted finally came true in 1999. Berkshire's gain in book value per share (Buffett's preferred, if only rough proxy) increased just 0.5% compared to an increase of 21% for the S&P 500. Buffett told shareholders the 20.5% underperformance was the worst of his career and that he deserved a D for capital allocation. Still, Berkshire did have some bright spots during the year, including the completion of an acquisition and the arrangement of two more.

The poor performance stemmed from a couple of different spots. The first was a lackluster performance by the marketable securities portfolio. Poor operating performance at the underlying companies caused their stock prices to decline, in turn impacting Berkshire's book value. [347] The price declines were also likely exacerbated by the internet fever still gripping the country. The Nasdaq Composite rose fivefold between 1995 and 2000, but only for companies investing in technology stock. Berkshire had made no such investments. Additionally, mistakes at General Re, Berkshire's new reinsurance subsidiary, led to a large underwriting loss that caused a corresponding pre-tax operating loss (excluding investment income).

Insurance

Berkshire reported its first loss from insurance underwriting since 1992. General Re contributed most of the $1.4 billion pre-tax loss, but weakness in other areas played a part. Berkshire's 5.8% cost of float approximated long-term US government bond rates at the time.

Table 6.18: Berkshire Hathaway—Insurance Underwriting

($ millions)	1999	1998
GEICO Corporation		
Premiums written	$4,953	$4,18

		2
Premiums earned	4,757	4,033
Underwriting gain/(loss) - pre-tax	$24	$269
General Re		
Premiums written	$7,043	$6,084
Premiums earned	6,905	6,095
Underwriting gain/(loss) - pre-tax	($1,184)	($370)
Berkshire Hathaway Reinsurance Group		
Premiums written	$2,410	$986
Premiums earned	2,382	939
Underwriting gain/(loss) - pre-tax	($256)	($21)
Berkshire Hathaway Primary Group		
Premiums earned	$262	$328
Underwriting gain/(loss) - pre-tax	$22	$17
Total underwriting gain/(loss)	($1,394)	$265
Year-end average float - total	24,026	15,070
Cost of float	5.8%	(1.8%)
Aggregate adverse (favorable) loss development	($192)	($195)

Notes:

1. Totals and ratios for 1998 do not include General Re as it was only owned for ten days.

2. Berkshire Hathaway Primary Group written premiums were not detailed.

Sources: Berkshire Hathaway Annual Report 1998–1999 and author’s calculations.

General Re

During 1999, mistakes of the past finally caught up with General Re. The reinsurer had significantly underpriced its business in both domestic and international markets. Buffett hinted that the culprit might have been the compensation structure at General Re and its major subsidiary, Cologne Re. Those structures were changed. At both companies “incentive compensation plans are now directly tied to the variables of float growth and cost of float, the same variables that determine value for owners.” Yet even with perfect hindsight Buffett said he’d make the same deal to acquire General Re.

Just how bad were the 1999 results at General Re? On earned premiums of $6.9 billion General Re recorded an underwriting loss of $1.2 billion—a combined ratio of 117.1%. General Re's results fell into three main components:

- North American property/casualty: A pre-tax underwriting loss of $584 million on $2.8 billion of earned premiums (combined ratio of 120.6%). *Reason for the loss* : inadequate premium rates, higher losses, and unfavorable loss development.
- International property/casualty: A pre-tax loss of $473 million on $2.3 billion of earned premiums (combined ratio of 120.2%). *Reason for the loss* : losses on a motion picture insurance contract, catastrophe losses resulting from European winter storms, earthquakes in Taiwan and Turkey, and a hailstorm in Australia.
- Global life/health: A pre-tax underwriting loss of $127 million on earned premiums of $1.7 billion (a combined ratio of 107.4%).

While the Global life/health line at General Re was the relative bright spot during 1999 in terms of financial results, it bore the stain of a past mistake. Its 1998 underwriting loss [348] was largely the result of the "Unicover affair." According to an industry article written in 2014 by future CEO Tad Montross, [349] participants in Unicover (a pool of life insurers) "sold dollar bills for 50 cents" via their hugely underpriced reinsurance of the policies. At the Annual Meeting, Buffett praised General Re for being one of the first to record the expected future loss, whereas some others had punted the loss recognition into future years. In a rare lapse, General Re had strayed from its circle of competence and was hurt, but Buffett thought it learned its lesson.

Berkshire Hathaway Reinsurance Group

Berkshire's home-grown reinsurance operation, created and run by Ajit Jain, also posted an underwriting loss during 1999. Here things were a little different as the loss largely reflected the expectations of volatility of results over time in reinsurance. The group continued to write large covers, and in 1999 it wrote $2.4 billion of premiums (and earned just about the same), including $1.25 billion from a single contract. The group's overall

underwriting loss of $256 million pre-tax included a $220 million loss from a single aggregate excess contract (a type of reinsurance contract that produces a lot of float, but with one large upfront loss) during the fourth quarter of the year. Other non-catastrophe losses totaled $135 million and retroactive reinsurance reported a loss of $97 million. With a profit of $196 million, the super cat business reported yet another year of gains.

Berkshire Hathaway Primary Group

The direct or primary lines continued their understated success. Though premium volume slipped 20% to $262 million, the group wrote to an underwriting profit of $22 million, up 29%. In his letter to shareholders, Buffett praised Ron Eldred, Brad Kinstler, John Kizer, Don Towle, and Don Wurster for collectively earning $192 million in pre-tax underwriting profit over the preceding five years.

GEICO

GEICO was still Berkshire's shining star, even if not as bright as the prior two years. Those years saw outsized profitability industrywide driven by lower accident rates and few-to-no catastrophe losses. Accordingly, GEICO's combined ratios of 91.9% and 93.3% in 1997 and 1998, respectively, were too low. In 1999, it returned to earth at 99.5%.

Part of the reason for the return to a normal combined ratio was the effects of higher claims and reduced pricing on the loss ratio. The other part of the equation was GEICO's discretionary spending on advertising for customer acquisition. GEICO might only need to spend $50 million to maintain its policy count, but it instead spent $242 million to grow its business in 1999 and expected to spend up to $350 million in 2000. Buffett said CEO Tony Nicely's "foot is going to stay on the advertising pedal (and my foot will be on his)." Buffett was willing to commit $1 billion a year to advertising if it would result in new business at an attractive cost. They didn't, in part because media rates were up, and each additional dollar of advertising had a diminishing return.

GEICO added 1.65 million new voluntary auto policies in 1999, bringing the in-force count to over 4.3 million. Its premium volume grew accordingly and so did its float, up 10% from 1998 to $ 3.4 billion.

It was around this time that GEICO introduced the gecko, as GEICO was often mispronounced gecko. The tiny, green, happy creature told people: "My job is to save people money. I love my job." His job was also to attract new customers, which made GEICO a lot of money. A closer look at GEICO's 1999 underwriting gain shows this. Included in underwriting expenses are all costs associated with running the business (including advertising); excluded is losses and loss expenses. At 19.3% of premiums earned, underwriting expenses were about the same as the year before—but they would have been another four points lower without such heavy advertising.

At other auto insurers, and especially publicly traded ones, growth spending might be held back to report higher profits. GEICO, Berkshire, and Buffett were squarely focused on the future. This meant trading current reported profits for a chance to capture a greater slice of the overall market (GEICO's share was 4.1%)—a cycle that would repeat successfully in the future.

Jordan's Furniture

Jordan's Furniture found a new home at Berkshire Hathaway on November 13, 1999, in an all-cash transaction. Berkshire now owned what Buffett considered the four best furniture retailers in the country. The other three: Nebraska Furniture Mart, RC Willey in Utah, and Star Furniture in Texas, had all told Buffett about Jordan's. Buffett hinted about this in previous Annual Reports without naming Jordan's. Now he could talk about it freely.

Buffett said Jordan's had the highest sales per square foot in the country and was the largest furniture retailer in Massachusetts and New Hampshire. Jordan's was operated by Barry and Eliot Tatelman. Their grandfather started the family business in 1927. Jordan's grew by turning shopping into an entertainment experience with soda, cookies, ice cream, and even an IMAX movie theater on site at some locations to augment the shopping experience. In later years, they would again lead the way by adding indoor ropes courses, therefore attracting families for every reason but furniture shopping.

Upon selling the family business to Berkshire, the Tatelmans provided bonuses to long-time employees. They used $9 million of the sale proceeds

to give each employee 50 cents for each hour they had been with the company.

Each of Berkshire's furniture stores was the dominant furniture retailer in its geographic market. Together they were a furniture retailing powerhouse with revenues nearing $1 billion annually. Including Jordan's from the time it joined Berkshire in late 1999, Berkshire's furniture group reported $917 million in revenues for the year and $79 million of pre-tax operating profit. Neither the purchase price nor Jordan's earnings were publicly disclosed.

Manufacturing, Service, and Retailing

Viewed as one business, the Manufacturing, Service, and Retailing businesses earned $444 million pre-tax in 1999, which represented a return on capital of 26.7% (down 4.4 points). After-tax and with modest leverage it translated into a respectable 21.5% return on average equity. Most businesses performed well in 1999, but others struggled.

The Shoe Group again reported a decline in pre-tax operating profit, down 52% to $17 million. Dexter was to blame. Its US-produced product was badly impacted by imports. Over 90% of shoes came from outside of the US, where they had the advantage of low-cost labor. To compete, Dexter was making more shoes overseas.

See's Candies again found success in its wholesale and mail-order program, bringing total poundage up 7.2% over the prior year. Sales topped $306 million (up 6%) and a strong operating margin of 24% (up 2.5 percentage points) led to a 19% gain in pre-tax earnings to $74 million.

As profitable as See's was, the business faced few growth prospects. Speaking at the Annual Meeting the following year, Buffett noted how See's, and candy in general, really wasn't that portable. See's found ways to increase its physical volume slightly, but there weren't huge opportunities for growth like other businesses. For some reason candy didn't travel well. Soda and shaving blades did, but See's couldn't just open a store in a faraway state and expect to have the same results. It was tried more than once.

Berkshire's jewelry operations increased pre-tax earnings by 31% to $51 million as costs at Helzberg were brought under control. Scott Fetzer's earnings increased 7% to $147 million.

The Aviation Services segment, comprised of FlightSafety and Executive Jet, collectively earned $225 million in 1999, up 24% from the year before. Part of the increase in earnings was because Executive Jet was acquired in August 1998, so it wasn't a true comparison. The other factor was the ability of the businesses, particularly FlightSafety, to invest in profitable growth.

FlightSafety was a capital-intensive business but had a high operating margin that translated into satisfactory returns on capital. (Its pre-tax return on capital was consistently in the mid-20% range prior to Berkshire acquiring it.) Each flight simulator required up to a $15 million capital investment and could only be used by one person at a time. Together FlightSafety and Executive Jet spent $323 million on capital expenditures in 1999, compared to depreciation of just $77 million. The sky was the limit for these two Berkshire subsidiaries.

Investments

Berkshire's equity portfolio returned low single digits [350] against the backdrop of the S&P 500 marching forward 21% during the year. Another way to view this performance is via look-through earnings. We can make an approximation based on the $476 million in dividends reported by the Insurance Group. This probably represented the bulk of dividends Berkshire earned as most of its marketable securities were held in the insurance subsidiaries. On top of that, Berkshire's major investees had look-through earnings of $707 million. Together this amounted to $1.2 billion or 3% of the average portfolio value.

Berkshire's bond portfolio also contributed to the lackluster performance of its investment portfolio. At year-end 1999, unrealized losses on the $30 billion bond portfolio had grown by $1.1 billion. A sharp rise in interest rates was the culprit (the 10-year Treasury increased from 4.7% to 6.5% from December 1998 to December 1999).

Fortune Magazine Article

Included with the 1999 Annual Report was an article Buffett penned for *Fortune* magazine in November 1999. [351] In it, he laid out his case for why the market was setting itself up for disappointment. While not predicting an immediate decline, Buffett hinted toward the market being overvalued. He

cited a survey of investors at that time who expected annualized returns of over 22% percent for lower-experienced investors, and as high as almost 13% for more experienced ones who had more insight into markets. He said both were probably too optimistic.

To make his point, Buffett used what he always did: logic. Looking at the Fortune 500 overall, the companies earned $334 billion in 1998. The market value of those same 500 companies as of early 1999 was about $10 trillion. This meant that if one hypothetically owned the entirety of those companies they would be earning a return of something like 3.3%, pre-tax. And this wasn't counting the frictional costs of moving in-and-out of stocks as investors did, which Buffett estimated to be about $100 billion a year.

In early 1999, the 10-year US Treasury Note yielded between 1 and 2 percentage points higher than that 3.3%. Why would investors rationally own a group of risky companies when they could buy a risk-free government security? Likely because investors thought stocks would keep going up, as they had in the past. A more rationally sounding (though not entirely rational) argument was the belief that either interest rates would decline, or corporate profits would increase. Only under those two circumstances would the stock valuations in 1999 make sense.

Buffett believed many company valuations were out of touch with reality. [352] He discussed valuations at the 2000 Annual Meeting, travelling back in time to make his point. "The first investment primer that I know of, and it was pretty good advice, was delivered in about 600 B.C. by Aesop. And Aesop, you'll remember, said, 'A bird in the hand is worth two in the bush.'" He meant that investing involves deciding based on the projected value of a business in the future. Value in this case is calculated by estimating how many birds (how much cash) are in the bush. The value of that cash is further based on when it emerges and the interest rate at that time.

Some companies were valued by the market as high as $500 billion yet produced very little actual earnings. If such a company wasn't going to pay an owner $50 billion that year (assuming a 10% required rate of return) then it had to pay out that much more the next year. Assuming no payment in year one, a $55 billion payout, in perpetuity, was required starting the following year. Wait another year and that annual payout rose to $60.5 billion, and so on to justify the 10% rate of return. Recalling Aesop again,

Buffett said that every year one waited to take out a bird (cash), that many more birds (cash) were required in the future. And how certain are you there are that many birds available to take?

This short lesson was important because it explained the rationale behind preferring companies earning cash today since the longer one waited it became that much more important to grow the future stream of cash. It also highlighted the importance of certainty. If you weren't going to get cash immediately, how much worse was it that the future cash flows were uncertain because of the risks to changing business economics? Lastly, the preceding example using a hypothetical $500 billion market cap company would have been the rare elephant, given the requirement to earn something like $80 billion a year pre-tax to get that $50 billion after tax. Since such companies didn't then exist (and even now in 2020 are rare), valuations were clearly incorporating some unrealistic expectations.

As painful as 1999 was from a business perspective (with book value up just half a percentage point), Berkshire Hathaway's stock price also took a big hit. Shares traded between a low of $52,000 and a high of $81,100. Considering Berkshire ended the year with $47,000 of per-share investments, the market was almost entirely discounting Berkshire's significant operating businesses. Even though operating earnings fell, Berkshire remained a wonderful, growing collection of businesses. Its long-term growth in per share book value over the preceding thirty-five years that Buffett had been in control remained at an astounding 24% compounded annually.

Year 2000 Issue

The big worry as the calendar turned to the new millennium was the so-called year 2000 issue, or Y2K. The problem lay with computers and their ability to handle the turn of the millennium with respect to dates. No one knew if, for example, January 1, 2000, would register as January 1, 1900. Such a mistake could cause havoc with systems as some calculations would be a hundred years off, spelling disaster for timing and payment systems, for one.

Berkshire incurred roughly $60 million in costs (not all in 1999) getting ready for the date change. Even though everyone knew the year was

coming, some, including governments, were far behind in their preparations and testing. In the end, it was all hype.

Berkshire entered the new century and the new millennium with old-world businesses in hand—and a readiness to acquire more.

2000

At the turn of the millennium Berkshire's two capital allocators faced unrelenting pressure to change their ways. [353] With internet mania fueling the dot-com boom, Berkshire was decidedly old world and proud of it. Experienced managers Warren Buffett and Charlie Munger, now both in their seventies, stayed within their circle of competence. They, and Berkshire's shareholders, were rewarded for this patience. The year 2000 brought some exciting acquisitions along with some spots of trouble.

Checkbook in hand, Berkshire went on a spending spree. It paid close to $8 billion for eight acquisitions, completing two agreed to in 1999 (MidAmerican and CORT, discussed below) and arranging another six. To make things better, almost 97% of the amount spent was in cash and Berkshire incurred no debt in the process. Despite this frenzy of acquisition activity, Berkshire remained flush with investable funds, and ready for more (and larger) acquisitions.

Finding eight new operating subsidiaries to acquire in just over a year was most assuredly cause for a change in Buffett's self-graded D from 1999—though not the A a star pupil would flaunt to parents. Buffett characterized 2000 as only decent due to some struggles in its existing businesses. GEICO had the rare off year, weaknesses remained at General Re, and Dexter struggled mightily against foreign competition. To make matters worse, Buffett thought Berkshire's equities portfolio was fully priced, meaning its value would likely not rise beyond underlying gains in intrinsic business value.

Acquisitions

"Our acquisition technique at Berkshire is simplicity itself: We answer the phone," Buffett wrote to shareholders. He wasn't kidding. Buffett and Munger had long talked about their strategy of not having a strategy, and the year 2000 was proof it was working. Like business results in general,

acquisitions were necessarily lumpy and could not be anticipated or rushed along.

Did Berkshire's capital allocators cave and purchase some fallen internet companies? Quite the opposite. Buffett reported that Berkshire had "embraced the 21st century by entering such cutting-edge industries as brick, carpet, insulation and paint. Try to control your excitement." Though these businesses were the very antithesis of internet companies, the dot-com boom and subsequent bust did play a role in Berkshire acquiring them. Two factors led to this flurry of acquisition activity.

One was the prospect of a near-term economic slowdown. Other people were reluctant to commit in the face of uncertainty. Berkshire was buying to keep and had its eye on the horizon. The second factor was that Berkshire paid with cash and analyzed businesses on an all-equity basis. Other purchasers relied on financing from the junk bond market, which had dried up.

1. MidAmerican Energy

Acquisition Date: March 14, 2000

Description: Provider of electric service in the Midwest US and the United Kingdom

Purchase Price: $1.24 billion for 76% of the company

MidAmerican was more than an energy business; it was a conglomeration of numerous energy subsidiaries. Like its new conglomerate parent, MidAmerican had a long history and decentralized operations.

MidAmerican's lineage is too long to discuss here, but its history just prior to joining Berkshire is worth mentioning. MidAmerican Energy Holdings Company was the result of the 1998 acquisition of a company of the same name by CalEnergy, an Omaha-based utility company. The new company was renamed MidAmerican Energy Holdings Company and reincorporated in Iowa. MidAmerican's Chairman and CEO David Sokol, and his right-hand man, President Gregory Abel, along with investor and board member, Walter Scott, Jr., used this base to acquire other energy assets.

The MidAmerican deal came about via Walter Scott, Jr., who also sat on Berkshire's board of directors. MidAmerican's talented and entrepreneurial management team impressed Buffett, and he thought investing in

MidAmerican might make sense at the right price. Buffett was cited in a press release saying, “We buy good companies with outstanding management and good growth potential at a fair price, and we’re willing to wait longer than some investors for that potential to be realized. This investment is right in our sweet spot.” [354]

Buffett did not detail his exact thought process in determining the attractiveness of the MidAmerican investment, but there are a few factors that likely weighed into his decision:

- *History as a low-cost operator* : In addition to achieving the highest returns available under regulatory frameworks, the low-cost operator could protect and reinforce its competitive position by keeping rates low for its customers. This in turn could gain favor from regulators, allowing additional investment.
- *Deregulation* : This opened certain markets to allow customers to buy energy from the producer of their choice. [355] A low-cost operator would have additional opportunities for expansion, aided by its ability to improve the assets it acquired.
- *A strong balance sheet* : MidAmerican’s investment-grade credit rating allowed it to lower its cost of debt and thereby improve its ability to keep costs low for customers. It was a virtuous cycle.

Even with the prospect of wider deregulation, MidAmerican remained an operator in regulated markets, most notably in the Midwest United States. During 1999, 66% of MidAmerican’s revenues were generated in regulated electric markets, 25% from regulated gas, and 9% from nonregulated businesses. [356] Energy companies within the regulated markets enjoyed protected returns on capital that were typically in the low double-digit area. For example, MidAmerican’s Iowa operations were allowed a 12% return on equity. [357] [358]

The downside of a regulated return was offset by the ability to invest large sums of capital. MidAmerican offered Berkshire Hathaway a place to direct the substantial excess earnings from its other businesses into long-term projects with a near-certain rate of return. At a time when Berkshire was

finding little else to do with a growing amount of cash, MidAmerican was a fitting solution.

One final attribute of MidAmerican relates to taxes. Here Berkshire could benefit in two ways. One was via a consolidated tax return. Berkshire's vast collection of highly profitable operating businesses generated a significant tax bill that could potentially be offset by MidAmerican's tax position, which sometimes included tax credits. A standalone energy business might not have the ability to use favorable tax positions immediately if its taxable income was not high enough.

The second tax-related attribute of MidAmerican was deferred taxes. MidAmerican had substantial investments in fixed assets. The acceleration of depreciation allowed for tax purposes resulted in the company paying less tax than the income statement indicated. MidAmerican's ability to defer taxes was like the interest-free loan Berkshire created via its holdings of appreciated securities. It allowed the company to have a higher effective compounding rate on its equity capital than even the regulated rate of return would suggest. (It should be noted that regulators would take these tax advantages into account, which allowed the tax advantage to be passed along to customers. MidAmerican's unregulated businesses would benefit from it, however.)

A regulatory restriction barring simultaneous control of regulated and non-regulated entities, [359] required a unique ownership structure for the MidAmerican deal. Berkshire paid $1.24 billion for common stock and non-dividend paying convertible preferred stock, giving it a 76% economic interest in MidAmerican (see Table 6.19). Its voting interest, however, was just 9.7%. Additionally, Berkshire invested $455 million in an 11% fixed-income security and committed to invest another $345 million under the same arrangement. Because of this arrangement, Berkshire reported MidAmerican's results on one line on its income statement and balance sheet. Instead of reporting all its sales, expenses, and other costs, MidAmerican was carried on the balance sheet in the amount of Berkshire's investment and on the income statement as Berkshire's share of its net income. [360]

What were Buffett's financial expectations surrounding the MidAmerican acquisition? We cannot know for sure, though the regulated return limits and the 11% fixed income security provide some clues. Using financial

information for 1999, the last year before Berkshire purchased its ownership interest in the company, MidAmerican's pre-tax return on capital was 11%. [361] Was this a coincidence? Perhaps.

The analysis was probably much simpler. MidAmerican provided Berkshire a platform to invest large sums at low double-digit returns. An added bonus was the tax benefit from joining Berkshire's conglomerate holding structure. Considering its position as a low-cost operator and its monopolistic position in certain markets, the company had a strong likelihood of earning similar returns far into the future. In other words, MidAmerican was protected by a moat.

Table 6.19: MidAmerican Energy—acquisition analysis

($ millions)	1999	1998	1997
Revenues	$4,411	$2,683	$2,271
Earnings before interest and taxes	783	619	448
Interest expense	426	347	251
Earnings before taxes	357	272	197
Total shareholders' equity	$995	$827	$765
Long-term debt, preferred, minority interests	6,226	6,037	4,892
Total capital	7,221	6,864	5,657
BRK equity acquisition price (100% basis)[1]	$1,632		
BRK implied total purchase price[2]	7,858		
Pre-tax return on average total capital	11.1%		
BRK going-in purchase multiple[3]	1.09x		
BRK going-in pre-tax return on capital	10.2%		

Footnotes:
1. Berkshire paid $1.24 billion for 76% of MidAmerican.
2. This figure takes the existing debt and adds to it the price paid for the equity (100% basis).
3. BRK implied total purchase price / total capital.

