

Chairman's Letter - 1990

 berkshirehathaway.com/letters/1990.html

BERKSHIRE HATHAWAY INC.

To the Shareholders of Berkshire Hathaway Inc.:

Last year we made a prediction: "A reduction [in Berkshire's net worth] is almost certain in at least one of the next three years." During much of 1990's second half, we were on the road to quickly proving that forecast accurate. But some strengthening in stock prices late in the year enabled us to close 1990 with net worth up by \$362 million, or 7.3%. Over the last 26 years (that is, since present management took over) our per-share book value has grown from \$19.46 to \$4,612.06, or at a rate of 23.2% compounded annually.

Our growth rate was lackluster in 1990 because our four major common stock holdings, in aggregate, showed little change in market value. Last year I told you that though these companies - Capital Cities/ABC, Coca-Cola, GEICO, and Washington Post - had fine businesses and superb managements, widespread recognition of these attributes had pushed the stock prices of the four to lofty levels. The market prices of the two media companies have since fallen significantly - for good reasons relating to evolutionary industry developments that I will discuss later - and the price of Coca-Cola stock has increased significantly for what I also believe are good reasons. Overall, yearend 1990 prices of our "permanent four," though far from enticing, were a bit more appealing than they were a year earlier.

Berkshire's 26-year record is meaningless in forecasting future results; so also, we hope, is the one-year record. We continue to aim for a 15% average annual gain in intrinsic value. But, as we never tire of telling you, this goal becomes ever more difficult to reach as our equity base, now \$5.3 billion, increases.

If we do attain that 15% average, our shareholders should fare well. However, Berkshire's corporate gains will produce an identical gain for a specific shareholder only if he eventually sells his shares at the same relationship to intrinsic value that existed when he bought them. For example, if you buy at a 10% premium to intrinsic value; if intrinsic value subsequently grows at 15% a year; and if you then sell at a 10% premium, your own return will correspondingly be 15% compounded. (The calculation assumes that no dividends are paid.) If, however, you buy at a premium and sell at a smaller premium, your results will be somewhat inferior to those achieved by the company.

Ideally, the results of every Berkshire shareholder would closely mirror those of the company during his period of ownership. That is why Charlie Munger, Berkshire's Vice Chairman and my partner, and I hope for Berkshire to sell consistently at about intrinsic value. We prefer such steadiness to the value-ignoring volatility of the past two years: In 1989 intrinsic value grew less than did book value, which was up 44%, while the market

price rose 85%; in 1990 book value and intrinsic value increased by a small amount, while the market price fell 23%.

Berkshire's intrinsic value continues to exceed book value by a substantial margin. We can't tell you the exact differential because intrinsic value is necessarily an estimate; Charlie and I might, in fact, differ by 10% in our appraisals. We do know, however, that we own some exceptional businesses that are worth considerably more than the values at which they are carried on our books.

Much of the extra value that exists in our businesses has been created by the managers now running them. Charlie and I feel free to brag about this group because we had nothing to do with developing the skills they possess: These superstars just came that way. Our job is merely to identify talented managers and provide an environment in which they can do their stuff. Having done it, they send their cash to headquarters and we face our only other task: the intelligent deployment of these funds.

My own role in operations may best be illustrated by a small tale concerning my granddaughter, Emily, and her fourth birthday party last fall. Attending were other children, adoring relatives, and Beemer the Clown, a local entertainer who includes magic tricks in his act.

Beginning these, Beemer asked Emily to help him by waving a "magic wand" over "the box of wonders." Green handkerchiefs went into the box, Emily waved the wand, and Beemer removed blue ones. Loose handkerchiefs went in and, upon a magisterial wave by Emily, emerged knotted. After four such transformations, each more amazing than its predecessor, Emily was unable to contain herself. Her face aglow, she exulted: "Gee, I'm really good at this."

And that sums up my contribution to the performance of Berkshire's business magicians - the Blumkins, the Friedman family, Mike Goldberg, the Heldmans, Chuck Huggins, Stan Lipsey and Ralph Schey. They deserve your applause.

Sources of Reported Earnings

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

Much additional information about these businesses is given on pages 39-46, where you also will find our segment earnings reported on a GAAP basis. For information on

Wesco's businesses, I urge you to read Charlie Munger's letter, which starts on page 56. His letter also contains the clearest and most insightful discussion of the banking industry that I have seen.

(000s omitted)				

Berkshire's Share of Net Earnings (after taxes and Pre-Tax Earnings minority interests)				

1990	1989	1990	1989	
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Operating Earnings:				
Insurance Group:				
Underwriting	\$(26,647)	\$(24,400)	\$(14,936)	\$(12,259)
Net Investment Income	327,048	243,599	282,613	213,642
Buffalo News	43,954	46,047	25,981	27,771
Fechheimer	12,450	12,621	6,605	6,789
Kirby	27,445	26,114	17,613	16,803
Nebraska Furniture Mart	17,248	17,070	8,485	8,441
Scott Fetzer Manufacturing Group	30,378	33,165	18,458	19,996
See's Candies	39,580	34,235	23,892	20,626
Wesco - other than Insurance ..	12,441	13,008	9,676	9,810
World Book	31,896	25,583	20,420	16,372
Amortization of Goodwill	(3,476)	(3,387)	(3,461)	(3,372)
Other Purchase-Price				
Accounting Charges	(5,951)	(5,740)	(6,856)	(6,668)
Interest Expense*	(76,374)	(42,389)	(49,726)	(27,098)
Shareholder-Designated				
Contributions	(5,824)	(5,867)	(3,801)	(3,814)
Other	58,309	23,755	35,782	12,863

Operating Earnings	482,477	393,414	370,745	299,902
Sales of Securities	33,989	223,810	23,348	147,575

Total Earnings - All Entities	\$516,466	\$617,224	\$394,093	\$447,477
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**Excludes interest expense of Scott Fetzer Financial Group and Mutual Savings & Loan.*

We refer you also to pages 47-53, where we have rearranged Berkshire's financial data into four segments. These correspond to the way Charlie and I think about the business and should help you more in estimating Berkshire's intrinsic value than consolidated figures would do. Shown on these pages are balance sheets and earnings statements for: (1) our insurance operations, with their major investment positions itemized; (2) our manufacturing, publishing and retailing businesses, leaving aside certain non- operating assets and purchase-price accounting adjustments; (3) our subsidiaries engaged in finance-type operations, which are Mutual Savings and Scott Fetzer Financial; and (4) an all-other category that includes the non-operating assets

(primarily marketable securities) held by the companies in segment (2), all purchase-price accounting adjustments, and various assets and debts of the Wesco and Berkshire parent companies.

If you combine the earnings and net worths of these four segments, you will derive totals matching those shown on our GAAP statements. However, I want to emphasize that this four-category presentation does not fall within the purview of our auditors, who in no way bless it.

"Look-Through" Earnings

The term "earnings" has a precise ring to it. And when an earnings figure is accompanied by an unqualified auditor's certificate, a naive reader might think it comparable in certitude to pi, calculated to dozens of decimal places.

In reality, however, earnings can be as pliable as putty when a charlatan heads the company reporting them. Eventually truth will surface, but in the meantime a lot of money can change hands. Indeed, some important American fortunes have been created by the monetization of accounting mirages.

Funny business in accounting is not new. For connoisseurs of chicanery, I have attached as Appendix A on page 22 a previously unpublished satire on accounting practices written by Ben Graham in 1936. Alas, excesses similar to those he then lampooned have many times since found their way into the financial statements of major American corporations and been duly certified by big-name auditors. Clearly, investors must always keep their guard up and use accounting numbers as a beginning, not an end, in their attempts to calculate true "economic earnings" accruing to them.

Berkshire's own reported earnings are misleading in a different, but important, way: We have huge investments in companies ("investees") whose earnings far exceed their dividends and in which we record our share of earnings only to the extent of the dividends we receive. The extreme case is Capital Cities/ABC, Inc. Our 17% share of the company's earnings amounted to more than \$83 million last year. Yet only about \$530,000 (\$600,000 of dividends it paid us less some \$70,000 of tax) is counted in Berkshire's GAAP earnings. The residual \$82 million-plus stayed with Cap Cities as retained earnings, which work for our benefit but go unrecorded on our books.

Our perspective on such "forgotten-but-not-gone" earnings is simple: The way they are accounted for is of no importance, but their ownership and subsequent utilization is all-important. We care not whether the auditors hear a tree fall in the forest; we do care who owns the tree and what's next done with it.

When Coca-Cola uses retained earnings to repurchase its shares, the company increases our percentage ownership in what I regard to be the most valuable franchise in the world. (Coke also, of course, uses retained earnings in many other value-enhancing ways.) Instead of repurchasing stock, Coca-Cola could pay those funds to us in dividends, which we could then use to purchase more Coke shares. That would be a less efficient

scenario: Because of taxes we would pay on dividend income, we would not be able to increase our proportionate ownership to the degree that Coke can, acting for us. If this less efficient procedure were followed, however, Berkshire would report far greater "earnings."

