The Essays of Warren Buffett: Lessons for Corporate America Study Guide

The Essays of Warren Buffett: Lessons for Corporate America by Warren Buffett

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Plot Summary

The Essays of Warren Buffett: Lessons for Corporate America, published in 1997, is compiled by Lawrence A. Cunningham from the Essays of Warren Buffett. The editor prepares this collection of Buffett essays as the core of a symposium and standard text for his course in business practices. The original conference is attended by Warren Buffett and Charlie Munger, the Chairman and Vice-Chairman respectively of Berkshire Hathaway Inc., which is a $70 billion enterprise based on the investment principles of Ben Graham. This work is the non-fiction story of Berkshire Hathaway and significant steps along its development to the multi-billion dollar global holding company it is today.

Berkshire Hathaway begins in the early 1800s as a textile plant. Warren Buffett and Charlie Munger develop the company by the late 1990s as a holding company that owns insurance and other leading business interests, although not textiles. The $70 billion enterprise they control includes GEICO and General Re Corporation, two of the largest US and world insurance companies, many manufacturing and distribution companies in consumer products and services, candy, ice cream, training, general aviation, and electric and gas power generating fractional interests. Substantial equity interest is owned in American Express, Coca-Cola, Gillette, and Wells Fargo.

Cunningham selects and compiles Warren Buffett's writings that illustrate his modest, self-effacing gracious and considerate manner as a successful billion-dollar manager. Together with his partner Charlie Munger they build Berkshire from humble roots as a textile company to the $70 billion dollar holding company in Omaha, Nebraska, Buffett's hometown. Berkshire today donates almost $200 million to four thousand charities. Buffett is generous to his operating managers, making sure that Berkshire pays them enough for their performance to be active investors in the companies. In over sixty-three years of profitable investing, Buffett disproves many Wall Street investment theories and high-flying fads.

The highly structured format and appearance belies the delightful reading content. A formal layout presents a well-defined roadmap of a Buffet theory of business acquisition and development. The Table of Contents lists subjects covered, such as "Corporate Finance and Investing" and "Accounting and Valuation." Chapter subsection titles add a touch of humor, like "Cigar Butts and the Institutional Imperative" and "Aesop and Inefficient Bush Theory." The challenging content of Buffett's essays is easy to read. Difficult ideas appear Zen-like in simple form. Their understanding comes like a flash in a memorable verbal wrapper. Buffett's homespun quips are delightful to read and their quiet wisdom shows in the many anecdotes he shares.

Introduction and Prologue

Introduction and Prologue Summary and Analysis

Cunningham selects and compiles Warren Buffett's writings that illustrate his modest, self-effacing, gracious, and considerate manner as a successful billion-dollar manager. Together with his partner, Charlie Munger, they build Berkshire from humble roots as a textile company to the $70 billion dollar holding company in Omaha, Nebraska, Buffett's hometown. Lawrence A. Cunningham compiles the essays and writes the Introduction to "The Essays of Warren Buffett: Lessons for Corporate America." Content of this book is the core of a symposium and standard text for Cunningham's course in business practices at Cardozo School of Law and other law and business schools. The original conference is attended by Warren Buffett and Charlie Munger. They are both available in the front row to answer questions from the other attendees. Warren Buffett and Charlie Munger are Chairman and Vice-Chairman respectively of Berkshire Hathaway Inc. Following the principles of teachers Ben Graham and David Dodd, Warren Buffet acquires Berkshire in 1964 with a book value per share of $19.46 that he increases to $40,000 per share thirty years later. The book value in 1964 far overstates Berkshire's intrinsic value then and a $40,000 value now much farther understates its current intrinsic value.

Berkshire Hathaway begins in the early 1800s as a textile company. The company is developed by the late 1990s as a holding company that owns insurance and other leading business interests but excludes textiles. The $70 billion enterprise Buffet and Munger control include GEICO and General Re Corporation, two of the largest US and world insurance companies, many manufacturing and distribution companies in consumer products and services, candy, ice cream, training, general aviation, and electric and gas power generating fractional interests. Substantial equity interest is owned in American Express, Coca-Cola, Gillette, and Wells Fargo. Berkshire invests in firms with excellent economic prospects and outstanding managers. Buffett and Munger prefer buying 100% interest in a company at a fair price. They consider a lesser interest if the pro-rata price is less than what it would be for 100%. This method is a "double-barreled approach" that increases Berkshire's per share marketable portfolio securities from $4 in 1965 to $50,000 by 2000.

Warren Buffett manages by "owner-related business principles." He deems Berkshire a partnership with himself, Munger, and other shareholders. Buffett's long-term economic goal is to maximize per share intrinsic value of Berkshire stock by owning a diversified group of businesses that generate cash and above-average returns. His wealth is solely in Berkshire stock. He retains or reinvests earnings based on its proportional increase per share market value over time. Buffett does not expand, borrow, or sell unless Berkshire receives as much value as it gives. These principles are organizing themes of his essays and writings on management, investment, finance, and accounting. Buffett relies on the teachings of Ben Graham. He authorizes Cunningham to use these essays to popularize Graham's ideas and his own implementation of Graham's teaching.

Cunningham provides a succinct summary of the chapter contents in the remaining pages of this Introduction and Prologue. Essays are from annual reports that Buffett prepares and writes for Berkshire shareholders. Warren Buffett is proud of the fact that 98% of the shares outstanding at the end of each year are held by the same shareholders as at the beginning. Buffet writes annual reports with the same degree of consistency, accuracy, and reporting he expects from the managers of firms that report to him. Buffett compares Berkshire shareholders to patrons of a restaurant. He prefers owners who like consistent service, regular menu choices, and are happy to return for more of the same at Berkshire.

Corporate Governance

Corporate Governance Summary and Analysis

Buffet claims many annual meetings as a waste time for both shareholders and management. Managers may be unwilling to discuss substantive business issues and stockholders may be more interested in stating personal concerns than company ideas. Berkshire meetings are conducted like the business forum Buffet and Munger believe is valuable to inform business owners about the year's business growth and development. To reach that goal, Buffett conducts an open-ended meeting. Any and all questions can be asked and are answered by them except for investment strategies that may cost the company money.

Fourteen owner-related business principles are listed that Buffett uses to guide Berkshire business operations and shareholder meetings. Berkshire is a public corporation, but Buffett and Munger see themselves as general partners responsible to other shareholders as long-term owner-partners. The corporation is a mechanism by which fellow partners own Berkshire assets. Most Berkshire directors have their net worth invested primarily in the company. Long-term economic goal is to maximize per-share average annual rate of gain at 15% of intrinsic business value. This goal is reached by direct, preferably 100% ownership of diverse business firms generating cash and consistent above-average returns on capital. Alternatively, lesser percentage ownership may be acquired when the market presents opportunities. This two-prong method of business ownership and consolidated earnings report requirements may cloud the clarity of Berkshire economic performance. Buffet and Munger promise to provide sufficient additional information to evaluate true results. Confusing accounting requirements are offset by their willingness to report "look-through earnings" apart from Berkshire's earnings and capital gains. Some other principles Buffett and Munger follow are minimal use of debt and leverage, only acquiring firms that support increased per-share intrinsic value, wise use of retained earnings and reluctance to issue stock or divest any Berkshire business interest. Other principles include using candor reporting results fully and finally, making no comment on prospective investment ideas.