Sources: MidAmerican Energy Holdings 10K reports, 1998, 1999; Berkshire Hathaway Annual Report 2000; and author's calculations.

2. CORT Business Services

Acquisition Date: February 18, 2000

Description: Renting furniture to businesses and apartment owners via its 117 showrooms

Purchase Price: $386 million

The CORT Business Services acquisition began in 1999 but closed in 2000 (see Table 6.20). The opportunity materialized after an unfriendly takeover by one of its competitors failed to go through. [362] Buffett liked the "fine though unglamorous business," its CEO Paul Arnold, and the price (established via the failed deal amount).

Berkshire purchased CORT via Wesco, its 80%-owned subsidiary. Wesco's Chairman, remember, was Charlie Munger. Munger summed up the deal succinctly in his 2000 letter to Wesco shareholders: "Thus, in essence, Wesco paid $386 million for $54.3 million in pre-tax operating earnings." Berkshire paid a premium over the company's underlying capital, but its going-in return was satisfactory at 11%. Additionally, it had the prospect of earning good returns on incremental capital going forward if CORT could continue to grow. In short, it appears Wesco and Berkshire acquired a good company for a fair price.

Table 6.20: CORT Business Services—acquisition analysis

($ millions)	1998	1997	1996
Revenues	$319	$287	$234
Revenues/avg. capital[1]	$1.81	$1.89	$1.87
EBIT margin[1]	17%	17%	16%
Pre-tax return on capital	31%	31%	29%
Purchase price (equity)	$386		
Assumed debt	91		
Effective purchase price	$477		
Purchase multiple	2.71x		
BRK going-in pre-tax return	11.4%		

Footnote:
1. Adjustments were made to account for acquired goodwill and its related amortization.

Sources: Berkshire Hathaway Annual Report 2000; Wesco Annual Report 2000; CORT Annual Reports 1996–1998; and author's calculations.

3. U.S. Liability

Acquisition Date: August 8, 2000

Description: Insurance

Purchase Price: Undisclosed (half cash, half stock)

Augmenting Berkshire's already-large slate of insurance businesses, US Investment Corporation (USIC) was the parent company of U.S. Liability,

“a medium-sized, highly-respected writer of unusual risks,” wrote Buffett. USIC also came with two smaller sister companies, Mount Vernon Fire, and U.S. Underwriters Insurance Company. [363] The deal came about via General Re CEO Ron Ferguson, who introduced Buffett to USIC CEO Bob Berry. Berry’s family had owned U.S. Liability for forty-nine years, though the company was now run by Tom Nerney, a manager Buffett praised for having “achieved a rare combination of excellent growth and unusual profitability.”

4. Ben Bridge Jeweler

Acquisition Date: July 3, 2000

Description: A sixty-five-store chain of upscale jewelry stores in shopping malls in the West

Purchase Price: Undisclosed (half cash, half stock)

The Ben Bridge acquisition had many similarities to other successful Berkshire acquisitions, including expanding a business Berkshire was already in (in this case jewelry), being introduced to Berkshire by the home-grown recruitment system (this time Barnett Helzberg) and managers who Buffett admired and trusted to run the business without interference (cousins Ed and Jon Bridge).

Buffett liked the 89-year-old company’s truly remarkable record of same-store sales growth over the preceding seven years. [364] Like Helzberg, Ben Bridge operated out of multiple locations, versus the one-store operation of fellow Berkshire jewelry retailer, Borsheims. Similar to the Tatelman brothers of Jordan’s Furniture, the Bridges gave some of their sale proceeds to employees.

5. Justin Industries

Acquisition Date: August 1, 2000

Description: Maker of western boots and bricks for construction

Purchase Price: $570 million

Justin was a somewhat unusual company with its two unrelated business lines, but it was right at home within Berkshire. H.J. Justin started the business in 1879 doing boot repairs. His sons expanded the business to twenty-six states, Canada, Mexico, and Cuba, until 1948, when John Justin,

Jr. purchased the business from his father and uncles. In 1968, Justin Industries was formed to hold the boot business and a new, unrelated sister company, Acme Brick. Justin later added Nocona Boot, Chippewa Shoe Company, and Tony Lama Boots.

John Justin, Jr. unfortunately passed away in February 2001, shortly after Berkshire acquired it. Justin left two managers in charge: Harrold Melton who ran Acme, and Randy Watson, in charge of Justin Boot.

Acme produced over a billion bricks a year in twenty-two plants and accounted for 11.7% of US brick production. Rare for a maker of bricks, Acme had a 75% name recognition rate in Texas, compared to 16% for the runner-up. This differential in brand name extended to its dominance in its local market. Because bricks are necessarily a low value-per-pound item (low cost and very heavy), its natural market was limited to a certain radius around each plant by the economics of shipping heavy items. Acme's brick business was subject to economic cycles, but its local economies of scale, and basic necessary business would lead to long-term returns on capital that were satisfactory and protected.

It appeared most of the value in Justin Industries resided in Acme Brick. The brick business grew from 52% of revenues in 1995 to 68% by 1999, [365] and over that time accounted for over 100% of pre-tax operating profits. By contrast, the footwear business struggled over the same period. Footwear profits slowly vanished and losses mounted as management tried to compete against brutal competition. It was a familiar story to Berkshire's existing footwear businesses.

We can see the relative stability in Justin's financial statements during the five years ended in 1999. Its revenues grew just 10% during that period and it maintained steady margins and returns on capital. [366] If we assume Justin would earn an average of $1.50 of revenues per dollar of invested capital at a pre-tax margin of 9.25% (about its five-year average), the company-level return would amount to 13.9%. With its purchase price of 1.75 times the company's enterprise value, Berkshire could expect to earn a going-in pre-tax return on invested capital of around 8%, close to its going-in return when it made the acquisition.

Table 6.21: Justin Industries—acquisition analysis

($ millions)	1999	1998	1997	1996	1995

Revenues	$510	$455	$440	$448	$461
Revenues/avg. capital	$1.52	$1.47	$1.51	$1.55	$1.59
EBIT margin	9%	9%	10%	9%	10%
Pre-tax return on capital	13%	14%	15%	14%	16%
Purchase price (equity)	$570				
Assumed debt	40				
Effective purchase price	$610				
Purchase multiple	1.75x				
BRK going-in pre-tax return	7.6%				

Sources: Berkshire Hathaway Annual Report 2000; Justin Industries Annual Reports 1995–1999; and author's calculations.

Looking at the brick business more closely reveals the true margin of safety in the Justin acquisition. As discussed above, the business had all the attributes of a moat along with its associated protected returns on capital. While the data is imperfect, it reveals a growing business with solid and stable margins and attractive return on assets. Justin's overall results were dragged down by the low or nonexistent profits from footwear, and this hid the true value of the acquisition.

Table 6.22: Justin Industries—Acme Brick analysis

($ millions)	1999	1998	1997	1996	1995
Revenues	$346	$293	$265	$261	$240
Identifiable assets	255	197	181	172	150
Operating profit	67	49	43	44	42
EBIT margin	19%	17%	16%	17%	18%
Pre-tax return on assets	26%	25%	24%	26%	28%

Sources: Berkshire Hathaway Annual Report 2000; Justin Industries Annual Reports 1995–1999; and author's calculations.

6. Shaw Industries

Acquisition Date: January 8, 2001

Description: Maker of carpet, rugs, and other floor coverings

Purchase Price: $2.3 billion for 87.3% of the company

Flooring is higher tech than bricks, but not much. Shaw had just the kind of attributes Berkshire looked for: a business with a dominant market share—one third of the US flooring market—and increasing profitability in a fundamental business. [367] It was also a business with increasing economies of scale and one with invested family owners. A key feature of the deal was a requirement that Chairman Robert Shaw, President Julian Saul, and their families retain 5% of the company.

Shaw was started by Robert Shaw's father in 1946 as the Star Dye Company. Julian Saul joined Shaw in 1998 when his family's carpet company, Queen Carpet, was acquired by Shaw Industries. [368] By the time of the Shaw and Queen combination, Shaw had over a quarter of the market share of the US carpet market and Queen controlled 8%. [369]

With $4 billion of revenues, Shaw became Berkshire's largest (by revenues) non-insurance subsidiary. Reflecting on this in his characteristic humor, Buffett told shareholders: "Now, if people walk all over us, we won't mind." Buffett said the Shaw deal came about when Robert Shaw, Saul, and an unnamed CEO of a potential suitor for Shaw Industries, came to see him about writing an insurance policy. Shaw had a potential merger partner with asbestos liabilities from prior years which it desired to lay off on an insurer. Berkshire was unwilling to assume an open-ended risk and the insurance deal fell through—but the meeting planted the seeds for the acquisition soon after.

What did Buffett see in Shaw, and what was Berkshire getting for its money? To start, revenues grew 43% between 1995 and 1999. Part of that growth, to be sure, came from acquisitions, including the 1998 acquisition of Queen, and from strong housing starts in the US. Its pre-tax margin (as adjusted for certain non-recurring items [370]) doubled between 1995 and 1999, and its pre-tax return on capital almost tripled in that same period. These are evidence of the company achieving economies of scale. [371]

Shaw's 1999 operating results translated into a return on tangible capital of 36%. If these returns could be sustained, Berkshire would see its going-in pre-tax return continue to grow from a base of 15%. Even if we assume 1999 was a high year and that Shaw's normalized return on capital was its five-year average of 20%, Berkshire's resulting earnings yield would be 7.8%. In either case, Berkshire's purchase price would be pulled upward

over time if the business continued to grow while earning good returns on the capital it employed.

Table 6.23: Shaw Industries—acquisition analysis

($ millions)	1999	1998	1997	1996	1995
Revenues	$4,108	$3,542	$3,576	$3,202	$2,870
Revenues/avg. capital[1]	$3.18	$2.68	$2.73	$2.54	$2.34
EBIT margin[1,2]	11%	8%	5%	5%	6%
Pre-tax return on capital	36%	21%	15%	14%	13%
Purchase price (equity)	$2,291				
Assumed debt	824				
Effective purchase price	$3,115				
Purchase multiple	2.45x				
BRK going-in pre-tax return	14.6%				

Footnotes:
1. Adjustments were made to account for acquired goodwill and its related amortization.
2. Operating income adjusted to remove the effects of non-recurring items and equity in income from joint venture.

Sources: Berkshire Hathaway Annual Report 2000; Shaw Industries Annual Reports 1997–1999; and author's calculations.

7. Benjamin Moore Paint

Acquisition Date: December 8, 2000

Description: Paint

Purchase Price: $1 billion cash

Benjamin Moore added to the slate of low-tech housing-related companies joining the Berkshire family. The 117-year-old business operated via a system of independent dealers, commonly found within hardware stores.

The deal came about in July 2000 when a director of the company, Bob Mundheim, who was also general counsel at Salomon, broached the subject of a possible deal with Buffett. Buffett said he liked the business and its management, Richard Roob and Yvan Dupay. He and Munger "made a $1 billion cash offer on the spot." Other financial details of the company were not disclosed.

8. Johns Manville Corp.

Acquisition Date: February 27, 2001

Description: Manufactures and sells insulation and building products in North America, Europe, and China

Purchase Price: $1.8 billion

Johns Manville took a long and a winding road to its acquisition by Berkshire. The insulation products manufactured and sold by Johns Manville previously contained asbestos and were subsequently found to have caused many health problems. Litigation led to the company's bankruptcy in 1982. To compensate victims, the bankruptcy court set up a trust for the victims and used a controlling interest in the company as the major asset.

The trust now sought a buyer to diversify its holdings. When a leveraged buyout (LBO) firm could not find financing, Berkshire made a quick all-cash no-financing-strings-attached offer. Buffett convinced Jerry Henry, Johns Manville's retiring CEO, to stay in his post. Henry ultimately retired in mid-2004. [372]

Johns Manville's returns on capital were good but cyclical. This is not surprising considering how closely it was tied to a notoriously cycle-prone industry. Between 1993 and 1999 its return on capital averaged 18%, which included a low of 4% in 1993. The premium Berkshire paid for Johns Manville was double the company's underlying capital. Berkshire could still earn a satisfactory return for itself if Johns Manville continued to average the same results through future business cycles.

Table 6.24: Johns Manville—acquisition analysis

($ millions)	1999	1998	1997	1996	1995
Revenues	$2,162	$1,781	$1,648	$1,552	$1,392
Revenues/avg. capital[1]	$1.94	$1.71	$1.77	$1.22	$0.88
EBIT margin[1]	17%	16%	14%	12%	14%
Pre-tax return on capital	33%	28%	24%	15%	13%
Purchase price (equity)	$1,800				
Assumed debt	513				
Effective purchase price	$2,313				
Purchase multiple	2.08x				
BRK going-in pre-tax return	16.0%				
Footnote: 1. Adjustments were made to account for acquired goodwill and its related amortization.					

Sources: Berkshire Hathaway Annual Report 2000; Johns Manville Annual Reports 1997–1999; and

author's calculations.

Insurance

Berkshire's Insurance Group posted an underwriting loss of $1.6 billion that produced a cost of float of 6.1%. As we will see in a moment, this cost was not as bad as it seemed. Compared to an average 10-year US Treasury rate of around 5.5%, it was higher than Buffett preferred. Apart from the Primary Group, each of Berkshire's main insurance operating segments posted a pre-tax underwriting loss, and General Re's was by far the worst.

Table 6.25: Berkshire Hathaway—Insurance Underwriting

($ millions)	2000	1999
GEICO Corporation		
Premiums written	$5,778	$4,953
Premiums earned	5,610	4,757
Underwriting gain/(loss) - pre-tax	($224)	$24
General Re		
Premiums written	$8,696	$7,043
Premiums earned	8,696	6,905
Underwriting gain/(loss) - pre-tax	($1,254)	($1,184)
Berkshire Hathaway Reinsurance Group		
Premiums written	$4,724	$2,410
Premiums earned	4,712	2,382
Underwriting gain/(loss) - pre-tax	($162)	($256)
Berkshire Hathaway Primary Group		
Premiums earned	$325	$262
Underwriting gain/(loss) - pre-tax	$25	$22
Total underwriting gain/(loss)	($1,615)	($1,394)
Year-end average float - total	26,585	24,026
Cost of float	6.1%	5.8%
Aggregate adverse (favorable) loss development	$211	($192)

Notes:

1. The results for 2000 at General Re include five quarters. In 2000 General Re International and Global Life/Health changed its reporting from a one-quarter lag. The total underwriting loss for 12 months was $1,156 million (2001 presentation).

2. Berkshire Hathaway Primary Group written premiums were not detailed.

Sources: Berkshire Hathaway Annual Report 1999, 2001; and author's calculations.

General Re

General Re posted a $1.25 billion underwriting loss. It represented a cost of float of over 8% on the unit's average float of $15 billion. Pricing mistakes of the past still affected General Re, and it would take time to reprice certain policies. Correcting for those past underwriting mistakes required booking a charge in the current year to cover the adverse loss development of policies written in the past. Progress was being made by top managers, Ron Ferguson, Joe Brandon, and Tad Montross, to get underwriting discipline under control.

In General Re's North American property/casualty line, earned premiums rose 19.5% to $3.39 billion, but its underwriting loss grew 7% to $656 million. [373] Despite the year-over-year loss widening, results were considered better because underwriting discipline began producing improvements and because of a large aggregate excess reinsurance contract. This contract was responsible for a large part of the increase in premiums but also $239 million of the net underwriting loss due to accounting rules.

The economics of excess reinsurance contracts is such that a large premium is paid upfront, and claims are paid (usually) over a long period of time. The result is a large amount of float, which compensates the reinsurer for assuming an expected payout above the premium amount. Such an economic arrangement is not unlike that of a loan. The way the accounting works for these contracts is the premium is booked upfront in addition to all future expected losses; the difference (usually a negative number) is booked as an underwriting loss. [374]

Table 6.26: Accounting and economics of General Re's North American property/casualty unit excess reinsurance contract, 2000

Accounting treatment	
($ millions)	
Upfront premium	$404
All expected future losses	(643)
Underwriting loss	($239)
Economics	
Interest cost if a loan over:	

5 years	9.7%
10 years	4.8%
15 years	3.1%

Sources: Berkshire Hathaway Annual Report 2000 and author’s calculations.

Berkshire had a total of $482 million of such excess reinsurance losses in 2000 ($239 million at Gen Re, the remainder at Berkshire Hathaway Reinsurance Group, or BHRG). This represented over one-third (34.4%) of the underwriting loss for the year in reinsurance. Given the accounting treatment, Buffett thought it appropriate to adjust for these types of contracts when analyzing Berkshire’s cost of float. This adjustment changed Berkshire’s cost of float to more like 4.5%, said Buffett. Better than 6%, but not zero.

The other type of reinsurance contract Berkshire wrote (General Re and Berkshire Reinsurance) was retroactive reinsurance, where accounting and economic treatments were more closely aligned. The economics of retroactive reinsurance contracts are very similar to an excess contract, with premiums booked upfront. However, instead of being booked as an immediate underwriting loss, the difference between the lower premium amount and the higher expected loss is booked as an asset. This asset is then amortized into earnings as an incurred loss expense over time. [375]

Both excess reinsurance and retroactive reinsurance were considered good lines of business for Berkshire, even if they were not of the gold standard negative cost-type. Buffett welcomed such “pain-today, gain-tomorrow” business so long as the policies were priced appropriately, and he thought it important that shareholders understand the economics and accounting of such business.

Returning to General Re, the notes to the financial statements did not sugar coat the results in International property/casualty. “Underwriting results for General Re’s International property/casualty segment for 2000 remained very bad.” It suffered another year of motion picture losses, which added 4 points to the ratio. The only good news was that the aforementioned contract had ended. Berkshire’s summary of the carnage in General Re’s International property/casualty segment:

- 2000: $416 million loss on $2.48 billion of earned premiums; combined ratio of 117%. [376]

- Comparison from 1999: $473 million loss on $2.34 billion of earned premiums; combined ratio of 120%.

General Re Global life/health earned just 2.8% more business in 2000 and its underwriting results remained unsatisfactory. On premiums earned of $1.77 billion, the group lost $84 million, a combined ratio of 104.7%. [377]

Both General Re Global life/health and the International property/casualty segments reported an extra quarter of earnings in 2000. The fifteen months of results, which were not considered to be material to Berkshire's overall results, was done to bring reporting in-line with other segments. The two groups had previously been reporting on a one-quarter lag, and in 2000 that lag was corrected.

Berkshire Hathaway Reinsurance Group

Buffett heaped well-deserved praise on Berkshire Hathaway Reinsurance Group (BHRG) head Ajit Jain. During 2000, volume at Jain's group nearly doubled to $4.7 billion. The growth came mainly from a single $2.44 billion contract that retroactively covered a major UK company (not disclosed). Jain also wrote a contract for the Texas Rangers covering its star, Alex Rodriguez, in case he became permanently disabled. Berkshire covered disability for many sports figures. Another contract covered the payout of a $1 billion ($170 million present value) prize for Grab.com . The underwriting loss from retroactive reinsurance was $191 million.

Like General Re, BHRG wrote excess-of-loss reinsurance contracts that produced first-year losses with no offsetting accounting treatment. In 2000, such losses were $154 million, [378] which accounted for the bulk of the $162 million underwriting loss from the group. Its catastrophe business again experienced favorable results and posted a profit of $183 million.

BHRG had become a remarkable operation under Jain's leadership. Supporting nearly $5 billion in premium volume was just 2.4 percentage points of overhead (the underwriting expenses line). The rest was 101.3 points of losses and loss expenses. Due to the nature of its business writing a few very large contracts, overhead rates fell to low single digits beginning in 1999 as premiums swelled. Before that, the group's overhead ran closer to 20 points, which was about the same as General Re's rate between 1998 and 2000.

Berkshire Hathaway Primary Group

Within the more mundane (but no less exciting from an economic standpoint) Primary Group, premiums expanded 24% to $325 million and pre-tax underwriting profits rose 14% to $25 million. The increases were primarily due to the inclusion of U.S. Liability.

GEICO

GEICO had the rare off year after many years of very good results. One of the reasons was self-inflicted. Buffett said he was wrong in the enthusiasm he displayed in 1999 about investing heavily in advertising. The law of diminishing returns hit GEICO hard. In some cases, the company ran three advertisements per hour, with the third most likely having very little effect on new business compared to the first. Additionally, GEICO's growing market share meant it had already picked the low-hanging fruit. Other customers would take longer to convert.

Due to these factors, GEICO entered a new phase of its operations where growth would be slower. This new phase was already evident in 2000. GEICO previously focused on preferred customers, or good drivers that were low risks to insure. The non-preferred market was dominated by drivers with blemishes on their driving records including traffic violations and sometimes driving under the influence (DUI). With the non-preferred business, lapse ratios (where people did not pay their premiums) were higher, meaning fewer renewals. So even though GEICO added almost a million and a half new voluntary policies during the year, its policies-in-force count grew by only about 20% of that amount.

The major factor in GEICO's underwriting loss was competition. The dominant player in the auto insurance industry in the US was (and still is) State Farm. With 19% of the market, State Farm let its pricing slip and tolerated higher loss ratios. This put pressure on industry rates. GEICO played the long game and focused on underwriting profitably. Its higher market share and increased pricing translated into 18% premium growth, but this wasn't sufficient to cover all costs.

One poor year and a 6.1% cost of float wasn't enough to tarnish GEICO's reputation or its prospects. It still had the low-cost business model and plenty of room to grow and catch up with State Farm.

Manufacturing, Service, and Retailing

Berkshire's financial reporting again shifted to accommodate the newer, larger businesses joining the family. *The Buffalo News* , the Shoe Group, Dairy Queen, and See's Candies now found themselves lumped together with Berkshire's many smaller businesses in the other businesses category. This was necessary to make room for a new building products reporting line to accommodate Acme Building Brands, [379] Benjamin Moore and Johns Manville (when that acquisition closed in 2001). These businesses reported pre-tax earnings of $906 million. That represented strong growth compared to the year before but included new businesses. A more comparable metric is pre-tax return on capital, which fell six percentage points to 20.7%. [380]

Buffett was not one to bury problems. In his letter to shareholders he touched on the Shoe Group, which struggled mightily against foreign competition. Dexter played its part in dragging the Shoe Group's pre-tax operating profit down from $85 million in 1994 to $17 million in 1999 (the last year before the group was consolidated into other business). Berkshire now had overwhelming evidence that Dexter was worth less than it had paid for the company. As a result, it recorded a $219 million goodwill impairment charge late in 2000. In retrospect, acquiring Dexter was a mistake—a mistake compounded by the fact that Dexter was purchased with Berkshire shares. Buffett would continually chide himself for underestimating the powerful economic forces at work. "We may regain some economic goodwill at Dexter in the future, but we clearly have none at present," Buffett wrote. Other US shoe manufacturers probably shared this sentiment.

Earnings from the two Flight Services businesses dipped 5% that year to $213 million but still represented 13% of Berkshire's consolidated pre-tax operating earnings. FlightSafety, the pilot training business, spent $272 million on simulators during 2000. That figure was far above the $70 million figure Buffett cited at the Annual Meeting as the company's annual depreciation expense; [381] the larger number represented physical growth of the business. FlightSafety's 83-year-old founder, Al Ueltschi—like Buffett—was not slowing down.