I believe the best way to think about our earnings is in terms of "look-through" results, calculated as follows: Take \$250 million, which is roughly our share of the 1990 operating earnings retained by our investees; subtract \$30 million, for the incremental taxes we would have owed had that \$250 million been paid to us in dividends; and add the remainder, \$220 million, to our reported operating earnings of \$371 million. Thus our 1990 "look-through earnings" were about \$590 million.

As I mentioned last year, we hope to have look-through earnings grow about 15% annually. In 1990 we substantially exceeded that rate but in 1991 we will fall far short of it. Our Gillette preferred has been called and we will convert it into common stock on April 1. This will reduce reported earnings by about \$35 million annually and look-through earnings by a much smaller, but still significant, amount. Additionally, our media earnings - both direct and look-through - appear sure to decline. Whatever the results, we will post you annually on how we are doing on a look-through basis.

Non-Insurance Operations

Take another look at the figures on page 51, which aggregate the earnings and balance sheets of our non-insurance operations. After-tax earnings on average equity in 1990 were 51%, a result that would have placed the group about 20th on the 1989 Fortune 500.

Two factors make this return even more remarkable. First, leverage did not produce it: Almost all our major facilities are owned, not leased, and such small debt as these operations have is basically offset by cash they hold. In fact, if the measurement was return on assets - a calculation that eliminates the effect of debt upon returns - our group would rank in Fortune's top ten.

Equally important, our return was not earned from industries, such as cigarettes or network television stations, possessing spectacular economics for all participating in them. Instead it came from a group of businesses operating in such prosaic fields as furniture retailing, candy, vacuum cleaners, and even steel warehousing. The explanation is clear: Our extraordinary returns flow from outstanding operating managers, not fortuitous industry economics.

Let's look at the larger operations:

- o It was a poor year for retailing - particularly for big-ticket items - but someone forgot to tell Ike Friedman at Borsheim's. Sales were up 18%. That's both a same-stores and all-stores percentage, since Borsheim's operates but one establishment.

But, oh, what an establishment! We can't be sure about the fact (because most fine-jewelry retailers are privately owned) but we believe that this jewelry store does more volume than any other in the U.S., except for Tiffany's New York store.

Borsheim's could not do nearly that well if our customers came only from the Omaha metropolitan area, whose population is about 600,000. We have long had a huge percentage of greater Omaha's jewelry business, so growth in that market is necessarily limited. But every year business from non-Midwest customers grows dramatically. Many visit the store in person. A large number of others, however, buy through the mail in a manner you will find interesting.

These customers request a jewelry selection of a certain type and value - say, emeralds in the \$10,000 - \$20,000 range - and we then send them five to ten items meeting their specifications and from which they can pick. Last year we mailed about 1,500 assortments of all kinds, carrying values ranging from under \$1,000 to hundreds of thousands of dollars.

The selections are sent all over the country, some to people no one at Borsheim's has ever met. (They must always have been well recommended, however.) While the number of mailings in 1990 was a record, Ike has been sending merchandise far and wide for decades. Misanthropes will be crushed to learn how well our "honor-system" works: We have yet to experience a loss from customer dishonesty.

We attract business nationwide because we have several advantages that competitors can't match. The most important item in the equation is our operating costs, which run about 18% of sales compared to 40% or so at the typical competitor. (Included in the 18% are occupancy and buying costs, which some public companies include in "cost of goods sold.") Just as Wal-Mart, with its 15% operating costs, sells at prices that high-cost competitors can't touch and thereby constantly increases its market share, so does Borsheim's. What works with diapers works with diamonds.

Our low prices create huge volume that in turn allows us to carry an extraordinarily broad inventory of goods, running ten or more times the size of that at the typical fine-jewelry store. Couple our breadth of selection and low prices with superb service and you can understand how Ike and his family have built a national jewelry phenomenon from an Omaha location.

And family it is. Ike's crew always includes son Alan and sons-in-law Marvin Cohn and Donald Yale. And when things are busy - that's often - they are joined by Ike's wife, Roz, and his daughters, Janis and Susie. In addition, Fran Blumkin, wife of Louie (Chairman of Nebraska Furniture Mart and Ike's cousin), regularly pitches in. Finally, you'll find Ike's 89-year-old mother, Rebecca, in the store most afternoons, Wall Street Journal in hand. Given a family commitment like this, is it any surprise that Borsheim's runs rings around competitors whose managers are thinking about how soon 5 o'clock will arrive?

- While Fran Blumkin was helping the Friedman family set records at Borsheim's, her

sons, Irv and Ron, along with husband Louie, were setting records at The Nebraska Furniture Mart. Sales at our one-and-only location were \$159 million, up 4% from 1989. Though again the fact can't be conclusively proved, we believe NFM does close to double the volume of any other home furnishings store in the country.

The NFM formula for success parallels that of Borsheim's. First, operating costs are rock-bottom - 15% in 1990 against about 40% for Levitz, the country's largest furniture retailer, and 25% for Circuit City Stores, the leading discount retailer of electronics and appliances. Second, NFM's low costs allow the business to price well below all competitors. Indeed, major chains, knowing what they will face, steer clear of Omaha. Third, the huge volume generated by our bargain prices allows us to carry the broadest selection of merchandise available anywhere.

Some idea of NFM's merchandising power can be gleaned from a recent report of consumer behavior in Des Moines, which showed that NFM was Number 3 in popularity among 20 furniture retailers serving that city. That may sound like no big deal until you consider that 19 of those retailers are located in Des Moines, whereas our store is 130 miles away. This leaves customers driving a distance equal to that between Washington and Philadelphia in order to shop with us, even though they have a multitude of alternatives next door. In effect, NFM, like Borsheim's, has dramatically expanded the territory it serves - not by the traditional method of opening new stores but rather by creating an irresistible magnet that employs price and selection to pull in the crowds.

Last year at the Mart there occurred an historic event: I experienced a counterrevelation. Regular readers of this report know that I have long scorned the boasts of corporate executives about synergy, deriding such claims as the last refuge of scoundrels defending foolish acquisitions. But now I know better: In Berkshire's first synergistic explosion, NFM put a See's candy cart in the store late last year and sold more candy than that moved by some of the full-fledged stores See's operates in California. This success contradicts all tenets of retailing. With the Blumkins, though, the impossible is routine.

- At See's, physical volume set a record in 1990 - but only barely and only because of good sales early in the year. After the invasion of Kuwait, mall traffic in the West fell. Our poundage volume at Christmas dropped slightly, though our dollar sales were up because of a 5% price increase.

That increase, and better control of expenses, improved profit margins. Against the backdrop of a weak retailing environment, Chuck Huggins delivered outstanding results, as he has in each of the nineteen years we have owned See's. Chuck's imprint on the business - a virtual fanaticism about quality and service - is visible at all of our 225 stores.

One happening in 1990 illustrates the close bond between See's and its customers. After 15 years of operation, our store in Albuquerque was endangered: The landlord would not renew our lease, wanting us instead to move to an inferior location in the mall

and even so to pay a much higher rent. These changes would have wiped out the store's profit. After extended negotiations got us nowhere, we set a date for closing the store.

On her own, the store's manager, Ann Filkins, then took action, urging customers to protest the closing. Some 263 responded by sending letters and making phone calls to See's headquarters in San Francisco, in some cases threatening to boycott the mall. An alert reporter at the Albuquerque paper picked up the story. Supplied with this evidence of a consumer uprising, our landlord offered us a satisfactory deal. (He, too, proved susceptible to a counterrevelation.)

Chuck subsequently wrote personal letters of thanks to every loyalist and sent each a gift certificate. He repeated his thanks in a newspaper ad that listed the names of all 263. The sequel: Christmas sales in Albuquerque were up substantially.

- Charlie and I were surprised at developments this past year in the media industry, including newspapers such as our Buffalo News. The business showed far more vulnerability to the early stages of a recession than has been the case in the past. The question is whether this erosion is just part of an aberrational cycle - to be fully made up in the next upturn - or whether the business has slipped in a way that permanently reduces intrinsic business values.

Since I didn't predict what *has* happened, you may question the value of my prediction about what *will* happen. Nevertheless, I'll proffer a judgment: While many media businesses will remain economic marvels in comparison with American industry generally, they will prove considerably less marvelous than I, the industry, or lenders thought would be the case only a few years ago.

The reason media businesses have been so outstanding in the past was not physical growth, but rather the unusual pricing power that most participants wielded. Now, however, advertising dollars are growing slowly. In addition, retailers that do little or no media advertising (though they sometimes use the Postal Service) have gradually taken market share in certain merchandise categories. Most important of all, the number of both print and electronic advertising channels has substantially increased. As a consequence, advertising dollars are more widely dispersed and the pricing power of ad vendors has diminished. These circumstances materially reduce the intrinsic value of our major media investments and also the value of our operating unit, Buffalo News - though all remain fine businesses.

Notwithstanding the problems, Stan Lipsey's management of the News continues to be superb. During 1990, our earnings held up much better than those of most metropolitan papers, falling only 5%. In the last few months of the year, however, the rate of decrease was far greater.

I can safely make two promises about the News in 1991: (1) Stan will again rank at the top among newspaper publishers; and (2) earnings will fall substantially. Despite a slowdown in the demand for newsprint, the price per ton will average significantly more

in 1991 and the paper's labor costs will also be considerably higher. Since revenues may meanwhile be down, we face a real squeeze.