Buffett and Munger are committed to provide full and fair, simultaneous reporting to all 300,000 shareholder/partners. They expect the same full and fair disclosure from each of the company CEOs that report to them. Chairman and Vice-Chairman both oppose any "selective disclosure" and predictive growth rates from the CEOs who report to them. Buffett claims any CEO who sets earnings targets and forecasts may also take risks with accounting measures to merely "make the numbers" that they predict.

The Board is responsible for CEO performance. Unlike a secretary whose performance is readily evaluated, the typical underperforming CEO can be carried indefinitely. A CEO has no direct supervisor or clear standards of performance. Board members and a CEO may be colleagues and criticism at board meetings inappropriate. Buffett lists three different, yet typical board situations. The first situation has no corporate controlling

shareholder to whom board members report. A concerned director must convince other board members or report to an absentee owner. Berkshire's Board is the second situation with a controlling owner/manager. Other board members may use persuasion to effect change. If results are unsatisfactory they may object or resign. The third situation is the controlling owner who does not manage. Buffett considers this style most effective for management. First case board members can only change by consensus and second case board members may not get an owner/manager to resign. Third case owner may listen to objections of a board member about company management. Berkshire will evolve into a third form at Buffett's death. His widow or foundation is an interested, non-management owner to whom the Board reports. Buffett and Munger give company CEOs a mandate to run the company like they own it as the only asset he will ever have and cannot sell it for fifty years. Buffett claims most Berkshire shareholders own Berkshire shares for life.

Buffett is the general partner of Buffett Partnership, Ltd. when he acquires Berkshire Hathaway, a textile business in 1964. The business premise is that non-union, southern textile plants have a competitive advantage and Berkshire can be run much better by a long-time employee/manager. Initially, Berkshire throws off sufficient cash for Buffett to acquire an insurance business, National Indemnity Company. Berkshire is moderately profitable until 1979, when it begins consuming cash through 1985. Despite best efforts of Buffett and company management, they close the textile business. Buffett comes to the conclusion economic returns are more a result of the boat you get in than how well you row it. He decides he can better use his energy changing vessels than patching leaks.

Half of all major American companies match charitable donations of directors. Buffett decides Berkshire owners should pick contribution matches. Over 95% of shareholders agree. Almost two million dollars are distributed to 675 charities by designation. Buffett credits Charlie Munger, Vice Chairman and managing partner with this idea. Aggregate giving reaches 4,000 charities and almost $200 million by early 2000s. Buffett analyzes executive performance by separating retained earnings income from CEO profits earned on capital available to him. Buffett comments on management stock options that relate to overall corporate performance. Options should be granted only to managers with overall firm responsibility. Options must be priced and structured realistically on true business value not bargain priced to a company insider. Buffett discourages options in favor of cash incentive programs with unlimited bonus amounts for performance. Berkshire pays CEOs enough cash for performance to buy stock at market price without stock options. Buffett compliments the cash incentive program of H.H. Brown Shoe Co. Key managers are paid nominal wage plus a percentage of profits net of capital costs. Buffett claims, "Managers eager to bet heavily on their abilities usually have plenty of ability to bet on."

Corporate Finance and Investing

Corporate Finance and Investing Summary and Analysis

Buffett's purchase of Washington Post Company in 1973 is an example of Ben Graham's investing principles. Security analysts and Buffet estimate company's intrinsic business value between $400 and $500 million. Washington's stock market value is $100 million. Ironically, the popular acquisition theory in mid-1970s relies on stock market value and ignores intrinsic business value. Key principles of Graham's that Buffett practices is to buy good businesses when the market discounts underlying business value. Popular theory is that the market is totally efficient at pricing investment. Buffett buys Washington Post's $400 million intrinsic business value for its market efficient price of $100 million.

Buffett and Munger buy public companies on the stock market like they buy private companies. They consider economic prospects of the business, its management, and its asking price like business analysts. An active trading market provides a flow of business opportunities to evaluate. Ben Graham's teaching personifies the market with the name "Mr. Market." Buffett lists the traits Graham identifies. Mr. Market is a business partner with incurable emotional problems. He appears daily to buy or sell, on some happy days at high prices and on other sad days at low prices like any manic-depressive personality. Mr. Market can be foolish, foolhardy, or just be fooling buyers and sellers. Buffett keeps this image in mind to avoid distraction by analysis and pricing trends. Buffet and Munger invest based on company operating results not price quotes. Berkshire's principle to buy and hold investments for the long term is comfortable for them. Buffett comments on paradoxical stock buyers happy with rising prices when they should prefer lower prices to buy more stock. Most Berkshire shareholders remain owners throughout the year.

Some Berkshire insurance subsidiaries use arbitrage with its greater returns than Treasury Bills for short-term cash equivalents. Arbitrage is speculating to take advantage of price differences between markets. The term and meaning evolves after World War I into "risk arbitrage" or pursuit of profits from anticipated events. Elements in arbitrage include its likelihood, length of time money is committed, the chance a competing event occurs, and unexpected external action. For example, Buffett recalls Arcata-KKR arbitrage in 1982 that, despite deal-killing delays, pays a satisfactory $24.6 million, 15% return and $19.3 million more in 1987. Arbitrage is useful for excess cash when Buffett likes the odds.

Buffett criticizes "efficient market theory" or EMT that his experiences with Graham, the Buffet Partnership, and Berkshire supports. He claims because the market is frequently efficient does not make it always efficient. Over sixty-three years experience successfully profiting from pricing differences between markets, Buffett concludes that the evidence he sees disputes the efficient market theory. Buffett compares the CEO's

views of his operating business portfolio and investment portfolio. A CEO unlikely to dispose of his successful operating business may sell profitable stock investments to redeploy capital. For example, Buffett notes $40 invested in Coca-Cola in 1919 grows to $3,277 by 1938, but a new $40 invested then grows to $25,000 by 1993. Specifically, a concentrated portfolio of winning stocks may have lower risk when defined as "possible loss or injury" rather than "beta" of stock volatility defined by academics. With either 100% or partial interest firms, Buffett and Munger do not check Mr. Market's manic-depressive daily price quotes to validate their investment. Many stocks have a beta, like Coke, but none have the same market share.

Buffett and Munger maintain three primary Berkshire holdings as permanent. They are Capital Cities/ABC, Inc., GEICO, and the Washington Post, in addition to See's and Buffalo Evening News that they do not intend to sell no matter the price. Berkshire's principals follow John Maynard Keynes' 1934 opinion "that the right method in investment is to put fairly large sums into enterprises which one thinks one knows something about and in the management of which one thoroughly believes." Buffett makes little distinction between buying a controlled business or marketable holding. The goal in either case is to acquire outstanding firms at a sensible price with high-grade, talented, and likeable managers in place. Buffett claims a controlled company has twin benefits of capital allocation and tax advantages. In some cases, the benefits of partial ownership earnings may far outweigh the per-share acquisition cost. Buffett notes the term "value investing" is redundant since investing is a process of seeking value to justify the amount paid. Investment growth is a component of Buffett's value investing as well. Berkshire investment is unlike the either or choice of value or growth presented by investment professionals. An investor should acquire the best business defined as the one that employs large amounts of incremental capital at high rates of return over an extended period. Buffett insists any stock purchase have a "margin of safety" considered by Graham the cornerstone of investment success.