Executive Jet's monthly management fees and hourly usage fees grew by 49% during the year, which was on top of 46% growth the year before. The

business was growing as fast as it could, taking up 7% of the world's output of jets. But building out its business, including an expansion into Europe, was expensive. This weighed on profits and was the reason behind the overall decline in earnings for Flight Services.

With soaring growth, Executive Jet was at the same time careful. Buffett said Founder and CEO Rich Santulli insisted on "unusually high amounts of pilot training" (good news for FlightSafety). Executive Jet's pilots flew just one aircraft model and received an average of twenty-three days a year of training, making them among the best. Citing a competitors' crash the year before in Aspen, Colorado, Charlie Munger told shareholders that Executive Jet's pilots had refused to fly into the airport due to weather conditions. The competitor was pressured by its customer to make the landing, which ended in tragedy.

Operating profit from Scott Fetzer's twenty non-finance businesses declined 17% to $122 million. The big hitters were Kirby, Campbell Hausfeld, and World Book, which comprised 60% of its revenues and 65% of operating profits. Continued struggles at World Book and an unusually strong year at its generator business the year before due to the Y2K scare hurt comparable results in 2000.

Buffett devoted a section of his Annual Report to praise Ralph Schey, who retired at the end of 2000. Since Berkshire purchased Scott Fetzer in 1985, it had sent $1.03 billion to Omaha against a net purchase price of $230 million. Those funds were the seed capital for some of Berkshire's subsequent purchases. He attributed billions of dollars of value to Schey's contributions to Berkshire. Buffett wrote that he and Munger welcomed Schey to the Berkshire Hall of Fame.

Finance and Financial Products

The Finance and Financial Products businesses had quietly grown sizable and received a boost in 1998 with the addition of General Re's finance-related business. At year-end 2000, it had $16.8 billion of assets supported by $1.77 billion of equity capital. It looked very much like a bank leveraged almost ten times (such leverage was ordinary for a bank). Pre-tax earnings jumped from $125 million in 1999 to $530 million in 2000. [382] It housed everything from Scott Fetzer's finance arm to the structured settlements and annuities business, to General Re's securities business, but relatively little

was disclosed about it. Shareholders understandably wondered about the unit.

At the Annual Meeting the following year, Buffett reassured shareholders about the relative risk of the unit, though he really did not reveal much. The more basic operations, he said, such as the structured settlements business, were straightforward, "quite predictable and a very easy business to understand."

Moving up the complexity scale, the segment also contained a trading business outside the normal investment category. Buffett described this as "arbitrage or semi-arbitrage of various types of fixed-income securities." That line of business was run by Mark Byrne (son of long-time GEICO manager Jack Byrne), whom Buffett and Munger praised as smart and trustworthy.

Buffett said the derivatives business within General Re was admittedly outside of their comfort zone, which led them to begin winding down the business. In 2000, Gen Re Securities still had a huge number of derivatives contracts on the books that would take a lot of time—and ultimately a lot of red ink—to dispose. [383]

Investments

Turning to Berkshire's main investment business, run by Buffett (with Munger's input), almost all of its Fannie Mae and Freddie Mac shares were sold. The investments were jettisoned after Berkshire's chief capital allocators sensed their risk profiles had changed. [384] [385] They would later be proven right after the companies were found to have overstated their earnings. They would also play a part in the 2008–09 financial crisis close to a decade later.

Poking around the edges, Buffett said Berkshire "established 15% positions in several mid-sized companies, bought the high-yield bonds of a few issuers … and added to our holdings of high-grade mortgage-backed securities. There are no 'bargains' among our current holdings: We're content with what we own but far from excited from it."

With little exciting investment news to share, Buffett devoted a couple pages of his Chairman's letter to expanding on the Aesop analogy he first discussed at the prior years' Annual Meeting. He said investing was as

simple as the Aesop's proverb that a bird in the hand was worth two in the bush—with one minor qualification. The qualification was *when* , and what was the risk-free rate? If you can answer these three questions, he said, you "rank the attractiveness of all possible uses of capital throughout the universe." Those questions were:

1. How certain are you that there are indeed birds (cash) in the bush?
2. When will they emerge and how many will there be?
3. What is the risk-free interest rate?

The answers to these questions were the foundation of Berkshire's investment program. It was no coincidence that certainty was placed at the head of the list. Buffett said others had strayed into speculation and forgot to pay attention to this framework. They were instead more concerned about movements in share prices that often traded far ahead of what the fundamentals would suggest was reasonable.

A comment by Charlie Munger at the 2001 Annual Meeting was instructive, as it sheds light on his and Buffett's correct thinking about buying internet companies around the time of the dot-com bubble. He recalled that both he and Buffett had worked at Buffett's grandfather's grocery store in Omaha as youngsters. Munger noted that the business, which included delivering goods to customers, "barely supported one family". Buffett made explicit what Munger was referring to: Webvan, an internet-based grocery delivery business, ran into the same costs that Buffett & Son did generations earlier delivering groceries.

The internet hype roped many into a speculative frenzy based on the false belief that technology would somehow eliminate costs and shower profits on all. Buffett and Munger looked beneath to the basic economics and saw otherwise. They saw that ordering groceries would go from paper to computer entry, but the costs of buying the product and distributing it to customers would not change. "There was a lot of money transferred … from the gullible to the promoters [of internet stocks] … It's been a huge trap for the public," Buffett said.

Berkshire vs. S&P 500

Though Berkshire beat its preferred benchmark the S&P 500 by 15.6% in 2000, its book value increased just 6.5%. That was because of a 9.1% decline in the S&P that year. Buffett told shareholders he thought Berkshire's gain in intrinsic value (the metric that really counted) moderately exceeded the gain in book value.

With 1999 and 2000 containing pre-tax operating losses before considering investment income, the two-column method (investments per share plus some multiple of pre-tax operating earnings per share, excluding investment income) for determining Berkshire's intrinsic value became a bit more complicated (see Table 6.27). Buffett even omitted the table in his 2000 Annual Report. Estimating Berkshire's value required working directly from the financial statements, and it also called for some assumptions on insurance profitability.

Table 6.27: Berkshire Hathaway intrinsic value estimation

Per A-share:	2000	1999
Investments	$50,507	$47,339
Pre-tax operating earnings (ex. investment income; adjusted to breakeven insurance underwriting)	846	550
Estimated value (investments + 10x operating earnings)	58,966	52,844
Year-end share price	71,000	56,100
Year-end book value per share	40,442	37,987
Price/estimated value	1.20x	1.06x
Price/book	1.76x	1.48x
Value/book	1.46x	1.39x
Change in estimated value	12%	
Change in share price	27%	

Sources: Berkshire Hathaway Annual Reports, 1999, 2000; and author's calculations.

The first part of this estimate, investments per share, is relatively straightforward. Berkshire's balance sheet provides the amounts for cash and investments excluding the Finance Businesses. [386]

Pre-tax operating earnings is a little more complicated. A quick calculation results in a per-share loss. [387] Capitalizing a loss would lead to a larger negative value, which would reduce the intrinsic value calculation. Yet we know that Buffett would not tolerate large ongoing losses from insurance underwriting, and we know that the operating businesses had meaningful value. If we make the relatively conservative assumption that insurance

underwriting would breakeven, the per-share operating earnings from the non-insurance businesses can be capitalized.

We can use the same methodology for 1999, which showed a similar pre-tax loss due to insurance underwriting. The change in intrinsic value from 1999 to 2000, using the same method, is 12%—a figure consistent with Buffett's moderately higher change.

Berkshire's goal of attaining a 15% average annual rate of return was getting harder year by year, owing to Berkshire's growing size. Buffett told shareholders at the Annual Meeting that very few large companies would achieve such a record over the next decade. Berkshire would do its best, using opportunity cost as its guide. Buffett summed up the strategy very well at the 2001 Annual Meeting:

> "I think our method is a pretty good one. I mean, I think the idea of having a group of good businesses to throw off cash in aggregate, in a big way, that themselves grow, that are run by terrific people, and then adding onto those, sometimes at a slow rate, but every now and then at a good clip, more businesses of the same kind, and not increasing the outstanding shares, I think that's about as good a business model as you can have for a company our size. But what it produces, we'll have to see."

There is nothing more to add.

2001

In its race to outpace the S&P 500, Berkshire Hathaway had only fallen short of the benchmark a few times. [388] Those years, it at least finished with some sort of increase to book value per share. That changed in 2001 when book value per share declined 6.2% against a decline of 11.9% for the S&P. The string of advances was broken only by a truly terrible catastrophe—the terrorist attacks of September 11, 2001. Like the United States itself, Berkshire was injured but resilient in the face of adversity.

Buffett reminded shareholders that relative performance was the name of the game. Berkshire had outperformed the S&P by 5.7%. "If you expect—as Charlie Munger, Berkshire's Vice Chairman, and I do—that owning the S&P 500 will produce reasonably satisfactory results over time, it follows that, for long-term investors, gaining small advantages annually over that

index *must* prove rewarding." [389] Some disagreed with Buffett, but he was stalwart, reminding shareholders his goal of relative performance would not change.

Part of Berkshire's poor performance during 2001 was self-inflicted. Buffett admitted as much. General Re had taken on terrorism-related risks without being properly compensated. Buffett chided himself for knowing General Re was exposed to some of those risks, but he said "on September 11th , this error caught up with us."

On the non-insurance front, Berkshire's businesses were also affected by the attacks and the economy. Buffett thought the country had entered a recession, even though economists hadn't announced it. Officials later dated the early 2000s recession between March and November 2001. Still, Berkshire added non-insurance subsidiaries during the year, completing the previously announced Shaw and Johns Manville acquisitions, and closing and initiating several others. The long-term strategy at Berkshire of continually searching for good investment opportunities was unchanged, even in the face the shock of September 11th . Three of them are listed below:

MiTek

Acquisition Date: July 31, 2001

Description: Building products company

Purchase Price: $400 million in cash for 90%

MiTek made connector plates for roofing trusses, as well as other building-related materials. It also had a proprietary software system it leased to customers. [390] The business came to Buffett's attention the prior year when Gene Toombs, its CEO, sent him a letter along with a hunk of metal (a connector plate).

Prior to Berkshire's purchase, MiTek was owned by Rexam PLC, a UK company. [391] MiTek was headquartered in Chesterfield, Missouri. The remaining 10% of the company was purchased by fifty-five of its managers, each of whom put up their own cash [392] to participate. No detailed financial information was available for MiTek because it was part of a group within Rexam.

XTRA

Acquisition Date: September 11, 2001

Description: Trailer leasing business

Purchase Price: About $578 million

Buffett said the deal came from his friend, Julian Robertson, whose investment fund, Tiger Fund, owned shares in the company. Even though Berkshire's offer contained an out that would have allowed it to back away considering the events of the day, Berkshire completed the acquisition.

XTRA purchased trailers which were then leased to trucking companies and others moving freight. Its dependence on economic activity made it a cyclical business and therefore like many of Berkshire's other businesses, which overall earned good returns. Owing to the nature of the business it was placed among the Finance and Financial Products businesses.

As a financial-related business, XTRA's balance sheet contained a meaningful amount of debt. The company also earned good returns on total capital. Berkshire's purchase price represented a premium of about 60% over the company's underlying equity capital. Considering the purchase from the standpoint of a 100% cash-financed business, the effective purchase price yielded 12%. [393]

Table 6.28: XTRA Corporation—acquisition analysis

($ millions)	2000	1999	1998
Revenues	$477	$464	$461
Revenues/average capital[1]	$0.41	$0.39	$0.37
EBIT margin[1]	34%	33%	35%
Pre-tax return on capital	14%	13%	13%
Purchase price (equity)	$578		
Assumed debt	788		
Effective purchase price	$1,366		
Purchase multiple	1.17x		
BRK going-in pre-tax return	12.0%		

Footnotes:
1. Adjustments were made for an asset write-down ($25 million) and restructuring costs ($13 million) in 1999.

Sources: Berkshire Hathaway Annual Report 2001, XTRA Corporation Annual Reports 1998–2000, and author's calculations.

Larson-Juhl

Acquisition Date: February 8, 2002

Description: Manufacturer and distributor of quality custom framing products

Purchase Price: Approximately $225 million

Continuing to add to its low-tech, non-insurance businesses, Berkshire in 2001 agreed to purchase Albecca, Inc., which conducted business as Larson-Juhl. The company serviced a network of 18,000 framing shops in the US and also did business in Canada and Europe.

The company was owned by Craig Ponzio, who had worked in manufacturing in college. Ponzio bought the company in 1981 and went on to increase its revenues 100-fold to $300 million. The business was now run by CEO Steve McKenzie.

Larson-Juhl's economics were very simple. The company serviced many smaller framing shops with very small volumes of business each year. What was important to those shops was a wide selection of inventory available but without the large carrying costs. With its tens of thousands of customers, Larson-Juhl could carry such inventory economically, even though each individual shop might place orders infrequently. This meant 85% of the time Larson-Juhl could have an order to a framing shop the next day. This network and a service organization that called on customers half a dozen times a year created a moat around the business.

Buffett said the deal came together quickly, having first come to his attention on December 3, 2001. He called it a fat pitch, meaning one which took less than fifteen minutes to size up over the phone and ninety minutes to work out in person. Buffett foresaw opportunities for bolt-on acquisitions (small acquisitions by Larson-Juhl that would fit into its existing operations) in the future.

Insurance

The main story of 2001 was insurance. The September 11th attacks caused the largest insured losses in history and Berkshire took its share. Buffett took the unusual step of issuing a press release on September 12, 2001. He said estimating losses from the terrorist attacks would take a very long time

to determine but he thought Berkshire would incur about 3% to 5% of the industry's losses.

In a subsequent unusual move, Buffett included commentary in Berkshire's third quarter earnings release, which estimated the loss at about $2.275 billion. In that same press release, Buffett chided General Re for breaking all three of the rules of operating a successful insurance company. Paraphrasing, those rules were:

1. Only accept risks one is capable of evaluating
2. Limit aggregated exposure (i.e. diversify risks)
3. Avoid doing business with bad actors.

Breaking those rules cost CEO Ron Ferguson his job. [394] Buffett replaced him with Joe Brandon and praised Brandon and his new lieutenant, President Tad Montross, as talented leaders who would clean up General Re. While Berkshire Hathaway Reinsurance had lost money on September 11, Buffett noted that that unit, led by Ajit Jain, had adhered to all three rules of successful underwriting.

The Insurance Group as a unit turned in an underwriting loss of $4.1 billion on $18 billion of earned premiums. Berkshire's cost of float was a staggering 12.8%. That average float grew 19% to $35.5 billion at year-end 2001 was not necessarily a good thing. Remember that a component of float is unpaid losses. Berkshire's float during 2001 grew in large part by incurring losses for which it wasn't compensated. Float at an overall cost in the double digits would not be tolerated for long at Berkshire.

Table 6.29: Berkshire Hathaway—Insurance Underwriting

($ millions)	2001	2000
GEICO Corporation		
Premiums written	$6,176	$5,778
Premiums earned	6,060	5,610
Underwriting gain/(loss) - pre-tax	$221	($224)
General Re		
Premiums written	$8,730	$8,696
Premiums earned	8,353	8,696
Underwriting gain/(loss) - pre-tax	($3,671)	($1,254)

Berkshire Hathaway Reinsurance Group		
Premiums written	$3,254	$4,724
Premiums earned	2,991	4,712
Underwriting gain/(loss) - pre-tax	($647)	($162)
Berkshire Hathaway Primary Group		
Premiums earned	$501	$325
Underwriting gain/(loss) - pre-tax	$30	$25
Total underwriting gain/(loss)	($4,067)	($1,615)
Year-end average float - total	31,690	26,585
Cost of float	12.8%	6.1%
Aggregate adverse (favorable) loss development	$1,165	$211

Notes:

1. The results for 2000 at General Re include five quarters. In 2000 General Re International and Global Life/Health changed its reporting from a one-quarter lag.

2. Berkshire Hathaway Primary Group written premiums were not detailed.

Sources: Berkshire Hathaway Annual Report 2001 and author's calculations.

General Re

Since Berkshire had purchased General Re in late 1998, the business had cumulatively lost nearly $6.5 billion from underwriting. In fact, in each year since 1998 the losses had only grown. The $3.7 billion loss for 2001 was a terrible underwriting result. Having written coverage for which it wasn't paid (terrorism insurance), General Re lost $1.9 billion from the attacks alone. The segment also took an $800 million loss to correct prior years' underwriting miscalculations.

The bulk of the loss at General Re came from its North American property/casualty segment, a $2.84 billion loss on $3.97 billion of earned premiums. This was not a case of long-tail contracts or any effect of accounting, but simply poor underwriting. A full $1.54 billion of the loss came from September 11th . It was the North American property/casualty segment that recorded the $800 million addition to its loss reserves during the year.

The international property/casualty segment at General Re also experienced very poor results. Some stemmed from September 11th . On earned premiums of $2.4 billion (up slightly from $2.5 billion), the unit lost $746

million. The international segment recorded a net $313 million of September 11th -related losses, as well as a $143 million loss from coverage of a steel plant in the UK which had exploded. An additional blunder at General Re was its Argentinian business, which was in peril owing to an economic and political crisis there.

General Re's global life/health business continued to be the less dark segment. During 2001, the unit increased premiums 10.4% to $1.99 billion. It reported an underwriting loss of $82 million, including $15 million of September 11th losses.

Berkshire Hathaway Reinsurance Group (BHRG)

While Ajit Jain's group contained some terrorism-related losses from September 11th , they were not nearly as bad as at General Re. On $2.99 billion of earned premiums (down from $4.7 billion) BHRG reported a $647 million pre-tax underwriting loss. Of that, $530 million or 82% was related to September 11th . BHRG's results also included $371 million in losses from retroactive reinsurance contracts, which were the type that came with deferred charges relating to the asset put on the books at inception. While it's possible some of the loss was due to incorrect underwriting, it's more likely the bulk of that $371 million came from accounting charges. [395]

Buffett expanded on his thinking regarding the economics of retroactive reinsurance policies at the 2002 Annual Meeting. It didn't matter, he said, what type of claims they were. Buffett used the example of asbestos versus auto claims. What really mattered was the speed of the claims. Since Berkshire always capped its limits, even if it paid up to the capped limit (but over a long period of time), the economics would still be favorable owing to the large amount of float. From purely a financial standpoint, Berkshire's insurance companies (especially the reinsurers) were entities that incurred debt of a slightly different nature. Unlike traditional debt, insurance liabilities had irregular and unknown payments and the possibility of paying less than full face value. Each insurer played an important role in society, which in turn provided it the opportunity to generate float.

Deferred charges relating to retroactive policies masked good performance elsewhere at BHRG. Other catastrophe and non-retroactive reinsurance business earned a profit of $254 million, which partially offset the

September 11th losses. With its core catastrophe and non-retro business profitable, Buffett praised Ajit Jain in his letter to shareholders commenting, “never on even a single occasion have I seen him break any of our three underwriting rules.” Jain’s team, now with eighteen other individuals, would occasionally book a loss, as would be expected, but they would not, Buffett wrote, book foolish losses.

While General Re was in restructuring mode under close supervision by Buffett, BHRG used its position as a leader with unparalleled financial strength to write considerable business. Right after the attacks, Jain’s group wrote billions of dollars’ worth of premiums for coverage relating to terrorism and all risk was retained for Berkshire’s account. This time, Berkshire was paid appropriately for the risk and its coverage contained both caps on exposure and exclusions relating to nuclear, chemical, or biological-type attacks. These latter exposures were so large that they could conceivably wipe out all the capital in the insurance industry, therefore the only natural insurer of such risks was the government.

Berkshire Hathaway Primary Group

Berkshire’s steady group of direct writers of insurance reported equally steady gains during 2001. On earned premiums of $501 million, the group reported an underwriting profit of $30 million. While they likely had some terrorism-related losses, none were disclosed.

GEICO

GEICO bounced back from its rare off year with a $221 million underwriting gain in 2001, the best performance within the Insurance Group. Earned premiums rose 8% to $6.1 billion. Its reversal back to a positive underwriting experience was driven primarily from lower losses, which fell 2.9 points to 77% of earned premiums. This was partly due to a mild winter with fewer accidents.

GEICO still had difficulty turning advertising dollars into new customers. It spent $219 million on advertising in 2001 while treading water on the new policy front. Its largest share of customers, the preferred group (the segment on which GEICO had built its business) represented 81% of policyholders and grew just 1.6%. The non-preferred standard and non-standard group fell

by over 10% during the year, resulting in a 0.8% decline in overall policies in force.

GEICO's float grew 8% to $4.25 billion despite the overall decline in policies in force. And there were signs soon after year-end pointing to growth in policies in force resuming at GEICO.

Manufacturing, Service, and Retailing

Note: In 2001, Berkshire stopped reporting separate financials for the MSR businesses, so data for their collective earnings and return on capital aren't available. Data reappeared in the 2003 Chairman's letter with an earnings lookback to 2002. Rather than attempt to fill in the gaps, we'll proceed with a look at the individual business units.

The addition of so many new businesses necessitated another change in grouping Berkshire's results. The Building Products line, new in 2000, listed just $34 million in pre-tax profit that year. In 2001, it swelled to $461 million as Benjamin Moore, Johns Manville, and MiTek contributed results.

Shaw received its own reporting line because of its size. In 2001, it earned $292 million pre-tax on $4 billion of revenues. Revenues declined $100 million reflecting lower volumes and were attributed to the September 11th -initiated recession in homebuilding. Shortly after year-end 2001, Berkshire acquired the remaining 12.7% of Shaw it did not own. Berkshire paid 4,740 in A share-equivalents, or about $324 million. [396]

The September 11th terrorist attacks directly impacted the Flight Services businesses. Executive Jet would need to incur additional costs relating to new safety and security rules. There was also a slowdown in fractional jet services usage and a lower level of training at FlightSafety. Executive Jet still had its competitive advantage, which stemmed from its 300-plane fleet of jets available on short-notice to ferry customers around the country and Europe. FlightSafety also remained committed to the long term, investing $67 million more than its annual depreciation expense to expand capacity.

Retail Operations, comprised of the home furnishings and jewelry businesses, earned $175 million, unchanged from the year before. This flat result represented weakness since it included a full year from Ben Bridge, a small acquisition by Nebraska Furniture Mart, and a new RC Willey store in Nevada. Same-store sales from the jewelry businesses declined 8%.

Scott Fetzer managed to increase earnings 6% to $129 million through continued cost discipline. This was even more impressive in the face of continued declines in sales of Kirby units overseas and at World Book generally.

Utilities

Perhaps one of the most noticeable changes, aside from the large losses in insurance, was MidAmerican. In 2000, Berkshire reported $197 million in pre-tax earnings for MidAmerican. In 2001 this figure jumped to $565 million. [397] Why? Two major factors were an increase in operating earnings and the fact that GAAP stopped requiring goodwill amortization (affecting MidAmerican to the tune of $94 million in 2000). [398]

Finance and Financial Products

The Finance and Financial Products business again reported strong pre-tax results ($519 million pre-tax vs. $530 the year before), but this was becoming Buffett's show more than ever. [399] The core businesses of Scott Fetzer's finance arm and the annuity business remained. General Re Securities, like its parent, had fallen from grace. General Re's derivatives business was now in run-off mode; Berkshire was doing its best to get out of the business, but it would take a long time.