Profits may be off but our pride in the product remains. We continue to have a larger "news hole" - the portion of the paper devoted to news - than any comparable paper. In 1990, the proportion rose to 52.3% against 50.1% in 1989. Alas, the increase resulted from a decline in advertising pages rather than from a gain in news pages. Regardless of earnings pressures, we will maintain at least a 50% news hole. Cutting product quality is not a proper response to adversity.

- The news at Fechheimer, our manufacturer and retailer of uniforms, is all good with one exception: George Heldman, at 69, has decided to retire. I tried to talk him out of it but he had one irrefutable argument: With four other Heldmans - Bob, Fred, Gary and Roger - to carry on, he was leaving us with an abundance of managerial talent.

Fechheimer's operating performance improved considerably in 1990, as many of the problems we encountered in integrating the large acquisition we made in 1988 were moderated or solved. However, several unusual items caused the earnings reported in the "Sources" table to be flat. In the retail operation, we continue to add stores and now have 42 in 22 states. Overall, prospects appear excellent for Fechheimer.

- At Scott Fetzer, Ralph Schey runs 19 businesses with a mastery few bring to running one. In addition to overseeing three entities listed on page 6 - World Book, Kirby, and Scott Fetzer Manufacturing - Ralph directs a finance operation that earned a record \$12.2 million pre-tax in 1990.

Were Scott Fetzer an independent company, it would rank close to the top of the Fortune 500 in terms of return on equity, although it is not in businesses that one would expect to be economic champs. The superior results are directly attributable to Ralph.

At World Book, earnings improved on a small decrease in unit volume. The costs of our decentralization move were considerably less in 1990 than 1989 and the benefits of decentralization are being realized. World Book remains far and away the leader in United States encyclopedia sales and we are growing internationally, though from a small base.

Kirby unit volume grew substantially in 1990 with the help of our new vacuum cleaner, The Generation 3, which was an unqualified success. Earnings did not grow as fast as sales because of both start-up expenditures and "learning-curve" problems we encountered in manufacturing the new product. International business, whose dramatic growth I described last year, had a further 20% sales gain in 1990. With the aid of a recent price increase, we expect excellent earnings at Kirby in 1991.

Within the Scott Fetzer Manufacturing Group, Campbell Hausfeld, its largest unit, had a particularly fine year. This company, the country's leading producer of small and medium-sized air compressors, achieved record sales of \$109 million, more than 30% of which came from products introduced during the last five years.

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In looking at the figures for our non-insurance operations, you will see that net worth increased by only \$47 million in 1990 although earnings were \$133 million. This does not mean that our managers are in any way skimping on investments that strengthen their business franchises or that promote growth. Indeed, they diligently pursue both goals.

But they also never deploy capital without good reason. The result: In the past five years they have funneled well over 80% of their earnings to Charlie and me for use in new business and investment opportunities.

Insurance Operations

Shown below is an updated version of our usual table presenting key figures for the property-casualty insurance industry:

	<i>Yearly Change in Premiums Written (%)</i>	<i>Combined Ratio After Policyholder Dividends</i>	<i>Yearly Change in Incurred Losses (%)</i>	<i>Inflation Rate Measured by GNP Deflator (%)</i>
1981	3.8	106.0	6.5	9.6
1982	3.7	109.6	8.4	6.5
1983	5.0	112.0	6.8	3.8
1984	8.5	118.0	16.9	3.8
1985	22.1	116.3	16.1	3.0
1986	22.2	108.0	13.5	2.6
1987	9.4	104.6	7.8	3.1
1988	4.4	105.4	5.5	3.3
1989 (Revised)	3.2	109.2	7.7	4.1
1990(Est.)	4.5	109.8	5.0	4.1

Source: A.M. Best Co.

The combined ratio represents total insurance costs (losses incurred plus expenses) compared to revenue from premiums: A ratio below 100 indicates an underwriting profit, and one above 100 indicates a loss. The higher the ratio, the worse the year. When the investment income that an insurer earns from holding policyholders' funds ("the float") is taken into account, a combined ratio in the 107 - 111 range typically produces an overall breakeven result, exclusive of earnings on the funds provided by shareholders.

For the reasons laid out in previous reports, we expect the industry's incurred losses to grow at an average of 10% annually, even in periods when general inflation runs considerably lower. (Over the last 25 years, incurred losses have in reality grown at a still faster rate, 11%.) If premium growth meanwhile materially lags that 10% rate, underwriting losses will mount, though the industry's tendency to under-reserve when business turns bad may obscure their size for a time.

Last year premium growth fell far short of the required 10% and underwriting results therefore worsened. (In our table, however, the severity of the deterioration in 1990 is masked because the industry's 1989 losses from Hurricane Hugo caused the ratio for that year to be somewhat above trendline.) The combined ratio will again increase in 1991, probably by about two points.

Results will improve only when most insurance managements become so fearful that they run from business, even though it can be done at much higher prices than now exist. At some point these managements will indeed get the message: The most important thing to do when you find yourself in a hole is to stop digging. But so far that point hasn't gotten across: Insurance managers continue to dig - sullenly but vigorously.

The picture would change quickly if a major physical or financial catastrophe were to occur. Absent such a shock, one to two years will likely pass before underwriting losses become large enough to raise management fear to a level that would spur major price increases. When that moment arrives, Berkshire will be ready - both financially and psychologically - to write huge amounts of business.

In the meantime, our insurance volume continues to be small but satisfactory. In the next section of this report we will give you a framework for evaluating insurance results. From that discussion, you will gain an understanding of why I am so enthusiastic about the performance of our insurance manager, Mike Goldberg, and his cadre of stars, Rod Eldred, Dinos Iordanou, Ajit Jain, and Don Wurster.

In assessing our insurance results over the next few years, you should be aware of one type of business we are pursuing that could cause them to be unusually volatile. If this line of business expands, as it may, our underwriting experience will deviate from the trendline you might expect: In most years we will somewhat exceed expectations and in an occasional year we will fall far below them.

The volatility I predict reflects the fact that we have become a large seller of insurance against truly major catastrophes ("super-cats"), which could for example be hurricanes, windstorms or earthquakes. The buyers of these policies are reinsurance companies that themselves are in the business of writing catastrophe coverage for primary insurers and that wish to "lay off," or rid themselves, of part of their exposure to catastrophes of special severity. Because the need for these buyers to collect on such a policy will only arise at times of extreme stress - perhaps even chaos - in the insurance business, they seek financially strong sellers. And here we have a major competitive advantage: In the industry, our strength is unmatched.

A typical super-cat contract is complicated. But in a plain-vanilla instance we might write a one-year, \$10 million policy providing that the buyer, a reinsurer, would be paid that sum only if a catastrophe caused two results: (1) specific losses for the reinsurer above a threshold amount; and (2) aggregate losses for the insurance industry of, say, more than \$5 billion. Under virtually all circumstances, loss levels that satisfy the second condition will also have caused the first to be met.

For this \$10 million policy, we might receive a premium of, say, \$3 million. Say, also, that we take in annual premiums of \$100 million from super-cat policies of all kinds. In that case we are very likely in any given year to report either a profit of close to \$100 million or a loss of well over \$200 million. Note that we are not spreading risk as insurers typically do; we are concentrating it. Therefore, our yearly combined ratio on this business will almost never fall in the industry range of 100 - 120, but will instead be close to either zero or 300%.

Most insurers are financially unable to tolerate such swings. And if they have the ability to do so, they often lack the desire. They may back away, for example, because they write gobs of primary property insurance that would deliver them dismal results at the very time they would be experiencing major losses on super-cat reinsurance. In addition, most corporate managements believe that their shareholders dislike volatility in results.

We can take a different tack: Our business in primary property insurance is small and we believe that Berkshire shareholders, if properly informed, can handle unusual volatility in profits so long as the swings carry with them the prospect of superior long-term results. (Charlie and I always have preferred a lumpy 15% return to a smooth 12%.)

We want to emphasize three points: (1) While we expect our super-cat business to produce satisfactory results over, say, a decade, we're sure it will produce absolutely terrible results in at least an occasional year; (2) Our expectations can be based on little more than subjective judgments - for this kind of insurance, historical loss data are of very limited value to us as we decide what rates to charge today; and (3) Though we expect to write significant quantities of super-cat business, we will do so only at prices we believe to be commensurate with risk. If competitors become optimistic, our volume will fall. This insurance has, in fact, tended in recent years to be woefully underpriced; most sellers have left the field on stretchers.

At the moment, we believe Berkshire to be the largest U.S. writer of super-cat business. So when a major quake occurs in an urban area or a winter storm rages across Europe, light a candle for us.

Measuring Insurance Performance

In the previous section I mentioned "float," the funds of others that insurers, in the conduct of their business, temporarily hold. Because these funds are available to be invested, the typical property-casualty insurer can absorb losses and expenses that exceed premiums by 7% to 11% and still be able to break even on its business. Again, this calculation excludes the earnings the insurer realizes on net worth - that is, on the funds provided by shareholders.