An irony of Buffett and Munger's intelligent investing is that "inactivity" is intelligent behavior. They prefer to monitor management as an investment strategy. In a long-term environment competitive, advantage develops with strong operations ten or twenty years in the future. For example, Coke's founder designs a blueprint in 1896 for the following hundred years that current management still uses. Buffett calls Coke and other firms like Gillette "The Inevitables." Buffett advises private investors to consider an index fund or, alternatively, a portfolio of partial interests in understandable, strong earnings firms for the next ten years at a rational price. He concludes by advising "cigar butt investing" is not the approach to use. A cigar butt found on the street may be cheap, but the one puff left in the bargain purchase is foolish unless one is in the business of liquidating.

Alternatives to Common Stock

Alternatives to Common Stock Summary and Analysis

Berkshire Hathaway's insurance companies maintain three permanent common stock holdings and several marketable securities selected from five categories. In addition to short-term arbitrage, Buffett can select short-term cash equivalents, medium-term fixed income and long-term fixed income securities and long-term common stock investments. His criteria measures mathematical expectations of highest after-tax returns to maximize net worth in the long run. Buffett claims "lethargy bordering on sloth" as an investment style. For example, they make no purchases or sales of stock in five of Berkshire's six major investments in the last year. Wells Fargo is a major holding they increase in 1989 and 1990 to almost 10%. Buffett dislikes banking because of its leverage. However, Wells Fargo is exceptionally well-managed and $290 million purchase price is less than five times after-tax and three times pre-tax earnings. Despite investment quality, Buffett fears falling real estate values with earthquakes and overbuilding in California. Business contraction or financial panic may cause system-wide danger to leveraged firms. Buffett dismisses risk with his notion falling stock prices present an opportunity to buy stock.

Berkshire adds RJR Nabisco bond holdings in 1989 to total $440 million by 1990's year end. Below-investment-grade bonds, traditionally called "fallen angels" but transformed into "junk bonds" and an industry by Michael Milken in the 1980s are a rare investment consideration for Berkshire. Buffett relies on the words of Ben Graham when facing the sales assurances that large amounts of debt make operating managers more focused like daggers on a steering wheel make drivers more careful. Buffett replies with Graham's margin of safety. Fallen angels begin as angels, which are high-grade bonds issued by good credits that fall on bad times. Their degenerate cousins, however, begin as junk and get worse with higher rates. The academic thought promoted by sales pitches is that junk bonds produce higher net returns than a portfolio of high-grade bonds. The underlying premise is that "new" junk and fallen angels with similar rating pay as well but junk pays more. A missing piece, perhaps overlooked by Wall Street for revenues' sake, is that the angel is fallen from investment quality with the possibility of return but junk has nowhere else to go. Buffett's RJR Nabisco bonds are fallen and classed as "junk" but prove to be "angels" with a market value increase over purchase price of $150 million at writing date.

Buffett promotes Berkshire's zero-coupon bonds for many of the same reasons they are a challenging investment to buy. Zero-coupon bonds are familiar as the widely-sold Series E US Savings Bond issues during World War II. Typically, a Series E bond is purchased for $18.75 to mature in 10 years at $25.00. If a bondholder cashes a Series E bond early, interest is paid to date at 2.9%. Similarly, Berkshire issues $902.6 million in principal to be paid at maturity. These zero-coupon bonds do not pay current interest but the investor pays $4,431.40 to receive $10,000 in 15 years. Berkshire receives $400 million without interest payments for 15 years when $902.6 million is paid. The investor

earns interest at 5.5% with tax due and Berkshire deducts interest with no cash paid out. Features include convertibility into stock by the investor and early retirement of principal by Berkshire.

Like Wall Street's aberration of fallen angels into junk, zeros do not escape schemes of promoters and investment bankers. A bond is debt with regular payment of interest and repayment of principal. However, a zero is a bond that may not require interest payments from the issuer, but if required can be satisfied with "pay-in-kind" bonds, according to Buffett. Furthermore, the promoter can claim that an issuer who does not promise to pay for a long time does not risk default for a long time. If interest is paid by pay-in-kind bonds, principal too can be paid in kind by refinancing. Buffett cites author Galbraith's new economic term, the "bezzle" or the amount of undiscovered embezzlement. Magic of the bezzle is an embezzler gets richer but a victim doesn't feel poorer. Buffett notes Galbraith's satire is miniscule compared to the real-world zero-coupon bond nonsense.

Preferred stock is considered with management that Buffett and Munger like, admire, and trust. Firms whose management fit requirements include Salomon, Gillette, USAir, and Champion. Berkshire reaches satisfactory preferred returns if common stock performs well. The business premise is that preferred firms must pay returns above fixed-income investments and be compatible with management. Buffett admits mistakes with USAir from superficial, erroneous analysis of difficult industry conditions and a recent merger. Value comes from a fixed-income feature to set minimum value with conversion a bonus. Gillette is outstanding since $600 million invested appreciates to $4.8 billion.

Alternative investments are considered for short-term high quality investments when a preferable business investment cannot be located. At year-end in late 1990s, Berkshire has three non-traditional investments in oil derivative contracts, 111.2 million ounces in silver, and $4.6 billion in zero-coupon U.S. Treasury obligations. Buffett and Munger have 99% and 90% respectively of their net worth concentrated in Berkshire stock.

Common Stock

Common Stock Summary and Analysis

Two super-contagious diseases of fear and greed regularly occur in the investment community. Since one or the other appears without warning, Buffett tries to be fearful when others are greedy and greedy when others are fearful. Stocks cannot outperform business indefinitely because earnings on stock investments are reduced by the amount of transaction and investment management costs. Berkshire shares are about to be traded on the New York Stock Exchange (NYSE) in 1988. The Exchange rules newly-listed firms have at least 2,000 shareholders who own 100 shares. Berkshire is allowed an exception for number of shareholders holding 100 shares to a ten-share round lot rule. The value of ten Berkshire shares exceeds the 100-share value of any other listed stock. An NYSE listing is expected to have no effect on their policy of consistent selling in a narrow range around intrinsic business value. The NYSE listing is expected to reduce transaction costs for shareholders by ensuring a narrow market-maker spread. Henderson Brothers, Inc. is the oldest continuing specialist and represents Berkshire shares. Buffet wants to narrow differences between bid and asked prices on the NYSE not maximize share price. Buffett prefers trading a narrow range around intrinsic business value to favor long-term owners.

Buffett makes distinctions in dividend policy to account for differences in earnings. Some earnings, e.g., from inflation, should be restricted from consideration for dividend distribution to ensure adequate equity. The unrestricted earnings portion can be retained or distributed depending on what makes sense for the business owners. Buffett proposes a principle that earnings should be retained to the extent each retained dollar creates at least one dollar of market value for owners. Owners are expected to conclude retained earnings are better left in the corporation for reinvestment at a higher rate than paid out as dividends for investment by owners at a lower rate. This approach is similar to earnings distribution decisions between subsidiary and parent company management. A company may consider repurchasing shares when it has available funds beyond near-term needs of the business and its stock sells below intrinsic value on the market. Buffett recognizes many companies may repurchase their own shares to increase or support a flagging stock price despite disservice to continuing stockholders. Management of other companies may respond to requests to promote repurchase to encourage a price increase or retard price decreases. Buffett and Munger promise as a matter of policy to never repurchase shares unless they are selling at a market price well below intrinsic business value.