Investments

As in prior years, Berkshire's investment portfolio changed at a glacial pace in 2001. Buffett's letter to shareholders used such descriptive phrases "as few changes," "restrained enthusiasm," and "lukewarm feelings about the prospects" to describe his and Munger's feelings toward investments and the market overall. They were content to hold on to most of what Berkshire already owned, since the long-term prospects for American Express, Coca-Cola, Gillette, Washington Post, and Wells Fargo remained favorable. But they thought their own portfolio in aggregate was not undervalued.

Two new investments did join the summary chart in Buffett's letter in 2001, having crossed the $500 million threshold established as a cutoff. Berkshire's nearly 16 million shares in H&R Block, Inc., a tax preparation service company, had a market value of $715 million at year-end 2001 and

cost Berkshire $255 million. While new to the table, Berkshire had owned shares in the company since the last quarter of 2000. [400] Another investment crossing the threshold was Moody's Corporation. Moody's was a credit-rating agency that graded companies' debt instruments for investors. Berkshire owned 24 million shares in the company and had first purchased it at the same time as the H&R Block stake. [401]

Berkshire put its money where Buffett's mouth was in terms of lower expectations on its investment performance. The expected rate of return on its pension plan was reduced to 6.5% in 2001 from 8.3% that it expected in 2000. This caused a higher expense and greater liability, all things being equal, since a shortfall between expected returns in the market and cash contributed by Berkshire would widen.

Berkshire made a significant fixed income investment in 2001. Early in the year it committed to be part of a joint venture to loan money on a secured basis to FINOVA Group. FINOVA was a troubled finance company that failed. Its prepackaged bankruptcy had been approved in August 2001. While the deal did close, it was not before being terminated and renegotiated. Berkshire chose to terminate the deal based on a clause allowing Berkshire to do so if the markets closed, which they did after the September 11th attacks. Unlike the XTRA deal, which contained a similar clause but went unexercised, FINOVA was materially affected by the event. FINOVA's assets contained loans relating to aircraft assets that were significantly diminished by September 11th . Its receivables were also affected negatively.

The deal called for Berkshire and Leucadia National Corporation to form a joint venture. The joint venture, dubbed "Berkadia," purchased the failed company. As part of the deal, Berkadia would borrow $5.6 billion to re-lend (with a 2% spread) to FINOVA for its own finance activities. This debt in turn was guaranteed by Berkshire and Leucadia. Berkshire provided a 90% primary guaranty matching its economic interest in the loan. Berkadia also received 50% of FINOVA's common shares, which were in turn owned 50/50 by the joint venture. [402] True to Berkshire's style, it would be the Leucadia part of the partnership that would manage the investment, not Berkshire.

Goodwill

In June 2001, the Financial Accounting Standards Board (FASB) changed the way goodwill was presented in company financial statements. Prior to this change, goodwill was amortized over a period of forty years. Starting in mid-2001 it would remain on the books forever, until and unless it was found to be impaired. Such an impairment was available under the old system as well, and Berkshire had made such a charge in 2000 when it wrote off the goodwill associated with Dexter. [403]

A consequence of this accounting change was to bring the accounting closer to the economic reality that Berkshire had always considered more appropriate. For years Buffett had presented his Summary of Reported Earnings table in a way that separated accounting charges from the underlying business results that he and Munger considered most important. The new accounting, begun in July 2001, affected acquisitions made after that date. For acquisitions made prior, it would begin in 2002.

If the acquisitions Berkshire made during the year were not proof enough of its unwavering long-term optimism, its existing operating subsidiaries were undeterred as well. Buffett pointed to RC Willey, which had made an unusual investment [404] in Idaho and then turned to do the same thing in Las Vegas to much success. Nebraska Furniture Mart began constructing a 450,000 square foot store in Kansas City, which would open in 2003.

Berkshire was bruised but not broken by the trying year. Like the country itself, Berkshire learned its lessons and moved forward to strengthen into a better version of the company it was pre-September 11th .

2002

September 11th and the 2001 recession were in the near past, but you wouldn't know it looking at Berkshire's results in 2002. Knowing where and how it erred, Berkshire almost immediately began writing large amounts of reinsurance. Save for General Re, each of the four major parts of the Insurance Group turned in favorable results. During the year it completed and initiated billions of dollars of additional investment and its marketable securities portfolio outdid the market even though valuations remained elevated. These factors came together to produce a 10% increase in per share book value—fully 32.1 percentage points higher than the S&P

500. As Buffett put it in the opening sentences of his 2002 letter to shareholders: “In all respects 2002 was a banner year.”

Insurance

After poor results for three years, Berkshire had a 1% cost of float in 2002 (compared to 12.8% the prior year). On earned premiums of $19.2 billion, Berkshire posted a pre-tax underwriting loss of $411 million. This result was mostly due to no large catastrophe losses. Float grew by $5.7 billion to end the year at $41.2 billion. The real story, though, was many stories—meaning the individual businesses in Berkshire’s insurance operating segment. General Re began the process of remolding itself into the reinsurer Buffett had thought he purchased at the outset, Ajit Jain’s group at Berkshire Hathaway Reinsurance Group outdid itself again, GEICO “shot the lights out,” and the Primary Group had an outstanding year.

Table 6.30: Berkshire Hathaway—Insurance Underwriting

($ millions)	2002	2001
GEICO Corporation		
Premiums written	$6,963	$6,176
Premiums earned	6,670	6,060
Underwriting gain/(loss) - pre-tax	$416	$221
General Re		
Premiums written	$8,521	$8,730
Premiums earned	8,500	8,353
Underwriting gain/(loss) - pre-tax	($1,393)	($3,671)
Berkshire Hathaway Reinsurance Group		
Premiums written		$3,254
Premiums earned	3,300	2,991
Underwriting gain/(loss) - pre-tax	$534	($647)
Berkshire Hathaway Primary Group		
Premiums earned	$712	$501
Underwriting gain/(loss) - pre-tax	$32	$30
Total underwriting gain/(loss)	($411)	($4,067)
Year-end average float - total	38,366	31,690
Cost of float	1.1%	12.8%
Aggregate adverse (favorable) loss development	$1,540	$1,165

Notes:

1. Berkshire Hathaway Primary Group written premiums were not detailed.

2. Berkshire Hathaway Reinsurance Group written premiums stopped being reported in 2002.

Sources: Berkshire Hathaway Annual Report 2001–2002 and author's calculations.

General Re

With Joe Brandon and Tad Montross now in control at General Re, Buffett thought the company was "well positioned to deliver huge amounts of no-cost float to Berkshire" without the hidden risks of yesteryear. Both Brandon and Montross focused on profitability of underwriting above all else—long the formula of Berkshire's other insurance businesses. The pair increased premium rates on new business, which served to offset the lower volume of business written across General Re's units.

Even though General Re's combined ratio came in at 116.4% on $8.5 billion of premiums (a loss of $1.4 billion), the underlying business was transformed in short order. This was evident in its underwriting loss, which fell 62% from 2001. The bulk of the loss stemmed from a $1 billion underwriting loss in the North American property/casualty segment, which in turn reflected $990 million of additional loss reserves and followed $800 million in 2001. Continued upward revisions to prior year loss reserves represented real liabilities and clearly frustrated Buffett.

The large loss reserve adjustment swamped a $66 million gain attributable to the 2002 accident year, and followed a $115 million reduction in reserves related to September 11th , which had been estimated too conservatively. Proving Buffett's hunch that September 11th claims would take a long time to sort out, the North American segment paid out just $241 million of the estimated $1.54 billion net loss attributable to the terrorist attacks. [405]

The underlying positives were a nice reversal for General Re. But like all things related to reinsurance the ultimate results would not be known for years. Berkshire estimated that just 15% of reinsurance claims in any year were reported the year they occurred. A full 50% of the General Re North American property/casualty net loss reserves of $14.9 billion were of the incurred-but-not-reported (IBNR) category. In other words, future information could move the figure in any direction.

The International property/casualty segment at General Re turned in an underwriting loss of $319 million on written premiums of $2.65 billion. Premiums earned grew 10% in dollar terms and were aided by the group's participation in a Lloyd's of London syndicate program where General Re International took over 90% of written business. Like the North American segment, the International segment recorded a loss to correct prior loss reserves, this time to the tune of $240 million. The group also recorded $107 million in losses relating to floods and storms in Europe.

General Re Global life/health saw its underwriting loss improve to $55 million on earned premiums of $1.89 billion. This was a slight improvement from the $82 million loss on $1.99 billion of earned premiums the year before. Its underwriting results were characterized as poor, reflecting losses from exited lines of business.

Berkshire Hathaway Reinsurance Group

"Ajit Jain made so much money I don't even want to tell you about it," Buffett quipped at the 2003 Annual Meeting. BHRG turned in an underwriting gain of $534 million before tax, a dramatic reversal from the previous year's $647 million loss and the most of any insurance division. To do this, BHRG overcame accounting charges and was aided by no major super cat losses.

For the first time, the Annual Report broke down BHRG's sub-segments in table form to clearly show its various lines of business. Due to a lack of catastrophes during the year, the catastrophe and individual risk line turned in a pre-tax underwriting gain of $1 billion on $1.3 billion of premiums earned. The catastrophe segment also benefitted from $85 million of reduced reserves relating to the September 11th terrorist attacks. Like General Re, BHRG overestimated its losses and an accounting adjustment corrected for the new estimate. Catastrophe was the type of business prone to large fluctuations in results, but over time was expected to earn a reasonable profit. The profit in 2002 was clearly on the upside. Buffett told shareholders to adjust their assessments of Berkshire's earnings power downward because of it.

It was not uncommon for reinsurers to lay off their own risk. To do this, they would purchase reinsurance to cover the risks they assumed in reinsuring primary companies. Berkshire Hathaway Reinsurance rarely did

this. Berkshire was wary of the ability of collecting on others' promises many years into the future and had seen supposedly strong reinsurers go out of business. [406] Berkshire was willing to take the volatility in periodic results in exchange for better results over the long term—and it had the necessary capital to hold all its volume.

The retroactive reinsurance segment of BHRG reported a loss of $446 million on earned premiums of just $407 million. It was this segment of BHRG's operations that had significant accounting peculiarities. Even though the economics were in Berkshire's favor—receiving large premiums up front followed by (usually) long periods of payments out the door—the accounting caused results to look poor. The premiums earned in 2002 were swamped by $428 million amortization of deferred charges relating to premiums earned in prior years.

The favorable economics are illustrated in the $7.5 billion of year-end float from retroactive reinsurance. [407] Berkshire could put this sum to work for its own benefit while concurrently paying claims as they came in. Amortization of the deferred charge asset related to writing those premiums would remain no matter how much in premiums showed up on the topline. Berkshire estimated that 2003 would see $400 million of such charges from contracts already on the bo oks in 2002.

BHRG's quota-share business grew almost sixfold in 2002. The quota-share business, which was a way of participating in a percentage of the business of another insurer, earned premiums of $1.29 billion and reported a loss of $86 million on that volume. Seeing favorable underwriting conditions, the group participated in new Lloyd's of London syndicates and booked a contract with a major US-based insurer. BHRG also earned $60 million on $321 million of earned premiums in its Other segment.

It is worth taking a moment to discuss Lloyd's of London, which has been noted several times. Lloyd's of London was not a single entity, but rather a marketplace for insurance transactions. [408] Insurers could come together to form syndicates, or risk-sharing pools. Lloyds was like a clearinghouse with known rules and ways of conducting business.

Berkshire Hathaway Primary Group

The primary lines turned in another year of profit and grew float 38% to $943 million. While most of this segment continued to do well, the workers' compensation business in the Home State Group suffered. [409] Buffett said its reserving severely missed the mark. Placing profitability over growth, he said: "Until we figure out how to get this business right, we will keep it small."

GEICO

Buffett had a maxim: there are no positive surprises in insurance. This was perhaps off mark with GEICO. GEICO had another great year in 2002 and Buffett summed it up succinctly:

> "At GEICO, everything went so well in 2002 that we should pinch ourselves. Growth was substantial, profits were outstanding, policyholder retention was up, and sales productivity jumped significantly. These trends continued in early 2003."

GEICO's 10% growth in earned premiums reflected its growth in voluntary auto policies. [410] Its loss ratio also benefitted from a milder winter, which edged down 2.9 percentage points to 77% of earned premiums. Its combined ratio came in at 93.8%—a 6.2% pre-tax underwriting margin. Outstanding indeed.

Acquisitions

During 2002, Berkshire closed five substantial acquisitions in addition to numerous bolt-on acquisitions to operating subsidiaries. Two of the five closed transactions were Albecca (doing business as Larson-Juhl and discussed in 2001) and Fruit of the Loom (discussed below). Two others, with a combined pre-tax profit of $60 million, were CTB and Garan. CTB made agriculture equipment for the poultry, hog, egg production, and grain industries. Garan manufactured children's apparel and is best known for Garanimals, its largest line. Buffett said each company earned decent returns on capital, but no details were disclosed.

Berkshire acquired The Pampered Chef on October 31, 2002, the same day it closed on Garan. Doris Christopher started The Pampered Chef in her basement in 1980 with $3,000 borrowed from her life insurance policy. The company sold kitchenware and equipment at home parties. At the time of

Berkshire's purchase, the company was doing $700 million of sales a year through its 67,000 kitchen consultants.

Buffett told shareholders it took about ten seconds for him to decide Berkshire wanted to partner with Christopher and the CEO she had brought in to run the company, Sheila O'Connell Cooper. The purchase price wasn't disclosed.

Fruit of the Loom

The well-known underwear maker was the latest low-tech business to find its way onto Berkshire's radar. How Fruit of the Loom became a Berkshire subsidiary was a little out of the ordinary. The company faced bankruptcy after stumbling with operating and financing issues. Berkshire first purchased its bonds and bank debt at 50% of face value, which equated to a 15% current return and amounted to 10% of Fruit of the Loom's senior debt. An unusual feature of the bankruptcy allowing for interest payments on senior debt during the bankruptcy process attracted Buffett. The investment was originally intended to be nothing more than a junk bond investment, one of very few such outlays during that time.

Two things led to Fruit of the Loom's bankruptcy. First, the company ran up debt of over $1.2 billion. This compared to revenues under $2 billion (and falling), and just $130 million of gross profit. Buffett said such metrics pointed to "a company that, in a financial sense, was out of control." A second major issue, which both precipitated the debt problem and exacerbated it, was bloated costs and other operating issues.

Buffett saw the potential for it to regain its status as a low-cost producer of a basic needed product. It had a 40%+ market share in the men's and boy's market. Buffett believed the company could once again be a good business once it shed its debt burden and costs were brought back in line.

The man to do that job was Fruit of the Loom's former CEO John Holland, who returned on the scene to fix the mess the prior management team made. It was telling that the only major contingency in Berkshire's offer to the bankruptcy court was that Holland remain as CEO.

Berkshire offered the bankruptcy court $835 million, which included the assumption of certain liabilities. [411] Unlike its other deals, the offer to buy Fruit of the Loom came with no strings attached save for Holland running

the company. Neither Berkshire's ability to finance the deal, or even war could derail the transaction from closing (many contracts have what's called force majeure clauses that allow termination for major events such as war or other unforeseeable circumstances). The deal closed on April 30, 2002.

It's not entirely clear what sort of financial returns Berkshire could expect from Fruit of the Loom. It appears the purchase price roughly equated to book value. [412] If the rescued Fruit of the Loom could earn returns on capital near what it had during Holland's heyday Berkshire could likely expect satisfactory returns upwards of 15%. [413]

The Fruit of the Loom story has another historical element. During the 1950s while Buffett was working for Graham-Newman, Fruit of the Loom crossed his path. Union Underwear Company (which produced a product under the Fruit of the Loom brand name) had been sold at a mouth-watering price to a company Buffett owned shares in, the Philadelphia and Reading Coal and Iron Company. Philadelphia and Reading purchased Union Underwear, which subsequently purchased control of the Fruit of the Loom brand name and grew pre-tax earnings to over $200 million.

Both the 1955 and 2001 deals were assisted by Graham-Newman partner, Mickey Newman. Mickey was the son of Graham-Newman partner, Jerome Newman, and had assisted Buffett during the 2001 bankruptcy proceedings by sharing his historical knowledge of the company and introducing Buffett to John Holland. Newman attended the 2002 Berkshire Annual Meeting and received applause from shareholders for his work on their behalf.

Another related historical note is appropriate. In December of 2001, H.H. Brown acquired the inventory and trademarks of Acme Boot. Acme had also been purchased by Philadelphia and Reading in 1956. Unlike Fruit of the Loom, Acme had fallen from its former graces. What had been a company with $7 million in annual revenues was sold for a tenth of that amount in 2001.

Berkshire also made two additional acquisitions through MidAmerican. MidAmerican contracted to buy Northern Natural Gas, a 16,600-mile pipeline supplying gas to Midwestern states. The business was originally headquartered in Omaha. It ultimately ended up with the infamous Enron Company in Texas. Enron's bankruptcy led to the business being held by Dynegy, an Enron creditor that took the pipeline as collateral. It was then quickly sold to MidAmerican over the course of a weekend. The other

MidAmerican purchase in 2002 was Kern River. Kern River was also a pipeline business, this time supplying gas to Southern California. MidAmerican now supplied 8% of the gas used annually in the United States.

Berkshire injected additional capital into MidAmerican to fund the Northern Natural and Kern River purchases. Remember that Berkshire could not control MidAmerican, so its original purchase was structured in such a way to give it a majority economic interest but a much lower voting interest. To remain a non-controlling shareholder of MidAmerican and in compliance with the Public Utilities Company Holding Act, Berkshire purchased an additional $402 million of convertible preferred stock and $1.27 billion of trust preferred securities. As a result of the additional investments, Berkshire's fully diluted economic interest in MidAmerican rose to 80.2% at year-end.

Interestingly, MidAmerican was not just an energy company. It had an "accidental" business called HomeServices, a residential real estate brokerage. Residential real estate and energy were very different, but so were the myriad businesses at Berkshire. HomeServices had grown to be the second largest residential broker in the country and did $37 billion of transactions in 2002 alone. This was double its volume just a year earlier. The business was cyclical, but had low capital requirements and plenty of room for growth under the leadership of CEO Ron Peltier.

Mid American's pre-tax earnings grew 8% to $613 million, in part due to acquisitions.

Manufacturing, Service, and Retailing [414]

Berkshire's other non-insurance businesses had good results in 2002, especially when considering the recent recession. General weakness in the consumer market prevailed but Berkshire's jewelry and furniture businesses held their own. Pre-tax earnings in the Retail Operations segment, which included jewelry and furniture, dropped just 5% to $166 million.

Shaw, the newly acquired carpet manufacturer, increased earnings by 45% to $424 million. Just 1% of the increase was attributable to prices, while the rest was because the company judiciously controlled expenses, leading to margin improvement.

The Chairman's letter grouped Acme Brick, Benjamin Moore, Johns Manville, MiTek and Shaw into a home and construction–related businesses category for discussion purposes. As a group these businesses earned $941 million in 2002.

The Apparel segment reported pre-tax profits of $229 million. These weren't comparable to the $33 million loss the year before since the current year included results from Fruit of the Loom, Garan, and H.H. Brown. Scott Fetzer's pre-tax earnings were unchanged at $129 million.

Results in the Flight Services segment were worse than they appeared. The reported 21% increase in pre-tax earnings to $225 million included a $60 million gain from exiting a joint venture with Boeing. Operations continued to struggle with post-September 11th challenges that included reduced training (reflecting fewer overall flights) and costs to expand fractional jet service into Europe.

Finance and Financial Products

Within the Finance and Financial Products businesses category, pre-tax earnings grew from $519 million in 2001 to $1 billion in 2002. Considering that included a $173 million loss related to winding down General Re Securities, contributions from elsewhere were significant. A large part came from Buffett himself, who conducted undisclosed arbitrage-related activities in highly rated fixed income securities. Another boost came from Berkshire's earnings in its stake in Value Capital, a limited partnership run by former GEICO CEO Jack Byrne's son, Mark.

Viewed in two broad categories—insurance underwriting and non-insurance businesses—the progress made at Berkshire in 2002 was readily apparent. From an underwriting loss of $2.66 billion (after-tax and after minority interests) in 2001, Berkshire's Insurance Group improved to a $292 million loss in 2002. On the non-insurance front earnings jumped from $1.3 billion to $2.2 billion (again after tax) due largely to the addition of several new operating businesses. Berkshire was putting its cash to use productively and returning its core business of insurance to the top of the industry. [415]

Investments

Charlie Munger's favorite shareholder meeting quip of "nothing to add" seems appropriate with respect to Berkshire's equity investments in 2002. M&T Bank made the $500 million cutoff to be included in the Chairman's letter table for the first time, though it was not a new investment. American Express, Coke, Gillette, and Wells Fargo remained untouched. The only change was in the other category with about $600 million of additional investment (at cost). Berkshire's equity portfolio remained concentrated, with 69% of its $28 billion year-end market value in the four returning companies just mentioned above.

It seemed Berkshire's equity portfolio would remain in a holding pattern for some time. Buffett told shareholders that, "unless, however, we see a very high probability of at least a 10% pre-tax return (which translate to 6.5%-7% after corporate tax), we will sit on the sidelines." Asked about this 10% target at the next year's Annual Meeting Buffett said it was nothing scientific, only a somewhat arbitrary point below which it would feel sloppy. He and Munger would rather endure low rates earned on cash (then historically low at around 1.25%) and wait for opportunities to earn higher rates.

While equity markers weren't accommodating, credit markets offered an opportunity for Berkshire to put some of its surplus cash to work at attractive rates of return. A significant decline in the prices of junk bonds began in 2001 and continued into 2002. This improved the risk/reward scenario. As noted earlier, the Fruit of the Loom investment started as a junk bond investment. Berkshire purchased $8 billion of additional junk bonds in 2002 in various energy and telecommunications companies. One notable purchase was $169 million (cost) of euro-denominated Amazon.com junk bonds trading at 57% of par, purchased after the company announced it would expense stock options, a practice that was optional at the time. [416] The action gave Buffett confidence in the business and its management.

Derivatives

As much as Buffett disliked the accounting of stock options, he thought derivatives as a class represented a true risk to the real economy. Buffett railed against the widespread use of derivatives and their potential to cause unintended harm, devoting two pages of his Chairman's letter to it.

Derivatives, as the word implies, are contracts that derive value from the performance of an underlying entity such as an asset, index or interest rate. Buffett called them time bombs and saw their potential to aggregate risk, rather than disperse it. Once concentrated into a few counterparties, those would then pose systemic risks to the financial system and the broader economy. Derivatives "carry dangers that, while now latent, are potentially lethal."

In December 2001, Enron's bankruptcy filing shined a light on the dangers of derivatives. Enron had created a market for energy-based derivatives. When the market collapsed, Enron shareholders lost $74 billion. Less than a decade later, their dangers would again be on display during the real estate crisis, in that case due to mortgage-backed securities. [417]

The problem was not the efficacy of derivatives to shift risk among parties on a microlevel, but their aggregated effects. One entity taking the risk of another at times made sense, such as a manufacturer hedging a key input so that costs are known and fixed prices can be established. The issue arose on a macro level where certain intermediaries collected many of these micro transactions. These intermediaries would then seek to hedge their own risks with the use of still more derivative transactions, thinking themselves protected. This is the type of behavior that General Re Securities undertook, eventually finding itself with over 14,000 contracts with 672 counterparties. [418]

Disaster could (and did) strike when a key counterparty failed, or several down the line failed to keep their promises. This could cause a chain reaction that wiped out many once-strong institutions. Think of Enron.