However, many exceptions to this 7% to 11% range exist. For example, insurance covering losses to crops from hail damage produces virtually no float at all. Premiums on this kind of business are paid to the insurer just prior to the time hailstorms are a threat,

and if a farmer sustains a loss he will be paid almost immediately. Thus, a combined ratio of 100 for crop hail insurance produces no profit for the insurer.

At the other extreme, malpractice insurance covering the potential liabilities of doctors, lawyers and accountants produces a very high amount of float compared to annual premium volume. The float materializes because claims are often brought long after the alleged wrongdoing takes place and because their payment may be still further delayed by lengthy litigation. The industry calls malpractice and certain other kinds of liability insurance "long- tail" business, in recognition of the extended period during which insurers get to hold large sums that in the end will go to claimants and their lawyers (and to the *insurer's* lawyers as well).

In long-tail situations a combined ratio of 115 (or even more) can prove profitable, since earnings produced by the float will exceed the 15% by which claims and expenses overrun premiums. The catch, though, is that "long-tail" means exactly that: Liability business written in a given year and presumed at first to have produced a combined ratio of 115 may eventually smack the insurer with 200, 300 or worse when the years have rolled by and all claims have finally been settled.

The pitfalls of this business mandate an operating principle that too often is ignored: Though certain long-tail lines may prove profitable at combined ratios of 110 or 115, insurers will invariably find it unprofitable to price using those ratios as targets. Instead, prices must provide a healthy margin of safety against the societal trends that are forever springing expensive surprises on the insurance industry. Setting a target of 100 can itself result in heavy losses; aiming for 110 - 115 is business suicide.

All of that said, what should the measure of an insurer's profitability be? Analysts and managers customarily look to the combined ratio - and it's true that this yardstick usually is a good indicator of where a company ranks in profitability. We believe a better measure, however, to be a comparison of underwriting loss to float developed.

This loss/float ratio, like any statistic used in evaluating insurance results, is meaningless over short time periods: Quarterly underwriting figures and even annual ones are too heavily based on estimates to be much good. But when the ratio takes in a period of years, it gives a rough indication of the cost of funds generated by insurance operations. A low cost of funds signifies a good business; a high cost translates into a poor business.

On the next page we show the underwriting loss, if any, of our insurance group in each year since we entered the business and relate that bottom line to the average float we have held during the year. From this data we have computed a "cost of funds developed from insurance."

	(1)	(2)	Yearend Yield	
	Underwriting		Approximate	on Long-Term
	Loss	Average Float	Cost of Funds	Govt. Bonds
	-----	-----	-----	-----
	(In \$ Millions)	(Ratio of 1 to 2)		
1967	profit	\$17.3	less than zero	5.50%
1968	profit	19.9	less than zero	5.90%
1969	profit	23.4	less than zero	6.79%
1970	\$0.37	32.4	1.14%	6.25%
1971	profit	52.5	less than zero	5.81%
1972	profit	69.5	less than zero	5.82%
1973	profit	73.3	less than zero	7.27%
1974	7.36	79.1	9.30%	8.13%
1975	11.35	87.6	12.96%	8.03%
1976	profit	102.6	less than zero	7.30%
1977	profit	139.0	less than zero	7.97%
1978	profit	190.4	less than zero	8.93%
1979	profit	227.3	less than zero	10.08%
1980	profit	237.0	less than zero	11.94%
1981	profit	228.4	less than zero	13.61%
1982	21.56	220.6	9.77%	10.64%
1983	33.87	231.3	14.64%	11.84%
1984	48.06	253.2	18.98%	11.58%
1985	44.23	390.2	11.34%	9.34%
1986	55.84	797.5	7.00%	7.60%
1987	55.43	1,266.7	4.38%	8.95%
1988	11.08	1,497.7	0.74%	9.00%
1989	24.40	1,541.3	1.58%	7.97%
1990	26.65	1,637.3	1.63%	8.24%

The float figures are derived from the total of loss reserves, loss adjustment expense reserves and unearned premium reserves minus agents' balances, prepaid acquisition costs and deferred charges applicable to assumed reinsurance. At some insurers other items should enter into the calculation, but in our case these are unimportant and have been ignored.

During 1990 we held about \$1.6 billion of float slated eventually to find its way into the hands of others. The underwriting loss we sustained during the year was \$27 million and thus our insurance operation produced funds for us at a cost of about 1.6%. As the table shows, we managed in some years to underwrite at a profit and in those instances our cost of funds was less than zero. In other years, such as 1984, we paid a very high price for float. In 19 years out of the 24 we have been in insurance, though, we have developed funds at a cost below that paid by the government.

There are two important qualifications to this calculation. First, the fat lady has yet to gargle, let alone sing, and we won't know our true 1967 - 1990 cost of funds until all losses from this period have been settled many decades from now. Second, the value of the float to shareholders is somewhat undercut by the fact that they must put up their own funds to support the insurance operation and are subject to double taxation on the investment income these funds earn. Direct investments would be more tax-efficient.

The tax penalty that indirect investments impose on shareholders is in fact substantial. Though the calculation is necessarily imprecise, I would estimate that the owners of the average insurance company would find the tax penalty adds about one percentage point to their cost of float. I also think that approximates the correct figure for Berkshire.

Figuring a cost of funds for an insurance business allows anyone analyzing it to determine whether the operation has a positive or negative value for shareholders. If this cost (including the tax penalty) is higher than that applying to alternative sources of funds, the value is negative. If the cost is lower, the value is positive - and if the cost is *significantly* lower, the insurance business qualifies as a very valuable asset.

So far Berkshire has fallen into the significantly-lower camp. Even more dramatic are the numbers at GEICO, in which our ownership interest is now 48% and which customarily operates at an underwriting profit. GEICO's growth has generated an ever-larger amount of funds for investment that have an effective cost of considerably less than zero. Essentially, GEICO's policyholders, in aggregate, pay the company interest on the float rather than the other way around. (But handsome is as handsome does: GEICO's unusual profitability results from its extraordinary operating efficiency and its careful classification of risks, a package that in turn allows rock-bottom prices for policyholders.)

Many well-known insurance companies, on the other hand, incur an underwriting loss/float cost that, combined with the tax penalty, produces negative results for owners. In addition, these companies, like all others in the industry, are vulnerable to catastrophe losses that could exceed their reinsurance protection and take their cost of float right off the chart. Unless these companies can materially improve their underwriting performance - and history indicates that is an almost impossible task - their shareholders will experience results similar to those borne by the owners of a bank that pays a higher rate of interest on deposits than it receives on loans.

All in all, the insurance business has treated us very well. We have expanded our float at a cost that on the average is reasonable, and we have further prospered because we have earned good returns on these low-cost funds. Our shareholders, true, have incurred extra taxes, but they have been more than compensated for this cost (so far) by the benefits produced by the float.

A particularly encouraging point about our record is that it was achieved despite some colossal mistakes made by your Chairman prior to Mike Goldberg's arrival. Insurance offers a host of opportunities for error, and when opportunity knocked, too often I answered. Many years later, the bills keep arriving for these mistakes: In the insurance business, there is no statute of limitations on stupidity.

The intrinsic value of our insurance business will always be far more difficult to calculate than the value of, say, our candy or newspaper companies. By any measure, however, the business is worth far more than its carrying value. Furthermore, despite the

problems this operation periodically hands us, it is the one - among all the fine businesses we own - that has the greatest potential.

Marketable Securities

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

Shares	Company	12/31/90	
		Cost	Market
-----	-----	-----	-----
(000s omitted)			
3,000,000	Capital Cities/ABC, Inc.	\$ 517,500	\$1,377,375
46,700,000	The Coca-Cola Co.	1,023,920	2,171,550
2,400,000	Federal Home Loan Mortgage Corp.	71,729	117,000
6,850,000	GEICO Corp.	45,713	1,110,556
1,727,765	The Washington Post Company	9,731	342,097
5,000,000	Wells Fargo & Company	289,431	289,375

Lethargy bordering on sloth remains the cornerstone of our investment style: This year we neither bought nor sold a share of five of our six major holdings. The exception was Wells Fargo, a superbly-managed, high-return banking operation in which we increased our ownership to just under 10%, the most we can own without the approval of the Federal Reserve Board. About one-sixth of our position was bought in 1989, the rest in 1990.

The banking business is no favorite of ours. When assets are twenty times equity - a common ratio in this industry - mistakes that involve only a small portion of assets can destroy a major portion of equity. And mistakes have been the rule rather than the exception at many major banks. Most have resulted from a managerial failing that we described last year when discussing the "institutional imperative:" the tendency of executives to mindlessly imitate the behavior of their peers, no matter how foolish it may be to do so. In their lending, many bankers played follow-the-leader with lemming-like zeal; now they are experiencing a lemming-like fate.

Because leverage of 20:1 magnifies the effects of managerial strengths and weaknesses, we have no interest in purchasing shares of a poorly-managed bank at a "cheap" price. Instead, our only interest is in buying into well-managed banks at fair prices.