Buffett and Munger are often asked to split stock under the assumption it can benefit shareholders. They disagree with this concept because it violates their core principle to sell stock at a price that is rational relative to its intrinsic business value. Berkshire management goal is to acquire and retain high-quality shareholders. Buffett and Munger are committed to present a consistent business and ownership philosophy. They want to attract investors who understand their operations, attitudes, and expectations. They

believe investors should pay attention to business results, not market prices. A stock split may attract investors unlike the current investor group that may downgrade their quality. Buffett and Munger believe "marketability and liquidity" terms promote high turnover that conflicts with their preference for stable market activity. For example, a $1,300 price after a stock split is easier for brokers to sell. In 1992, Berkshire's per-share stock price increases past $10,000. Buffett advises three tax-free gifting tactics to shareholders that include married couple gifting, bargain sale and partnership form. In 1995 and 1996, Buffett and Munger recapitalize Berkshire into Class A and B non-voting shares to offer a lower trading price that does not affect intrinsic business value. One Class A share is convertible at holders' option to 30 Class B shares. Their main goal is to combat the Berkshire investment clones that disappoint small investors using the Graham approach.

Mergers and Acquisitions

Mergers and Acquisitions Summary and Analysis

Buffett compares the exhilarating process he and Charlie follow to acquire a business like looking for a spouse. They are active, interested, and open-minded but unhurried. Buffett retells the princess that kissed a frog fairy tale and remembers younger days kissing toads that croak. A golf pro tells him "practice makes permanent," so he changes from buying fair business at good prices to buying good business at fair prices. Buffett and Munger consider buying 100% ownership or marketable securities representing partial ownership, but any new investment must use large amounts of capital. Their goal maximizes real economic benefits, not number of enterprises. Two business categories are of major interest. The first is firms adapted to inflationary times that can readily increase prices and scale up to larger volume with minimal new capital infusion. The second is firms that have extraordinary management talent exhibiting skillful executive achievement.

The question of an exchange of stock arises with a 1983 merger between Berkshire and Blue Chip. Buffett follows a simple rule that the same amount of intrinsic business value must be exchanged with each stock transaction. The seller has no difficulty determining how much cash or stock is acceptable in the transaction. Similarly, if the buyer's stock sells in the market at full intrinsic value, there is no difficulty. However, if the buyer's stock sells at less than intrinsic value, he buys with undervalued currency and suffers an unequal exchange. Three excuses are often given by an overpaying buyer, to include the target company will be worth more in the future, the buyer must grow, and buyer's stock is undervalued but as little as possible is being used. Buffett avoids diluting share value to existing shareholders by true value for value merger, using stock as inflated currency and by repurchasing the same number of shares as in the merger. Buffett admits issuing stock in mergers cost stockholders money. Berkshire is too well developed and managed to add intrinsic business value with new acquisitions paid for with common stock.

Buffett states clearly his position that any stock repurchase does not imply acceptance of "greenmail," which he calls extortion. Since successful business acquisition is difficult, Buffett suggests the popularity of leveraged buyouts (LBO) results from associated tax benefits, leverage, selling off business parts, and cost reduction than improved business viability. LBO operators benefit from the use of debt to reshuffle business, risk little of their own money to gain high fees, and share in business gains. Buffett and Munger do not operate from a strategic plan of acquisition but compare opportunities against passive investments. Berkshire looks for six features in acquisition opportunities that include at least $50 million pre-tax earnings, consistent earnings power, good returns on equity with little debt, management in place, simple businesses and an offering price from the seller. All acquisition considerations are confidential, friendly, and generally for cash. Berkshire offers advantages to sellers of keeping the business operating as it is

by current successful management, doing what they promise, paying in cash and offering value for value trade.

Accounting and Valuation

Accounting and Valuation Summary and Analysis

Berkshire shareholders can be assured that the company financial statements are accurate. Buffett and Munger have most of their own money in Berkshire, run the business so all stockholders gain proportionately and are producing satisfactory results. Consequently, many take Buffett and Munger presentations on faith, but some others are analytical and like accounting notes. Buffett begins his comments with a six-point satire by his mentor Ben Graham. US Steel takes fictional accounting actions that show absurd accounting manipulations to let it undersell all competition to dominate the industry. The first step charges off fixed assets value to negative one million dollars so the company can convert depreciation cost to annual appreciation gain. Common Stock Par Value is reduced to one cent. Option warrants are used to pay salaries and wages, which eliminates payroll with increased employee compensation. Warrants exercised for a penny par add $49.99 to credit Capital Surplus. Annual cash outgo for wages is reversed by accounting for cash inflow from warrants. Finally, inventory is carried at $1 value to minimize any loss from accounting adjustments in addition to other satirical accounting action.

Buffett comments in a serous manner on reporting income of one company that owns another, called "look-through earnings." Percentage of voting stock owned is the criteria used to include earnings from holdings. Generally, earnings are reported when classified by a company as more than 50% owned, 20 to 50% owned and under 20% owned. Reporting is specified by "generally accepted accounting principles." Buffett adapts Berkshire reports with "look-through" results to show the effectiveness of earnings use rather than ownership percentage. For example, the Berkshire dividend share of Coca-Cola's 1990 retained operating earnings is $250 million. Coke could pay Berkshire dividends less $30 million taxes to net $220 million. Berkshire has both dividend and non-dividend earnings portions on its Coke investment. Berkshire reports a net $220 million plus non-dividend operating earnings of $371 million to total 1990 "look-through earnings" of $590 million.

Buffett makes a distinction between economic goodwill and accounting goodwill. He admits to thinking the difference was insignificant thirty-five years earlier when he sought firms with tangible assets rather than firms relying on economic goodwill. He and Charlie now believe Berkshire has substantial economic good will that far exceeds its book value. For example, accounting for the purchase of a business requires allocating the purchase price first to the fair value of net assets and then any remaining amount to the "excess of cost over equity in net assets acquired" or "goodwill." This accounting goodwill is amortized to zero by a regular annual amount over an acceptable term. However, a purchased firm may have economic goodwill that increases in value over time by the amount of inflation and successful operating results. Accounting goodwill is charged off financial statements against earnings according to "generally accepted accounting principles" (GAAP). Economic goodwill is not amortized but may grow in

value that GAAP does not require be disclosed on financial statements. For example, GEICO purchase accounting requires a $40 million annual charge against earnings be disclosed on financial statements while its economic goodwill increases substantially more but need not be disclosed.

The financial statements of Company O and Company N are presented to demonstrate the difference accounting from different points of view makes. Buffett takes the position that the "owner earnings" approach Berkshire uses better reflects more accurate figures than formal GAAP reporting. Use of the term "cash flow" is meaningless in manufacturing, retail, and utility firm accounting. Buffett and Munger claim accounting is the starting point of investment evaluation and analysis that can aid but not replace business thinking. Buffett points out inconsistencies in GAAP accounting. Partially-owned firms are carried in Berkshire net worth at their underlying business value but earnings are not shown in the income statement. Fully-owned firm earnings are shown in the Berkshire income account but carried at purchased book value regardless of the increased value since then. Buffett and Munger define business value by focusing on future earning power of both.

Intrinsic value is the critical concept Buffett uses for comparative analysis. He defines intrinsic value as "the discounted value of the cash that can be taken out of a business during its remaining life." Buffett acknowledges its calculation is not as simple as its definition. An estimate can be derived, but not a precise value. Berkshire's per-share book value from $19.46 in 1964 to $15,180 in 1996 provides a tracking measure between the two periods that can show the difference between book and intrinsic value. The 1964 value overstates Berkshire intrinsic value because the textile business is sub-profitable and the 1996 value far understates Berkshire intrinsic value. The Berkshire businesses are carried at book value according to GAAP which is much less than the businesses are worth at intrinsic value. Over time Berkshire's intrinsic value increases significantly but its per-share market price changes little. Stock price over and under performs businesses that provide unusual benefits to trading participants whether they be sellers or buyers. Buffett distinguishes between investment and speculation. Speculation focuses on what the next buyer will pay rather than what the asset produces. As a result, the promoters of bubble companies take as their goal making money off investors rather than for investors.