Another related pernicious effect of derivatives was on accounting and compensation. Buffett and Munger had first-hand knowledge from their time at Salomon, and then at General Re, of how hard some derivatives were to value. With sometimes thin trading, many derivatives were "marked to model," meaning accountants couldn't use market data to establish their value and instead relied on a calculation of value. Oftentimes these models were constructed by the same people compensated for their results. Accountants, to their shame, sometimes failed to question them. Optimism seeped in, of course, and some contracts had a profit attached to it on both sides of the transaction, which clearly could not be the case. Further, since

many contracts spanned years or decades, the results of bad bets would be felt long after the traders who booked them received their own paychecks.

Berkshire began winding down General Re's derivatives book at the start of 2002, realizing losses in the process.

SQUARZ Notes

Berkshire issued a first-of-its-kind security during 2002. It was done with the help of Byron Trott, a Goldman Sachs banker who would play an increasingly larger role in Berkshire's acquisitions and financing over the coming years. Christened SQUARZ, the $400 million issue carried a negative interest rate in exchange for the right to purchase shares in Berkshire at a premium (see Table 6.31).

The issue was broken up into $10,000 par value notes due in November 2007. Each required the holder to pay Berkshire 3.75% annually for the right to a 3.00% coupon and the ability to convert the notes into 0.1116 BRK A shares. [419] Thus, Berkshire was paid 0.75%, net annually. What did the terms of the SQUARZ notes say about Berkshire's prospects as judged by each side of the transaction?

Those purchasing the notes would benefit only if Berkshire shares increased at a steady clip over the ensuing five years. But the rate of return would be lower than the underlying change in share price because of the large upfront premium to both the underlying share price and book value. If the share price declined, holders could elect to receive their cash back at maturity—after paying Berkshire for the privilege.

The advantages of the SQUARZ notes lay almost entirely with Berkshire, yet investors nonetheless found them attractive, perhaps due to Berkshire's historical rates of return. Berkshire had the benefit of:

1. Upfront use of the cash
2. Annual interest income from the negative interest rate
3. Low effective cost if the notes were converted into shares

Buffett was effectively monetizing his modest outlook for Berkshire's future returns.

Table 6.31: Berkshire Hathaway SQUARZ Notes—select data

Price-to-book ratio 2002-Q2	1.75x
Implied price-to-book ratio at issuance	2.24x
Annual return to warrant holder if BRK:	
Increased by 15%/year over five years	8.71 %
Increased by 10%/year over five years	3.95 %

Sources: Berkshire Hathaway Annual Report 2002 and author's calculations.

Accounting Lessons

Buffett's 2002 Chairman's letter purported to be the first to include a negative pro forma adjustment to earnings. He was poking fun at a very serious problem gripping the accounting and business world. Some companies of the day touted adjusted numbers that sought to exclude one-time or non-recurring items. [420] These appeared to make sense on the surface, but over time they served to divert the reader from what was happening. Buffett's jab in his letter was a downward revision (since others adjusted upward without fail) to correct for Berkshire's benefit from no catastrophe losses in 2002 and some outsize gains Buffett booked in the financial products business.

His lessons for investors were simple and founded on a base of sound skepticism. Lesson one was be wary of company's displaying weak accounting. He used three examples:

1. Companies not expensing stock options, which was still optional at the time;
2. Overly optimistic pension assumptions;
3. And companies and managements touting EBITDA (earnings before interest taxes, depreciation and amortization).

The "D" in EBITDA, depreciation, particularly bothered Buffett. He said ignoring depreciation was akin to ignoring some other real expense. Just because depreciation was considered non-cash, since no cash went out the door after the initial capital outlay, it was still an expense. Further, it was the worst kind of expense since money went out the door day one and was only recouped over time as the expense was charged against earnings. He

knew from first-hand experience that companies not spending their average depreciation would fall behind in real terms.

The second lesson was to be skeptical of unintelligible footnotes. He thought such fuzzy disclosures indicate untrustworthy management. If a reader couldn't understand them, it was probably not their fault—and it could be because the CEO didn't want them to.

His third lesson was to have a healthy level of skepticism. It's worth repeating in i ts entirety:

> "Finally, be suspicious of companies that trumpet earnings projections and growth expectations. Businesses seldom operate in a tranquil, no-surprise environment, and earnings simply don't advance smoothly (except, of course, in the offering books of investment bankers).
>
> Charlie and I not only don't know today what our businesses will earn *next year* —we don't even know what they will earn *next quarter* . We are suspicious of those CEOs who regularly claim they do know the future—and we become downright incredulous if they consistently reach their declared targets. Managers that always promise to 'make the numbers' will at some point be tempted to make up the numbers."

Business results fall where they may, Buffett would always tell the unvarnished truth.

2003

Berkshire's gain in book value per share fell behind the S&P 500 for the first time in three years. While Berkshire's 21% gain was itself highly satisfactory, the 7.7% lag nonetheless represented the fifth time since 1965 that it had fallen short of the market. Part of the reason had to do with the changing nature of the company. Berkshire's fortunes were less tied to its marketable securities portfolio [421] after it completed a slew of acquisitions. A higher proportion of capital invested in operating businesses would cause performance to lag in an up market like 2003 but lead to outperformance during market downturns. Capital allocation decisions and operating performance in 2003 were far from disappointing. On the contrary, Berkshire added important non-insurance subsidiaries to its roster and the Insurance Group turned in underwriting results fit for praise.

Insurance

"Last year was a standout," wrote Buffett of 2003 Insurance Group performance. The group turned in an underwriting profit of $1.7 billion and float grew to a record $44 billion. All four of its main insurance segments contributed. Berkshire Hathaway Reinsurance Group continued its tradition of over-achieving, General Re was fixed, GEICO continued to impress, and Berkshire Hathaway Primary Group remained stellar.

Table 6.32: Berkshire Hathaway—Insurance Underwriting

($ millions)	2003	2002
GEICO Corporation		
Premiums written	$8,081	$6,963
Premiums earned	7,784	6,670
Underwriting gain/(loss) - pre-tax	$452	$416
General Re		
Premiums written	$8,021	$8,521
Premiums earned	8,245	8,500
Underwriting gain/(loss) - pre-tax	$145	($1,393)
Berkshire Hathaway Reinsurance Group		
Premiums earned	$4,430	$3,300
Underwriting gain/(loss) - pre-tax	$1,047	$534
Berkshire Hathaway Primary Group		
Premiums earned	$1,034	$712
Underwriting gain/(loss) - pre-tax	$74	$32
Total underwriting gain/(loss)	$1,718	($411)
Year-end average float - total	42,722	38,366
Cost of float	(4.0%)	1.1%
Aggregate adverse (favorable) loss development	$480	$1,540

Notes:

1. Berkshire Hathaway Primary Group written premiums were not detailed.

2. Berkshire Hathaway Reinsurance Group written premiums stopped being reported in 2002.

Sources: Berkshire Hathaway Annual Reports 2002–2003 and author's calculations.

Berkshire Hathaway Reinsurance Group

Ajit Jain's group at BHRG again impressed during 2003. Its total underwriting gain of $1 billion on $4.4 billion of earned premiums was in large part due to a lack of catastrophes.

The catastrophe and individual risk segment (the segment holding the catastrophe risks) earned $1.1 billion on its $1.3 billion earned premiums for the year. Its maximum probable loss from a single event was $6.7 billion. Such a loss would swamp several years of gains. But its operating philosophy was sound with expectations of modest profits over the long term, catastrophes included. Individual risks also contributed to profits in 2003. Jain's group found easy bars to step over. One was a Pepsi promotion where Berkshire insured a $1 billion prize (no one won). [422] Such "mammoth and unusual risks" were bread-and-butter for BHRG.

The retroactive reinsurance segment reported a $387 million loss on $526 million of earned premiums. This was a good result considering amortization of deferred charges hit losses to the tune of $400 million a year regardless of premium volume. [423] Even with low levels of earned premiums and reported losses, the retroactive reinsurance segment remained a money-generator for Berkshire. This segment alone accounted for $7.7 billion of the nearly $14 billion of float attributable to BHRG.

Buried in the footnotes in 2003 was an unusual $41 million gain attributed to the BHRG retroactive segment relating to a "commutation of contracts written in prior years in exchange for payments of $710 million." What was going on here? While retroactive reinsurance contracts are typically long-term arrangements, they are sometimes prematurely terminated. The $710 million represented a payment by Berkshire to the original ceding company, essentially giving them back some of their original premium. The $41 million was the accounting gain relating to over-reserving expected losses from those contracts. The net effect was a reduction in float for Berkshire as the premium was returned.

Other activities at BHRG in 2003 included $2.6 billion of earned premiums and $326 million of underwriting profit on traditional multi-line business,

with a large part coming from Lloyd’s of London syndicates.

General Re

The fixers of General Re, CEO Joe Brandon and President Tad Montross, received Buffett’s praise for restoring underwriting discipline to Berkshire’s problem child. The company was still beset by some unfavorable prior-year loss estimates. Nonetheless, General Re managed to eke out a $145 million underwriting gain on $8.2 billion of earned premiums.

General Re’s North American segment, which recovered its underwriting to a $67 million profit on $3.4 billion of earned premiums, improved most. This was up from a staggering loss of $1 billion on $4 billion of earned premiums in 2002. The segment was able to this via a combination of increased pricing (which was partially responsible for the lower premium volume) and a lack of major catastrophes during 2003. Its current year gains (underwriting attributable to just 2003) were $200 million, but those were offset by $133 million of adjustments relating to prior year losses. Included in those prior year loss adjustments were increases to director and officers’ insurance liabilities resulting from the fallout from the scandals of the early 2000s. Director and officers insurance provides protection to executives for claims arising from their governance and management of companies. Claims for misconduct in prior years (and the related adjustments insurance companies make to account for them) happen after the fact since most claims come to light only after a major scandal or bankruptcy.

One drag on General Re’s North American underwriting results in 2003 was a change to the discount rate used to value workers’ compensation claims. Berkshire changed its discount rate of 4.5% for claims prior to 2003 and began using a 1% rate. This reflected conservatism on the part of Berkshire. This weighted those liabilities closer to the present, which necessitated a $74 million charge in 2003.

The International segment of General Re improved similarly in 2003. While premiums earned increased about 6% to $1.9 billion, they only did so as a result of the weakness in the US dollar. Absent such currency-related tailwinds, premium volume declined over 8%. A $20 million pre-tax underwriting gain was a marked improvement from the $319 million loss booked in 2002 and came after a $104 million addition to loss reserves.

Berkshire disclosed more details on General Re's activities in the Faraday or London market, which was previously and subsequently included as part of International. General Re participated in 61% of the Faraday Syndicate 435 business in 2001, 97% in 2002, and 100% in 2003. This additional information showed that most losses were outside of Faraday. The segment was responsible for $200 million of losses between 2001 and 2003, inclusive (with $178 million of that coming in 2001), which was just a fraction of the $921 million of pre-tax loss from the segmented International property/casualty results over that same time period.

The General Re Global life/health segment reported a $58 million gain in 2003. Most of the gains were in its international business.

GEICO

GEICO had excellent results in 2003—even by its own high standards. Preferred policyholder count grew 8.2% and non-preferred grew 21.4%, for a 10.9% overall growth rate. Premiums grew 16.7% to $7.8 billion on the heels of the unit growth and a 2% average premium rate increase.

Such high growth rates necessitated expansion, and in 2003 the company announced an expansion into Buffalo, New York. It was no coincidence that it was in the same city as Berkshire's newspaper, *The Buffalo News* . Stan Lipsey, the paper's publisher, was instrumental in the expansion, which would eventually add 2,500 new jobs.

Even with its ever-increasing need for more employees and space, GEICO kept costs down and profits up. GEICO boosted advertising during the year and still achieved a combined ratio of 94.2%. Moreover, growth in premiums and policies reflected an increasing market share. From the time CEO Tony Nicely took over in 1992 to 2003, GEICO more than doubled its market share from 2.1% to 5%.

Berkshire Hathaway Primary Group

The Primary Group turned in an underwriting profit of $74 million on premiums of $1 billion. Its float grew 41% to $1.3 billion. How could Buffett and Munger be anything but very pleased with this group of managers? It seemed every year the group turned in higher premiums, higher profits, and more float. Buffett's comment in his letter to

shareholders in 2003 sums up the group nicely: “These men, though operating in unexciting ways, produce truly exciting results.”

Acquisitions

During the year, Berkshire agreed to acquire two companies: Clayton Homes, a leading producer and financer of manufactured homes, and McLane, a distributor of goods to convenience stores and related outlets.

Clayton Homes

The Clayton acquisition came about in a most unusual way—even for Berkshire. Buffett long hosted groups of students who flocked to Omaha to hear him speak. On one such visit he received an autobiography of Clayton founder, Jim Clayton, from a group of Tennessee students. Buffett had some familiarity with Tennessee-based Clayton Homes, but he had not studied the company to any great extent.

Clayton was a big business. It had twenty manufacturing plants, 300 company-owned stores, over 500 independent retailers, and eighty-nine housing communities. It also had a financial services arm that played an integral role in the company’s success.

Buffett’s newly piqued interest combined with industry turmoil led Berkshire to make an offer for Clayton. Some of Clayton’s competitors engaged in poor lending practices to sell homes or make loans to unqualified consumers. Such practices continued longer than they otherwise would have because most loans were securitized. Securitization is a process where many loans are packaged together and sold to investors. Those investors then take on the risk of borrowers defaulting from the manufacturer-originators. Once credit problems began to materialize, the ability to securitize dried up and affected Clayton’s ability to obtain financing and in turn lend to its own customers.

Clayton’s board of directors recognized Berkshire’s ability to provide financing and agreed to sell to Berkshire. Berkshire paid $1.7 billion for Clayton. The deal closed on August 7, 2003.

When Berkshire completed the acquisition of Clayton Homes, it placed its operations in the Finance and Financial Products category. At first this seems quite odd. That is until the extent and importance of its financing

business becomes apparent. The basic business model worked like this: A manufacturer like Clayton produced a home and marketed it through a distribution channel that could include its own stores or other retailers. Clayton had a mix of both. The home was either purchased for cash or, (more likely) with financing provided by an unrelated third party or a financing arm of the manufacturer.

Over time, lenders incented to make loans and manufacturers incented to sell homes loosened their standards and began pushing homes and loans on unsuspecting customers with poor credit. To increase their volume of business, the financing was often securitized. The original packagers of the loans, incented to produce volume irrespective of repayment capacity, ultimately underwrote many bad loans. The resulting defaults then caused the securitization market to dry up, which affected everyone in the industry, including Clayton. [424]

When this happened, Clayton had no way to recoup its cash for additional loans. Berkshire's purchase solved that problem by providing almost unlimited financing to Clayton. Berkshire borrowed money and re-lent it to Clayton at a 1% spread. But why not just give Clayton the money since Berkshire had ample cash and it was now entirely owned by Berkshire? Buffett said Berkshire had a philosophy of "every tub on its own bottom." He went on to explain. "We believe that any subsidiary lending money should pay an appropriate rate for the funds needed to carry its receivables and should not be subsidized by its parent. Otherwise, having a rich daddy can lead to sloppy decisions." At year-end 2003, Clayton had just over $2 billion of such loans on its books to finance customers' purchases.

Clayton's financing arrangements contain two lessons. One, financing interest-bearing receivables [425] with debt is entirely appropriate. It was like a mini bank inside Berkshire that funded its interest-bearing assets with interest-bearing liabilities to take a spread. This was not the first of its kind at Berkshire. Scott Fetzer had a financing subsidiary that financed the purchase of World Book Encyclopedias and Kirby vacuum cleaners this way.

A second lesson from Clayton's financing was the role of credit risk and incentives. With Clayton under Berkshire's umbrella, it could retain all its loans from its customers. This meant it would ultimately bear the cost of underwriting bad loans and had an incentive to do good by its customers. [426]

The securitization model in which the industry previously operated failed in large part because lenders did not care about short-term outcomes. Requiring lenders to keep some of each loan would play a key role in re-shaping the US credit system after the Great Recession of 2009 where many subprime loans were resold in packages as mortgage-backed securities.

Berkshire's purchase price of $1.7 billion suggests it paid a fair price for Clayton's straightforward business model and its history of consistent financial returns. However, its pre-tax return on capital appears to have been at a low in 2002 as a result of the cyclical nature of its business. Berkshire could see an upside benefit if Clayton could achieve its historical average return of 21%. It could also benefit by providing financing to Clayton and avoiding expensive securitized financing.

Table 6.33: Clayton Homes—acquisition analysis

($ millions)	2002	2001	2000	1999	1998	1997	1996	1995	1994	1993
Total revenues	$1,199	$1,151	$1,293	$1,344	$1,128	$1,022	$929	$758	$628	$476
Revenues/avg. capital	$0.91	$0.95	$1.19	$1.24	$1.18	$1.40	$1.46	$1.35	$1.23	$0.98
EBIT margin	17%	15%	18%	19%	19%	18%	18%	17%	17%	18%
Pre-tax return on capital	15%	14%	21%	23%	23%	26%	26%	23%	21%	17%
Purchase price (equity)	$1,700									
Assumed debt	93									
Effective purchase price	$1,793									
Purchase multiple	1.36x									
BRK going-in pre-tax return	11.2%									

Sources: Berkshire Hathaway Annual Report 2003, Clayton Homes Annual Report 2002, and author’s calculations.

McLane

Berkshire’s second major acquisition of 2003 was McLane. McLane came to Buffett’s attention via Byron Trott, the Goldman Sachs banker who had worked on the SQUARZ debt issue.

McLane was a subsidiary of Walmart that had grown from Walmart’s need to distribute products to many stores. The business then expanded to include non-Walmart stores such as convenience stores, drug stores, wholesale clubs, restaurants, and theaters. Not surprisingly Walmart accounted for 35% of McLane’s revenues. McLane conflicted with Walmart’s competitors because of its growth, leading Walmart to sell the subsidiary.

Berkshire paid Walmart $1.5 billion for McLane, with the transaction closing on May 23, 2003 (see Table 6.34). The business was simple and understandable and fit right in with Berkshire’s other non-insurance businesses. From an earning power standpoint, McLane’s business was not all that unusual. Its profit margins compared to other Berkshire subsidiaries, however, were.

McLane was a no-value-add type operation. It simply moved products from one location to another. Consequently, it commanded slim margins. So slim that it earned just 1% pre-tax on a massive $23 billion of revenues. This was a figure greater than all of Berkshire’s non-insurance subsidiaries *combined* . While it was profits not revenues that mattered, accounting

conventions required that businesses be reported based on their revenues. As a result, McLane would have to remain a separate reporting item in all Berkshire's financial reports going forward.

McLane's thin profit margins are a good lesson on the importance of focusing on the right variables in business analysis. Profit margins would seem to be a good indicator of the desirability of a business, and indeed they do carry some important information. As McLane proves, however, a small profit margin can translate into a satisfactory return on capital, provided enough turnover. [427]

Table 6.34: McLane—acquisition analysis

($ millions)	
Revenues	$23,000
Pre-tax margin	1%
Pre-tax income	$230
Berkshire's purchase price	$1,500
BRK going-in pre-tax return	15.3%

Sources: Berkshire Hathaway Annual Report 2003 and author's calculations.

Non-Insurance Businesses

As Berkshire's stable of businesses grew in number it became challenging to report results to shareholders in a useful and intelligible way. Or as Buffett put it: "without turning out something as long as the World Book." In 2003, the long-familiar Sources of Reported Earnings was omitted from the Chairman's letter. [428] In its place Buffett reported on Berkshire's four major operating sectors:

1. Insurance
2. Regulated Utility Businesses
3. Finance and Financial Products
4. Manufacturing, Service, and Retailing [429]

Buffett said his goal was to give shareholders the facts he and Munger would want if roles were reversed, without providing data inessential to

calculating Berkshire's intrinsic value. [430] He also cautioned shareholders to be careful in their analysis and to "remember that the company should be viewed as an unfolding movie, not as a still photograph. Those who focused in the past on only the snapshot of the day sometimes reached erroneous conclusions." With Berkshire's policy of retaining all its earnings, the reinvestment factor was an important part of the valuation exercise.

Regulated Utility Businesses

Since the Insurance Group was presented above we will start with the utility businesses, all under the umbrella of MidAmerican. MidAmerican's $1.1 billion of earnings before interest and taxes (EBIT) broke down as follows:

- $289 million, UK utilities
- $269 million, Iowa-based utility businesses
- $261 million, pipelines
- $113 million, Home Services
- $144 million, other income

MidAmerican's 2003 EBIT increased 36% and its net earnings of $416 million were up 9% from the year before. These increases were largely due to the new pipelines funded with additional capital contributions. MidAmerican owed $10.3 billion to others and $1.6 billion to Berkshire Hathaway. Including interest income, Berkshire's earnings from MidAmerican were $429 million (up from $359 million the year before).

Finance and Financial Products

The Finance and Financial Products segment had the feeling of a drawer of financial odds and ends. All were important businesses and capital allocation activities. Because of the bank-like nature of these activities, they were largely supported by borrowings.

One of the largest businesses was trading, which earned $379 million in 2003 and was supported by $7.8 billion of interest-bearing liabilities at year-end. This was an operation managed entirely by Buffett and consisting of "a few opportunistic strategies in AAA fixed-income securities. Though far from foolproof, these transactions involve no credit risk and are

conducted in exceptionally liquid securities." In other words, an arbitrage operation.

The flipside to Buffett's operation was Gen Re Securities, where the derivative business continued to lose money as it was wound down. Gen Re Securities lost $99 million pre-tax during 2003 as outstanding contracts shrunk almost 50% from the year before. [431] Such a slow unwinding illustrated a major risk of derivatives. Berkshire was trying to exit during a time of market tranquility. What would happen if markets wouldn't (or couldn't) work in an orderly fashion? That question would be answered in just a few years.

Another investment included in this segment was Berkshire's investment in Value Capital, a fund run by Mark Byrne. Buffett noted that though the fund had close to $20 billion of debt, the operation was sound and Berkshire did not guarantee the debt. At year-end 2003, Berkshire had a net investment of $634 million in Value Capital after receiving a $30 million distribution.

The more natural components of this segment were the trailer leasing business, XTRA, which was reported under Leasing Operations, and the life and annuity business. The segment also contained the Berkadia operation, which was nearly complete at year-end 2003. [432] As was noted earlier, Clayton's entire operations were included in the Finance and Financial Products segment due to the size of its financing operation even though it also manufactured and sold housing units.

All told the Finance and Financial Products segment earned $666 million pre-tax in 2003, compared to $775 million in 2002. These figures were before $1.2 billion and $578 million of pre-tax capital gains in 2003 and 2002, respectively.

Manufacturing, Service, and Retailing

As the years went on Buffett's Sources of Reported Earnings table had been consolidating certain businesses with others. Home Furnishings and Jewelry became Retail Operations; Scott Fetzer's non-finance businesses were re-consolidated back into that category; and *The Buffalo News* , the Shoe Group, Dairy Queen, and See's Candies were lumped into Other Businesses. Beginning in 2002, the table disappeared but the commentary

and the Annual Report footnotes still contained line items for Apparel, Building Products, Flight Services, McLane, and Shaw Industries.

These businesses could be viewed as one sector because of their similarities, though detail was provided for many businesses where needed or important. Each business in this group was closer to a typical business that required working capital, fixed assets, and some limited amounts of debt, than the Insurance or Utilities sectors. To aid analysis, Buffett now presented a summary balance sheet and earnings statement for the MSR Group that was like the supplemental disclosure presented up until 2000.