With Wells Fargo, we think we have obtained the best managers in the business, Carl Reichardt and Paul Hazen. In many ways the combination of Carl and Paul reminds me of another - Tom Murphy and Dan Burke at Capital Cities/ABC. First, each pair is stronger than the sum of its parts because each partner understands, trusts and admires the other. Second, both managerial teams pay able people well, but abhor having a bigger head count than is needed. Third, both attack costs as vigorously when profits are at

record levels as when they are under pressure. Finally, both stick with what they understand and let their abilities, not their egos, determine what they attempt. (Thomas J. Watson Sr. of IBM followed the same rule: "I'm no genius," he said. "I'm smart in spots - but I stay around those spots.")

Our purchases of Wells Fargo in 1990 were helped by a chaotic market in bank stocks. The disarray was appropriate: Month by month the foolish loan decisions of once well-regarded banks were put on public display. As one huge loss after another was unveiled - often on the heels of managerial assurances that all was well - investors understandably concluded that no bank's numbers were to be trusted. Aided by their flight from bank stocks, we purchased our 10% interest in Wells Fargo for \$290 million, less than five times after-tax earnings, and less than three times pre-tax earnings.

Wells Fargo is big - it has \$56 billion in assets - and has been earning more than 20% on equity and 1.25% on assets. Our purchase of one-tenth of the bank may be thought of as roughly equivalent to our buying 100% of a \$5 billion bank with identical financial characteristics. But were we to make such a purchase, we would have to pay about twice the \$290 million we paid for Wells Fargo. Moreover, that \$5 billion bank, commanding a premium price, would present us with another problem: We would not be able to find a Carl Reichardt to run it. In recent years, Wells Fargo executives have been more avidly recruited than any others in the banking business; no one, however, has been able to hire the dean.

Of course, ownership of a bank - or about any other business - is far from riskless. California banks face the specific risk of a major earthquake, which might wreak enough havoc on borrowers to in turn destroy the banks lending to them. A second risk is systemic - the possibility of a business contraction or financial panic so severe that it would endanger almost every highly-leveraged institution, no matter how intelligently run. Finally, the market's major fear of the moment is that West Coast real estate values will tumble because of overbuilding and deliver huge losses to banks that have financed the expansion. Because it is a leading real estate lender, Wells Fargo is thought to be particularly vulnerable.

None of these eventualities can be ruled out. The probability of the first two occurring, however, is low and even a meaningful drop in real estate values is unlikely to cause major problems for well-managed institutions. Consider some mathematics: Wells Fargo currently earns well over \$1 billion pre-tax annually after expensing more than \$300 million for loan losses. If 10% of all \$48 billion of the bank's loans - not just its real estate loans - were hit by problems in 1991, and these produced losses (including foregone interest) averaging 30% of principal, the company would roughly break even.

A year like that - which we consider only a low-level possibility, not a likelihood - would not distress us. In fact, at Berkshire we would love to acquire businesses or invest in capital projects that produced no return for a year, but that could then be expected to earn 20% on growing equity. Nevertheless, fears of a California real estate disaster similar to that experienced in New England caused the price of Wells Fargo stock to fall

almost 50% within a few months during 1990. Even though we had bought some shares at the prices prevailing before the fall, we welcomed the decline because it allowed us to pick up many more shares at the new, panic prices.

Investors who expect to be ongoing buyers of investments throughout their lifetimes should adopt a similar attitude toward market fluctuations; instead many illogically become euphoric when stock prices rise and unhappy when they fall. They show no such confusion in their reaction to food prices: Knowing they are forever going to be buyers of food, they welcome falling prices and deplore price increases. (It's the seller of food who doesn't like declining prices.) Similarly, at the Buffalo News we would cheer lower prices for newsprint - even though it would mean marking down the value of the large inventory of newsprint we always keep on hand - because we know we are going to be perpetually buying the product.

Identical reasoning guides our thinking about Berkshire's investments. We will be buying businesses - or small parts of businesses, called stocks - year in, year out as long as I live (and longer, if Berkshire's directors attend the seances I have scheduled). Given these intentions, declining prices for businesses benefit us, and rising prices hurt us.

The most common cause of low prices is pessimism - some times pervasive, some times specific to a company or industry. We *want* to do business in such an environment, not because we like pessimism but because we like the prices it produces. It's optimism that is the enemy of the rational buyer.

None of this means, however, that a business or stock is an intelligent purchase simply because it is unpopular; a contrarian approach is just as foolish as a follow-the-crowd strategy. What's required is thinking rather than polling. Unfortunately, Bertrand Russell's observation about life in general applies with unusual force in the financial world: "Most men would rather die than think. Many do."

* * * * *

Our other major portfolio change last year was large additions to our holdings of RJR Nabisco bonds, securities that we first bought in late 1989. At yearend 1990 we had \$440 million invested in these securities, an amount that approximated market value. (As I write this, however, their market value has risen by more than \$150 million.)

Just as buying into the banking business is unusual for us, so is the purchase of below-investment-grade bonds. But opportunities that interest us and that are also large enough to have a worthwhile impact on Berkshire's results are rare. 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.")

In the past we have bought a few below-investment-grade bonds with success, though these were all old-fashioned "fallen angels" - bonds that were initially of

investment grade but that were downgraded when the issuers fell on bad times. In the 1984 annual report we described our rationale for buying one fallen angel, the Washington Public Power Supply System.

A kind of bastardized fallen angel burst onto the investment scene in the 1980s - "junk bonds" that were far below investment-grade when issued. As the decade progressed, new offerings of manufactured junk became ever junkier and ultimately the predictable outcome occurred: Junk bonds lived up to their name. In 1990 - even before the recession dealt its blows - the financial sky became dark with the bodies of failing corporations.

The disciples of debt assured us that this collapse wouldn't happen: Huge debt, we were told, would cause operating managers to focus their efforts as never before, much as a dagger mounted on the steering wheel of a car could be expected to make its driver proceed with intensified care. We'll acknowledge that such an attention-getter would produce a very alert driver. But another certain consequence would be a deadly - and unnecessary - accident if the car hit even the tiniest pothole or sliver of ice. The roads of business are riddled with potholes; a plan that requires dodging them all is a plan for disaster.

In the final chapter of The Intelligent Investor Ben Graham forcefully rejected the dagger thesis: "Confronted with a challenge to distill the secret of sound investment into three words, we venture the motto, Margin of Safety." Forty-two years after reading that, I still think those are the right three words. The failure of investors to heed this simple message caused them staggering losses as the 1990s began.

At the height of the debt mania, capital structures were concocted that guaranteed failure: In some cases, so much debt was issued that even highly favorable business results could not produce the funds to service it. One particularly egregious "kill- 'em-at-birth" case a few years back involved the purchase of a mature television station in Tampa, bought with so much debt that the interest on it exceeded the station's *gross revenues*. Even if you assume that all labor, programs and services were donated rather than purchased, this capital structure required revenues to explode - or else the station was doomed to go broke. (Many of the bonds that financed the purchase were sold to now-failed savings and loan associations; as a taxpayer, you are picking up the tab for this folly.)

All of this seems impossible now. When these misdeeds were done, however, dagger-selling investment bankers pointed to the "scholarly" research of academics, which reported that over the years the higher interest rates received from low-grade bonds had more than compensated for their higher rate of default. Thus, said the friendly salesmen, a diversified portfolio of junk bonds would produce greater net returns than would a portfolio of high-grade bonds. (Beware of past-performance "proofs" in finance: If history books were the key to riches, the Forbes 400 would consist of librarians.)

There was a flaw in the salesmen's logic - one that a first-year student in statistics is taught to recognize. An assumption was being made that the universe of newly-minted junk bonds was identical to the universe of low-grade fallen angels and that, therefore, the default experience of the latter group was meaningful in predicting the default experience of the new issues. (That was an error similar to checking the historical death rate from Kool-Aid before drinking the version served at Jonestown.)

The universes were of course dissimilar in several vital respects. For openers, the manager of a fallen angel almost invariably yearned to regain investment-grade status and worked toward that goal. The junk-bond operator was usually an entirely different breed. Behaving much as a heroin user might, he devoted his energies not to finding a cure for his debt-ridden condition, but rather to finding another fix. Additionally, the fiduciary sensitivities of the executives managing the typical fallen angel were often, though not always, more finely developed than were those of the junk-bond-issuing financier.

Wall Street cared little for such distinctions. As usual, the Street's enthusiasm for an idea was proportional not to its merit, but rather to the revenue it would produce. Mountains of junk bonds were sold by those who didn't care to those who didn't think - and there was no shortage of either.

Junk bonds remain a mine field, even at prices that today are often a small fraction of issue price. As we said last year, we have never bought a new issue of a junk bond. (The only time to buy these is on a day with no "y" in it.) We are, however, willing to look at the field, now that it is in disarray.

In the case of RJR Nabisco, we feel the Company's credit is considerably better than was generally perceived for a while and that the yield we receive, as well as the potential for capital gain, more than compensates for the risk we incur (though that is far from nil). RJR has made asset sales at favorable prices, has added major amounts of equity, and in general is being run well.

However, as we survey the field, most low-grade bonds still look unattractive. The handiwork of the Wall Street of the 1980s is even worse than we had thought: Many important businesses have been mortally wounded. We will, though, keep looking for opportunities as the junk market continues to unravel.

