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Not so fast, Warren Buffett

"Productive" assets are the ones to buy, counsels the chairman of Berkshire Hathaway, low- or non-yielding assets the kind to shun. Who could quibble? Why, this publication. We now commence an argument with the second-richest man in America (we have no problem with Bill Gates).

"Procreative" is the word that Warren Buffett uses to extol the earning assets of which he approves—businesses, farms, real estate. Other kinds of assets, e.g., money-market instruments, fixed-income securities and "tulip," both ancient or modern, he broadly rejects. The latter, he contends in the new, must-read Berkshire annual, are the "assets that will never produce anything, but that are purchased in the buyer's hope that someone else—who also knows that the assets will be forever unproductive—will pay more for them in the future."

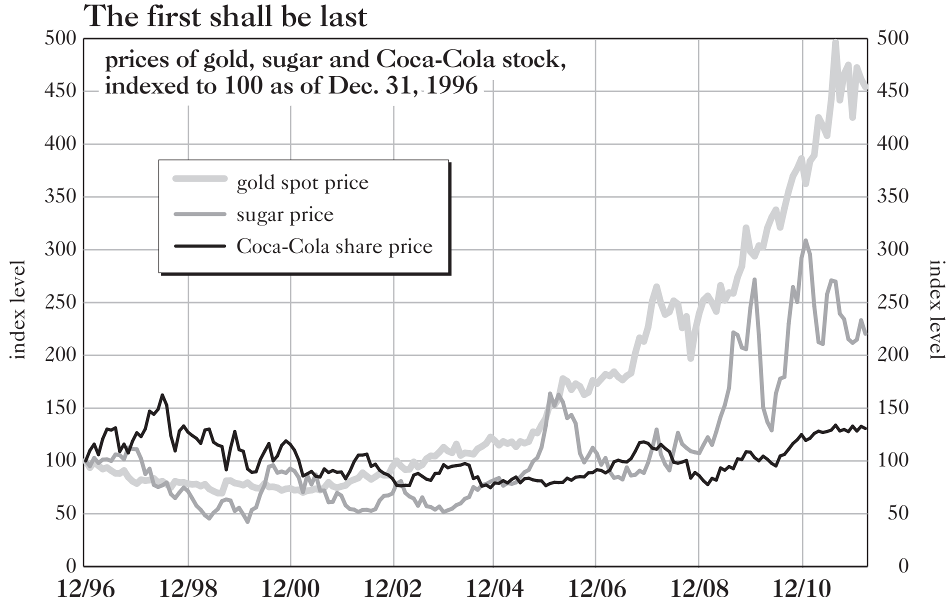
For Buffett, Coca-Cola is a prime example of the procreative investment, gold the archetypical other. For us, we submit that the chairman has failed to take proper account of today's unique monetary backdrop. Interest rates are uncommonly low, worldwide monetary policy unprecedentedly easy. No institution under the sun is so procreative as the quantitatively easing central bank. Faster than even the best business can spin cash flow, the Federal Reserve can materialize scrip. What to do about this novel fact is one of the foremost investment questions of our time.

Never was a goldphobe more alert to the reasons to own the very metal he mocks than the Sage of Omaha. "Even in the U.S.," Buffett observes, "where the wish for a stable currency is strong, the dollar has fallen a staggering 86% in value since 1965, when I took over management of Berkshire. It takes no less than $7 today to buy what $1 did at that time. . . . '[I]n God We Trust' may be imprinted on our currency, but the hand that activates our government's printing press has been all too human."

So then, how can the holder of wealth insure against continued overcranking? Buffett, of all people, should have something to say on the subject. Not only has he excelled as an investor (since 1965, Berkshire's book value has grown at a compound annual rate of 19.8%), but also as an insurance underwriter. Thus, the Berkshire insurance division has produced an underwriting profit for nine years running. For comparison, State Farm, the biggest American insurance company, has borne an underwriting loss in eight of the past 11 years. So when one of America's all-time great appraisers of risk holds forth about the risk to the currency, one should lend an ear.

We have listened carefully, and pondered respectfully. And our response is: Come again? For Buffett, paper money is a short sale, but gold is no haven, only jewelry. Fearful people buy it because they believe that still more fearful people will ultimately pay an even higher price to take it off their hands. "Meanwhile," Buffett concludes—and he is correct about this—"if you own

The first shall be last



source: The Bloomberg

one ounce of gold for an eternity, you will still own one ounce at its end."