Buffett said the "eclectic group, which sells products ranging from Dilly Bars to B-737s" earned $1.3 billion on $32.1 billion of revenues in 2003. The resulting 20.1% return on average tangible net assets (tangible equity) was evidence of their above-average economic characteristics. While we don't have information from 2002 to compare, we know the Manufacturing, Service, and Retailing businesses earned higher returns in the past. In 1994 (the first year of the former presentation), after-tax return on equity was 32.4%. Returns dropped to the low 20%-range by the late 1990s as Berkshire acquired additional businesses. The new businesses were very good, just not quite as good as the earlier ones. Struggles in footwear and publishing hurt results, too.

Buffett judged businesses and their operating managers based on returns on capital employed. But Berkshire paid a premium to acquire many of its subsidiaries and he judged himself based on total purchase price, which included goodwill. Berkshire's after-tax return on carrying value for the MSR businesses was just 9.2% in 2003. [433] Berkshire separated purchase accounting and goodwill accounts to enable shareholders to distinguish the true quality and performance of the businesses and their accounting representation.

The building-materials businesses (Acme Brick, Benjamin Moore, and MiTek) earned 21% on tangible net worth. This was quite an impressive statistic for boring businesses. The businesses collectively earned $559 million pre-tax (up 8%) on revenues of $3.8 billion (up 4%), benefitting from strong housing demand.

Shaw also benefitted from the strong housing market and earned $436 million pre-tax (up 3%) on revenues of $4.7 billion (up 8%) In November

Shaw acquired a related carpet business from Dixie Group, which added $240 million to its revenues.

Fruit of the Loom, under the direction of John Holland, returned to profitability and now accounted for 42% of the men's and boys' underwear sold by large retailers. Its women's and girls' share incre ased to 14%.

Two of Berkshire's furniture retailers opened new stores during 2003. RC Willey opened a hugely successful store in Las Vegas (which was even more impressive given its closed-on-Sunday policy) and Nebraska Furniture Mart opened a large store in Kansas City, Missouri.

Revenues for the retail segment (which included the jewelry businesses) increased 10% to $2.3 billion, but pre-tax earnings remained flat at $165 million due to start-up costs for new stores.

Flight Services continued to experience some turbulence. Combined pre-tax earnings fell 68% to $72 million. FlightSafety earned $113 million after writing off $37 million in obsolete simulators. NetJets (Executive Jet now went by this name) lost $41 million as it continued to struggle despite being the dominant player in the fractional jet industry. The NetJets loss included a $32 million loss on aircraft inventory on top of continued operating losses building out its European business. Buffett remained upbeat on both businesses and noted that both FlightSafety and NetJets were leaders in their fields.

The apparel businesses continued to struggle. While the additions of Fruit of the Loom and Garan increased reported pre-tax earnings to $289 million on revenues of $2.1 billion, revenues declined 5% and earnings declined 11% on a comparative basis.

Investments

Berkshire's portfolio of equity securities moved just faster than glacial speed in 2003. Buffett reminded shareholders its major positions hadn't changed in a long time: Coca-Cola (1994), American Express (1998), Gillette (1989), Washington Post Company (1973), and Moody's (2000). The one exception was Wells Fargo, whose cost basis [434] increased by $157 million. This raised Berkshire's position by 3.2 million shares and brought its ownership interest to about 56.5 million shares and 3.3% of the company.

Two new companies made the $500 million threshold be included in the Chairman's letter: HCA, Inc., a company that ran hospitals, and PetroChina, an oil and gas company. Berkshire had 15.5 million shares in HCA, representing a 3.1% interest in the company. At year-end 2003, it had 2.3 billion shares in PetroChina, representing a 1.3% interest in the Chinese company.

Buffett expressed neutral feelings on the portfolio, both in his letter to shareholders and at the next year's Annual Meeting. "We are neither enthusiastic nor negative about the portfolio we hold. We own pieces of excellent businesses—all of which had good gains in intrinsic value last year—but their current prices reflect their excellence." While the intrinsic values of these companies increased, so did their share prices. This did not create a price/value discrepancy wide enough to make major changes.

Buffett also discussed Berkshire's default position, which was to place any surplus cash in US Treasuries. He said Berkshire would "never 'reach' for a little more income by dropping our credit standards or by extending maturities. Charlie and I detest taking even small risks unless we feel we are being adequately compensated for doing so." Knowing that markets could turn quickly, and valuing certainty, Berkshire placed its excess cash in the safest, most liquid securities available.

Governance

Berkshire added four new board members to its roster in 2003. This brought its total to eleven. The four, all friends of Buffett, were David Gottesman, Charlotte Guyman, Don Keough, and Tom Murphy.

Don Keough, a former Coca-Cola executive who now served as chair of Allen and Company, and Tom Murphy, of Capital Cities/ABC, were already known to Berkshire shareholders through Buffett's writings and comments over the years. Buffett had known David "Sandy" Gottesman for almost as long as he had known Munger. Gottesman had partnered with Buffett and Munger in the Hochschild-Kohn department store acquisition in the mid-1960s, which was purchased via Diversified Retailing, the entity that was eventually merged into Berkshire Hathaway.

The last addition was Charlotte Guyman. Guyman retired from Microsoft in 1999, [435] and at the time of her appointment to the Berkshire board she was

chair of the finance committee of the University of Washington Medical Center.

All of Berkshire's directors shared common traits essential to Buffett. To start, each director and his/her family owned at least $4 million of Berkshire stock that they had, importantly, acquired themselves and held over many years. Six had fortunes that included hundreds of millions of dollars worth of Berkshire stock. This meaningful level of ownership aligned their interests with those of "rank and file shareholders," wrote Buffett. He said the common trait among the group was "business savvy, a shareholder orientation, and a genuine interest in the company."

Buffett valued their independence, even though not all of them met the strict SEC test. Buffett's wife, Susan, and son, Howard, clearly failed the test as family members. Their role was to ensure the culture of Berkshire continued intact once he was no longer in control. Ron Olson also failed the test because his firm, Munger, Tolles, Olson, performed legal work for Berkshire. Buffett reasoned that the single-digit percentage of income Olson received from Berkshire would not be enough to cause him to lose his independence. Buffett pointed to the directorship of other corporations, including mutual funds, whose directors derived a significant percentage of their income from directors' fees but were nonetheless considered independent per SEC rules. Berkshire would comply with the SEC rules, though it would do it in such a way that ensured it was to Berkshire's shareholders' benefit, not just to meet a technical test. Buffett defined true independence not by family or financial ties but as "the willingness to challenge a forceful CEO when something is wrong or foolish."

Gifts Program

Berkshire's designated gifts program had directed $197 million to thousands of charities since its inception in 1981. In 2003, that program was terminated due to politics. Individuals and groups who were pro-life had begun to boycott Pampered Chef because of Berkshire's donations (at the direction of shareholders) to pro-choice charities. Buffett said it did not matter to these groups that other Berkshire shareholders had donated to pro-life organizations. Buffett and Munger terminated the program after judging the negative impact to the independent consultants as greater than the benefit.

Burlington Industries

In early 2003, Berkshire placed a bid for bankrupt former competitor, Burlington Industries. Burlington had labored on long after Berkshire got out of the textile business. Not surprisingly, it struggled mightily. The bid was a $500 million offer to the bankruptcy court to buy Burlington. Ultimately the court decided that Berkshire's $14 million breakup fee (less than 3% of the offer) was too rich.

2004

Berkshire just missed matching the S&P 500 in 2004. Its 10.5% increase in per share book value fell 0.4% behind the benchmark. The cause was the self-forged anchor Buffett long predicted. Berkshire's operating businesses, with their .400 sluggers, were hitting it out of the park. But that success and the resulting growing cash pile in Omaha had no immediate profitable outlet. As was typical of Buffett, he blamed himself for not finding operating businesses or marketable securities to put Berkshire's now $43 billion cash pile to work.

Insurance

Buffett devoted a few pages of his Chairman's letter to a history of how Berkshire had grown from a $20 *million* float business in 1967 to its 2004 collection of excellent insurance businesses with over $46 *billion* of float. He asked: how had Berkshire overcome the "dismal economics of the industry"? The answer: discipline, correct incentives, and capit al strength.

The Chairman's letter presented a Portrait of a Disciplined Underwriter, a summary table of National Indemnity's key metrics from 1980 to 2004. Over that time, it had some loss years but overall wrote to a profit. It also survived a decade-long slump in premiums that tested its managers and employees. National Indemnity had grown to $366 million of written premiums in 1986 and then endured thirteen years of declines in volume, ending 1999 with just $54.5 million of premiums written before rocketing back to $606 million in 2004. Importantly, in each of those thirteen down years National Indemnity wrote to an underwriting profit (subsequently the only loss year was 2001).

Buffett contended that other insurance companies could not or would not endure the unrelenting decline in volume. Where its competitors were focused primarily on volume, National Indemnity focused solely on profitability. Even though huge volumes of business were available, National Indemnity only accepted risks it understood and could price to a profit.

Part and parcel to the disciplined underwriting were incentives that encouraged such behavior. Starting with National Indemnity, employees of Berkshire's insurance companies were rewarded based on profitability, not volume. The incentives at National Indemnity extended to a no layoff policy, which dissuaded writing business to justify an employee's existence. This did not mean indiscriminate spending on personnel. Costs would have to be controlled, but Berkshire tolerated higher levels of operating expenses than its competitors. [436]

National Indemnity and Berkshire's other insurance businesses also possessed above-average (and usually far above-average) capital strength. Capital strength was less important to National Indemnity in its primary operations. (After all, no one bought an auto policy based on name brand; price was usually the deciding factor.) But capital strength allowed Berkshire's insurance companies to market themselves to knowledgeable buyers, including other insurance companies via its reinsurance operations.

Once Berkshire entered the reinsurance field Buffett quickly realized that capital strength could be a huge advantage. Primary insurers looking to shed risks they might have to collect on years in the future understandably sought out a well-capitalized reinsurer to pay the bill. So too would buyers of super cat policies with large covers. Berkshire, bolstered by its conservatism and capital, was (and is) a standout.

Another way to prosper in a commodity-like business is to be the low-cost operator, and GEICO was among the best. Its direct-to-consumer distribution model provided a price advantage over rivals. Though the company had lost its underwriting discipline in the 1970s, it avoided bankruptcy. Under Berkshire's complete ownership it had flourished as a disciplined and much larger enterprise with an almost 6% market share.

Perhaps Buffett's most important job as overseer of the insurance managers was to monitor and reinforce the culture of discipline. His guidance was needed after General Re stumbled, but Berkshire was blessed to have

managers like Tony Nicely at GEICO, Ajit Jain at Berkshire Hathaway Reinsurance Group, and many others within the Primary Group who operated with strong discipline.

Each of Berkshire's major segments within the Insurance Group reported a profit in 2004. On $21 billion of premium volume, the group earned $1.6 billion pre-tax, producing Buffett's highly valued negative cost of float. Float increased by 6% to $46.1 billion at year-end.

Table 6.35: Berkshire Hathaway—Insurance Underwriting

($ millions)	2004	2003
GEICO Corporation		
Premiums written	$9,212	$8,081
Premiums earned	8,915	7,784
Underwriting gain/(loss) - pre-tax	$970	$452
General Re		
Premiums written	$6,860	$8,021
Premiums earned	7,245	8,245
Underwriting gain/(loss) - pre-tax	$3	$145
Berkshire Hathaway Reinsurance Group		
Premiums earned	$3,714	$4,430
Underwriting gain/(loss) - pre-tax	$417	$1,047
Berkshire Hathaway Primary Group		
Premiums earned	$1,211	$1,034
Underwriting gain/(loss) - pre-tax	$161	$74
Total underwriting gain/(loss)	$1,551	$1,718
Year-end average float - total	45,157	42,722
Cost of float	(3.4%)	(4.0%)
Aggregate adverse (favorable) loss development	$419	$480

Note: Berkshire Hathaway Primary Group and BHRG written premiums were not detailed.

Sources: Berkshire Hathaway Annual Report 2003–2004 and author's calculations.

GEICO

GEICO continued to shower profits on Berkshire. In 2004, its 89.1% combined ratio produced a pre-tax profit of almost $1 billion. Premiums earned grew 14.5%, reflecting an 11.8% increase in policies-in-force [437] on top of a 2% rate increase. Part of the growth resulted from expanding into a new state during the third quarter of 2004. Prior to this, the state of New Jersey had a tough regulatory climate and GEICO chose not to do business there. GEICO now served 140,000 customers in New Jersey, or about 4% of the state—a clear vote of confidence in GEICO's ability to save its customers money.

While GEICO held its overhead in check, [438] it was the loss experience that really boosted the results for the year. GEICO experienced lower claims frequencies in physical and bodily damage, which more than offset the increased severity it saw in both categories.

General Re

Berkshire's former problem child demonstrated it was refocused on the one thing that mattered: profitability. It raised prices and rejected unsound risks. Consequently, it allowed written premiums to fall 14.5% to $6.9 billion. Earned premiums declined 12% to $7.2 billion. General Re earned a second year of underwriting profits with a $3 million gain. The profit meant its cost of float was technically negative but the pullback in writing new business caused float to shrink 2% to $23 billion.

North American property/casualty earned premiums fell 15% to $3 billion. Current year gains of $166 million included $120 million of catastrophe losses from four hurricanes that hit the US. Unfavorable loss development of $155 million brought the profit down to $11 million.

International property/casualty business earned premiums fell 22% to $2.2 billion. Hurricane-related catastrophe losses of $110 million and $102 million of unfavorable loss development contributed to a pre-tax underwriting loss of $93 million.

Global life/health earned premiums grew 9% and reported an $85 million underwriting profit. Over half of the premium growth was a result of a weaker dollar against foreign currencies.

Berkshire Hathaway Reinsurance Group (BHRG)

Berkshire's untarnished reinsurance gem was hitting on all cylinders. It reported an overall profit of $417 million on earned premiums of $3.7 billion (down 16%) and grew float 9.5% to end the year at $15.3 billion. BHRG's float represented one-third of Berkshire's total float.

Declines in volume in the retroactive reinsurance and multi-line segments echoed Gen Re's experience, which was a general pullback due to inadequate pricing. Earned premiums in multi-line business declined 20% to $2.1 billion but profits grew 36% to $444 million on gains from aviation coverage and commutations.

Retroactive reinsurance almost fell off the map in 2004. From a high of almost $4 billion in 2000, earned premiums had fallen each year to $188 million in the current year. That line booked a $412 million loss, which was largely attributable to amortization of deferred charges.

The catastrophe and individual risk segment would have declined during the year had it not been for several contracts reinstated after the hurricane losses. [439] Even after $790 million of hurricane-related catastrophe losses, the catastrophe and individual risk segment reported a $385 million profit.

Berkshire Hathaway Primary Group

The Primary Group had another good year in 2004. Earned premiums grew 17% to $1.2 billion and favorable claims experience led to a 118% increase in underwriting profit, to $161 million. Its float ballooned 30% to $1.7 billion.

Manufacturing, Service, and Retailing

Berkshire's "eclectic group" of Manufacturing, Service, and Retailing businesses continued to produce good results despite some acute cost pressures. A separate balance sheet and income statement reappeared in the Chairman's letter and provided additional detail. The MSR businesses earned $1.5 billion on revenues of $44 billion in 2004. The addition of McLane in 2003 made a comparison to prior years difficult. A better comparison, return on tangible equity, improved from 20.7% in 2003 to 21.7% in 2004. Strong growth in the US economy, led by housing, played a part in the improved results.

The strong construction market led the building products segment to increase revenues 13% to $4.3 billion. Pre-tax earnings increased 15% to $643 million (earnings would have increased just 11% if not for a fire the year before at an insulation plant). Digging into some unit-specific results, MiTek, the building products business and a heavy user of steel, experienced a 100% increase in steel costs. Other businesses in this group also experienced increased input costs which negatively impacted margins.

At Shaw, input costs for carpet increased significantly due to rising oil prices (many synthetic fibers are made from oil). Shaw's input cost increases were followed by price increases to customers, though on somewhat of a lagging basis. Shaw nonetheless turned in an excellent year. Its revenues increased 11% to $5.2 billion on higher volume and higher pricing, and from the two acquisitions the year before. Its pre-tax earnings rose 7% to $466 million, which represented a 26% return on tangible equity.

Fruit of the Loom increased its unit sales by 10%, including a 31% increase in the women and girls' segment. That carried the apparel segment to a 6% increase in revenues, to $2.2 billion. Pre-tax earnings in apparel improved 12% to $325 million. Margin pressures at Fruit of the Loom kept its contribution to earnings at half, while H.H. Brown, Justin, and Garan contributed the rest. (Dexter by this time had been merged into H.H. Brown and its specific results weren't disclosed.)

Berkshire's jewelry and furniture retailers were buoyed by the strong US economy. [440] Ben Bridge and RC Willey particularly stood out. Ben Bridge had 11.4% growth in same-store sales, topping off a decade where annual same-store sales growth averaged 8.8%. RC Willey, against Buffett's better judgement, expanded its Las Vegas presence with a second store located within 20 miles from the first. The result was a huge success. While retailing revenues increased 13% to $2.6 billion, same-store sales in 2004 increased just 2.4%. Pre-tax earnings declined 1% to $163 million as start-up costs associated with the new stores weighed on profits.

FlightSafety earned a 15.1% return on tangible equity during 2004. This was up from 8.4% in 2003 as a result of a return to higher usage of the company's simulators by corporate and regional airlines. The 2004 result was after another write-down of simulators, but not to the same degree as the prior year. FlightSafety's founder, Al Ueltschi, while still involved in

the business, turned over the CEO position to Bruce Whitman, a 43-year veteran employee.

Buffett disclosed that Berkshire subsidiary NetJets (formerly Executive Jet) was FlightSafety's largest customer. This was not surprising given the average of eighteen days NetJets pilots spent in training annually, and the fact that the business was growing rapidly. NetJets captured 70% of net new business in 2004. Part of that growth was a result of a new non-affiliated company that was essentially further fractionalizing NetJets ownership. The Marquis Card, offered by Marquis Jet Partners, gave customers the ability to purchase flight time in twenty-five-hour increments. Buffett and NetJets apparently were okay with this arrangement, perhaps because it fed volume into the system without additional overhead on their part.

NetJets' profitability continued to lag with some US profits offset by expenses in building out its European business. Buffett pointed to the volume of US customers taking intercontinental and intracontinental European flights as reason to stay the course to become the market leader in Europe.

McLane, the distribution business acquired in May 2003, increased its revenues by 6% to $23 billion and its earnings by 1% to $228 million compared to its full prior year results.

Finance and Financial Products

Given Buffett's activities within this segment, large fluctuations were not uncommon. In 2004 pre-tax operating earnings fell 6% to $584 million with some important changes in the details.

Perhaps the most important segment within Finance and Financial Products was Clayton Homes (this included manufacturing). The company was doing well under Berkshire's ownership. Buffett even ventured to use the word synergy to describe the benefits to both parties of Berkshire financing Clayton's financing activities. At year-end 2004, these interest-bearing liabilities had risen $1.5 billion to $3.6 billion (by January 2005 the total had risen to $7.35 billion. [441])

Buffett used the word inadequate to describe the poor but improving earnings at CORT, the office furniture-leasing business held under Wesco. He also noted that XTRA, the trailer-leasing business, had taken a play

from GEICO. XTRA refocused on its core trailer-leasing business and dropped the container and intermodal businesses it previously entered. The strategy appeared successful as pre-tax earnings rebounded from $34 million in 2003 to $92 million in 2004.

One accounting-related change to this segment was Value Capital. Accounting rules dictated that large owners such as Berkshire Hathaway fully consolidate the financials of investees. [442] Since Value Capital had found additional investors, Berkshire would be spared this requirement.

Lastly, Buffett commented on the ongoing wind down of General Re's derivatives business. He said that even in a benign market, the portfolio had been stubbornly hard to liquidate. This fact served to reinforce his and Munger's view that derivatives were "weapons of mass destruction."

Regulated Utility Businesses

MidAmerican, in addition to its Iowa-based electric business, had grown to include a UK utility business and several pipelines. The company also owned a California geothermal operation that turned out to be a rare stumble for MidAmerican's management team.

MidAmerican's geothermal operation offered a tantalizing opportunity to recover and monetize zinc from the brine in its geothermal wells. Starting in 1998 and lasting four years, MidAmerican spent hundreds of millions of dollars trying unsuccessfully to make the project viable. It was ultimately shuttered when progress never materialized. The financial impact was a $579 million pre-tax loss in 2004 that included the project's write-off and followed a $46 million operating loss the year before.

The zinc project offered a broader lesson. Because of the many steps involved in the zinc recovery process, even small chances of failure at each step would compound into a very low overall success rate. Buffett reminded shareholders it was better to stay with simple propositions, bringing to mind his dictum to "avoid trying to clear 7-foot bars and focus on finding one-footers." [443]

Despite the zinc blunder, the core of MidAmerican's business was doing well and improved earnings in each segment. Berkshire's 80.5% share of MidAmerican's earnings fell 45% to $237 million largely due to the write-off of the zinc project. Berkshire also had slightly lower interest income as a

result of MidAmerican using $100 million of excess cash to repay some debt owed to Berkshire.

Investments

Berkshire's common stock investments changed little in 2004, but the cutoff to make the Chairman's list grew to $600 million. There was one new name on that list and it carried some historical significance. White Mountains Insurance Company was the remnants of the Fireman's Fund, the insurer former GEICO CEO Jack Byrne ran after leaving his post. [444]

Four companies accounted for 65% of the $37.7 billion portfolio. They were American Express, Coca-Cola, Gillette, and Wells Fargo. One statistic reflected Berkshire's business-owner mindset, as contrasted to a short-term trader's mindset: Berkshire's equity investments had been held for an average of twelve-and-a-half years. [445] Holding these investments through ups and downs (like an owner of a private business would), the normalized earnings from just those four now amounted to $1.2 billion, almost a third of their $3.8 billion purchase price.

Foreign Currency Investments

At year-end 2004, Berkshire owned $21.4 billion [446] of foreign exchange contracts across eight currencies. This was a decided change for Berkshire, which owned no foreign exchange contracts before March 2002. The investments were an example of Buffett putting his (and his shareholders') money where his mouth was. Over the past year or so, he became more vocal in public about America's worsening trade situation and even wrote an article in *Fortune Magazine* . The crux of the matter was that the United States was overconsuming. [447] Buffett thought the inevitable balancing effect would be depreciation of the dollar.

Buffett's focus was almost always on microeconomics, or the bottoms-up workings of the economy. But he was also well-versed in macroeconomics. Now the macro picture had changed significantly, providing Buffett with some certainty that something had to change, and he could profit from it. It was admittedly outside of his normal scope of investment activity. Judging there to be a probability of a decline of the dollar, he bet on currencies.

Buffett said he would have made the same decision had he owned 100% of Berkshire, and was prepared to risk embarrassment if he was wrong.

Buffett pined for something intelligent to do with the now $43 billion of cash on Berkshire's balance sheet. The marginal changes in the investment portfolio and the foreign currency investments were just activity around the edges. Buffett would remain disciplined just like his insurance companies and wait for an opportunity to swing the investing bat. His comment at the 2005 Annual Meeting was prescient: "I think you will get a chance to do something that is more screamingly intelligent in not too many years–and maybe a lot shorter–than the alternatives that you're offered now."

The Oracle of Omaha would be proven remarkably right.