Convertible Preferred Stocks

We continue to hold the convertible preferred stocks described in earlier reports: \$700 million of Salomon Inc, \$600 million of The Gillette Company, \$358 million of USAir Group, Inc. and \$300 million of Champion International Corp. Our Gillette holdings will be converted into 12 million shares of common stock on April 1. Weighing interest rates, credit quality and prices of the related common stocks, we can assess our holdings in Salomon and Champion at yearend 1990 as worth about what we paid, Gillette as worth somewhat more, and USAir as worth substantially less.

In making the USAir purchase, your Chairman displayed exquisite timing: I plunged into the business at almost the exact moment that it ran into severe problems. (No one pushed me; in tennis parlance, I committed an "unforced error.") The company's troubles were brought on both by industry conditions and by the post-merger difficulties it encountered in integrating Piedmont, an affliction I should have expected since almost all airline mergers have been followed by operational turmoil.

In short order, Ed Colodny and Seth Schofield resolved the second problem: The airline now gets excellent marks for service. Industry-wide problems have proved to be far more serious. Since our purchase, the economics of the airline industry have deteriorated at an alarming pace, accelerated by the kamikaze pricing tactics of certain carriers. The trouble this pricing has produced for all carriers illustrates an important truth: In a business selling a commodity-type product, it's impossible to be a lot smarter than your dumbest competitor.

However, unless the industry is decimated during the next few years, our USAir investment should work out all right. Ed and Seth have decisively addressed the current turbulence by making major changes in operations. Even so, our investment is now less secure than at the time I made it.

Our convertible preferred stocks are relatively simple securities, yet I should warn you that, if the past is any guide, you may from time to time read inaccurate or misleading statements about them. Last year, for example, several members of the press calculated the value of all our preferreds as equal to that of the common stock into which they are convertible. By their logic, that is, our Salomon preferred, convertible into common at \$38, would be worth 60% of face value if Salomon common were selling at \$22.80. But there is a small problem with this line of reasoning: Using it, one must conclude that all of the value of a convertible preferred resides in the conversion privilege and that the value of a *non*-convertible preferred of Salomon would be zero, no matter what its coupon or terms for redemption.

The point you should keep in mind is that most of the value of our convertible preferreds is derived from their fixed-income characteristics. That means the securities cannot be worth less than the value they would possess as non-convertible preferreds and may be worth more because of their conversion options.

* * * * *

I deeply regret having to end this section of the report with a note about my friend, Colman Mockler, Jr., CEO of Gillette, who died in January. No description better fitted Colman than "gentleman" - a word signifying integrity, courage and modesty. Couple these qualities with the humor and exceptional business ability that Colman possessed and you can understand why I thought it an undiluted pleasure to work with him and why I, and all others who knew him, will miss Colman so much.

A few days before Colman died, Gillette was richly praised in a Forbes cover story. Its theme was simple: The company's success in shaving products has come not from marketing savvy (though it exhibits that talent repeatedly) but has instead resulted from its devotion to quality. This mind-set has caused it to consistently focus its energies on coming up with something better, even though its existing products already ranked as the class of the field. In so depicting Gillette, Forbes in fact painted a portrait of Colman.

Help! Help!

Regular readers know that I shamelessly utilize the annual letter in an attempt to acquire businesses for Berkshire. And, as we constantly preach at the Buffalo News, advertising does work: Several businesses have knocked on our door because someone has read in these pages of our interest in making acquisitions. (Any good ad salesman will tell you that trying to sell something without advertising is like winking at a girl in the dark.)

In Appendix B (on pages 26-27) I've reproduced the essence of a letter I wrote a few years back to the owner/manager of a desirable business. If you have no personal connection with a business that might be of interest to us but have a friend who does, perhaps you can pass this report along to him.

Here's the sort of business we are looking for:

- (1) Large purchases (at least \$10 million of after-tax earnings),
- (2) Demonstrated consistent earning power (future projections are of little interest to us, nor are "turnaround" situations),
- (3) Businesses earning good returns on equity while employing little or no debt,
- (4) Management in place (we can't supply it),
- (5) Simple businesses (if there's lots of technology, we won't understand it),
- (6) An offering price (we don't want to waste our time or that of the seller by talking, even preliminarily, about a transaction when price is unknown).

We will not engage in unfriendly takeovers. We can promise complete confidentiality and a very fast answer - customarily within five minutes - as to whether we're interested. We prefer to buy for cash, but will consider issuing stock when we receive as much in intrinsic business value as we give.

Our favorite form of purchase is one fitting the Blumkin- Friedman-Heldman mold. In cases like these, the company's owner- managers wish to generate significant amounts of cash, sometimes for themselves, but often for their families or inactive shareholders. At the same time, these managers wish to remain significant owners who continue to

run their companies just as they have in the past. We think we offer a particularly good fit for owners with such objectives. We invite potential sellers to check us out by contacting people with whom we have done business in the past.

Charlie and I frequently get approached about acquisitions that don't come close to meeting our tests: We've found that if you advertise an interest in buying collies, a lot of people will call hoping to sell you their cocker spaniels. A line from a country song expresses our feeling about new ventures, turnarounds, or auction-like sales: "When the phone don't ring, you'll know it's me."

Besides being interested in the purchase of businesses as described above, we are also interested in the negotiated purchase of large, but not controlling, blocks of stock comparable to those we hold in Capital Cities, Salomon, Gillette, USAir, and Champion. We are not interested, however, in receiving suggestions about purchases we might make in the general stock market.

Miscellaneous

Ken Chace has decided not to stand for reelection as a director at our upcoming annual meeting. We have no mandatory retirement age for directors at Berkshire (and won't!), but Ken, at 75 and living in Maine, simply decided to cut back his activities.

Ken was my immediate choice to run the textile operation after Buffett Partnership, Ltd. assumed control of Berkshire early in 1965. Although I made an economic mistake in sticking with the textile business, I made no mistake in choosing Ken: He ran the operation well, he was always 100% straight with me about its problems, and he generated the funds that allowed us to diversify into insurance.

My wife, Susan, will be nominated to succeed Ken. She is now the second largest shareholder of Berkshire and if she outlives me will inherit all of my stock and effectively control the company. She knows, and agrees, with my thoughts on successor management and also shares my view that neither Berkshire nor its subsidiary businesses and important investments should be sold simply because some very high bid is received for one or all.

I feel strongly that the fate of our businesses and their managers should not depend on my health - which, it should be added, is excellent - and I have planned accordingly. Neither my estate plan nor that of my wife is designed to preserve the family fortune; instead, both are aimed at preserving the character of Berkshire and returning the fortune to society.

Were I to die tomorrow, you could be sure of three things: (1) None of my stock would have to be sold; (2) Both a controlling shareholder and a manager with philosophies similar to mine would follow me; and (3) Berkshire's earnings would increase by \$1 million annually, since Charlie would immediately sell our corporate jet, The Indefensible (ignoring my wish that it be buried with me).

* * * * *

About 97.3% of all eligible shares participated in Berkshire's 1990 shareholder-designated contributions program. Contributions made through the program were \$5.8 million, and 2,600 charities were recipients.

We suggest that new shareholders read the description of our shareholder-designated contributions program that appears on pages 54-55. To participate in future programs, you must make sure your shares are registered in the name of the actual owner, not in the nominee name of a broker, bank or depository. Shares not so registered on August 31, 1991 will be ineligible for the 1991 program.

In addition to the shareholder-designated contributions that Berkshire distributes, managers of our operating businesses make contributions, including merchandise, averaging about \$1.5 million annually. These contributions support local charities, such as The United Way, and produce roughly commensurate benefits for our businesses.

However, neither our operating managers nor officers of the parent company use Berkshire funds to make contributions to broad national programs or charitable activities of special personal interest to them, except to the extent they do so as shareholders. If your employees, including your CEO, wish to give to their alma maters or other institutions to which they feel a personal attachment, we believe they should use their own money, not yours.

* * * * *

The annual meeting this year will be held at the Orpheum Theater in downtown Omaha at 9:30 a.m. on Monday, April 29, 1991. Attendance last year grew to a record 1,300, about a 100-fold increase from ten years ago.

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

Charlie and I always enjoy the meeting, and we hope you can make it. The quality of our shareholders is reflected in the quality of the questions we get: We have never attended an annual meeting anywhere that features such a consistently high level of intelligent, owner-related questions.

An attachment to our proxy material explains how you can obtain the card you will need for admission to the meeting. Because weekday parking can be tight around the Orpheum, we have lined up a number of nearby lots for our shareholders to use. The attachment also contains information about them.

As usual, we will have buses to take you to Nebraska Furniture Mart and Borsheim's after the meeting and to take you to downtown hotels or to the airport later. I hope that you will allow plenty of time to fully explore the attractions of both stores. Those of you arriving early can visit the Furniture Mart any day of the week; it is open from 10 a.m. to 5:30 p.m. on Saturdays, and from noon to 5:30 p.m. on Sundays. While there, stop at the See's Candy cart and see for yourself the dawn of synergism at Berkshire.