So, then, according to the second-richest man and best investor and leading appraiser of risk in the 50 states and all the territories, Coca-Cola and farmland and Exxon and income-producing real estate and suchlike are the only things to own in these times of ultra-low interest rates and rapid-fire money printing. Let us see about that.

That *Grant's* has a soft spot for the barbarous relic is well known. But only the most venerable and retentive subscriber will remember our in-depth analysis of Coke. Sell it, we said.

The date was Oct. 11, 1996. The stock market was on the boil, and Coca-Cola was valued more richly than it had ever been since its 1919 IPO. At 49¾ a share, it was quoted at 39 times earnings. Not only was that the highest multiple on record, but also the highest valuation premium to the S&P 500 on record. Roberto C. Goizueta, Coke's hard-charging CEO—Buffett could hardly say enough nice things about him—spoke of "our virtually *infinite* opportunity for growth." The company measured its potential in terms of the liquids it did not yet supply toward mankind's average daily requirement of 64 fluid ounces. Inasmuch as Coke furnished less than two ounces of that intake, there were 62 to go. To express its vision of the opportunity it was doing everything in its power to grasp, management deployed the infinity symbol. It was, it said, an "unregistered trademark."

Clearly, Coke had reached a state of temporal perfection. In the 12 months to June 30, 1996, it returned 19.4% on assets and 54.1% on equity. Not for 10 years had the senior debt of the Coca-Cola Co. been rated triple-A, but no one could call the balance sheet over-leveraged. Long-term debt stood at just 16% of capital, and EBIT—i.e., earnings before interest and taxes—covered fixed charges by a factor of 17. *Fortune*'s "Most Admired Corporation" of 1996 had, in the 12 months to June 30, generated a 62% gross margin and a 17% net margin. Was any price too high to pay for an enterprise that came as close as any to duplicating the economics of the Federal Reserve?

Management thought not. "Is there ever a time you wouldn't consider buying your own stock?" the front office queried itself in the 1995 annual report, and replied: "Yes, whenever securities laws say we can't. Otherwise, we've yet to encounter a time when we felt our stock wasn't a long-term investment bargain for us."

Yet, we noted in our 1996 essay, though Coca-Cola had always been a marvelous business, it was not a consistently marvelous stock. In January 1974, at the peak of the so-called Nifty Fifty market (the half-a-hundred favored companies exhibiting characteristics that supposedly made them valuation-proof), Coke had commanded a price-earnings multiple of 36.9 times. What followed were the great inflation and a decade—for Coke as for many other one-decision favorites—in the equity wilderness. From 1973 to 1983, revenues vaulted to $6.8 billion from $2.1 billion and earnings to $559 million from $215 million. "However," as *Grant's* noted, "the price of a share of Coke would fail to match its January 1974 high until the summer of 1984, two years after the beginning of the intergalactic bull market and the company's near-simultaneous uncorking of Diet Coke."

Buffett had climbed aboard in 1988, buying 14,172,500 shares for $592.5 million and paying a multiple of 14.7 times 1998 earnings. To the Berkshire shareholders, he made a wry confession: "This Coca-Cola investment provides yet another example of the incredible speed with which your chairman responds to investment opportunities, no matter how obscure or well-disguised they may be. I believe I had my first Coca-Cola in 1935 or 1936." However, between the fourth quarter of 1988 and the fourth quarter of 1996, Coke delivered a total return of 961.3% against that of 220.5% for the S&P 500.

Plainly, as procreative assets went, Coke was it. Then, again, there was nobody who didn't seem to know it. There was, indeed, we thought at

Coca-Cola over the years
(in $ millions)

	full-year			
	2011	**2006**	**2001**	**1996**
Net operating revenues	$46,542	$24,088	$17,545	$18,673
Cost of goods sold	18,216	8,164	6,044	6,738
Gross profit	28,326	15,924	11,501	11,935
Gross profit margin	60.9%	66.1%	65.6%	63.5%
Earnings before interest and taxes (EBIT)	$10,154	$6,308	$5,352	$3,915
EBITDA minus capex	9,188	5,839	5,386	3,558
Free cash flow	6,554	4,550	3,341	2,473
Interest expense	417	220	289	286
Net income	8,572	5,080	3,969	3,492
Net income margin	18.4%	21.1%	22.6%	18.7%
Current assets	25,497	8,441	7,171	5,910
Total assets	79,974	29,963	22,417	16,161
Current liabilities	24,283	8,890	8,429	7,406
Short and long-term debt	28,569	4,582	5,118	4,513
Equity	31,921	16,920	11,316	6,156
Shares outstanding (millions)	2,263	2,318	2,486	2,481
Price-to-sales	3.4x	4.7x	6.7x	7.0x
Price-to-earnings	18.2	20.4	29.5	40.8
Price-to-book	5.0	6.6	10.3	21.21
Return on assets	11.2%	17.1%	18.3%	22.4%
Return on equity	27.2	30.5	38.4	60.5
EBIT/interest expense	24.4x	28.7x	18.5x	13.6x
Debt/total capitalization	47.2%	21.3%	31.1%	42.3%
Dividend yield	2.69	2.57	1.53	0.95