Accounting Policy and Tax Matters

Accounting Policy and Tax Matters Summary and Analysis

Despite Buffett's frustration with GAAP, he recognizes the purpose of accounting data is valuable to his own and Munger's decision-making. Information that must be reported helps an investor determine how much a company is worth, the likelihood of a company meeting future obligations, and how well managers are doing. Buffett notes several issues related to handling business transactions from an accounting viewpoint. A purchase and pooling transaction are different in that pooling allows only stock be paid compared to a purchase in which cash or stock and cash or other valuable consideration may be paid. Buffett agrees amortization is spurious compared to depreciation charges for deteriorating assets, inventory obsolescence, unpaid debt charge-offs, and warranty accruals. Pooling overcomes deficiency of goodwill amortization in a merger, which is really a purchase.

Many executives argue the costs of stock options should be ignored because they are hard to value or may harm smaller firms. Options are not cash outlays but should be estimated and recorded. Options are often re-priced at exercise which makes them more expensive than publicly-traded options. Non-transferability does not make them less costly to the employer. The underlying question of options is one of definition. If options are not compensation, what are they? If they are not expense, what are they? If options are not calculated through earnings, then how are they determined? CEOs committed to specific forecasts may think manipulating earnings, e.g., "earnings management" is expected by Wall Street to encourage the highest stock price available. Berkshire's consolidated statements meet outside requirements. Management recognizes they are not adequate compared to segment data that enables control of business. Buffett and Munger provide additional supplemental information to measure business value and performance. Major business activities grouped together aid analysis by providing data in a form more useful.

Buffett comments on many other issues that corporations must address. Businesses must recognize present-value liability for post-retirement health benefits. Open-ended health care promises threaten global competitiveness of major American industries. Accounting rules allow cash-basis accounting for these costs, which is reckless. Main tax changes that affect Berkshire relate to whether the business or the customer pays any increase or benefits from any decrease in tax regulation. The determination depends on the franchise strength and business regulation. In Berkshire's case with a strong franchise, the benefits of tax reduction are retained by Berkshire. Berkshire pays $390 million federal income tax in 1993 in addition to more than $400 million foreign tax by investee firms to total approximately ½ of 1% of total taxes paid by all American corporations. Buffet and Munger consider the taxes Berkshire pays to be acceptable for the benefits they receive. Tax-paying investors can realize more from single investment

compounding internally at given rate than from succession of investments compounding from the same rate. The tax code makes 80% ownership more profitable than a smaller share compared to marketable security For example, earnings from a controlled corporation is up-streamed to Berkshire with no additional income tax liability compared to dividends paid from partial interest that are subject to income tax liability.

Characters

Warren Buffett

Warren Buffett is the Chairman of Berkshire Hathaway and author of the essays compiled by Lawrence Cunningham in this book. Buffett's essays comprise the core content for a symposium and the standard text for Cunningham and other instructors' course in business practices. Warren Buffet begins his professional investing career with Ben Graham and David Dodd at Graham-Newman. Buffett is the general partner of Buffett Partnership, Ltd, the partnership that he uses to acquire Berkshire in 1964 when it is a non-union southern textile plant he thinks has a competitive advantage in the industry. Buffett considers Ben Graham his mentor, and his personal goal is the implementation of Graham's value investing model.

Warren Buffett's writing shows him to be a modest, self-effacing, gracious, and considerate successful billion-dollar manager. Warren and his partner Charlie Munger together build Berkshire from its humble roots as a textile company into the $70 plus billion dollar holding company headquartered in Omaha, Buffett's hometown. The company they developed today donates almost $200 million to four thousand charities. Buffett is generous to his operating managers, making sure that Berkshire pays them enough for their performance to be active investors in the companies. In more than sixty-three years of profitable investing, Buffett learns to dispute many academic and Wall Street investment fads like efficient market theory, junk bond investing, and LBO strategies. Buffett sets the tone for investing that follows Keynes idea to invest large sums in business enterprises that he knows about and management he believes in. Among their Berkshire Hathaway acquisitions are GEICO, Coca-Cola, Wells Fargo Bank, General Re, and others. Buffett considers the over three hundred thousand shareholders as partners to whom they are responsible to report.

Warren Buffett writes the annual report to shareholders that many of these essays abstract or consolidate. He conducts open-ended meetings to invite participation by the shareholders, and he or Charlie remains available to answer all appropriate questions. Ninety-nine percent of Buffett's net worth is invested in Berkshire shares and Warren remains deeply involved and committed to daily business of the corporation that he considers a "cushy" job. His wife is Susan; either she or a family foundation will own his Berkshire stock at death. Warren Buffett's job will be performed by two successor executives. One will handle investments and the other will manage operations. Both will report to the Board of Directors that are responsible to the controlling stockholder.

Charlie Munger

Charlie Munger is the Vice-Chairman of Berkshire Hathaway and the general partner with Buffet in their business operations. Throughout the essays Buffett refers to "Charlie" perhaps as alter ego, personal friend, adviser, and continuing business partner

of years. Charlie and Warren run Berkshire Hathaway together. They seem to think and act in lockstep, according to Buffett's writing. Charlie Munger remains available with Buffett to answer any questions from the initial symposium audience and regularly with the shareholders at their annual meeting. They are both committed to providing shareholders of Berkshire with full and fair disclosure and expect the same from CEOs that report to them. Investment decisions are made jointly by Buffett and Munger acting together, and there is no significant evidence presented that they do not agree in all matters. Warren Buffett compliments Munger on devising the shareholder designated contribution scheme as another of his good ideas.

Charlie seems to be about the same age as Buffett, so survival of the corporation is a question. Although Buffet's survivor plan is defined, Charlie's is not. Conceivably, the two-executive approach detailed by Buffett is the partnership plan they currently use while both are alive. Specifically, Charlie may be the operations executive and Warren the investment executive. The Munger family has ninety percent of its net worth in Berkshire shares as well. However, there is no successor plan outlined with Charlie and a question arises as to his death prior to or after Warren's. The close personal and business affiliation they seem to share may be problematic in the event of either's death or incapacity.

Berkshire Hathaway Shareholders

Berkshire Hathaway Shareholders are the owners of Berkshire Hathaway along with Buffett and Munger. There are over 300,000 shareholders to whom Buffett and Munger both express responsibility to report fully, fairly and simultaneously. Buffett is particularly proud of this group of shareholders because they regularly retain ownership of 98% of the total shares outstanding. There are not more than 2% of the total shares turned over, or sold to new stockholders in a year. Buffett compares his Berkshire stockholders to restaurant patrons who return regularly to dine at their favorite restaurant. These shareholders are provided the opportunity by Buffet and Munger to ask and receive an answer to almost any question they have about company business at the annual meeting. The Principals consider Berkshire shareholders to be partners just like each other. The corporation is the vehicle Buffet and Munger manage that holds their Berkshire assets. Buffett's long-term economic goal on a per-share basis is to maximize their average annual rate of gain at 15% of intrinsic business value. Buffett and Munger use fourteen owner-related business principles to guide Berkshire operations and shareholder meetings. Most Berkshire shareholders plan to retain their ownership for life.