Borsheim's normally is closed on Sunday, but we will open for shareholders and their guests from noon to 6 p.m. on Sunday, April 28. At our Sunday opening last year you made Ike very happy: After totaling the day's volume, he suggested to me that we start holding annual meetings quarterly. Join us at Borsheim's even if you just come to watch; it's a show you shouldn't miss.

Last year the first question at the annual meeting was asked by 11-year-old Nicholas Kenner, a third-generation shareholder from New York City. Nicholas plays rough: "How come the stock is down?" he fired at me. My answer was not memorable.

We hope that other business engagements won't keep Nicholas away from this year's meeting. If he attends, he will be offered the chance to again ask the first question; Charlie and I want to tackle him while we're *fresh*. This year, however, it's Charlie's turn to answer.

March 1, 1991 Warren E. Buffett
 Chairman of the
 Board

APPENDIX A

U. S. STEEL ANNOUNCES SWEEPING MODERNIZATION SCHEME*

* An unpublished satire by Ben Graham, written in 1936 and given by the author to Warren Buffett in 1954.

Myron C. Taylor, Chairman of U. S. Steel Corporation, today announced the long awaited plan for completely modernizing the world's largest industrial enterprise. Contrary to expectations, no changes will be made in the company's manufacturing or selling policies. Instead, the bookkeeping system is to be entirely revamped. By adopting and further improving a number of modern accounting and financial devices the corporation's earning power will be amazingly transformed. Even under the subnormal conditions of 1935, it is estimated that the new bookkeeping methods would have

yielded a reported profit of close to \$50 per share on the common stock. The scheme of improvement is the result of a comprehensive survey made by Messrs. Price, Bacon, Guthrie & Colpitts; it includes the following six points:

1. Writing down of Plant Account to Minus \$1,000,000,000.
2. Par value of common stock to be reduced to 1¢.
3. Payment of all wages and salaries in option warrants.
4. Inventories to be carried at \$1.
5. Preferred Stock to be replaced by non-interest bearing bonds redeemable at 50% discount.
6. A \$1,000,000,000 Contingency Reserve to be established.

The official statement of this extraordinary Modernization Plan follows in full:

The Board of Directors of U. S. Steel Corporation is pleased to announce that after intensive study of the problems arising from changed conditions in the industry, it has approved a comprehensive plan for remodeling the Corporation's accounting methods. A survey by a Special Committee, aided and abetted by Messrs. Price, Bacon, Guthrie & Colpitts, revealed that our company has lagged somewhat behind other American business enterprises in utilizing certain advanced bookkeeping methods, by means of which the earning power may be phenomenally enhanced without requiring any cash outlay or any changes in operating or sales conditions. It has been decided not only to adopt these newer methods, but to develop them to a still higher stage of perfection. The changes adopted by the Board may be summarized under six heads, as follows:

1. Fixed Assets to be written down to Minus \$1,000,000,000.

Many representative companies have relieved their income accounts of all charges for depreciation by writing down their plant account to \$1. The Special Committee points out that if their plants are worth only \$1, the fixed assets of U. S. Steel Corporation are worth a good deal less than that sum. It is now a well-recognized fact that many plants are in reality a liability rather than an asset, entailing not only depreciation charges, but taxes, maintenance, and other expenditures. Accordingly, the Board has decided to extend the write-down policy initiated in the 1935 report, and to mark down the Fixed Assets from \$1,338,522,858.96 to a round Minus \$1,000,000,000.

The advantages of this move should be evident. As the plant wears out, the liability becomes correspondingly reduced. Hence, instead of the present depreciation charge of some \$47,000,000 yearly there will be an annual appreciation credit of 5%, or \$50,000,000. This will increase earnings by no less than \$97,000,000 per annum.

2. Reduction of Par Value of Common Stock to 1 ¢, and

3. Payment of Salaries and Wages in Option Warrants.

Many corporations have been able to reduce their overhead expenses substantially by paying a large part of their executive salaries in the form of options to buy stock, which carry no charge against earnings. The full possibilities of this modern device have apparently not been adequately realized. The Board of Directors has adopted the following advanced form of this idea:

The entire personnel of the Corporation are to receive their compensation in the form of rights to buy common stock at \$50 per share, at the rate of one purchase right for each \$50 of salary and/or wages in their present amounts. The par value of the common stock is to be reduced to 1¢.

The almost incredible advantages of this new plan are evident from the following:

A. The payroll of the Corporation will be entirely eliminated, a saving of \$250,000,000 per annum, based on 1935 operations.

B. At the same time, the effective compensation of all our employees will be increased severalfold. Because of the large earnings per share to be shown on our common stock under the new methods, it is certain that the shares will command a price in the market far above the option level of \$50 per share, making the readily realizable value of these option warrants greatly in excess of the present cash wages that they will replace.

C. The Corporation will realize an additional large annual profit through the exercise of these warrants. Since the par value of the common stock will be fixed at 1¢, there will be a gain of \$49.99 on each share subscribed for. In the interest of conservative accounting, however, this profit will not be included in the income account, but will be shown separately as a credit to Capital Surplus.

D. The Corporation's cash position will be enormously strengthened. In place of the present annual cash outgo of \$250,000,000 for wages (1935 basis), there will be annual cash inflow of \$250,000,000 through exercise of the subscription warrants for 5,000,000 shares of common stock. The Company's large earnings and strong cash position will permit the payment of a liberal dividend which, in turn, will result in the exercise of these option warrants immediately after issuance which, in turn, will further improve the cash position which, in turn, will permit a higher dividend rate -- and so on, indefinitely.

4. Inventories to be carried at \$1.

Serious losses have been taken during the depression due to the necessity of adjusting inventory value to market. Various enterprises -- notably in the metal and cotton-textile fields -- have successfully dealt with this problem by carrying all or part of their inventories at extremely low unit prices. The U. S. Steel Corporation has decided to

adopt a still more progressive policy, and to carry its entire inventory at \$1. This will be effected by an appropriate write-down at the end of each year, the amount of said write-down to be charged to the Contingency Reserve hereinafter referred to.

The benefits to be derived from this new method are very great. Not only will it obviate all possibility of inventory depreciation, but it will substantially enhance the annual earnings of the Corporation. The inventory on hand at the beginning of the year, valued at \$1, will be sold during the year at an excellent profit. It is estimated that our income will be increased by means of this method to the extent of at least \$150,000,000 per annum which, by a coincidence, will about equal the amount of the write-down to be made each year against Contingency Reserve.

A minority report of the Special Committee recommends that Accounts Receivable and Cash also be written down to \$1, in the interest of consistency and to gain additional advantages similar to those just discussed. This proposal has been rejected for the time being because our auditors still require that any recoveries of receivables and cash so charged off be credited to surplus instead of to the year's income. It is expected, however, that this auditing rule -- which is rather reminiscent of the horse-and-buggy days -- will soon be changed in line with modern tendencies. Should this occur, the minority report will be given further and favorable consideration.

5. Replacement of Preferred Stock by Non-Interest-Bearing Bonds Redeemable at 50% Discount.

During the recent depression many companies have been able to offset their operating losses by including in income profits arising from repurchases of their own bonds at a substantial discount from par. Unfortunately the credit of U. S. Steel Corporation has always stood so high that this lucrative source of revenue has not hitherto been available to it. The Modernization Scheme will remedy this condition.

It is proposed that each share of preferred stock be exchanged for \$300 face value of non-interest-bearing sinking-fund notes, redeemable by lot at 50% of face value in 10 equal annual installments. This will require the issuance of \$1,080,000,000 of new notes, of which \$108,000,000 will be retired each year at a cost to the Corporation of only \$54,000,000, thus creating an annual profit of the same amount.

Like the wage-and/or-salary plan described under 3. above, this arrangement will benefit both the Corporation and its preferred stockholders. The latter are assured payment for their present shares at 150% of par value over an average period of five years. Since short-term securities yield practically no return at present, the non-interest-bearing feature is of no real importance. The Corporation will convert its present annual charge of \$25,000,000 for preferred dividends into an annual bond-retirement profit of \$54,000,000 -- an aggregate yearly gain of \$79,000,000.

6. Establishment of a Contingency Reserve of \$1,000,000,000.

The Directors are confident that the improvements hereinbefore described will

assure the Corporation of a satisfactory earning power under all conditions in the future. Under modern accounting methods, however, it is unnecessary to incur the slightest risk of loss through adverse business developments of any sort, since all these may be provided for in advance by means of a Contingency Reserve.

The Special Committee has recommended that the Corporation create such a Contingency Reserve in the fairly substantial amount of \$1,000,000,000. As previously set forth, the annual write-down of inventory to \$1 will be absorbed by this reserve. To prevent eventual exhaustion of the Contingency Reserve, it has been further decided that it be replenished each year by transfer of an appropriate sum from Capital Surplus. Since the latter is expected to increase each year by not less than \$250,000,000 through the exercise of the Stock Option Warrants (see 3. above), it will readily make good any drains on the Contingency Reserve.