Decade in Review

The word transformational could aptly be used to describe any decade of Berkshire's history. The 1995–2004 decade was notable for the wave of acquisition activity—in particular, the growth in insurance through the acquisitions of General Re and the remainder of GEICO. It was also notable for how little had changed. While the business world and economy were changed by the internet boom, Berkshire remained on the sidelines. Textiles were firmly in the past, but the lessons of investing in industries with sound economics was Berkshire's guide. Internet companies failed that test.

Berkshire expanded in the two broad areas that now defined its business activities: insurance and non-insurance. The insurance businesses provided the double benefit of profits and showers of float to invest. Buffett shared his formula in his 1995 Chairman's letter: Berkshire had "benefitted greatly—to a degree that is not generally well-understood—because our liabilities have cost us very little." Buffett said a company's profitability is determined by three factors: "1. What its assets earn; 2. What its liabilities cost; and 3. Its utilization of 'leverage'." Berkshire did a good job earning high returns on assets, but its liabilities also contributed to its outsized success. Not only did float provide leverage to enhance Berkshire's return on equity, it came at a negative cost and was therefore profitable.

The hardships of the prior decades gave Berkshire a complete understanding of how to maximize the value of an insurance operation. The secret was as obvious and simple as it was difficult: discipline. Berkshire's

insurers possessed a culture that prized profitability over volume, and this paid off handsomely.

Table 6.36: Reconciliation of shareholders' equity, 1965–2004

($ millions)	1965–74	1975–84	1985–94	1995–04	1965–04
Beginning of period shareholders' equity	$22	$88	$1,272	$11,875	$22
Net income - operations	57	366	2,869	19,344	22,636
Net income - realized gains	7	199	1,354	14,096	15,657
Unrealized appreciation of investments	0	486	5,877	15,000	21,363
Mergers/divestitures	0	133	433	25,085	25,651
Dividends/treasury stock	(3)	0	69	0	66
Issuance of Class-B stock	0	0	0	565	565
Other/misc.	4	0	0	(65)	(60)
End of period shareholders' equity	$88	$1,272	$11,875	$85,900	$85,900
Change in equity during period	$66	$1,184	$10,602	$74,026	$85,877

Note: Figures may not add due to rounding.

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

Table 6.37: Contribution toward change in equity during period

	1965–74	1975–84	1985–94	1995–04	1965–04
Net income - operations	86%	31%	27%	26%	26%
Net income - realized gains	11%	17%	13%	19%	18%
Unrealized appreciation of investments	0%	41%	55%	20%	25%
Mergers/divestitures	0%	11%	4%	34%	30%
Dividends/treasury stock	(4%)	0%	1%	0%	0%
Issuance of Class-B stock	0%	0%	0%	1%	1%
Other/misc.	7%	0%	0%	(0%)	(0%)
Total	100%	100%	100%	100%	100%

Note: Figures may not add due to rounding.

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

Comparing the sources of Berkshire's shareholders' equity growth between decades we see that some sources changed little while others changed significantly. Net income from operations contributed about the same as it had in the prior two decades. Realized gains are also about the same

proportion as in prior decades. Unrealized appreciation, however, had noticeably decreased.

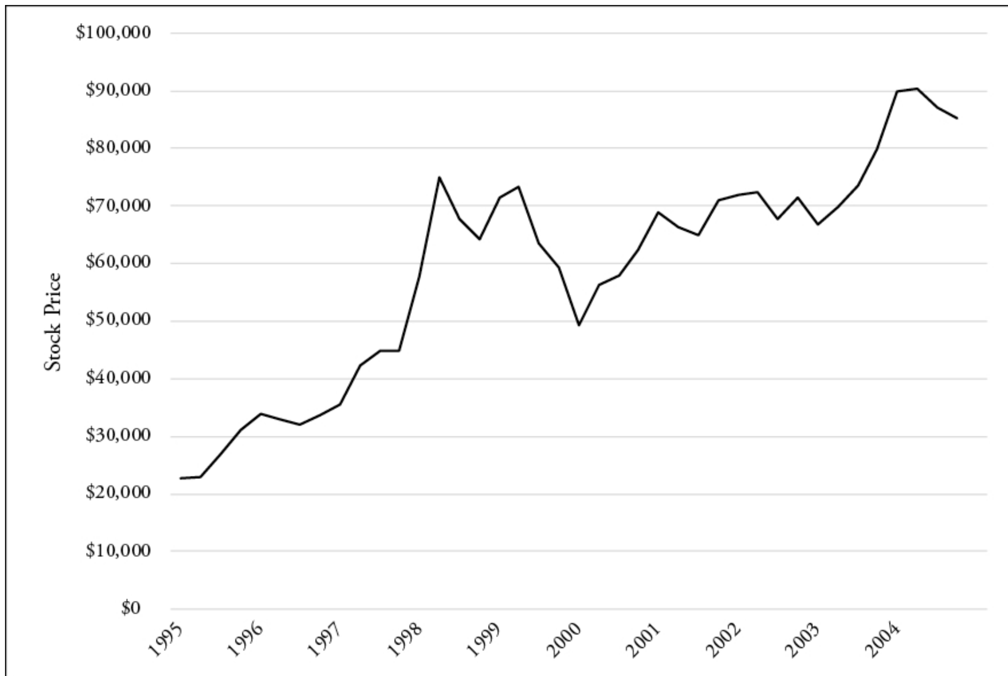
The big standout is in mergers/divestitures. During the ten years ending in 2004, Berkshire made numerous acquisitions in both the non-insurance and insurance fields. By far the largest was General Reinsurance, with $22 billion of shares issued in connection with the merger. Numerous other acquisitions completed in whole or in part with shares, as well as the SQUARZ notes, comprised the $3 billion balance. In total about one-third of the increase in Berkshire's net worth could be chalked up to shares issued.

All sources of equity considered, Berkshire increased its overall net worth by $74 billion during the 1995–04 decade—a 623% increase. However, as Buffett frequently pointed out, the increase in overall net worth was not the real measure of success. The most important concern for shareholders was the change in per-share value. The increase in net worth translated into an annual rate of change of 21.9%. However, adjusting for the increase in shares outstanding the per-share rate of book value change was 18.7% per annum.

Berkshire's stock price increased at an even slower (but by no means unsatisfactory) rate. A shareholder holding on at the average price between the fourth quarter 1994 and 2004 would have earned 15.6%. This three percentage point per annum deficit is explained by Berkshire's price-to-book value decline over the ten years. [448] While we cannot know for sure the reason for the decline in price/book, it wasn't interest rates. (The 10-year Treasury declined yet again, from 7.8% in December 1994 to 4.2% in December 2004.) The more likely reason was reversion to a proper range of valuation guided by Berkshire's communications.

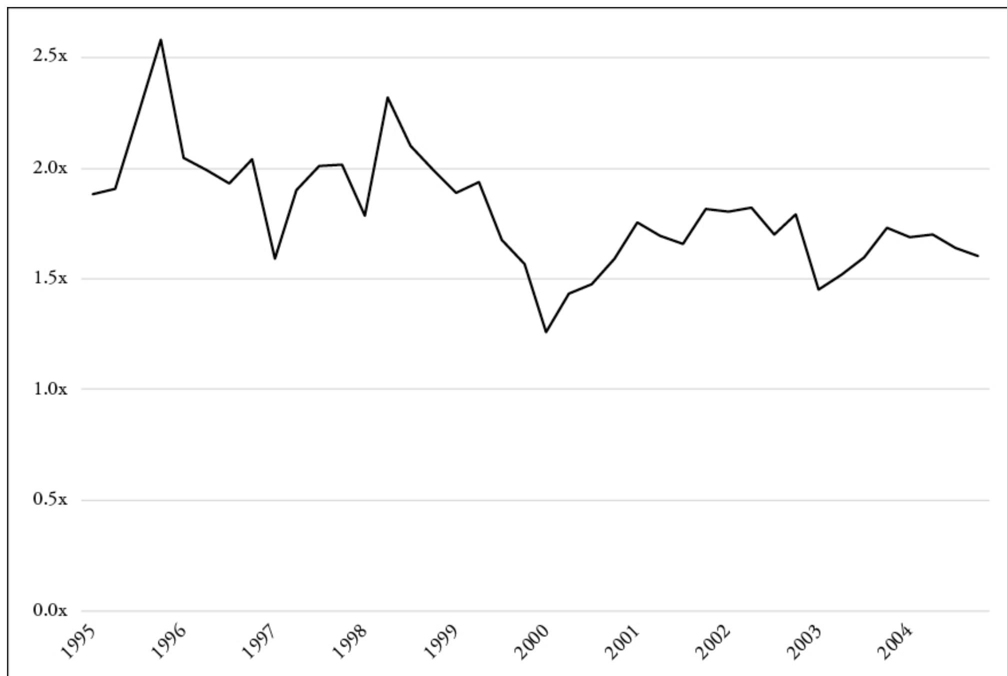
Berkshire's market capitalization rose from an average of $24 billion at year-end 1994 to over $130 billion in 2004. Berkshire found itself fourteenth on *Fortune Magazine* 's 500 largest company's list.

Figure 6.1: Berksire Hathaway stock price, 1995–2004



Sources: *Of Permanent Value* (Kilpatrick, 2015), Berkshire Hathaway Annual Reports 1995–2004, and author's calculations.

Figure 6.2: Berkshire Hathaway price-to-book ratio, 1995–2004



Sources: *Of Permanent Value* (Kilpatrick, 2015), Berkshire Hathaway Annual Reports 1995–2004, and author's calculations.

Berkshire went on a spending spree during the decade. The additional capital from float (which increased from an average of $3 billion at year-end 1994 to $45 billion at year-end 2004) and profits from existing operating businesses fueled the expansion.

Berkshire made two very important insurance investments and a host of non-insurance investments. In 1996, it paid $2.3 billion to acquire the half of GEICO it did not already own, and in 1998 it made the largest acquisition in its history with the $22 billion purchase of General Re. Both became catalysts for future growth in profits and float, though Gen Re went through some very difficult times to earn its worth.

Berkshire created mini powerhouses in jewelry and furniture retailing. It purchased jewelers Helzberg and Ben Bridge, and acquired furniture retailers RC Willey, Star Furniture, and Jordan's Furniture. In each case, Buffett allowed their managers complete autonomy to operate independently post- acquisition.

Berkshire also shunned the tech boom and doubled down on decidedly low-tech but proven cash-generating businesses important to everyday life. Some were household names; others were important to the workings of the economy but largely unknown to the average consumer. Berkshire

welcomed Justin Industries, Benjamin Moore, Shaw Industries, MiTek, Albecca (Larson-Juhl), CTB, Garan, The Pampered Chef, Clayton Homes, and McLane. In addition, three new operating subsidiaries, Johns Manville, Fruit of the Loom, and International Dairy Queen, came to Berkshire after stumbling on their own.

Berkshire's capital allocation strategy was subtly beginning to shift with the acquisition of a majority economic interest in MidAmerican. Finding it difficult to deploy capital into either wholly-owned business or part-ownership interests in common stocks, Berkshire found an outlet for some of its cash in highly stable though capital-intensive utility businesses. Returns from these investments would not come close to the potential of other, non-regulated businesses. But their relative certainty, coupled with the ability to put large incremental sums of capital to work, represented a logical outlet for Berkshire's excess cash.

Opportunities to put Berkshire's cash to work could not come fast enough to keep it from piling up at headquarters. Even with the large volume of acquisitions during this period Berkshire ended the decade with $40 billion of readily investible cash. [449] Compounding the problem was the relative scarcity of good opportunities in marketable securities, Berkshire's next go-to area of capital allocation.

Some opportunities had presented themselves. In 1994, Berkshire's balance sheet listed $15.2 billion of equity securities and another $2.4 billion in bonds. [450] Ten years later at the end of 2004, the balance sheet had $37.7 billion in equities, $22.8 billion in bonds, and $2.3 billion of other investments.

Viewing Berkshire's equity portfolio on a point-to-point basis (below), we see remarkably little change. Five of its investments at year-end 1994 remained over the ten-year period: American Express, Coca-Cola, Gillette, Washington Post and Wells Fargo. In addition, one investment at year-end 1994, GEICO, turned into a wholly-owned subsidiary.

The net $3.5 billion of additional investment in the equity portfolio during the decade is somewhat misleading since the portfolio did generate substantial capital gains. Berkshire sold or otherwise disposed of its investment in Salomon/Travelers, Capital Cities ABC/Walt Disney, and McDonalds, among others.

In the minds of Buffett and Munger, the equity portfolio was largely a category of less-than-100%-owned businesses to complement their wholly-owned subsidiaries. They would not have minded if the stock market did not give them quoted values for their holdings at all. All they wanted was to increase their holdings at favorable prices. At year-end 1994, Berkshire's investment in American Express, Coca-Cola, Gillette, and Wells Fargo represented 57% of the entire portfolio. Fast forward ten years and those same four represented 65% of the portfolio. Two, Coke and Gillette, went untouched during the period while Berkshire added to its holdings in American Express, and to a lesser extent Wells Fargo.

Table 6.38: Berkshire Hathaway—equity portfolio, select detail

	2004		1994		Change	
($ millions)	Cost	Market	Cost	Market	Cost	Market
American Express	$1,470	$8,546	$724	$819	$746	$7,727
The Coca-Cola Company	1,299	8,328	1,299	5,150	0	3,178
The Gillette Company	600	4,299	600	1,797	0	2,502
Wells Fargo & Company	463	3,508	424	985	39	2,523
Washington Post	11	1,698	10	419	1	1,279
All other	5,213	11,338	2,526	6,066	2,687	5,272
Total equity securities	$9,056	$37,717	$5,583	$15,236	$3,473	$22,481

Sources: Berkshire Hathaway Annual Reports 1994, 2004; and author's calculations.

Berkshire's balance sheet remained fortress-like. Its $189 billion of 2004 year-end assets were financed by $86 billion of equity and just $3.5 billion of true debt. The balance sheet was funded with other real liabilities, but these were of a different nature. The largest were the insurance-related liabilities including losses and loss adjustment expenses, and unearned premiums. In all, these insurance liabilities amounted to $59 billion. Berkshire also had a $12 billion year-end deferred tax liability that provided capital to fund assets. While very much a real liability, deferred tax liabilities were payable only if/when Berkshire sold its appreciated investments or stopped investing in capital expenditures in excess of its depreciation costs.

The last category of liabilities, amounting to $20 billion, were the Finance and Financial Products liabilities. These liabilities included borrowings to

finance Clayton Homes' mortgage portfolio, Scott Fetzer's finance arm, and other bank-like activities. Considering that the $20 billion of liabilities were backed by $30 billion of assets (including $3.4 billion in cash), this Berkshire mini bank was very conservatively financed. The $9.7 billion of equity attributable to Finance and Financial Products was akin to a 32% capital ratio—far in excess of anything seen in a typical bank.

As the decade progressed, Berkshire became less concentrated in insurance (see Table 6.39). Not only was Berkshire moving more into non-insurance operations but as we've seen the many businesses it acquired over the preceding decade were very diverse.

Table 6.39: Relative size of Berkshire's insurance subsidiaries

($ millions)	2004	1994
Insurance assets	$114,759	$18,494
Percentage of total BRK assets	61%	87%
Pre-tax underwriting profit	$1,551	$130
Pre-tax net investment income	$2,824	$419
Pre-tax income from non-insurance	$3,302	$333
Year-end float	$46,094	$3,057

Sources: Berkshire Hathaway Annual Reports 1994, 2004; and author's calculations.

The shift away from the concentration in insurance was a natural consequence of Berkshire's growth, and the non-insurance businesses reinforced the insurance businesses. Berkshire was well poised to take on huge insurance risks others could not or would not take on themselves because it had a growing and diverse stream of non-insurance earnings. The insurance companies were strong on their own, but to have assets and earnings streams not tied to insurance gave Berkshire confidence to expand into the reinsurance field when opportunities arose. Neither the economics of the business (the ability to take the lumpiness as it came), nor the accounting, were impediments.

The little debt that Berkshire incurred during this time was structured in Berkshire's favor and done cheaply. In 1996, it issued a $500 million convertible issue. Berkshire also issued the first negative interest rate security with its $400 million SQUARZ issue in 2002. Other debt was incurred in the Finance and Financial Products area to support the FINOVA/Berkadia transaction and Clayton Homes' lending activities, and

to fund certain arbitrage situations managed by Buffett. Otherwise, very little debt was used at Berkshire by design. The one exception was MidAmerican. Being a utility, MidAmerican had the stability of earnings to borrow appropriately. Importantly, this debt was not guaranteed by Berkshire.

There were more than a few instances of share issuances during the decade. The largest was the $22 billion issued in connection with the General Reinsurance acquisition. Numerous other acquisitions during the decade, including Helzberg, RC Willey, Flight Safety, Executive Jet (NetJets) and Dairy Queen, had all or some Berkshire sto ck involved.

The issuance of the Class-B shares brought $565 million of net proceeds to Berkshire not tied to any acquisition. Increasing Berkshire's share count by about 1% it prevented investors from being duped by a stock promotor that sought to cash in on Berkshire's well-earned reputation. But it was otherwise, in Munger's words, a non-event. What would have been a real event was if any of the attempts to create unit trusts using Berkshire stock had been successful. That would have harmed the reputation of Berkshire and Buffett, as investment returns would necessarily have lagged Berkshire's underlying business results.

Berkshire was well-positioned to enter a fifth decade under Buffett's control. It had $40 billion of cash to work with, additional cash coming in from diverse streams, and reasonable expectations of additional capital via growth in float. It faced real challenges, to be sure, including its massive size, earning it the number fourteen spot on the Fortune 500. Its size would prevent it from earning the types of returns it had in the past. But Berkshire would have plenty of opportunities in future years to grow into a conglomerate in a class of its own.

Forty years in, Buffett and his longtime business partner, Charlie Munger, acted as if they were just getting started.

Lessons: 1995–2004

1. A well-structured liability like insurance float can be just as valuable as equity. Under the right conditions (such as within Berkshire's Insurance Group where profits were placed ahead of growth), float acted more like equity. Better yet, it did not dilute existing shareholders' equity and could grow without additional capital

investment. Just as important is the acknowledgement that others recognized the value of float and competed vigorously (sometimes irrationally) for premium volume, which drove down pricing.

2. There are many ways to earn a satisfactory return on investment. Focusing on just one number can be misleading. A great extreme example is McLane. With its 1% pre-tax margin on revenues, McLane might not seem like a good business. Yet with extremely high capital turnover, that slim margin turns into a much larger (and satisfactory) return on capital. An opposite example is FlightSafety. With low capital turnover, its hefty near-30% pre-tax margin turns into a lower-but-still-good return on capital. (Better is See's, which had a 20%+ profit margin and low capital requirements but little opportunity for reinvestment. Nirvana was Coke with the ability to reinvest at very high rates of return.)
3. Economics is more important than accounting. Berkshire accepted different types of insurance business that greatly impacted its financial statements. Since Berkshire was focused on long-term profitability, it ignored (but communicated to shareholders) the accounting treatment which made the business look much worse than it was.Berkshire did not have stock options of its own, but Buffett wrote about the pernicious effects of their accounting. "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?"
4. Thinking through basic economics is important (and profitable). The internet craze that took the world by storm tricked many, but not Berkshire's managers. They correctly considered the implications of the internet and concluded the exact opposite of many participants: that competition would negate most advantages offered by technology, and that some costs simply could not be eliminated due to the internet (grocery sales, for example, still required delivery vehicles). The internet would change the world, but in the early 2000s profits were still elusive and many investors ultimately lost money. It would take another decade for the industry to mature and develop into an investment landscape capable of attracting the attention of serious value investors.

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 6.40: Berkshire Hathaway—select parent-level financial information

Table 6.41: Reconciliation of shareholders' equity

Table 6.42: Berkshire Hathaway Insurance Group balance sheets, 1994–2000

Table 6.43: Berkshire Hathaway Insurance Group income statements, 1994–2000

Table 6.44: Berkshire Hathaway Insurance Group key ratios and figures, 1994–2000

Table 6.45: Berkshire Hathaway—insurance underwriting detail

Table 6.46: Berkshire Hathaway—insurance underwriting overview

Table 6.47: Berkshire Hathaway Insurance Group float, select data and information

Year-end Float (in $ millions)

Year	GEICO	General Reins.	Other Reins.	Other Primary	Total	Avg. Float	Float Cost
1994						3,057	(4.3%)
1995						3,607	(0.6%)
1996						6,702	(3.3%)
1997	2,917	n/a	4,014	455	7,386	7,093	(6.5%)
1998	3,125	14,909	4,305	415	22,754	15,070	(1.8%)
1999	3,444	15,166	6,285	403	25,298	24,026	5.8%
2000	3,943	15,525	7,805	598	27,871	26,585	6.1%
2001	4,251	19,310	11,262	685	35,508	31,690	12.8%
2002	4,678	22,207	13,396	943	41,224	38,366	1.1%
2003	5,287	23,654	13,948	1,331	44,220	42,722	(4.0%)
2004	5,960	23,120	15,278	1,736	46,094	45,157	(3.4%)

Year-end Float Growth %

Year	GEICO	General Reins.	Other Reins.	Other Primary	Total	Avg. Float
1994						16.5%
1995						18.0%
1996						85.8%
1997						5.8%
1998	7.1%	n/a	7.2%	(8.8%)	208.1%	112.5%
1999	10.2%	1.7%	46.0%	(2.9%)	11.2%	59.4%
2000	14.5%	2.4%	24.2%	48.4%	10.2%	10.6%
2001	7.8%	24.4%	44.3%	14.5%	27.4%	19.2%
2002	10.0%	15.0%	18.9%	37.7%	16.1%	21.1%
2003	13.0%	6.5%	4.1%	41.1%	7.3%	11.4%
2004	12.7%	(2.3%)	9.5%	30.4%	4.2%	5.7%

Year-end Float % Total Float

Year	GEICO	General Reins.	Other Reins.	Other Primary	Total
1994					
1995					
1996					
1997	39.5%	n/a	54.3%	6.2%	100.0%
1998	13.7%	65.5%	18.9%	1.8%	100.0%
1999	13.6%	59.9%	24.8%	1.6%	100.0%
2000	14.1%	55.7%	28.0%	2.1%	100.0%
2001	12.0%	54.4%	31.7%	1.9%	100.0%
2002	11.3%	53.9%	32.5%	2.3%	100.0%
2003	12.0%	53.5%	31.5%	3.0%	100.0%
2004	12.9%	50.2%	33.1%	3.8%	100.0%

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 6.48: Berkshire Hathaway property and casualty loss development

Table 6.49: Manufacturing, Publishing, and Retailing businesses—balance sheets, 1994–2000

Table 6.50: Manufacturing, Publishing, and Retailing businesses—income statements, 1994–2000

Table 6.51: Manufacturing, Publishing, and Retailing businesses—ratios and key figures, 1994–2000

Table 6.52: Manufacturing, Service, and Retailing Operations—balance sheets, 2003–2004

Table 6.53: Manufacturing, Service, and Retailing Operations—income statements, 2002–2004

Table 6.54: Manufacturing, Service, and Retailing Operations—ratios and key figures, 2003–2004

Table 6.55: Finance Businesses—balance sheets, 1994–2000

Table 6.56: Finance Businesses—income statements, 1994–2000

Table 6.57: Finance Businesses—ratios, 1994–2000

Table 6.58: Non-operating activities—balance sheets, 1994–2000

Table 6.59: Non-operating activities—income statements, 1994–2000

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303 The headline increase in net worth was 45%. That return was diluted by the issuance of shares.
304 Just to be sure the reader is clear, cost-free float means, at worst, a breakeven underwriting result over time.
305 Buffett stated at the 1996 Annual Meeting that GEICO’s float was almost certain to grow.
306 Buffett said he and Munger would always attempt to explain to shareholders any major points.
307 While equity capital was not disclosed specifically for See’s, we know from the footnotes that it had $69.4 million of beginning identifiable assets and, though not detailed, a large remaining balance of goodwill was included in those assets.
308 If the issue were non-cumulative preferred USAir would not have been required to make the missed payments.
309 As strong as Berkshire was, it was never as risk free as the US government, which could print money.