Berkshire Hathaway Company Managers

Berkshire Hathaway Company Managers are the subsidiary company managers of Berkshire Hathaway. Most company CEOs are independently wealthy and work for Berkshire because they enjoy working. Principals expect operating managers to report on a full, fair, and simultaneous basis like they report to stockholders. Buffett

discourages CEOs from setting earnings targets and forecasts to avoid risky accounting measures to merely "make the numbers" they predict. Buffett opposes options in favor of cash incentive programs that offer unlimited bonus amounts for performance. Berkshire pays CEOs enough cash for performance to buy stock at market price without stock options.

Ben Graham

Ben Graham is the mentor and teacher of Warren Buffett at the beginning of his professional investing career. Ben Graham is an instructor at Columbia Business School in the 1950s where Warren Buffett studies as a graduate student. Graham writes "The Intelligent Investor" and many other works on investing. The major concept Graham introduces is distinguishing price and value. Price is the amount one pays, whereas value is what one receives. Prevailing thought at the time he introduces this concept is that price equates to value. Many other concepts are introduced by Graham that include a margin-of-safety principle and Mr. Market. Ben Graham operates Graham-Newman for twenty years using these investment principles with Buffett working for him.

Mr. Market

Mr. Market is the name Ben Graham uses to identify the active trading market of securities and other financial instruments that provides a regular flow of business opportunities. Ben Graham's teaching personifies the market with the name "Mr. Market" and identifies some specific traits. Mr. Market is a business partner who has incurable emotional problems. He appears daily to buy and sell. He sells on happy days at high prices and on depressed days he sells at low prices just like any manic-depressive personality. Mr. Market is a caricature that can be foolish, foolhardy, or can just fool buyers and sellers to counter the efficient market theory of investment pricing that is prevalent at the time.

Michael Milken

Michael Milken is the name of a securities broker who founds the "junk bond" industry in the 1980s. Milken's junk bond enables many LBO transactions to be financed through high risk debt. Milken devises a theory that market prices are efficient with extra payment for volatility, junk bond prices are fair because high interest rates covers the increased risk of loss, and savings and loan associations that diversify junk bond investment enough may get better than average returns.

Ken Galbraith

Ken Galbraith is an economist and author of "The Great Crash." In this book he describes the satirical "bezzle" that is an economic term referring to the amount of

undiscovered embezzlement. The bezzle is magical to the extent an embezzler gets richer while the victim does not feel any poorer.

Arthur Levitt, Jr.

Arthur Levitt, Jr. is a past Chairman of the Securities and Exchange Commission (SEC). Buffett and Munger applaud his efforts to diminish the use and impact of "selective disclosure" by corporations to guide analysts by earnings expectations that favor speculators over investors. Levitt also speaks on the corporate practice of "earnings management" which he tries to eliminate.

Lawrence A. Cunningham

Lawrence A. Cunningham compiles the essays of this book from annual reports of Berkshire Hathaway and organizes the Buffet/Munger symposium. Cunningham edits and publishes this book as a standard text for his course in business practice at Cardozo School of Law and other law and business schools. Cunningham is authorized by Warren Buffett to use these essays to promote Graham's ideas and Buffett's implementation of them.

Objects/Places

Berkshire Hathaway

Berkshire Hathaway is the name of the holding company that Buffet and Munger use as their vehicle to acquire and hold business interests. Berkshire is a public company listed on the New York Stock Exchange (NYSE).

Omaha, Nebraska

Omaha, Nebraska is the hometown of Warren Buffett and home-office of Berkshire Hathaway. Buffett still lives in Omaha.

Efficient Market Theory

Efficient Market Theory (EMT) is the name of a financial theory whose premise is that a market efficiently allocates investment dollars between risk and return. For any degree of risk, the market will price assets to attract the appropriate available amount of investment dollars.

Double-barrel Acquisition

Double-barrel Acquisition is an investment style used by Buffett and Munger to acquire either 100% of a company or less than 100% in stock market purchases.

Intrinsic Value

Intrinsic Value is the name of a business value measure used by Buffett that is defined as the discounted present value of cash that can be taken out of the business over the long run.

Beta

Beta is the name used to measure the amount of variance or volatility that a given security has with respect to the market at large.

Look-through Earnings

Look-through Earnings is an alternative approach to GAAP reporting that measures the investor's economic performance in a partial interest company.

Controlled Business Interest

Controlled business interest is the name used to refer to businesses that are owned totally by another company.

Marketable Securities

Marketable securities business interest is the name used to refer to businesses that are partially owned by another company.

Cigar Butt Investing

Cigar Butt Investing is the name Warren Buffett uses to describe a certain type of investing style. Specifically, a cigar butt found on the street may be cheap but the one puff remaining in the purchase price is foolish. Similarly, a low-priced stock may have some short-term profit, but the long-term performance is disappointing.

Fallen Angels

Fallen angels is the name used to refer to investment grade bonds whose issuing company has fallen on difficult times that impairs its credit rating. RJR Nabisco is a fallen angel that Buffett invests in. The Berkshire investment of $440 million in RJR Nabisco increases by $150 million in the second year-end after purchase.

Margin of Safety

Margin of safety is the name given by Ben Graham to refer to a presumed safety zone, i.e., margin, between the purchase price and value of an investment. The fundamental concept is that a security investment should not be made unless there is sufficient basis to believe the price being paid is substantially lower than the value being delivered.

Junk Bond

Junk bond is the name that refers to non-investment grade debt instruments that are issued by lower quality company credits. Michael Milken is the notorious founder and promoter of the junk bond industry. Junk bonds are often used to finance high-leverage acquisition transactions, e.g., LBO.

Zero-coupon Bonds

Zero-coupon bonds is the name used to refer to investment securities whose regular interest payments are either non-existent, i.e., Series E U.S. Savings Bond, or whose

interest payments, i.e., coupons, may have been separated from the bond, i.e., STRIPS. Buffett issues zeroes for Berkshire but does not advise buying them.

Bezzle

Bezzle is the name given by Peter Galbraith to refer to an ongoing embezzlement that is unknown to the victim because in the short run it does not hurt him. The "magical" name bezzle is used for a scheme that enriches the embezzler without making the victim feel poorer at the time.

Convertible Preferred

Convertible preferred is the name used to refer to a bond security that can be exchanged for common stock at a specific exchange or conversion rate.

GAAP

GAAP is the acronym for "generally accepted accounting principles" that is defined by FASB, which is an acronym for the Financial Accounting Standards Board. Buffett disputes many of the rules and results for their inadequacy in presenting investor-useful information.

Goodwill

Goodwill is the term used by Buffett in two contexts. Accounting goodwill is the premium paid over net allocated value assigned to assets acquired in a purchase transaction. Accounting goodwill is amortized to zero in regular annual charges up to forty years. Economic goodwill is an intangible value from a firm's profitable operations over a period of years. Accounting goodwill is carried on a company's financial statement and is amortized to zero. Economic goodwill is not carried on a company's financial statement and increases in value over time.

Themes

Berkshire Hathaway as Model Manager/Owner

Warren Buffett and Charlie Munger are Chairman and Vice-Chairman respectively of Berkshire Hathaway Inc. Berkshire Hathaway is a southern textile plant in 1964 when Buffett acquires it through his Buffett Partnership, Ltd. Book value of the stock at the time of acquisition is $19.46 per share. Class A stock value at the date of publication is approximately $40,000 per share. Class A stock is convertible into thirty shares of Class B stock. Managing-ownership of Berkshire transforms a marginal textile industry company over thirty-some years ago into a global multiple-industry $70 billion enterprise. Warren Buffett and Charlie Munger are active owner-managers of the holding corporation and maintain responsibility for capital allocation, investments, and executive management relations for the holding and subsidiary companies.