In setting up this arrangement, the Board of Directors must confess regretfully that they have been unable to improve upon the devices already employed by important corporations in transferring large sums between Capital, Capital Surplus, Contingency Reserves and other Balance Sheet Accounts. In fact, it must be admitted that our entries will be somewhat too simple, and will lack that element of extreme mystification that characterizes the most advanced procedure in this field. The Board of Directors, however, have insisted upon clarity and simplicity in framing their Modernization Plan, even at the sacrifice of possible advantage to the Corporation's earning power.

In order to show the combined effect of the new proposals upon the Corporation's earning power, we submit herewith a condensed Income Account for 1935 on two bases, viz:

	<u>A. As Reported</u>	<u>B. Pro-Forma Giving Effect to Changes Proposed Herewith</u>
Gross Receipts from all Sources (Including Inter-Company)	\$765,000,000	\$765,000,000
Salaries and Wages	251,000,000	--
Other Operating Expenses and Taxes	461,000,000	311,000,000

Depreciation ..	47,000,000	(50,000,000)
Interest	5,000,000	5,000,000
Discount on Bonds Retired	--	(54,000,000)
Preferred Dividends ...	25,000,000	--
Balance for Common	(24,000,000)	553,000,000
Average Shares Outstanding	8,703,252	11,203,252
Earned Per Share ...	(\$2.76)	\$49.80

In accordance with a somewhat antiquated custom there is appended herewith a condensed pro-forma Balance Sheet of the U. S. Steel Corporation as of December 31, 1935, after giving effect to proposed changes in asset and liability accounts.

ASSETS

Fixed Assets, net	(\$1,000,000,000)
Cash Assets	142,000,000
Receivables	56,000,000
Inventory	1
Miscellaneous Assets	<u>27,000,000</u>

Total	(\$774,999,999)
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LIABILITIES

Common Stock Par 1¢ (Par Value \$87,032.52) Stated Value*	(\$3,500,000,000)
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Subsidiaries' Bonds and Stocks	113,000,000
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New Sinking Fund Notes	1,080,000,000
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Current Liabilities	69,000,000
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Contingency Reserve	1,000,000,000
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Other Reserves	74,000,000
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Initial Surplus	<u>389,000,001</u>
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Total	(\$774,999,999)
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*Given a Stated Value differing from Par Value, in accordance with the laws of the State of Virginia, where the company will be re-incorporated.

It is perhaps unnecessary to point out to our stockholders that modern accounting methods give rise to balance sheets differing somewhat in appearance from those of a less advanced period. In view of the very large earning power that will result from these changes in the Corporation's Balance Sheet, it is not expected that undue attention will be paid to the details of assets and liabilities.

In conclusion, the Board desires to point out that the combined procedure, whereby plant will be carried at a minus figure, our wage bill will be eliminated, and inventory will stand on our books at virtually nothing, will give U. S. Steel Corporation an enormous competitive advantage in the industry. We shall be able to sell our products at exceedingly low prices and still show a handsome margin of profit. It is the considered view of the Board of Directors that under the Modernization Scheme we shall be able to undersell all competitors to such a point that the anti-trust laws will constitute the only barrier to 100% domination of the industry.

In making this statement, the Board is not unmindful of the possibility that some of our competitors may seek to offset our new advantages by adopting similar accounting improvements. We are confident, however, that U. S. Steel will be able to retain the loyalty of its customers, old and new, through the unique prestige that will accrue to it as the originator and pioneer in these new fields of service to the user of steel. Should necessity arise, moreover, we believe we shall be able to maintain our deserved superiority by introducing still more advanced bookkeeping methods, which are even now under development in our Experimental Accounting Laboratory.

APPENDIX B

Some Thoughts on Selling Your Business*

*This is an edited version of a letter I sent some years ago to a man who had indicated that he might want to sell his family business. I present it here because it is a message I would like to convey to other prospective sellers. -- W.E.B.

Dear _____:

Here are a few thoughts pursuant to our conversation of the other day.

Most business owners spend the better part of their lifetimes building their businesses. By experience built upon endless repetition, they sharpen their skills in merchandising, purchasing, personnel selection, etc. It's a learning process, and mistakes made in one year often contribute to competence and success in succeeding years.

In contrast, owner-managers sell their business only once -- frequently in an emotionally-charged atmosphere with a multitude of pressures coming from different directions. Often, much of the pressure comes from brokers whose compensation is contingent upon consummation of a sale, regardless of its consequences for both buyer and seller. The fact that the decision is so important, both financially and personally, to the owner can make the process more, rather than less, prone to error. And, mistakes made in the once-in-a-lifetime sale of a business are not reversible.

Price is very important, but often is not the most critical aspect of the sale. You and your family have an extraordinary business -- one of a kind in your field -- and any buyer is going to recognize that. It's also a business that is going to get more valuable as the years go by. So if you decide not to sell now, you are very likely to realize more money later on. With that knowledge you can deal from strength and take the time required to select the buyer you want.

If you should decide to sell, I think Berkshire Hathaway offers some advantages that most other buyers do not. Practically all of these buyers will fall into one of two categories:

(1) A company located elsewhere but operating in your business or in a business somewhat akin to yours. Such a buyer -- no matter what promises are made -- will usually have managers who feel they know how to run your business operations and, sooner or later, will want to apply some hands-on "help." If the acquiring company is much larger, it often will have squads of managers, recruited over the years in part by promises that they will get to run future acquisitions. They will have their own way of doing things and, even though your business record undoubtedly will be far better than theirs, human nature will at some point cause them to believe that their methods of operating are superior. You and your family probably have friends who have sold their businesses to larger companies, and I suspect that their experiences will confirm the tendency of parent companies to take over the running of their subsidiaries, particularly when the parent knows the industry, or thinks it does.

(2) A financial maneuverer, invariably operating with large amounts of borrowed money, who plans to resell either to the public or to another corporation as soon as the time is favorable. Frequently, this buyer's major contribution will be to change accounting methods so that earnings can be presented in the most favorable light just prior to his bailing out. I'm enclosing a recent article that describes this sort of transaction, which is becoming much more frequent because of a rising stock market and the great supply of funds available for such transactions.

If the sole motive of the present owners is to cash their chips and put the business behind them -- and plenty of sellers fall in this category -- either type of buyer that I've just described is satisfactory. But if the sellers' business represents the creative work of a lifetime and forms an integral part of their personality and sense of being, buyers of either type have serious flaws.

Berkshire is another kind of buyer -- a rather unusual one. We buy to keep, but we don't have, and don't expect to have, operating people in our parent organization. All of the businesses we own are run autonomously to an extraordinary degree. In most cases, the managers of important businesses we have owned for many years have not been to Omaha or even met each other. When we buy a business, the sellers go on running it just as they did before the sale; we adapt to their methods rather than vice versa.

We have no one -- family, recently recruited MBAs, etc. -- to whom we have promised a chance to run businesses we have bought from owner-managers. And we won't have.

You know of some of our past purchases. I'm enclosing a list of everyone from whom we have ever bought a business, and I invite you to check with them as to our performance versus our promises. You should be particularly interested in checking with the few whose businesses did not do well in order to ascertain how we behaved under difficult conditions.

Any buyer will tell you that he needs you personally -- and if he has any brains, he most certainly does need you. But a great many buyers, for the reasons mentioned above, don't match their subsequent actions to their earlier words. We will behave exactly as promised, both because we have so promised, and because we need to in order to achieve the best business results.

This need explains why we would want the operating members of your family to retain a 20% interest in the business. We need 80% to consolidate earnings for tax purposes, which is a step important to us. It is equally important to us that the family members who run the business remain as owners. Very simply, we would not want to buy unless we felt key members of present management would stay on as our partners. Contracts cannot guarantee your continued interest; we would simply rely on your word.

The areas I get involved in are capital allocation and selection and compensation of the top man. Other personnel decisions, operating strategies, etc. are his bailiwick. Some Berkshire managers talk over some of their decisions with me; some don't. It depends upon their personalities and, to an extent, upon their own personal relationship with me.

If you should decide to do business with Berkshire, we would pay in cash. Your business would not be used as collateral for any loan by Berkshire. There would be no brokers involved.

Furthermore, there would be no chance that a deal would be announced and that the buyer would then back off or start suggesting adjustments (with apologies, of course, and with an explanation that banks, lawyers, boards of directors, etc. were to be blamed). And finally, you would know exactly with whom you are dealing. You would not have one executive negotiate the deal only to have someone else in charge a few years later, or have the president regretfully tell you that his board of directors required this change or that (or possibly required sale of your business to finance some new interest of the parent's).

It's only fair to tell you that you would be no richer after the sale than now. The ownership of your business already makes you wealthy and soundly invested. A sale would change the form of your wealth, but it wouldn't change its amount. If you sell, you will have exchanged a 100%-owned valuable asset that you understand for another valuable asset -- cash -- that will probably be invested in small pieces (stocks) of other businesses that you understand less well. There is often a sound reason to sell but, if the transaction is a fair one, the reason is not so that the seller can become wealthier.

I will not pester you; if you have any possible interest in selling, I would appreciate your call. I would be extraordinarily proud to have Berkshire, along with the key members of your family, own _____; I believe we would do very well financially; and I believe you would have just as much fun running the business over the next 20 years as you have had during the past 20.

Sincerely,

/s/ Warren E. Buffett