310 If a company gets bigger by investing in projects that earn less than their cost of capital, they destroy value. Even though a company's cost of equity capital is impossible to precisely define, projects earning a rate below an investor's discount rate mean the company is not increasing value for that investor. The discount rate incorporates the benchmark set by the risk-free rate and a margin capturing risk. A higher discount rate means future cash flows are not worth as much in the present, and vice versa. Growth factors into the equation by offsetting the effect of discounting (assuming such growth does not destroy value).

311 As a check on this valuation exercise we can also impute the earnings yield the $1.5 billion of look-through earnings provides on a roughly $33 billion above valuation. The result of approximately 4.5% would imply a 5.5% growth rate (assuming a 10% discount rate), which would not be out of line with Berkshire's growth rates at the time, especially considering the value inherent in the recent GEICO acquisition.

312 In his 1996 Chairman's letter, Buffett said he offered $75 million for the company; Charlie Munger's comments in his Wesco letter put the figure at about $80 million.

313 Wesco, 1997 Chairman's letter, p. 4–5.

314 For consistency with other years the GAAP combined ratio is used going forward. The relative stability of premiums written and earned means the GAAP and SAP ratios would be very close.

315 GAAP basis.

316 The word "voluntary" is important. These were the policies GEICO sought out and which formed the basis for its superior profitability. Involuntary policies, by contrast, came from "risk pools" that every participating company was forced to take part of to insure those that could not find insurance but whose state laws required them to be insured.

317 As a reminder, these figures are the non-GAAP results published at the back of the Annual Report and exclude purchase price adjustments and amortization of goodwill, etc.

318 Invested capital (debt + equity) for the MPR businesses increased 46% between 1995 and 1996. FlightSafety employed about $450 million in capital at year-end 1995.

319 In Buffett's 1996 Chairman's letter, he wrote that there was an overpayment risk in virtually all stocks.

320 Unless otherwise noted, all references to per share figures are on an A-share equivalent basis.

321 Like cutting a pizza into additional slices, stock splits increase the number of shares outstanding without affecting the underlying value of a business. In other words, it's largely cosmetic.

322 Without giving advice on the matter, Buffett had previously told shareholders of a way to set up a family corporation that could own the stock, and whose own shares could then be gifted to children, etc.

323 Such a unit trust was not illegal nor was Berkshire's permission required. While some may have sought this scheme as a way to effectively split the stock for convenience, others were doubtless attracted by the possibility of profit.

324 Using data from the table of identifiable assets in the Annual Report. We are ignoring goodwill for simplicity.

325 A business like FlightSafety could reinvest its own profits, and if it needed more, Berkshire's conglomerate structure allowed profits from a business like See's with little reinvestment opportunities to be transferred easily and without tax consequences.

326 While we cannot be certain there weren't other tuck-in acquisitions during the year, the notes to the financial statements disclose "common stock issued in connection with acquisition of business" of $73 million. This figure probably would not have been inappropriate for Star.

327 Those electing cash would receive $27 per share, where those electing stock were offered $26 per share.

328 Buffett made it clear the sale of McDonalds stock wasn't connected to Berkshire's purchase of

IDQ.

329 For the non-sports types, batting averages are expressed as a three-decimal number. A 1.000 average would mean a perfect batter. A 0.400 was the more realistic ideal hit only rarely in baseball history. A 0.350 hitter was a very good hitter, while a 0.380 hitter could be described as great.

330 Coke split its shares 2:1 in May 1996.

331 For those technically-minded readers, Berkshire's 1996 issue of exchangeable notes (a preferred issue convertible into shares of Salomon that Berkshire held) remained after the transaction. The ratio of shares exchangeable was revised to reflect the Salomon-to-Travelers share price. Additionally, Berkshire was required to book against unrealized investment gains a charge reflecting the excess of the value of Travelers stock over the accreted value of the Notes, since the Exchange Notes had more value in exchange owing to the appreciation of the underlying stock. At year-end 1997 this contingent value, the amount charged against unrealized appreciation, amounted to $342.6 million.

332 A simple example might illustrate the effect of such above-book-value issuances of shares. If I sold you a silver dollar containing $1.50 worth of silver metal for $1.50, I would show a 50% increase in book value (the $1.50 you gave me compared to the $1 face value of the coin). Yet, I would not have gained anything in value since the coin I originally possessed had the same $1.50 value. Berkshire's shares were the silver dollar in the preceding example and the transaction merely shed light on the underlying value exchange.

333 Continuing the silver dollar example, the proper valuation for the $1 silver dollar worth $1.50 was 1.5:1. If it were exchanged for $1.50 then the valuation would clearly drop to 1:1 even though no actual diminution of intrinsic value would have occurred.

334 Assuming 1998 pre-tax operating earnings equal to those of 1997, the estimated value/book ratio would increase to 1.45x. With the addition of General Re at year-end 1998, Buffett told readers of his Chairman's letter that he had intentionally omitted the look-through earnings segment. "Neither a historical nor a pro-forma calculation of a 1998 number seems relevant."

335 Here is a more robust description of General Re, taken from the 1998 Berkshire Hathaway Annual Report: "In addition, General Re writes excess and surplus lines insurance through General Star Management Company, provides alternative risk solutions through Genesis Underwriting Management Company, provides reinsurance brokerage services through Herbert Clough, Inc., manages aviation insurance risks through United States Aviation Underwriters, Inc., and acts as a business development consultant and reinsurance intermediary through Ardent Risk Services, Inc. General Re also operates as a dealer in the swap and derivatives market through General Re Financial Products Corporation, and provides specialized investment services to the insurance industry through General Re-New England Asset Management, Inc."

336 Both men were skeptical of the reasons many managements gave for pursuing acquisitions. Acquisitions often relied on projected savings or other efficiencies that usually failed to materialize. In this case, there were real benefits that could be realized by combining the two companies.

337 General Re, 1997 Annual Report.

338 According to the notes to Berkshire's financial statements.

339 Using a price/book multiple of 1.75x (a multiple in-line with our previous estimates of value) applied to Berkshire's pre-merger June 30, 1998 book value results in approximately the same valuation used here.

340 Warren Buffett comment at 1999 Berkshire Hathaway Annual Meeting.

341 Alice Schroeder and Gregory Lapin, "The Ultimate Conglomerate Discount," research study by PaineWebber, January 1999.

342 Buffett noted at the 1999 Annual Meeting that the Fortune 500 was valued by the market at around $10 trillion yet earned just $334 billion. Doing the math this equated to an earnings yield of 3.34%. On the basis of a P/E ratio, this was a multiple of thirty times.

343 Only three of Scott Fetzer's many businesses were mentioned in relation to its results, Kirby, Campbell Hausfeld, and World Book. Campbell Hausfeld manufactured air compressors and other related items. Its growth began to overshadow World Book, which continued to struggle with revenues but did generate improved international results according to the footnotes.
344 Usually overnight loans secured by government securities.
345 Accounting now appropriately includes stock options as an expense on the income statement, although it is imperfect.
346 "Remarks by Chairman Arthur Levitt," The Securities and Exchange Commission, September 28, 1998, https://www.sec.gov/news/speech/speecharchive/1998/spch220.txt .
347 Unrealized gains and losses, remember, flowed through book value as a component of equity, after recognizing the effect of taxes on the gain/loss.
348 $290 million on $1.3 billion of premiums.
349 Tad Montross, "The Battlefield," July 16, 2014, http://www.genre.com/knowledge/blog/the-battlefield.html .
350 At year-end 1998, Berkshire had an equity portfolio of $39.8 billion, representing a cost of $10.9 billion and unrealized gains totaling $28.9 billion. At year-end 1999, the portfolio shrunk slightly to $39.5 billion with an unrealized gain of $28.2 billion. But, during the year it also increased its investment to $11.3 billion and realized net gains of $1.4 billion. The net result was a gain of $749 million. Translated into a percentage, this represented a change of just 1.9%.
351 Warren Buffett and Carol Loomis, "Mr. Buffett on the Stock Market," *Fortune* magazine archives, November 22, 1999, http://archive.fortune.com/magazines/fortune/fortune_archive/1999/11/22/269071/index.htm .
352 Buffett used corporate profits as a percentage of GDP as a key data point. In 1999 they were around 6% compared to the historical range of 4% to 6.5%. Buffett thought a 6% return over the coming decade was the most investors could expect; and that was including an expected 2% inflation rate.
353 Buffett and Munger faced continued pressure externally and internally to adapt to the times. Shareholders at prior Annual Meetings had asked why, if they were so smart, couldn't Buffett and Munger figure out internet companies and pick winners. The calls from shareholders were likely amplified by the fact that Berkshire's stock price also took a hit, falling about 50% from a high of about $81,000 in March 1999 to a low of $41,000 by March 2000.
354 Berkshire Hathaway press release, "Berkshire Hathaway, Walter Scott and David Sokol to Acquire MidAmerican Energy Holdings," October 25, 1999, http://www.berkshirehathaway.com/news/oct2599.html .
355 It's important to understand that deregulation was not a uniform definition and was different across markets and energy types (electric vs. gas, etc.). It could also be full or partial. Broadly speaking, it was the energy production market that was deregulated with distribution remaining more tightly controlled.
356 MidAmerican, 1999 Securities and Exchange Commission 10-K filing, March 30, 2000, https://www.sec.gov/Archives/edgar/data/1081316/000108131600000009/0001081316-00-000009.txt .
357 An added feature was the ability to earn a higher return so long as part was shared with customers. For example, if MidAmerican earned a return between 12% and 14%, half of those earnings were required to be returned to customers.
358 Ibid.
359 The Public Utility Holding Company Act of 1935.
360 Readers will remember a similar accounting treatment existed for Berkshire's first insurance investments, Blue Chip Stamps, and The Illinois National Bank.

361 The pre-tax return on capital for 1998 was 10%.
362 “Rival Bidders Face Off Over Cort Furniture,” *Washington Business Journal* , June 21, 1999. https://www.bizjournals.com/washington/stories/1999/06/21/story6.html , accessed 10/28/20 .
363 “Berkshire to Acquire U.S. Investment Corp.,” *Insurance Journal* , April 20, 2000, https://usli.com/about-us and https://www.insurancejournal.com/news/national/2000/04/28/10967.htm .
364 Buffett’s letter cites same store growth of 9%, 11%, 13%, 10%, 12%, 21%, and 7%.
365 Justin Industries, 1999 Annual Report.
366 To be sure, this was a relatively stable period in the United States economically.
367 Carrick Mollenkamp and Devon Spurgeon, “Shaw Industries Got Berkshire As Investor Simply by Asking,” *The Wall Street Journal* , November 20, 2000, https://www.wsj.com/articles/SB974678647739635225 .
368 James R. Hagerty, “Shaw Industries Plans to Acquire Queen Carpet for $470 Million,” *The Wall Street Journal* , August 14, 1998, https://www.wsj.com/articles/SB903043434761383500 .
369 Ibid.
370 Buffett had written unfavorably about managements that always pointed to non-recurring items. Here I’ve added them back as I believe they do in fact skew the true, long-term earnings power of the business.
371 Other clues were that working capital fell 9% to $582 million and investment in fixed assets grew just 19% or about half of the increase in revenues.
372 Johns Manville press release, “Johns Manville Chairman & CEO Jerry Henry Retires; Steve Hochhauser to Become Chairman, President & CEO,” May 11, 2004, https://news.jm.com/press-release/historical-archive/johns-manville-chairman-ceo-jerry-henry-retires-steve-hochhauser-be .
373 Note that these figures are from the 2001 presentation and the underwriting loss is $30 million greater than the original 2000 presentation.
374 Making some generalized assumptions, we can view the economics of the transaction, which is not unlike that of a loan. If Berkshire had use of the $404 million premium for five years and it could pay back the $643 million in year five, it would cost it 10% per year; a ten-year payout would result in a cost of 5% (see Table 6.26). In practice, the timing of payouts could stretch decades, which would affect the cost.
375 Since the losses were incurred in prior years, they are booked as prior year losses and cause apparent unfavorable loss development. It is somewhat counterintuitive to place an asset on the books from the assumption of a liability, but it makes more sense from an economic perspective since it roughly reflects the time value of money inherent in float. In theory, the earnings from the premium received would equal the charge against the deferred charge asset (or perhaps produce a small gain).
376 Twelve-month figure presented for comparability. The 15-month result was a loss of $518 million.
377 Twelve-month figure presented for comparability. The 15-month result was a loss of $80 million.
378 This figure was revised from the $167 million presented in the 2000 financials, which also had the BHRG combined underwriting loss at $175 million. I’ve used the 2001 presentation here.
379 Justin Industries’ footwear business, Justin Brands, was reported under footwear in Other.
380 Justin Industries was likely the main reason for the significant decline since its return on capital was in the low double digits.
381 Total Flight Services depreciation was $90 million, which would leave $20 million as Executive Jets’ depreciation.
382 There are minor discrepancies between these figures, which come from the Chairman’s letter, and those presented in the supplemental statements. Discrepancies exist between the 2000 and 2001 presentations too, which are minor.

383 At the time there were some 17,000 contracts representing over $650 billion of notional value.
384 The companies were moving away from the fee-guaranty business into holding the mortgages. They owned some mortgages before the crisis too.
385 Bethany McLean, "The Fall of Fannie Mae," *Fortune* magazine archive, January 24, 2005, http://archive.fortune.com/magazines/fortune/fortune_archive/2005/01/24/8234040/index.htm .
386 I am assuming that the cash and investments in the Finance Business are required for its operation. Including them and the operating earnings would be double counting. A case could be made to exclude some amount of cash for the operating businesses as well, however, this would probably be small and not worth the effort given our roughly right vs. exactly wrong approach here.
387 The loss was about $193 per share.
388 The years Berkshire's book value change had fallen behind the S&P 500 were: 1967, 1975, 1980, and 1999.
389 Emphasis original.
390 Corporate history book by MiTek, "MiTek: A Global Success Story," MiTek publication, 88.
391 Because MiTek's financial performance was reported alongside another subsidiary its specific results and the economics behind Berkshire's purchase cannot be determined.
392 Buffett wrote that the minimum investment was $100,000, and he said that "many borrowed money so they could participate". There were no options granted.
393 Because of the effects of leverage, the going-in return on equity was closer to 18% pre-tax and 11% after tax.
394 In Alice Schroeders's book, *The Snowball* , she recounts how Buffett was not pleased with Ferguson's performance leading up to this point. Ferguson didn't like the "one foot bars" Buffett and Ajit Jain looked for, instead preferring, apparently, the intellectually tough challenges. Schroeder wrote that Buffett saw what was actually happening was that General Re's customers were dictating terms to General Re, instead of the other way around.
395 The notes to the financial statements in 2001 disclosed that Berkshire anticipated $400 million of deferred charge amortization in 2002. The balance of the unamortized charges grew from $2.6 billion in 2000 to $3.1 billion in 2001.
396 This implied a valuation of $2.55 billion for the entire company and an 11% pre-tax return on the $292 million of pre-tax income.
397 I am using the figure from the 2002 Annual Report here, since it would have been more accurate. The original figure presented in the 2001 Chairman's letter was $600 million.
398 The after-tax, after-minority interest figures are instructive here. In 2001, Berkshire's share, including the interest-income it earned from the preferred stock, totaled $230 million, up from $109 million in 2000. Additionally, on Berkshire's audited income statement only the equity in net earnings of MidAmerican are shown (interest income is shown elsewhere). These figures were $165 million and $105 million for 2001 and 2000, respectively.
399 Buffett told shareholders earlier that the growth in that business was largely due to his activities.
400 Berkshire Hathaway, Securities and Exchange Commission 13f filing, February 14, 2001, https://www.sec.gov/Archives/edgar/data/1067983/000109581101001369/a69281e13f-hr.txt .
401 Ibid.
402 The common shares were completely written off during the third quarter of 2001 due to operating losses.
403 It is important to note that this change was for GAAP purposes. Goodwill remained a tax deduction, typically for up to fifteen years.
404 RC Willey, remember, opened a store outside of Mormon Utah, continuing its closed-on-Sunday policy. This, coupled with the fact that Bill Child insisted on funding the store himself in case it failed, made the investment unusual.

405 The $1.54 billion figure was the amount of underwriting loss Berkshire attributed to the September 11th attacks in the General Re North American segment in 2001. After the $115 million adjustment in reserves in 2002 this net loss from September 11th would have been $1.425 billion.
406 Buffett told the story in his 2002 Chairman's letter of how GEICO once took in $72,000 of premiums for risks "deadbeat reinsurers" ceased paying. This episode had cost GEICO over $90 million so far, including $19 million in 2002 alone. "So much for 'cheap' reinsurance," he wrote.
407 This was about half of the $13.4 billion of year-end float attributable to BHRG.
408 The entity was technically incorporated by the English Parliament in 1871 but functions like a marketplace.
409 There was no cause attributed to the "poor results" of workers' compensation; however, Munger long lamented the issues surrounding that business, especially in California. Claimants would come forward with all types of non-physical and emotional ailments which wreaked havoc on the system.
410 Voluntary policies-in-force grew 9.6%. This included a 7% increase in the preferred segment and a 17.4% increase in the non-preferred segment.
411 The Q2 2002 Berkshire quarterly report indicates the cash purchase price was $730 million. It's possible this lower figure incorporates one or both of the assumed liabilities and working capital adjustments.
412 The purchase agreement stipulated a net working capital figure of $540 million. In addition Fruit of the Loom as of its 2000 10K filing had $277 million of net fixed assets (this assumes Berkshire acquired the majority of the company's fixed assets).
413 This is a very rough approximation. One source (Kilpatrick, 2015) states that Buffett indicated the company might earn $130 million to $140 million pre-tax. This would equate to a 15% pre-tax return and is consistent with returns on capital in the mid-1990s under Holland's direction.
414 As a reminder, Berkshire stopped reporting separate financial statements for the Manufacturing, Service, and Retailing businesses in 2001. The reporting began again in 2003.
415 Berkshire's after-tax operating earnings (before investment gains but including investment income, corporate interest expense, purchase-price adjustments, and other) rose to $3.9 billion from a loss of $47 million in 2001.
416 "Buffett Praises Amazon, Then Buys Its Debt," *Chicago Tribune* , Greg Wiles, Bloomberg News, April 12, 2003. https://www.chicagotribune.com/news/ct-xpm-2003-04-12-0304120174-story.html accessed 10/29/20 .
417 "Enron Fast Facts," CNN, updated April 24, 2020, https://www.cnn.com/2013/07/02/us/enron-fast-facts/index.html .
418 The footnotes to the 2002 Annual Report estimated that if all of the counterparties to General Re's derivative book defaulted, the loss to Berkshire would be roughly $4.9 billion.
419 The holder could also elect the equivalent number of B shares, or 3.3480.
420 This practice continues but generally ebbs and flows with the markets' and regulators' scrutiny.
421 Buffett's letter pointed to the fact that the equity portfolio (including preferred stocks) had fallen from 114% of Berkshire's net worth in the 1980s to 50% in 2000–2003.
422 The present value was $250 million. Though details are not known on the premium BHRG received, a similar contest a few years prior for Grab.com purportedly was a 10-to-1 premium for 100-to-1 odds (*The Snowball* , p. 689).
423 The $400 million figure comes from the 2002 Annual Report. Unamortized deferred charges were $2.8 billion at year-end 2003.
424 One cannot help but think that the issues plaguing the manufactured home industry during this time was but a small precursor to the main event that was the housing crisis later in the decade.
425 This term is used broadly to include longer-term receivables and notes such as the mortgages

Clayton held on its customers' homes.
426 Clayton incented its dealers to make good loans (requiring adequate down payments and checking repayment capacity) by charging any losses to that dealer. It forced long-term thinking. Such long-term thinking was in the customers' best interest as well.
427 The notes to the financial statements disclose that McLane's 2002 revenues and pre-tax earnings were $21.9 billion and $220 million, respectively.
428 I have attempted to recreate this table for 2003 and 2004 using data from the Annual Report for continuity of the table at the beginning of the chapter.
429 I have attempted to align the analysis in this book with Buffett's clues as to the most intelligible way of viewing Berkshire, while at the same time bringing certain interesting or important topics to the attention of the reader.
430 At the 2004 Annual Meeting, Buffett noted Berkshire's $130 billion market cap and how it wasn't "too important to get keen insights into some business making a relatively small amount of money…you have to look at them in aggregate."
431 Outstanding contracts shrunk to 7,580 among 453 counterparties.
432 The FINOVA-related debt was entirely repaid in February 2004.
433 Goodwill and intangibles totaled $8.35 billion.
434 Cost basis is the original cost of an investment. The cost basis of an investment changes when shares are purchased or sold, or in other cases such as a return of capital from the company. Usually the basis for tax purposes and financial reporting purposes is the same, but they can differ.
435 Monte Enbysk, "Alumna revives her Microsoft passion at Save the Children," Microsoft Alumni Network, March 22, 2012, https://www.microsoftalumni.com/s/1769/19/interior.aspx?sid=1769&gid=2&pgid=252&cid=1773&ecid=1773&crid=0&calpgid=466&calcid=1401 .
436 National Indemnity's expense ratio topped 41% in 1999, up from 25.9% in 1986.
437 The larger preferred segment grew 8.8% and the non-preferred grew 21.6%, according to the footnotes to the financial statements.
438 Underwriting expenses ticked up slightly from 17.7% to 17.8% of earned premiums.
439 Primary insurers, not wanting to go uncovered, often had what amounted to auto-renewing policies. If a loss event triggered a claim, the insurer would have to buy coverage for subsequent catastrophes to protect itself.
440 U.S. real GDP growth was 3.8% in 2004 according to the St. Louis Federal Reserve (FRED).
441 The footnotes to the 2004 financial statements disclose that Berkshire issued $1.6 billion in notes in 2004 and an additional $3.75 billion of notes in January 2005 to finance the Clayton portfolio.
442 In response to the Enron fiasco, accounting rules were changed to require the consolidation of Variable Interest Entities, or VIEs. Enron had abused the prior accounting which allowed it to hide significant risks off balance sheet.
443 About a decade later, your author committed an investing mistake related to a zinc-recovery investment, proving that the study of history is not a sure antidote to making foolish decisions.
444 Susanne Sclafane, "Former White Mountains' Chair, GEICO Rescuer Byrne Passes Away," *Insurance Journal* , March 11, 2013, https://www.insurancejournal.com/news/national/2013/03/11/284185.htm .
445 Buffett calculated the dollar-weighted purchase date as being July 1992.
446 Notional value, or the underlying asset in a derivative trade.
447 Buffett used the analogy of a large farm in which pieces were being sold off to fund consumption. The technical term for this is current account deficit, which should not be confused with a budget deficit.
448 One can see how much worse the result would have been for shareholders of the foiled Berkshire unit trust who would have bought in at a higher price and faced frictional costs along the way.

449 I'm only including the Insurance and Other category. The cash held within Finance and Financial Products was debt-funded. I'm assuming cash held at other operating entities was needed for operations.
450 Included in the bond category are $1.8 billion of fixed maturity securities and the Salomon, Inc. convertible preferred of $580.6 million.