Subsidiary company executives are responsible for the profitable management and operations of their respective businesses. Berkshire Hathaway investments include controlled insurance companies including GEICO and General Re and other controlled companies in manufacturing and distribution, consumer products and services, candy, ice cream, training, and general aviation. Fractional interests are owned in electric and gas power generating firms and substantial equity interest is owned in American Express, Coca-Cola, Gillette and Wells Fargo. Buffett and Munger, Berkshires' managing owners have 99% and 90% respectively of their net worth invested in Berkshire. Subsidiary company CEOs and other executive management are paid competitively with incentives that enable them to purchase Berkshire Hathaway stock on the open market at fair market value without options or other devices that favor insiders over other shareholders.

Buffett and Munger consider the three hundred thousand shareholders to be fellow partners in the Berkshire Hathaway enterprise, which uses a corporate form to hold their equity interest in assets of the endeavor. Buffett's long-term economic goal is to maximize per share intrinsic value of Berkshire stock for the owner-shareholders. General partners, Buffett and Munger, manage the corporation and shareholder meetings using "owner-related business principles." They run the annual meetings like a business forum at which they agree to answer any and all questions put to them about the Berkshire business. The meeting lasts until all appropriate questions are answered to the shareholders satisfaction.

Intrinsic Versus Market Value of Business

A key principle of investing promoted by Graham and religiously practiced by Buffett and Munger is based upon the determination of intrinsic business value. A model of the approach is provided by Berkshire's acquisition of the Washington Post Company in 1973. A distinction is made between market value and intrinsic business value. A

market, whether public like the NYSE or private like an owner's offer, quotes a price for the asset which a seller will sell, i.e., market value. Apart from the market quote of price, however, may be other determinants of value. A prevalent practice during the Washington Post transaction period is reliance on the widely held notion that a public stock market is the most efficient investment pricing mechanism. The public stock market quote of $100 million is determined to be the Washington Post market value.

Based on Graham's theory and Buffett's calculation, the Washington Post Company has an intrinsic business value of at least $400 million. Other security analysts at that time independently corroborate Buffett's calculation. Consequently, Berkshire's purchase of the Washington Post at $100 million is concluded by Buffett with at least a $300 million margin of safety. Summarizing, the intrinsic business value of $400 million is discounted $300 million by application of the "efficient market theory" to the Washington Post Company market value of $100 million.

Buffett and Munger make acquisition investment considerations for the long-term, so temporary fluctuations in market value in the short-term are insignificant except for the buying opportunity they present. Calculation of a company's intrinsic business value is the primary consideration in the Berkshire acquisition policy. For another example, Wells Fargo purchase price of $290 million is less than five times after-tax and three times pre-tax earnings. RJR Nabisco bond holdings of $440 million in 1989 increase their market value by $150 million or one-third at year-end 1990. Other examples include the Gillette investment of $600 million that grows to $4.8 billion and Coca-Cola "look-through earnings" to $590 million. Buffett and Munger establish their notion of business value based on future earning power. Intrinsic business value is defined by them as the "discounted value of the cash that can be taken out of the business during its remaining life."

Buffett Sayings as Oracle

Despite the challenging content of Buffett's essays, their reading flows well. Buffett presents difficult concepts in a Zen-like form. Understanding them comes like a flash and is memorable for their verbal package. His quips are a delight to read and their kernel of truth pops almost without notice. Addressing sometimes senseless financial maneuvers on Wall Street, he says "what the wise do in the beginning, fools do in the end." Noting casino-like activity in the stock market, Buffett says "investors should understand that what is good for the croupier is not good for the customer. A hyperactive stock market is the pick-pocket of enterprise." When a trend looks too good to be true, he cites Herb Stein, "If something can't go on forever, it will end." Warren and Charlie happily follow the motto, "If at first you do succeed, quit trying."

Buffett and Munger seek proven winners, since "our reaction to a fermenting industry is much like our attitude toward space exploration: We applaud the endeavor but prefer to skip the ride." When a Berkshire investment does particularly well, Buffett wryly gives credit; "this holding has proved extraordinarily profitable thanks to a move by your Chairman that combined luck and skill - 110% luck, the balance skill." Ever careful to

reason clearly while Berkshire produces $70 billion in revenue, Buffett cautions, "Nothing sedates rationality like large doses of effortless money."

With that much money flowing through an active investment holding company, there are continuing needs to allocate substantial capital effectively. Buffett and Munger find "if you advertise an interest in buying collies, a lot of people will call hoping to sell you their cocker spaniels." Buffet and Munger consistently focus on long-term consequences of their actions and decisions. Their controlled and partial interest new investment companies are expected to be a permanent part of the Berkshire program which Buffet is painfully aware since closing the textile plant in 1985. Knowing the road ahead, he is cautious. "If corporate pregnancy is going to be the consequence of corporate mating, the time to face that fact is before the moment of ecstasy." Ever the diplomats in these potential corporate combination's, Buffett and Munger agree: "we've done better by avoiding dragons than by slaying them."

Style

Perspective

The Essays of Warren Buffett: Lessons for Corporate America is selected, arranged, and introduced by Lawrence A. Cunningham from the essays of Warren Buffett. The editor is a George Washington University Law School Professor who prepares this collection of Buffett essays as core of a symposium and standard text for his course in business practices at Cardozo School of Law and other law and business schools. The original conference is attended by Warren Buffett and Charlie Munger, who are Chairman and Vice-Chairman respectively of Berkshire Hathaway Inc. Together the two of them manage the $70 billion enterprise based on the investment principles of Ben Graham.

Warren Buffet begins his professional investing career with Ben Graham and David Dodd at Graham-Newman. Prior to that, Graham instructs Warren Buffett at Columbia Business School in the 1950s, where he is a graduate student. The essays presented in this volume are excerpted from annual reports that Buffett prepares and writes for Berkshire shareholders. Buffett authorizes Cunningham to use these essays to popularize teachings and theory of his instructor and mentor Ben Graham and the implementation of Graham's ideas by him in Berkshire Hathaway, Inc.

Tone

The essays are written by Warren Buffett in the first person singular and plural when referring to his activity with Charlie Munger. Cunningham as compiler and editor lets Buffett's ideas, personality, and thoughts pervade the work. Buffett's writing surprisingly is fully subjective and enjoyable about the most objective and potentially uninteresting matters of corporate structure and financial investment. Buffett writes with a modest, self-effacing gracious and considerate down-home manner unexpected from a hugely successful billion-dollar owner/manager.

Challenging content of Buffett's essays does not interrupt their easy reading. Difficult concepts appear Zen-like and in disarmingly simple form. Their understanding comes like a flash in a memorable verbal wrapper. His homespun quips are delightful to read and their quiet wisdom shows in the many anecdotes shared. A reader can enjoy the paradox of learning high finance with a smile.

Structure

The book is a 243 page non-fiction volume that presents excerpts from the annual shareholder meeting of Berkshire Hathaway, Inc. The work is comprised of a Table of Contents, Introduction, Prologue, Chapters, Epilogue, Afterword, Acknowledgments plus Index, Concept Glossary, and Disposition Table. Seven chapters range in size from

twenty-one to thirty-seven pages with chapter subsections from A to H. Each title of chapter and subsection is clearly indicated as to its content. The layout is formal, logical, and detailed to clearly present the particular topic.