source: company reports, the Bloomberg

the time, nobody who didn't seem to believe that the stock market was the stairway to heaven. Two months after we published, Alan Greenspan delivered his famous "irrational exuberance" speech (the Maestro wasn't bearish for long, only until he began to absorb the abuse that his somewhat halting expression of skepticism about the stock market brought down on his head). Were things not looking a little toppy?

While throwing stones at the Coca-Cola share price, we quoted a few lines from Paul Fussell's memoir, "Doing Battle." In describing a series of botched night patrols in which he participated in France as a junior infantry officer during World War II, Fussell had much to say about the nature of risk. "I was learning," wrote the former lieutenant, "from these mortal-farcical events about the eternal presence in human affairs of accident and contingency, as well as the fatuity of optimism at any time or place. All planning was not just likely to recoil ironically; it was almost certain to do so. Human beings were clearly not like machines. They were mysterious congeries of twisted will and error, misapprehensions and misrepresentation, and the expected could not be expected of them."

The Street expected continued great things of Coke, many preceding years of greatness notwithstanding. "Coca-Cola a Buy Despite High P/E," ventured Standard & Poor's in "The Outlook" (a brilliant medium-term call, as it turned out). Let us say, we proposed, that Coca-Cola's earnings grow at the same rate for the next 10 years as the 18% they were expected to grow in the following 12 months, i.e., calendar 1997. That would put net income at $18.3 billion in 2006. Capitalized at the same 39 times multiple, Coke would command a 2006 stock-market cap of $713 billion.

These things did not, in fact, come to pass. Over the 10 years to 2006, Coke's compound earnings growth worked out not to 18% per annum but to 3.8%. Net income in 2006 totaled not $18.3 billion but $5.1 billion. The company's year-end 2006 stock market cap worked out not to $713 billion but $112 billion.

Seemingly valued for a perfect world, Coke had to make do with the fact of imperfection. Human beings, conforming to the Fussell script, sometimes disappointed. For instance, Goizueta's handpicked successor, M. Douglas Ivester, resigned 30 months after his appointment. By 2001, the company was ratcheting down its expectations for growth in unit volume to 5% or 6% a year from 7% or 8%, and in its earnings per share to 11% to 12% from 15%.

The Internet bubble burst. Not intending to seed another excess with which to replace the dot-com boom, the Fed did exactly that by pressing its funds rate down to 1%. Up went house prices. Late in 2002, then Fed governor Ben S. Bernanke, in a speech heard round the world, observed that, if need be in a fiat money system, the Federal Reserve could drop currency out of helicopter doors.

In the 2011 Berkshire letter, Buffett approvingly quotes the business adage, "Buy commodities, sell brands." "It has produced enormous and sustained profits for Coca-Cola since 1886 and Wrigley since 1891," the chairman writes. "On a smaller scale, we have enjoyed good fortune with this approach at See's Candy since we purchased it 40 years ago."

However, for one reason or another—not least the muscular money printing of the world's central banks—commodity prices have been in the ascendant. In a comparative measure of total returns in the 15 years since 1996, the S&P 500 has delivered 119.9%, the Goldman Sachs Commodity Index 207.9%.

The Coca-Cola formula is the darkest and deepest of corporate secrets, but anyone with taste buds knows there's a sweetener in it somewhere. In 1996, a pound of raw cane sugar fetched 11 cents. Fifteen years on, at year-end 2011, the same non-procreative pound was quoted at 23 cents. The fact is that, from year-end 1996 through year-end 2011, the hypothetical continuous holder of the generic sugar futures contract earned a compound annual return of 5.13%, while a stockholder in the utterly non-generic Coca-Cola Co. had to settle for a compound annual return of 3.99%. In 1996, some of the best business advice on offer (Jimmy Rogers had the call) was "Buy commodities, period."