Despite a highly structured format and appearance, the content is delightful to read. The formal layout presents a clearly defined roadmap to the elements of a Buffet/Graham theory of business acquisition and development. The Table of Contents pinpoints subjects under discussion such as "Corporate Finance and Investing" and "Accounting and Valuation." Chapter subsection titles bring a touch of humor like "Cigar Butts and the Institutional Imperative" and "Aesop and Inefficient Bush Theory." The Index and Concept Glossary provide page references to specific names and capsule ideas. The format is essential to a ready understanding and follow-up to a challenging study.

Quotes

"Buffet jokes that calling someone who trades actively in the market an investor 'is like calling someone who repeatedly engages in one-night stands a romantic.'" Introduction and Prologue, p. 11

"Buffet's essays can reeducate a generation of students, and continue the education of others. That is important because the gospel of modern finance theory that swept America in the past thirty years is still commonly preached. A lemming-like willingness to follow the crowd endures. Entailing the destruction of both leadership and independent thought, that weakness is the intellectual foe in the struggle Buffett's essays wage for intelligent and focused investing. While the battle remains to be won, this compendium is intended to aid in the quest." Introduction and Prologue, p. 24

"Charlie and I know that the right players will make almost any team manager look good. We subscribe to the philosophy of Ogilvy & Mather's founding genius, David Ogilvy: 'If each of us hires people who are smaller than we are, we shall become a company of dwarfs. But, if each of us hires people who are bigger than we are, we shall become a company of giants.'" Chap. I, p. 43

"This devastating outcome for the shareholders indicates what can happen when much brain power and energy are applied to a faulty premise. The situation is suggestive of Samuel Johnson's horse: 'A horse that can count to ten is a remarkable horse - not a remarkable mathematician.' Likewise, a textile company that allocates capital brilliantly within its industry is a remarkable textile company - but not a remarkable business." Chap. I, p. 48

"Indeed, if we were not paid at all, Charlie and I would be delighted with the cushy jobs we hold. At bottom, we subscribe to Ronald Reagan's creed: 'It's probably true that hard work never killed anyone, but I figure why take the chance.'" Chap. I, p. 60

"Charlie and I decided long ago that in an investment lifetime it's too hard to make hundreds of smart decisions. That judgment became ever more compelling as Berkshire's capital mushroomed and the universe of investments that could significantly affect our results shrank dramatically. Therefore, we adopted a strategy that required our being smart - and not too smart at that - only a very few times. Indeed, we'll now settle for one good idea a year. (Charlie says it's my turn.)" Chap. II, p. 76

"To suggest that this investor should sell off portions of his most successful investments simply because they have come to dominate his portfolio is akin to suggesting that the Bulls trade Michael Jordan because he has become so important to the team." Chap. II, p. 91

"Therefore, we will look at any category of investment, so long as we understand the business we're buying into and believe that price and value may differ significantly. (Woody Allen, in another context, pointed out the advantage of open-mindedness: 'I

can't understand why more people aren't bi-sexual because it doubles your chances for a date on Saturday night.')" Chap. III, p. 104

"This principle at work - that you need not default for a long time if you solemnly promise to pay nothing for a long time - has not been lost on promoters and investment bankers seeking to finance ever-shakier deals." Chap. III, p. 109

"Some time ago Ken Galbraith, in his witty and insightful "The Great Crash", coined a new economic term: 'the bezzle,' defined as the current amount of undiscovered embezzlement. This financial creature has a magical quality: The embezzlers are richer by the amount of the bezzle, while the embezzlees do not yet feel poorer." Chap. III, p. 111

"(We are aware of the pie-expanding argument that says such activities improve the rationality of the capital allocation process. We think that this argument is specious and that, on balance, hyperactive equity markets subvert rational capital allocation and act as pie-shrinkers. Adam Smith felt that all noncollusive acts in a free market were guided by an invisible hand that led an economy to maximum progress; our view is that casino-type markets and hair-trigger investment management act as an invisible foot that trips up and slows down a forward-moving economy.)" Chap. IV, p. 141

"After several failures of this type, I finally remembered some useful advice I once got from a golf pro (who, like all pros who have had anything to do with my game, wishes to remain anonymous). Said the pro: 'Practice doesn't make perfect; practice makes permanent.' And thereafter I revised my strategy and tried to buy good businesses at fair prices rather than fair businesses at good prices." Chap. V, p. 149

"But often the CEO asks a strategic planning staff, consultants or investment bankers whether an acquisition or two might make sense. That's like asking your interior decorator whether you need a $50,000 rug." Chap. V, p. 159

"In any case, why potential buyers even look at projections prepared by sellers baffles me. Charlie and I never give them a glance, but instead keep in mind the story of the man with an ailing horse. Visiting the vet, he said: 'Can you help me? Sometimes my horse walks just fine and sometimes he limps.' The vet's reply was pointed: 'No problem - when he's walking fine, sell him.' In the world of mergers and acquisitions, that horse would be peddled as Secretariat." Chap. V, p. 163

"We would not like to have the job of designing a better system. It's simply to say that managers and investors alike must understand that accounting numbers are the beginning, not the end, of business valuation." Chap. VI, p. 183

"In an accounting sense, consequently, our GEICO Goodwill will disappear gradually in even-sized bites. But the one thing I can guarantee you is that the economic Goodwill we have purchased at GEICO will not decline in the same measured way. In fact, my best guess is that the economic goodwill assignable to GEICO will not decline at all, but rather will increase - and probably in a very substantial way." Chap. VI, p. 192

"Now, speculation - in which the focus is not on what an asset will produce but rather on what the next fellow will pay for it - is neither illegal, immoral nor un-American. But it is not a game in which Charlie and I wish to play. We bring nothing to the party, so why should we expect to take anything home?" Chap. VI, p. 205

"Managers thinking about accounting issues should never forget one of Abraham Lincoln's favorite riddles: 'How many legs does a dog have if you call his tail a leg?' The answer: 'Four, because calling a tail a leg does not make it a leg.' It behooves managers to remember that Abe's right even if an auditor is willing to certify that the tail is a leg." Chap. VII, p. 224

Topics for Discussion

Identify, list, and describe five or more subsidiary companies of Berkshire Hathaway that Buffett and Munger either control completely or maintain a partial investment interest.

Define, explain, and discuss Buffett's long-term economic goal for Berkshire and its shareholders.

Describe and discuss the significance of Ben Graham to Warren Buffett's method of stock acquisition.

Identify, list, and describe at least five of the most significant "owner-related business principles" that Buffett uses to guide Berkshire business operations and shareholder meetings.

Describe and characterize from inception to its current state of development the charitable contributions program Charlie Munger devised for the shareholders.

Describe and discuss the acquisition of Washington Post with respect to the significance between market value and intrinsic business value.

Identify, describe, and discuss characteristics of Mr. Market and his significance to Buffett's acquisition policy and practices.

Identify, describe, and discuss the significance of "efficient market theory."

Compare and contrast significant elements of Graham's "margin of safety" concept with Buffett's "cigar butt investing."

Identify, list, and describe alternatives to common stock that Buffett and Munger can use in their capital allocation program.

Describe and discuss Buffett's experience with arbitration and Rockwood cocoa beans.

Identify, describe, and discuss the "bezzle."

Compare and contrast the distinguishing features of a pooling versus a purchase.

Identify, describe, and compare company ownership percentages with regard to control, accounting, acquisition, income, dividends, and Berkshire policy.

Describe and discuss features of Warren Buffett's survivorship plan for Berkshire.