And what about our advice, "sell Coke"? Let us just say that nobody had to rush out to implement the idea. Coca-Cola, though it had never been more richly valued than it was when we wrote, proceeded to become still more richly valued. The share price peaked at $87.93 on July 14, 1998, up 77% from our Oct. 11, 1996, call, the trailing P/E ratio leaping to 57 from 39. In the new Berkshire annual, Buffett calls gold a "bubble." For ourselves, we would call modern central banking a "bubble." Anyway, Coke at 57 times earnings exhibited more than a few bubble-like symptoms. A decade and a half later, the price has still not regained those oxygen-free heights.

By this time, relates Alice Schroeder in her 2008 biography, "The Snowball: Warren Buffett and the Business of Life," Berkshire's stake in Coke had multiplied 14-fold, to $13 billion, "and [Buffett] had gone so far as to declare the company an 'inevitable' to his shareholders, as if it were a stock he would never sell. He reasoned that Coca-Cola would send more swallows down more throats in each passing decade 'for an investing lifetime,' which made it about as close to immortal, for a brand, as you could get. Berkshire now owned more than eight percent of the company. Coca-Cola stock was trading as high as forty times its estimated 2000 earnings—a multiple that said investors believed the stock would keep rising by at least 20 percent a year. But to do that, it would have to increase earnings twenty-five percent a year for five years—impossible. It would have to almost triple sales, to a number nearly as large as the entire soft-drink market in 1999—again impossible. No amount of bottler sales or accounting finagles could produce results like that. Buffett knew it. Nevertheless, he did not sell his Coca-Cola stock."

As to why not, "the reason was partly inertia," Schroeder continues. After all, "Buffett liked to say he made most of his money by 'sitting on his ass.' Like the investors who kept their GEICO stock when it fell to $2 a share, inertia had protected him from many mistakes—both of commission and omission. He also owned too much Coke to sell without creating a major headache. The symbolism of Warren Buffett—the "world's greatest investor" and a board member—dumping Coca-Cola stock would be unmistakable." Besides, there would be taxes to pay on the realized gains. Then, too, by not selling, Buffett saved himself the job of deciding when, if ever, to repurchase.

Maybe now would be the time to buy if he had ever sold. Sixteen years ago, we characterized Coke, only half-facetiously, as "the corporate equivalent of Mount Rushmore, the hot dog, the Bureau of Engraving and Printing and Muhammad Ali, all rolled into one." It remains so today. Employing 146,000 people, it operates in 200 countries and boasts no fewer than 15 brands that generate annual revenues of $1 billion or more. Coke, Sprite, Fanta and Diet Coke, its top four brands, exceed total annual revenues of $10 billion. Of the $35 billion of growth in the total retail value of worldwide ready-to-drink sales in 2011, Coke captured no less than 40%.

The present-day Coca-Cola value proposition represents a boundless improvement over the one on offer in 1996. At $68.76 apiece, the shares are quoted at 17.9 times trailing net income and 16.9 times the 2012 estimate. And the indicated $2.04 per-share 2012 payout points to a dividend yield of 2.97%, well in excess of the utterly non-procreative 2% yield on the 10-year Treasury note. Banking on perfection in 1996, CEO Goizueta strove for 20% earnings growth, which his successors did not attain. Banking on something less than perfection in a very different world, today's CEO, Muhtar Kent, seems to be aiming for growth at less than half that rate, which, in 2011, he topped (EPS growth coming in at 10% before abnormal items). If Coke is not a compelling absolute investment, it is a fetching relative one. It is, moreover, as the accompanying table points up, a most terrific business.

Concerning gold, Buffett does have a point. Unlike Coke, it generates no earnings and pays no dividend. Yet, since 1996, its value—denominated in the Greenspan/Bernanke dollar—has appreciated more than two-and-a-half times faster than that of Coke, dividends included. But gold, contrary to the Buffett formulation, is no investment but rather money, and money is, by definition, sterile. In our view, the gold price is a mirror to the world's faith in the procedures of the stewards of fiat currencies. As more money holders come to doubt the words and deeds of the paper wizards, the gold price tends to push higher. Buffett maintains that gold is the refuge of the "fearful." It is, in part. And it is, in part, the refuge of the momentum seeker, just as Coke was way back when. More substantially, gold is the refuge of the wary. The constructively anxious gold bug will ask germane questions. For instance, what if QE spins out of control? What if the inflation rate gets out of hand? How can I preserve purchasing power sufficient to allow me to buy oodles of Coke at the next bear-market bottom?

Earning nothing, gold is impossible to value. It is, indeed, a speculation, but a well-founded speculation on the not-bright future of the kind of money that, with a push from the Federal Reserve, just seems to drop out of the sky.

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